

Economic and Capital Markets Commentary and Outlook – February 2002

Commentary – Signs of Economic Recovery and Additional Setbacks for Stocks

- Despite recent indications of consumer-led economic recovery in the U.S., stocks have continued to trade lower on bad news, such as the fallout from the Enron scandal, questionable earnings forecasts and high valuations.
- Recent economic news suggests that the U.S. economy may be pulling out of its recession. Recently, the government revised fourth-quarter real GDP numbers higher. Strong home sales, a large reduction in business inventories and better-than-expected retail sales in January indicate that the U.S. economy may well be on the road to recovery.
- Even with the positive news in the household sector, it is not safe to assume that we are out of the “recession woods.” A solid and sustainable recovery will require a strong upturn in both consumer and corporate spending. The consumer is still spending, but is only buying heavily discounted products and services. The consumer is also assuming more debt to sustain this spending behavior. In the corporate sector, companies keep cutting costs (i.e., overhead) and show no signs of returning to the capital-spending levels of the 1990s anytime soon.
- Since the first of the year, most sectors of the stock market have moved lower, with the largest declines posted in the utilities and telecom sectors. The materials and consumer staples sectors have posted the biggest gains so far this year.
- Overseas equity markets have fared no better, with the MSCI EAFE Index performing even worse than the U.S. stock market since the first of the year. Only two markets have posted positive returns so far this year: Singapore and Austria. The two worst-performing markets year-to-date are Ireland and Spain.
- In the U.S. bond markets, the slope of the yield curve remains steep, and yield spreads between Treasury issues and corporate issues remain wide. On a year-to-date basis, higher-quality, longer-maturity bonds have been the best performers, reflecting the slight decline in bond yields and the high level of uncertainty that exists in the global economy.

Outlook – Accounting Problems Are Just the Latest Fallout from the 1990s Boom

- The recent fallout from the Enron scandal, combined with the declared bankruptcies of companies like Kmart and Global Crossings, has caused investors to question future earnings estimates and their reliability.
- Shorter term, more instances of creative accounting and lax corporate oversight are likely to come to light, placing further downward pressure on stock prices. Longer term, these developments should prove a positive, as greater scrutiny and review lead to more accountability.
- Stock valuation levels are still rich, based on unrealistic growth rate projections over the next three years. Most earnings estimates assume that companies will return to annual capital spending rates between 17% and 19% over the next three to five years, especially in the area of telecommunication services. These forecasts also assume that consumer demand will remain steady. Both scenarios are highly unlikely.
- There are a number of reasons to be confident about the outlook for the next few years, including: 1) the focus of fundamental research will revert back to actual cash flow vs. future earnings projections; 2) company management will refocus on managing their business rather than massaging earnings; and 3) the excesses of the 1990s will continue to be wrung out of the system.
- Recently, the U.S. economy has shown signs of recovery based on revised GDP data and stronger-than-expected retail sales, housing-related data and productivity gains. We still believe that the U.S. economy is treading on fragile ground and is most likely to move sideways, if it moves at all, for the rest of the year. Any sustainable recovery should begin to surface near the end of the year or into the first half of next year.
- Many optimists still assume that the consumer will pull the economy out of its current lull. It will take more than the consumer to revive real economic growth this time around. It will require businesses to return to strong investment spending.
- Pinning hopes for a sustainable recovery on the consumer may be ill-advised. The consumer continues to finance purchases on borrowed money, real incomes remain weak, and the unemployment situation continues to worsen.