Economic and Capital Markets Commentary and Outlook – July 2002

Commentary – Worst Stock Market Declines Since the 1970s, Accounting Scandals, Inflated Valuations and the Shift Toward Real Assets

- U.S. stocks continued to decline during the quarter, with stocks surpassing the peak-to-trough losses posted during the last extended bear market of 1973 and 1974. Even though most sectors of the market have turned south, areas such as REITs, gold stocks and small-value stocks have fared quite well.

- The strong rebound in stock prices posted after 9/11 through year-end 2001 was erased during the first six months of 2002. Corporate accounting restatements and allegations of fraud by companies such as Enron, Adelphia, Global Crossing, WorldCom and Xerox have shattered the hopes and confidence of investors. The restatement of earnings to account for these misdeeds and others, including the omission of stock option and pension expenses, has subtracted at least $15-$20 per share from 2002 earnings estimates on the S&P 500.

- By any measure of valuation, stocks are trading at historic highs relative to their long-term norms. Price-to-earnings ratios range from 19 to 40 times earnings, depending on whether you consider current prices relative to trailing 12-month earnings, 2002 bottom-up estimated operating earnings, or 2002 top-down estimated operating earnings.

- Bond prices moved higher and bond yields moved lower during the quarter with the 10-year Treasury bond ending the period with a yield near 4.85%. Stronger performance in the bond market was the result of investors fleeing stocks for the safety of bonds.

- International stock markets of developed countries moved lower during the quarter. High valuations, weak earnings and sluggish economic growth pushed local returns lower throughout much of Europe. Japanese stocks moved moderately higher during the quarter on improved valuations and a pick-up in foreign purchases. Returns to U.S. investors in many of these markets were dampened as both the Euro and Yen moved 10%-12% higher.

- The best-performing assets during the quarter were real assets. Real estate and gold prices moved higher during the quarter as investors looked for alternatives to financial assets (stocks/bonds). The real estate sector has been a strong performer as mortgage rates continue to slide and property values to rise. Gold prices have moved higher for some of the same reasons that bonds have moved higher. Investors perceive that real assets, such as gold, are immune to the negative forces that afflict the stock market.

Outlook – The "New" Normal: Single-Digit Returns, Economic Rebuilding and Pockets of Opportunity

- Over the coming decade, returns from stocks and bonds are expected to be well-below the average returns during the great bull market of 1981 to March 2002 and below the long-term average returns that many experts use as assumptions in their models. Nominal (before inflation) returns for stocks are expected to fall in a range between 7% and 8.5% per year, with returns for bonds between 5% and 5.5%.

- Stock market valuations for the total stock market are high by almost any measure of valuation. Dividend yields are low (1.5%), nominal earnings expectations modest (inflation expected to remain low), and p/e ratios are more likely to contract than to expand from current levels.

- P/E ratios for the entire stock market are trading in a range between 19 and 22 times next year's earnings depending on whether you apply estimates from Wall Street strategists (top-down) or Wall Street security analysts (bottom-up).

- The recent accounting scandals have soured investors and consumer sentiment remains bearish. Regulators and leaders from the corporate sector have responded swiftly. The near-term pain inflicted on investors by these scandals will eventually subside and the markets will respond to measurable attributes such as free cash flow and a company's ability to generate real profits from operations.

- The U.S. economy continues to grow at a 3.5% real rate of annual growth with improvement in areas such as industrial production, inventory rebuilding, real personal income growth, productivity and the labor market. The disconnect between the U.S. economy and corporate profits continues, with some improvement in earnings showing up in the financial services and basic materials sectors.

- Despite all the bad news and the muted expectations for longer-term gains in both the stock and bond markets, there are pockets of opportunity. Stocks that should excel during this leg of the market cycle are those with lower-than-average price-to-earnings multiples and price-to-cash flow, and higher-than-average dividend yields, credit ratings and levels of transparency.

- Investment strategies that we do not expect to fare well over the coming decade are those that embrace price and earnings momentum, expected earnings, the use of leverage or companies that do not pay out dividends.