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A Look Forward

Thoughts on the Coming One to Four Years

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In our monthly briefings, we summarize each month's pertinent economic and geo-political events and their actual and projected impact upon domestic and international financial markets. Unfortunately, because of space considerations we rarely have the opportunity to engage in a broader discussion of where we think our country might be headed economically or where markets might be going in the coming years. In light of recent market performance, additional tax law changes, and a thirteenth consecutive interest rate reduction by the Federal Reserve Open Market Committee, we thought now might be an appropriate time to share our thoughts with you as we look ahead to the coming twelve to forty-eight months. In order to put our "look ahead" into perspective, we think it is helpful to briefly look back at where we have been over the last five to ten years and where we are now.

Where We Have Been

As everyone who participated in U.S. equity markets over the last decade well knows, this was a period of great volatility. The major equity indices, especially the DJIA, NASDAQ, and S&P 500, enjoyed an amazingly long and vigorous upward ride during the 1990's only to adjust dramatically over the last three or so years. The DJIA, for example, started January 1, 1990 at 2753 and closed out the decade at 11497 – a 317% advance averaging over 15% per year compounded.

During this same time period, the NASDAQ went from 454 to 4069 – advancing an incredible 796%, or 24.52% per year compounded. These figures are well in excess of "normal" equity market performance. Traditionally, U.S. equity markets, over time, return approximately 10% per year compounded. If you look at a slightly longer period of time – say from January 1, 1990 to June 30, 2003, you will see that the equity indices returned much closer to the 10% norm. The DJIA returned approximately 9.2% per year and the NASDAQ rose about 10.2% per year.

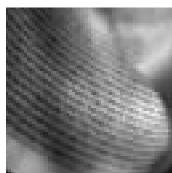
Thus, despite all the volatility and unusual market activity of late at the end of the day the equity markets actually returned what investors should have expected given historical returns.

A number of variables combined to allow the extraordinary 1990's bull market to run so long and hard. The technology "revolution" of the mid- to late-1990's, spurred on by the anticipated potential of the Internet and the expected rapid increase in worker productivity and efficiency, led the way. Low unemployment, reasonably low inflation, moderate interest rates, decent economic growth overseas, a trend towards globalization, and falling tax rates also helped pave the way to tremendous growth in the prices of most stocks. The nation's need to ramp up for Y2K further accelerated market growth in the late 1990's.

The technology boom of the late 1990's also fueled a huge amount of very speculative IPO's (initial public offerings). These IPO's were like adding kindling to an equity market already on fire. Many small, untested, privately held technology companies rushed to go public in order to cash out at tremendous premiums. Investors could not get enough of these companies since they too saw a cash cow in the making. Remember the IPO frenzy of 1998 and 1999 when stocks initially offered at $12 - $16 per share would have a first ever public trade over $100 and the stock price would shoot straight up from there? Of course, many of these companies had yet to ever turn a profit and probably should not have been brought public. Several years later most were out of business leaving disgruntled shareholders with significant losses.

The market excesses of the late 1990's finally gave way to a market correction that so far has lasted about four times longer than the average – about 36 months rather than the usual 9 months. A number of variables conspired to exert extreme downward pressure on U.S. equity markets. The after-effects of the massive Y2K build-up probably got the ball rolling, particularly since our entrance into the new millennium was fairly uneventful.

Many businesses found themselves with extra inventory originally stockpiled in anticipation of possible computer snafus that could have caused supply chain interruptions. These businesses then did not need to continue producing at their inflated late 1990's rate. Also, most businesses embarked upon capital spending projects in the mid- to late-1990's to ensure they would be Y2K compliant. With the dawn of 2000, most of these businesses then had no need to upgrade their equipment and technology. Much of the economic activity in the late 1990's abruptly slowed since it was centered upon Y2K related issues. In other words, because of Y2K concerns many businesses accelerated their own purchases and upgrades thereby boosting economic growth in 1998 and 1999. This boost looked great in 1998 and 1999 but it came at great expense since it left 2000 and 2001 with little fuel to generate further economic growth. Absent the Y2K concerns, some of the economic activity in 1998 and 1999 probably would have occurred in 2000 or 2001.



As the weeks progressed through 2000 and into 2001, the overcapacity of the technology and telecommunications industries became increasingly apparent and the market continued to adjust. Other factors later came into play placing further downward pressure on the economy and equity market. A hotly disputed presidential election, a terrorist attack on U.S. soil, military campaigns in Afghanistan and Iraq, escalating violence in the Middle East, accounting scandals and a general crisis in corporate ethics, SARS – the list just goes on and on. There was no way for anyone to anticipate all the difficult events and circumstances our country had to deal with in such a short period of time. All these events generated massive uncertainty and caused businesses and consumers alike to act very cautiously. Apart from a downward adjustment in U.S. equity markets, the end result was a brief recession followed by a lingering period of slow economic growth.

Where Are We Now?

There is a lot of speculation and conjecture as to precisely where our economy is at the present time. Because economic data always looks backwards, we never really know till after the fact where our economy was at any given point in time. The general consensus is that we are still in a period of relatively slow growth and virtually non-existent inflation. Unemployment is now over 6% and has been hovering in the 6% range for months. There has been little, if any, job growth over the past twelve to eighteen months. Worker productivity and efficiency, though, continue to rise thanks to technological advances. Many economists expect that economic growth should begin to accelerate in the coming six to twelve months. However, some economists, including Federal Reserve Chairman Greenspan, are concerned about the possibility that we might be headed toward deflation, a period of falling costs for goods and services. Thirteen interest rate decreases over the last few years and two major tax reform bills provided, and continue to provide, a huge amount of monetary and fiscal stimuli designed to encourage sustainable economic growth and hopefully stave off deflation and recession. Since interest expense is a major production cost, lower interest rates translate into lower production costs. Additionally, in periods of slower demand, profit margins tend to shrink as competition for existing business grows.

As we contemplate where we are now and where we have been, a couple of key items immediately come to mind. First, the federal funds rate is at just 1%, the lowest rate in recent history. Second, the federal government has made a concerted effort over the last few years to inject fiscal stimuli into our economy in the form of two large tax cuts – both of which almost immediately placed cash into the hands of many American taxpayers who are also major consumers. Third, we are well into the fourth year in a row in which the pace of capital spending by U.S. businesses lags behind normal levels. Fourth, we appear to be in a period of greater government spending for the foreseeable future as defense, anti-terrorism, and disaster-readiness spending zoomed upwards following 9/11. Fifth, we now seem to be in a period when psychology rather than financial, market, or economic fundamentals drive investing decisions and economic strategy.

The first four items have two critically important similarities. They are all economic stimulants and they all operate in a cumulative fashion. Low interest rates allow American consumers to refinance their mortgages and other high cost debt, thereby placing more money in their pockets for the purchase of other goods and services. Low interest rates offer U.S. corporations the opportunity to reduce debt costs and embark upon capital expenditures at a low borrowing rate, which, in turn, should lower production costs. Lower tax rates also mean more money in consumers' pockets and in business coffers. Again, this is money that is now available for the purchase of other goods and services.

Limited capital spending over the last three to four years suggests that many businesses now have a pent-up need to embark upon capital spending projects to further increase productivity, control

production costs, and remain competitive. At some point, a few businesses will begin to upgrade their technology, modernize their production facilities, purchase new software programs, and initiate other capital spending projects to retain, and hopefully improve, their competitive edge. Once this happens, it is likely their competitors will be forced to rush to engage in similar projects for fear of being left behind. The demand for capital spending funds at low interest rates could increase dramatically.

Finally, since the events of September 11th basically created a new world with new sets of demands, our government has spent massive amounts of money to clean up lower Manhattan, rebuild the damaged Pentagon, create the Office of Homeland Security and give it a very large budget, deploy hundreds of thousands of U.S. troops in Afghanistan, Iraq, and other Middle East locations, and increase defense spending to cover the costs of all the weapons that must be replaced following our recent military engagements. It is unlikely that we will see much of a drop in total defense spending over the near term. This dramatic increase in government spending will, no doubt, stimulate our economy as it injects billions of additional dollars into the economy. This spending supports the hiring of additional personnel by defense contractors.

The fifth item – psychology – is a bit of a wild card because it is so nebulous and subject to rapid change. Still, psychology plays a key role in market performance. Right now, we see psychology cropping up on several fronts. First, there seems to be a general consensus amongst investors that our economy will soon grow at a faster pace. Stock market performance of late is a key indicator of this sentiment. The DJIA, for example is up over 22.5% since early March. Second, the Federal Reserve's recent decision to lower interest rates appears to be motivated by a need to appease psychological concerns and not just an attempt to jump start the economy. The actual economic impact of the latest rate reduction will likely be minor and will not occur till months from now. But, the psychological impact of the rate reduction was immediate. There are at least two key issues here: (1) that economic data ultimately support current sentiment about future economic activity; and (2) that market psychology not get too far ahead of itself. Only time will tell how our economy will perform over the coming months and years.

As for the second issue, the financial markets have a long history of overdoing it on both the up and the down sides. There is no reason to think that the coming few years will be any different. Given this tendency, we caution it is likely the markets may get ahead of themselves on the up side and then may over react again on the downside should inflation surge and interest rate increases start coming at us fast and furious.

Under "normal" circumstances, any one of these variables might generate sufficient economic activity to exert inflationary pressures. However, we are now more than three years into a concerted stimulatory effort by our government, inflation is extremely low, and deflation is a primary concern. What is going on here and what does this all mean?

Where Might We Be Going?

When we consider what the future might bring us in terms of economic and market performance, we think about current circumstances and how they might play out given economic and market performance in previous similar circumstances. In other words, we have no choice but to look backwards to make, what are hopefully reasonable and somewhat accurate, assumptions about what the near- to mid-term future will hold. Unfortunately, this methodology is inherently flawed and far from perfect since history does not exactly replay itself.

We think the geo-political events of the past few years effectively negated, or at least delayed, the stimulatory impact the tax and interest rate cuts would otherwise have had. In other words, businesses and individuals behaved more timidly because of all the uncertainty and fear surrounding September 11th and its outgrowth. For example, if a business was unable to forecast future business trends with any degree of reliability because of all the interference caused by the terrorist events and resulting military conflicts, then, it probably chose not to proceed with any business upgrade or expansion projects other than those necessary to keep the business alive and functioning. Even though money is cheap, the negatives surrounding all the uncertainties outweighed the benefits of immediately taking advantage of low interest rates. Also, a falling interest rate environment exacerbates the problem since it encourages business owners to defer borrowing money until rates hit absolute bottom. Perhaps a more important question is how fast will the demand for money grow when the rates begin to rise?

As we see it, the investing challenges ahead will center upon how to take advantage of what likely will be a rising interest rate environment over the coming one to four years. With money market, certificates of deposit, and bond yields now at historically low levels it is hard to start worrying about rising interest rates. Those living on fixed incomes – particularly those Americans who need interest payments to make ends meet – now find yields are too low to generate any meaningful income. For example, the yield on a one-year Treasury bill is a measly 0.77%.

In other words, if you loan the U.S. government $1000 for one year all you will receive in interest for making that loan is $7.70 – hardly enough to even cover the cost of purchasing the bond! An investor has to take on almost two years of interest rate risk to receive a 1% yield and four years of interest rate risk for a paltry 2% yield. The ten-year Treasury yields just 3.49%.

At these historically low levels, interest rates can not go much lower but could possibly head much higher in coming years. Indeed, we have not seen yields or interest rates this low since World War II. This fact, alone, particularly when combined with the laws of statistics, suggests that at some point interest rates will regress to the mean and return to more usual levels. Historically, the bond market has returned about 5-6% per year compounded. When the huge amount of monetary and fiscal stimuli injected into the U.S. economy over the last few years is factored in, a return to higher interest rates seems inevitable. Indeed, it is quite likely that once interest rates turn and start to rise the upward pressure will exceed that which is truly necessary. In other words, the upward movement in rates may be just as exaggerated and overdone as the downward movement. The Federal Reserve may find itself scrambling to curb rising inflation by raising interest rates quickly and dramatically. As always, though, the Federal Reserve walks a difficult tightrope as it attempts to encourage a stable economy that supports and nurtures sustainable growth.

We think a likely scenario for the coming few years is a steadily improving economy and rising inflation and interest rates. We think a key issue will be whether inflation remains within an acceptable range or breaks out on the up side. Increased economic activity and growth, in and of itself, may increase inflation, which now sits at a negligible level. When you then add in all the monetary and fiscal stimuli – some of which have yet to make their impact felt throughout the economy – the increased government spending and the likely pent-up corporate demand for capital expenditure projects, the stage appears set for stronger growth and higher inflation. Better economic growth should mean that more Americans will return to work during the coming year.

More people working translates into more consumer demand. Higher demand for limited goods and services usually means rising prices (a/k/a inflation).

From an investment standpoint, the challenge is how to benefit during a rising interest rate environment. One way is to select high quality, proven equity investments from industries that performed relatively poorly of late but should do better as our economic recovery becomes more vigorous. Some of the leading companies in these industries now pay attractive dividends and could see their stock prices rise as the economy strengthens. Another strategy is to patiently wait for interest rate sensitive investments, that are now priced well over par and yielding minuscule amounts, to fall in value and return to more normal yields.

If our expectation of considerably higher rates materializes in the next two to four years, it may then be strategically possible, in the years ahead, to lock in these higher rates before the next downward cycle in rates occurs. In other words, normal demand, plus catch-up demand, plus aggressive stimuli may very well result in higher inflation and much higher interest rates as the economy is perking ahead at an overall rate that it possibly will not be able to sustain indefinitely. This would require a strategic locking in of higher rates at the higher end of the next cycle upward in order to protect investors from getting trapped in another very volatile downward rate swing.

Our current position is that we think the economy possibly is now emerging from a long patch of bad weather and that fair weather is on the horizon. We realize, though, that our "look ahead" essentially outlines what we think could be another patch of bad weather on the more distant horizon. Our hope is that this briefing on our views regarding possible future economic developments will give some additional depth to our monthly briefings. As future developments occur, we will attempt to further adjust and refine our views and then relate those views to a strategy. This strategy will include ideas concerning specific investment categories and investment income instruments and securities.

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