

Goelzer Investment Management
Economic & Market Review and Outlook
July 1, 2003

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On June 1, 1975, American movie audiences were first treated to a thoroughly frightening adaptation of Peter Benchley's best selling novel *Jaws*. As the film moved toward its climax, everything was going wrong: the boat was sinking, the shark had gotten the best of the old sailor, Quint, and, as far as Police Chief Martin Brody knew, it was simply a matter of time before he joined Hooper and Quint as victims of the great white shark they had set out to defeat. Of course, the Chief heroically destroys the shark with mere seconds to spare and then discovers that Hooper—stunned and hiding out with his SCUBA gear near the ocean floor—is alive and well. The movie ends with the two of them exhausted but safely paddling back to shore. What's the moral of this story? Despite Chief Brody's dire circumstances he stayed focused, remained collected, and ultimately won the battle. Feel familiar? Whether we've just entered the next bull market or not, we can all breathe a bit more easily after the recent rally in stocks. Patience, discipline, and an accurate understanding of your financial and psychological capacity to accept risk have helped you weather the storm. We're not yet interested in striking up the tune "Happy Days Are Here Again," though we do feel that the rays of sunlight now shining on investors are a reward for staying the course. Congratulations! Your fortitude has begun to pay off—and will continue to do so in the months and years ahead.

The Economy

- The U.S. housing market remains strong, with building permit issuance growing at a rate faster than anticipated. Housing starts, too, have been strong, growing 6% from April to May.
- The consumer price index (CPI) remains steady at 2.1% year over year. Core CPI (excluding price changes in food and energy) stands at 1.6%.
- The unemployment rate has edged up to 6.1%, though it appears that the number of workers initially filing for unemployment compensation has started to decline.
- Capacity utilization remains low at approximately 74.5%. Expansionary periods are characterized by sustained capacity utilization rates of 80% or higher.
- Leading economic indicators were higher in June, pointing toward a stronger second half of 2003.

Outlook: It might accurately be said that one of the lines in Alan Greenspan's brow is attributable to deflation. Actually, the Fed remains most concerned not about deflation per se, but about the possible combination of recession and deflation—the macroeconomic equivalent of mixing bleach and ammonia. For most of the last quarter of the 19th century, another period when many asset values were generally declining, the economy was growing nicely; America enjoyed a period of significant prosperity. Today, too, we are beginning to see signs of a reasonably healthy economic expansion on the horizon even as inflation and nominal interest rates have been declining.

The employment rate remains sub-optimal but not terrible. President George H.W. Bush was defeated in 1992 on the false premise that his economic policies had produced a 'jobless recovery.' In fact, hiring always lags improvements in GDP growth. The same holds true today. We would expect to see signs of economic expansion before widespread hiring. One area of concern remains excess capacity, though our sense is that the presence of massive fiscal and monetary stimulus will be sufficient to induce the requisite demand.

Stock Market

- In the month of June, over \$11 billion flowed into equity mutual funds—the largest inflow since March 2002.
- The S&P 500 stock index is up 11.8% year-to-date and 22.3% since the March low.
- The price to earnings ratio for the S&P 500 has climbed above 20, renewing concerns about excessive valuations.

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Outlook: The bears have begun to sound the valuation alarm again, pointing to the recent run up in equity prices which seems to have lacked a corresponding economic rebound. Yes, it is true that the stock market has performed quite well since March. It is also true that the P/E ratio for the S&P 500 (now at 20+) is quite a bit higher than the mean P/E ratio (14.4) over the last 130 years. But does this mean that the rebound in equity prices was unwarranted and that valuations are inappropriate? The stock market is without question the most effective single leading economic indicator; investors would reasonably infer, then, that the stock market has actually been pointing toward an improving economy. Moreover, the inverse relationship between interest rates and sustainable P/E ratios suggests that—with interest rates this low—valuations are not out of whack. Having said these things, we believe that constant vigilance has no substitute when managing investment portfolios. We continue to look for opportunities to sell over-valued positions and add to stocks whose current prices under-appreciate the companies' capacities to create shareholder value.

Bond Market

- During the 2nd quarter, interest rates slid to the lowest levels since the Eisenhower administration.
- Bond investors benefited handsomely as interest rates declined, causing bond prices to rise.
- Since the low yield mark of June 13, the yield curve has experienced an upward parallel shift. The average yield on Treasury notes has increased by roughly 40 basis points.

Outlook: We have said in prior EMRO articles that we believed that the next major move in interest rates would be up. While thus far our prediction has yet to materialize in a meaningful way, we are beginning to see signs that it might be moving in that direction. In general, higher interest rates correspond with increased economic growth. If you feel (as we do) that the U.S. economy is in the early stages of a significant recovery, then higher rates appear inevitable. We have been taking advantage of this period of extraordinarily low interest rates in a number of ways. First, we have continued to invest in bonds at the short end of the maturity spectrum, with the intent of extending maturities as rates move higher. We have also sought equity alternatives to bonds in stocks with relatively higher dividend yields. As well, we have selectively sold bonds into the strength of the fixed income rally. Finally, where suitable, we have sold U.S. Treasury strips, anticipating significant appreciation potential as interest rates recover to prior levels.

As rates begin to rise, we will cautiously extend portfolio duration into the intermediate segment of the yield curve. Our conviction remains that U.S. government agency bonds offer the best risk adjusted return in non-taxable, and in many taxable, portfolios. However, we routinely re-evaluate which sectors offer the best values, and will continue to watch for new opportunities.

DJIA 8985.44 S&P 500 974.50 10 Yr. US Treasury 3.52%