Three Steps Ahead

July 9, 2003

At the end of March, we had just entered into war with Iraq and President Bush's package of tax reforms and spending initiatives was being debated by Congress. We cited these two issues as being "Two Steps Back" in the outlook for financial markets. The only positive was that interest rates were at record lows prompting existing homeowners to re-finance their mortgages and providing renters the affordability to purchase their first home. Three months later, we find ourselves three steps ahead. The war with Iraq is over and the price the country paid both in lives and money was lower than predictions. President Bush succeeded in getting fiscal stimulus approved resulting in lower taxes on dividends (15%), lower taxes on capital gains (15%) and a lower top personal income tax rate (35%). And finally, all equity markets rallied finishing out the second quarter with double-digit gains.

Bull market? Bear market? Is the market cheap or expensive? These questions dominate the financial news, and absorb the lion's share of attention among Wall Street economists, strategists, analysts, and cognoscenti. But the endless back-and-forth debate between bulls and bears is getting tired. Ideologues on both sides so dislike and disparage the other side that it often seems that they would rather win than be right. With so much data available, and with so much of it ambiguous, both sides have ample fodder to continue the battle for the foreseeable future.

While optimists and pessimists trade punches, the investing landscape is changing. The equity market is being defined not by bulls, bears, or even by sectors, but by companies with skilled management who adapt to current conditions and anticipate future trends. We are entering a financial environment that doesn't irrationally punish or reward, and is comprised of many companies that offer solid prospects for long-term returns.

U.S. Economic Summary

Overall, the economy began to accelerate in June. Stimulus from tax cuts, dividend tax relief, rising federal spending, a rate cut from the Federal Reserve, and a still strong refinancing boom in home mortgages buoyed economic activity. First quarter GDP growth was revised upward to 1.9% from a previously reported 1.6%. Consensus estimates for second quarter GDP are at 2.0% - 2.5%, and it is now widely expected that growth in the third quarter will approach or exceed 4.0%. Corporate profits, meanwhile, are rising 8.0% to 10.0% on a year-over-year basis and have risen for five consecutive quarters. Most of the increases have come from greater efficiency and productivity -- not from higher prices or increasing sales.

The June 25th meeting of the Federal Open Market Committee was the source of endless speculation. The "Street" consensus was that the Fed would cut the Fed funds rate, just not by how much. As it turned out, the Fed funds rate was cut 25 basis points, to one percent, because of concern that end-demand for goods and services was still lagging. The risk, from the Fed's point of view, was that deflationary pressures had been keeping profits down making it illogical for companies to increase capital spending substantially. The Fed hoped that the additional liquidity would push the economy over the edge into robust, sustained growth. However, with the core CPI rising for the first time since the summer of 2002, we question whether deflation is such a threat and we don't believe that additional rate cuts will be of benefit.

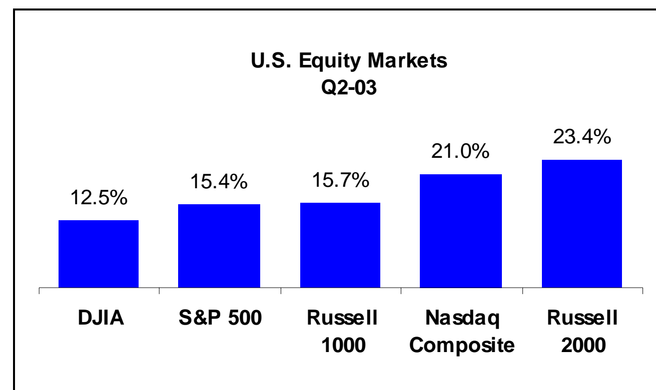
Manufacturing surveys during the second quarter all trended sharply upward. The most dramatic jump was in the New York Fed Empire State Manufacturing Index, which reached its highest level in two years, at 26.8 up from 10.6. The June Philadelphia Fed Index went to 4.0 from -4.8 in May, though the survey indicated that prices were not increasing. The ISM Manufacturing index went to 49.4 up from 45.4, just on the fringe of expansion. In general, the data showed an increase in industrial activity and future orders but still a weak pricing environment.

Last fall, many forecasters were saying that the refinancing boom triggered by low interest rates would end sometime in early 2003, but rates continued to decline to 45 year lows, and a new wave of refinancing activity was triggered. It is estimated that, with mortgage rates below 6%, nearly half of all mortgages outstanding can still be refinanced. That means that this year could easily surpass last year, when people took out nearly $200 billion in cash from their homes - an amount that translates into almost 2% of GDP. In short, mortgage refinancing alone can provide liquidity that can then be used either for expenditures or for savings, including purchasing equities.

Consumer confidence numbers suggested tentative optimism and lingering uncertainty, which is reflected in the balance between savings and spending. During the quarter, consumers spent less on summer apparel but more on electronics and home furnishings while the savings rate crept up to nearly 4.0%. Personal income growth came in at a healthy rate of 3.4% year-over-year. On the downside, unemployment remained high at 6.4% and job growth was weak.

U.S. Financial Markets:

The second quarter of 2003 appears to have marked a major turning point in both the bond and stock markets. Virtually all equity indices recorded double-digit gains reflecting a wave of new-found investor interest while the bond bull lost steam. Despite a month-end pullback, the S&P 500 index finished its best quarter in 4½ years, rising 15.4%. The Dow Jones Industrial Average rose 12.5% while the Nasdaq Composite jumped 21.0% during the second quarter.



The second quarter reversed a trend in which large caps outperformed small caps for three consecutive quarters. The performance spread between the small-cap Russell 2000 index and the large-cap Russell 1000 index was more than 740 basis points at the end of June. By contrast, the spread for the first quarter was only 155 basis points and the spread for 2002 was a paltry 117 basis points. The spread hasn't been this wide since the fourth quarter of 2001 when small caps outperformed large caps by nearly 1,000 basis points. It is also noteworthy that economically sensitive, high-beta stocks led the small-cap rally in the second quarter.

While indices reflected a performance disparity between large caps and small caps during the second quarter, they did not reveal much difference between growth and value stocks. The Russell 2000 Growth index (+24%), for example, barely outpaced the Russell 2000 Value index (+22%), and the Russell 1000 Growth index (+15%) and Russell 1000 Value index (+16%) showed even less disparity in performance.

The bottom line: As investors moved more of their money back into equities they sought opportunities in nearly every corner of the market -- they didn't flock toward growth or value stocks as has been the case in recent years.

Two of the best-performing stock sectors in the second quarter were among those beaten up over the past few years: utilities and telecommunications. While these two sectors have seen their fair share of bankruptcies in the past year -- NRG Energy and Worldcom were among the largest in each sector -- some of the bearishness and anxiety created by these bankruptcies negatively affected other companies that survived. The worst performing sector of the second quarter was consumer goods. Even though this sector was in positive territory for the past three months, this marks the second straight quarter in which consumer-goods stocks were at the bottom of the performance heap.

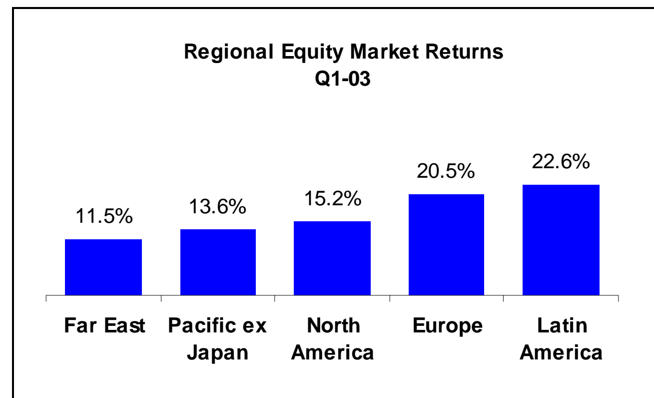
At the more specialized industry level, homebuilders led the pack during the second quarter. With mortgage rates at their lowest levels in almost five decades, the real estate market remained strong. The business/online services industry that includes many dot-com firms was a star performer, up more than 40% during the second quarter. Biotechnology surged nearly 42% as investors ignored risk and jumped on the speculative bandwagon. Only a handful of industries were in the red at the end of the second quarter. Hospitals were the worst performing industry on the back of continued corporate scandals: the government investigation into Tenet Healthcare's billing practices and the accounting fraud charge at HealthSouth.

The recent equity market rally was led by technology stocks. Skeptics believe this is a reflection of unrealistic investors trying to find gains from beaten-up, fundamentally weak stocks. At the end of 2002, there was a tech rally that gave up its gains early in 2003; that was, we believe, a rally that exceeded short-term fundamentals. The recent run-up, however, is different. Leading tech companies are seeing improved earnings and fundamentals because they have tackled cost-structure issues and become more efficient and realistic. More significant from our perspective is that more companies are meeting their earnings expectations and corporate debt issuance is up. That is usually a sign that companies are preparing for a round of expenditures, fueled by the cash flow generated by higher earnings and/or by debt. As earnings rise, many stock valuations, particularly for growth stocks based on 12-month forward earnings, seem to be very fairly priced.

Summer is not usually a strong period for stocks. Since 1952, July has ranked 7th and August has ranked 10th on a list of best months for equities. That may mean a consolidation of the gains of the last three months, but if so, that will create opportunities to invest in the companies that are leading and will lead the market. We also believe that the extra liquidity that is about to hit the economy will act as a counterbalance to the normal summer lull on Wall Street.

The bond markets were less than enthralled by the Federal Reserve and Alan Greenspan's 25 basis point cut in the Federal funds rate late in June. The market was generally expecting a 50 basis point cut and its disappointment resulted in a fairly dramatic sell-off for U.S. Treasuries across the curve. Despite this late-quarter decline, the 10-year has advanced 4.4% year-to-date. As the yields of money market and fixed income instruments have dropped over the last 15 months, income-seeking investors turned their attention to high yield and emerging market bonds. Partly as a reaction to the declining U.S. Treasury markets, high yield and emerging market bond markets also suffered late in the second quarter. Year-to-date, however, high yield bonds have jumped 17.2% while emerging market bonds have gained 19.7%. Despite absorbing a significant amount of new issue during the quarter, investor demand and liquidity in the high yield market remains strong as corporate fundamentals improve and the default rate continues its decline. The loser in the second quarter was the long-successful mortgage sector as consumer prepayments of mortgages hurt returns, along with the surprise management shake-up at government-sponsored mortgage company Freddie Mac amid disclosures of accounting irregularities.

Foreign Financial Markets:



Foreign equity markets sprang back to life in the second quarter as events involving the U.S. -- from the winding down of the war in Iraq to signs of an improving American economy and better-than-expected corporate earnings -- offered a catalyst for a world-wide rally in stocks. The MSCI EAFE index finished the second quarter up 19.3%. Japan and Singapore rose 7.4% and 5.8%, respectively. European markets notched up a whopping 43.1% second-quarter gain. Emerging markets were another bright spot, with the MSCI Emerging Markets Free index jumping 22.2% for the quarter. More broadly, the EuroStoxx 50 index of euro-zone blue chips rose 19%, easily outperforming the Dow Jones Industrial Average's 12% gain for the quarter. London's FTSE 100 index advanced 12%, while the Paris CAC 40 index rose 18%.

During a period when almost every major stock index pointed skyward, the second quarter's top performers tended to be those that had fallen the hardest in the first quarter. Frankfurt's Xetra Dax jumped 33% after a 16% drop in the first quarter and South Korea's Kospi leapt 25% after falling 15%. Argentina continues to bounce back from last year's collapse; the Merval was up 35%. Even in Israel, where the unemployment rate is in the double-digits and terrorist attacks continue, the Tel Aviv 25 gained 33% in the past three months.

After years of poor performance, European stocks enjoyed some of the biggest bounces in the second quarter after ending the first quarter at 1996 levels. With valuations much cheaper than their U.S. counterparts, many European blue-chip stocks assumed the role normally played by emerging markets: they fell harder in the bad times but rose faster once the selling momentum reversed. Perhaps most remarkable was the turnaround in insurance stocks. These companies were leveraged to the broader stock-market performance because of their large exposure to equities. As the markets fell, their portfolios suffered. That forced insurers to sell additional stocks in order to maintain their required solvency levels. It also led to downgrades by the credit-rating agencies and market rumors that one or more of the major European insurers might not survive. But these companies turned around and soared 28% during the second quarter, erasing nearly all losses for the first three months of the year. German insurer Allianz and France's Axa were among the top performers. Other top performers included Ericsson and Alcatel, that helped make the telecom-equipment sector among the second quarter standouts. At the other end were the traditional safe plays: consumer-staple stocks, such as the Netherlands' Unilever, and energy companies.

The outlook for Europe's home economies, meanwhile, remains mixed at best. Business sentiment improved recently in Germany and Italy, but that encouraging news was undercut by worsening sentiment in the Netherlands and France. In fact, a series of crippling strikes in France, combined with a drop in consumer spending, means that the euro-zone's second-largest economy may have contracted in the second quarter. Investors are counting on another European Central Bank rate reduction to stimulate the economy, but that may not come until the fourth quarter.

In the Asian Pacific region, Tokyo's Nikkei Stock Average advanced 14% for the quarter, as foreign investors saw enough positive signs to send Japan's popular blue-chip exporters higher. Canon gained 33%, while Toyota Motor -- one of the automakers that managed to avoid the pitfalls of the domestic economy by stepping up exports -- was 18% higher.

Despite a still slumbering economy, a 13-year bear market has made Japanese stocks relatively cheap. They look even more attractive when compared with Japanese bonds: the yield on 10-year government debt (JGBs) recently fell to a record low 0.43%. At the same time, a number of Japanese companies have at least managed to convince foreign investors that their debt problems are easing. Global fund managers also viewed the government's $17 billion bailout of Resona Holdings as a de facto nationalization of Japan's fifth-largest bank and a sign that the Tokyo is taking more aggressive steps to clean deteriorating bank balance sheets.

Emerging Markets were the leaders abroad for the second quarter. With energy prices remaining firm, oil-producing nations were at the top of the list. Venezuela's blue-chip index soared 60%, while Russia's RTS gained 40%. Jakarta's JSX index was up 27%, making Indonesia the top-performing Asian market.

U.S. investors in foreign stocks continued to receive an additional boost from a weakening currency. Returns in Japan and the 12 countries participating in the euro, among others, were even higher when translated to dollars.

With the threat of the sometimes deadly respiratory disease SARS easing in Asia, political reform proceeding in Brazil and interest rates falling everywhere, a long-anticipated rally in emerging-market stocks may be under way.

Looking toward the second half of this year, interest rates should remain low -- and could even fall further in Europe -- and this should continue to send money into the stock market. We are cautiously optimistic on the outlook for international markets. We remain vigilant and focus on identifying stocks that have strong balance sheets and positive long-term cash-flow-generation prospects. With yields on bonds from the U.S. to Tokyo at their lowest levels in decades, stocks are looking increasingly attractive compared with debt.

Conclusion

We are entering an equity market that will be led by superior companies. And after more than five years where the market was driven by sentiment, fear, euphoria, international crises, and momentum, that is a substantial shift.

What are these companies? They are companies like Oracle, one of the early software giants of the information technology revolution of the 1990s that has survived a rough few years. Larry Ellison, Oracle’s CEO, is a larger-than-life persona who has been a lightening rod for praise and for criticism. In late June, Oracle launched a hostile take-over bid for a rival enterprise software firm, PeopleSoft. With his typical bravado, Ellison announced that he would spend more than $6 billion dollars in order to acquire and then cease selling PeopleSoft products. Instead, PeopleSoft’s existing customers (about 6,000 of them) would gradually be shifted over to Oracle’s e-business suite of applications. Larry Ellison and Oracle have staked out a position that the software industry is entering maturity, that growth will be moderate and that software pricing will continue to decline. In this view, customers will demand more standardized products at lower costs and with better service, not the latest technology at a premium price. If this is the software industry’s future then efficiency in delivering software and services will be more important competitively than nimbleness or “cutting edge” technology. In short, Oracle believes market dominance is ever more vital.

Oracle may or may not be right about the future of software, the PeopleSoft bid may not go through, and Larry Ellison is famous for changing his mind. But Oracle is one of many leading companies because it understands that capitalism is a process of creative destruction, and its management wants to be the driver, not the deer caught in the headlights. Like Oracle, superior companies have management teams

that are willing to take a hard look at their business, their industry, and the needs of customers, and then are willing to make difficult decisions in order to try to catch the next wave of growth.

The guessing game about what the stock market will do over the summer months may be frustrating but it is less important than what good companies are doing now and what their earnings will look like in the coming quarters. The bull-versus-bear story makes for great tag lines on television and in news stories, and it can be fun to indulge in the argument. But we believe that times have changed. True fundamental investors care little about prognostications on the market as a whole; they focus on finding the best companies, one at a time, that are doing well in their industries under current economic conditions, and who have the management, products, and vision to lead. It is these companies we seek out to include in our client portfolios.

Quote for Thought: **“**Never buy on the bottom, and always sell too soon**”** **--** *Jesse Livermore*

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