

C *Economic & Market* o m m e n t a r y

Is That A Light At The End Of The Tunnel?

As we look forward to the new year and consider the possibilities, we should also look over our shoulder at the last two years to put the possibilities into the proper perspective. The markets had to contend with a global technology meltdown, a rapidly changing economic environment with varied opinions regarding the depth, length and breadth of the slowdown, and the shock of terrorist actions. 2002 should offer the proverbial light at the end of the tunnel.

In past commentaries, we have discussed three short-term evils of economic health: *Stagflation*, *Inflation*, and *Recession*, and the potential side effects of an overly-restrictive monetary policy. Our contention has been that policy makers would ultimately see the light and embrace policies that support economic growth and guide us past these evils. At last, it seems that policy makers, economists, and politicians are less concerned with hyperinflation and more concerned with recession. As we had expected, common measurements of inflation show minimal growth, and commodity prices, which fell rapidly throughout 2001, staged a modest recovery through year-end, still remain more than 15 percent below year-ago levels. As our domestic economic engine sputtered, the Federal Reserve began lowering short-term interest rates at a rapid clip, and we currently stand at the most accommodative levels in well over 30 years, with the “real” cost of short-term funds (interest rate less inflation rate) near zero.

By the end of 2001, the Dow Jones Industrial Average was down approximately 5.44 percent, the broader S&P 500 down 11.89 percent, the technology heavy NASDAQ was down 21.05 percent, and the Dow Jones World Index (ex-U.S.) was down 21.02 percent. For the two year period (2000 & 2001), the Dow Jones was down close to 12 percent, the S&P 500 was down close to 22 percent, the NASDAQ was down close to 60 percent, and the Dow Jones World Index was down close to 38 percent. With respect to the markets in general, we did what we set out to do...offer our clients less volatility and better principal protection.

Looking forward, the government has been debating a stimulus package to aid in the recovery, but it has been bogged down in election year politics, and has not yet emerged. While the right kind of package may help, we may have already moved past the optimal time for a stimulus package. With or without a stimulus package, it seems that the economy is already on the mend, and barring any surprises, the issue is not if, but how strong the recovery will be, and what level of profits corporate America will earn.

Economic growth is important to the growth rates of individual companies, our federal budget, and the success of our financial markets. The global nature of the U.S. economy and its impact on the rest of the world creates a delicate balance between effective economic and trade policy. There will be debates on both sides of the aisle, but in the end, when the appropriate mix is agreed upon, we will move forward.

We have to believe that after the economy recovers, the Federal Reserve Governors will embark on a mission to take back the recent rate cuts to build in room for future cuts, when economic conditions dictate. This will be aided by an increase in the demand for funds and an increase in the “real” cost of funds towards historic levels. The combination of these forces will ultimately push interest rates a bit higher. The turnaround in the equity markets (typically a leading economic indicator) seems to indicate that the economy has finally gained traction. As mid and long-term interest rates have risen since October, others may see the same writing on the wall. We have maintained a bond investment strategy of owning the highest-quality bonds and have kept bond maturities on average between 4 and 8 years to earn decent interest income, and limit principal and interest rate risk in client portfolios.

Opinions regarding the level of projected corporate earnings range from a drop of 5 percent to an increase of over 10 percent in 2002. These projections coincide at times with the analysts’ economic growth projections and at other times with the analysts’ opinions regarding how effectively corporations will convert revenue into earnings. The width of the range reflects the inherent risk in the market. While we believe that profit growth will be healthy, which could lead one to embrace more aggressive investments, we are more comfortable owning companies with clearly visible revenue and earnings streams, and lower debt levels. Since we are taking a more conservative position with our investments, we may lag the overall market if 2002 turns out to be a terrific year, but should also experience less volatility and offer better protection of principal should something go wrong.

There are a number of positives that should benefit corporations, consumers and investors. On the borrowing front, the aggressive rate cuts by the Federal Reserve have decreased the cost of short-term funds to corporations and consumers, and the lower mortgage interest rates that followed have reduced the long-term financing costs for homeowners. We have sharply lower energy costs which reduce the operating costs of cars, homes, and many industries, and gradually falling tax rates in the coming years. If we concern ourselves with the “employment” rate (close to 95%), these trends put a tremendous amount of additional money into the hands of consumers, corporations, and investors. With short-term rates at historic lows, many investors are challenged to find attractive rates of return without assuming some market risk. These factors combined should be crucial building blocks for an economic recovery and better markets.

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