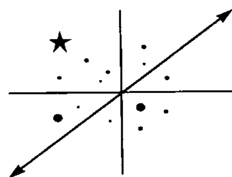

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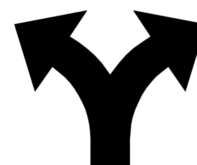
FOURTH QUARTER 2001

Moving on ... Moving up?



No sooner had the clock stopped chiming 12:01AM, 1/1/02, than some of the people at the New Year's Eve party I attended started to leave. It was "time to go". The celebration had been muted all night, and people just wanted to get to bed, get up, and get a ***fresh start*** *on 2002. Sound familiar?*

Three months ago our country was only days removed from the worst human tragedy on home soil in many lifetimes - and it wasn't any accident. We thought we were on the edge of an economic recession – only to be told in November that we were actually in the middle of it. And, we knew for sure that most of our equity investments had fallen sharply in value, due to plummeting corporate earnings.

Faced with perhaps maximum investment uncertainty, global equity markets staged a sharp 4th quarter rally. This provided a remarkable end to a truly remarkable year. We've all turned the page in our calendars and "moved on". The question now is, are things finally going to be "moving up?"

Table 1. Index Benchmarks

	Q4	Trailing Returns *			
	2001	1Yr	3Yr	5Yr	10Yr
S&P 500	10.7	-11.9	-1.0	10.7	12.9
Large-cap Stocks	9.4	-14.6	-3.0	10.5	12.8
Mid-cap Stocks	17.2	-5.6	6.5	11.4	13.6
Small-cap Stocks	21.1	2.6	6.5	7.5	11.5
International Stocks	7.0	-21.5	-4.9	1.1	4.7
T-bills (3 month)	0.7	4.1	4.9	5.0	4.7
1-3 Year Gov't Bonds	0.8	8.3	6.4	6.6	6.1
Aggregate Bonds	0.0	8.4	6.3	7.4	7.2
High Yield Bonds	6.6	5.4	0.4	3.5	8.0
Global Bonds, hedged	0.3	6.2	6.0	7.9	8.2
CPI, *annualized*	-0.9	1.6	2.5	2.1	2.5

* Annualized trailing returns for periods ending 12/31/01.

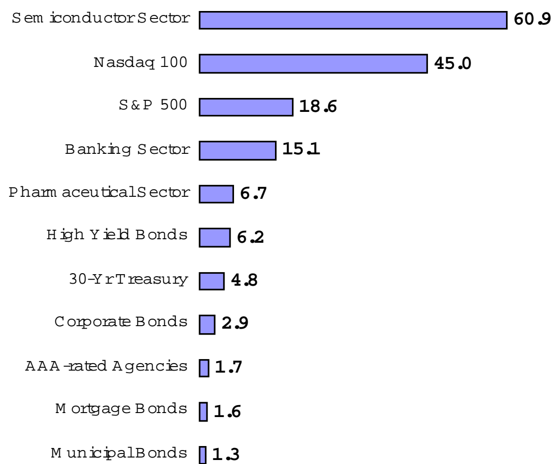
Table 2. Average Mutual Fund Returns

	Q4	Trailing Returns *			
	2001	1Yr	3Yr	5Yr	10Yr
US Large-cap	12.1	-14.1	-0.2	9.2	11.3
US Small-cap	21.2	4.1	12.5	10.9	12.4
Foreign Equity	8.6	-20.6	-0.9	2.9	6.4
Emerging Markets	24.5	-2.0	5.9	-4.7	2.2
Balanced/Hybrid	6.4	-3.5	2.8	8.0	9.2
General Bond	0.0	7.6	5.5	6.4	6.6
Government Bond	-0.2	6.9	5.5	6.5	6.2
High Yield Bond	5.4	2.0	-0.4	1.8	6.6

* Annualized trailing returns for periods ending 12/31/01.
Source of fund's data: Morningstar

In Search of . . . . Risk

As we were writing this quarter's review, we came across the following chart in the January 14th edition of the Wall Street Journal. If you study it closely, one pretty amazing observation becomes abundantly clear – domestic investors have been aggressively "buying risk" since late September. The more historically volatile the asset class, the better it has done over the past 4 months. The short-term correlation between higher risk and return has been almost perfect.

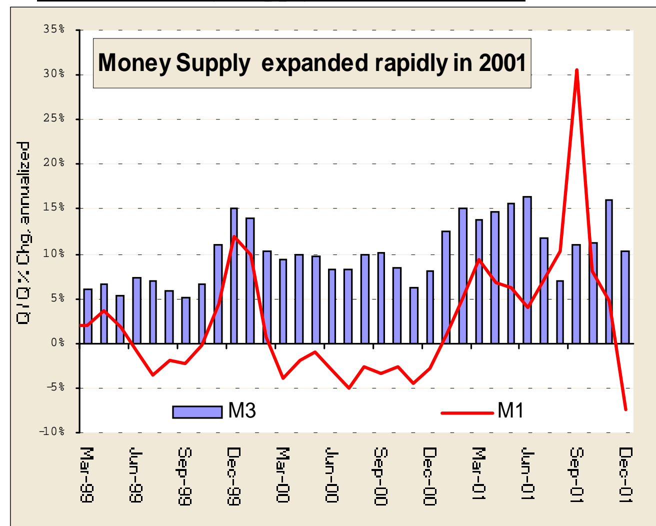


It's remarkable to us that domestic investors have chosen this highly uncertain economic (*recession*) and societal (*war on terrorism*) transition period to once again embrace risk, and do so empathically. While the result has been pleasant, the effect has been to once again take our equity market's fundamental valuation (P/E basis) at year-end 2001 to very high levels *relative to* long-term market interest rates available to investors. At December's close the S&P 500 was right at the top end of its normal valuation range for the past 13 years. It has been more "overvalued" in the past, but not by much. The scary thing is that this aggressive valuation has already discounted a 20% or better rebound in 2002 corporate operating earnings. They'd better materialize, or it won't be pretty.

Will the Recession Last?

It is important to recognize that the primary cause of this recession has not been a traditional monetary crunch. Rather, it was triggered by a sharp retrenchment on the part of corporations after an extended period of overinvestment had savaged balance sheets and cashflow. The Federal Reserve has attempted to foster conditions that allow consumer and corporate spending to hold up despite falling employment and incomes. In 2001, eleven reductions in the fed funds rate, to a multi-generational low of 1.75%, sharply reduced short-term borrowing costs for financial institutions and corporations (and, indirectly, consumers). As important, the Fed engineered an aggressive and consistent increase in money supply throughout 2001, with a dramatic spike following September 11th.

Chart 1. Money Supply Growth, '99 - 01



- ***Growth***

In November, the Economic Cycle Research Institute announced we slipped into recession in March 2001, even though the economy was still growing modestly (GDP rose 1.3% in Q1 and 0.3% in Q2) and total employment levels were even with the prior quarter. Subsequently, it was confirmed that GDP declined by 1.3% during the 3rd quarter, the weakest figure in 10 years. Expect a greater decline for the 4th quarter.

Consumer & Corporate Spending

For the 3 months ended November, total consumer spending rose just 0.5%. This was actually a surprisingly strong figure, since disposable personal income fell 3.0% in the period. The fuel for this spending rise was sharply increased consumer debt, particularly non-revolving loans (up 19% in October and November). 0% car loans sold like hotcakes. The other driver of growth, industrial production, declined at an annual rate of 7.2% in the 4th quarter. That makes 5 consecutive quarters of industrial contraction.

- ***Employment***

Compared to September, one million fewer people were employed at the end of December. Employment levels declined by 1.8 million persons over the full year 2001. Unemployment rose by 1.2mm in the quarter and 2.6mm for the full year, as the economy was unable to accommodate a rising labor force. The unemployment rate rose to 5.8% in December, versus 4.9% in September. Of note, the number of part-time workers *for economic reasons* rose only 100,000 in the 4th quarter, but has increased by 1.1mm since December 2000.

- ***Inflation***

Inflationary forces certainly remained at bay in the 4th quarter. In fact, concern about the impact of deflation has become much more prevalent. Generalized consumer prices declined at a 2.0% annualized rate during the 4th quarter, because energy prices fell at a 44% annualized rate. Falling energy costs cut 1.2% off the full-year CPI index, which rose only 1.6%. In 2000, *rising* energy prices added 0.8% to the CPI. Producer prices for finished goods declined at a seasonally adjusted annualized rate of **10.8%** in the 4th quarter. This was primarily due to falling energy costs, but non-food and energy prices fell 1.8%. For CY2001, producer prices declined at each level - finished, intermediate and crude. Even our record import volumes in 2001 were accommodated by an 8.9% decline in prices.

Give Bond Investors Some Credit

At the end of the 3rd quarter, we observed that short-term risk-free interest rates hovered just below 2.5%, *lower than* the prior twelve months' inflation rate, and the 10-year Treasury bond's yield was only 4.6%. We suggested the next big move in underlying interest rates was most likely upward. Well, it might have started.

While the Fed continued to aggressively cut the fed funds rate, and inflation indices were declining, yields for 5- and 10-year Treasury bonds *rose* 50 basis points during the 4th quarter. Even yields on the 2-year T-note rose, to 3.15%, from just 2.85% at the end of September.

The Fed's unprecedented easing activities throughout 2001 had a huge impact on the short-term market, dropping T-bill yields (1.7% now, 5.7% a year ago) or commercial paper rates (1.8% now, 6.3% a year ago), but very little or no impact on the long-term bond market. The 10-year T-bond's yield was 5.15% during the last week of December 2001, *up* from 5.10% the last week of December 2000. Its range for the year was a very narrow 4.6–6.0%. Closer to home, average conventional 30-year mortgage rates began and ended the year at 7.15%, after very briefly dipping to 6.4% in October (I refinanced at 6.5%, whew!).

Table 3. Fixed Income Sector Returns

Periods ended 12/31/01; indices are cap-weighted

	4th Qtr	CY01	3 Years
Aggregate Bonds	***0.0%***	***8.4%***	***6.3%***
US Treas, long	-2.0	4.2	4.8
US Gov't, all	-0.6	7.2	5.9
Mortgages	0.1	8.2	7.0
Credit Bonds *	0.9	10.4	5.8

High Yield Bonds	6.6	5.4	0.4
Global Bonds	-3.2	-1.0	-1.3
Global Bonds, Hdgd	0.3	6.2	6.0

* *investment grade only*

The "action", as it were, has been in the credit markets. High yield bond returns soared during the 4th quarter (see table 3), despite events like the Enron bankruptcy. Admittedly, high yield returns had been decidedly punk earlier in the year, as defaults on junk bonds accelerated. Last year, 211 companies worldwide defaulted on $115 billion of debt, compared to the previous record of $42bn, set in 2000. Still, as investors embrace the notion of a sharp recovery in corporate profitability, it follows that junk bonds, which often possess equity-like characteristics, should do very well in that environment. With junk bond credit spreads still in the 500-800 bps range, we think investors should remain interested.

BBB or better corporate bonds enjoyed something of a modest relative rally in the 4th quarter, outperforming the other investment-grade sectors. Credit spreads for AAA issuers declined over 1% from the panic-induced levels of late-September. Spreads on seasoned BBB bonds dropped by 65bps during the 4th quarter. As of year-end, credit spreads on seasoned AAA bonds were 150bps, while those for BBB bonds were 282bps. These are considerably higher than the 10-year averages.

In Search of . . . . Earnings

Table 4 summarizes the quarter's extraordinary rebound by the domestic equity markets, broken down into style and market cap sectors.

Table 4. Equity Returns by Style/Market Cap

Periods ended 12/31/01; indices are cap-weighted

	4th Qtr	CY01	3 Years
Growth			
Large Cap	12.9%	-20.5%	-8.0%
Mid Cap	27.1	-20.2	2.2
Small Cap	26.2	-9.1	0.3
Value			
Large Cap	5.5	-8.8	1.2
Mid Cap	12.0	2.3	6.8
Small Cap	16.7	14.1	11.4

While all the negative returns were turning to positives for the 4th quarter, at least one market element remained constant – smaller cap stocks bettered larger cap. This was true during most of 2001 (except September), and to such an extent the 3-year annualized figures are also skewed that way.

What did reverse in the 4th quarter was the "value beats growth" premise that has dominated the past two years. This is consistent with my "investors embracing risk" thesis. However, it's quite possible value stocks simply paused for awhile, after having so soundly exceeded growth stock returns during the first 9 months of 2001.

Table 5. U.S. Equities - Sector Performance

Periods ended 12/31/01; indices are cap-weighted

Sector (*% of S&P*)	Non-S&P 4Q01	S&P 4Q01	S&P 2001
Technology *(18)*	44.6%	32.8%	-26.7%
Financial *(18)*	7.9	7.6	-9.3
Health Care *(14)*	15.3	0.6	-11.3
Utilities *(9)*	4.5	-7.4	-18.1
Consumer Staples *(8)*	11.2	4.2	-2.0
Energy *(6)*	18.5	4.0	-11.3
Retail *(8)*	11.2	20.0	6.0
Consumer Srvcs *(5)*	23.3	12.9	-8.4
Business Srvcs *(3)*	31.7	28.8	19.8
Capital Goods *(3)*	18.6	24.2	0.7
Raw Materials *(2)*	14.9	12.1	1.0
Combined Sectors	**18.9%**	**10.7%**	**-11.9%**

Data Source: Vestek

Sector selection during the 4th quarter mattered somewhat in the S&P500, but less so for the rest of the equity market (generally small and mid-cap companies). In the S&P500, the previously moribund information technology sector exploded upward, while "recession-proof" consumer staples and health care firms attracted relatively few investors. Utility stock returns were affected by Enron's one-shot demise, but also suffered from lingering concerns regarding the future of big telecom services firms, like AT&T, Worldcom, and the Baby Bells.

International – A "Euronic" End to 2001

Brand new euro notes and coins are now filling the pockets and purses of 305 million Europeans, but the 4th quarter run-up to the euro's physical introduction did precious little to help its valuation. It declined 2.2% in the quarter, and was off 5.2% for all of 2001. On a similar note, the yen plunged in value during the quarter (down 9.1% versus the US$), and the full year (- 12.9%).

Table 6. International Investor Markets

Cumulative % Returns for the periods ended 12/31/01;

	Past Year		Five Years	
	Return In US$	Return In Local Currency	Return In US$	Return In Local Currency
MSCI EAFE	**-21.2**	**-16.0**	**6.0**	**33.8**
United States	**-12.0**	**-12.0**	**65.0**	**65.0**
MSCI Europe	*-19.6*	-16.1	37.4	82.0
Germany	-22.0	-17.7	29.4	84.4
UK	-14.0	-11.8	23.5	45.2
MSCI Pacific	*-25.2*	*-16.0*	*na*	*na*
Japan	-29.3	-18.8	-33.8	-25.2

Data Source: Capital Guardian

International equity market returns were dominated by country and sector allocation issues during the 4th quarter and FY2001. *In local market terms*, the Euro, European, and EAFE indices all beat or matched the S&P 500's fourth quarter advance. Only the Euro did after translation to US$ terms. For Japan, which dominates the developed Pacific Rim region, local market returns were a relatively weak 3.5% for the quarter. In contrast, Singapore and Hong Kong markets each advanced over 23%.

The full year 2001 was more of the same for international equity investors. Geographic sector returns were weak compared to the United States, but certain countries posted relatively competitive returns. However, when local market figures are translated into US$, the performance gap widens considerably. Japan's "contribution" to investment returns in 2001, indeed over the past 5 years, has been stunningly negative.

The five-year return figures in Table 6 are going to cause many people to write off the concept of international equity exposure. Before doing so, we think a few issues should be carefully evaluated –

a. Check out the 5-year cumulative return of the broad European sector, in local market terms. It far surpassed the cumulative return of the S&P500. The Dollar's appreciation over the past five years completely accounts for the European equity market's underperformance in US$ terms;

b. Compared to a trade-weighted basket of 19 major currencies, the US Dollar's average index value has been 107 during the past 31 years, in a normal range of 98 to 118. Its current value is 127.8, a level previously exceeded for just nine months in 1985;

c. Per Table 7, many geographical markets offer some very interesting fundamental valuation opportunities compared to the U.S. Prices in most major foreign markets are quite low relative to current cash earnings and local interest rates.

Table 7. Foreign Equities – Fundamentals

	Price / Cash Earnings			10-Yr Bonds
	Current	10 Yr Avg.	10 Yr High	Current Yield
MSCI EAFE	**9.8**	**10.4**	**16.6**	**-**
United States	**16.0**	**12.9**	**19.7**	**5.1**
MSCI Europe	***10.1***	*9.9*	*16.6*	-
Germany	**6.8**	7.2	12.5	5.0
UK	**11.5**	11.6	17.9	5.1
Japan	***8.5***	*11.2*	*16.2*	*1.4*
Pacific ex Japan	**13.6**	12.1	18.5	-

Data Source: Capital Guardian

Caveat Emptor

Everyone talks about Enron as if it were a total outlier. I know the firm from a decade ago. They were doing *very* aggressive accounting and tax stuff then; all the analysts, bankers, and auditors knew it; and the pressure was on everyone to do business with them because they didn't quibble too much about fees. Same old same old, only they got *way* carried away with their own brilliance. I refused to have anything more to do with them in 1993 (too early, but not wrong).

However, they represent just one very bad tip of the iceberg (Sunbeam, Waste Management, Long Term Capital, Providian, Pets.com, Global Crossing, Henry Blodgett, etc.). Our managers need the resources and experience to sort the wheat from the chaff, because Wall Street is too conflicted to help when you really need it.

We alluded to some concerns about domestic equity market valuations following the 4th quarter's sharp rebound. Admitting we often sound like the voice of doom, it bugs us that -

a. Corporate operating earnings will fall 30% in the 12 months through 12/2001, by far the weakest 4 quarter profit change in 15 years (much worse than the 1990-91 recession);

b. Even conservative predictions foresee corporate operating earnings rising over 15% in the next twelve months. Yet, in the last recession it took over two years from the first yr/yr decline for earnings to rebound – and they did so more gradually;

c. On both a trailing earnings basis and forward looking basis, the market is at the high end of its long-term valuation range unless you dare predict corporate earnings will rise 30% this year. That's a figure only Wall Street analysts are willing to embrace;

Fixed income markets are discounting a very benign inflation environment. This sentiment could easily change if our economic growth hits the 4-6% annualized rates people are forecasting for the second half of 2002.

Rates will also change, bigtime, if we have any oil supply disruptions. With the current yield to maturity of high quality (AAA and better) bonds so low, taking pure interest rate risk doesn't seem particularly safe to us. A "safer" route might be to take much more credit risk, in return for the protection of high yields. If we are in the beginning stages of an economic recovery, then lesser-rated credits won't be getting any weaker and credit spreads will decline. This will be the case even if the equity markets don't cooperate.

Which brings us to international market investing. A very tough call. The steep decline in short-term US$ interest rates – both in absolute terms and relative to the rest of the industrialized world – was widely expected to weigh heavily against the dollar; yet the U.S. currency has held its ground. Large financial flows into the U.S. slowed considerably in 2001 compared to 1999 and 2000, but were still a net positive. If the key explanation for this was the sharp slowdown in U.S. growth, what does that say about the next upleg of our economic cycle?

Ultimately, we come down in favor of the active faith that supports a meaningful allocation to international markets (kept in the hands of active managers), but acknowledge this has rightfully become a very individualized, plan-specific, issue.

In early October, we recommended clients move low equity allocations back up to neutral target levels, after separating out the liquidity needed for the next year. This recommendation set has worked out *okay*, but proved to be a little cautious. Equity markets have climbed a huge wall of worry since the terrorist attacks, on the back of few positive fundamentals. We're still okay with "a little cautious".

See you next quarter!

Natalka Bukalo

Richard Shaffer, CFA