

Economic and Capital Markets Commentary and Outlook – January 2002

Commentary — September 11th, Investment Spending Boom/Bust and The New World Order

- The events of September 11, 2001 will overshadow any review of last year, whether political or economic. From that day forward, the world operated according to a different model. The global economy, stock markets and corporate profits were already in a slump before September 11; those events just raised the level of uncertainty and, historically, markets do not respond well to higher levels of uncertainty.
- In the U.S., the stock market posted negative results for the year. It was the second consecutive annual loss for stocks, which has not occurred since the 1970s. Equity performance is a direct reflection of corporate profits and valuation levels. The stock market losses were the result of poor corporate performance, resulting from excessive capital spending in the late 1990s, weakening pricing power (disinflation), and high valuations.
- A few sectors of the economy, where earnings have been stable and valuations more reasonable, have weathered the downturn. Despite overall losses in the broad stock market during 2001, some areas bucked the trend. Small-cap stocks, mid-cap stocks and REITs posted positive results for the year. Attractive valuations and stable earnings were the primary reasons for the superior results in these sectors.
- Most economic sectors of the market declined during the year, with the exceptions being business equipment and services, capital goods and retail. Lower-than-market valuations and expectations of higher earnings growth in 2002 helped move these sectors higher.
- Despite a steeper yield curve during the final quarter, bonds were the best-performing asset class in 2001. Short-to-intermediate high-quality credits were the top performers and longer-maturity credits were the laggards. Bonds declined during the fourth quarter as investors bet on an end to interest rate easing by the Fed and economic recovery in early-to-mid 2002.
- International stock markets were even less kind to U.S. investors, with many of the developed markets posting even larger losses than the U.S. market. Large local market declines and a strong dollar contributed to

overall losses in the foreign markets. Results were mixed in the emerging markets, but most suffered the same fate as the developed markets. Capital flows to the emerging markets slowed to a trickle and the contagion from Argentina's economic misfortunes began to spread to neighboring markets.

- With the level of uncertainty increasing in the world's equity markets, many investors continued to pour money into U.S. money market funds. The level of money market assets increased to nearly \$2.3 trillion by year-end. Unfortunately, the cost of investing in those funds, plus inflation, has exceeded the average yield generated.

Outlook — High Valuations + Muted Economic and Profit Recovery = Single-Digit Returns for Stocks

- Stock valuations, based on forward price/earnings ratios (12-month earnings growth forecasts), are now back to the peak levels reached in March of 2000. The relative value of stocks to bonds has deteriorated, with stocks now trading at a 10%-15% premium to bonds. High valuation levels suggest that p/e multiples are more likely to contract than to expand over the next year.
- The consensus forecasting among Wall Street analysts is for a recovery in corporate profits during the first or second quarter, with a forecasted 2002 earnings growth rate of 16% for the S&P 500. This forecast is well above Lockwood's estimate of 7.5%, as well as those of top-down market strategists. Most analysts are relying on a quick rebound in profits in 2002 based on lower inventory levels and the low earnings base in 2001.
- A return to double-digit earnings growth is unlikely in 2002 for several reasons. There is still excess capacity in many sectors of the global economy, debt loads in the household and corporate sectors are rising to worrisome levels, overall prices are falling, and unemployment numbers are expected to move higher.
- There is little hope that a further rate cut by the Fed or a government-sponsored stimulus package will move the economy higher any time soon. Lower rates have helped sustain household consumption levels, but have done little to stem the decline in economic output. At the corporate level, lower interest rates have not made a difference. Excess capacity and lower demand have prevented a return to the capital-spending levels witnessed in the late 1990s.
- The halcyon days of annual stock market returns in the 15%-20% range are over. The extraordinary performance of stocks in the 1980s and 1990s will not likely be matched anytime soon. Our expectation is that, over the long-term (five years or more), stocks will post annual returns closer to 8%-8.5%, bonds 5%-5.5%, and that there will be little or no inflation.