

Economic and Capital Markets Commentary and Outlook – September 2002

Commentary – Weakness and Uncertainty Prevails

- U.S. stock prices continued to fall during the month of August. Stocks are down over 21% since the beginning of the calendar year and over 36% since the peak in March of 2000. Weakness in the stock market continues to be influenced by weak corporate earnings, fallout from corporate scandals and the ongoing threat of war with Iraq.
- Most economists and analysts have revised their third- and fourth-quarter growth forecasts lower due to lower-than-expected second-quarter real GDP growth, recent indications of a weakening labor market, and lower-than-expected industrial production output.
- Retail spending has been surprisingly strong despite eroding consumer confidence and businesses have yet to return to long-term trend levels of fixed investment. Inflation remains nonexistent and interest rates remain at all-time lows. Bond yields moved to levels not witnessed since 1963 due to heightened uncertainty in the economy and stock market. The “flight to safety” toward government bonds has also pushed the yield on 10-Year Treasury bonds below 4%.
- Debt levels in the consumer, corporate and government sectors continue to grow, as commodity prices remain stagnant and financial asset prices continue to fall. The risk of deflation is still present and only becomes a concern when combined with a growing debt burden and rising unemployment. In the current environment, low interest rates continue to fuel the housing market and have offset, or even postponed, a significant decline in personal consumption expenditures.
- Overseas markets have fared worse than U.S. markets, with some of the more prominent stock markets, such as Germany and France, posting larger losses than in the U.S. Real growth is negative in Germany and flat in France. Unemployment is still high in the region and both businesses and consumers have cut back their spending. The dollar has strengthened only slightly over the last several months relative to the Euro and Yen.

- Bond prices moved higher and yields moved lower during the last month as investors continued to place financial assets in safe haven investments such as U.S. Treasury bonds. Corporate bond yields continued to move higher relative to Treasury issues as investors shunned most forms of equity risk.

Outlook – Slow Growth, Weak Profits and The Risk of Deflation

- Real GDP growth chugged along during the second quarter and the prospects for a move toward a trend line rate of economic growth near 3% to 3.5% by the fourth quarter seem to be fading. Retail spending has been strong, but only due to record auto sales, a result of zero-percent financing deals. There seems to be little appetite for stepped-up purchases in most other areas of the retail consumer market. In addition, businesses have not increased their capital spending and show no signs of doing so in the immediate future.
- Corporate earnings showed some signs of improvement during the second quarter, but that trend now looks questionable due to lower economic growth forecasts for the third and fourth quarters. Businesses are still struggling to increase revenue growth due to lower demand and a lack of pricing power. Most companies continue to focus on the cost side of the balance sheet in an effort to improve profit margins.
- Stock market valuations are still rich when considering current growth expectations and current dividend yields. There continues to be a higher likelihood of p/e multiple contraction rather than p/e multiple expansion. However, certain sectors look attractive based on current price levels, current growth expectations, and the rate and depth of an expected earnings recovery. Consumer staples and financial services are two such sectors.
- We expect a recovery in stocks and a return to trend line real economic growth, but the timing of such a recovery will be dependent on clear signs of improvement with respect to earnings growth, earnings quality and a reduction in overall debt. A stronger labor market will also play a key role in the recovery process.
- We still believe that the Fed should ease interest rate policy, that stocks are too expensive, that there is a greater chance of deflation as opposed to inflation, and that the U.S. economy will continue to grow at a 2% to 2.5% annual rate. Our long-term return estimates for the major asset classes have not changed, with stocks expected to deliver between 7.5% and 8.5% annual returns and bonds between 5% and 5.5%.