

April 16, 2002

THE ECONOMIC OUTLOOK – GAINING TRACTION

Even though the headline number in the Labor Department's latest jobs report showed the U.S. unemployment rate to have upticked to 5.7% in March, erasing the jobs gains made since January, the release was laced with evidence the economy continues to gain traction following its' 9/11 swoon. Employers increased their payrolls on a seasonally adjusted basis by 58,000 jobs, the first such monthly increase since last July. Temporary help firms added staff rapidly, a sign their clients needed workers to meet rising demand. Meanwhile, manufacturers, who accelerated their use of overtime in March and laid off fewer people, expecting further improvement, are becoming more reluctant to downsize. Since the unemployment rate usually lags in an economic upturn, we fully expect further increases in this indicator to above 6% over the next several months. Interestingly, following the end of the 1990-91 recession, unemployment continued to rise for another 15 months, and the work force shrank until 1993.

Other signs the economy continues to improve, with first quarter growth stronger than expected, are as follows:

1. The Institute of Supply Management's manufacturing index shows this sector to be expanding following 18 months of contraction;
2. Consumers, who account for over two-thirds of real GDP, appear to be aware of the economic improvement. The Conference Board's measure of consumer confidence surged 15.2 points to 110.2, the largest improvement since March 1991, marking the conclusion of both the last recession and the Gulf War. Since continued strong consumer confidence will, in part, depend upon a favorable job market it is noteworthy that the gap between households viewing jobs as "hard to get" versus "plentiful" almost disappeared in March. The gain of 4.2 percentage points in this key indicator is the first meaningful one since July 2000. Meanwhile, help wanted advertising increased in 7 of 9 regions of the nation in the first quarter;

3. Sharper than forecast increases in consumer income and spending also show the economy to be gaining momentum. Increases of 0.6% in these measures in February were the strongest since last fall;
4. Revisions to fourth quarter 2001 GDP show the economy growing at 1.7%, far above most optimistic estimates including our own, causing forecasters to revise upward their projections of growth for the current quarter and the balance of this year;
5. The Conference Board's Measure of Business Confidence, a survey of 120 CEO's, increased sharply from 40 to 66 in the first quarter. Nearly 80% of the respondents expect economic conditions to improve in the coming months -- up from 42% last quarter. Their optimism augurs well for the labor market and for future capital spending;
6. Auto sales have been tracking above industry expectations, bringing inventories to abnormally low levels and, accordingly, production schedules have been increasing in response to greater than forecast demand;
7. A number of global shipping and freight-related indicators we regularly monitor have moved up sharply from their lows of last winter signaling a turn in global economic activity, and;
8. Our Economic Model, a copy of which is attached, continues to point to a sustained economic expansion.

In recent days, a number of analysts have voiced concern that consumer spending might falter as a number of its underpinnings, including low oil prices and mortgage refinancing, begin to fade. Indeed, on the surface, some of the latest data available seem to support this view. Excluding vehicles and gas, retail sales rose a scant 0.1% in March and the preliminary University of Michigan consumer sentiment index for April slipped to 94.4 from 95.7 for March. In our view, however, the small downtick in April confidence was driven by the reaction to stock market turmoil and rising gasoline prices which have now begun to recede. The smaller-than-expected March retail sales increase followed several months of extremely strong gains, partly induced, we believe, by mild winter weather. As a result, overall consumer spending in the first quarter appears to have advanced at a strong 3.5% rate and should continue apace in the current quarter. Moreover, the

latest inventory data suggest a substantial moderation in inventory liquidation for the first quarter of this year. That swing alone could add 3.5 percentage points to first quarter GDP, assuring a stronger than expected economic performance for the period. Looking at the most recent data, we now expect GDP growth last quarter to have exceeded 4 ½%. Growth in the current quarter may well match that figure.

The Risks

With business conditions stronger than expected, the consensus of forecasters now sees GDP growth at over 5% for the quarter just ended and 3 ½ % over the next 12 months. As we see it, the risks to this forecast include the following:

Deferred Capital Spending: In retrospect, overspending by businesses on capital goods leading up to Y2K and the subsequent collapse of outlays for computers, software and telecommunications equipment precipitated the 2001 slowdown. Once businesses restock inventories, the vigor of the economy will depend upon executives' willingness to invest. The largest single risk to our forecast is the possibility that a recovery in business capital spending, which declined 6.4% last year, and is expected to revive in the second half of this year, is deferred until 2003 when corporate profits are expected to show accelerating gains.

Higher Energy Prices: Oil prices have risen from about \$20 per barrel early this year to about \$25 currently reflecting the anticipation by traders of both stronger demand for energy as the global economy firms and fears of further turmoil interrupting Mideast and Venezuelan oil flows. While the U.S. is less dependant on OPEC oil than it was 30 years ago, the possibility of high oil prices is still a concern. The \$5 price increase, if sustained, could cost the U.S. economy \$40 billion this year. And keep in mind the fact that high oil prices have played a role in almost all recessions in the past 30 years. As we see the current situation, there is no shortage of physical oil - - inventory levels are rising rapidly - - and the recent price increase has begun to reverse as Venezuelan oil is again flowing, Russia seeks to increase its market share through higher production and OPEC has made it clear it will supply sufficient oil to keep prices restrained.

High Housing Prices: Rising home values have undoubtedly sustained consumers' confidence and, thanks to home equity loans and refinancings, given many the ability to maintain their spending through the slowdown. Home equity loans have grown by \$1.2 trillion since the start of 2000. The

government's home price index increased 9.2% in 2000 and 6.9% in 2001. Some analysts are forecasting an end to this real estate boom citing rising interest rates and the fact that there is a limit as to how long housing prices can climb more rapidly than incomes. A sharp decline in housing prices could threaten the forecast recovery. Nevertheless, we believe there are strong structural underpinnings supporting housing prices. Interest rates, while rising, are low by historical standards. The tax code provides strong incentives for real estate investment. Immigration and demographics are driving demand, while abundant capital and innovative lending arrangements are making homeownership available to a greater number of people. Lastly, the most recent National Association of Realtors housing affordability index reading of 138.3 suggests housing prices are not particularly extended. A reading of 138 indicates a family earning the median income has 138% of the earning power necessary to qualify for a conventional loan on the median-priced existing home.

Structural Changes

Most analysts agree that in the face of the severe decline of the past two years in equity asset values and the unprecedented blow from terrorists to our financial market systems and national psyche, the U.S. economy has proven remarkably resilient. Indeed, we appear to have experienced a significantly milder downturn than would have been expected given the severity of the shocks we have sustained. There have been a number of structural changes in our economy in the past decade which we believe have contributed to this surprisingly good performance including:

- Substantial improvement in the *access of businesses to real-time information* has played a big role. Years ago imbalances were inadvertently allowed to build to such an extent that their inevitable correction created significant economic distress leading to deep and prolonged recessions. Today, businesses have large quantities of data available virtually in real time enabling them to deal with these imbalances more rapidly than in the past.
- *Deregulation* over the past 25 years has increased the flexibility of the American economy. The collapse of Enron barely registered in the vital markets for natural gas and electric power.
- *Deregulation and innovation in the financial sector* have been particularly important in enhancing overall economic resilience. New financial products

– including derivatives, asset backed securities and collateralized loan and mortgage obligations, have enabled risk to be dispersed more effectively to those willing to, and capable of, bearing it. Shocks to the economic system are, therefore, less likely to create a cascading financial failure. Indeed, by many measures the U.S. banking system has come through the slowdown in better shape than in past recessions.

Fixed Income Outlook

While short-term rates, administered by the Fed, remain at generational lows, intermediate and longer term rates have drifted higher. Yields on both the 10- and 30-year U.S. Treasury bond have now each risen by about one full percentage point since their November lows discounting a stronger economic environment. We continue to expect the FOMC to remain on hold until its members are convinced the economic expansion is solidly entrenched. Their first rate increases are, therefore, not likely to come until August at the earliest. Meanwhile, longer rates are likely to continue to move intermittently higher with 10-year rates approaching 5 ¾ % by year-end and 30-year bond yields rising to about 6%. While bond yields are tempting when compared with the historically low rates available on very short-term paper, we maintain reserves with which to add to bond positions as yields move higher later this year.

Corporate Profits Recovery

As the business recovery gains momentum over the months ahead, we believe the benefits of operating leverage during this expansion will largely fall to the bottom line of corporate income statements. We, therefore, expect robust sequential gains in corporate profitability commencing with the quarter just concluded. The first flurry of last quarter's earnings reports we have reviewed appear to support this view. Specifically, S&P 500 operating earnings are now expected to advance 13% this year following an estimated 30% drop in 2001. Gains in S&P operating profits next year should approach 25%, which will still leave them a shade below their 2000 peak. Sharp turnarounds are expected for the technology and telecommunications sectors, albeit from extremely depressed levels, as tech spending begins its revival. Nevertheless, earnings in both areas will likely remain well below their 2000 peaks until 2004. Industrial and healthcare companies are also expected to experience double-digit growth.

Stock Market Outlook

In a succession of challenges that would have seemed like fiction two years ago, the U.S. Stock Market has been bombarded by fears of additional terrorist attacks, spreading violence in the Mideast, oil production halts, inadequate economic growth and, since the Enron/Arthur Andersen debacle, fears that the earnings on which growth is calculated have been misrepresented and/or overstated. The uncertainties that have characterized the current situation have importantly contributed to the day-to-day volatility of investor sentiment and stock performance. Daily, investors are tossed about as each new bit of economic data is viewed with microscopic intensity, then analyzed and interpreted with manic fervor. Losing track of the salient trends in this torrent of information is easy.

The most important of the trends we have seen emerging is that while earnings momentum has clearly begun to turn up, the stock market has largely ignored this trend. Many analysts who had been behind the curve in recognizing the sharp deterioration in company earnings in 2001 are now still behind the curve finding themselves forced to raise expectations and projections. In short, the investment environment in which we now find ourselves looks more and more like the mirror image of the last two years. Fundamentals and the economy are improving but investor sentiment has not fully appreciated this. Therefore, we continue to expect the U.S. stock market's performance to improve as the year progresses, as business conditions strengthen, and as investors begin to accept the view that this expansion is durable. We are particularly attracted to shares of depressed blue chip companies which have been beaten down due to post-Enron accounting issues, to depressed shares of leading technology companies likely to emerge from the slowdown as dominant leaders in their industries, and to manufacturing companies whose businesses will experience sharp profit expansions over the quarters ahead. Also, for the first time in years, we have begun to build positions in the energy area which will benefit from improving demand as the global expansion proceeds.

Reflecting the improving profits outlook, portfolios are now tilted toward *growth* shares with 60% in that category and 40% in *value* shares.

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