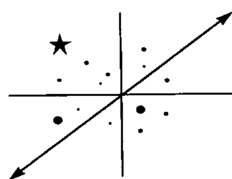

Chartwell Consulting

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CHARTWELL REVIEWS . . . . . FIRST QUARTER 2001

" Fuh-gedda-boud-it"

As in: the bull market ….. the tech stock boom ….. the internet economy ….. fuhgeddaboudit!

We confess – New Jersey is ground zero for the Sopranos, and it is hard to avoid some of the analogies! Investors may want to forget about first quarter results, but it will be difficult. There was nowhere to hide in the equity markets. After much searching, the only positive quarterly returns we found were in the small cap area (S&P Smallcap ***equal-****weighted index was up +0.46%; Russell 2000 Value index +0.95%), and the S&P Transportation, Consumer Durables, and Consumer Services* ***sectors.***

We're now in the 13th month of a bear market. Major broad market indices are down between 15%-25% over the past year. Growth indices have fallen 40+%, while the NASDAQ is off 60%. This exceeds the fall of Japan's Nikkei in 1990 (-50%) and the drop of the Dow in 1929. As Tony would say, the past year certainly qualifies as a "shakedown" for most investors.

Table 1. Index Benchmarks

	Q1	Trailing Returns *			
	2001	1Yr	3Yr	5Yr	10Yr
S&P 500	-11.9	-21.7	3.1	14.2	14.4
Large Cap Stocks	-13.2	-25.8	2.8	14.5	14.4
Mid Cap Stocks	-10.5	-12.0	4.4	12.8	14.8
Small Cap Stocks	-6.5	-15.3	-0.9	7.8	11.8
International Stocks	-13.7	-25.7	-0.3	3.7	6.2
T-bills (3 month)	1.4	6.0	5.3	5.3	4.8
1-3 Year Gov't Bonds	2.8	9.6	6.4	6.4	6.5
Aggregate Bonds	3.0	12.5	6.9	7.5	8.0
High Yield Bonds	6.1	2.7	0.4	5.5	10.0
Global Bonds, hedged	2.6	10.7	7.6	9.0	8.8
CPI, *annualized*	1.2	2.9	2.7	2.4	2.6

*Annualized trailing returns for periods ending 3/31/01.

Table 2. Median Mutual Fund Results

	Q1	Trailing Returns *			
	2001	1Yr	3Yr	5Yr	10Yr
Balanced	-5.9	-7.2	3.2	9.2	10.4
Growth & Income	-8.4	-9.1	2.7	11.6	12.8
Growth	-13.3	-16.7	3.5	11.7	12.7
Aggressive Growth	-17.1	-26.3	2.3	9.7	13.1
All Fixed Income	2.8	7.4	4.1	6.0	7.3
Government Bond	2.4	10.7	5.8	6.3	6.9
High Yield Bond	3.7	-3.9	-2.2	3.8	8.7
International Stock	-10.9	-24.8	-0.2	3.8	7.5

*Annualized trailing returns for periods ending 3/31/01.
Source of fund's data: CDA/Wiesenberger & Lipper

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Badda Bing!

As the new millenium's first quarter came to a close, two issues dominated the minds of investors: the U.S. economy's outlook and the stock market's sell-off. Most people have closely linked the short-term outlook for each in their minds: when the economy starts to rebound, the bull market we so loved will return and 20+% annual gains will again be the norm. Badda bing!

Maybe this time around its payback time, my friend. Maybe the domestic economy's outlook was best summed up by that boss of bosses, Alan Greenspan, in the Fed's March 20th press release, which stated: "Although current developments do not appear to have materially diminished the prospects for long-term growth in productivity, excess productive capacity has emerged recently. The possibility that this excess could continue for some time and the potential for weakness in global economic conditions suggest substantial risk that demand and production could remain soft".

Figuring out the stock market sell-off, or more precisely the prospects for continued sell-off, will test the wisdom of the best consigliere. A favorite (printable) joke on the Street is that the stock markets have discounted 8 out of the last 4 recessions. Last year saw Old Economy stocks advancing while the New Economy stocks were under attack. The 1st quarter saw a broad retreat across the entire equity front. Now, everyone seems to be looking for the bottom.

In this Review's last section we've pulled together a look at some of the many technical, statistical and fundamental factors that investors often refer to for guidance during periods of market weakness. The desire for insight in this respect may be at an all-time high (there's no direct index of investor anxiety) for one simple reason - since the beginning of 1990 to date there has been only one 3-year period when investing in the S&P 500 has not produced better returns than investments in cash equivalents or the broad bond market. That was the 3-year period ending March 31, 2001.

Going to the Mattresses

(def. – *going to war with a rival clan or family*)

What we knew as the 1st quarter began – an accelerated shift downward in GDP growth was taking place, caused by a surprising build-up of business inventories relative to sales, sharp reductions in business capital spending after a period of unprecedented growth, slower growth rates for housing and consumer durable items, and higher energy prices (particularly for heating and power). Moreover, both corporations and consumers were becoming increasingly "tapped out," with debt leverage burdens as high as they'd been in a generation.

With this in mind, The Federal Reserve declared "war" on GDP slowdown during the first week of January, cutting its fed funds rate target by 50 basis points. Additional 50 basis point cuts followed during the quarter on 1/31 and 3/20, with another same-sized cut on April 18th. The 2.0% drop in the fed funds target rate (to 4.5%) in less than four months was the sharpest such action ever. It more than reversed the 1.75% increase from June 1999 to May 2000. By comparison, the Fed took fifteen steps starting in 1990 to cut rates by 4% and get the economy out of recession.

What do we know about the economy today?

1. Real GDP increased at the annual rate of only 1.0% in the 4th quarter of 2000, compared to a 2.2% increase in the 3rd quarter. Slowing growth was a function of the factors cited above, plus a 10% decline in product exports;
2. Pre-tax corporate profits after inventory and depreciation adjustments *decreased* $56 billion in the 4th quarter;
3. The domestic unemployment rate rose to 4.3% at the end of the 1st quarter, up from 4.0% last December. The number of unemployed persons rose from 5.6 to 6.1 million. The unemployment rate in manufacturing industries rose sharply from 3.6% in December to 5.0% in March, as factory job losses totaled 270,000.

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4. Average weekly earnings rose by 1.7% during this year's first quarter (0.9% in real terms), with most of the rise occurring in March. This figure was up only 0.5% in the 4th quarter. From 3/00 to 3/01, weekly earnings rose by 3.7%, but only 0.9% in real terms. Real earnings in the goods-producing areas have declined by 1.2% in the past year, but risen 1.5% in the services sector.
5. Housing sales in the 1st quarter were very strong, with March setting all-time records.
6. Total industrial production rose 0.4% in March 2001, after falling for 6 consecutive months. For the year ended 3/01, industrial production rose 0.8%, but production *capacity* rose 4.4%. High-tech production (computers, communications equipment, and components) grew at a 5% annual rate during the 1st quarter, following 55% growth in 2000. The total industry capacity utilization rate slipped to 79.4% in March, down from 82.2% one year earlier. The high-tech utilization rate dipped to 78.8%, down from 89.1% last September.
7. The NAPM manufacturing index has declined for 8 months in a row, but the rate of contraction finally slowed down in March.
8. Import prices declined 2.2% in the 1st quarter, due to declining petroleum prices. Import prices have fallen 1.5% over the past year. The Producer Price Index for finished goods declined slightly in March, due to falling energy prices, but rose at a 4.9% annualized rate for the entire quarter. The CPI rose only 0.2% in March, but rose at a 4.0% annualized rate over the entire quarter.

What's our take on all this? 1) it's unclear whether our economy will slip into a recession. It certainly hasn't yet; 2) unemployment is on the rise, but this pressure is not yet hurting the pocketbook of those who remain employed; 3) industrial production growth is weak at best, but the real problem is capacity utilization. Many companies, particularly some in high-tech industries, have entered a phase of profitless prosperity, as sales volumes hold up only at the expense of falling margins; 4) inflation isn't anyone's concern right now, but consumer and producer prices are up alot since this time last year. Last, we think the Fed's aggressive actions were taken as much to restore confidence in the prospects for future growth, as they were to facilitate growth with cheap money. What Tony Soprano might call a *message job*.

But, our economy's slowdown is being led so far by sharp, and needed, pullbacks at the corporate level, as firms must get their capex spending and production under control. Lower short-term interest rates will help some with current debt service costs, but that is only part of the problem. If cutbacks in production are accommodated by slashing employment, the already debt burdened U.S. consumer will be faced with the prospect of declining real income. Final demand will fall.

Paying the Juice

Given the Fed's unprecedented 1st quarter action, one might guess this had a very positive impact on the bond market, as interest rates fell. You might have also expected investors to be concerned about increasing credit risks, if the economy was in such a sorry state to start with.

Unexpectedly, Table 3 reveals investment returns during the first quarter were only moderate, and positively correlated with **increasing** credit risk.

Table 3. Fixed Income Sector Returns

For periods ended 3/31/01

	1st Q 2001	**2000 Return**
Emerging Markets	2.0%	13.6%
Treasuries	2.4	13.5
Mortgages	2.7	11.2
Aggregate Index *	**3.0**	**11.6**
AA Corporates	4.1	11.3
BBB Corporates	4.5	7.4
High Yield Index	6.4	(5.9)
CCC Corporates	9.9	(17.8)

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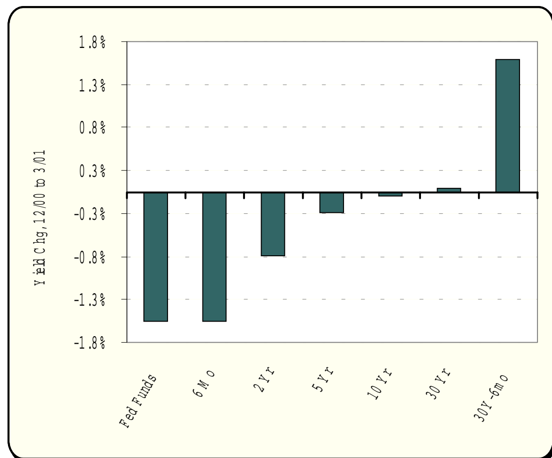
Have bond investors so quickly replaced last year's fear with 2001's greed? We don't think so; a further look at Table 3 reveals that last year's poorest performing fixed income classes were the past quarter's best. The 1st quarter presented an opportunity to correct the fourth quarter's "overshoot". However, in doing so bond investors are looking past the current credit situation – last year, a record 106 companies defaulted on a record $33 billion of public bonds; during just the 1st quarter another 40 companies defaulted on $24 billion of bonds.

The other major debt market issue during the quarter was the impact on bond yields the Fed's action would have. It is very early days yet, but the answer so far is decidedly mixed. The drop in fed funds rates has had a direct effect on the 6-month Treasury bill, but virtually no impact on long-term rates. The yield curve has simply shifted from being inverted 20 basis points at year-end, to upward sloping by 135 bps at the end of March. Even after fed funds were cut another 50 bps on April 18th, long-term Treasury yields remained nearly 30 bps above those at the beginning of 2001.

Chart 1. Yield Changes During the 1st Quarter



Thus, near-term benefits of the sharp 2% fed funds decline will only accrue to short-term and floating rate borrowers (reducing the cost of carrying those excess corporate inventories). Historically, changes in monetary policy take 12 to 18 months to have a positive impact throughout the rest of the economy.

Domestic Equity Markets Get Whacked

The thud you heard was either the domestic stock market falling off its vaunted perch, or investors with too much large-cap growth stock exposure fainting away after looking at their 1st quarter manager reports.

Table 4. Equity Returns by Style/Market Cap

*Periods ended 3/31/01; **indices are cap-weighted***

	1st Q 2001	Trailing 1 Year	Trailing 3 Years, p.a.
Growth			
Large Cap	-20.0%	-42.0%	-0.8%
Mid Cap	-25.1	-45.4	1.8
Small Cap	-15.2	-39.7	-5.2
Value			
Large Cap	-6.9	-5.1	4.4
Mid Cap	-3.5	13.8	3.1
Small Cap	0.9	19.7	1.9

Large growth stocks have declined in each of the last 4 quarters, with the pace seeming to have accelerated. The broad S&P 500 index closed the quarter at 1160. Its 11.8% decline during the quarter fully accounts for its 10.3% drop (before dividends) over the past two years. The broad market has essentially completed more than a "round-turn" in that time. The most notable difference in the past quarter was the weakness of value equities, particularly those of large and mid-sized companies.

Table 5 provides some insight to the sources of equity market weakness during the 1st quarter, by reviewing sector-by-sector performance of both the S&P 500 companies and the 7,000 public firms not part of the S&P index. The latter category is something of a proxy for the broad small/mid-cap market of companies, although the S&P's selection process excludes many very large companies.

Virtually every primary sector of the S&P 500 index posted negative first quarter returns. The same generally holds true for non-S&P firms, except for those in the retailing and consumer staples sectors.

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It appears that larger companies performed better (i.e., lost less in percentage terms) than smaller ones during the quarter, because the S&P declined less than the non-S&P. But that was not really true. **Comparing the S&P sectors'** *cap*-weighted returns (which are dominated by the results of larger companies) to the *equal*-weighted returns (the result of the median-sized company), we observe that in 12 out of the 15 sectors the equal-weighted sector returns were higher. Overall, the equal-weighted S&P declined "just" 5% during the quarter and is off 5% over the past 12 months. The cap-weighted index dropped 11.8% in Q1, and is off 21.8% over the past year.

Looking only at non-S&P firms, the contrast between large and small firms is very stark indeed. On an equal-weighted basis, the companies in every sector posted gains during the first quarter, with the combined index up 20.2%! The median tech stock gained 4% in Q1, but the cap-weighted sector lost 38%. The median health care company was up 7.7%, but the cap-weighted sector dropped 28%. Even financial services stocks displayed this "market-cap effect", up 10.7% on an equal-weighted basis but off 5.5% in cap-weighted terms.

Table 5. U.S. Equities - Sector Performance

Periods ended 3/31/01; indices are ***cap-weighted***

Sector *(% of Total)*	**Non-S&P 1Q01**	**S&P 1Q01**	**Total 1Q01**
Technology *(18)*	-37.8%	-25.5%	-28.1%
Financial *(18)*	-5.5	-9.8	-8.8
Health Care *(13)*	-28.1	-14.1	-16.9
Utilities *(10)*	-8.0	-3.3	-4.3
Consumer Staples *(7)*	2.6	-10.9	-9.1
Energy *(6)*	-4.2	-6.3	-5.8
Retail *(6)*	10.2	-1.8	-0.4
Consumer Srvcs (6)	-2.8	1.2	-0.6
Business Srvcs. *(4)*	-23.1	-1.5	-15.3
Capital Goods *(3)*	-2.9	-16.0	-12.4
Raw Materials *(2)*	3.4	-5.4	-3.5
Combined Sectors	**-15.2**	**-11.8%**	**-12.6%**

Data Source: Vestek

A Spring Cleaning for Foreign Markets

(def. – *getting rid of the evidence*)

Non-U.S. equity markets were quite weak during the 1st quarter, in parallel with domestic results. Added to this weakness were negative currency translation effects, as the US$ increased in value against almost all other major currencies. The results are reflected below --

Table 6. International Investor Markets

In US$ terms; equity returns are cap-weighted

	1st Q 2001	**Latest 12 mos.**	**Latest 3 Yrs, p.a.**
World, ex-U.S.	**-14.0%**	**-25.7%**	**-0.2%**
MSCI Japan	-8.6	-34.8	3.1
- ¥en	*-9.4*	*-18.6*	*7.1*
MSCI Europe	-15.5	-22.5	-1.1
- Deutschmark	*-6.8*	*-8.2*	*-17.0*
- £ Sterling	*-5.2*	*-11.1*	*-14.6*
- EURO	*-6.3*	*-7.6*	*-24.7 **
Pacific, ex-Japan	-11.6	-19.8	-2.0
- Aussie Dollar	*-13.1*	*-20.2*	*-26.2*
- Taiwan Dollar	*1.0*	*-5.2*	*0.5*
Emerging Markets	-5.5	-35.9	-8.4
- Mexican Peso	*2.0*	*-1.7*	*-9.7*
- Brazilian Real	*-9.4*	*-7.4*	*-47.1*
Global Bonds	-3.0	-1.7	2.5
Global Bonds, hdgd	2.6	10.7	7.6

** Since inception on 1/1/99*

In order of total market capitalization the four major non-U.S. regional indices are: Europe, Japan, Pacific Rim (except Japan), and the collective Emerging Markets. All regional indices declined in US$ terms during the 1st quarter, although the Japanese market did advance in local terms.

We think that many investors will now look at the weak returns over the past 1- and 3-year periods, and begin to bail out of international equities. They'll completely miss the fact that domestic large-cap stocks did worse, and that negative currency effects (which will end) contributed significantly to the results.

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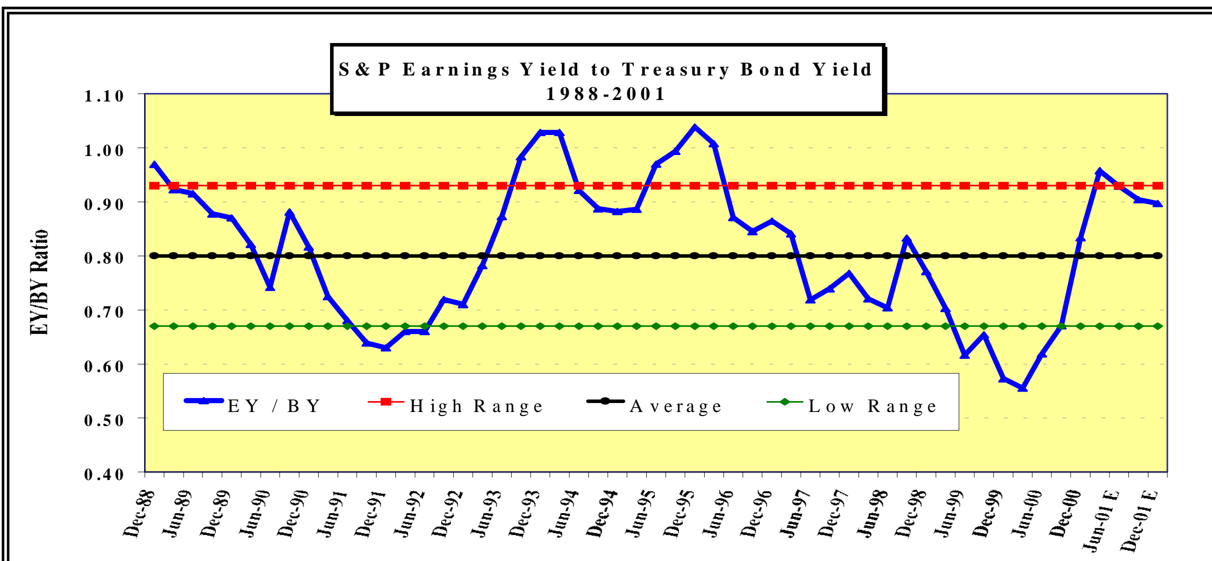
IS IT SAFE?

We promised some thoughts on what we might expect from the domestic equity markets in the days ahead, based on market history tempered by current affairs.

The pessimist's case is easy to make – a weakening economy, due to possibly declining domestic and global demand, leads to declining profitability among the countries' and the world's heretofore fastest growing and most attractive firms. Any boost in equity market returns from a declining yield curve will be marginal, because rates are already low and future inflation remains a concern due to energy prices. With the P/E ratio of the broad market (S&P 500) still well above historical averages, equity investing is unlikely to be rewarding.

But there is definitely another side of this coin. It's built on the back of these observations –

- Since WWII, stocks have done better in years when S&P earnings fell at least 5% than in years when S&P earnings rose;
- A recovery in the S&P has preceded the trough of each recession since WWII by an average of 4.9 months;
- The market contains many high P/E stocks that may prove to be overvalued. The largest of these dominate the statistics, but the *median p/e* of the S&P is now below 16x, compared to a 50 year average of 14.5x;
- The market has, on average risen 18% in the year after monetary policy turns stimulative, with double-digit returns in 13 of the 15 turning points since 1966.



Which brings us to this graph. First, think of the market's P/E in terms of how much earnings you are able to acquire per $100 invested. Then, compare this "earnings yield" to how much interest income you are able to acquire for every $100 invested in long-term Treasury bonds. A rational long-term investor implicitly makes this comparison when she chooses stocks or bonds.

Of course, equity earnings aren't guaranteed, like bond interest, but then equity earnings can grow over time and bond coupons do not.

Since 1988, including a recession in 1990-91, the ratio of "EY-to BY" has averaged 0.80, and has almost always stayed in a range of 0.93 to 0.67. Assuming 1st quarter earnings declined 12% from last year, the ratio stood at 0.96 as of 3/31/01. If S&P earnings fall 10% in 2001 *and interest rates don't rise*, the ratio will remain at or above 0.90 **unless the S&P 500 index rises.**

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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