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Fourth Quarter 2001 Investment Outlook

On September 11, the world changed. It will likely prove to be one of those days that we all recall where we were and how we felt when we first heard the news, similar in that respect to the bombing of Pearl Harbor and the assassination of John F. Kennedy. While it almost seems trivial to focus on our finances at this time, our economy and financial markets are an important part of what makes our country the greatest and strongest in the world today.

Given the uniqueness of the event, it is difficult to find an equivalent parallel in our history. In many ways, we are in uncharted waters since we do not know how well any past incident will conform to the current experience. Our best guidance then may be to choose parts of previous historical episodes as a way to make an estimate as to what is in store for the future. Making a comparison between current economic conditions and the previous recession in 1990-1991 may assist us in determining what is ahead. There are two common factors that may make the parallel useful. One is the war-like environment and the other is that we believe the Fed played a hand in the slowdown and recovery in each case.

During the late-eighties we experienced a Resolution Trust Corporation (the federal agency set up to unwind the real estate banking crisis) related credit crunch. The Fed was quite tough with lending standards and the Bush tax rate increase provided the final recessionary push to the economy. Fortunately, this time the current Bush administration has implemented a tax-rate-cut policy. Unfortunately, the Fed has been less forthcoming with their handling of the credit system. Alan Greenspan migrated away from focusing on inflation with Y2K concerns and has had a tough time getting back on track. The net effect has been a micromanaging of the monetary conditions that has created increased uncertainty and a credit squeeze. This has increased the fragility of the U.S. economy substantially.

The events of September 11 had a devastating impact on the psyche of the economy. The question is whether the policymakers react in an aggressive enough manner to restore confidence, not only in the economy, but also in our way of life. The ideal policy mix would be one that addresses the short-run problems in a way that is consistent with long-run policy objectives. In the short-term we are faced with two problems: first, how to re-energize the economy and, second, how to restore confidence in the markets. In short, we need to raise asset values and get the economy going again.

We believe that the most direct way to push asset values in a positive direction is through a reduction in the capital gains tax rate. What a capital gains rate cut does is increase the value of profits. With the higher valuation, incentives to invest increase and, hence, so do future profits. Acceleration of the personal income tax rate cuts would also increase short-term incentives. The lower rates would make current production and profits more attractive. Other policies that are being contemplated are not as attractive. One, accelerated depreciation, may be okay if it is targeted to industries whose true economic depreciation rates are faster than those allowed in the tax tables (technology is a good example). Another, the Investment Tax Credit, is not an attractive option. The way we describe it is that it is an incentive to buy a new machine, a very Keynesian concept. What we want is increased incentives to use both new and old machines. Finally, the reduction in the corporate tax rate is a desirable move that will reduce the double taxation of the economy. However, given the bang for the buck, the capital gains and personal income tax reductions are much more attractive options.

In the past we have criticized Alan Greenspan for deviating from the focus on inflation. We believe that Y2K derailed the Fed Chief and since then he has been over- and under-shooting his target. This has added instability to the financial markets. Another negative contribution by the Fed has been its concern over capital adequacy. We don’t know whether the policy was deliberate but the effect has been to create a quiet credit crunch that is being felt by small and mid-size companies. However, as we look at the data, inflation seems to be well under control.

Looking at the term structure of interest rates and the futures market, we come to the conclusion that short rates are about to bottom. Given our inflation outlook, the fluctuations in short rates will reflect fluctuations in the real rate of return. This development seems to be a bullish one. One way to illustrate the point is that as people expect rates to decline they will delay the purchases of consumer durables, refinancing, etc. However, as rates are about to trough and expectations of future rate increases materialize, people will accelerate purchases of consumer durables as well as refinancing activity. In short, interest rate expectations will tend to alter the timing of purchases and overall economic activity. With rates near the bottom and with expectations of future rises in short-term interest rates, a surge in economic activity should follow. The increased economic activity will lead to an improved profit outlook and higher valuations. We expect the turnaround to begin sometime in the first quarter of next year and gain momentum as 2002 progresses. The following paragraphs develop our market view in some detail.

Our revised economic outlook calls for unemployment rate to rise to 6% or above and the economy to contract for two to three quarters. At this time the stock market still appears to be event driven. Prior to September 11 we had been in an earnings-news-driven market. The markets are likely to fall when military action takes place (or worse, if we suffer defeats or additional acts of terrorism), and should rise on victories. Until the war on terrorism is displaced from the front page of newspapers and TV news shows, market action will likely be tied to the events of the day.

Some perspective on daily trading in stocks may be useful. During the bull market of the late 1990's, it was consumers clicking in market orders for tech stocks that kept prices strong and continuously moving higher. As the market hit a wall last year, control of the daily price action shifted to the hedge funds—fund managers who make money for their customers going long and selling short (betting against) stocks.

Although it may be difficult to recognize today, we believe a new and sustainable bull market foundation is being built. The components should come together sometime next year for the upside earnings surprises required to turn sellers into buyers. These include:

1. Corporate overheads are becoming lean once again.

2. Year-over-year earnings comparisons will become easier every quarter beginning in 2002.

3. $300 billion in fiscal and monetary stimulus will hit our economy—over $1.5 trillion in the next 24-36 months when you add up ALL the spending (military, civilian and other governmental) needed to fight this global war.

4. Inflation and interest rates remain at historically low levels.

5. Company buy-backs reduce stock inventory —supply/demand imbalances turn positive.

6. Massive consolidation will leave ALL industries with better balance sheets, stronger operating teams and lean businesses that will produce strong profits as business returns to normal.

We continue to believe our equity portfolios are positioned properly for the environment we have outlined above. While some minor turnover may occur in the weeks ahead, by and large the companies we are invested in are amongst the most financially sound companies in the entire world, well able to endure and prosper in the current downturn. As the recovery takes hold, these companies' stock prices are likely to recover quite rapidly.

At Covenant Capital, we mourn the loss of many colleagues and friends in the recent terrorist attacks and have been saddened to hear of losses many of our clients have experienced. We express our heart-felt sympathy to those who were injured and to the families and friends of those who lost their lives. While our grief cannot return them to us, our memory of them will never be lost from our hearts. We stand behind our President and our military and stand united with all Americans in resolving to fight for the triumph of good over evil, peace over violence and justice over intolerance. In this very challenging environment, we encourage you to call or schedule a meeting with us to discuss any specific questions or concerns.