

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

Goelzer Investment Management

Economic & Market Review and Outlook

October 1, 2003

“Are we there yet?” Ah, the very phrase conjures up images from vacations past. Images of the kids hoping that the car trip to Florida isn’t any longer than the distance from home to the nearest interstate access ramp. Many American adults are asking the same question today, albeit with different concerns in mind: Are we winning the war against terrorism? Is the economy really getting better? One of the candidates for next year’s presidential election recently proffered that we are no more secure today than we were on September 10, 2001—a rather preposterous claim, frankly. But the question about the economy deserves more careful analysis. After all, as investors, the pace of economic expansion will significantly impact our measure of success.

It seems that the answer to the economic question “are we there yet” might be “yes but no.” In other words, we have begun to experience an economic expansion, but we are by no means enjoying the prosperity we have come to expect. That last point really gets at the heart of the matter: this expansion doesn’t square with our expectation of how expansions should feel. Frankly, the euphoric days of the latter 1990s spoiled us in many ways. Think about the late 90s: cigar parties, rising values of vacation properties, increased foreign travel, etc. Much of this luxury was financed by the meteoric rise (in hindsight, unsustainable) in stocks of companies like *e-anything* or *whatever.com*. 1976 through 1979 was another period of expansion, but no one would argue that it engendered a party atmosphere. While much has been written of late of the jobless recovery and continuing layoffs, our current unemployment rate of 6.1% remains low by historical standards. The U.S. economy remains the global engine of growth, and the backdrop of an accommodative fiscal and monetary environment, the American entrepreneurial spirit, and our adjusted expectations will likely help us realize that we have indeed arrived.

The Economy

- The economy grew by 3.3% during the second quarter, better than expected.
- The negative trend in capacity utilization appears to have stabilized, reaching a 20-year low in June at 74.1%. Working off excess capacity is a critical precursor to sustained economic expansion.
- U.S. Industrial production rose in the month of August, offering its first back-to-back gain since February. Renewed business investments in plant, equipment and productivity-enhancing technology are key signs that will indicate the current expansion is becoming sustainable.
- Consumers have continued to demonstrate remarkable resilience, with retail sales poised to turn in their best 3rd quarter in 4 years. This despite continued job losses arising from increased globalization and domestic businesses’ relentless drive to cut costs.
- Unemployment, at 6.1% for the 3rd quarter, is off the high of 6.4% during the second quarter but remains a concern, as does the escalation of protectionist rhetoric that this so-called jobless recovery has aroused.

Outlook: We pointed out in last quarter’s EMRO that the U.S. economy has not known a ‘jobless recovery’—eventually companies begin to hire again. In the current recovery, though, companies have been slower than usual to begin re-hiring, and we’re inclined to see that step as being crucial to extending this expansion. A consensus is emerging among economists that GDP will grow by as much as 4% to 4.5% during the second half of this year. Companies must now use their increased profitability to re-invest in capital equipment as well as human resources. Consumers account for roughly 2/3 of U.S. spending. It follows that what this recovery needs most is more people making, saving, and spending money. Cheap overseas labor in developing economies and rising domestic health care costs are but two key hurdles that must be cleared in coming years to ensure this recovery’s sustainability.

Stock Market

- The 3rd quarter saw a continuation of positive earnings momentum, with well over 50% of companies issuing guidance that points toward higher expected earnings.
- On the heels of three consecutive years of decline, the S&P 500 index is up 14.7% year to date.
- The technology-laden NASDAQ composite index is up an impressive 34.3% since the end of last year.

Outlook: Wouldn’t it be nice to call it a year right now? Most stocks have performed well after their trek through the worst bear market since the Great Depression. As is most often the case, a significant share of market gains come in anticipation of economic recovery, occurring before the popular media gets on board

Goelzer Investment Management

Economic & Market Review and Outlook

October 1, 2003

proclaiming it safe to move back into the stock market. In the midst of this recovery in share prices certain sectors of the market (and many individual stocks) may have gotten ahead of themselves, leading to valuations based upon rosy earnings projections for several quarters to come. We've heard it said, though, that it's not so much a stock market as it is a market of stocks. To wit, health care stocks have declined amid concern of government intervention in the face of rising U.S. pharmaceutical costs, while some technology shares have risen to levels not seen since the bubble--again, perhaps a bit too far, a bit too fast.

Happily, the quality of corporate earnings is as high as it's been in several years. A vigilant SEC has increasingly held executives personally responsible for the veracity of corporate financial statements and auditors have become well educated to the risks of looking the other way. Companies have again become lean and mean, witnessed by the tremendous gains in productivity enjoyed this year. This in turn should translate into nice gains in earnings in coming quarters and lend support to the market in the months ahead.

Bond Market

- The yield on the 5-year U.S. Treasury Note rose to 3.61% on September 2nd (from 2.41% at the beginning of the quarter) before pulling back to 2.83% at quarter end.
- After cutting the Fed funds rate to 1% on June 24th, the central bank has remained on hold through the 3rd quarter, citing equal risk between inflation and recession.
- The price of gold stands at a 7-year high. Does this augur a trend toward inflation?

Outlook: The sell off in bonds we had anticipated came with a vengeance during the middle of the summer, driving yields on short-intermediate bonds up to levels that seem much more reasonable in light of the pace of economic recovery. Since the beginning of September, though, yields have come back down, while gold, the perennial inflation hedge, has enjoyed a remarkable run over the last two years. Where in the world are we headed?

The Fed will likely remain on hold until it sees evidence of significant strength in the jobs market. As well, Mr. Greenspan—wishing to avoid criticism from either Democrats or Republicans—might well choose to avoid making dramatic moves during the thick of next year's election season. In short, we envision a Fed that remains accommodative for the foreseeable future. As the jobs market strengthens, yields on longer bonds could rise first, steepening the yield curve. The rapid rise in gold prices might not be pointing toward an immanent return to inflation; rather, gold may have become, in our post 9/11 world, a short-term substitute for a weak U.S. dollar. More on this topic next quarter.

DJIA 9275.06 S&P 500 995.97 10 Yr. US Treasury 3.94%