

Economic and Capital Markets Commentary and Outlook – May 2002

Commentary – Stocks Trade Sideways and Accounting Surprises Keep Coming

- U.S. stocks temporarily moved out of their slump during the second week in May, spurred by positive earnings news from Tech giant Intel and encouraging economic reports, such as retail sales.
- Although recent economic news has been encouraging in the manufacturing and consumer-related areas, businesses have yet to return to normal levels of investment spending. Consumer spending has been stronger than expected, but concerns remain due to a weaker labor market and rising debt levels.
- There have been no indications of a sustained stock market rally even though buyers outnumbered sellers in recent weeks. High stock market valuations, weak earnings growth and heightened uncertainty associated with global tension in the Middle East and the War on Terror continue to weigh heavily on stocks.
- U.S. stocks continued to trade lower during April and the first half of May. Most sectors were impacted, with the exception of consumer-related sectors such as consumer durables, consumer non-durables and retail. However, almost all sectors posted positive results for the first three weeks of May.
- Overseas equity markets have fared slightly better during the last six weeks, with the biggest gains posted in Japan. Performance in the emerging markets was mixed over the same period. Investors have only recently begun moving back into undervalued areas of the Japanese market and the emerging markets. The biggest news in the global markets recently has been the decline of the U.S. dollar relative to the Euro. This trend is a result of less foreign capital moving into the U.S. markets and traders betting on an undervalued Euro relative to the U.S. dollar.
- During the last several weeks, bond prices moved lower and yields moved higher based on positive economic news and anticipation of tightening by the Fed this summer. Money market assets continued to grow over the last two months on increased uncertainty in the global stock and bond markets. Current money market asset levels are back to their late April levels.

Outlook – The Disconnect Continues and Now, The Dollar

- Even with the positive news on the economic front, earnings news and expectations remain weak. Though recent economic indicators suggest strength in the consumer spending area, there are still questions as to whether such strength is sustainable or if recent statistics are just masking a bigger problem. The labor market continues to weaken, as businesses cut expenses to improve margins.
- Unlike other boom-bust cycles since WWII, this economic recovery probably will not be robust or quick. Most quick and robust recoveries are led by pent-up consumer demand. Consumers have already leveraged their investment position via the eleven rate cuts by the Fed last year and by borrowing against the equity in their homes. At this point, a suspect labor market and higher debt loads have pushed consumers to increase their savings (liquidity) rather than invest in an expensive stock market.
- Stocks are expensive no matter how you measure valuation. P/E ratio, the most popular measure, can be calculated several ways. Stocks currently trade at a P/E ratio ranging from 22 to 42 times earnings, depending on if you consider bottom-up estimated operating earnings, reported earnings, trailing earnings or top-down operating earnings.
- The earnings picture has become even cloudier with the recent disclosure of problems with firms ranging from Enron to WorldCom. The investment industry is now also struggling with how to report the true cost of executive stock options and account for pension fund assets.
- The U.S. dollar has recently weakened relative to the Euro. While it has been stated for months that the U.S. dollar is overvalued, only recently has there been concern that a lower U.S. dollar could dampen a U.S. economic recovery and stock prices. Recent evidence clearly shows that foreign investors are committing less capital to U.S. stock purchases. A weaker dollar also suggests that the U.S. trade gap will continue to grow.
- Fiscal spending has also mushroomed well beyond previous expectations, with the U.S. government now running a budget deficit. A growing deficit, due to this major step-up in fiscal spending, will eventually have a negative impact on real economic growth.