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Second Quarter 2002 Investment Outlook

The equity market is something of a puzzle at the moment. In the fourth quarter of 2001, the equity market appeared to be anticipating the end of the recession. A rally is typical in the late stages of recession and, by the beginning of January 2002, the move up in U.S. equity prices was in line with rallies seen in previous recessions. However, in the last few weeks, even as the economic data appear to provide strong support for the view that the recession has drawn to a close, the equity market has stumbled badly. Either there is a disconnect between equity prices and economic fundamentals or the equity market is anticipating a new downturn in the economy. We believe that the mid-east turmoil and concerns over accounting and disclosure issues are weighing on the market as opposed to serious questions surrounding the economic recovery, particularly since most market watchers have been upgrading their assessment of the near-term outlook for the economy.

Obviously the Middle East situation is throwing a monkey wrench into the stock market in the short term. Geopolitical influences DO affect the markets because they cause uncertainty, and uncertainty keeps people and investors from making decisions - except the decision to make no decision and "wait and see." Right now, the worst-case scenario is the most convincing (i.e., the U.S. peace attempt fails and the Israelis go ahead with their terrorist defense strategy), which is why we believe the Powell visit is risky for the markets short term. Additionally, investor concerns over accounting and disclosure issues appear to have derailed the link between economic fundamentals and equity prices. We do not think that the recent decline in equity prices is a signal of a new downturn in economic growth lurking around the corner.

It is interesting to note that in the first year of an economic recovery the equity market has gone up in each of the nine post-war recoveries. The gains, measured by the S&P 500, have been as small as 7.8% in the case of the recovery from the January 1980 – July 1980 recession and as large as 34.9% in the case of the August 1957 – April 1958 recession. The second thing to note is that the primary determinant of the size of the gain in the market is the rate of real GDP growth in the first year of recovery. If you rank the recoveries by the strength of GDP growth or the size of equity market gains, the correlation between the ranks is 0.88. However, the P/E multiple of the S&P 500 at the end of recessions has had no statistical bearing on the gain in the equity price over the succeeding 12 months. The correlation of the ranks between equity price gains and the P/E at the end is an insignificant 0.18. According to history, therefore, if you knew how strong the recovery was going to be you would have a fairly good idea of how robust the equity market increase was going to be in the first year of recovery regardless of the initial P/E multiple.

Our expectation of 3.0% real GDP growth in 2002 would suggest a gain in equity prices of around 10% this year based upon these historical correlation statistics. This projected increase in equity prices is also consistent with the outlook for corporate profits based on consensus economic forecasts. Although the recession was very mild in GDP terms and personal income growth held up reasonably well in real terms compared to past recessions, the recession was deep in terms of the decline in corporate profits. In the recovery, therefore, we believe corporations will strive to re-establish profit margins and the evidence is that companies have already aggressively embarked on that process. Headcount reductions and cutbacks in infrastructure and equipment spending are well under way across corporate America in an attempt to control costs and restore profitability.

There remains the issue of P/E multiples and whether the high multiple on the S&P 500 presents significant downside risk for equities in 2002. Our view is that the valuations on the S&P, though high by historical standards, are justified given the inflation and interest rate environment. The near-term economic growth environment ought to be supportive for equity prices while the outlook for inflation and interest rates, in our view, ought to sustain equity valuations. Key to this view, however, is the assumption that the Fed does not seek an early reversal of interest rate cuts unless economic growth is considerably more robust than the market is anticipating. If growth of output and productivity is significantly stronger than current projections for 2002 accompanied by higher interest rates from the Fed, we think this scenario would be bullish for stocks. Under this scenario, interest rate increases would merely be following the natural rate of interest higher. This scenario would see more robust profit growth which ought to drive equity prices higher regardless of the interest rate environment.

The only problem we foresee from interest rates is if the Fed attempts to drive rates higher in another pre-emptive inflation fight without evidence that the economy is undergoing a vigorous recovery. We believe the probability of the Fed doing this to be quite low as it is likely the Fed will be very cautious when it comes to reversing course on interest rates. It is unlikely that the Federal Reserve will boost interest rates while unemployment rates are still rising. In addition, sluggish economic conditions in Europe, Japan and other parts of the world continue to persist arguing against a near term rise in rates of any note. When the Fed ultimately does begin raising short-term interest rates, intermediate and longer-term yields are unlikely to rise commensurately given the steepness of the yield curve. Equity valuation is more closely linked to longer, not shorter, rates and these are not expected to change much more during 2002.

We do not expect the recovery phase to be as robust as many prior cycles due to a variety of factors, including strength already seen in housing and autos due to lower interest rates. These sectors have already provided a notable boost to aggregate economic data, driven by strength in disposable incomes. Unfortunately, growth in real wages and salaries is apt to slow in the coming months just as the benefits of lower short-term interest rates and energy prices reverse course. In addition, employers are likely to be conservative in adding to payrolls in an environment where low inflation constrains top-line growth. Nervous CEOs may be reluctant to add to their work forces until they are more confident that revenue growth has resumed.

In this environment, we have maintained a cautious approach to investing in the fixed income markets, choosing to allow many bond redemptions and expirations to remain in low yielding money market funds for now. This tactic has proven sensible, as rates have risen by almost a full percentage point since the trough last September. Another modest increase of 25 to 50 basis points would trigger us to begin investing short-term assets back into the bond market. Our equity strategy during the past six months has been somewhat of a barbell approach. On the one end are companies with little to no sensitivity to the corporate business cycle such as healthcare stocks, consumer staples, defense companies and other consumer related companies. These stocks have generally performed quite admirably during the profit recession of the past two years and a fair number of them have been hitting new 52-week highs recently. On the other end of the barbell are companies that derive their revenues predominately from corporate capital spending or are more sensitive to the business cycle. Many of these companies are in technology or technology related businesses. This sector continues to be an area of frustration, as it has been difficult to gauge when market participants will begin to discount a profit recovery. Typically, investors begin to buy stocks six to nine months prior to a rebound in profits, but the recovery continues to be deferred. We still believe we are invested in the right stocks to participate in the rebound when it begins in earnest and believe it continues to make sense to maintain a balanced approach between defensive and economically sensitive holdings. As always, please give us a call with any of your questions or comments.