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Fourth Quarter 2002 Investment Outlook

Pervasive gloom and doom continue to be the prevailing tone on Wall Street. The recently ended third quarter was the worst for stocks since the 1987 crash with the S&P 500 and DJIA declining by 18% and the NASDAQ Composite by 20%. While a lot of uncertainty has been generated by all the talk of war and corporate malfeasance, the main reason for the dismal performance is skepticism about the sustainability of the anemic economic recovery that began last year. The inability of businesses to expand margins and boost profits has been a tremendous drag on stock prices. Companies are still suffering from the aftermath of the 1990's capital equipment overinvestment and, until demand improves, they are reluctant to spend capital on projects or additional labor. And despite the expected solid Q3 real GDP figure due to be reported later this month, important profit drivers - including manufacturing activity, industrial production, and capacity utilization - are all weak.

Much of the economic dialogue on Wall Street today inevitably focuses on consumer spending. After all, while business investment has languished, consumers have continued to spend as the unemployment rate has stayed low, income tax rates have been reduced and mortgage and other consumer debts have been refinanced at the lowest interest rate levels in decades. But businesses and consumers cannot indefinitely pretend to inhabit separate economies. Consumer confidence has been sliding, and is likely to continue doing so if unemployment rises or talk of war intensifies. And in an environment in which companies are scrambling to improve their productivity, employment will likely weaken. Another point of concern is the so called "wealth affect", or in this case, the negative wealth affect since consumers net worths have suffered greatly at the hands of a miserable decline in stock prices. Fortunately, these declines have been somewhat offset by rising real estate prices.

Finally, there are concerns that consumers are over-leveraged. At the top of the bubble in early 2000, household debt as a percentage of GDP was about 72%; now its 79%. So while it is true that debt has continued to soar during the bear market, the ability for consumers to service the debt has actually improved, as monthly payments have been reduced due to the refinancing boom.

Currently, third-quarter earnings for S&P 500 companies are expected to rise by 7% over the comparable 2001 period, but the magnitude of the forecast has been dropping rapidly. Corporate profits are of tremendous importance to the market today, now that identifiable external events - the deadline for corporate officers to certify their books and the 9/11 anniversary - have passed. Even more relevant than rhetoric about a possible military strike against Iraq and the related crude oil price spike, is the profit picture. With interest rates exceedingly low, inflation not a problem and stocks having been battered for two and a half years now, it is puzzling to many investors that a sustained, durable rally in stocks hasn't developed. The possibility that the weak market this year has been signaling poor earnings - rather than “ignoring” good fundamental news - is now something that Wall Street analysts have finally begun discussing.

The unwinding of the 1990’s bubble and the slowing of global growth continue to pressure profits with consensus S&P 500 operating EPS expectations having been cut to around $52, down from over $60 earlier this year. Still, even allowing for the lowered expectations, at 15 times earnings, valuation levels are not high in the current inflation and interest rate environment. However, the market will not likely rebound just because it is cheap. Rather, it will probably require the combination of a cheap market and rising profits to boost stock prices. Calendar 2003 real GDP growth estimates now hover in the 3.0% range, down from 3.5% earlier. Growth in 2003 will likely be somewhat more “back loaded” because of heightened near-term geopolitical uncertainties. Also, the still-expected capital spending recovery probably will be somewhat more modest than earlier forecast with information services spending now expected to rebound by 3-5% in 2003. Telecom equipment spending however is likely to contract more in 2003 before beginning to recover in the 2004-2005 timeframe.

Turning to Federal Reserve policy and interest rates, the Fed next meets on November 6, one day after mid-term elections. The importance of this date is that most Fed-watchers expect the Fed to cut the Fed Funds rate by 25 basis points at that meeting. If not for the election and the unwillingness of Fed officials to appear to act with political motivations, the Fed may already have intervened by lowering rates as economic activity began to wane during the third quarter.

Not surprisingly, the combination of earnings weakness and jittery investor sentiment has generated mutual fund outflows over the past three months, further restraining any rebound in the equity markets and producing one of the worst Septembers for the equity markets on record. Any significant bad news that coincides with investors opening up their 401k or brokerage statements in October could cause a repeat of July when we witnessed "I can't take it anymore" sell-it-all panic selling. But what makes investing in stocks so difficult is that markets seldom do what everyone expects - especially when everyone and their uncle is shorting stocks as the "sure way" to make money in a bear market. The market has a diabolical way of doing the exact opposite of what the crowd expects.

We thought it might be helpful at this juncture to provide a perspective on the various scenarios being offered by Wall Street prognosticators. The bearish camp is claiming that the occasional one day surges we have experienced during the last several months are the direct result of investors covering their short positions. To cover their short positions, short sellers normally buy back the stocks they have borrowed. A short squeeze on various visible high profile stocks can fuel a market rebound and create a sudden and often violent surge to the upside in the marketplace. The bears are also suggesting that the market has fallen so far, so fast that the market is now oversold. As a result a sharp short-term rebound can occur to alleviate this oversold technical condition. However they believe that this is only a technical bounce, as the market will subsequently trade in the direction of its predominant primary trend, which has been down for the past two and a half years.

The bullish camp on the other hand is claiming that conditions are now in place for a more substantial market bottom and the beginning of a sustainable market rally. The bulls’ upward bias opinion on the market rests on the following supporting evidence: The belief that the past two and a half years’ decline in the U.S. stock market is approaching the duration and severity of previous extreme market declines (ex: 1973-1975 and 1929-1932). Many also believed that an asset allocation swap from cash and bonds into stocks might fuel the potential for a substantial stock market rally. The fact that we are nearing the favorable seasonal period from November to April as well as the historical bullish mid-term presidential election year trading phenomenon would suggest a more sustainable rally going forward. Both the bulls and bears appear to have equally valid points and this may be the reason why strategists remain evenly divided between the two camps.

With so much confusion in the marketplace, we thought it would be appropriate to offer our own views on market prospects. U.S. share prices remain below fair value, reflecting high aversion to risk by investors. This risk intolerance likely peaked during this past summer. Investor concerns now center around developments involving Iraq, and implications for the already-sluggish global economy. Short-term obstacles to higher share prices in the U.S. include year-end portfolio adjustments (tax-selling and "window dressing"), and the shift in stock ratings systems by investment research providers. Beyond these short-term issues, it is our contention that the U.S. stock market has entered into a secular trading range market environment that will be categorized by many bull and bear market cycles. The previous 14 secular trends that occurred in the U.S. stock market in the past 200 years have been as short as eight years in duration to as long as 20 years. In addition, the cyclical bull and bear cycles typically last from several months to as long as a couple of years. On an intermediate-term basis, we remain cautiously optimistic that a cycle low will soon develop, possibly as early as October. From this cycle low we believe that the U.S. stock market will embark on a cyclical uptrend that may last as short as several months to as long as a couple of years, generating favorable returns for opportunistic traders and investors.

The financial environment has been excruciatingly painful for an extended period of time and it is difficult to posit the exact conditions or timeframe that will provide relief. We have attempted to steer clear of the riskiest sectors of the market, but no area has been exempt from the harsh declines experienced this year. We still believe that a diversified portfolio of high quality stocks and bonds will provide attractive investment results for investors with an intermediate to long time horizon. In light of the severe erosion in equity portfolio values and the extreme low level of interest rates, we recommend a re-evaluation of your financial plan taking into consideration your current and future income requirements. If we haven't met with you recently, we will be calling to schedule an appointment. In the interim, if you have any questions, please do not hesitate to call.