Economic and Capital Markets Commentary and Outlook – June 2002

Commentary – Negative News Continues to Weigh Heavy on Stocks

- U.S. stocks continued their downward spiral on negative reports of corporate accounting practices, sluggish earnings news, new terrorist threats and indications that the U.S. economy was not growing as fast as many previously predicted.

- The market's expectation of a strong return to real growth in the U.S. was called into question as lower-than-expected retail sales for May surprised many who thought consumers would continue to maintain their previous spending levels and move the economy toward a sustainable recovery.

- Stocks have moved significantly lower since the beginning of the year with losses in most sectors. A few areas of the market, such as consumer staples, basic materials and energy, have moved higher. The biggest year-to-date losses have been posted in the telecom and information technology sectors.

- Stocks in the overseas markets also trended lower during the month. However, these losses were minimized by the strength of the Euro and Yen relative to the U.S. dollar. The best-performing area of the overseas markets has been the Far East, specifically Japan. Many institutional investors have slowly increased their stock positions in Japan based on improving market valuations and hopes for a corporate profit recovery.

- Bond prices moved higher and yields lower during the last several weeks due to negative sentiment in the stock market, weaker-than-expected economic news, and a growing overall uncertainty in the marketplace due to increased concerns over terror threats and negative news on companies such as Tyco.

Outlook – The "We Told You So" Economic Recovery and An Oversold Stock Market

- As stated in earlier commentaries, the economic recovery in the U.S. will be less robust than many expect due to a tapped-out consumer and weak labor market. Also, a full economic recovery will not be realized until the corporate sector returns to normal (long-term average) capital spending levels.

- The one strong component in the economy over the last several years--the housing sector--appears to be near a peak. The uncertain state of the labor market and bottom of the interest rate cycle, combined with the recent speculation in the residential housing sector, suggest that prices for existing and new homes have hit a peak. The recent strength of the housing sector has been one of the bright spots in this weak global economy.

- Our view of the stock market has not materially changed since 8-12 months ago. Market valuations are still rich (but now closer to fair valuation), the corporate profit outlook uncertain (with some signs of recovery in select sectors), and the economy is not yet on a clear course toward strong recovery. Stock prices have continued to move lower despite slightly improved investment fundamentals. This implies that the current stock market is oversold, as sentiment remains negative.

- Historically, the competitive nature of both the economy and the capital markets has corrected any imbalances, such as overvaluation and undervaluation. Any short-term discrepancy from underlying fundamentals is usually arbitraged away. Frequently, this process involves temporary periods of overreaction or underreaction by investors.

- Recently, investors have overreacted to the daily barrage of warnings of domestic terror threats and new discoveries in the area of corporate accounting discrepancies. Preliminary evidence shows that businesses in some sectors are beginning to rehire labor and commit more capital to longer-term projects.

- The U.S. dollar has recently weakened relative to the Euro and Yen as capital flows from overseas into the U.S. stock and bond markets have slowed. This does not necessarily signal a trend, as overall purchases of stocks and bonds by overseas investors remain strong.