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First Quarter 2002 Investment Outlook

When 2001 ended, it was as if the entire nation collectively let out a sigh of relief. This was attributable to far more than the desire for a clean slate for a new investment year. The nation seems anxious to close a terrible chapter in our history and to move forward. The tragic events of 2001 have left some positive residue however. It has been a long time since our nation has been so united behind a common cause. The passion and patriotism we all feel about the war on terrorism has perhaps single-handedly enabled the restoration of our national confidence. From the comforting words of our leaders and renewed attention to homeland security to the highly successful war in Afghanistan, faith in our national security has been growing almost daily. The powerful fourth quarter rebound in stock prices even gives us hope that our economy hit bottom and is now beginning to show signs of recovery.

While the fourth quarter stock rally appears to signal the beginning of a new bull market, there are risks we will outline making it impossible to declare a new nirvana. In order to frame our market outlook effectively, a narrative on the last several decades will be helpful. Skyrocketing oil prices in the late 1970s and early 1980s led to double-digit inflation rates. Investors were extremely apprehensive about investing in common stocks during this period as the dismal record in the 1970s combined with high inflation and a spate of bankruptcies plaguing key parts of the U.S. economy. The reflection of investor attitudes toward stocks could be witnessed by the single digit price-earnings (P/E) ratios prevalent at that time. An inflection point for the U.S. economy came when certain structural reforms were implemented. Federal Reserve chairman Paul Volcker attacked inflation from a monetary perspective, while President Ronald Reagan attacked it fiscally from the supply side by slashing tax rates. This combination led to painful back-to-back recessions (although ultimately, it halted the inflationary spiral and led to the beginning of the disinflationary period of the 1980s and 1990s).

As it turned out, all of this bad news at the start of the 1980s was actually good news because expectations were so low that many equity investors could only be pleasantly surprised. The powerful disinflationary forces at work in the 1980s and 1990s (the productivity explosion, deregulation, globalization) led to a steady ratcheting down of inflation expectations. Declining inflation expectations *and* a drop in real interest rates - thanks, in large part, to the elimination of the federal budget deficit - led to a steady decline in interest rates. Although painful initially, the restructuring of corporate America in the late 1980s and early 1990s ultimately paid big dividends in the form of sustained corporate profit growth.

The combination of expanding P/Es and steadily growing corporate profits meant that the S&P 500 appreciated 1261% over the subsequent two decades, a 14% compound annual rate for the twenty-year period 1979-1999, a 15% annual rate for the ten-year period 1989-1999 and a 26% annual rate for the five-year period 1994-1999. If the “good” news at the start of the 1980s was that expectations for equities’ performance were very low (and so were easily surpassed), the “bad” news today is that investors have already discounted much “good” news in stock prices. The key pieces of “good” news today are: 1) Inflationary pressures remain muted. 2) Both short and long-term rates are well below their levels of the early 1990s, and far below the levels of the early 1980s. 3) Corporate profits are forecast to experience just one year of negative growth, as compared to three consecutive years of nil/negative growth at the onset of the 1980s. So, whereas the 1970s might be labeled as the “decade of sub-normal returns” (rising oil prices and inflation leading to stagnating corporate profits and contracting P/Es) and the 1980s and 1990s might be labeled as the “decades of abnormal returns” (secular disinflation leading to rapid P/E expansion and, thereby, above average stock price appreciation), the next ten years will likely turn out to be the “decade of normal returns.” This will likely mean the end of disinflation (although this will *not* mean a return to inflation). So P/Es are unlikely to contract or expand much from current levels. In addition, we can expect secular corporate profit growth of 7-8%, (derived by 2-3% price increases or inflation), 2-3% productivity induced margin improvements and 3% real (unit) growth). Therefore, after an initial rebound in stock prices beginning last September (from the September 21 bottom to be precise) and extending into 2003 (reflecting a surge in corporate profit growth from the trough), we expect price appreciation of the major indices for the balance of the decade that is in line with corporate profit growth.

Transitioning to the current economic environment, we do believe there are more and more signs pointing to the end of the recession and the resumption of growth. Before September 11, the global economy had slowed to a snail’s pace and it appeared that growth on average in 2002 would remain below its 25-year norm. The attacks of September 11 helped trigger the first *global* recession in nearly 20 years. Today’s predictions for a solid recovery are premised on two issues. We were in need of a psychological bottom, and as expressed earlier, after Sept. 11 we certainly got one! We think many people still underestimate the significance of this attitude shift and the psychological transformation that occurred. Second, we needed evidence of an economic bottom. Recent economic data are consistent with troughs in some deeply afflicted industries, including elements of manufacturing. There has been good demand strength in so-called early-cycle industries, such as housing and autos, which have benefited from aggressive Federal Reserve ease. After very large declines in jobs in October and November, the rate of loss diminished sharply in December. The job loss of 124,000 in December compares with an average of about 400,000 per month in October and November. All of the loss was in manufacturing; the service sector has stabilized after prior big declines. We think that manufacturing is near the end of its drop and in services, jobs will start to rise, which will ultimately bring an end to the recession. The Conference Board’s Index of Consumer Sentiment far exceeded expectations in December with the Expectations component of the Index recording its highest monthly rise since December 1992. And, after many months of downward estimate revisions, the outlook for corporate profits has stabilized and is even showing some modest signs of improvement. Corporate cost cutting is starting to pay off, as shown by remarkably strong productivity growth in the third quarter. The improvement in the outlook for the U.S. economy and S&P profits is also due to the fiscal and monetary stimulus that has been undertaken in 2001.

Based upon this data, it now seems clear that we are in the transition phase of the business cycle somewhere between the bottom of the trough and the first leg up of the next expansion. Looking for a moment at the typical stages of economic recoveries - the first leg is fueled by liquidity in the monetary system coupled with a willingness to lend and, most importantly, investments that businesses can make that return more than the cost of borrowing. With fed fund rates at historic lows (1.75%), this first leg is under way and should be in high gear by mid-2002. The next leg up comes from inventory replenishment. Over the last three quarters inventory reduction has been a drag on GDP, negating demand for new production, especially in technology. But now, not only is inventory being rapidly taken down, any leftover technology inventory is going to be obsolete anyway by mid-2002 as users don't upgrade by buying old technology. Finally, the third stage occurs when corporate profits start to rise. Look for the first material signs of this in the second half of 2002.

The business cycle is part of the economic cleansing that renews the vigor of our economy. As an example, look at what is happening now with the large number of layoffs. Higher cost, less-productive workers are being let go or replaced by lower cost, more-productive workers. Consolidation is also taking place during this slump. Some economists call this America's creative destruction capitalism – where bad businesses fail or are absorbed by stronger competitors. During downturns, the strong get stronger and the weak are eliminated. This means that when new orders begin to kick in by late in 2002, margins will be expanding and profits will begin strongly rebounding. Technology capital spending may be inhibited from a powerful rebound until 2003 as the financial services and communications sectors (the two largest technology spenders) hold down expenses this year in hopes of restoring profitability. Whether the world has to wait until 2003 for a synchronized global recovery remains to be seen, but it seems highly likely that, fueled by stimulative global fiscal and monetary policies, global economic and profit growth will rebound strongly sometime in the next 12-24 months. And with the U.S. being the first into the downturn and the first to adopt stimulative measures, it is not surprising that it will likely see the first signs of recovery.

Other influences that may affect our economy and financial markets in 2002 include election-year politics and Federal Reserve policy changes. Partisan positions killed the proposed economic stimulus package (this late in the downturn it might be counter productive anyway) and on this and other matters it is going to become increasingly difficult to pass legislation as we get closer to the November elections. And after a year of extraordinary monetary policy easing in the face of slumping business conditions, Fed officials during 2002 likely will show considerable patience as they hope for an economic rebound. We would not absolutely rule out another 25 basis point cut, but we are right at the end of the cycle and there will probably be no more easing. No tightening is apt to be contemplated at least until real GDP moves above its long-term equilibrium growth pace, which we estimate at around 3% per year but some central bankers view as even higher. History shows that the Fed never reverses course following a sustained easing amid recession until the unemployment rate has started to turn down. This may not happen until 2003. So on both the monetary and fiscal policy front, 2002 is very likely to be neutral after two years of roller coaster like action.

As indicated earlier, there are still some risks to the economic recovery scenario we've outlined above. First, late and ineffectual stimulus measures cause the European downturn to accelerate, thereby impairing U.S. exports and exacerbating already weak pricing conditions. Second, CEO confidence is not yet on the same recovery path as consumer confidence. Business leaders make the critical decisions of whether to fire, rather than hire, workers and whether to reduce, rather than increase, capital spending, inventories and other expenditures. Third, international policy concerns. These may include Japanese banking problems deepening or additional developing market financial crises similar to Argentina's recent defaults. Fourth, stubbornly wide credit spreads. Corporate yield spreads have narrowed to pre-September 11 levels but remain relatively wide. Spreads have been an important confirming indicator for turns in earnings growth expectations. Finally, there are concerns about the unknown, including additional acts of terrorism. Risks of higher energy prices would fall in this category. Our assumptions are that oil prices move in line with futures, implying little change. But uncertainty remains high amid instability in the Middle East.

Pessimists argue that the fallout of September 11 will significantly diminish the U.S. long-run economic outlook by damaging productivity prospects. The direction of this argument appears correct but not the scale. Higher costs of doing business, the focus on security rather than productivity and the reduced resources available for private investment all point to a near-term productivity setback beyond the cyclical influences. Provided that the global political situation steadies, however, the burden of proof remains on those who argue that such damage will prove large on a sustained basis. The key driving force in the U.S. productivity pickup of the late 1990s - the innovations that depressed the relative price of information technology on a trend basis, appears largely unaffected by September 11.

It is our belief that all major stock indices have the opportunity for double-digit rates of return during 2002, within a range of 10%-20% from current levels. Using the S&P 500 as a benchmark, we are targeting modest overweighted positions in the following sectors: Financial Services, Consumer Cyclicals, Capital Goods and Technology. We are currently modeling under-weighted positions in: Consumer Staples, Telecom, and Utilities. Oil service and drilling shares may be best contrarian bets for this year and as growth stock managers, we will be pondering how to participate in this potential opportunity. Our market forecast suggests the renewed importance of individual security selection and is not unusual for a period of economic transition in which some companies fare far better than others in the same industry. In this environment, we will be most attracted to companies that have superior operational and financial strength as measured by market share, technological prowess, profit margins, balance sheet strength and return on invested capital.