

Goelzer Investment Management  
Economic & Market Review and Outlook  
**April 3, 2002**

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Ah, springtime in Indiana. The flowers are blooming, the trees are budding, and the Hoosiers are playing for the National Title. All is again right with the world, or so it would seem! Regardless of the outcome, our heartfelt congratulations go out to the Indiana University basketball program. Job well done! In the financial markets, however, investors experienced a mixed bag. Numerous signs that the economic climate in the U.S. is improving more rapidly than most prognosticators anticipated are being weighed against the prospects of rising interest rates, higher energy costs, and the continuing uncertainty surrounding the war against terrorism. This brighter outlook for the economy and, in turn, earnings has helped to restore investor confidence, following the near crisis of confidence inspired by the Enron debacle and ensuing heightened scrutiny of accounting practices. While the improving economic backdrop bodes well for earnings and the stock market in general in coming months, other factors may work to restrain exuberance as 2002 unfolds, as outlined below.

### The Economy

- As we mentioned last quarter, a combination of massive economic stimulus, monetary and fiscal, domestic and global, following the attacks of September 11, worked to blunt the duration and severity of the recent economic downturn. The manufacturing sector, especially hard hit by weak demand and excess capacity and inventory, has shown renewed signs of life, as new orders were received by factories in March at the fastest pace in more than 14 years.
- Similarly, while the U.S. unemployment rate is expected to have inched higher in March to 5.6%, near its highest level since 1994, the picture is improving. Personal income and spending have remained remarkably strong during the recent period of economic weakness and uncertainty. Since the consumer is responsible for approximately 2/3<sup>rd</sup>s of the economy, this resiliency has also helped to mute the decline.

**Outlook:** The U.S. economy appears to be firing on all cylinders once again, as growth this quarter will be significantly ahead of estimates. However, several factors will work to mute the strength of this recovery phase in coming months. Current consensus estimates call for the Fed to begin raising interest rates as soon as its next meeting in May. If the Fed moves too aggressively, higher interest rates may work to restrain economic growth going forward. Likewise, higher energy prices arising from increased demand as well as renewed unrest in the Middle East may also act as a drag on earnings and economic growth in coming months. In all, barring further unforeseen surprises, 2002 will prove to be a year of solid growth for our economy, and the recent recession will prove to be the mildest of the post-war era.

### Stock Market

- First quarter performance in the equity markets favored old economy stocks over new, as witnessed by the relatively strong showing from the industrial sector, versus flat results for the broader market as measured by the S&P 500 and a 5% decline for the tech-heavy NASDAQ Composite.
- Economically sensitive, energy and consumer related sectors performed best during the first three months of 2002, while telecom and related technology sectors continued to struggle with excess capacity and weak pricing. However, as we alluded to last quarter, selectivity and stock selection were critical elements to determining results during the quarter and will continue to be key to performance for the remainder of 2002.

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- On the earnings front, 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 2002 unfolds. Look for the upcoming reporting period to reveal far more positive surprises than in recent quarters.
- Bottom line, shares of many of our favorite companies have recovered quite nicely since the lows of last September. As such, valuation and sentiment indicators are now not nearly as bullish as we would like to see. While the earnings outlook is clearly improving, valuations and rising interest rates will likely prevent an explosive rally from this level in the near term. Most of the damage from the bear market is behind us, and better days for equity investors lie ahead, but overall returns from equities will likely be modest in 2002.

**Outlook:** The key questions for the balance of the year remain how much of the current economic recovery is already factored into stock prices and, of critical importance, is this recent economy strength sustainable. With earnings expectations low, good news in the upcoming reporting period may serve as a catalyst for a market rally. However, stocks in general are not inexpensive based upon traditional measures of value and are clearly anticipating a solid earnings recovery in coming quarters. If our friends at the Fed do not become overly zealous in their next round of tightening, this recovery will be real and sustainable, providing the backdrop for the strong earnings gains that are necessary to propel share prices higher from current levels.

## **Bond Market**

- Following the Fed's final rate cut of 2001, the federal funds rate now stands at 1.75%, down from 6.5% in January 2001. At its last formal meeting, the Federal Open Market Committee moved from a bias toward further rate cuts to stimulate the economy, to a neutral stance, stating that the risk between economic weakness and rising inflation are now balanced. This is generally viewed as setting the stage for rate increases by the Fed should the economy continue to accelerate.
- Responding to signs of renewed growth, bond yields rose during the first quarter, with shorter-term yields rising more than long, reflecting this view that stronger growth may lead to rate hikes by the Fed in coming months.
- Within sectors, in general terms, mortgage-backed securities turned in the best showing during the quarter, followed by Agencies and high-grade corporates. U.S. Treasuries fared the worst, as money moved out of the relative safety and liquidity of Treasuries in search of higher returns.
- Not surprisingly, in the face of rising interest rates, shorter maturity securities fared better than their longer-dated brethren did. As mentioned last quarter, we have intentionally maintained a short average maturity in our client's portfolios, in anticipation of this rise in yields.

**Outlook:** Given our view that economic growth will reaccelerate as 2002 progresses, we see little incentive to buy longer-dated bonds, but rather have tended to keep maturities toward the short to intermediate sector of the yield curve. In the near-term, however, we will continue to take advantage of any increase in yield spreads by purchasing high quality corporate bonds and enhancing current income by taking advantage of the widened spreads currently offered by Agencies.

**DJIA 10198.30 S&P 500 1125.40 10 Yr. US Treasury 5.28%**