

**Investment Policy Committee
Strategy Review**

“The Price of Success”

There is little question that the U.S. economy is on the upswing. Last quarter’s GDP growth of 4.1% was quite strong, and it brought growth for all of 2003 to 3.1%. Even though the economy is just beginning to surge, the stock market has already looked forward: over the past twelve months the Dow, the Standard & Poor’s 500 Index, and the Nasdaq Composite Index in turn rose 35%, 37%, and 52%. As much as investors welcome higher stock prices, the question arises as to whether the market has done *too* good a job of anticipating an economic rebound. Yes, stocks merited higher prices this past year, but have they exceeded the *right* price of economic success?

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Before we address equity valuations, let us first review our economic data. Manufacturing continues to look healthy. The manufacturing index published by the Institute for Supply Management has given positive readings for eighth consecutive months (through January). Factory orders, which have grown in four of the last six months, rose 1.1% in December, with orders for durable goods increasing 1.6%. We await the release of January factory orders, though the initial report on durable goods is that orders fell 1.8%. While this is disappointing, it must be remembered that durable goods orders are notoriously volatile. Finally, to put aside orders and focus simply on current activity, industrial production has been strong. It jumped by 1.0% in November – which was the biggest one-month gain in four years – held that elevated level in December, and then grew another 0.9% in January.

One issue which is closely related to manufacturing, and which has implications for other sectors of the economy, *and* which is crucial to overall productivity, is business investment. Quarterly GDP reports tally investment figures, but we also watch monthly numbers for non-defense capital goods orders. If one excludes aircraft-related orders (which is a common adjustment) capital spending increased in four months out of the last six, and rose 7.1% for all of 2003. Though this is a modest rate of improvement, it does mean that there is untapped potential in our economic recovery.

In our December *Strategy Review* we discussed the issue of an “inventory snap-back”. As we expected, businesses are still scrambling to restock their shelves. For instance, in November and December wholesale inventories grew by 0.5% and 0.6% respectively. However, sales grew even more, rising 0.6% and 1.0%. At the broader, overall business level, inventories rose 0.4% and 0.3% for the last two months of the year, yet, here again, this failed to keep pace with sales growth, which was 0.7% and 0.9%. At the overall business level there are now only enough inventories for 1.34 months of sales. This is quite lean, and pressure for greater production should remain.

Turning to the all-important housing market, some moderation is apparent. New home sales rose by 1.3% in December but slipped by 1.7% in January. In the much larger market for existing homes sales grew 3.9% in December before falling 5.2% in January. Despite this drop, January was the 6th best month on record for existing home sales, and sales from August through January are the highest on record for a six-month period. The other noteworthy data on housing are those for starts and permits. Difficult weather in January cut housing starts by 7.9%. This was the first drop in five months, though, and it still leaves housing starts near historic levels. Building permits are a more forward-looking (and less weather-sensitive) take on housing. The numbers here are mixed: permits rose 4.8% in December but fell 2.8% in January.

Our final economic data are those pertaining to consumers. On balance, the news here is good. Personal income rose 0.3% in November and 0.2% in December. Consumer sentiment remains positive. In January the Conference

Board's index of consumer confidence was 96.4, which was the highest reading in well over a year, though that measure did fall to 87.3 in February. For both months the area in which consumers expressed the most concern is the job market. This worry is understandable. Non-farm payrolls rose a paltry 16 thousand in December and then a tepid 112 thousand in January. During periods of vigorous economic expansion business can add 300 thousand workers to their payrolls each month. Still, growth of 112 thousand was the biggest increase since December 2000. Further, we must remember that job creation is a lagging indicator, and we expect hiring to accelerate as corporations come to see the recovery as sustainable.

Because consumer spending accounts for roughly two-thirds of the economy, the labor market concerns us because of its great potential to affect household spending. Fortunately, we see no cause for alarm. Personal spending increased by 0.5% in November and 0.4% in December, while retail and food sales gained 0.2% in December before falling unexpectedly (by 0.3%) in January. Admittedly this last number is not good, but most analysts adjust these numbers by stripping out automobile and gasoline sales. When this is done the results are reassuring. Ex-automobile and gasoline, retail and food sales increased 0.2% in December and 0.8% in January.

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All of this good economic news is translating into improved profits. With virtually all companies in the S&P 500 having reported their fourth quarter results, aggregate, 2003 operating earnings for the index are on target for \$55 per share. This will represent an exceptionally strong 20% improvement over 2002 earnings. Looking at 2004, we expect profit growth to moderate slightly, to a still-strong 18%, or \$65 per share. As discussed earlier, however, the central question for investors is what those earnings are worth? Currently near 1150, the S&P 500 Index is trading at 21-times last year's earnings. Even if the P/E ratio shrinks a bit this year on slightly cooler profit growth, at 20-times trailing earnings of \$65 per-share, the S&P 500 would end the year at 1300. This would represent (approximately) a healthy 13.5% gain from current levels.

What, though, is our view of a trailing P/E ratio of 20 for the market? We believe this is not only reasonable, but also potentially low. It has been approximately eight years since the S&P 500 Index market traded below 20-times trailing earnings. Yes, if one looks back over several decades market multiples have typically been much lower. However, that does not mean that investors have unrealistic expectations for future earnings growth, or that the market is applying an insufficient "risk premium" to equity values. After all, growth expectations and risk premiums are only two 'legs of the stool' for deriving appropriate market multiples. The third leg is interest rates.

Interest rates have a very powerful effect on stock valuations, and one *must* adjust for today's low rates before comparing current multiples to those of years gone by. Without going into a lot of detail, we can use a very simple formula, called the Gordon Model, to illustrate this. If we use 4% for interest rates (this is roughly what long-term treasuries yield), 3.5% for a "risk premium" (this says that investors will only invest in stocks if they can expect to earn 3.5% above and beyond treasuries; 3.5% is in line with most empirical measures of this premium), and then 3% for long-term, sustainable earnings growth (this is a reasonable estimate of long-term growth in the economy), we come up with an appropriate market multiple of 22-times earnings. (Note that this is very close to the currently prevailing S&P 500 multiple.) Suppose, though, that the yield on long-term treasuries were 4.5%? Our market multiple would drop to 20. At interest rates of 5.0% the appropriate market multiple would be 18, at 6.0% it would be 15, and at 8.0% the market should trade at only 12 times earnings. Now, given that ten-year treasuries yielded more than 8% for almost all of the 1980s, and more than 6% for the vast majority of the 1990s, our view is that current price levels in the equities market are indeed consistent with historical valuations.

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For The Investment Policy Committee
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