

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

One Step Forward, Two Steps Back

One of the more popular themes currently being discussed in investment circles is the apparent disconnect between the financial markets and the economy. There has been an upturn in the economic numbers recently, but a downturn in the stock market. The bond market has been mixed, as inflation fears drive yields up (prices down) one day, and double-dip recession fears drive yields down (prices up) the next. At some point, the economy and the investment markets performance must converge. The question is, which one will do the converging?

At the end of the first quarter, we took the stance that the economy was improving, and that the markets should follow suit. Since that time, economic data has improved, but lingering accounting concerns, escalation of turmoil in the Middle East, and new terrorism concerns have contributed to a lack of investor confidence. There has also been debate about the durability of the U.S. economic recovery. With this debate comes a host of other issues including the exchange rate of the Dollar, the level of corporate earnings growth, and the health of Federal and State budgets. It doesn't seem to be any one issue, but the combination of issues that has kept buyers at bay.

Accounting issues have continued to plague the markets. They have damaged confidence in Corporate America and detracted the markets from improving economic news. While the actions of a handful of corporate leaders remain front-page news, we do not believe these actions represent the norm for Corporate America. The allegations, headlines, investigations and resolutions of accounting issues will all have to run their course. Some new regulations will likely be enacted as a result, and this should be healthy for the financial system, however, regulations alone will not restore the public's confidence; it will have to be earned.

The questions regarding the durability of the recovery, deficit spending, the value of the U.S. Dollar, and the combined impact on U.S. inflation levels are important. We have raised these issues in previous commentaries, but we still don't see convincing signs that a decided increase in inflation is either here, or just around the corner. The Dow Jones Commodity Index, while rising in the last 6 months, is still near levels from three years ago, and many companies are still experiencing a lack of pricing power.

This combination of issues has caused the market to shorten time horizons and focus on what can be counted this quarter. Companies whose values depend more heavily on future profits and have more complicated financial structures are much more susceptible to these issues. Many people talk about the value of stocks in terms of a P/E multiple (price per share divided by earnings per share). The price of a stock is the dependent variable, in that its value depends on both earnings, and what "multiple" the market will pay for those earnings. If the earnings are \$1.50/share and the market is willing to pay 20 times earnings (P/E = 20), then the price of the stock would be \$30. Reducing the earnings by \$0.15 per

share, and using the same P/E of 20, the resulting price is \$27. If however, the markets determine that a P/E of 18 is a more appropriate valuation, the price of the stock would be \$24.30 $((\$1.50 - \$0.15) \times 18 = \$24.30)$). As you can see, the combination of the two events can drag a stock price down dramatically. Earnings are driven by corporate performance and the multiple is typically driven by investor confidence. Whether the opinion regarding corporate earnings or the multiple are right or wrong, both events serve to lower the stock price in its own ways. In the midst of this environment, we are seeing some companies gaining market share, and setting themselves up to capture more of the growth available in a particular industry in the future.

Another issue that may be weighing on the market without getting much press is “nominal” Gross Domestic Product (GDP) growth. This is a measure of economic growth without an inflation adjustment. For instance, if the economy grows at a rate of 5 percent, nominal GDP growth is 5 percent. If there is 2 percent inflation, “real” GDP growth equals 3 percent. Typically, GDP estimates and reports are made on a real basis. That’s a good measure for the economy, but may not be the best measure for expectations of corporate earnings, because corporations measure revenue and earnings growth on a nominal, or non-inflation adjusted basis. If, as in the previous example, the economy grew at a 3 percent nominal rate, with 0 inflation, real GDP growth would still be 3 percent. Corporations stand a better chance of increasing revenue in the first example, as economic activity coincides with corporate activity. Economic growth is the keystone to pulling our equity markets out of the mire.

Will the market pull the economy down to its level, or will the market regain its confidence and converge on the economy. Tempering my natural bias, which favors the benefits of a highly liquid equity market as a means to participate in the long-term growth of the economy, I still believe the markets will eventually converge on the economy. Diversification is the key strategy that will see investors through the choppy markets, and past the turmoil *du jour*.

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