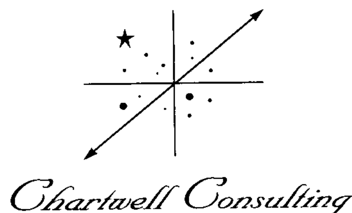

CHARTWELL REVIEW

April 2003 **FIRST QUARTER 2003** Volume X, Issue No.1

Gut Check Time

If you've ever played a sport in competition with others, you're familiar with our title. There is a point in the competition when anxiety is at its highest. You must face up to your weaknesses and fears, and either get past them to a higher performance plane, or not. In the former case, there's still no guarantee you'll be successful (except in the movies), but the latter case is normally a lock "to the downside."

For investors, we can't think of any period in time during the past *two decades* more deserving of our title than the last six months leading up to today. This relates to observations we made last quarter about investor's heightened aversion to return uncertainty and their need for some near-term positive reinforcement. A glance to your right at the 1-year and 3-year columns helps explain why. A glance at the front page of any major newspaper will complete the picture. The "fog of war" has understandably clouded everyone's perceptions during the past 3-6 months about future economic activity and (therefore) investment returns.

In this environment of maximum anxiety and risk aversion, we offer up the following: since September 2002, investing in the US Government bond index has produced a +2% total return, while investing in an equally-weighted index of the 5,000 largest U.S. stocks has provided a +15% total return. What happens when the fear dissipates?

Table 1. Index Benchmarks

Market Index	Q1 2003	Trailing Returns * 1Yr	3Yr	5Yr	10Yr
S&P 500	-3.2	-24.8	-16.1	-3.8	8.5
Large-cap Stocks	-3.1	-25.5	-18.4	-4.5	8.4
Mid-cap Stocks	-2.4	-21.5	-8.8	-0.4	9.1
Small-cap Stocks	-4.5	-27.0	-11.0	-4.1	6.2
International Stocks	-7.4	-22.3	-19.1	-6.6	2.5
T-bills (3 month)	0.3	1.8	4.0	4.4	4.5
1-3 Year Treasuries	0.6	6.4	7.1	6.2	5.9
Aggregate Bonds	1.4	11.7	9.8	7.5	7.2
High Yield Bonds	7.1	3.3	1.9	1.3	6.2
Global Bonds, hedged	1.2	9.9	7.8	7.1	7.9
CPI, **annualized**	5.2*	3.1	2.6	2.6	2.5

* Annualized trailing returns for periods ending 3/31/03.

Table 2. Average Mutual Fund Returns

Fund Category	Q1 2003	Trailing Returns * 1Yr	3Yr	5Yr	10Yr
US Large-cap	-3.1	-25.5	-16.0	-3.9	7.2
US Mid-cap	-2.5	-25.4	-16.8	-1.3	7.7
US Small-cap	-4.6	-26.1	-7.6	-0.4	8.0
International Equity	-8.0	-23.0	-17.9	-4.8	4.4
Emerg. Mkt. Equity	-5.6	-21.2	-15.5	-4.9	-1.0
Balanced/Hybrid	-1.6	-11.6	-5.2	0.4	6.7
Inv. Grade Bond	1.5	9.5	8.2	6.3	6.3
Government Bond	0.8	9.6	8.3	6.4	6.1
High Yield Bond	5.8	3.0	-0.1	-0.8	4.7

* Annualized trailing returns for periods ending 3/31/03.
Source of fund's data: Morningstar

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The End of the Beginning

Late last week, Tom Brokaw used this term in reference to the present state of our country's involvement in Iraq. It's not a new concept. Churchill coined the phrase when referring to the first allied victories of WWII in North Africa. What Brokaw meant was the 30-day war we just won (?) is only the very first step, albeit a big one, in what will be a drawn-out and complicated process of revised Middle Eastern relationships.

You may want to look at your current investment allocation with a similar perspective. We are at a true inflection point with regard to global investment markets. During the past few months we've been completing the last phase of stabilizing the equity markets, at very low levels. While mark-to-market stock prices have been quite volatile, domestic corporate earnings have been on the mend for five consecutive quarters (including 1Q03). This is the first big step to the equity markets' recovery, which also promises to be a complicated process.

Perhaps just as important, companies have been repairing their balance sheets. Strong cashflow generation has taken internal financing ratios above 100%. This means many firms are able to fully cover their capital spending from internal sources, rather than having to rely on borrowing. Overall corporate debt capacity has risen during the past 18 months, due to lower borrowings and lower interest rates. This de-leveraging is an important pre-condition to the next expansion phase.

Equity returns have always reacted directly to changes in corporate profitability, while exogenous events and investor psychology have always served to contract or expand the reaction time, and its magnitude. Last July, we suggested a two-year time frame would be required to complete the latter process. But then, we began a long and globally divisive march to war. A lot of people, companies, and countries effectively put matters on hold for six months as they focused on geopolitical issues. This did not stop the recovery process – indeed, the equity markets have handily outperformed both the cash and bond markets during this time (it doesn't seem like that happened, but it did).

Nevertheless, it's prudent to assume the war has pushed out the market recovery timeline at least to the end of 2004. So, we've pushed out our prediction of S&P 1100. At 900+, this index is up 11% since our late July 2002 briefing note. We think continued progress on the economic and corporate recovery front (a big assumption, given the delicate Middle Eastern situation) could take it up another 24% by January 2005. That 2-year return may not sound like much to some investors, but it will probably beat most alternatives.

The Economy

In March, the Commerce Dept. issued its final estimate of 4th quarter GDP growth. Rather than the decline many had previously feared, it actually rose by 1.4%. This is a low figure, but still represents the fifth straight quarter of real growth. Curiously, the National Bureau of Economic Research has not yet bothered to lift its recession designation.

Contributors to this result may be found in Table 3. In essence the quarter's slow growth was attributable to slower growth in personal consumption expenditures (by far the largest component of GDP), and the sharply negative impact of our rising trade deficit. The former was a function of slower growing disposable personal income and faster rising savings rates. Only some of this can be laid at the "uncertainty of war" doorstep. On the other hand, the increasingly negative trade deficit was very certainly related to the quarter's rising costs for imported energy.

Table 3. Components of GDP Growth

(seasonally adjusted annual rates)	Contribution to GDP Growth		
	4Q '02	**2002**	**Past 4-Years**
GDP Growth, annualized	1.4%	2.9%	2.4%
Personal Consumption	1.2	1.9	2.4
Gross Private Investment			
- Fixed Investment	0.7	0.1	0.2
- Change in Inventories	0.3	1.2	(0.1)
Net Exports	(1.6)	(0.9)	(0.7)
Government Spending			
- Federal	0.7	0.5	0.3
- State & Local	0.1	0.2	0.4

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Estimates of 1Q03 real GDP growth have been rising since February. Current consensus is that it advanced by nearly 2.5%. The flash report is due out on 4/25 (it is typically much revised). We think the components will reflect the same pattern as the 4th quarter; personal consumption up modestly, but less than personal income due to a higher savings rate; the trade deficit an increasing drag due to a sharp rise in the cost of imported energy; and, in offset, increased private fixed investment.

- ***1Q03 Production and Capacity***

Preliminary estimates are that total industrial production rose at a very modest 0.5% seasonally adjusted annual rate in the 1st quarter, compared to a 3.4% *decline* during the previous quarter. However, the total index peaked in January and weakened thereafter. By market groups, the quarter's bright spots were in defense and space equipment (+8.3%) and energy (+8.9%). No surprises there.

Modest production growth over the past 12 months (0.5%) has been accompanied by modest capacity growth (+1.1%). Thus, capacity utilization for total industry has not edged up during the past year.

Business sector productivity (output per hour of all working persons) increased 4.8% in 2002, the largest annual productivity gain since 1950. Output rose 2.7%, while hours declined 2.0%.

- ***1Q03 Employment***

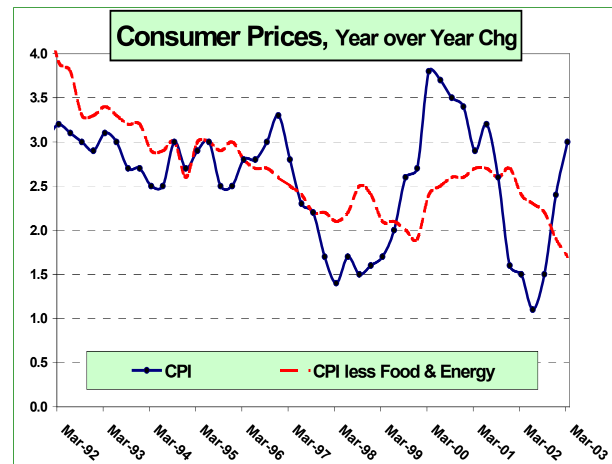
Employment data has always been subject to selective interpretation. Conspiracy theorists think the figures are manipulated for political reasons. Based on household data, and ignoring the often curious effect of seasonal adjustments, the BLS estimated 136.8 million persons were employed at the end of March, from a civilian labor force of 145.8mm. One year ago, employment was estimated at 135.6mm, from a 144.3mm labor force. So total employment has actually risen over the past year. **Except** that *total nonfarm payroll employment* (based on establishment data) at the end of March 2003 was 129.6mm, compared to 129.9mm one year ago. So, employment has actually declined during the past year.

Got it?

- ***1Q03 Inflation***

Consumer price inflation rose at a seasonally adjusted annual rate of 5.2% for the three-months ended March 2003. This sharp increase led to a 3.1% change in prices for the 12 months ended March '03. These are concerning figures, but the increases were largely a function of price changes in the Energy prices index, as Chart 1 reflects. The Energy index rose at a 77% annualized rate during the quarter, and 23.4% over the past year.

Chart 1. Recent Consumer Price Changes



Rapidly rising energy prices are the purest manifestation of the *economic* costs associated with the Iraq war. Some refer to this as a "tax" on the economy. That very much understates the negative strategic impact. Domestic taxes are fully recycled back into the economy by our governments. Higher payments for imported energy simply leave our shores, unless producers re-invest the proceeds in America. That's why April's decline in oil prices is having such a positive economic impact.

The Bond Market

The Lehman Aggregate Bond Index has returned an exceptional 11.7% during the past *year*, but very little of it came during the latest quarter. As Table 1 reflects, the domestic investment grade bond market returned just 1.4% during the first quarter. You'll recall this index returned only 1.6% during last year's 4th quarter.

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Why the modest, but positive, quarterly result? Despite considerable intra-quarter volatility, risk-free yields (on Treasuries) at the end of March were virtually unchanged from December. Yields on bond market "bellweathers" look like this –

	@ March '03	@December '02
6-mo.	1.12%	1.22%
2-year	1.51	1.59
5-year	2.74	2.73
10-year	3.82	3.83
30-year	4.84	4.79
Lehman Agg.	3.94%	4.06%

The Index' overall yield-to-maturity declined by 12bps during the quarter. This provided some price protection to bond investors, augmenting otherwise skinny coupon payments. The monthly coupon-only return of the Lehman Aggregate is only 0.4%.

Table 4. Fixed Income Sector Returns

Periods ended March 31, 2003; indices are cap-weighted

	1Q03	1 Yr.	3 Yrs.
Aggregate Bonds	**1.4**	**11.7**	**9.8**
US Treas, long	1.4	20.4	11.2
US Gov't, all	1.1	13.4	9.8
Mortgages	0.9	8.7	9.2
Inv. Grade Credit	2.4	13.5	10.5
BBB-rated Bonds	3.4	12.8	9.5
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High Yield Bonds	7.1	3.3	1.9
CCC-rated Bonds	19.0	8.9	(5.1)
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Global Bonds	3.1	25.2	7.4
Global Bonds, Hdgd	1.2	9.9	7.8

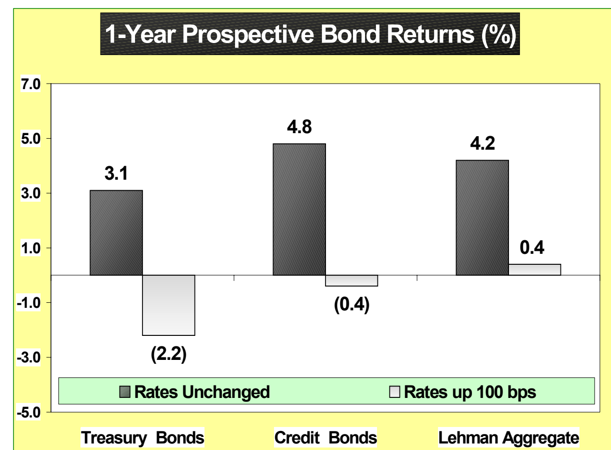
Declining yields (i.e., rising bond prices) were principally a feature of the corporate bond sector during the 1st quarter, as credit-related spreads narrowed by 15-40bps. Yield premiums on "BBB" bonds fell twice as much as yield premiums on "AA" paper. Yield premiums on junk bonds declined the furthest of all. Table 4 clearly captures the result; lower-rated bonds outperformed during the 1st quarter, just as they did during last year's final three months. The exception to this was mortgage-backed securities, which slightly <u>under</u>performed higher-rated Government bonds.

Bond managers we've talked to are universally concerned about future fixed income returns -

- Risk-free rates are historically low at each major point along the maturity spectrum. The steep curve should act as an inducement to extend maturities, but bond managers are extremely reluctant to take the bait. The largest firms are suggesting diversification into high-grade foreign bonds, as currency-hedged yields exceed domestic ones.
- The Federal Government is expected to sell over $65 billion of "new debt" in May. With our budget deficit above $350bn, there will be many new debt financing rounds to come.
- Managers are concerned the mortgage sector, which is now about 36% of the entire market, will be subject to considerable near-term price declines if market interest rates rise.
- Finally, some managers are attracted to the current yields on lesser-rated issues (BBB and below), but they admit this requires a positive "call" on the economy's growth.

In order to gauge the impact of moderately rising interest rates, we asked Western Asset Management to compile the data in Chart 2. It compares the investment grade bond market's potential return during 2003 if interest rates remain unchanged, versus an estimate of returns if Treasury yields rise 1% across all maturities. This isn't a particularly pretty picture, although rates would need to rise 2% to produce double-digit losses on bonds.

Chart 2. If Interest Rates Rise, look out



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Domestic Equities

(As we go to print, the S&P 500 index stands at 912. This compares to 848 at quarter's end)

This year's 1st quarter marked the third anniversary of the start of our current domestic equity bear market. The sea of red in Table 5 tells the tale. Only one asset sub-class, small cap value stocks, has produced a positive 3-year return after adjusting for inflation.

Last quarter also marked the fifth straight quarter the S&P 500 companies will have reported rising operating earnings (operating and net profits were expected to rise in the quarter by 10% and 20%, respectively, and early reports are generally beating estimates). Despite this, investors did not find the environment conducive to extending their equity exposure. Too much focus on the war, and investors have always had a very difficult time evaluating and "pricing" war risk (on the other hand, traders usually relish the volatility and uncertainty).

Table 5. Equity Returns by Style/Market Cap

Periods ended March. 31, 2003; indices are cap-weighted

	1Q03	1 Year	3 Years
Growth			
Large Cap	(1.3)	(26.9)	(25.7)
Mid Cap	0.0	(26.1)	(25.0)
Small Cap	(3.9)	(31.6)	(24.4)
Value			
Large Cap	(5.2)	(24.2)	(10.3)
Mid Cap	(4.1)	(19.7)	1.6
Small Cap	(5.1)	(23.3)	4.4

You may recall the strong 4th quarter advance was decidedly led by technology, telecom, and other business cyclical stocks, and not by consumer-related firms. Some called it a "junk stock" rally, because the most beaten-down growth stocks did the best. Yet, in one way the first quarter was more of the same. Technology stocks surrendered little in the first quarter (*see Table 6*).

The first quarter continued what has been a "quiet," but strong, style rotation toward growth stocks.

The first quarter clearly favored growth versus value across the capitalization spectrum, as Table 5 indicates. Further, while 1-year trailing returns don't yet hint at this, since June 2002 the large-growth indices have outperformed large-value by 5.5%, and the small-growth index has exceeded small-value by 2.5%. Further, large-cap has beaten small-cap by over 6%. This trend has been extended as April has progressed, and we look for it to continue (with some breaks) for the next year.

Table 6. U.S. Equities - Sector Performance

Sector (*% of S&P*)	1Q03	1-Year
Business Equipment & Serv. (3%)	-3.2	-32.4
Capital Goods (2%)	-10.8	-32.5
Consumer Durables (1%)	-11.5	-39.2
Consumer Non-Durables (9%)	-6.1	-14.8
Consumer Services (5%)	-1.7	-27.2
Energy (6%)	0.8	-19.2
Financial Services (20%)	-5.2	-21.9
Health Care (16%)	1.3	-17.5
Multi-Industry (4%)	3.9	-26.2
Raw Materials (2%)	-7.6	-20.4
Retail (8%)	0.2	-26.9
Shelter (1%)	-3.0	-19.5
Technology (16%)	-2.4	-31.9
Transportation (2%)	-6.6	-27.0
Utilities (7%)	-9.9	-32.8
S&P 500	**-3.1**	**-24.8**

International Equities

Despite a modest boost from currency effects, developed and emerging international equity markets generally underperformed our domestic one during the quarter. The Dollar's decline added only 1.3% to local market returns, which were led down by European markets. You'll recall European markets led the developed market benchmark up in the 4th quarter, on a potent combination of strong local markets and positive currency effects.

Notwithstanding the weak quarter, during the past 12 months all primary sectors of the non-U.S. equity marketplace have provided returns significantly exceeding those produced from domestic stocks. However, only the emerging markets sector has done so before currency effects *(see Table 7)*.

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Table 7. International Equity Markets

Cumulative % returns for the periods ended March 31, 2003

	1Q03		One Year	
	Return In US$	Currency Return	Return In US$	Currency Return
MSCI EAFE	**(8.1)**	**1.3**	**(15.7)**	**13.7**
MSCI Europe	(9.2)	1.4	(18.1)	15.6
MSCI Pacific	(5.5)	1.3	(9.0)	9.6
- Japan	(7.7)	0.1	(10.1)	10.4
MSCI EMF	**(5.9)**	**0.3**	**(6.0)**	**1.2**

Data Source: Capital Guardian

Said differently, international investors have greatly benefited from the US Dollar's weakness, because local market returns, especially those of the major Continental Europe countries, have been poor. So, one can certainly be concerned about the return components, but our recommendation of 15 months ago ("we come down in favor of the active faith that supports a meaningful allocation to international markets") has proven valuable.

From a country perspective, the Australian, New Zealand, Canadian and Irish markets produced positive returns of 4-6% during the first quarter. Stock markets of France, Germany, Norway and the Netherlands posted losses in the 10-16% range.

The strongest industry groups in non-US markets were utilities, telecom services, industrials and health care, although none of these sectors posted gains. Weakest industry groups were consumer discretionary (including retailing, which did well in the US), financial services (especially insurance stocks), and materials (basic industries, like chemicals).

Looking forward, ROE improvement by companies domiciled in emerging markets continues to outpace those of developed markets, directly reflecting those countries' higher GDP growth rates. Yet, the EM indices have made little overall progress since the 1998 sell-off. A strong investment thesis in favor of Emerging Markets may be developing.

Conclusion

The equity asset sub-class with by far the worst record exactly three years ago was domestic small-cap value. At that time, its 3-year performance was almost 29% per annum worse than large-growth. Today, the 3-year difference in these two indices is 30% per annum, but in the opposite direction!

According to a series of studies/surveys reported on this April, many institutional investors (especially funds or plans with >$1bn) are doing all they can to avoid adding to their equity allocation. Rather than rebalance to current strategic targets, many are announcing fresh strategic asset allocation reviews with the generalized goal of reducing risk, but some plans are simply suspending rebalancing because "the chief investment officer or next highest authority is bearish" (to quote Barton Biggs, chief global strategist at Morgan Stanley).

Last quarter, we posed a number of questions investors should develop a forward-looking "view" on, instead of being blinded by the red ink in the rear-view mirror. Now that the war is at least unofficially over, we recommend dusting those questions off as you take a fresh look at your strategic asset allocation.

We admit to no short-term market foresight (which at least makes us honest). But, like others, we do foresee deficit fiscal spending and easy monetary policy providing a strong boost to GDP growth, only not as much as the numbers might suggest. Our trade deficit remains a negative factor (and source of US$ weakness), even after oil prices decline. Deflation seems an unlikely prospect, but rising inflation concerns do not. These factors all line up against Treasury bonds and the Dollar. That is not the same as a strategic argument in favor of equities, but we made that case over 10% ago.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." (Sir John Templeton)

See you next quarter!

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