



Economic Commentary - 4th Quarter 2002

Not a boom but definitely not a bust

Although the year 2003 didn't give us the economic growth many wanted it also was not as bad as many surmised and through its hesitant growth has perhaps formed a foundation for a more prosperous and well balanced 2003. Overall the year was a record maker by topping three years of economic misery both here and abroad in which most segments of the economy and most investors suffered. The year will be remembered for corporate scandals, bankruptcies and a wide loss of investor confidence.

It is almost impossible to write about the fourth quarter of a year without a quick look back and 2002 brought many records and surprises. Here are some 2002 records we hope stand for a long time.

- the biggest bankruptcy in history
- the worst of corporate governance scandals in loans and personal loans to CEOs
- the boldest of accounting frauds
- the first time in 60 years the Dow was down three consecutive years
- the biggest trading day on the NYSE - ever - on July 24th with 2.8 billion shares trading – UP!
- the biggest swing in the federal budget from 2001's surplus of \$127 billion to 2002's deficit of \$159 billion
- the first knighthood of a Federal Reserve Chairman, and
- the reduction of the Big Five accounting firms to Big Four

The year also created new trends that will take time to be absorbed by the economy and the culture.

- the distrust of all things corporate
- the disclosure of all things corporate
- the new focus and laws from Congress on financial disclosure (Sarbanes Oxley)
- the re-focus on divisions between all financial responsibilities especially investment banking and investment advice

But, has 2002 left us better than it feels or worse than it looks? Time does indeed heal all wounds and all the economic obstacles and trends of 2002 will be absorbed and become part of the fundamentals for the new year. And, although we are all committed to starting a new year on an optimistic tone it is difficult not to focus on the negative aspects of the current economy and geo-political situations.

Some bad news: The fear of war with Iraq and the nuclear threat in Korea cast a pall over the last half of the year. The uncertainty created by this situation will have to subside before economic fundamentals can control the markets. After a non-stop spending spree the consumer finally began to slow his credit-card-flattening activities and produced sub-par holiday retail sales. Since the consumer has carried the economy through the recession this is certainly cause for concern. The slow down could have been influenced by a stagnant labor market and layoffs coming on the heels of some major bankruptcies like United Airlines. It could also have been affected by a persistent decline in stock prices which took the Dow on a 17% YTY decline in 2002 (with a high of 10,635 in March to a low of 7,286 in October). A car sales glut and slower commercial construction spending (which shaved GDP .6%) added to the minimal growth in manufacturing and generally lower corporate profits (down again 1.8% in 3Q). And, even with a west coast dock strike, the US ended the year as a net exporter further injuring manufacturing.

Some good news: The economy however is not deteriorating. It is biding its time and slowly building in strength. The US economy is the only economy showing strength world-wide and though we came to expect double-digit, unsustainable growth, GDP is on pace for a respectable near-4% for the 3Q after a 3.4% growth in the first three quarters. The Dow was up 9.9% in the last quarter and core retail is up. Overall things look reasonable after such a tumble. In the tech sector, spending on software has risen 6.6% in 3Q and hardware computer spending is up 32% in 2002 –the best since 1998. Replenishing of inventories added .5% in 3Q GDP so the remainder came from final consumer demand. Clearly the uneven expansion and growth has been dependent on the consumer rather than business. Consumer spending rose 4.1% in Q3 with 2.9% going to GDP. The fence sitting attitude of business regarding capital spending is keeping the economy slow. Perhaps the corporate risk takers took too many personal losses in 2000!

That is not to say that there is nothing to worry about and that the path is crystal clear to prosperity. But each of these black clouds has a silver lining starting to peek through.

US Dollar – Last year the dollar was down 10% - 17% against our major trading partners' currencies making our products, stocks, and bonds less attractive. The overnight rate, adjusted for inflation is a disincentive to park money in the US. The markets were hoodwinked by Rubin into a strong dollar rhetoric and only slowly has the current administration moved to a market based dollar realizing that markets not administrations set FX prices. With a change in the DC economic spokesmen (Snow and Friedman) we can expect to see value determined

Auto Sales –There is also a fear that 0% financings which have become common place are eating into future sales and profits. However, with higher incomes the sales are actually below previous peaks as a percent of disposable consumer income. Cars more simply more affordable and our planned obsolescence continues to build in a future need. The median age of autos on the American road is 7.7 years.

Unemployment – We continue to see layoffs and bankruptcies and the unemployment rate crept up to 6% once again by year end. However, initial claims for unemployment are down. The early 1990's saw a jobless recovery and with the increases in productivity we may see it again. Companies have to lay off expensive labor costs to survive and turn around. However, companies had significant trouble hiring in 1999-2000 and remembering that companies will not let their productive staffs go unless it becomes necessary.

Small Business – The backbone of recovery is small business. Although we monitor large cap industries for growth it is small business that normally gets the economy rolling again and it is still robust. Look at the effect of loan demand from small business on CD rates to get a glimpse of the underlying strength.

State and Local Governmental Budgets – Many states and localities are experiencing severe deterioration of their financial positions with lowered tax revenues. This will reduce infrastructure spending and new hires and be a drag on recovery. To what extent this will be offset by the immense stimulus packages in place and on the drawing boards for 2003 remains to be seen.

Clearly, the economic picture is not entirely rosy and unhinged optimism is not yet called for. It is not time to return to *irrational exuberance*. We have major headwinds to overcome such as slow growth in our trading partners which will impair the export ability of US manufacturers. We must also eliminate the uncertainty of war and the threat of terrorists to rebound fully, but, it is legitimate to wonder at this point whether 2002 left us better than it feels or worse than it looks.

A quick look at 2002:

	<u>01/01/02</u>	<u>12/31/02</u>	<u>Range</u>
3 month T-Bill	1.729 %	1.197 %	1.154 – 1.858 %
6 month T-Bill	1.824 %	1.209 %	1.209 – 2.125 %
2 year T-Note	3.051 %	1.617 %	1.595 – 3.727 %
5 year T-Note	4.336 %	2.741 %	2.562 – 4.840 %
10 year T-Note	5.042 %	3.828 %	3.569 – 5.426 %
30 year T-Bond	5.480 %	4.770 %	4.630 – 5.834 %