

C *Economic & Market* Commentary

Running the Course

The economy always has been a combination of up and down cycles. To smooth out the cycles, the government has typically used a combination of policies designed to provide a counter balance to the current economic cycle. Like the story about Goldilocks and the three bears, we seem to like things, “not too hot and not too cold,” and history suggests there really is some sense to hovering right around the middle.

Currently, the best way to describe how many corporations are operating in this economic environment is cautious and guarded. Unsure about the level of business activity in their own industries, corporations seem to be just keeping pace with demand, and not willing to go too far out on a limb forecasting, or betting on future activity. With new business activity having slowed, firms are managing labor costs more effectively, reducing capital expenditures and looking to gain market share from their competitors. Banks are contributing to the slowdown as tighter lending requirements have led more banks to invest in government bonds and create fewer loans, thus slowing the expansion of credit, as shown in Exhibit 1, which is critical to the expansion of the economy. Industrial production, while turning up recently, has also lagged as shown in Exhibit II.

Exhibit I

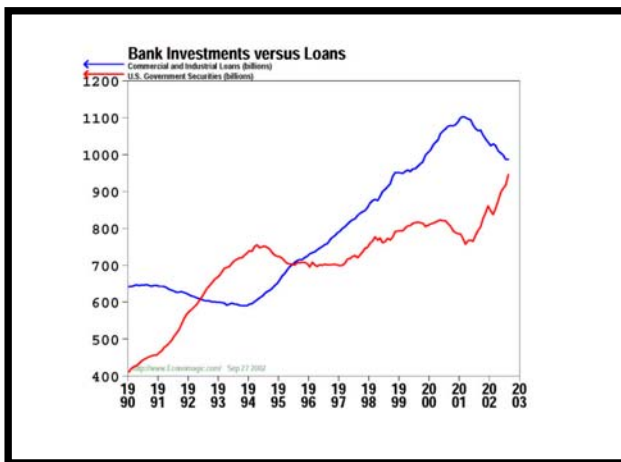
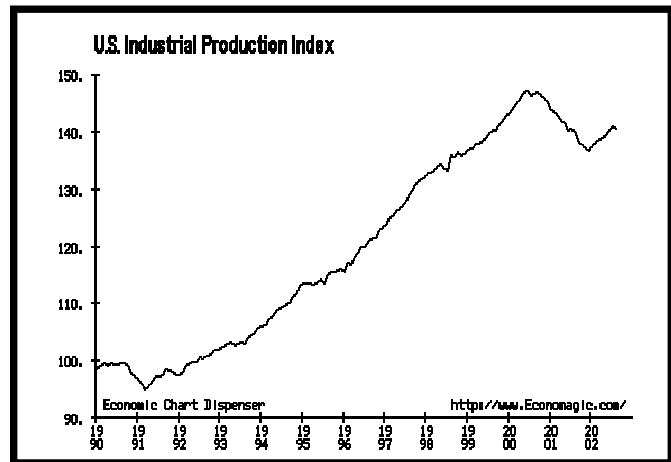
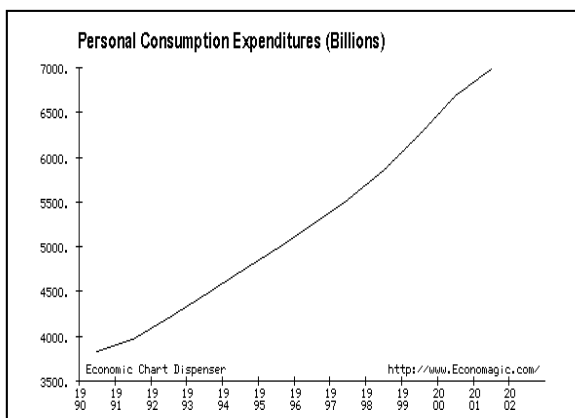


Exhibit II



Even though consumer confidence numbers have trended lower, consumer spending has continued to march forward, carrying the economy with it, as can be seen in Exhibit III, despite corporations having become more nearsighted. During this cycle in the economy, the government has used a few tools to encourage economic growth. These range from the reduction in the Fed Funds rate, the tax refund and the tax cut, to increases in defense spending and talk of restructuring the tax code to create a more favorable environment for business and investors.

Exhibit III



The S&P 500 has fallen 28.26 percent for the year. The forward price/earnings ratio (P/E) on the S&P 500 stands at 17, and the average dividend yield is 1.86 percent. The Lehman Brothers Composite Treasury Index is up 11.40 percent for the year, and the 10-year Treasury note is currently yielding 3.60 percent. AAA-rated corporate bonds yield 4.95 percent, roughly 37 percent more than the 10-year Treasury, and this differential increases as one compares lower-rated, but

still investment grade corporate bonds. From an investment standpoint, if we compare the three-month Treasury bill and the 10-year Treasury note at the end of the quarter, we see the three-month bill yielding about 1.53 percent and the 10-year note yielding about 3.60 percent. In terms of P/E ratios, the three-month note has a P/E of more than 65 and the 10-year note a ratio of more than 27. This is for a guaranteed flow of income and guaranteed principal repayment. For the time being, investors are seeking the shelter of something that has a guarantee associated with it. This “flight to quality” has caused a few things to happen in the investment markets. One very obvious result has been the continued slide in the equity market, and the increased interest rate differential between government bonds, corporate and municipal bonds.

When I consider the business climate in three to five years, or even 10 years out, I believe that the large, financially sound businesses will be prospering. If that is the case, these firms are likely to make enough money to pay interest due on their bonds, and support current dividend levels. If their businesses are run smartly, they should have the ability to both increase earnings and increase dividends paid to shareholders. Furthermore, the markets should support higher valuations. While I don’t know when, I do believe that a company with the ability to increase earnings and dividends should be valued more highly than a bond paying a static yield, especially at these low interest-rate levels. Ultimately, others in the market should come to the same conclusion.

That being said, allocations to stocks for our more risk-averse clients have been maintained at lower levels, with more of a focus on dividend paying situations. Bond allocations, where applicable, have been limited to U.S. Government and high-quality tax-free bonds (where appropriate), often using shorter maturities and/or adjustable coupon features where yields can rise if overall interest rates rise as well.

While it has been difficult to be enthusiastic about stocks in the face of the unrelenting decline in the stock market, we are encouraged when we look at the economic fundamentals and the valuations of individual companies in many sectors of the market. We may not be able to predict the near-term direction of the market, but our years of experience tell us that the stock valuations we see right now are compelling.

Steve Taddie
Managing Member
October 1, 2002