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First Quarter 2001 Investment Outlook

Simply put, 2000 was a terrible year for US equity markets. The NASDAQ market index fell 39.3% and was down almost 55% from its high, representing the single worst calendar-year loss for the NASDAQ Composite since its inception. The S&P 500 dropped 10.2% and the Dow declined by 6.2%. Value outperformed growth, but much of this reflected the collapse in growth stocks in the last quarter as opposed to great performance within the value discipline.

Before we turn our attention to the outlook for the coming year, a quick review of what happened in the year 2000 to create these negative results may be in order. Rising interest rates, energy prices and unit labor costs coupled with a strong US dollar led to a profit margin squeeze for US corporations. The economic response was declining stock prices, a mini credit crunch, lower consumer wealth and confidence and reduced business capital spending plans. The erosion of consumer confidence resulted in significantly slower demand for high cost durable goods like motor vehicles. In turn, the automobile industry slashed vehicle production - a cut that likely pared about three-quarters of a percentage point from fourth quarter GDP growth, thus helping to push the economy toward a serious slowdown or possibly recession. In 2001, big-ticket consumer durables and capital spending, especially in information technology, are likely to be among the key victims.

On January 3 the Federal Reserve Board significantly altered the investment landscape by lowering short-term interest rates in a rare decision between Federal Open Market Committee (FOMC) meetings. The Fed indicated that its half-point cut in the federal funds and discount rates is most likely the start of a series of cuts and we believe that the next easing will occur at the January 30-31 FOMC meeting. In addition to citing the abrupt slowing in economic activity (for a variety of reasons), the Fed noted “tight conditions in some segments of financial markets” as spurring the move. The unusually wide quality spreads in fixed income markets have created a more difficult credit situation than perhaps the Fed had intended to engineer, and the resultant tight liquidity has been a serious drag on stock performance. Our best estimate is that the Fed will ease by another full percentage point by mid-year 2001. Investors are expecting another 50 basis point cut on January 30-31. We also expect cuts of 25 basis points at each of the subsequent two meetings, resulting in a 5% fed funds rate by mid-year.

While downside risks for the economy and the stock market remain, our expectation is for any downturn from here to be mild and short-lived. Among the reasons we believe growth prospects should actually improve later in 2001 are lower interest rates, falling energy prices and a weaker dollar. In addition, inventory excesses are small and should be worked off quickly as demand begins to improve. With the Fed easing monetary policy and credit spreads tightening, a steeper yield curve may comfort lenders, potentially setting off a debt-refinancing boom that could bolster business and consumer cash flows.

There is no question that corporate earnings growth in 2001 is decelerating rapidly as the consensus estimate has fallen from 16% last summer to 9% currently. The trend is toward a low single digit growth rate by mid-year 2001. But while earnings and the economy will get worse, and the economic news on a lot of levels will not be good, the good news is found in the adage “Don’t fight the Fed.” Historically, one of the most reliable bullish signals is two Fed rate cuts plus a Federal tax cut. With weak economic conditions and a strong push by the new Bush administration, this scenario is becoming increasingly likely. Research shows that in the 17 periods following two rate cuts by the Fed since 1921, the stock market on average has gained 13.6% in the following six months and 26% in the following year. Investors typically begin to look across the valley of economic slowdown or recession when the Fed is cutting rates. In this environment, even though earnings growth is declining, it is not the most important factor. To some extent, investors even welcome bad economic news since it may lead to a more accommodative Fed. Thus, our view is that earnings growth is headed down, but the stock market is headed up.

Usually when the Fed eases rates, the more leveraged and more economically sensitive stocks are most responsive on the upside. Positive relative strength is likely to be found in cyclical stocks and interest rate sensitive sectors. Cyclicals may include cyclical technology (like semiconductors) although technology investors are not usually inclined to “peer over the valley.” Therefore, we may begin to see the start of a protracted rotation out of defensive stocks and into technology and other economically sensitive sectors. Of course, while investors had just begun to feel comfortable with defensive holdings in the fourth quarter, the Fed easing raised the specter of more aggressive leadership as the New Year begins. Fortunately, we have all become quite conditioned to such whipsaw action on Wall Street over the last several years.

Looking ahead, we expect the S&P 500 to finish the year between 1500 and 1550. This assumption dictates a somewhat more balanced sector approach than we have advocated historically. While we will not venture into the deep cyclical parts of the economy, clients should expect a subtle rotation into stocks with lower valuations within the aforementioned sectors as beneficiaries of the economic scenario we have outlined.