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Investment Outlook Third Quarter 2003

What a difference a quarter makes. Even as geopolitical events dominated first quarter news, the easing of tensions in the Middle East allowed the focus of market participants to return to economic factors. The major stock market indices all posted their best quarterly gains in five years as investors turned their attention to an expected rebound in economic activity in the second half of the year. With GDP growth and S&P profit growth expected to double between the second and third quarters and second half GDP growth expected to average between 3.5% and 4.0%, market participants abandoned their cautious ways and aggressively jumped into speculative stocks. A combination of enormous money flows into the financial system and harried short-covering by hedge funds caught with too many short positions fed the intensity of this movement. The DJIA, S&P 500 and Nasdaq gained 12.4%, 14.9% and 21.0% respectively in the quarter. From the March 12 intra-day low, the Nasdaq has risen 29.4% and the DJIA and S&P 500 have each posted gains of more than 20%.

The economy continues to send mixed messages. Second-quarter growth will probably remain in the 1.5%-2% range, which is not enough to encourage employers to start hiring. Although employment statistics continue weak, signs of stabilization are beginning to appear (more on this later). Consumer spending has been sluggish but with the arrival of normal weather patterns a pick-up in demand has become evident. And while business investment is in the midst of a modest recovery, the potential for a more significant rebound has improved as consumer and business leader confidence has risen sharply. Additional optimism for acceleration in economic activity exists due to massive fiscal and monetary stimulus and improving corporate profits. Passage of the President’s tax reform package during the second quarter allows consumers to keep more of their hard-earned dollars and spend or invest the difference as they chose. The combination of marginal tax rate cuts and dividend and capital gains tax reductions has certainly had a positive impact on stock prices as market averages have tacked on steady gains since the legislation passed in early May. The Federal Reserve Bank cut short-term rates for the 13th time in the past two years in June signaling a renewed commitment to ensuring a sustainable return to normal economic growth. Since the Fed’s rate cut announcement, bond yields have risen sharply indicating a belief that economic activity will in fact accelerate in the foreseeable future.

Other economic growth drivers include 1) a significantly lower trade-weighted dollar valuation which stimulates exports, and increases foreign and domestic pricing power for capital goods 2) significantly lower corporate bond yields which lower interest rate expenses via refinancing at lower rates) 3) significantly higher mortgage rate refinancing 4) rising stock prices which allows corporate pension plan deficiencies to heal, improves consumer confidence and encourages capital formation by issuance of new stock/stock based acquisitions 5) an inventory replacement. With inventories at historic lows and unfilled backlogs for non-defense goods rising for the last three months, a return to normal rates of inventory to sales could add over 1% to GDP demand. We are already witnessing some of the benefits of rising stock prices as there has been a surge in merger and acquisition activity in recent weeks. This is another indication of growing business confidence in a solid economic recovery.

What remains unclear is whether or not the expected rebound in second half growth will be continue into next year. Pessimists believe the economy's anemic growth rates have been caused by more than a cascade of temporary shocks. They generally believe the investment bubble of the late 1990s, the accounting scandals, stock market collapse and debt build-up that accompanied it will have a more lasting effect on economic growth. Adherents to this view contend we're about halfway through the post-bubble adjustment process. Another issue that could undermine the economic rebound is concerns that what the federal government provides in the form of tax cuts, states and local governments will take away in the months ahead. States reportedly face a budget gap of about $78 billion for the coming fiscal year that needs to be closed through tax increases and spending cuts. With nearly $200 billion in federal tax cuts hitting the economy in the next 18 months, the state budget issues will likely mute but not eliminate the expected stimulus from this source.

One other concern expressed by some is over rising federal budget deficits. With the deficit expected to reach a record $450 billion this year, it may be useful to put this issue in perspective. Many of the arguments about deficits come from tax cut opponents. We will attempt to address a few of the most popular claims: 1) Deficits cause inflation and higher interest rates. Interest rates have fallen steadily since 1980 even during periods when we have produced "record deficits". And inflation has diminished to such an extent that the Fed is more worried about deflation than inflation even as the US faces a record budget deficit this year. 2) Deficits are bad for the economy. Deficits are a natural result of slow economic growth or contraction. When growth accelerates, the deficit will shrink or disappear. Since the days of well-regarded economist John Maynard Keynes, it has been considered normal to run a deficit when the economy is sluggish in order to stimulate demand. 3) The deficit is too big. As a share of GDP, this year's record deficit will be about 1.5%. This compares with an average of 2.6% since 1980 – a time associated with strong economic growth and steadily declining inflation and interest rates. 4) We have too much debt. It is true that US debt has grown by $3.5 trillion since 1990. But the US owns some $1 trillion in assets such as land, mineral rights and hospitals. And it is hard to place a price tag on the security we receive from our military assets. Plus, Americans' household wealth since 1990 has surged by $19 trillion, far more than the debt accrued. While we are not advocates of deficit spending as prudent fiscal policy over an extended period, it is plausible that in the current environment it is sound short-term economic policy. Just as Alan Greenspan has stated on numerous occasions, we favor lower federal government spending and faster economic growth as the best solution to reduce budget deficits over the long haul.

Another major concern for the US economy is the slack labor market. The most recent labor report showed a rise in unemployment to a nine-year high of 6.4%. Historically, employment has always been a lagging indicator of economic activity. In the past, unemployment rates have continued to rise for as long as 18 months after an economic recovery begins. The latest jobs report did contain some bright spots that may point to improvement in the months ahead. Significantly, temporary workers and the self-employed, both leading indicators of better jobs performance registered big gains in the future. In addition, 251,000 people re-entered the labor force in June, a sign of confidence, as hopes were raised by the new tax-cut package and its promise of new employment.

What does the potential economic recovery mean for bonds? Recent action in the bond market may be a good barometer of what's ahead. Treasury yields collapsed to record lows in mid-June on deflation fears only to surge to their highest levels in four months in the past three weeks following the Fed's latest interest rate cuts. Our view is that the likelihood of general price deflation in the US is extremely remote and bond market participants are increasingly coming to this conclusion as shown by their behavior since the Fed's pronouncement. With the yield on ten-year treasuries back to 4%, we believe rates will likely pause and trade between 3.75% and 4.25% until we see more definitive signs that the economy is accelerating. When GDP growth returns to normal at 3.5% or higher, we would expect ten-year treasury yields to trend towards 5%.

The question surrounding US dollar valuation has gained attention as the dollar has declined against most major currencies during the past year. We do not have a strong opinion on the direction of the dollar given the contradictory influences at work. On the one hand, our exports are exactly at the level they were back in 1997, meaning our goods are not competitive in world markets or the dollar is way overvalued. On the other hand, our economy is still the soundest and likely to be the fastest growing of any of the economically developed nations of the world. So we are not quite sure what this tug of war is likely to produce in the months ahead.

One other question we are often asked is whether the US stock market has entered a new bull phase or whether the recent rebound is merely another bear market rally? While we don't have a definitive answer to this question, it is encouraging to note that even if we were in a bear market rally, historical experience would suggest there is more upside potential ahead. Ned Davis Research has conducted the most extensive studies on this subject. Their research suggests that the S&P 500 went up an average of 50.6% and lasted 371 days during a cyclical bull rally in a secular bear market. As indicated earlier, the S&P 500 is up about 23% from the March 12 lows, suggesting plenty of room still to run. Our expectation is that the condition of the economy in 2004 will be the determining factor as to the stock markets prospects beyond the next six months.

The much heralded recovery in corporate profits will be watched carefully for signs that any acceleration in economic activity has staying power. With second quarter earnings reports beginning in earnest, investors will be looking for evidence to support expectations of a second half recovery. Consensus forecasts call for S&P operating earnings of $52 this year and $57 next year implying a P/E ratio of 19x 2003 earnings and 17.5x 2004 earnings. There have been a number of positive trends for corporate earnings this year including fewer negative earnings pre-announcements and significantly lower write-offs than we've seen in the past two years. The second quarter is expected to be the weakest of the year with gains of around 9% compared with 11.6% for the first quarter and expectations for 13% for the third quarter and 21% for the fourth quarter.

Having touched upon a myriad of financial market issues in this mid-year outlook, we trust it is clear that in our opinion, the odds favor economic acceleration accompanied with somewhat higher stock prices and bond yields. Our focus on companies with strong fundamentals and growth prospects has produced favorable equity returns for our clients during the first half as returns in most cases have exceeded the benchmarks we use to track investment performance. In addition, our cautious approach to the bond market has allowed us to generate reasonable fixed income returns in the current low interest rate environment while at the same time preserving principal. Our strategy for the second half will be continued caution in the bond market coupled with a stock specific approach in the equity market. While we remain attracted to the traditional growth sectors of the economy including healthcare, technology, financial and business services and specialty retail, not all boats will rise at the same rate as the economic river begins to fill up. We will therefore be highly selective in acquiring new investments in the aforementioned economic sectors.

Our best wishes for a healthy, prosperous and enjoyable summer!