STELLAR
CAPITAL MANAGEMENT, LLC

Economic & Market
Commentary

Year of the Cockroach

While dining in a Chinese restaurant on Christmas Eve, our conversation turned to the name of the Chinese year. While the Chinese calendar is not perfectly correlated with ours, for the most part, 2002 was the Year of the Horse. For American businesses, a better name might have been the Year of the Cockroach. The aftermath of 9-11, the regular "perp walk" of fallen corporate leaders, and a mad scramble for profitability led many corporations to act like a cockroach and seek out a small crack in the economy to crawl into and hide. In this "just in time" business environment businesses cut head counts, marketing budgets, capital expenditures, and kept inventories at bare minimums. What was the impact on the markets? Stocks fell and bonds rose.

As 2002 comes to a close, we log into the record books the third straight negative year for the Standard & Poor's (S&P) 500 Stock index. This index has not produced a negative return for three consecutive years in 60 years. Specifically, the S&P 500 index was down 22.10 percent and the S&P Global 100 index was down 23.57 percent for the year. The bond market indexes were generally higher as the 10-year Treasury bond interest rates followed the trend of the stock market indexes. When stocks dropped, Treasury yields dropped as well, pushing Treasury bond prices higher. The Lehman Aggregate Bond Index was up 7.34 percent for the year and a cumulative 30 percent for the last three years. For the same three-year period, the S&P 500 index was down approximately 38 percent and the S&P Global 100 index down approximately 43 percent. The last time we had *four* down years in a row? 1929 – 1932, and a few times (the actual number depends on whose data you're looking at) in the 1800's, based on my interpretation of reconstructed data for the S&P 500.

On the other hand, the economy, as measured by Gross Domestic Product (GDP), has performed much better than the stock market averages would have us believe. Economic growth for 2002 should come in at about 2 ¾ to 3 percent, and for the three-year period (2000, 2001, and 2002), GDP looks to be ahead almost 7 percent. Expectations for GDP growth in 2003 are in line with economic activity for 2002, although some upward revisions are possible in the second half of the year. Inflation, another widely-watched economic indicator, has been registering about 2 ½ percent on average for the last three years. Actually, it is the fear of deflation (falling prices) rather than inflation that is currently capturing headlines.

Previous *Commentaries* have addressed the apparent disconnect between stock market performance and economic performance. While investment performance isn't measured by economic growth, over the long-term the two are correlated. The economic indicators are reflecting a growing economy, just not the breakneck pace of the late 1990's. The enthusiasm for equities is not at the level experienced in the late 90's and we must be prepared for this lack of enthusiasm to permeate the markets for a while. That

doesn't mean that the stock markets are dead, it means they are not likely to be as exciting (both up and down) as was the case during the last five years.

During the year we had a shift of control in the U.S. Senate and towards year-end an unplanned change in the Senate Majority Leader as Trent Lott resigned and Bill Frist, the Senator from Tennessee, was chosen to replace him. President Bush also nominated Stephen Friedman (former Co-Chair of Goldman Sachs) to replace Larry Lindsay as Economic Advisor and nominated John Snow (former C.E.O. of CSX Corporation) to replace Paul O'Neil as Treasury Secretary. In addition, William Donaldson (Co-Founder of Donaldson Lufkin Jenrette, and former head of the NYSE) was nominated to head the Securities Exchange Commission, filling the position left open after Harry Pitt resigned. These changes should lead to less political infighting, more focus on the Bush agenda, and potentially more growth oriented policies. Balancing the need for economic growth with budget issues at both the federal and state level, combined with the destabilizing effects of potential military confrontations will be challenging.

This conundrum did not go unnoticed by corporate America. As businesses crawl out from the cracks in the economy, capital investment has become more deliberate and "return on investment" oriented, and will continue to be such throughout 2003. Companies that are pursuing growth strategies are doing so in a more cautious manner, with every attempt being made to capture the low-hanging fruit first. The successful companies will capture market share, improve productivity, and maintain or improve profitability. Having a Federal Reserve Board that has stated that it "will take all measures" to avoid deflation, and that is "not concerned with inflation" is in the economy's favor.

We believe the best strategy in the current environment is to keep investment portfolios positioned to "wait out" the markets and focus on capturing a competitive yield along the way. Simply put, there is a greater focus on total rate of return (income + appreciation) rather than just capital appreciation at this time. For the equity markets, appreciation will ultimately come. While we wait it out, our objective is to earn a competitive yield in relation to the 10-year treasury, and seek out selective growth opportunities for the equity component of client accounts. Our fixed income strategy is to capture a yield competitive with the 10-year treasury without all the inflation risk associated with a longer-term bond. When the economy and corporations show that they indeed are not down for the count, valuations should improve, and dismay should be replaced by hope.

Steve Taddie
Managing Member
January 2003