



Two Steps Back

April 8, 2003

At the beginning of this year, we forecast that a change in corporate behavior would streamline U.S. business operations and result in investor-oriented initiatives. We also highlighted the importance of President Bush' tax reform package and the restoration of investor *Faith* – “One Step Closer”. The good news is that corporate America has already atoned for many of its sins. That's especially true of the policies used to guide corporate accounting, where balance sheet restructuring is conservative, capacity excesses have been purged, and profitability is on the mend. These positives have given rise to the notion that the U.S. could actually be on the brink of a capex-led recovery. The bad news is that Congress and the administration have not yet agreed on a package of tax cuts and spending initiatives. While enactment is still likely by mid-year, the details remain highly uncertain. Moreover, on March 19th the United States went to war with Iraq. In the first days, it looked like the conflict could be over quickly, but it's now clear that it will last longer than expected. In the meantime, the financial markets remain at the mercy of geopolitics. Unfortunately, for stock market investors, we have taken one step forward and two steps back.

Financial markets have been in a three-year plus funk -- a huge post-tech bubble correction in world equity markets and an equally extraordinary surge in bonds. Over the same time frame, the global economy has been in one recession and is back on the brink of another one at this writing. The Fed's significant easing moves over the past two years and the current sluggish recovery have prompted a lot of speculation that monetary policy cannot get traction in a post-bubble environment, or indeed, that monetary easing always is like pushing on a string. With coalition troops now making forays into Baghdad, many are hopeful that a quick end to the war in Iraq will promote a healthy U.S. and global economic revival. Those hopes are likely to be frustrated, in our view, because war-related uncertainty is far from the only cause of the current economic malaise, and a successful military operation in Iraq won't end geopolitical uncertainty. Moreover, the other factors that have joined with war jitters to depress economic activity -- the energy shock, restrictive financial conditions, and the recent outbreak of the SARS epidemic -- are still playing out to the downside.

Barring additional shocks and the lack of clarification of the SARS epidemic, we are on the way to a reasonable economic recovery. One supporting statistic is the improvement in corporate profits. We believe that lower energy prices, a weaker dollar, and the ongoing benefit of lower interest rates should help promote renewed growth. A vigorous rebound will require additional fiscal stimulus, a big improvement in both business and consumer confidence and higher stock prices, and these expectations may not all be fulfilled in the near term.

U.S. Economic Summary

Aside from the broader effects of a regime change in Iraq, a successful conclusion to the war, when it comes, should be positive for the economy. First-quarter economic growth and corporate profits have clearly taken a hit from the surge in oil prices during the run-up to war. Although the drop in crude oil prices to the lowest levels in four months may not stick, the global economy will benefit from a permanent retreat in oil prices once the war is over. Less quantifiable but still real has been the uncertain effect of geopolitical instability on consumer and business confidence and, presumably, spending -- we

expect that just clearing out this fog will help the economy. Even the Fed's ability to make decisions has been affected: after its policy meeting in March, at which no action was taken, the FOMC said that because of the uncertainties in the geopolitical situation, it was unable to "usefully characterize the current balance of risks" with regard to economic growth and inflation.

The Fed's ambivalence on whether slower growth or higher inflation is the bigger risk is a direct hedge on its earlier position that geopolitical uncertainties have been the main factor in the recent "soft spot" in the recovery (a view it repeated in the post-meeting statement). Even if the end of the war were to remove some important geopolitical issues going forward, the damage already done could retard the economy's momentum. And until war is out of the picture, we can't know for sure how much, if any, of the recent soft spot is due to other problems, such as lingering effects of the 1990s technology meltdown. The likelihood that such occurrences are still in play was raised late in the quarter by New York Fed President William McDonough, who said: "the effects of the bursting of the stock market bubble have proven to be far more long-term and pervasive than expected."

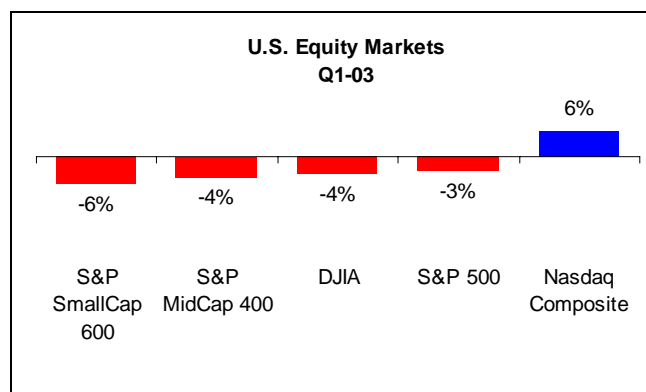
Recent news on the economy has mostly been negative. The Conference Board reported that the leading economic indicators declined for the first time in five months in February. The falloff in both manufacturing and non-manufacturing and the sharp deterioration in employment prospects have caused consumer confidence to plunge to the lowest level since 1993. But there are a few bits of good news for the economy. First, the "CNN-effect" on consumers is turning out to be less than might have been expected. Second, the dramatic drop in the price of oil, if it sticks, would be welcome relief for consumers at the gas pump. Third, another leg to the mortgage refinancing boom is in full swing which will help sustain consumer spending during this time of heightened economic stress. Meanwhile, the core rate of inflation hit a 36-year low of 1.7% in February. With inflation likely to head higher, bond yields might fall further. Companies' lack of pricing power is limiting profit growth. That means that a bit more inflation might be a lubricant for earnings growth that, in turn, could fuel increases in capital spending and hiring.

U.S. Financial Markets:

Following three consecutive years of negative returns for the major stock indexes, most investors began 2003 anxiously hoping that the stock market's funk would reverse. However, the continued weakness in this year's market performance has been disappointing inasmuch as we have already experienced the worst bear market of our lifetimes without a major economic decline. Although stocks started to show some signs of life over the past three months, market performance was sharply split. During the first quarter, the S&P 500 index dropped 3.15% and the Dow Jones industrial average fell by 3.46%.

Conversely, the tech-heavy Nasdaq Composite gained 5.66%. In many ways, the market in early 2003 was reminiscent of 1990, when Iraq's invasion of Kuwait set off another major conflict in the desert sands. Then, as now, bonds and large-growth stocks topped the performance charts as investors grappled with an uncertain market and difficult economic conditions.

Despite a late rally, the majority of stocks lost ground during the quarter, and some of the worst declines came from automakers, which were down 7% since the start of the year. Ford Motor dropped roughly 20% during the quarter, following a 40% decline in 2002. After years of aggressive rebates and zero-



financing offers, American consumers' appetite for new autos may be sated. Department store stocks also experienced a price decline in the past three months. May Department Stores and J.C. Penney were both down about 10% for the quarter. These companies were being squeezed from two directions: innovative discounters, such as Target, provide competitive products with superior pricing while specialty firms, such as Abercrombie & Fitch's Hollister concept, strip away younger, more fashion-conscious consumers. Traditional department stores may not disappear, but there's little if any growth left in the business.

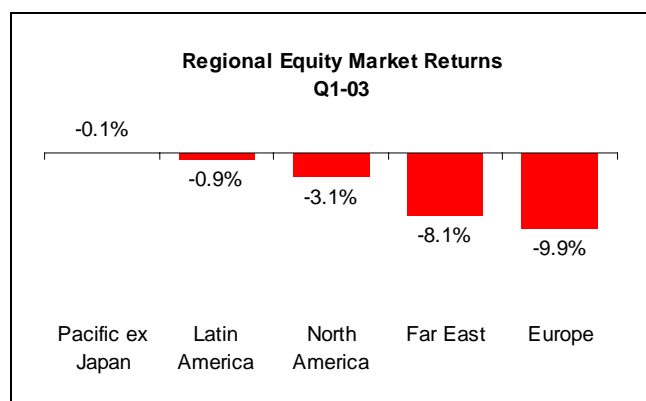
Few would have guessed that two of the hottest stocks of the dot-com gilded age would top the performance charts again. Economically sensitive optical equipment maker Corning returned a whopping 80% since the end of 2002. In the online retail arena, Amazon.com was up some 40% during the first quarter. The hardware and software sectors, which showed bigger gains after a rally late in the quarter, were the best-performing sectors for the first quarter. Given the uncertain trajectory of the economy, it's no surprise that Microsoft, that has a dominant position in the PC market and \$40 billion of cash, maintained its value since the end of 2002. Conversely, the telecom business is still waiting for a new day to dawn. At the end of the first quarter, SBC Communications and Verizon were down 20% and 7%, respectively.

Concern about disruptions in America's energy supply sent oil prices to nearly \$40 a barrel during the first quarter. Oil prices have remained high partly due to supply problems emanating out of Nigeria and Venezuela on the back of continued political unrest. Energy stocks, however, struggled to reap gains from higher oil prices during the first quarter. Exxon Mobil shares were practically unchanged, and Royal Dutch Petroleum's American depository shares shed nearly 9% so far this year.

In the latest quarter, as the war in Iraq created new appetite for many fixed-income investments, junk bonds took the spotlight. Although stocks surged when the war began, they slumped shortly after and became highly correlated to developments in Operation Iraqi Freedom. Junk bonds, meanwhile, returned about 7%. These gains suggest that despite all the talk of consumer and investor pessimism someone is stepping forward and buying growth and optimism. Corporate bonds were in demand throughout the quarter as many investors continued to seek the safety and steady yields of fixed income securities. Treasuries led the way early in the year, but suffered late in the quarter as more investors shifted into junk bonds and stocks. As a result, the yield on the benchmark 10-year Treasury note ended the quarter at 3.807%, barely changed from the yield of 3.818% at the beginning of 2003 – but still at 40-year lows.

Foreign Financial Markets:

After drifting lower during the first two months of the year, foreign markets suddenly staged a powerful March rally that began shortly before the outbreak of war. But as the quarter came to an end, investor confidence in overseas markets appeared to be shaken all over again. Even if the war were to end soon, concerns about the insecure state of the global economy and future battles in the continuing war on terrorism led many investors to bemoan that foreign markets were back in the woods of uncertainty.



March's gains took some of the sting out of a quarter marked largely by growing risk aversion and steady selling throughout the first two months of the year. European markets are dominated by financial companies that have strict capital ratios. These companies are often forced to be sellers of stock when the markets are in decline, exacerbating losses. Moreover, many European companies have higher fixed

costs, such as labor and pension plans, that make managing profits more difficult. With European leaders divided over war in Iraq and with European relations with the U.S. in a state of flux, it was perhaps no surprise that the markets suffered a highly volatile quarter. Despite the late-quarter rally, major European markets all closed lower. London's FTSE 100 Index fell 8.3%, while the Paris CAC 40 Index lost 14.5%. Frankfurt's Xetra DAX Index slipped 16.2%. Stock selection didn't offer much relief in Europe during the quarter as revelations of an accounting scandal at Dutch supermarket chain Ahold caused its shares to plunge 70% in just three trading days. The news also raised questions about whether potential scandals at other European companies awaited investors.

On the bright side, telecommunications shares rebounded after a weak 2002. The sector's 1% loss was the best performance in Europe. That came despite Deutsche Telekom's March announcement that it lost €24.6 billion (\$26.8 billion) in 2002, the biggest loss in German corporate history. Its shares fell 17.5% for the quarter. Vivendi Universal also reported a record loss of €3.3 billion for last year. The media company's shares fell 21% in the quarter.

In Tokyo, stocks continued to struggle as the Nikkei slipped to a two-decade low that sent Japanese policy makers scrambling to find some way to boost investor confidence and the market. As in past years, the Japanese government indicated it was taking efforts to boost a slumping stock market before the March 31 fiscal-year end. But unlike last year, when restrictions on short-selling unleashed a powerful Tokyo rally, efforts to weaken the yen and talk of relaxing rules on company share buybacks failed to swing the market into positive territory. The Nikkei ended the quarter down 7%. While that return exceeds those in many other foreign markets, investors increasingly say that Japan won't enjoy a sustained rally until it addresses the fundamental weakness of the banking system and its non-performing loans. Global investors were also largely disappointed with the government's choice of a new central banker, Toshiko Fukui, who many considered too conservative a choice at a time when the Japanese financial system requires bolder change.

Hong Kong stocks fell to a four-and-a-half year low at the end of the quarter as concern grew over the likely economic impact of an outbreak of pneumonia, or severe acute respiratory syndrome (SARS). The rapid spread of SARS, which first emerged in China last year, is threatening to undermine an expected economic recovery in Hong Kong this year, having affected 1,600 people and caused almost 100 deaths so far. Retail and services sectors as well as tourism are the most affected areas of the market. Overall, the MSCI Pacific ex Japan index was down less than 1% primarily due to strength in Thai equities.

In Latin America, Argentine and Brazilian equities performed well over the first quarter, posting gains of 19.1% and 3.7%, respectively. Argentine stocks rose and bond yield spreads over U.S. Treasuries fell by 10 percentage points amid signs the economic recovery is gathering pace and a debt rescheduling deal might be possible before the end of the year. The bank controls imposed in December 2001 were lifted at the end of the quarter, which helped bring the peso below three to the dollar for the first time in nearly a year. In Brazil, improved sentiment towards the new president Lula, and a higher fiscal and trade surplus contributed to stock market gains.

Emerging market opportunities are back in fashion among investors, especially Asian companies that offer investors exposure to the Chinese consumer, as they look to find yields and returns that are unavailable in depressed mainstream markets. But fund flows to these stocks were disappointingly low compared with past years, with emerging-market bonds attracting more interest during the first quarter. Stocks in developing countries didn't participate in the war rally to the same degree as many European and U.S. stocks did, a sign of their decreasing volatility. But the MSCI emerging markets index managed a respectable performance, especially given rising risk aversion, with a loss of just 5% for the three-month period. During the quarter we saw the continued emergence of China as a real investment story. Shanghai's B-Share Index of companies open to foreign investors rose nearly 8%.

Conclusion

The equity market seems to take one step forward and two steps back. Economic data and corporate earnings should be less important when hundreds of thousands of our troops are engaged in a dangerous war with sponsors of terrorism. Whether one was for or against this war (and there have been honorable voices on both sides of the debate), it is happening. The safety of our forces and of the civilians of Iraq naturally occupies more public attention than whether or not company "X" missed or beat its earnings or whether or not housing starts were up or down. Those statistics are important, but they are not matters of life and death. Like you, our thoughts are with our troops and their families, and we honor their commitment.

We think the war in Iraq is the real issue right now along with the spurt in energy prices and the fears of terrorist acts. The progress of the war will be the decisive factor governing the short-term movement of markets. Long-term, there are questions of the rebuilding of Iraq, fragmented international relations, the political and social stability of the Middle East, and the unresolved crisis over North Korea and nuclear proliferation. These questions will take quite some time to answer, but at present, it seems clear that Saddam Hussein's regime is about to end, in a matter of weeks at best or months at worst. Even as the conflict becomes more intense in the days ahead, it's vital not to get so caught up in the current news that we miss the big picture.

The most likely scenario seems to be a step forward, but still a measured pace of recovery once the war is behind us. Corporate profit forecasts have been scaled back further -- analysts now expect S&P 500 earnings to increase 12% this year; on January 1, the target was 14% and three months before that, 18%. Moreover, there is the potential for further negative wealth effects occasioned by falling share prices and a continued flight to safety in Treasury bonds. At quarter's end, the S&P 500 was 11% above its October low and 9% below its mid-January high, reflecting investor indecision about whether the next major move will be up or down. It's a standoff, you might say, about which is the appropriate paradigm: the 40% under valuation in stocks indicated by the Fed model or the 15% overvaluation indicated by the market's absolute P/E relative to the norm of the past four decades.

The flip side of the stock valuation dilemma is an equally difficult one in bonds. Assuming a second-half improvement in U.S. economic growth, a rise in corporate pricing power and a satisfactory end to the war, bonds appear to be richly priced, and our long-term judgment is that higher yields are coming.

Quote for Thought: "Life can only be understood backwards, but must be lived forwards." -- *Robert Green Ingersoll*

Diane V. Nugent, *President*
Wealth Management Services, Inc.
1000 Main Street, Suite 100-B
Hilton Head Island, SC 29926

Tel: 843-342-3044
www.wms4you.com