

Goelzer Investment Management  
Economic & Market Review and Outlook  
**October 1, 2002**

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**Incredibly**, it's been three years since the technology stock craze of the late 1990s began its unsustainable crescendo: the NASDAQ composite index appreciated more than 48% during the fourth quarter of 1999, before peaking in March of 2000. The tale of the tape since has been quite different, of course, and has provided financial historians ample opportunities to draw comparisons with other volatile periods. In particular, much has been made of the similarities between the Japanese bubble of the 1980s and our own speculative excesses a decade later. There are a number of differences between the Japanese scenario and our own, though. To begin with, the U.S. Federal Reserve has been much more responsive in cutting interest rates than its Japanese counterpart. An earlier stimulus will most likely yield an earlier response. Too, U.S. corporations have been much quicker to curtail capital spending in the face of declining demand. This has caused significant pain in the short run as earnings across the economy have been negatively impacted, in many cases quite dramatically. The upshot however, portends brighter days ahead in the manufacturing sector, as inventories have been reduced more quickly, thereby facilitating future new production. Finally, the Japanese commitment to lifetime employment meant that labor costs were fixed. While painful for anyone who's been laid off, U.S. corporations have benefited by being able to manage labor costs more effectively. In sum, while no one can say with certainty when happy days will be here again, we believe they'll return much more quickly here than in the land of the rising sun.

### The Economy

- Not surprisingly, the Conference Board's consumer confidence index has continued its recent decline in the face of accounting irregularities, economic and earnings uncertainty, Iraq saber rattling and unrest in the Middle East.
- However, several bright spots remain in the outlook for the economy. Notably, durable goods orders have extended their recovery—albeit in a non-linear fashion—from the trough in the second quarter of 2001.
- Mortgage re-financings have reached record highs as homeowners take advantage of forty-year lows in consumer lending rates, supporting the thesis that the consumer may continue to buttress the economy in coming months.
- The Federal Reserve left the target federal funds rate at 1.75%, though it maintained an easing bias. Two of the twelve voting members dissented in the vote, indicating a greater likelihood that the Fed will cut rates at, or possibly before, its November meeting.

**Outlook:** How bad are things right now, economically speaking? While household net worth has dropped with the decline in the stock market, its descent has been mitigated by the appreciation in the real estate market. Also, unemployment continues at levels considered to be a very acceptable in a market economy. The refinancing boom has significantly increased household discretionary cash flow, thereby increasing purchasing power. Moreover, the steady increase in durable goods orders points to an eventual increase in capital expenditures by businesses. Remember, many businesses chose to replace entire computer systems in anticipation of Y2K in late 1999, rather than opt for expensive upgrades to existing legacy systems. Those systems are now three years old, and in many cases lacking in CPU and/or storage capacity. The eventual upgrade cycle will occur, and each passing day brings us closer to this resumption in business spending on technology as well as other capital equipment. While overall economic growth will likely remain subdued in the immediate future, the catalysts are in place for sustained economic

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expansion. Contrary to popular opinion during the roaring days of the late 1990s, we have not eliminated the business cycle. As our ability to anticipate and respond to macro-economic trends increases in the information age, we may expect more muted recessions, but slower recoveries as well. However, as long as the long-term trend for the U.S. economy is upward—and we see no reason why it isn't—Americans' standard of living in the long run will advance as well.

### **Stock Market**

- September was indeed a cruel month for stocks, culminating in the major indices' worst quarterly showing since 1987.
- Over the past year—for the first time since 1988—equity mutual funds experienced net out-flows on an annualized basis. Net redemption from equity funds totaled approximately \$15 billion over the period. Large net outflows from equity mutual funds have tended to be a very effective contrarian indicator, with double-digit stock returns following similar extremes in the past.
- Indicating the relative attractiveness of stocks versus bonds, as the quarter drew to a close, the dividend yield on the S&P 500, at 1.9%, exceeded the 1.7% yield on the two-year Treasury, the first time this has occurred since 1958.
- In light of recent events, investors are not cash poor but rather risk averse. Record levels of cash, nearly \$5 trillion dollars, are currently invested in low-yielding savings accounts and money market mutual funds, with average yields now under 1.5%. As sentiment improves with the economy, even a modest shift back to equities would represent a significant positive for stocks.

**Outlook:** Sentiment in the market place improved during the month of August, as successes in the war against terrorism became evident and investors gained confidence that corporate financial reports would be scrutinized. Since then, negative earnings pre-announcements, mixed signals on the economy and the possibility of an extended military campaign in Iraq have caused stocks to again retest their lows for the year. It is important to remember that markets form sustainable bottoms over a period of months, not days or weeks. We continue to feel that an increase in business capital spending will be needed to lead the economy and the stock market out of the doldrums. Of course, no one can be certain when that will begin. We are, however, finding that shares of many very high quality companies are now trading at valuation levels and dividends yields not seen in over five years. An improving economy, reasonable valuation, low inflation and interest rates coupled with all-time high cash levels give us confidence that the worst of this bear market is likely behind us.

### **Bond Market**

- Bonds continued to provide some solace to investors during the latest quarter, as prices rose and yields continued their decline to levels last seen in 1961.
- Treasuries, the ultimate safe haven during a flight to quality, performed best during the quarter, returning approximately 7% on average to investors.

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**Outlook:** How low can interest rates go? The Federal Reserve appears concerned to “keep some powder dry” in the event that another major shock to the system should produce a strain on liquidity. Normally, the Federal Funds rate is targeted to be 1% lower than the yield on the two-year Treasury note, now at about 1.7%. That this spread has become negative indicates that the market anticipates another rate cut before year-end. We feel, however, that the next *significant* move in interest rates will be up and accordingly have continued to concentrate on bonds in the short to intermediate section of the yield curve. Among fixed income sectors, we see the best risk-adjusted potential returns in government agency securities. In light of record low bond yields and the relatively steep short end of the yield curve, we continue to look at opportunities to capture return by, where appropriate, “rolling down the yield curve,” that is, by selling appreciated bonds as they approach maturity or a call. As market sentiment improves and the recent flight to quality trade begins to unwind, especially in the short end of the Treasury curve, we will look to extend our portfolio duration (weighted-average maturity).

**DJIA 7591.93 S&P 500 815.28 10 Yr. US Treasury 3.63%**