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January 2003

Investment Outlook First Quarter 2003

Intense risk aversion in 2002 hurt the economy and financial markets. We have never experienced a period like we did last year when in the first year of an economic expansion the stock market continued to decline as it did until October. A number of factors were probably at work to produce this anomaly. No. 1 was the aftermath of 9/11 and concerns about terrorist activities and mounting concerns about a war with Iraq and the affects on oil prices and the global economy. Also, series of corporate governance concerns including accounting irregularities, fraud and insider trading added additional downward pressures. Finally, the late 1990's was an unprecedented period of overvaluation, even beyond the overvaluation that existed in 1972 and 1929. These factors might help to explain why the market declined so much while the economy was actually improving. Within the financial markets, the risk premium demanded by potential owners of stocks and corporate bonds reached extreme levels, leading to extraordinary levels of equity risk premium and extremely wide corporate bond yield spreads. Risk avoidance by corporate decision-makers inhibited economic growth by dampening inventory investment and capital spending, and by reducing the willingness to hire new workers. Recently, this has begun to abate, leading to a decline in the still-high implied equity risk premium and reduction in still-wide corporate bond yield spreads.

The global economy remains in the doldrums as 2003 begins. Recovery from the recession of 2001 has been both lackluster and uneven. Before looking ahead into 2003 we will begin with a brief review of 2002. Nearly all forecasts at the beginning of last year misgauged the magnitude and duration of the afore-mentioned risk aversion. The ongoing geopolitical worries, and disappointing news from companies, were more intense than most investors had expected. For example, while there was much discussion about global terrorism, the potential for military engagement with Iraq was not on anyone's radar screen a year ago, or its impact on energy prices, or the detrimental effects on global growth. Domestically, it was also nearly impossible to anticipate the size of the disclosures by rogue corporations regarding improperly recognized revenues, overstated earnings or inaccurate balance sheets, and therefore the intensity of the resulting investor backlash against the overall corporate sector. Business leaders themselves adopted defensive postures, often focusing on internal matters such as audit processes and cost containment, rather than business expansion and opportunities. Many individual developments and factors contributed to this intense risk aversion. We think it is useful to organize them into three categories: (1) economic uncertainty; (2) concerns about corporate accounting and governance, and related issues; and (3) geopolitical worries, including terrorism and the potential outcomes with regard to Iraq.

As a new year begins, progress in two of the three risk categories has been made resulting in a diminution of the intense risk aversion. While corporate accounting will once again be on investors' radar screens in 2003, we believe that there has been dramatic progress in this area. Cleaner and more complete corporate disclosures set the stage for reduced investor cynicism and lowered risk aversion. Many corporations made large and rapid adjustments in a desire to calm disillusioned shareholders, and to respond to FAS 142, the accounting standard that requires the write-down of impaired goodwill. An indication that the largest adjustments are behind us is that these charges have dramatically decreased since the second quarter. Forecasts are that write-downs in 2003 will be only one-third the size of those taken in 2002. Accounting issue discussions in the United States in 2003 is likely to center on: (1) accounting for pensions; (2) accounting for employee stock options; (3) ongoing moves to synchronize accounting between nations; and (4) corporate board auditing standards.

Data released in recent weeks suggest that the US economy is increasingly likely to avoid a near-term recession and deflationary pressures. Of course, that is not to say that the economy is expected to be extremely vigorous. Consensus forecasts of real GDP growth in the coming quarters are below the economy's long-term potential. Growth will be hindered by a deceleration in consumption, sluggish business fixed investment, and lackluster exports. The currently low level of inventories relative to sales could be helpful should demand improve. The risks to economic and stock price performance in 2003 will share key elements with those in 2000-2002. Low confidence among CEOs and other business leaders has been a major impediment to domestic economic growth during this period. Reluctance to hire new workers and fund new capital projects slows economic growth, and delays the transition from recession recovery to more vibrant economic expansion.

The one risk category yet to show discernable improvement is in the geopolitical arena. Tensions in Iraq, North Korea, Venezuela and Israel have oil and gold prices rising. We think a favorable resolution regarding Iraq will cause oil prices to fall and will create a more favorable global environment for business investment, inventory rebuilding, and equity market gains. Consensus economic forecasts are likely to rise substantially once engagement begins. OPEC will most likely be unable to maintain its $22-28 per barrel price target. Freer oil markets, if Iraq developments lead in that direction, would be a major boost to global growth prospects. However, given the great deal of uncertainty and unpredictability regarding the Iraqi situation, we’d like to outline several possible scenarios and their impact on oil price, economic activity and global financial markets.

Scenario No. 1 - Status quo: OPEC keeps the market under tight control

In this scenario, we assume that the Iraqi regime makes enough concessions to survive the current crisis, but that the UN Security Council remains suspicious enough to keep the country under military surveillance and oil export controls. The structure of the crude oil market remains similar to what it has been since 1999, an oligopoly dominated by Saudi Arabia, the only genuine "swing producer," and aimed at minimizing price volatility. OPEC has shown it has the means to keep oil prices within a cautiously chosen target (OPEC basket price ranging from $22 to $28/bbl). That is high enough to extract a significant portion of consumers’ budgets, but not enough to trigger a global recession. In this base-line scenario, we assume that oil markets would first normalize, as Venezuela’s exports and Japanese domestic power supply recover pushing oil prices down to $24/bbl by June 2003 and then move progressively towards OPEC’s upper limit, as the global recovery, subdued as it might be, fuels stronger demand growth.

Scenario No. 2 - Clean war: Regime change in Iraq, OPEC breaks up

A swift military action by the US and/or a coalition of allies, resulting in a regime changeover in Baghdad and capital inflows in Iraq’s oilfields, could significantly change the long-term equilibrium in oil markets. OPEC as it is now would become irrelevant and, in the medium term, Iraq and Saudi Arabia would compete for the top position as "swing producer." Iraq’s production appears unlikely to accelerate for several years, given the huge amount of investment needed to restore its oil extracting capacity. Still, markets would likely detect a structural change and price the long-term trajectory of oil prices at a lower level, with immediate effect. In this scenario, we assume a short-lived spike to $40 in early 2003, and then a sharp decline during 2003 down to under $20, as oil output rises before global demand recovers. In the future, the global economy would benefit from lower oil prices, amplifying the global recovery anticipated in 2004. Rebounding demand would likely bring back oil prices above $20/bbl in early 2004.

Scenario No. 3 - Messy war: Supply disruption

The worst-case scenario is one in which either Iraq or terrorist groups manage to attack Middle East oil fields and make them unusable because of contamination by biological or radioactive material. The situation would, to some extent, be comparable to that of 1973, with the difference that, for technical and economic reasons, namely the impossibility or the cost of decontaminating oil fields, it would be partially irreversible. Not only would oil prices likely spike (some experts have already mentioned very high levels, maybe $100/bbl, amounting to a replay of the 1979 shock in today's prices) but also the long-term equilibrium of oil markets would be totally different from today. Other oil producers would have to rethink their strategy, oil substitutes would appear (synthetic oil made from coal, fuel cells, etc.), but also oil prices would be so high that a global recession would likely be unavoidable. Of course, demand for oil would also plummet, as a result of the recession and slump in international transportation, but, even so, prices would remain very high compared to the last 20 years. A tentative scenario would suggest the price of a barrel of oil at $50 on average in 2003 and above $40 in 2004.

The 1991 Gulf War lasted a total of 43 days. Since then, the technological and military might of the US and its coalition allies have dramatically widened relative to Iraq. By all accounts, military plans for Iraq have been in the works for many months now and while no outcome can be predicted with a great deal of certainty, the odds would have to favor a resolution, with or without military engagement that more closely resembles Scenario 2 described above. A regime change in Iraq has the potential to unleash a domino effect in the region whereby tensions are dramatically subdued and world oil markets become far freer. This could provide the needed catalyst to propel global economic activity out of its doldrums.

Not content to rely upon easing geopolitical tensions and accommodative monetary policy to jump-start the economy, President Bush recently announced new economic policy initiatives intended to provide both short-term economic stimulus and long-term growth and job creation. One Bush advisor described the plan as a "growth insurance" plan aimed at assuring that the economy grows at greater than 3% expected this year. The White House is worried that the prospect of war, uncertainties in financial markets, lagging capital spending and a slowdown in consumer spending might undermine the economy without some stimulus. Many economists believe the unemployment rate won't begin to fall until the economy grows at an annual rate higher than 3.3%. The President's plan calls for $674 billion (over ten years) in tax cuts including an acceleration of the marginal income tax rate reductions legislated by Congress in 2001 and set to take affect in 2004 and 2006. The new plan calls for immediate implementation, reducing the top tax from 38.6% and introducing a new 10% bracket for those taxpayers now subject to a 15% rate. The plan also calls for an end to the marriage penalty, boosts child tax credits, encourages capital spending and ends taxes on dividends. Reaction to the proposals are mostly split along political party lines with Republicans applauding them as well constructed and much needed and Democrats claiming the plan is light on short-term stimulus and a windfall for the rich to aid Bush's re-election in 2004. It is true that disappointing economic performance was a secondary concern during the mid-term elections in November 2002, but could have more notable political consequences for the President if left unaddressed. The final shape of any stimulus package will be debated long and hard on Capital Hill likely resulting in a plan where both sides can claim at least some credit and benefits for their constituents. In addition to more aggressive fiscal policy, other policy initiatives contemplated by the administration and new Republican controlled Congress include (1) tort and regulatory reform, (2) Medicaid reform (3) a prescription drug plan for Medicare recipients and possibly (4) Social Security reform.

Should some dividend tax relief be included in any final legislation, many corporations might engage in some mild-mannered adjustments to their dividend payout policies as a gesture of good faith to their shareholders. Successful seasoned companies currently without dividends might introduce a small payout, and other companies might modestly raise their existing payouts. However, in the long term, it is unlikely that successful companies with attractive ROEs would dramatically boost their payout ratios. The S&P 500 ROE is in the mid-teens, notable above the return most investors expect on financial assets. Shareholders would have better returns, including ultimate dividend yield on initial investment, by allowing successful companies to reinvest most of their earnings in the company. Long-term growth in dividends is best enhanced by earnings growth, and not a one-time step up in payout ratios. Dividends typically grow most strongly when economic and profit growth is robust. This final point is relevant to investors now wishing to position their portfolios for a possible change in tax policy. For most investors, the focus should not be on the highest-yielding equities, but on equities of companies with the strongest earnings and cash flow. In many instances, the long-term returns for shareholders is enhanced when the cash is used for other purposes, including capital expenditures, merger and acquisition activity, and share repurchases (which are conceptually similar to dividends but can be timed to coincide with share price weakness, or occur when cash is not needed for other purposes).

The consumer has carried the economy the past two years with business investment having contracted substantially from the highs reached in 2000. With consumer spending beginning to wane, all eyes are on the manufacturing sector as an indicator of the pace and magnitude of growth in 2003-2004. Much like the early 1960's, the current economic backdrop of low and stable inflation should produce a similar sensitivity to earnings growth as a driver of stock prices. For this reason a great deal of attention will be focused on proxies of economic growth such as the Institute of Supply Management (ISM) indices. A rising ISM has historically correlated with periods of outperformance by the cyclical sectors of the economy. An indication of this point occurred on January 2 when an upbeat ISM report helped start the year off on a positive note. The question is whether the manufacturing sector can continue to gather momentum during the first quarter.

Another issue that has weighed on stock prices is valuation levels. A recent article in Barron's magazine compared stock prices to five different measures; short-term interest rates, bond yields, historical P/E averages, earnings growth and current economic policy. In each comparison, the current valuation of US stocks was deemed to be fair to attractive. With this in mind, the downside for the market is likely limited from current levels. The equity bubble that existed in 2000 is largely deflated, and valuation has probably been a significant support in recent months. With a favorable outcome in Iraq, global growth expectations should rise dragging along corporate earnings and stock prices.

From a technical analysis standpoint, the trend of the stock market's major averages for the last three years has been to surpass their 200-day moving averages and then evaporate below their 50-day moving averages. The long, 200-day moving average ceiling has been the limit to the market for what seems like forever. This lower highs, lower lows trend has been in place since April 2000 and must be carefully respected. Closing above key support levels (which are resting at Dow 8,577, S&P 500 905, Nasdaq 1,395 at this writing) will be the key evidence to support any bullish market thesis for this year. Closing below these levels portends another bear market test of last year's lows.

In conclusion, we expect moderate to normal economic and profit growth in 2003, accompanied by low inflation. As a consequence of this, and the valuation discussion above, we advise an above normal weighting in equities and corporate bonds, and a below normal weighting in Treasury and tax-exempt securities. Within the equity market, we generally prefer an emphasis on stocks with economic sensitivity. The exception would be our increased wariness regarding some early-cycle industries in the Consumer Discretionary sector, such as automobiles; housing and certain categories of retailing that have already enjoyed solid fundamental growth for several quarters. Similarly, many defensive stocks have already performed well, and are now less appealing on a valuation basis. The capital expenditure overhang of the late 1990s appears to have been reduced, if not eliminated, in many sectors. Although some categories, such as telecommunication equipment, remain unattractive, there are indications of improved demand in areas such as software applications and some semiconductor-related areas leading to our recommended overweight in Technology. Our model portfolio also includes a modest overweight in the Capital Goods sector, based on signs that broad-based capital spending may have bottomed.