

# Economic and Capital Markets Commentary and Outlook – April 2002

## Commentary – Economic Recovery, Weak Corporate Profits, Accounting Questions and Mideast Violence

- Recent economic news has been better than expected due to positive indications in the household sector, such as real personal income growth, higher-than-expected consumption expenditures, solid retail sales and higher consumer confidence numbers.
- While the consumer generates nearly two-thirds of all economic output, the recent recovery can only be sustainable and called a “full recovery” once business expenditures turn markedly higher from their current levels. Weak corporate profits mean that corporations are not returning to normal capital spending levels, but are still focused on cutting operating costs.
- Consumers are tapped out in terms of purchasing power. They have gotten the economy this far on borrowed money, low interest rates and low inflation. Debt levels are rising, interest rates may well have hit the bottom of the cycle and inflation has inched higher, especially in the energy sector. Corporations have not been able to improve profit margins through price increases so they must rely on the cost side of the balance sheet.
- A number of recent developments, ranging from the accounting irregularities that surfaced at several blue-chip U.S. companies to the escalation of violence in the Middle East, have fueled an increase in uncertainty surrounding the direction of the stock and bond markets.
- U.S. stocks ended the first quarter nearly where they began in early January. Small-cap value stocks continued to lead the rest of the market with consistent cheap valuations and improving earnings outlook. Large-cap value stocks also continued to outperform large-cap growth stocks during the quarter.
- The real strength in the stock market during the quarter was centered in the consumer durables, raw materials and energy sectors. The consumer durables sector benefited from strength in consumer spending. Strength in the materials and energy sectors can be attributed to a pick-up in manufacturing activity as well as a rise in energy prices.
- The capital goods, utilities and technology sectors continued to disappoint investors during the quarter as valuations remained expensive and the earnings outlook bleak. Excess capacity issues and weak pricing power continue to plague companies in the technology and telecommunication sectors.
- U.S. bond markets moved lower during the quarter as bond yields moved higher in anticipation of economic recovery and higher commodity prices. The best-performing sector of the bond market was the high-yield area, as investors took advantage of narrowing yield spreads over Treasury securities. The worst-performing sector was long-dated Treasury issues.

- Similar to the U.S. equity markets, the international stock markets of developed countries also ended the first quarter where they began back in January. Some of the downward pressure came in the form of a stronger dollar relative to the Yen and the Euro. Many of the local markets of Europe and Japan moved higher on hopes of economic recovery in the U.S. The top-performing markets for the quarter were Singapore, Austria and New Zealand, and the worst-performing were Ireland, Greece and Finland.
- The emerging markets posted some of the quarter’s largest gains on signs of economic recovery in the U.S. and Europe. Capital flows also increased into these markets as investors took advantage of cheap valuations.

## Outlook – Optimism vs. Delusion: Many Unanswered Questions, Yet Many Investors Too Bullish

- Wall Street continues to ignore high stock market valuations, a weak corporate profit outlook and the possibility that recent signs of economic recovery may only be temporary. The manufacturing sector appears to have emerged from the recession that began in that sector in March 2000 and consumers continue to spend. Most analysts have “upped” their earnings growth forecasts for 2002 based on these signs of economic recovery.
- The most recent recession may be the most brief in history, but don’t expect the robust recovery that has typically emerged from past recessions. Corporations and individuals borrowed heavily in the mid-to-late-1990s on expectations of a profit boom that never really materialized and lower interest rates. The leftover capacity from this buying binge, along with higher debt levels, will most likely result in a slow, gradual recovery to sustainable real economic growth.
- U.S. stock market valuations are still rich, with the S&P 500 currently trading at a p/e multiple of 21 times forecasted earnings for the next 12 months and 42 times trailing earnings. A gradual recovery in economic and earnings growth suggests that current p/e multiples are more likely to contract than to expand.
- Earnings forecasts for 2002 are still too optimistic as analysts continue to raise their previous estimates. The consensus now expects profits to grow 17% in 2002. This forecast is based on recently revised economic forecasts and the fact that profits are coming off a very low base in 2001. Historically, actual corporate profits (government-reported national account data) have correlated very closely to nominal GDP. This would suggest that the consensus forecast for 2002 is more apt to disappoint investors as actual profit growth falls well short of consensus.
- A 17% growth rate for 2002 implies that profit growth in the fourth quarter of this year will be 40% higher than the same period last year. This certainly ensures disappointment for those investors basing their expectations on these forecasts. A slower-than-expected economic recovery and lack of pricing power in corporate America are evidence of this.
- Potential bright spots still exist in the small/mid-cap sector, the value sector and Europe, as valuations remain attractive on a relative basis and earnings look reasonable relative to consensus expectations.
- The bond market is likely to trade in a narrow range until clear signs of a sustainable economic and profit recovery are visible.