



The Big Mo' Returns

October 14, 2003

No, it's not stock momentum we're thinking of! It's earnings momentum. The economy is accelerating and pulling profits along for the ride. Analysts are raising earnings estimates after underestimating them too much earlier this year. And earnings estimate revisions are not just taking place in the "bubble" technology sector. The industrial sector is benefiting from new tax laws on depreciation allowances. The materials sector is witnessing commodity price strength, particularly in metals, mining and wood products. In fact, earnings growth or lack thereof tends to be one of the more important influences on the stock market over time, with a fairly impressive correlation. Consequently, the data on earnings that show increasing strength are clearly helpful for stock price appreciation. Fascinatingly, First Call's economists estimate that third quarter 2003 earnings per share for the S&P 500 could be up by 19% year-over-year! This gain would dwarf the 11.7% rise in the first quarter and the 9.6% increase in the second quarter. Not surprisingly, we are a bit dumbfounded by claims that earnings growth has already peaked. Therefore, despite worries that the market has come too far in too short a period, we contend that further upside appreciation potential is more than likely and that seasonality is in favor of equities, with the fourth quarter generally being the most rewarding for the stock market. So hang on for the Big Mo'!

U.S. Economic Summary

During the third quarter, the Fed said that it will sustain low rates as long as necessary to ensure a viable economic recovery. Thus, the willingness to pump liquidity into the system remains very much a part of Fed policy beyond simply holding down the fed funds rate. Other economic data released during the quarter were mostly positive. Consumer spending and car sales remained at fairly strong levels in September, wages and salaries grew, albeit not at high rates, but the 2003 tax cuts boosted disposable personal incomes at a 7% annual rate in the latest three months. And consumers are spending at least some of this tax windfall; personal consumption expenditures are estimated to have grown at a 6% annual rate in real terms during the third quarter. On an annualized basis, tax and non-tax payments for an individual were \$388 less burdensome to the consumer's profit & loss statement in August 2003 than they were when George W. Bush took office in 2001; personal savings is up \$118 billion at an annual rate over the same period.

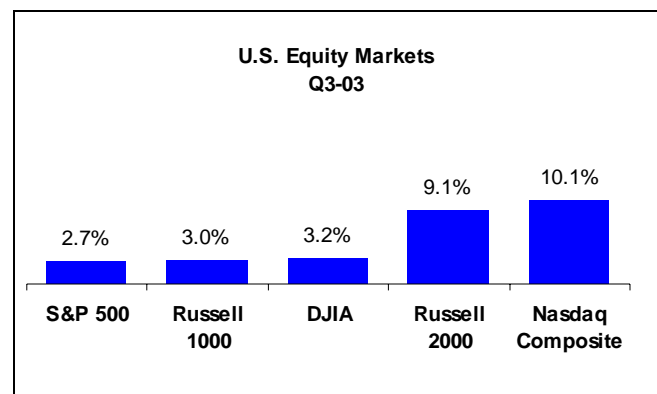
But what about job growth? Economic pundits have beaten this story to a pulp over the last few weeks. In an economy of 130 million jobs, the tally of 57,000 jobs added in the month of September is below levels achieved in past recoveries. Agreed. More importantly, this announcement marks the first month of job growth since January and is a step in the right direction. The United States has not lost its manufacturing prowess. It still has the largest industrial and manufacturing output in the world. The difference is that new technology and information systems have allowed a single worker to do far more today than one could do ten years ago. As a result, productivity continues to soar, and in numbers released on September 4th, productivity was revised up to 6.8% growth for the second quarter. In short, the fact that this economic recovery has not seen strong job growth is a reflection not of economic weakness, but of efficiency and economic strength. Fewer jobs in manufacturing is a painful consequence. While job growth remains an issue, the economy is moving forward rapidly. Activity is accelerating, and almost all major indicators are reflecting that fact.

We expect the current expansion to remain on the moderate side, but that doesn't preclude a few quarters of 4% (maybe even 5%) GDP growth. The economy is headed for a very robust 2nd half of 2003 that looks to continue into 2004. Global growth is accelerating as well, and the long-stagnant Japanese economy has been showing unexpected signs of life. China's economic growth has hardly missed a beat. Some commentators have begun to refer to a "global synergy" that will see growth spurring growth. Combined, the United States and China will account for more than 50% of world economic growth in 2003 and 2004!

This is the environment we have been anticipating. Consumers have been carrying the lion's share of the economy; now, companies are adding that missing element. It is a potent recipe, and it means higher, faster, more sustainable growth than we have seen in over two years and a favorable backdrop for a continued bull market in stocks.

U.S. Financial Markets:

The wedge between stock and bond performance widened during the third quarter. Equities, led by technology, continued to build on their first half gains. The Nasdaq Composite and the Russell 2000 index of small cap stocks were up by more than 9% this quarter. The Dow Jones Industrial Average and the S&P 500 index have experienced more modest gains over the past three months, yet their YTD gains were in the range of 15%. Growth stocks outperformed value for both the quarter and the year. The weakness in bonds was led by the unwinding of the "deflation trade" in U.S.



Treasuries at the beginning of the quarter, which had a smaller effect on the markets for corporate and high yield bonds.

In the two years since the September 11th tragedies, the S&P 500 index has fallen by 7.5%. This period has been marked by recession, fears of further terrorist attacks, a global war on terror, an uneven economic recovery, corporate accounting scandals, record low interest rates, war with Iraq, two tax cuts and three husbands for J-Lo. Throughout this turmoil, investors have alternated between optimism and pessimism numerous times. After each bout of market blues, however, the equity markets have displayed a strong ability to rebound. The S&P 500 index bottomed out in the range of 780 during July and October of 2002. Corporate accounting scandals, fear of terror, and the spotty economic recovery combined to push stocks to their lowest levels in more than five years. In March of this year, the S&P 500 once again approached these lows as uncertainty regarding the potential war with Iraq overwhelmed investors. Clarity on action in Iraq delivered gains in excess of 10% during late March and early April. In addition, the new tax law signed by President Bush resulted in another re-pricing for anticipated dividend growth within the equity markets, pushing stocks up another 10% or so in late May and early-June. All told, the Dow Jones Industrial Average and the S&P 500 index have climbed by approximately 25% since the lows achieved in March of this year. (The technology-laden Nasdaq Composite has risen by more than 40% in the past six months.)

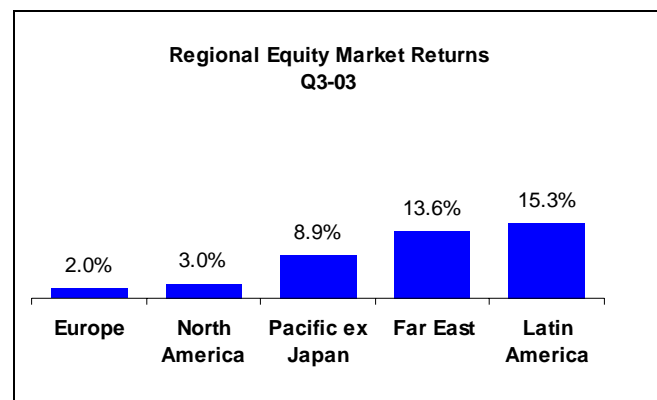
Given the dramatic increases in stock prices, many investors are beginning to wonder whether or not these gains are sustainable. While a "healthy" pullback should never be ruled out as a possibility, we believe the combination of economic, fundamental, and technical developments will preserve a majority of recent gains, strengthening the foundation for stocks to deliver historically average gains over the next few years.

The improved fundamental picture has been driven by the drastic cost cutting measures undertaken by U.S. businesses over the past two years. As a result, we expect improving demand (sales) to result in higher than average corporate profit margin growth in the coming quarters. Earnings momentum continues to gather steam and will likely continue to surprise on the upside.

After having failed to sustain 20%-plus gains twice during 2002, we believe the technical case can be made for sustained stock market performance. Over the past several months, the ratio of advancing to declining stocks has been strong on "up" days, yet only mildly negative on most "down" days, suggesting a positive trend. In addition, a mountain of cash in excess of \$5 trillion remains "on the sidelines" in CD's, savings and money market accounts. As money market rates remain low, we believe new cash entering the market will help improve volume, which has averaged approximately 1.4 billion shares a day on the New York Stock Exchange over the past three months. This strong level of market participation is an encouraging sign for investors.

Foreign Financial Markets:

For most of the third quarter, the best way to make money in foreign equity markets was to bet on economic growth. Asset allocators favored Japan and emerging markets. Stock pickers went for economically sensitive stocks. Latin America led regional gains, up 15.3%, primarily due to the 23.4% gain in Brazil's Bovespa index. The Far East came in second posting a gain of 13.6% while Europe eked out a positive return of 2.0%. The top national market performers included Hong Kong's Hang Seng index, up 24.3%, India's Bombay Sensex that surged 23.8%, and Taiwan's weighted index, up 18.6%. Conversely, Finland Helsinki's index finished down 2.2%. The dollar's renewed decline against the yen and the euro following the September meeting of finance ministers from the Group of Seven leading industrial countries, that bluntly called for "flexibility" in exchange rates, sent stock markets reeling. Europe's gains for the entire year nearly melted away in just seven days. The dollar ended the quarter at 111.47 yen while the euro stood at \$1.16.



Japan was the unexpected star of the third quarter, but lost some luster as the yen strengthened during the final days of September. The Nikkei 225 index, which reached a 15-month high of 11,033.32 on September 18th, has since fallen 7%. It ended the quarter with an overall gain of 12.5%. Nonetheless, as the quarter progressed, foreign investors became more enamored with the Nikkei 225 index that has a reputation for short steep rises, on news that Japan posted an annualized growth rate of 3.9% during the April-June quarter, its fastest rate in 2½ years and faster than the growth rate of the U.S. Unfortunately, the government has yet to make the deep changes that many economists say are necessary, and such rapid growth is considered unsustainable. Consumption remains weak; retail sales in August fell for the 29th consecutive month! The rising yen could hurt exporters that have been the driving force behind the stock market's ascent.

For most investors, Europe remained in the doghouse. Sweden was the best-performing European market, with the Oslo Market index up 6.7%, aided by such stocks as telecom-equipment maker Telefon AB L.M. Ericsson and engineering giant ABB, both recovering fallen angels. But Germany's DAX, which skyrocketed in the second quarter, was flat, losing about half a percent. Among other national markets, the United Kingdom's FTSE-100 index, which is considered less sensitive to economic swings because it includes some of the world's largest pharmaceutical and oil companies, edged up 1.5%, while France's CAC-40 rose 1.7%.

Europe's poor showing is a result of stubbornly slow economic growth. GDP growth is expected to reach just 0.5% this year, and while it is expected to improve next year, many still think it will remain low. But there is some light at the end of the tunnel. Germany's closely watched Ifo business-confidence index has now risen for five straight months. Additionally, the pace of European earnings upgrades increased during the quarter indicating that there is further upside momentum in equity markets.

From Asia to Latin America, emerging markets were global investors' markets of choice in the third quarter. Among national markets, Indonesia's JSX rose 18.2%. As a group, global emerging markets are the most undervalued stock market, despite six months of steep climbs. Moreover, emerging markets, with raw materials and cheap labor, tend to benefit more from a global economic recovery than other developed economies. Taiwan and South Korea have been favorites as a way to profit from the growing Chinese economy. Brazil and Mexico, the most liquid of the Latin American markets, are tied more directly to the U.S. economic revival.

Conclusion

We said at the end of June that we were entering an equity market that would be led by superior companies. Corporate America is in the late stages of cleaning up its act, negative earnings pre-announcements are down sharply, and actual earnings are coming in better than expected. Moreover, the macroeconomic environment is highly favorable. The retroactive tax cuts for the first half of 2003 will be put into effect entirely through the tax refund season of April 2004. This tax boost to income will thus have the largest effect in first half 2004, when we expect a record level of tax refunds. Fed officials continue to remind us that improving growth has not removed the risk of further disinflation meaning they aren't going to be raising interest rates any time soon. Against this backdrop, policy and financial settings continue to provide a critical bridge to the economic recovery.

Fundamentally, the U.S. economy appears to have worked through its largest impediments to growth. Excess or badly directed investment no longer characterizes the U.S. economy after the largest cumulative decline in capital spending since 1958. Indeed, 3 million private sector layoffs associated with a multiyear corporate output and investment purge does not sound like "irrational exuberance."

For the rest of 2003, we believe the driving force for higher equity markets is the positive supply/demand ratio for stocks. Upside momentum supported by improving corporate earnings is a magnet that pulls sidelined cash into the market. With more than \$5 trillion in deposits held by individuals earning paltry returns, there is plenty of stock-buying firepower.

The most important considerations for investors over the next nine months will be Iraq and the president's poll ratings. The recent election of a new governor in the Golden State could have a positive impact on the outcome of the 2004 elections and on financial markets. Governor-elect Schwarzenegger now has it within his grasp to tip the entire political balance of the nation toward more pro-growth, free-market policies. Such a tilt, if it comes to pass, would be an enormous plus for the long-term economic outlook of the country and for equity markets.

Quote for Thought: "He who hesitates is sometimes wise" -- *Malcolm Forbes*

Tom's Tidbit: Why did the "pro's" on Wall Street fire bullish strategists at the bottom of the market?"

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