**ONE YEAR TREASURY BILL 16.7%**
**FEDERAL FUNDS RATE PEAKS AT 20.0%**

**INFLATION RATE OF 11.4%**

**20 YEAR "AAA" RATED MUNICIPAL YIELD 10.2%**

**"Those were the days my friend, I thought they'd never end..." (Anonymous bond investor, circa 1982)**

1982 was a long time ago. A different time with different problems. The Federal funds rate and the consumer price index INCREASED regularly. The Chairman of the Federal Reserve was a tall, highly visible outspoken man who smoked a cigar in public. He attacked the inflation beast that was ravaging our economy. We have not seen it since.

Today, the Federal funds rate DECREASES regularly. The Fed Chairman is a diminutive, softly spoken man rarely seen in public. He doesn't smoke a cigar (in public anyway). He is battling a beast too, albeit, one with a different bite; Deflation.

Milton Friedman, the Nobel Prize winning economist, stated that "inflation is always and everywhere a monetary phenomenon". Inflation occurs because money supply increases and demand does not. Rising prices follow. They are the symptoms, not the cause. In the early eighties, Chairman Volcker tightened the money supply and eventually vanquished the inflation beast.

Deflation is the opposite of inflation. Presumably, the forces that cause deflation are the opposite of those that cause inflation. We will have to wait and see about that.

In the meantime, our current Fed Chairman is attacking the deflation beast with a strong dose of easy credit. The Fed has dropped the overnight bank loan rate to a 45 year low of 1%. It has purchased long term government bonds in the open market causing absolute bond yields to plummet and bond values to soar. It is paying for these purchases by printing money. The theory is: Print money and eliminate the threat of deflation. We all know that the government prints money well (and eagerly) so deflation should be easily tamed; so goes the theory.

Arguably, these aggressive Fed actions have helped economic growth, but it remains anemic. Approximately 324,000 jobs have been lost in the last six months, the producer price index (PPI) declined .3% in May while the core price index gained only .1%. Clearly, there is very little inflation pressure at this time, in spite of the Fed's actions over the past several months.

What happens now? Obviously, the Fed cannot reduce short-term rates much more. Those rates are near zero and cannot be driven much lower. The problem in the economy now is not around interest rates or monetary policy, but around confidence. The Fed's goal is to restore that confidence.

The Fed is concerned about deflation taking hold on our economy. Japan has suffered through years of deflation and the effects have been devastating to that country's economy. Now we are hearing Germany is also beginning to experience these pressures. Are we next?

Certain experts think so. These "Deflationists" point to certain economic data to support their position: business investment in equipment and software fell $14.7 billion on an annualized basis or 6.3% in the first quarter, no employment growth and a declining April CPI.

Yet, year-to-year CPI has increased over 2%. Additionally, the dollar is weak which will increase prices as imports (i.e.... energy) become more expensive. Furthermore, our deficit grows daily and money remains cheap. Clearly, price growth has slowed to a crawl, but is it deflation?

There is no doubt in our mind that Chairman Greenspan will battle the deflation threat with the same tenacity that Paul Volcker battled it's evil twin over 20 years ago. Reinflation is Greenspan's goal. We suspect he, too, will prevail. Time will tell.

In the meantime, we will continue to manage portfolios keeping all of this uncertainty in mind.

Issuers of long-term municipal debt sent volume to an unprecedented level in the first six months of 2003. A record $198 billion of municipal bonds was issued in the first half of the year, a 19% increase over the same period last year.

Municipal yields are very attractive relative to taxable Treasury bond returns. High quality municipals bonds maturing in five years return 2.35%, federal income tax free. The five-year Treasury bond returns only 2.84% TAXABLE. This huge supply is a primary reason that municipal yields are so high relative to comparable quality taxable issues.

Over the past quarter we took advantage of this anomaly and made investments in the tax-exempt sector where the best value existed. We will continue to follow this strategy in the months ahead and continue to take profits when we see opportunities to do so within context of client portfolio guidelines and our feelings about the market. Opportunities continue to present themselves.

Bond investors should recognize that the 10% and greater annual returns earned in years past will be difficult to duplicate in 2003. Interest rates are at 45 year lows so the upside in market appreciation is limited. Investors should also pay close attention to mutual fund management fees. Penny pinching in this area will add a lot to your total return.

The average bond fund had an expense ratio of approximately .7% in 2002. With the 5 year Treasury Bill yielding 2.84%, shareholders paying a .7% expense charge see much of their return going to pay for management. If you have not examined recently what you are paying in fund expenses, please call and we will analyze your funds cost structure.

Our composites continue to perform well with our short maturity composite returning 1.75% in the quarter versus .88% for the Lehman 3 year index. Year to date, other Bernardi short composite has returned 2.77% versus 1.74% for the Lehman 3 year index.

Thank you for your continued confidence in our team and our portfolio research and management process.

Ronald P. Bernardi
President

7/17/2003