

Goelzer Investment Management
Economic & Market Review and Outlook
April 9, 2001

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In a near mirror image to the first quarter of last year, the first three months of 2001 have been difficult for equity investors as stocks moved sharply lower, continuing the losses of the latter half of 2000. After attempting a brief recovery in early January on the heels of the surprise cut in interest rates by the Fed, all major stock market indices plummeted as a result of an onslaught of earnings warnings and fears of a possible recession. The Nasdaq had its worst quarterly loss since its inception in 1971, while the Dow Jones ended the quarter below the psychologically important 10,000 level. When the reports are in, corporate earnings for the first quarter for the S&P 500 companies are expected to be the worst we have seen since 1991.

But amid all the pessimism, there exists signs of a possible turnaround in the upcoming months. It is human nature to view the current environment and extrapolate its continuance for the foreseeable future. Just as a case can be clearly made for the existence of irrational exuberance this time last year, an equally compelling case can be made for the current irrational pessimism. Mr. Greenspan was right in theory when he made his famous statement about irrational exuberance in December of 1996, but several years early!

The Economy

- The U.S. economic slowdown, induced in large measure by the six interest rate increases orchestrated by the Federal Reserve, accelerated this past quarter, and the drop was much sharper than previously anticipated. In particular, the manufacturing sector has been hard hit by a combination of overcapacity and weakening demand. The drop in stock prices and the corresponding loss of wealth have also shaken consumer confidence.
- As a result, the Federal Reserve has *cut* interest rates by 1.5% since January in an aggressive move to revitalize the economy and restore confidence in the economic markets.
- The U.S. unemployment rate rose to 4.3% in March, its highest level in 20 months, as businesses cut payrolls by 86,000. While unemployment is still at historically low levels, the job market is clearly beginning to weaken and some economists fear a snowball effect. This latest sign of a slowdown in the world's largest economy almost guarantees a further interest rate cut at the Federal Reserve's next meeting on May 15th, if not before.

Outlook: Despite the negative economic news, we believe the U.S. economy is not currently in a recession, which is defined as two quarters of consecutive negative economic growth, and is not headed for one in the near future. With the Federal Reserve aggressively cutting interest rates, we believe the economy will stabilize and continue to grow, albeit at much lower rates than the above-trend growth of the past few years. Again, we anticipate the Federal Reserve cutting interest rates another 50 basis points on May 15th or perhaps sooner if ensuing economic releases warrant. Given that interest rate cuts usually take about six to nine months to affect the economy, we believe the fourth quarter of 2001 and first quarter of 2002 is when the real effects of the current Fed action will be felt. In addition, the economic stimulus package currently being prepared by the Bush administration should act as another boost for the economy.

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Stock Market

- The weakness in technology shares spread to the general market as the S&P 500 ended the quarter down nearly 12%. The Nasdaq fell a tremendous 25.5% for the quarter and hit a 29-month low. A major slowdown has hit the technology sector and nearly every major technology firm has warned of lower revenue and earnings for 2001.
- The myth that the technology sector is immune to cyclical slowdown has clearly been dispelled, but share prices now are more than adequately discounting the earnings that we foresee in coming quarters. The bar has been lowered, as expectations are now very low contrasted to this time last year. Consequently, the stage is set for a shift to positive results relative to expectations as we move into the latter months of 2001 and into 2002.
- The upshot to the recent declines in share prices has been a dramatic increase in cash available for investment, primarily in money market accounts. Over the past twelve months, money fund assets have increased by over \$400 billion, to the highest level ever, now in excess of *\$2.1 trillion!*
- Bottom line, key measures of sentiment, valuation and liquidity are now at the most favorable level since the third quarter of 1998. While it will take some time for a sustainable market bottom to form, and the next two quarters will likely continue to be challenging from an earnings perspective, most of the damage from this bear market is behind us, and better days for equity investors lie ahead.

Outlook: The key question now becomes how much of the current economic weakness is already factored into stock prices. The stock market tends to overreact on both good and bad news, and we believe current market prices reflect an overreaction to the downside. With earnings expectations so low, any good news or even a lack of bad news will serve as a catalyst for a market rally. Market sentiment is extremely negative, and it is at times like this when a bottom begins to form. We expect the markets to stabilize in the short-term and begin building a base from which a sustainable advance can occur as earnings recover with the economy.

Bond Market

- As of January of this year, corporate/treasury yield spreads had widened to the largest levels in over a decade. This widening was in large part a flight to quality move into intermediate Treasuries, taking their yields to the lowest levels since the 4th quarter of 1998.
- This presented an opportunity for our clients. Where appropriate, we took advantage of these yield spreads by purchasing investment grade corporate bonds. This is the just the second time that we have felt spreads justified the higher risk inherent in corporates in several years.
- For our taxable clients, municipal bonds were offering tremendous value as the quarter began. While yields on intermediate term Treasuries declined sharply during the first quarter, municipal bond yields have not fallen nearly as much. Consequently, intermediate maturity muni yields are near parity to Treasury yields, yet interest earned is exempt from federal, state and local income taxes.

Outlook: While current economic weakness may warrant further Fed interest rate cuts in the near-term, the combination of these cuts, tax relief by the Bush administration, higher tax refunds and record levels of mortgage refinancing activity will allow the economy to stabilize and psychology to improve as 2001 unfolds. These factors will likely lead to *higher* Treasury yields later this year, in our view. With this view in mind, we have maintained our focus on maturities in the 3-5 year range, which have benefited most from recent moves by the Fed to lower interest rates. As the economy shows signs of

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improvement, we anticipate the corresponding rise in bond yields to provide an excellent opportunity to extend maturities at more attractive yields.

DJIA 9878.78 S&P 500 1160.33 10 Yr. US Treasury 4.915%