Economic and Capital Markets Commentary and Outlook – October 2002

Commentary – Stocks Take Largest Plunge Since Third Quarter 1987 and Fears of the "Double Dip"

- U.S. stock prices, as well as stock prices around the globe, fell nearly 20% during the third quarter. Economic reports indicated that U.S. economic growth was showing clear signs of faltering, and that consumer confidence was eroding on fears of war with Iraq.

- Investors shunned all stocks during the quarter, resulting in double-digit losses in both value and growth styles across small, medium and large capitalization ranges. Investor distaste for equities resulted in higher inflows into high-quality fixed income securities and real estate assets. Bonds were the best-performing asset class during the quarter. Real asset groups, such as gold and precious metals, also outperformed the overall stock market.

- Stock prices moved lower on continued skepticism with respect to reported and forecasted corporate earnings. Many investors have lost all confidence in Wall Street and sell-side research recommendations. Flat real growth during the second quarter and recent news of slower retail sales also spooked investors.

- Bond yields moved to their lowest levels since the 1950s, as "flight to quality" continued to be the overall theme in the markets. Yield spreads between corporate and Treasury bonds continued to widen on concerns of defaults, especially in the global telecom sector.

- Overseas equity markets moved in the same downward direction as U.S. markets during the quarter, as economic news worsened in Europe and Japan. Financial crises in Argentina and Brazil placed downward pressure on returns in the emerging markets.

- The real estate market has been the one bright spot for investors of late. Historically low mortgage rates have contributed to a record flow of monies into residential real estate, especially in the big cities. There is the threat of a housing market bubble, as many of these markets are now overvalued by 20% to 40%, and homebuyers continue to leverage their personal financial positions.

Outlook – Deflation, War and Recession Fears: Is There Light at the End of the Tunnel?

- Despite nearly three years of declining stock prices, stock market valuations are still expensive by historical standards. The earnings "e" in p/e ratios is now suspect as investors scurry to understand real corporate profits after write-downs, stock option expenses and pension costs.

- Companies are struggling to maintain profit margins. With the lack of pricing power, revenues are flat or falling. Companies have been primarily focused on the expense side of the balance sheet. This means that they have placed business spending on indefinite hold and continue to make big cuts in personnel spending.

- The risk of deflation persists, as there is still excess capacity around the globe and the U.S. continues to import lower inflation from countries such as China. This phenomenon forces U.S.-based companies to lower prices in an effort to be competitive.

- Many fear that sluggish business and consumer spending indicates that the U.S. economy is slipping back into recession. Double-dip recessions are not unusual. Most previous U.S. recessions have experienced a double dip, and a few have experienced a "triple dip." In each case, the U.S. economy has successfully emerged based on the strength and resilience of the U.S. consumer and U.S. businesses.

- Equity and bond prices probably already reflect a majority of the bad news, including possible war with Iraq. The real recovery in the U.S. economy and corporate profits will come when excess capacities are whittled down, debt levels are reduced, and confidence returns. Investors forget that stocks compounded at an 18.3% annual rate of return from early 1982 to early 2000, higher than during any other bull market in history. It's also important to note that the last two to three years of the bull market were based on pure speculation, not improving fundamentals.

- It will take time to deflate the excesses of the late 1990s and the phantom profits in which so many invested their dreams. We will only see a sustainable and believable rally in the global stock market when p/e ratios and dividend yields return to fair value and when investors can trust corporate earnings reports. The good news is that this market cycle *will* end; the bad news is that no one can yet predict exactly when.