

Outlook for 2003 – Legitimate *Hope*

Looking back over the past two years, it should be clear that the economic situation could have been worse. The United States was caught in a “perfect storm:” a combination of the severe equity decline that could have only occurred after a record bull market, the aftershocks of 9/11, the crisis of investor confidence in the wake of Wall Street scandals, and the consolidation and commoditization of the tech industry. Yet this perfect storm has not undermined the fundamental strengths of the U.S. economy. For sure, it has hurt economic growth, and several sectors have suffered substantially. These past two years have been painful, but the economy has weathered a remarkable series of shocks. Perfect storms are rare, and we doubt that the future will pose challenges as grave as the ones that have already confronted us. One more reason we are more likely to be surprised on the upside than on the downside is the sheer magnitude of the factors that have triggered a record bear market.

Calling the bottom of a bear market is impossible, and stocks have had a habit of remaining both over- and undervalued for long time periods. However, current valuations are compelling on stocks across many sectors, and long-term investors are likely to be rewarded for seeking out companies with viable long-term outlooks when their valuations are reasonable. If the market today is not providing a guaranteed buying opportunity, it is at least offering investors a noteworthy chance to buy high-quality investments at a significant discount to historic norms.

There are three primary risks to our outlook: (1) the path of the U.S. economy, (2) geopolitical risks associated with Iraq and North Korea, and (3) the value of the U.S. dollar versus the currencies of its major trading partners.

Currently, U.S. bond markets appear to be expecting a moderate domestic recovery (somewhere around 3.0% year-over-year) while domestic equity investors, given the flat to single-digit returns expected by many prominent houses, are viewing a similar path for the economy. Therefore, the main economic risk for the first quarter of 2003 would be business managers, especially manufacturers, sitting on their hands when it comes to capital spending, awaiting the clarification of the Iraq situation.

Deflation risks, which many have mentioned in their forecasts, are probably not going to affect domestic inflation in 2003, but could easily continue to influence producer prices. It is entirely possible that China and India will continue to export capital goods deflation worldwide (that’s not a bad thing). And, as the U.S. remains at the high end of the global wage and price scale, Internet forces could equalize both, with U.S. businesses experiencing a deeper adjustment and consumers benefiting accordingly. The probability of this adjustment occurring will likely be driven by country-related worker productivity levels and international capital flows, as well as previously mentioned deflationary trends seen in parts of Asia.

The upward movement in agricultural and energy prices, as well as in other consumer goods over the course of 2002, seems to suggest that inflationary forces and pricing power are building in the consumer goods arena. The impact of rising prices on the consumer side and declining prices on the manufacturing side could present an interesting puzzle for the Fed as the year 2003 unfolds. The bond market may vote before the Fed and ratchet up the ten-year note rate to levels not seen in quite some time. If these inflationary forces do manifest themselves, the upper range of our yield estimate is 5% - 6% for the ten-year Treasury bond.

Already the U.S. dollar is being driven down in part by concerns about how the U.S. will weather a rising trade deficit and the possible war against Iraq. When the peril of the “twin deficits” arises (trade and federal government budget), expect the U.S. dollar to continue the slide it resumed in October 2002. As measured by the U.S. Dollar Index (a trade-weighted index for the U.S. currency), the dollar has already fallen 6% from its October high.

Another 2%-3% decline could easily happen. Though it is hard to say what all the risks to the U.S. dollar currently are, certainly the twin deficits and any war with Iraq would weigh heavily on the currency.

The majority view on 2003 is that the domestic equity market will end its string of three consecutive annual declines -- but that the net gain will be moderate, probably less than 10%. Military action in Iraq is already factored in as a virtual "given," although a protracted engagement would be received as a negative surprise. Moreover, most U.S. bond and stock markets seem to have priced in war, but not another terror attack. While we should be concerned that another terror attack could occur on U.S. soil, our view is if one does occur and is on the scale of the 9/11 attack, risk aversion will reenter the market in a big way, causing Treasury yields and stock prices to test their old lows. Given the events surrounding such an attack, new lows could reinforce claims by a number of bears that it will take six to seven years for the 1990s price bubble to "correct". The North Korea situation is a continuing uncertainty, although rhetoric from politicians on both sides became less shrill in late December, so this may prove a nonevent and merely a simmering worry spot in 2003.

The U.S. economy seems in the process of trying to finish working off the excesses of the teltech.com bubble. Recently, renewed layoffs and the weight of lost wealth have subdued consumer confidence and retail activity. While a case can readily be made for a consumer-led extension of the flat-growth phase, history suggests having faith in things has not yet been seen. Somehow, despite seemingly being well extended on credit, consumers tend to pull the overall economy through -- and we suspect this will ultimately be the case in 2003. Capital spending would follow, rather than lead.

While a handful of individual nations are currently experiencing strong economic growth, overall the European, Latin American, and Asian regions seem likely to require a rebound in U.S. growth before their economic engines kick in. Thus, overall 2003 seems likely to be one of rolling and gradual recovery rather than a time of either a collapse or a strong rebound. Stock markets by reputation are supposed to anticipate economic shifts. But in the new age of instantaneous worldwide information and opinion dissemination, markets seem more volatile -- tending to swing with the latest new inputs. Given equity investors' freshly remembered wounds from 2000-2002, we suspect that rapidly earned profits may be booked rather than allowed to ride. Likewise, we believe that investors will lean towards cautious rather than aggressive strategies as the incipient bull market takes hold.

Contrary to predominant historical tendencies, we would expect the early part of the rally to be led by value rather than growth as a style. Moreover, the success of President Bush's tax cut for dividends could bolster the value theme. Valuations in popular-name large-cap stocks -- consumer, drug, etc.--are still generous and technology earnings are not yet visible (and investors will be wary of going down the technology path again so soon after their recent scars). Recent flows have favored core and value, with growth still seeing net drains. Mid-cap has been strongly preferred over large- and small-cap in terms of flows. With the U.S. dollar seemingly headed for a further decline of perhaps as much as 10%, international stocks seem likely to benefit. Emerging markets could do well if economic recovery seems firmly established, as economies in such nations will receive the highest benefits.

The New Year offers investors legitimate *Hope* for a stronger economy, modest inflation and interest rates, and improving corporate profits if the president's stimulus package or a bill of equal size is signed into law.