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Quarterly Review and Outlook

First Quarter 2003

A Recessionary Environment

Despite six consecutive quarters of **real** GDP growth that has averaged 2.6%, the U.S. economy continues to experience **recession-like** conditions in employment and corporate profits. Job losses now total 2.6 million in the private sector since the peak employment level reached in February of 2001, for an average monthly loss of 105,000. This 25 month contraction is the longest employment slump in the postwar period (Chart 1.) Corporate profits after tax on an annual basis (without CCA or IVA) totaled \$197 billion in 2002, which was down 4% from the previous year and down 42% from the peak reached in 1997. Profits now stand at their 1993 levels when the Dow Jones averaged about 3500 (Chart 2.)

This poor profit performance and resultant cutback in payrolls reflect the fact that it is not the **real** GDP that counts when measuring job and profit activity, but **nominal** GDP, which is mired near forty-year lows, expanding by only an estimated 3.4% over the past twelve months (Chart 3.) This lack of top line growth suggests that the U.S. has experienced the worst

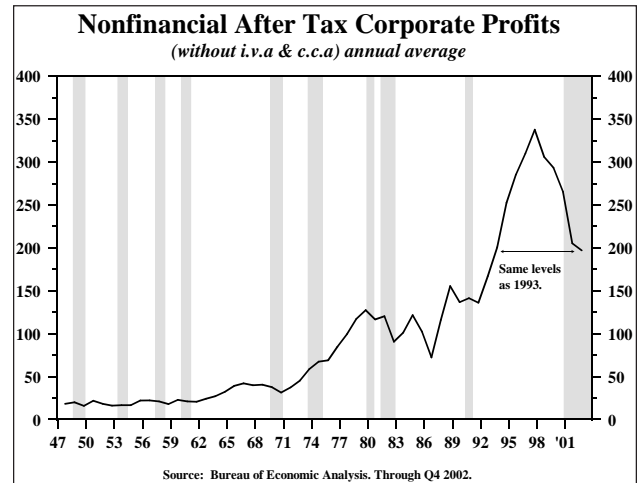


Chart 2

recession in more than four decades—a recession that may, in fact, still be lingering today.

This sluggish growth has been blamed on the unprecedented external shocks that have hit the economic system, such as the September 11 tragedy, corporate malfeasance, and the current conflict in Iraq. It is assumed that after the current disruption of war, normal cyclical growth will resume. Some bounce may be expected in the near term. However, a sustained,

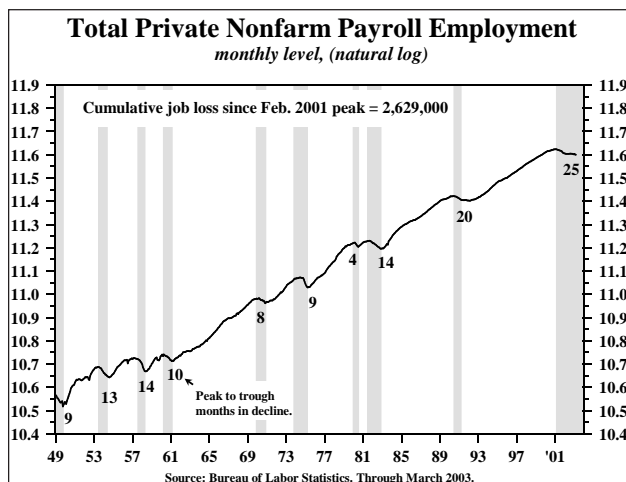


Chart 1

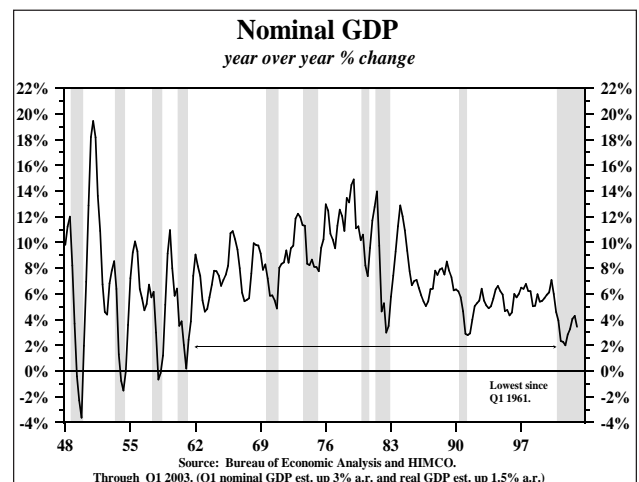


Chart 3

typical postwar recovery will continue to be absent due to some deep seated problems in the U.S. economy that have taken years to develop. Quick policy solutions are unavailable, and sudden relief is unobtainable.

Debt Deflation

Paramount to the structural problems that beset the U.S. economy has been a decade of malinvestment or over-investment in plant and equipment by businesses and the continued acquisition of depreciable goods by consumers, which have been significantly funded by the issuance of debt rather than by current income. This multi-year activity has resulted in an excess of nonproductive plant and equipment for businesses and a large stock of rapidly-depreciating goods for consumers. To alleviate this debt burden, a noticeable portion of future income streams from both businesses and consumers must be diverted to repay this excessive level of private sector debt (Chart 4.) This process of debt reduction is often referred to as debt **deflation**. It is of concern that this debt deflation process has, in other economies, and at other times in this economy, led to price deflation, a circumstance where normal macroeconomic policy tools become ineffectual.

While very short periods of debt repayment have occurred over the past fifty years, the general trend for the U.S. economy has been one of debt **inflation**, whereby debt is increased relative to GDP. Monetary policy works through the borrowing and lending cycle that creates debt, money, and ultimately the purchase

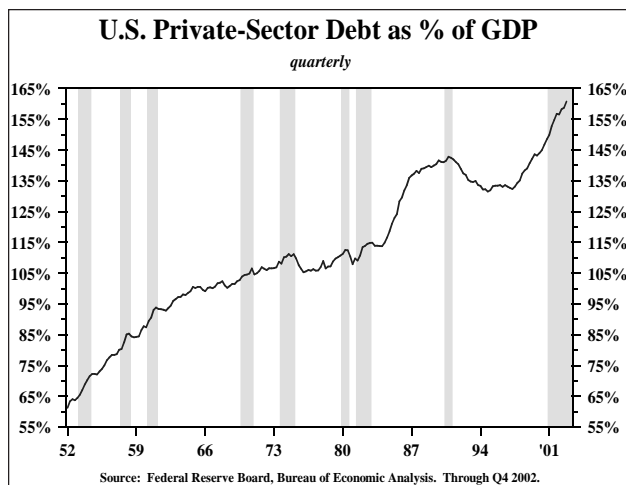


Chart 4

of cars, homes and capital goods. In debt deflation this very objective of monetary policy is thwarted. Equally important, fiscal policy is also ineffective in the face of debt deflation.

Strained Balance Sheets

In the fourth quarter, there was a near record 56¢ of total debt for every dollar of net worth in nonfinancial corporations. As recently as the third quarter of 1997, only 47¢ of total debt existed for every dollar of net worth. This severe deterioration of balance sheet strength since the fall of 1997 is a reflection of: (1) a \$232 billion advance in plant and equipment spending; (2) corporate repurchase of their own stock to the tune of \$646 billion of their own shares outstanding (largely in an effort to boost their stock price;) and (3) buyouts of other firms, with corporate goodwill rising by \$3.1 trillion on balance sheets. The surge in goodwill partially reflects the premium paid by acquiring firms.

These three considerations argue that the highly weakened balance sheet of business cannot be corrected easily or quickly. First, top line growth is too slow to generate sufficient profits to sustain current operations and simultaneously pay down debt. Second, soft final demand in the face of high levels of excess capacity strongly indicates that firms may see their pricing power weaken even further. This lack of pricing power would further erode profits and slow the process of debt repayment. Third, foreign economies are in even worse shape than ours, suggesting that a rising inflow of low priced products can be expected for the foreseeable future, reducing profit margins of domestic companies.

Idle Plants

Recently, manufacturing plants operated at just 72.9% of capacity, very close to its nineteen year low. Given the prevailing macroeconomic conditions, many years of strong growth would be needed to rationalize the unneeded facilities and return manufacturing plant use to 81.7%, the post-World War II average. Increasing factory utilization rate will play an important part in determining the speed at which the corporate balance sheet can be made healthy.

Paltry Profits

In many respects, the problems in the corporate sector run deep. Equity valuations remain extremely high relative to profits. This statement may seem surprising since stock prices have declined considerably from their 2000 peaks, and a noticeable recovery in profits from the worst levels recorded in Q4 2001 has occurred. Unfortunately, profits are still severely depressed when measured fairly and accurately. Much of the confusion about profits stems from the continued emphasis on “operating earnings” by many corporations and analysts on Wall Street. Operating earnings may be defined as “generally accepted accounting principles” (GAAP) less exclusion of all the “bad stuff.” However, what constitutes “bad stuff” is naturally determined differently from one corporation to the next. When composite estimates of “operating earnings” are made for this year and next, it is impossible to measure a constant and uniform comparison. Accordingly, operating profit projections have an apples and oranges composition problem, as well as a strong tendency to be consistently biased upward.

In contrast to a subjective profit measure, after tax profits of the nonfinancial corporations, as compiled by the Bureau of Economic Analysis (BEA) of the Commerce Department, is a series that avoids the pitfalls of relying on “operating earnings.” The BEA measure of profits, while calculated on a National Income and Products Basis, is very similar in principal to those calculated under GAAP. The BEA profits are derived from the tax reports filed by corporations to the Internal Revenue Service. Since no one would want to pay taxes on phantom profits, we can be fairly certain profits calculated in this manner are not overstated.

As noted above, utilizing this measure 2002 after tax profits stood at \$197 billion, down 4% from 2001. This decline incorporates the 58% fourth quarter to fourth quarter rise from the low of \$140 billion reached at the end of 2001. Profits as a percent of GDP also reveal the equity valuation problem. The total value of stocks in 2002 stood about 83% of GDP, well below their peak valuation levels of 148% reached in 2000. Despite this massive price adjustment the total value of equities relative to the size of the economy

was 27% **higher** than the postwar average. In stark contrast, profits stood at less than 2% of GDP, nearly 50% **lower** than their postwar average (Chart 5.) In 2003, a first quarter margin squeeze and weakness in final demand suggest that profits were actually lower than in the fourth quarter. Indeed, equity valuations are high, suggesting that future deterioration in consumer net worth is likely.

The Dividend Problem

An examination of corporate dividends provides an alternative equity valuation assessment. From 1871 through 2002, stocks, as measured by Standard and Poor’s, posted a compound total annual return of 9%. Over this period, dividends registered a 4.6% compound return, thus generating slightly **more than half** of the total return on equities. Dividends are highly unlikely to make such a powerful contribution going forward for two reasons. First, this dividend yield was only 1.6% in 2002. Second, even that paltry dividend payment does not look secure. For the S&P 500 the dividend payout ratio in 2002 was 57%, a full ten percentage points above the average payout ratio for the previous thirty years.

The emphasis on holding dividends can be understood since stock prices typically plummet when a company cuts its dividend. But, by maintaining dividends, firms have fewer resources for hiring, capital spending, advertising and a host of other uses. This has been painfully evident for the 2.6 million private sector job losers.

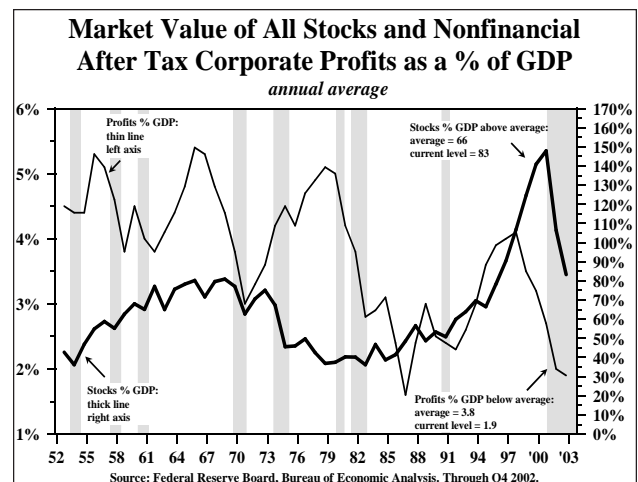


Chart 5

Pressure on Income and Wealth

The effort by corporations to sustain their profitability in the face of deteriorating top line growth has been the singular cause of the enormous contraction in private payroll employment over the past 25 months. This reduction of jobs has contributed to a reduction of aggregate real average weekly earnings in February of 0.1% versus the year earlier level. Business cost cutting is equally apparent to those still working since the increase in private sector wages has been reduced from 4.2% in 1999 to 2.7% over the past twelve months, the slowest growth rate in a decade. This diminution of income and wages is far more important than geopolitical concerns. Should employment continue to contract, and wage rates adjust downward, the risk of a consumer spending recession rises accordingly, and the present record 44 consecutive quarterly increases in real consumer spending is in jeopardy.

Consumer net worth, which is the sum of the market values of consumer real estate (homes) plus financial assets less their debt, rose from five times disposable income at the end of 1995 to a peak of 6.3 times at the end of 1999, before falling back to 4.9 times in the latest quarter (Chart 6.) Prior to the end of all previous postwar recessions this critical and accurate leading indicator has risen as stock prices lifted off and consumers paid off their debt, boosting net worth. This superb leading indicator has yet to advance, signaling that a healthy expansion is still elusive and that a consumer-led recession may lie ahead.

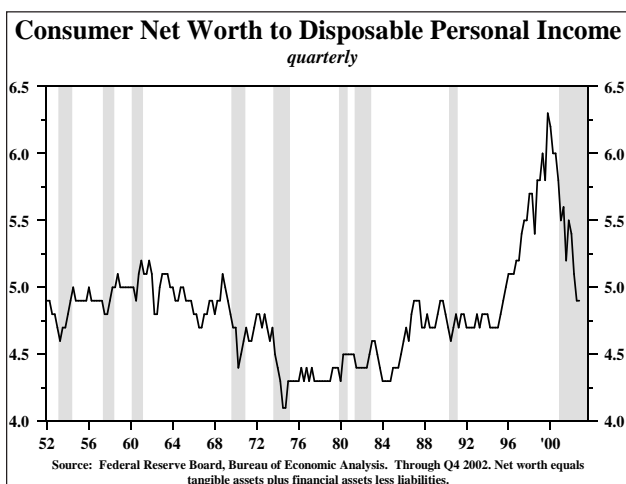


Chart 6

Depressed Foreign Economies

Economic conditions in the United States are highly tenuous, and this is reflected in the global economy since the U.S. has been supporting the rest of the world for the past several years. The U.S. international trade deficit in the fourth quarter was at an all time record at about 5.6% of GDP. Only five short years ago our trade deficit was 1.7% of GDP, meaning that we have shifted 4%, or over \$400 billion of our GDP overseas via the purchases of their goods and services. With the abrupt slowing of our nominal growth rate, now only 3.4% year over year and near forty-year lows, our stimulus to the rest of the world has been significantly reduced. Because the final domestic demand of the major foreign economies has been weak for a sustained period of time, the loss of their major export market has now created substantial problems in their economies. For instance, the latest Tankan survey indicates that Japan remains mired in recession. Key measures of European business and consumer sentiment are at the lowest levels in six to nine years. Unemployment in Europe is at multi-year highs. Moreover, the level of unemployment in Europe is considerably higher at 8.7% versus the United States at 5.8%.

The trend in stock prices is a good indication of the relatively poorer condition overseas. In local currency, U.S. equity prices declined 3.1% in the first quarter, but the most comprehensive measure of European stock prices fell 12.8%, with the slumps in the mid-teens registered in Germany and France. The Nikkei and the Hang Seng declined less than the European bourses, but the drop in the two key Asian markets was twice as fast as in the United States. This decline follows large losses in 2002.

When goods produced in Europe, Asia and Latin America are not sold locally they must be shipped to the United States. This puts downward pressure on pricing power of U.S. concerns and delays the badly needed restructuring of the disfigured aggregate corporate balance sheet. The record 32 consecutive monthly declines in manufacturing payrolls attest to this massive foreign competition.

Treasury Yields—Multi-year Decline Still Ahead

While the global and U.S. economic climates are deteriorating, the environment for long-dated Treasury bonds is improving. Subpar economic growth, falling inflation and the urgent need for household and corporate balance sheet repair suggest that long-term interest rates could work lower for several more years. Many reports have stated that interest rates are at record lows, but this is not the case. Since 1871, the average long-term U.S. Treasury bond rate was 4.2%. The long term Treasury bond yield averaged 3.5% or less for 72 of these 132 years (55% of the time.) As recently as the 1950s, long Treasury yields averaged 3%, 200 basis

points below recent yields of off-the-run long Treasuries. In the first half of the 1960s the average was just barely above 4%. The lowest annual average long Treasury rates in both the 19th and 20th centuries were 2.1% and 1.8%, respectively.

Even in a very mild and nonpersistent deflation, yields on long Treasury bonds could drop to 3.5%, creating large capital gains. In the past five years the S&P registered a compounded negative 3.7% return compared with a positive 7.5% return for an unmanaged long U. S. Treasury portfolio. Present conditions suggest a continuation of this disparate trend. We continue to maintain a firm commitment to long-term Treasury bonds and zero coupon Treasuries.

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