Economic and Capital Markets Commentary and Outlook – November 2002

Commentary – Stocks Make a Strong Comeback in October

- U.S. stock prices posted strong gains during the month of October, the biggest one-month gain since March 2000. Most sectors of the stock market posted gains during the month, with the strongest showing in the previously depressed technology sector.

- Most companies posted third-quarter results above previous analyst estimates and the market reacted in a positive manner. Corporate profit gains came in the form of higher cost efficiency, not higher revenues. In addition, the markets responded to expectations of a Fed rate cut on November 6.

- Strong consumer purchases in the auto sector were the chief cause for the 3.1% annual real rate of GDP during the third quarter. Record sales in the sector resulted primarily from the automakers that aggressively extended zero-percent financing incentives.

- Consumer spending was surprisingly resilient during October, with many of the major discounters such as Wal-Mart, Costco and Kohl's leading the pack in terms of year-over-year same-store sales. Business spending also picked up slightly during the month, as evidenced by a pick-up in computer hardware and software sales.

- The overseas equity markets also picked up steam during October with the broad-based EAFE Index up over 5%. Most markets, with the exception of Japan, posted high single-digit or low double-digit gains during October. Japanese stocks fell on the news of a failed attempt by the administration to address bank loan problems and mounting evidence that the local economy was moving back into recession.

- Bond prices moved lower and yields higher during October as investors moved out of bonds and into equities. Three years of a bear market in equities and an improved earnings outlook were the primary causes for the shift in investor attitude. Despite large spreads between corporate bond yields and Treasury bond yields, the trend in October was a slight narrowing of this yield spread, which indicated investor confidence in a U.S. economic recovery.

Outlook – Economic Growth and Corporate Profits Uncertain, Fed Eases and Republicans Control Congress

- The U.S. economy grew at a 3.1% annual rate of real growth during the third quarter, mostly due to record sales of trucks and autos. This rate of growth masked the true underlying growth rate, which remained flat. Final demand GDP numbers (ex-inventory adjustment) remain flat. Three of the largest economies in the world (U.S., Japan and Germany) are either not growing or declining.

- Corporate profit growth for most companies in the S&P 500 Index surprised on the upside during the third quarter relative to prior expectations. Despite the positive surprises, Wall Street's optimistic earnings forecasts for the next 12 months do not jive with a real economy that is growing well below the long-term trend rate of 3.5%. Earnings improvement is expected, but the market has already priced in forecasts that do not account for rising pension costs, stock option expenses and bad loan write-offs.

- The Fed recently eased its feds fund rate target from 1.75% to 1.25% in a signal to investors that the recent signs of sluggish economic growth and negative sentiment are a concern. We believe the recent Fed action is also a response to declining prices and the slowdown in Germany, Japan and the Far East. More recent Fed discussions have focused on the risk of deflation as opposed to inflation, as it would be far easier for the Fed to manage inflation than deflation.

- We believe that current stock prices reflect much of the bad news related to corporate accounting issues and potential war with Iraq. At the same time, the market does not reflect a clear consensus on the direction and timing of a full recovery in corporate profit growth. Until both the consumer and business sectors pick up the pace on spending, real economic growth is expected to grow well below the trend line, thus delaying any significant sustainable recovery in corporate profits.

- The recent departure of Harvey Pitt at the SEC and the Republican victories in both the House and Senate are also positives for the capital markets. Swift and accountable action by the SEC, as it relates to accounting reform and disclosure, is crucial toward restoring consumer confidence. A Republican majority should also provide for a favorable economic stimulus on both the tax and war fronts.