Economic and Capital Markets Commentary and Outlook – August 2002

Commentary – Investors Shift Focus From CEO Corruption to Weak Economy

- U.S. stocks continued their downward trend during the month of July. The trading month was marked by heavy volume and extremely high intraday volatility, suggesting the search for a stock market bottom. In the last several weeks, 1,000-point swings have been common. Investor focus has shifted from CEO corruption and corporate scandal to a U.S. economy that has been growing much slower than once thought.

- Slower-than-expected economic growth during the second quarter, along with a recent downward revision of real GDP growth for 2001 and first-quarter 2002, stunned investors and raised the odds of a "double-dip" recession by year-end. First-quarter real GDP was revised downward to a 5.1% annual rate of growth from over 6%, and second-quarter GDP grew at a 1.1% annual rate of growth, far lower than the 2.5% many had expected.

- Real GDP growth in the second quarter, after omitting a positive adjustment for inventories (final demand sales), was negative. Consumer expenditures slowed during the quarter and business spending showed a slight up-tick, especially in the technology spending area.

- The housing sector continued to be one of the few positives in the economy despite lower sales of new and existing homes. Low interest rates, poor performance in the stock market and a large percentage of consumer wealth in the housing market continue to keep real estate prices steady in most regions of the country.

- Overseas stock markets also traded lower during July, as growth prospects remained grim (even relative to the U.S. economy) and the job market uncertain. The Euro and the Yen lost some ground relative to the dollar during the month following several months of gains.

- Bond prices of Treasury and Agency issues continued to move higher during the quarter as yields moved to historic lows. Negative results and high volatility in the stock market, coupled with a sluggish U.S. economy, contributed to the slide in yields. Based on the Fed Fund futures market, investors anticipate that the Fed will lower rates by 25 basis points by year-end and possibly by even 50 basis points.

Outlook – Economic Recovery in Question & Lower Rates Ahead?

- Weaker-than-expected real GDP growth during the second quarter, especially the final demand numbers, suggests that the economy is struggling to emerge from the recession witnessed during the first nine months of 2001. The odds of a "double-dip" recession have moved higher, but are by no means a certainty. The real possibility of a rate cut by the Fed by year-end should continue to prop up the housing market and sustain a reasonable level of spending.

- Two positives in the economy during the quarter were the slight increase in business spending and the trend toward higher corporate profits. If this trend continues into the third and fourth quarters, the U.S. economy should recover to a 3%-3.5% annual rate of growth. The job market is still the wild card with respect to economic recovery. Any improvement in the job market will be dependent on a continuation of improvement in corporate profits and a pick-up in consumer spending.

- Stock market valuations are still high based on reported and consensus forecast earnings. The market also has not yet discounted corporate earnings to include stock option and pension expenses.

- Our long-term forecasts for stocks and bonds have not changed. Stocks are expected to return 7.5%-8.5% a year, on average, over the next ten years. Bonds are expected to return 5%-5.5% a year.

- The Fed Funds rate trades near 1.75% and the trend now favors a rate cut of at least 25 basis points by year-end. While this may temporarily stimulate spending and sustain a bull market in residential housing, the real function of a rate cut is to provide an ample supply of credit to the markets during this time of global uncertainty.

- Near-term, investment strategies that favor income-producing assets, low debt, transparency and stable revenue should fare best. For stock investors (long-term investors of seven-plus years), now may be a good time to commit to actively managed equity strategies with an emphasis on quality, income (dividend yield and dividend payout), and liquidity.