

CHARTWELL REVIEW

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Working the Problem

Despite a “relief rally” in the fourth quarter, 2002 marked the third consecutive calendar year during which our primary equity market indices declined. For the first year since 1988, equity mutual funds suffered net redemptions. As a glance to the right will confirm, if there was ever a time when the “rear view mirror” was going to dominate investor’s decision-making, it is now. We’re in such need of some positive reinforcement that many of us have shortened our de facto investment time horizon to a few weeks or months.

But, if we want to use history as our guide, then why not look at the worst *decade* on record? The worst 10-year period for U.S. stock returns included the stock market crash, 1929-1938. The average annual return was (0.9)%. The first three years of our current decade have produced an annualized (14.7)% return for the S&P. In order for the current decade to exceed the **worst** ten years ever, the S&P 500’s return would have to average more than 6% annually for the next seven years.

Our point is this - regardless of how uncertain the investment future now seems, we’ve still got to work the problem. Doing so requires that we apply some perspective and forward focus in figuring our next moves. Aversion to return uncertainty is higher than ever. Because of this, guaranteed returns are at 40-year lows and potential returns on risk capital haven’t been better in years.

Table 1. Index Benchmarks

Market Index	Q4	Trailing Returns *			
	2002	1Yr	3Yr	5Yr	10Yr
S&P 500	8.4	(22.1)	(14.6)	(0.6)	9.3
Large-cap Stocks	8.2	(23.4)	(16.8)	(1.3)	9.2
Mid-cap Stocks	7.9	(16.2)	(5.0)	2.2	9.9
Small-cap Stocks	6.2	(20.5)	(7.5)	(1.3)	7.2
International Stocks	6.6	(15.5)	(16.8)	(2.5)	4.4
T-bills (3 month)	0.4	1.7	3.9	4.3	4.5
1-3 Year Treasuries	0.9	5.8	7.3	6.2	6.0
Aggregate Bonds	1.6	10.3	10.1	7.5	7.5
High Yield Bonds	8.6	(1.5)	(0.7)	0.6	6.1
Global Bonds, hedged	1.4	8.1	8.3	7.4	8.2
CPI, annualized	0.0	2.5	2.5	2.3	2.4

* Annualized trailing returns for periods ending 12/31/02.

Table 2. Average Mutual Fund Returns

Fund Category	Q4	Trailing Returns *			
	2002	1Yr	3Yr	5Yr	10Yr
US Large-cap	6.8	(23.1)	(14.0)	(1.1)	7.9
US Mid-cap	5.2	(22.9)	(12.5)	1.3	8.0
US Small-cap	5.1	(19.6)	(3.4)	(2.5)	8.9
International Equity	5.6	(14.4)	(15.4)	(0.5)	5.7
Emerg. Mkt. Equity	7.7	(7.1)	(13.1)	(2.9)	0.4
Balanced/Hybrid	4.6	(10.0)	(4.1)	2.2	7.4
Inv. Grade Bond	1.7	7.6	8.2	6.3	7.9
Government Bond	0.9	9.0	8.8	6.5	7.5
High Yield Bond	5.9	(2.0)	(2.8)	(1.4)	4.7

* Annualized trailing returns for periods ending 12/31/02.

Source of fund’s data: Morningstar

Triple Dip

There is not a significant stock market worldwide that has escaped cumulative negative returns over the past three years, and just a handful of equity markets have a positive cumulative 5-year record: Australia, Canada, Finland and France. During the same period, high quality bond portfolios were earning as much as 8-10% per annum worldwide.

Three years ago even Diogenes couldn't have found someone who believed the above results were possible. Trailing 3-year market returns had been 27% (S&P 500), 16% (non-U.S. equity), and 6% (high quality bonds). Risk meant not matching the market's *gains*; no one lost money investing.

But, you already knew all of this (except perhaps the France thing). It seems that every investment report printed reminds us the U.S. equity market has declined four consecutive calendar years only once, during the Great Depression. Some writers cite this statistic in an effort to comfort us, as if the sentence really ends, "... and that can't happen again."

Let us suggest another alternative – sure it can. The issue isn't the length of time, or the calendar. Future investment returns are a function of three things: market pre-conditions, future investment dynamics and shifts in investor psychology. After three down years in equities, and three up years in bonds, it currently looks *to us* like a bottom in equities, rather than a top. And more like a top in bonds. But, that is because we see market pre-conditions favoring stocks, investment dynamics proceeding in the same direction, and negative investor psychology gradually dissipating. Not because we glanced in the rear-view mirror.

The Economy – Double Dip?

The U.S. economy entered a recession in March 2001, according the National Bureau of Economic Research. The NBER hasn't altered its official designation, despite four consecutive quarters of real growth in GDP (go figure). So, talk of a double dip recession is really referring to a slip in either nominal or real GDP growth. Readers should realize that such a slip occurred during **most** economic recoveries since WWII.

December's report from Commerce indicated real GDP grew at an annualized rate of 4% during the third quarter, making the cumulative one-year advance 3.25%. That is very close to the long-term average for annual GDP growth. In reaction, investors entered the current quarter very concerned that 4th quarter GDP data would show a slowdown in growth, or even a decline.

The following table summarizes the components of GDP growth, together with their individual contribution over the short and medium-term.

Table 3. Components of GDP Growth

	<u>Contribution to GDP Growth</u>		
	3Q '02	Past Year	Past 4-Years
GDP Growth, annualized	4.0%	3.2%	2.7%
Personal Consumption	2.9	2.6	2.5
<u>Gross Private Investment</u>			
- Fixed Investment	0.0	(0.4)	0.3
- Change in Inventories	0.6	0.8	-0.1
Net Exports	0.0	(0.6)	(0.6)
<u>Government Spending</u>			
- Federal	0.3	0.5	0.3
- State & Local	0.3	0.4	0.4

- ***Consumer Spending***

Personal consumption expenditures account for 68% of total GDP and clearly drive GDP growth. This element has been a consistently positive contributor over the past four years, including the most recent quarter and year. Rising disposable personal income in the 3rd quarter fueled a 3.5% annualized rise in personal spending during October and November. Consumers increased their savings rate in 2002, to the 4.5% range, which obviously came at the expense of current spending growth. Ultimately, rising disposable personal income has always produced rising consumer expenditures.

- ***Gross Private Fixed Investment***

This is considered the other linchpin of economic growth, although federal and local government spending accounts for a greater share of GDP (18% versus 16%).

Throughout 2000-01, “destocking” of inventories consistently cut down GDP growth. The pattern was reversed in each quarter of 2002. Even so, the broad Inventory/Sales ratio as of November had declined to 1.36x, which is the lowest figure in eight years. This represents a very favorable pre-condition for increasing production in 2003.

Which brings us to the whipping boy of economic seers - corporate fixed investment on structures and equipment. Real spending on structures (20% of the category) declined at a 21% annual rate in the 3rd quarter (latest data available), and has dropped for eight straight quarters. Spending in the much larger equipment sector (includes software) rose for the second consecutive quarter, advancing at a 6.7% annual rate. Equipment spending had fallen for six quarters, so we consider the *two*-quarter turnaround an important development. A particular positive was the double-digit growth in spending for the largest equipment area - information processing.

- **4Q Production and Capacity**

Total industrial production declined at a 2.4% annual rate in the 4th quarter, but was up 2.1% in 2002 (it fell 5.7% in 2001). By market groups, the quarter’s “bright” spots were in the relatively minor areas of defense equipment (+4%), paper (+4%) and consumer electronics and furnishings (+5%). Modest production growth last year was accompanied by modest overall capacity growth (+1.1%). Thus, capacity utilization for total industry edged up to 75.4% in December, a level above that of December 2001 but far below the long-term average.

- **4Q International Trade Deficit**

Net exports of goods and services, our negative trade balance, currently detracts 5.0% from annual GDP. As this number has consistently grown (13 out of 14 quarters), it has placed an overall 0.6% annual drag on our GDP growth since 1998. *Only personal consumption has had more impact on GDP growth than changes in our trade deficit.*

Our very recent international trade experience has been mixed-to-negative. October’s trade deficit declined versus September, but November’s deficit (reported in January ’03) rose a surprising \$5bn. Through the first eleven months of 2002, our trade

deficit increased 18% versus 2001. Our weaker Dollar should eventually cause the volume of import goods to drop and exports to rise (thereby adding to GDP growth), but this is likely to take quite some time.

- **4Q Employment**

Ignoring the effects of seasonal adjustments, an estimated 134.2 million persons were employed from a civilian labor force of 142.3mm at the end of 2002. This calculates out as an unemployment rate of 5.7%. At the end of 2001 an estimated 134.2mm were employed out of a 141.9mm person labor force. That represented an unemployment rate of 5.4% (for reference, employment peaked in December 2000 at 136.1 million persons). Within this big picture of flat employment for 2002, the 4th quarter was weak on a seasonally adjusted basis. Average employment in the fourth quarter declined by 200,000 persons versus the third.

- **4Q Inflation**

Having been declared dead by most policy-makers, *consumer* price inflation rose at a compound annual rate of just 1.8% for the three-months ended December, and just 2.4% for the 12 months just ended. Nevertheless, price increases have been robust (>5%, annualized) in the medical care and energy categories.

Producer prices for finished goods rose at a compound annual rate of 2.6% for the three-months ended December, and just 1.2% for the 12 months just ended. However, raw materials prices rose at a 50% annualized rate during the 4th quarter, and were up 26% for the entire year. This includes foodstuffs (+4.4%), energy goods (+66%!) and nonfood materials (+12.4%).

Three very significant events occurred during the latter half of the 4th quarter, although their effects will not be evident for some time -

- The Federal Reserve Bank cut its target for Fed Funds, to 1.25%. The European Central Bank also cut its target for overnight funds;
- Fed Governor Bernanke and Chairman Greenspan explicitly confirmed that the Fed was willing to take various unprecedented steps to combat deflation, including printing money in massive quantities.

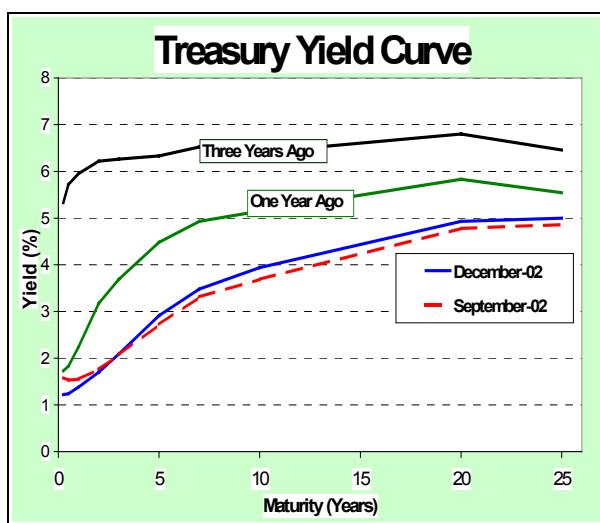
- The Bush Administration began laying out its plans for a significant tax cut in 2003, despite current projections of \$150+ billion federal budget deficits in 2002-3. Their plan was detailed early in January, giving rise to expectations it would add as much as \$300 billion per annum to the deficit;

In effect, after 20 years of focusing on inflation, the world's central banks acknowledged a fundamental policy shift to attacking deflation by any means available. In concert, domestic fiscal policy has been shifted into an almost unprecedented stimulative phase. If followed through, the combined effects of these two policy shifts promises to be substantial.

Bond Markets – No Dip?

After a spectacular decline during the third quarter, Treasury yields appear to have simply treaded water during the fourth (see Chart 1). Beneath the surface, however, there was quite a bit of volatility. First, the quarter's rate shift was not parallel. The 50 basis point Fed Funds rate cut helped push short-term rates down by 20-35 basis points. Conversely, investors were net sellers of long term T-bonds during the quarter, and yields rose 20bps.

Chart 1. Yield Curve Comparison



Treasury bond and large-cap stock seemed to move in a perfectly complementary fashion each day of the 4th quarter. If the stock market was up, bond prices were down. In fact, the degree of negative correlation between stock and bond prices last year *was* greater than at any other period during the past decade.

All bond market sectors produced negative returns in October. Coupons were simply not high enough to offset the price declines associated with even modestly rising interest rates. November was a similar story except for corporate bonds. As investor expectations of continued economic growth solidified, they sought the much higher coupons offered by bonds rated "A" or lower. Credit spreads narrowed sufficiently enough to keep yields unchanged. The end result was a strong relative quarter for higher risk securities, but generally low returns otherwise (see Table 4).

Table 4. Fixed Income Sector Returns

<i>Periods ended Dec. 31, 2002; indices are cap-weighted</i>			
	4Q02	1 Yr.	3 Yrs
<u>Aggregate Bonds</u>	1.6%	10.3%	10.1%
US Treas, long	0.0	16.8	13.5
US Gov't, all	0.7	11.5	10.6
Mortgages	1.4	8.7	9.4
Aa Credit Bonds	2.0	13.1	11.7
BBB Credit Bonds	4.6	8.6	8.7
High Yield Bonds	6.7	(1.4)	(0.8)
Global Bonds	4.7	19.5	6.3
Global Bonds, Hdgd	1.4	8.1	8.3

Table 4 also captures just how strong the high-grade bond markets have been for investors over the past three years. What this table doesn't show is impact of all this success on the present bond market. Current yields to maturity are very low in nominal and real terms. Money market funds will return less than 1% this year. Intermediate term government securities (26% of the domestic investment grade bond universe) yield an average of only 2.33% *per annum*. Mortgage-backed bonds, now making up over 35% of the universe, only yield 4.6% to investors, and that figure is based on some rather optimistic assumptions.

Domestic Equities – Only for Dips?

The S&P hit its current cyclical low of 776.76 on 10/9, and then began an eight-week rally into early December. During this time, the index advanced 20%. Despite a weak December, an 8+% quarterly return was the overall result. The advance was decidedly led by technology, telecom, and other business cyclical stocks, and not by consumer-related firms (*Table 5* below).

Table 5. U.S. Equities - Sector Performance

<i>Price performance as of 12/31/02; indices are cap-weighted</i>			
<u>Sector (% of S&P)</u>	<u>4th Qtr.</u>	<u>1-Yr</u>	<u>5-Yrs</u>
Consumer Disc. (13%)	1.8	(24.4)	1.1
Consumer Staples (9%)	0.5	(6.3)	(1.4)
Energy (6%)	6.1	(13.3)	(0.4)
Financials (20%)	6.8	(16.4)	0.7
Health Care (15%)	4.6	(20.0)	3.5
Industrials (12%)	5.0	(27.6)	(1.6)
Information Tech (14%)	22.2	(37.6)	(2.9)
Materials (3%)	12.1	(7.7)	(2.8)
Telecom Services (4%)	36.4	(35.9)	(10.2)
Utilities (3%)	3.5	(33.0)	(8.0)
S&P 500	7.9	(23.4)	(1.9)

Market strategists typified the 4th quarter rally as a positive vote on a business-led economic recovery. Indeed, in October we learned that S&P earnings rose sharply in the 3rd quarter, with “as reported” earnings per share up 68% and operating earnings up 27% compared to 2001 periods. Best estimates for 4th quarter and full year earnings are +25% and +20%, respectively.

The quarter’s rally was broad-based from a market cap perspective, despite what were weaker small-cap index returns (*Table 6*). Stocks over \$1bn in market cap performed similarly well, and stocks under \$500mm posted double-digit returns. Stocks in between, comprising just 4% of the total market but a majority of the small-cap index, underperformed. Style leadership rotated at the top, as large value outpaced large growth for the third time in the last four quarters.

The full year 2002 stock market will be remembered as the most volatile in recent history. There were more high volatility days (market up or down at least 1%) and extreme volatility days (market up or down at least 2%) than in any year

since the Great Depression. A primary contributor to this anxiety was the breadth of equity investment pain in 2002. Over 75% of S&P stocks declined in price last year. For the first calendar year since it has been tracked (1981), each S&P sector declined.

Table 6. Equity Returns by Style/Market Cap

<i>Periods ended Dec. 31, 2002; indices are cap-weighted</i>			
	<u>4Q02</u>	<u>1 Year</u>	<u>3 Years</u>
<i>Growth</i>			
Large Cap	6.7	(28.0)	(24.4)
Mid Cap	9.2	(27.4)	(20.0)
Small Cap	7.5	(30.2)	(21.1)
<i>Value</i>			
Large Cap	10.1	(18.1)	(8.6)
Mid Cap	7.1	(9.6)	3.3
Small Cap	4.9	(11.4)	7.5

International Equities – The Dollar Dips

After a weak third quarter, developed and emerging international equity markets generally rallied along with our domestic one. The pattern of return was also the same, with a weak December following strong returns in October and November. The big exception was the Japanese market, which declined 8% in Yen terms, after having been the strongest market during the first three quarters of 2002.

European markets led developed markets in the 4th quarter, advancing almost 6% in local currency terms and 11% in US\$ terms. The Euro rose over 6% versus the Dollar in the quarter and nearly 18% for the year, directly accounting for international returns exceeding our local markets’ in 2002.

But the full year 2002 was a very disappointing one for European investors. Led by the German market’s 43% decline, the region’s combined markets dropped 29% in local currency. The EU’s economic stability and growth pact have so far hurt the latter. Real interest rates, especially in Germany, remain high despite modest inflationary pressures.

Table 7. International Equity Markets

	<u>4Q02</u>		<u>One Year</u>	
	<u>Return In US\$</u>	<u>Return In Local Currency</u>	<u>Return In US\$</u>	<u>Return In Local Currency</u>
MSCI EAFE	6.5	2.3	(15.7)	(25.8)
MSCI Europe	10.9	5.9	(18.1)	(29.1)
MSCI Pacific	(3.2)	(5.6)	(9.0)	(17.0)
- Japan	(5.7)	(8.1)	(10.1)	(18.6)

MSCI EMF	10.0	5.2	(6.0)	(7.1)

Data Source: Capital Guardian

Asian markets outside Japan rose during the quarter, but Emerging Markets were led to top tier returns by Latin American countries. Telecom and information tech shares led the international rally, followed by financial services and energy firms.

Looking forward, its fair to say European markets may have over-reacted. Earnings have not gone through the “profits depression” we did in the U.S. P/E based valuations have dropped back to early 1990’s levels. Valuations are so low in Germany that the combined market cap of its largest 100 companies is less than America’s top two.

Conclusion

Investors appear to be very confused by current circumstances. We attribute this to everyone’s conviction we’re heading toward war, accompanied by widely varying reactions to this grim prospect. For example, if deflationary pressures are driving markets, how does one explain the 35% rise in the price of gold, a classic inflation hedge, since January 2002? If the driving factor is “sell all risky assets, buy risk-free” - and this certainly would explain alot – why have emerging markets been the top performing equity market over the past year? Finally, if the current thought is to sell all geopolitical risk (favoring things like gold and Swiss Francs), then why have U.S. bonds risen so high in price even as the US\$ was falling?

The answers are obviously harder than the questions. Equally important, the answers have varying implications for different investors. Whether derived from the views of others or not, your investment scenario necessarily ends up reflecting your basic investment beliefs. Keep focus on how you see the *future* unfolding, rather than re-reading old tea leaves. Last year contained many unusual or unprecedented investment occurrences. These won’t happen again soon. Issues that investors need to develop a “view” on are –

- In terms of pre-conditions, is the domestic economic situation favorable or not? Will the new fiscal and monetary policies help?
- Do I want to protect more against the effects of deflation or moderately rising inflation?
- Will global politics remain an adverse investment issue over the medium-term?
- Do I have confidence that corporate profitability will continue to grow? Is corporate governance on the upswing?

We foresee fiscal and monetary policy providing a strong boost to GDP growth, but not as much as the numbers might suggest. Our trade deficit remains a negative factor (and source of US\$ weakness). With the major central banks lined up against it, deflation seems an unlikely prospect but rising inflation does not. Bond prices rose last year on a record \$138 billion tide of net inflows to fixed income mutual funds. There are precious few forward-looking scenarios that indicate attractive future bond returns, except from the corporate and international sectors.

Many will find it easy to dismiss the 4th quarter equity market rally as something of a dead cat bounce, especially after the weak January we are having. We think this ignores what has continued to be a favorable actual corporate earnings trend. Gradually, this trend will be rewarded.

See you next quarter!

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