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Investment Policy Committee
Strategy Review

"The Phoenix?"

It is astonishing to consider where the market has been over the past several months. As discussed in our previous *Strategy Review*, we felt that stock prices had bottomed at the end of July, and we were greatly encouraged by the late-July/early-August rebound. Of course, that optimism proved premature. Stocks dropped precipitously throughout September and set new lows on October 10th. At that point matters were grim: the S&P 500 had lost half of its value from its all-time high, and had wiped out five and a-half years of gains. The Dow Jones Industrial Average had lost almost 40% of its peak value, and was back to where it last traded four years ago. Peak to trough losses of this magnitude have not been experienced since at least the crash of 1987, if not the Great Depression.

Since October 10th, stocks have rallied quite a bit, and this has dissipated a good portion of last month's gloom. Still, worries remain. Gross Domestic Product (GDP) growth improved from 1.3% in the second quarter to 3.1% in the third quarter, but that is below the 3.5% improvement predicted by economists, and is well off the 5.0% increase posted from January through March. Further, there are any number of more specific reports causing concern about the economy. After growing by 4.4% in July, factory orders fell 0.4% in August and another 2.3% in September. The status of durable goods is even more grim: after growing by 8.5% in July, orders for durable goods fell 1.1% in August, and then 4.9% in September. (We must note that durable goods orders are notoriously volatile.)

Other sources of discouraging news must also be recognized. To start there is the manufacturing index compiled by the Institute of Supply Management (ISM). After seven straight months where this index reflected growth in manufacturing (i.e., the number was above 50) the ISM's index slipped to 49.5 in September and then to 48.5 last month. Weakness is also evident in industrial production numbers, which we regard as a key measure of economic health: this has fallen two straight months, dropping 0.3% in August and 0.1% in September.

Rounding out our take on manufacturing are reports on inventory and capital spending. A key measure of investment spending is the figure for non-defense capital goods orders, ex-aircraft. (Orders for aircraft are ignored because they are quite large and tend to swing wildly month-to-month.) These orders shrank by 1.4% in August, and then by 4.3% in September. As for inventories, the recession of 2001 was in large part driven by an unwanted build-up of goods for sale, and this year's recovery began after the resulting cuts in production lasted long enough that excess inventories were whittled down. However, inventories remain exceptionally lean, with the ratio of inventory to sales reaching record-low levels in August. Such cautious inventory management is discouraging, though difficult to argue with. After all, growth in retail and food sales (excluding automobiles) has been tepid, rising 0.3% in August and only 0.1% in September.

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In the face of all the dour economic news just cited, it is important to bear in mind that, upon closer examination, "bad" trends sometimes have positive implications. Take the issue of capital spending. Yes, capital spending has to strengthen for the economy to enjoy robust growth, but in the short run reduced investment levels allow corporations to improve cash flow. Regarding manufacturers' reluctance to replenish inventories, the good news is that when sales growth does resume, a jump in production levels will come hard and fast. And, amidst the abundance of "bad" news, some economic data are immediately encouraging. As Alan Greenspan continues to note, the economy's remarkable gains in productivity continue. The importance of productivity improvements can hardly be overstated; over the long term, it drives not just profitability, but a society's very standard of living.

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In many respects the health of our economy depends not so much on the state of corporate America as it does on the status of the consumer. For the past two years a resilient consumer sector has effectively offset woes in the corporate sector. There are a number of issues, such as terrorism, war in the Middle East, and accounting scandals, that led the stock market to falter so badly in September. On top of all that, however, a significant worry was that the American consumer was beginning to wobble. In particular, it seemed that the employment picture was growing darker, and that the housing market had become a bubble ready to burst.

Let us look first at the employment picture, and the specific concern that our economy is experiencing a "jobless" recovery. To begin with, it is not unusual for employment growth to be weak in the first months of a recovery. In the first year following the 1991 recession, for instance, employment *fell* by an average of 18,000 per month. We also need to take great care with unemployment and payroll figures. Wall Street pays a lot of attention to the monthly non-farm payrolls number, yet payroll growth is commonly understated in the first months of a recovery – and this is precisely what we find occurring now. July non-farm payrolls, originally reported to have risen a scant 6,000, were later revised to a gain of 54,000. August non-farm payrolls, originally reported to have increased 39,000, were revised significantly upwards, to a gain of 107,000. And September non-farm payrolls, initially reported to have fallen 43,000, in fact fell by only 13,000. (The first take on October non-farm payrolls is that they declined by 5,000, slightly worse than expected.) Even though Wall Street analysts are somewhat dismissive of the usefulness of unemployment rate, it is far less subject to revision, and, as such, provides a superior real-time picture of employment. Further, the unemployment data are encouraging. From July through October the respective unemployment rates were 5.9%, 5.7%, 5.6%, and 5.7%. These numbers simply do not indicate a worsening employment environment for the American worker.

Moving onto other reports on the consumer sector, yes, personal spending has tailed off, and that bears watching. After rising by 1.0% in July, which was the largest jump in seven months, spending cooled to 0.4% growth in August before falling 0.4% in September. Personal income, on the other hand, has held up well. After being unchanged in July, income grew 0.3% in August and 0.4% in September. Then there is the housing market, which continues to enjoy record-low interest rates. New-home sales rose to a record annual rate of 1.017 million in August, and then proceeded to set another record in September (annual sales rate of 1.021 million). In the market for existing-homes, sales softened a bit in August, dropping 1.3% to a 5.30 million annual rate, but in September rebounded 1.9%, to an annual rate of 5.40 million. This was the best performance for existing homes sales in five months. Lastly, housing starts in September leapt by an astonishing 13.3% to a 1.84 million annual sales rate. This is the highest level in sixteen years.

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From their respective lows of October 10th through month-end, the Standard & Poor's 500 has risen 15%, the Dow Jones Industrial Average 17%, and the Nasdaq Composite Index 20%. A number of factors are driving this rally. First and foremost, third quarter earnings reports were surprisingly good. This was especially so within the technology sector, with IBM and Microsoft the most prominent examples, as well as - remarkably enough - the telecommunications sector. At month-end the S&P Telecommunications Services index had risen 36% off its 52-week low, set just three weeks earlier. In our more dramatic moments we are tempted to describe the market as some sort of Phoenix rising from the ashes. Still, hyperbole aside, the gains over the past three weeks have been impressive, earnings have been mildly positive, the issue of corporate governance is ebbing, economic data provide hope that our recovery can be sustained, and maybe, just maybe, we have at long last seen the worst of this bear market.

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