



Following the Beat of the Earnings Drummer

April 6, 2004

For the past six months, conventional wisdom on Wall Street has been that the economy is finally picking up; consumer demand is strong; corporate profits are better-than-expected; and economic growth is above average. Ergo, companies — whose CEOs have been waiting for clear signs that the economy is firmly on the upswing — will take these signs as proof that the recovery is for real and will, in due course, start to hire workers.

We have been unconvinced, but our view is out of the mainstream. Conventional wisdom appears to have shifted gears: without meaningful job creation of at least 200,000 new names being added to payrolls each month, the economy must soon slow because a weak labor market will force over-extended, debt-laden consumers to rein in their spending. This slowdown in spending will cause companies to be cautious about future capital spending that will result in decreased corporate profits as current margins (which are already high on a historical basis) cannot be maintained in the absence of new growth from investment.

We think there is another interpretation: the traditional relationship between job growth (particularly in manufacturing) and growth in corporate earnings is changing. As a result, there will be both continued weakness in the labor market and high levels of corporate profitability.

There are two reasons for this interpretation: globalization and technology. We have pointed to the dramatic effects of both trends over the past two years, and more than ever, they are the cause of both overall economic growth and continued weakness in the U.S. labor market. Globalization — especially the rise of China as a consumer/importer of goods and as a low-cost, high-quality producer of goods — means that U.S. consumers have a continuous supply of low-cost merchandise and, more recently, outsourced services. This trend means that the spending of Americans can continue to expand because other nations are willing to supply the U.S. with low cost goods in trade for future calls on U.S. output. Here again, China is key, because it has become a leading buyer of dollars over the past year. This buying activity has subsidized the U.S. dollar and has helped keep U.S. interest rates at 40-year lows.

Productivity is strong having increased 4.4% in 2003. In this favorable environment companies do not need to hire workers to meet increasing demand. In fact, there is still excess unused capacity in manufacturing and information technology. New software systems enable service-oriented companies to deliver more service with the same number of employees. Supply chain efficiencies allow companies to keep inventories more closely aligned with demand resulting in improved profitability, enhanced flexibility, and reduced pressure to expand their labor force in order to adjust to an increase in demand.

In short, we believe that contrary to current Wall Street wisdom, corporate earnings for the first half of 2004 have a good chance of surprising on the upside. The shrinking labor market is clearly a political and social issue, but it is not a sign of economic problems. Markets can be buffeted by politics and by crises - note the drop on Wall Street and world indices in the aftermath of the atrocious bombings in Madrid on March 11th. But they ultimately follow the beat of the earnings drummer. Given the factors just described, that beat is likely to remain quite loud.

U.S. Economic Summary

Slow payroll growth and an unemployment rate of 5.7% reported on March 5th contributed to a fall in consumer confidence during the first quarter. However the latest explosion in job growth in excess of 300,000 new jobs coupled with upward revisions for January and February solidified the bull's case that job growth was just around the corner. This surge in jobs may have signaled the end of low interest rates as the bond market fell sharply on both Friday April 2nd and Monday April 5th in the aftermath of this report.

Federal Reserve Chairman Alan Greenspan has made a series of speeches that indicated that the Fed would not raise interest rates until there is meaningful job creation or inflation. The latest jobs report may signal that the Fed is revisiting the idea of keeping rates low. Despite a dip in sales, the housing market remains at historically high levels. New home sales, for instance, are up nearly 10% year-over-year. Furthermore, home prices continue to rise, and were up on average 8% in the last quarter of 2003. With rates heading north again, there could well be a slowdown in mortgage refinancing, and the potential for a slowing in the overall pace of growth for the residential real estate market.

Final revisions of consumer spending for the fourth quarter of 2003 showed growth of 2.7%. Tax refunds have been a bit behind projections at more than \$70 billion, but are up from last year. Personal income that was boosted by these tax refunds was up 0.8% in January. Wages also continue to rise. The result is that retail sales have been much better than consumer confidence or the employment reports. Chain store sales soared 6.7% in February, the best increase since the spring of 2000. Overall retail sales growth, year-over-year, has been stronger than at any point in the past four years. The only negative has been a rise in oil prices, resulting in an increased price at the gas pump of \$1.80.

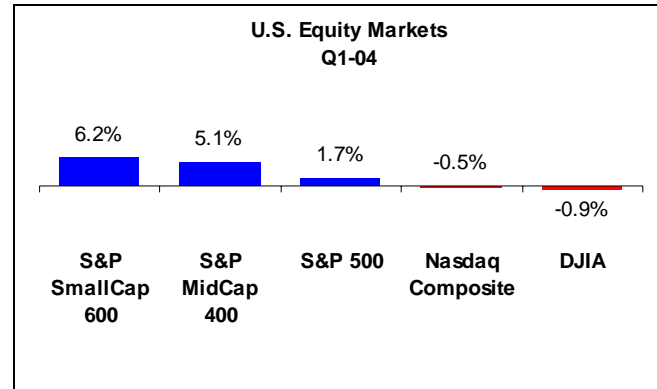
Consumer spending has been remarkably steady for the past two years, confounding most Wall Street analysts. The source of this spending is undoubtedly a result of the government's fiscal policy of increased deficit spending to get the economy back on a growth track. Rising wages coupled with low core inflation (currently at 1.2%) has meant that most people have money in their pockets and increased purchasing power. They have money not just from wage income but also from credit cards and mortgage refinancing. While consumer debt is high in absolute terms, debt servicing is still within historical norms, albeit on the high end of the range. Continued low interest rates and tax refunds in the coming months should mean continued expansion of spending. In addition, the price-deflation stemming from China will mean that U.S. consumers will continue to have access to a low-cost smorgasbord of products.

All gauges of manufacturing output fell during the first quarter: the ISM Manufacturing Index dipped to 61.4 and the Philadelphia Fed Index of manufacturing slipped to 31.4. Yet, Industrial capacity utilization increased 0.5% to 76.6%, its highest reading since August 2001. Industrial production rose sharply in both January and February, especially in tech goods, and is rising at an annual rate of 7.3%. Though manufacturing employment has shrunk, output has been increasing rapidly. The slight pullback in February was off of highs not seen in years, and manufacturing activity continues to be very, very strong across the country. This strength has meant high profits for many companies, but not larger payroll numbers.

The picture that emerges is that of an economy gathering momentum. The data support the view that above average economic growth will continue in the second half of this year when the stimulative effects of the tax rate cuts of 2003-04 wane. Though manufacturing might not exactly be on the verge of a renaissance, a healthy period of economic advance would appear to be ahead, one likely to favor equities over bonds.

U.S. Financial Markets

During the first quarter of 2004, the U.S. equity market entered its first extended pause in the one-plus-year advance. By the end of March, the major indexes were almost unchanged after rallying in January and February. The Dow industrials finished the quarter down 0.9%, at 10,357.70. The more volatile Nasdaq Composite, whose many technology stocks led last year's market gains and this year's declines, fell a bare 0.5% to 1,994.22. The broad S&P 500 rose 1.7% to 1,126.21 led by household-product stocks that are more stable in uncertain times. The March 11th train bombings in Madrid renewed fears that al Qaeda still is active and plotting fresh attacks on the West. That bombing, combined with Israel's assassination of Hamas leader Sheik Ahmed Yassin brought global terrorism concerns back to the fore.



The S&P SmallCap 600 gained 6.2% while the S&P MidCap 400 rose 5.1% as investors continued to chase smaller-cap names. The so-called low-quality rally of 2003, that featured double-and-triple-digit gains in high beta, small-cap, technology, telecommunications, and Internet companies with dubious balance sheets, seemed to lose momentum toward the end of the first quarter. However, the long-awaited rotation into the shares of large, high-quality companies with proven records of earnings growth hasn't yet fully materialized. Although many factors were at play, improving corporate fundamentals battled repeatedly for Wall Street's attention with concerns about still-tepid job growth and the continued threat of terrorism.

Merger news influenced the broad market's performance for the first three months of this year. Bank One and J.P. Morgan Chase that agreed to combine were among the leaders as was AT&T Wireless that sold itself to Cingular for \$41 billion. Business-software firm Oracle proved to be one of the biggest losers in the first quarter. Its stock fell more than 11% as the U.S. Department of Justice filed a lawsuit to block CEO Larry Ellison's bold and controversial bid to buy rival PeopleSoft.

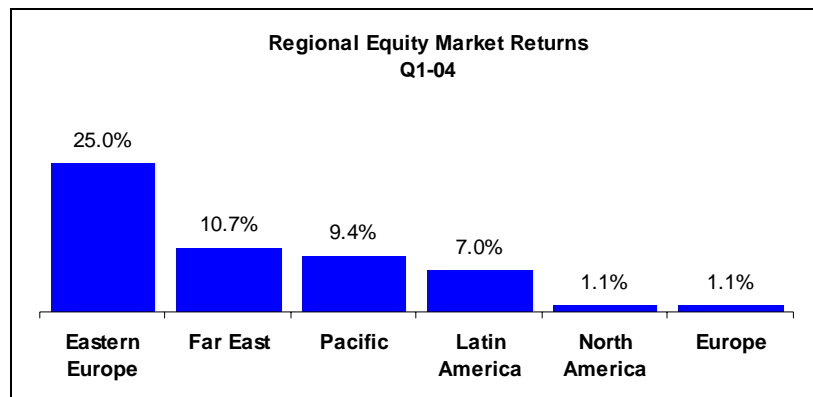
Intel led the technology sector lower in the first quarter of 2004. With corporate capital spending increasing, the financial performance and prospects of the world's largest semiconductor maker looked as strong as ever, but the stock had gotten expensive in last year's rally. Similarly, networking-gear-maker Cisco Systems that looked poised for strong growth suffered on fears of overvaluation. Software titan Microsoft also struggled as it failed to settle antitrust complaints with European Commission regulators. The company faces fines and orders to change the way it does business, which could affect its operations across the globe. Microsoft has also suffered a drop in its unearned revenue in recent quarters that could indicate some large customers are balking at signing big long-term software deals.

Performance in the health-care sector was mixed. Abbott Laboratories, Bristol-Myers Squibb, and Wyeth each posted double-digit losses as investors fretted about thin product pipelines, patent expirations, product approvals, and operational issues. Meanwhile, some smaller-cap biotech and specialty pharmaceutical stocks continued to flourish.

Real-estate investment trusts led the way during the first quarter, rising by 10%, after rising nearly 40% in 2003. Wireless-services providers helped make telecommunications stocks one of the best-performing sectors with a 4.2% gain. Verizon Communications rose more than 7% as the firm continued to attract new customers for its wireless services while retaining current users.

Foreign Financial Markets

Foreign stock markets outperformed domestic equities during the first quarter as optimism about global growth and strengthening local currencies vis-à-vis the dollar propelled markets higher. Eastern European emerging markets were up 25% as blue chips in Russia (+29%), the Czech Republic (+25%), and Hungary (+17%) gained. Far Eastern markets were up nearly 11% as Malaysia (+14%) and Korea (+12%) replaced last year's darlings Thailand (-14%) and India (-6%). Pacific stocks benefited from a rebound in Japanese equities (+11%) and were up 9.4% for the last three months. Latin American equities rose 7% as Mexican (+19%) and Venezuelan (+29%) stocks surged. Conversely, European equities rose a scant 1% as concerns over weak growth and continued lack of fiscal and monetary action weighed on equity markets.



The most active stock markets remain in the developing world as globalization continues to drive economic growth. The Moscow RTS Index gained 42%, helped by strong energy and commodity prices, fiscal policy reform that is favorable to both businesses and individuals, and a landslide re-election for President Vladimir Putin. The Russian market was also supported by high international investor demand as

Russian companies continued to deliver positive earnings surprises. Despite gains in the fourth quarter of last year, Chinese stocks fell 3% in the first quarter as investors worried about a stock-market bubble at a time when Beijing is making an effort to slow China's economic growth rate of 9%. During the quarter, Chinese officials introduced a new tax plan that will equalize corporate tax rates and announced a reduction in known bad loans as a percent of assets in the banking industry.

Strong growth occurred elsewhere in the Asian developing world. South Korea's Finance Minister announced that the economy was accelerating, led by rapid export growth, and may expand as much as 6% during 2004 compared to 3% growth last year. Overseas demand for Korea's goods surged; exports rose 46% during February, the largest gain in 15 years. Korea's semiconductors, cell phones and cars are in particularly high demand. This strong export performance has boosted business confidence, which now stands at a 17-month high. Taiwan released statistics indicating that growth rose 5.2% for the latest period. Taiwan's government expects the trend to continue, and has forecasted 4.7% growth for this year. Preliminary figures suggest that the Thai economy expanded 6.5% last year. If true, this is the fastest growth the country has experienced since 1995. Exports grew 23% led by autos and auto-related parts. Rubber exports in particular have risen sharply, as Thailand has geared up to serve China's burgeoning auto market. Strong production figures are leading some to predict 7 - 8% growth for the year ahead.

Shares in the Eastern Pacific, namely Japan, enjoyed a strong first quarter as the Japanese government has been known to order state-run funds to buy shares ahead of the March 31st fiscal year-end. Yet, this year was different. The real economy seems to be performing better. Fourth quarter 2003 GDP expanded 7% in real terms, sharply surpassing consensus estimates for growth. Other statistics also indicated strong underlying economic activity: capital spending increased 22% and exports rose nearly 18%. Betting that the Japanese economy is finally on the mend, foreign fund managers invested heavily in Japanese equities in the first three months of this year. The result was continued new highs in the Nikkei and Topix indices during the quarter. Japanese companies have been taking restructuring more seriously, reducing excess capacity and exiting businesses where they are less competitive. Unfortunately, the country still suffers from long-term demographic problems and a closed economy.

Meanwhile, Europe found itself in the unfortunate position as the center of global attention following the March 11th train bombings in Madrid. European markets fell hard after the attacks, though recovered and posted slight gains on the back of a steadying dollar easing concerns that weakness in the euro would crimp economic recovery by hurting exports. The European economic picture was mixed, however. On the downside, surveys revealed signs of declining business confidence across much of the region, especially in Germany, and unemployment remains stubbornly high. On the positive side, data showed that euro zone industrial orders rose in the last month of 2003.

Conclusion

On the domestic front, if the economy is headed into a sustained period of above-trend growth, as we expect, interest rates are likely to rise. But the Federal Reserve Board appears unlikely to raise interest rates as early or as aggressively as it has in the past. Moreover, the extent of the rise in interest rates should be limited because the economy's "slack" will take time to absorb, keeping inflation low. Indeed, low inflation will likely keep interest rates well below the averages of recent decades, even after the economy solidifies fully.

Stocks have typically benefited as the economy has entered the "sweet-spot" of the business cycle -- where inflation and interest rates are still low but growth is above average. In this stage, labor costs tend to remain low. But at the same time, productivity growth surges. As a result, profit margins tend to widen. Because companies are making more money, stock prices increase. This phenomenon has been reflected by the fact that corporate profits reached new highs in the fourth quarter of 2003. Pretax earnings for current production hit the \$1.2 trillion mark in the final quarter of 2003; as a ratio to total GDP, this equates to a profit rate of 10.7%, a level last achieved in 1997 and, before that, 1969. Economic profits increased 18% last year, with the fourth-quarter run rate up 29% over the Q4 2002 level, the biggest increase in 20 years! Considering these results, optimistic earnings' forecasts for 2004, and the performance of equities over the past year, we expect returns to be modest in the second half of this year. Moreover, increased concerns over terrorism and incumbent President Bush's re-election will keep markets volatile.

Looking ahead, we remain upbeat about prospects for Asia. With GDP growth accelerating, most countries have current account and trade surpluses, and domestic demand is gaining strength. We think that over the next few years the Chinese economy will continue to be an engine for the whole region.

There are some reasons to be optimistic about European equity markets. Next month, ten countries will join the European Union in the group's largest-ever expansion. With the new entrants' lower labor costs and corporate tax rates, the EU enlargement will help make some Western European companies globally competitive, as they move facilities eastward. European valuations continue to look more attractive than those of their U.S. peers. And a rebound by the U.S. dollar against the euro will reduce pressure on large European companies, whose goods had become less competitive because of the euro's strength.

A Thought for Spring: "With Spring, each man's plans and hopes result in new efforts, fresh actions."
Malcolm Forbes

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