

Economic and Capital Markets Commentary and Outlook – March 2002

Commentary – “The Great Disconnect”

- The U.S. economy continues to confound economic forecasters. Most economists have recently revised their growth forecasts for 2002 and 2003 sharply higher on the heels of strong economic growth during January and February.
- Industrial production in the manufacturing sector has recently reversed its slide, primarily due to the end of a massive liquidation of unwanted inventory. The demand side has improved slightly in both the household and government sectors. The recent massive inventory reduction has been the most significant since the end of World War II.
- Any sustainable economic recovery will depend on the strength of consumer expenditures. This recession/recovery is unlike previous ones. Consumers are tapped out, and there is little of the pent-up demand necessary for a sustainable recovery. High debt loads, bottoming interest rates and falling prices are some of the culprits.
- Stock prices here and abroad moved sharply higher over the last several weeks as investors digested the positive economic news. While the economy may be on the way to recovery, corporate profits are still weak and we believe that future expectations are too optimistic. Based on our view, stocks are still expensive. Hence, we believe there is a “disconnect” between the uncertain prospects for a sustainable economic recovery and the market’s recent performance.
- Recent gains in the stock market have helped erase the poor performance in January and most of February. Performance in the broad U.S. stock market is essentially flat on a year-to-date basis. The best-performing sectors since the beginning of the year are consumer durables, transportation and raw materials. The worst-performing sectors are capital goods, utilities and technology.
- The overseas markets have moved in the same direction as U.S. markets since the beginning of the year. A few of the Asian markets have shown strong gains over the last month in response to positive U.S. economic reports.

- Performance in the U.S. bond markets has declined since the beginning of the year due to expectations of higher interest rates on the heels of an economic recovery. The largest declines have been in longer-dated Treasury issues, with the investment-grade corporate sector performing only slightly better.

Outlook – Rich Market Valuations, First-Quarter Profits and the Fallout from Japan’s Woes

- U.S. stocks currently trade at 42 times trailing earnings and over 22 times next year’s forecasted earnings, in contrast to the long-term p/e average of 14-15. Longer-term stock returns are impacted the most by valuations. Nominal earnings growth has been consistent over longer periods, with the largest fluctuations in return resulting from change in dividend yields and p/e multiples (expansion and/or contraction).
- Dividend yields on stocks are at all-time lows and p/e ratios are more likely to contract than expand as stock prices adjust to more realistic earnings expectations. Corporate earnings will rebound as demand picks up in the business sector and companies return to a more normal pattern of capital spending.
- Corporate earnings for the first quarter will be announced soon. Wall Street expects some improvement with fewer negative pre-announcements, but more disappointing surprises than positive ones. The bottom line is that we are not out of the woods yet. Earnings will rebound, but the growth rates of the 1990s will not return anytime soon, as companies deal with a lack of pricing power, intense competition, and further scrutiny of financial accounting and reporting.
- While economic conditions are improving in the U.S., conditions in Japan continue to appear quite bleak. Economic recession, deflation, a growing debt problem and an essentially bankrupt banking system weigh heavily on Japan’s ability to emerge from the abyss. Our concern is what impact Japan’s woes may have on the rest of the world.
- In terms of capital flows, the Japanese own over one-fifth of all U.S. Treasury debt. A fair number of Japanese investors also hold stocks and direct investments in the U.S. Any reparation of capital would place downward pressure on stock and bond prices and upward pressure on interest rates. The other fear is that Japan could continue to export its deflation to the rest of the globe, as prices of imports for neighboring Asian countries and the U.S. continue to decline.
- As market valuations improve and the excesses from the boom of the 1990s get wrung out of the system, returns on both U.S. and European stocks will revert back to levels that attract capital away from risk-free assets.