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Quarterly Review and Outlook

Third quarter 2002

Valuation Fundamentals Still Favor Bonds

Our 15.8% return in the third quarter achieved with long-term Treasury securities versus the –17.3% loss in the S&P 500 has contributed to the out-performance of our Treasury only portfolio versus the S&P 500 for the past fifteen years (note performance table). The question today is whether a Treasury portfolio will continue to outperform the S&P 500 over the next five to ten years. A recent in-house study regarding this stock/bond question will appear in the fall issue of the *Journal of Portfolio Management*, and the conclusions of this study suggest a better than even probability that Treasury bonds will continue to be the superior asset class. This conclusion is based on three factors: 1) the current low dividend yield of equities versus the yield on bonds; 2) the low inflation environment which traditionally retards capital gains of equities and boosts them on bonds; and 3) continued overvaluation of equities as measured by the P/E (price earnings) ratio (Chart 1).

First, the long bond yield at 4.7% is 300 basis points above the dividend yield on the S&P 500. While it is our opinion that yields are headed lower, the dividend level may also decline since the payout ratio (dividends to after tax profits) for nonfinancial corporations was 175% in the last four quarters, a record high.

Second, in the period from 1871-1945, when the inflation rate was low, the capital gains differential in favor of stocks over bonds was low (i.e., the 1871-1945 period had both inflation and capital gains at less than 1%). In the deflationary episodes prior to World War II, total return on Treasury bonds exceeded the total return on the S&P 500. Today, and in the foreseeable future, low inflation seems probable, with concomitant small capital gains in stocks.

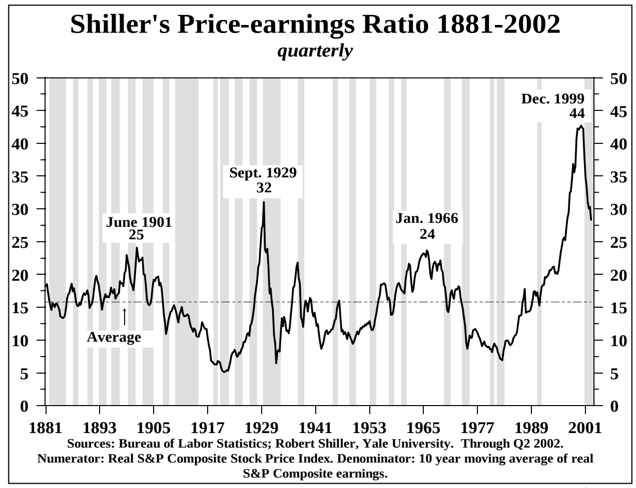

Chart 1

Third, the P/E ratio remains extended. Stock valuation is always difficult to determine, but of the measures that are available, the Shiller Price Earnings Ratio is the strongest on theoretical and practical grounds. Dr. Robert Shiller of Yale University argues, as is becoming increasingly apparent, that projected earnings, even from a huge sample group, are badly flawed. To arrive at fundamental or expected earnings, Shiller, following the methodology of Graham and Dodd, computes a ten-year moving average of earnings in real dollars. The recent reading of the Shiller P/E ratio on the S&P 500 was 28, compared with an average of 15 since 1881, and an average of just 13 in the recessions since 1881. The range of the Shiller P/E in these past recessions was from a high of 19 to a low of 5 (also Chart 1). This indicates a continued overvaluation of equities, and highlights the potential magnitude of the adjustment necessary to normalize equity valuation.

All three of these factors determine the "risk premium" for stocks, and suggest poor future returns for equities over a ten-year horizon. Long Treasuries, whose 4.7% coupon will be augmented with a modicum of capital gains, should be highly competitive with the expected return on equities.

Outlook

The near-term economic outlook continues to be unfavorable as excess capacity (oversupply) threatens to overwhelm further increases in consumption (demand). This condition, referred to by the arcane term "glut", describes the present situation domestically and globally. Until now, the post WWII business cycle model has not had to deal with a recession dominated by an investment spending contraction that eventually leads to a downturn in consumer spending, but this condition poses a clear risk for today's economy.

Spending or Borrowing?

Despite multiplying difficulties in the economy, reports on third quarter real consumer spending are likely to show a growth rate faster than the 54-year average of 3.6%. Although these figures are correct on a macroeconomic—or National Income and Product (NIPA)—basis, spending by the consumer at the microeconomic level may actually have declined. How can this be?

The answer to this riddle lies in the way in which consumers are procuring funds to make purchases. The stimulus behind the third quarter surge in consumer spending was 0% financing on virtually all vehicle models. With 0% financing widely available for a sixty-month car or truck loan, many consumers were able to "buy" a new car with no additional cash outlay. While 0% financing was not available to all, many were able to obtain forty-eight and sixty month loans for 2.4% or even 1.2%, making monthly payments lower and contributing to smaller down payments, a situation that is confirmed by the Federal Reserve statistics. Thus, in terms of the economy, car sales are higher only because consumers have plunged deeper into debt, not because they took money out of savings. There was little or no increase in cash expenditures or actual spending on a micro or individual basis—only an assumption of debt in exchange for a new asset. However, auto sales moved higher, as did production and overall GDP. This process of purchasing with debt due to lower interest rates cannot continue indefinitely since rates are now at zero, and future sales must come from income.

Consumer Spending Is Vulnerable

The lower interest rates have also been a stimulant to consumer spending since refinancing of mortgages has allowed equity in homesteads to be commuted to spendable cash. This added nearly $100 billion to consumer pocketbooks last year, and may contribute even more this year. However, there are two offsetting factors to ameliorate this income boost. These are consumer net worth and wage and salary income, both of which point toward slower spending ahead.

For example, in the second quarter the ratio of consumer net worth to disposable personal income dropped to 5.1, the lowest reading since the third quarter of 1996. We estimate a decline to 4.7 for the third quarter (Chart 2). This reading is below the 4.8 average from 1985 to 1995. Housing values rose, adding to net worth, but this was more than offset by the fall in stock prices and a dramatic buildup in consumer debt. As Chart 2 indicates, consumer net worth rises near the end of postwar recessions. The current pattern suggests that the recession may be continuing. With net worth down, consumers need to increase saving. This process has just begun, and it will put downward pressure on future spending.

Another offset to the mortgage windfall is the sluggish growth in real wage and salary income that inched along at a 1.8% annual rate in the latest three months, far below the 5.2% rate of growth in consumer spending. These numbers serve to illustrate why the

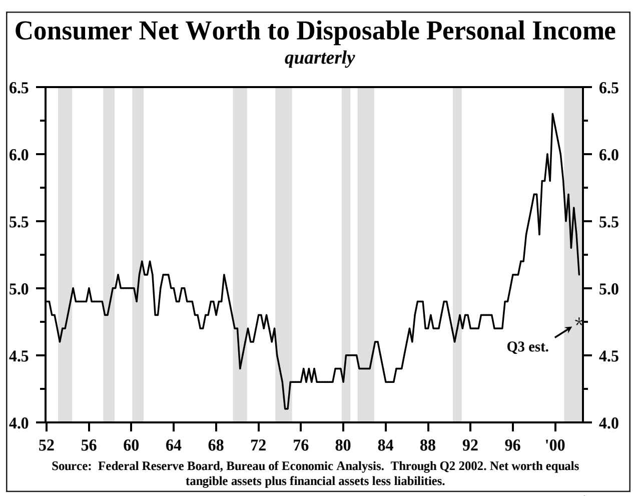

Chart 2

consumer, from an income point of view, was not able to boost dollar outlays for cars and trucks, but only to absorb debt. Spending can outpace income for short time spans, but there has to be a good explanation such as rising wealth, an attractive financing scheme, or a tax cut. But these factors are absent going forward. Last year, consumers were the beneficiaries of a $100 billion tax cut, but no new tax breaks occurs until 2004, and interest rate financing will not drop below zero.

Corporate America's Emaciated Finances

In the second quarter, after tax corporate profits of all nonfinancial firms was $193.6 billion, up from the lows of late last year, but amazingly near the same level as in the first quarter of 1993 (Chart 3). At that time the Dow Jones Industrial (DJI) Average was 3371. If financial firms are included, corporate profits in the second quarter were $449.3 billion, also up a bit off last year's low, but around the same level as in the first quarter of 1995. The DJI closed at 4158 on the last day of March in 1995.

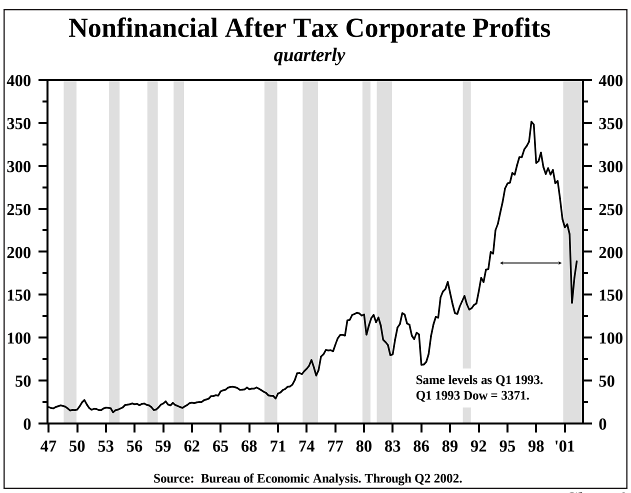

Chart 3

The retained earnings calculated by the Commerce Department also point to a potentially troubling problem in corporate finance. In the four quarters ending June of this year, the payout ratio (dividends as a percent of after tax profits) of all nonfinancial corporations averaged 162.4% (Chart 4). This is the highest annual reading since 1946. This suggests that corporate dividends are unlikely to be maintained. The high payout ratio indicates that corporations, in the aggregate, are in the extremely weak position of being forced to borrow to pay dividends. As such, there is a paucity of resources for capital investment and hiring. For all firms – financial and nonfinancial – the payout ratio was a record 95.3% in the past four quarters.

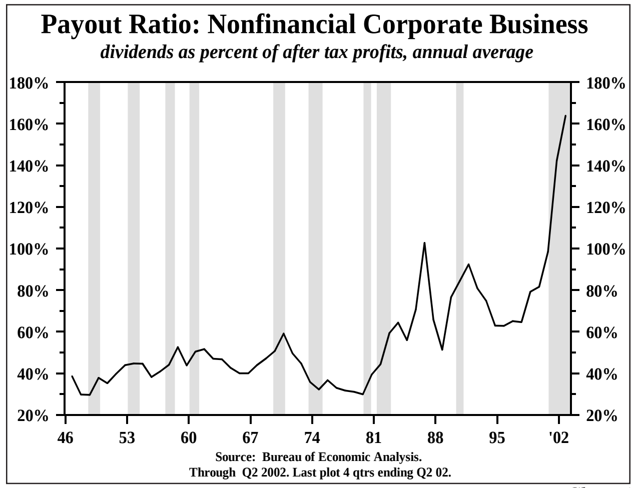

Chart 4

Deflation's Link to Corporate Problems

The U.S. economy is not in deflation and a generalized deflation is not imminent. However, the corporate sector is already in deflation, which is one of the reasons for the extremely depressed level of profits. The corporate sector deflator fell 0.6% in the last four quarters, the biggest contraction since 1953 (Chart 5). When this sector experiences deflation, margins erode and corporations are forced to restrict hiring and to cut back on capital spending and other discretionary outlays like travel and entertainment.

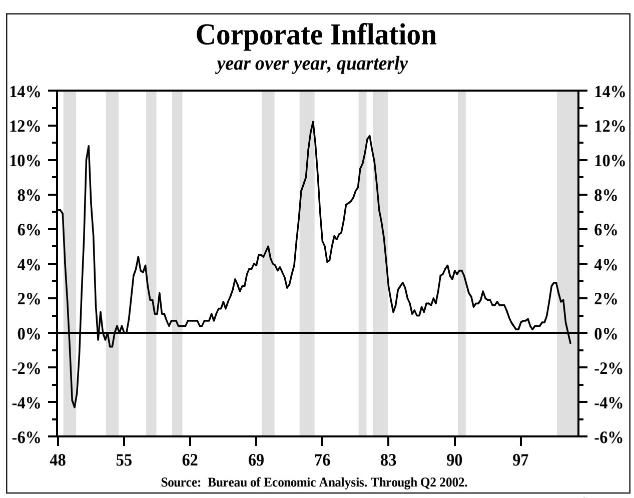

Chart 5

As the problems in the corporate sector demonstrate, deflation and its implications should not be taken lightly. We are not in a generalized deflation, but the pathway is open. The prevailing opinion is that the far larger service sector, where inflation has always been higher, will prevent the economy from going into deflation. But this view may be flawed. Already the service sector has demonstrated sensitivity to macroeconomic conditions. From a nearly 5.5% pace in 1990, the consumption deflator for services has dropped to a 2.6% rate of increase in the latest twelve months. The risk is that problems in the corporate sector continue to mount because high levels of excess capacity and debt ultimately force pay cuts and drive nominal wage levels lower. A fall in wages would, in turn, force service prices lower, including those in the medical sector where prices are considered to be largely immune to macro-conditions.

Dismal Global Economy

Foreign economies are experiencing even more serious economic woes. From mid-2001 to mid-2002, real domestic demand in the U.S. rose 2.8%. For the Euro twelve, real domestic demand declined 0.2%, and for the fifteen largest foreign economies, the drop was an even greater 0.4%.

The deflationary forces in Japan are unrelenting due to their persistent recession. China and Hong Kong are now in deflation, and the rest of Asia is disinflatiing. Thus, one-quarter of the world is experiencing deflation. Germany, Europe's leading economy, is plagued with huge excess capacity. German wages are about 50% higher than those in the United States, and their economy is heavily over-leveraged, so it is not surprising that asset values are depreciating dramatically.

Among the world's newly industrializing economies, multiple problems abound. In spite of a $30 billion IMF bailout, the Brazilian economy has continued to falter. The Brazilian real has dropped to an all time low against the dollar, falling 37% this year, and the problems in Brazil are contagious. The Mexican economy has weakened significantly, with the peso slumping 10% this year. These problems are exacerbated by the slowdown in imports resulting from another downturn in the U.S. economy.

Irrelevant Monetary Policy?

With the Fed posed to cut the Federal funds rate to a new forty year low, the question is whether monetary policy is on the road to irrelevancy since the Fed can't reduce short-term rates below zero. Further, quantitative easing may be less potent due to current financial conditions. Specifically, private sector debt in the U.S. rose to a record 160% of GDP in the second quarter, while total U.S. debt soared to 290.6% of GDP, the highest since early 1933. With debt levels so high, a vibrant borrowing and lending (i.e. credit) cycle may be several years away. This suggests that the potential for monetary injections could remain sterile since businesses and households are sufficiently leveraged to resist further borrowing. Moreover, the financial institutions may be unwilling to lend more because the risk of default is increasing. Thus, low interest rates, or even quantitative easing, may face significant head winds.

Indeed, signs of an eroding credit cycle have begun to emerge. In the third quarter, corporate bond sales plunged to their lowest level in more than five years, and the spread between corporate and U.S. government bonds widened sharply. Therefore, both the cost and availability of corporate debt deteriorated over the summer. In a related development, initial stock offerings in the third quarter dropped to their lowest level since 1997. Thus, some corporations have greatly reduced access to the capital markets.

Treasury Bonds A Safe Haven

The apparent strength in the third quarter real GDP was due largely to transitory gains in vehicle sales funded by debt. In spite of this strength, the growth recession seems to be pressing forward. Economic growth will continue to face severe head winds due to serious and persistent structural problems. Thus, financial markets should continue to experience an upward shift in investor preferences for longer-dated Treasury securities.

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