Economic and Capital Markets Commentary and Outlook – August 2001

Commentary – Not Much to Cheer About! Does That Mean We Are Near the Bottom?

- The market has not had a lot to cheer about. Even with the Fed easing a record seventh time this year, the stock market has found little reason to move higher. The market has reacted to lower profit forecasts across most sectors for the third and fourth quarters.

- As companies struggle to maintain profit margins, the consumer continues to spend. The good news is that companies are effectively reducing excess inventories and reducing overhead. The bad news is that consumer spending has slowed recently, evidence that the ever-increasing number of job layoffs is beginning to have an impact on the investor's psyche.

- With this confluence of events taking place, investor sentiment has declined. There are now more bears than bulls, more people moving money out of stocks and putting it into bonds and money market funds. There is currently over $1 trillion sitting on the sidelines in money market funds, representing over 20% of the stock market's current value.

- All of this suggests that, when the market does turn based on the perception that earnings growth is rebounding, a lot of liquidity will be available to move it higher in a more sustainable fashion.

- What is unique about this economic slowdown is that it is global in nature. The three largest economic regions of the world--the U.S., Japan and Europe--are barely growing in real terms. For global investors, the pain of past economic slowdowns in the U.S. has usually been offset by gains in economic growth in markets such as Japan and/or Europe.

- Over the last month, there have been few places to hide in both the U.S. and overseas markets. All major groups in the U.S. market, such as large-cap, small-cap, mid-cap, value and growth, moved lower during the past month. Stocks did, however, move higher in the consumer staples sector.

- The overseas markets continued to move lower during the last month, even as the Euro moved higher relative to the dollar. Slower growth and a less aggressive monetary stance by the European Central Bank placed downward pressure on stocks.

- U.S. bond markets moved slightly higher last month as yields declined due to worse than expected earnings news and a weakening labor market. Bonds also moved higher on comments by Alan Greenspan, who stated that more evidence is needed to show that companies are increasing their capital spending and adjusting inventories. Bond prices also moved higher on a continued flight to quality due to weakness in stocks and problems in Latin America, specifically Argentina.

Outlook – Powerful Combo of Fiscal and Monetary Stimulus Should Push Markets to Recovery

- Market valuations are still slightly expensive based on current bond yields and next year's earnings forecasts.

- The Fed's aggressive stance of easing interest rates since the first of the year is just now beginning to be felt via lower home mortgage rates. This, along with the tax rebates and tax rate cuts being eased in over the next 11 years, should provide the liquidity needed to help move U.S. economic growth higher into next year.

- Even though job layoffs have recently spread from the manufacturing sector into the service sector, the overall jobs market appears to be relatively strong. Remember, most economists have said that the economy is operating at full capacity when the unemployment rate is below 5%. The current unemployment rate is hovering near 4.5%.

- Future earnings prospects are more favorable for certain sectors of the market, including health care and consumer staples, and for select companies in the utilities and financial services sectors. But earnings expectations are probably still too optimistic in the technology and telecom sectors. Investors need to focus on the long-term opportunities that exist in the overall stock market and should not be obsessed with hopes for a quick and sustained reversal in technology stocks.