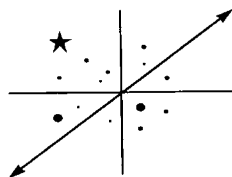

Chartwell Consulting

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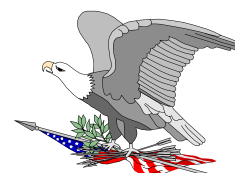
THIRD QUARTER 2001

Courage Under Fire



For the best and worst of reasons, we decided to "recycle" this title from a previous quarterly review. Perhaps no other time since WWII offers a sterner test of this country's courage and fortitude – and the investment marketplace may be the least of it.

Across all capitalization ranges, equities posted negative returns in July, August, and the first days of September. After the September 11th terrorist attacks, our equity markets were closed for four days. When they re-opened on September 17th, the across the board sell-off of equities represented the biggest weekly loss since the Great Depression.

In the market break, the Dow fell 14%, the S&P dropped 11% and the NASDAQ lost 16%. Since then, these markets have largely rallied back to pre-September 11th levels, but fell dramatically during the quarter. Eighteen months into a bear market, and standing at the edge of our economy's first recession in over a decade, investors definitely need courage to ride out the storm.

Table 1. Index Benchmarks

	Q3	Trailing Returns *			
	2001	**1Yr**	**3Yr**	**5Yr**	**10Yr**
S&P 500	-14.7	-26.6	2.04	10.2	12.7
Large Cap Stocks	-14.4	-30.3	1.0	10.4	12.7
Mid Cap Stocks	-17.9	-22.4	6.9	9.2	12.7
Small Cap Stocks	-20.8	-21.1	5.0	4.6	10.0
International Stocks	-14.0	-28.6	-1.0	.06	4.2
T-bills (3 month)	0.9	5.0	5.1	5.2	4.8
1-3 Year Gov't Bonds	3.4	10.4	6.4	6.8	6.4
Aggregate Bonds	4.6	13.0	6.4	8.1	7.8
High Yield Bonds	-4.2	-6.0	-0.6	3.0	7.9
Global Bonds, hedged	3.0	10.2	6.0	8.5	8.6
CPI, *annualized*	0.7	2.7	2.9	2.4	2.6

*Annualized trailing returns for periods ending 9/30/01.

Table 2. Median Mutual Fund Results

	Q3	Trailing Returns *			
	2001	**1Yr**	**3Yr**	**5Yr**	**10Yr**
Balanced	-8.1	-12.1	3.5	7.2	9.2
Growth & Income	-12.9	-17.5	3.8	8.2	11.2
Growth	-16.2	-26.7	4.2	7.8	10.9
Aggressive Growth	-24.1	-35.3	7.2	5.1	10.7
All Fixed Income	2.0	6.6	4.0	5.8	6.8
Government Bond	4.3	11.3	5.3	6.8	6.7
High Yield Bond	-5.1	-9.9	-2.2	0.9	6.3
International Stock	-17.7	-32.6	1.0	-2.0	5.1

*Annualized trailing returns for periods ending 9/30/01.
Source of fund's data: CDA/Wiesenberger & Lipper

Disengage or Re-engage?

War and recession. How bad will each get, how long will each last, and what will our recovery from each look like? If anybody offers you confident answers to these questions, run from the room. The same goes for specific forecasts of forward interest rates, next year's corporate earnings, and equity market price levels. Too many wild cards stand in the way of any short-term forecast.

So, what should a long-term investor do at this time of maximum uncertainty - disengage from the investment marketplace, and sit on lots of cash? At present yields of 2.5%, we don't think so. Periods of significant Fed easing have *always* been followed by positive changes in industrial production and the re-establishment of an upward track in the equity markets. The only variable has been timing. Our slowest recovery (since the 1930's) followed the recession of 1982-3. It took 18 months from the initial Fed rate cut to turn the economy around, and the domestic equity market's initial rebound was a tepid 15%. The point is, there was an equity market rebound, and it outpaced the cash and bond markets.

Assuming this recession will be at least as bad, we still think now is the time for long-term investors to begin to lift their focus to the other side of the valley, so to speak, even in the face of unparalleled geopolitical problems. As my father used to say, it's time to prepare for the worst, but plan for the best, by -

- ⇨ *Determining your minimum spending needs for the next 12-24 months (depending on your particular risk aversion). Raise a store of liquidity (money market and short bonds) to cover this short-term spending need;*
- ⇨ *Having prepared for the worst, allocate the rest of your funds in line with your strategic asset allocation policy. Develop a near-term timetable to systematically raise your equity allocation back up to its neutral long-term target %.*

The Economy . . . . Fading For Now

Pre- *September 11th, we'd have written –*

Our domestic economy moved from high growth to little growth in the span of 12 months ended this past June. In the 3rd quarter, activity moved to a negative growth phase (polite talk for the onset of a recession). Unlike previous recessions, the proximate cause of this one was an abrupt halting of capital spending by businesses following a period of overborrowing and overbuilding so dramatic in some sectors that excess capacity has not been higher in two decades. With production continuing to decline in September across all major market groups (now for 12 straight months - longest period since WWII), excess capacity worsened during the quarter.

Most post-WWII slowdowns have been initiated by a sharp consumer pullback, normally precipitated by a series of interest rate increases. This one is different because interest rates are very low by historical metrics, and consumer spending is just now showing signs of weakening during the 3rd quarter, after rising at a reasonable 2.7% rate during the first half of 2001. As employment growth continued to weaken during the 3rd quarter, consumer sentiment dropped sharply. Businesses are seeing their sales' activity weaken, and are reacting to this by cutting back on their biggest "variable" cost . . . . people.

Even with all the announced cutbacks in 2001, total employment at the end of the 3rd quarter was almost level with a year ago, and down only 700,000 from the January 2001 peak (employment increased by 5mm persons during 1998-00). The unemployment rate has risen to 5%, up from 3.9% a year ago, due to an expansion of the labor force rather than a reduction in employment. Now, decreased employment is nearly a fait accompli. We are in danger of moving toward a vicious cycle of layoffs begetting weaker consumer spending, begetting layoffs, etc.

***Post**- September 11th, we now observe –*

Things will get worse faster, before they start to turn around. Consumers' concerns about jobs, incomes, and safety have been ramped up. Conversely, consumers' spending rates should begin to ramp down. Businesses have been aggressively cutting investment spending, but not as fast as production and profitability have declined. With an uncertain consumer sector and a riskier political climate, watch for business spending to initially drop further, and faster, before rising.

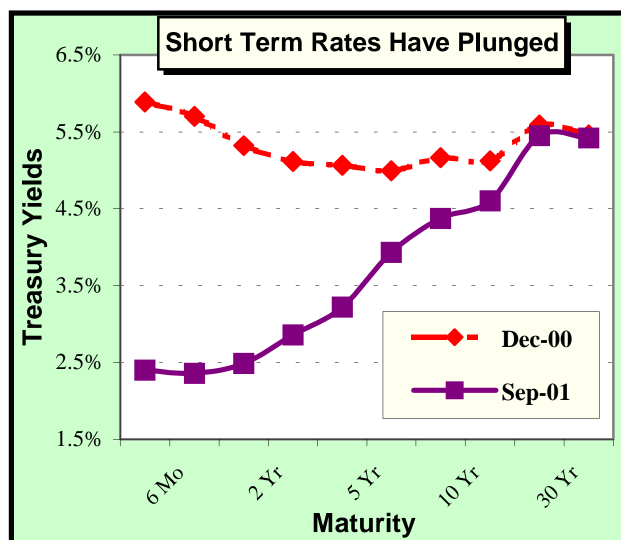
Some relevant economic factoids –

1. The U.S. index of leading economic indicators fell 0.5% in September, the biggest drop in more than 5 years;
2. Payroll employment dropped 199,000 in September (and was probably understated), the most jobs lost in a month in over a decade. New jobless claims for the second week of October approached a 9-year high;
3. The Consumer Price Index rose at an annualized rate of only 0.7% in the quarter, due to a sharp drop in energy prices, and increased by just 2.7% over the past year;
4. Aggressive monetary policy has taken the Fed Funds rate down to a 39-year low of 2.5%, and seen money supply grow at double-digit rates. Long-term interest rates have been "sticky" this year (see Chart 1), but rates for a 30-year fixed rate mortgage are very close to their lowest levels in 30 years. It's estimated that $1.5 trillion of existing mortgage debt is "refinanceable" at lower rates. Lower interest rates put enormous buying power into borrower's hands, if they choose to use it.
5. Despite the summer's $40 billion tax rebate, fiscal policy is turning to an increasingly accommodative mode, with more spending and less taxes under urgent consideration.

Bond Investors Sell Risk; Buy Safety

Earlier this year we posited the Fed would cut the funds rate to at least 3.0% before this easing cycle ended. They took it to 2.5% as of October 2nd, with the last 75bps following September 11th. Collective fed funds rate cuts totaling 4% during 2001 have exerted a very strong downward pull on the yields of short- and medium-term Treasuries, but have had little effect on long-term yields (see Chart 1).

Chart 1. Year-to-Date Yield Curve Shifts



Even so, Government securities topped the bond market's performance charts during the quarter (see Table 3, below), but not just because of a flight to quality. Long-term Treasuries gained almost 6% during July/August, as market yields dropped sharply. Long-term corporates also did very well in this period. Following September 11th, money flows decidedly favored short and medium term government securities.

The other noteworthy feature of September's market was a direct flight from credit risk. Long-term investment grade corporates declined nearly 2.5% in the month, the BB-rated bond index declined 5%, and CCC-rated securities dropped 10%.

Table 3. Fixed Income Sector Returns

For periods ended 9/30/2001

	Sept.	3rd Qtr	Y-T-D
Aggregate Bonds	***1.2***	***4.6***	***8.4***
US Gov't, medium	2.1	5.0	8.6
US Gov't, long	0.8	6.7	6.3
Mortgages	1.5	4.2	8.2
Corporates *	-0.2	3.8	9.4

High Yield Bonds	-6.7	-4.2	-0.5
Global Bonds	0.7	7.1	2.5
Global Bonds, Hedged	0.7	3.1	6.0

* *investment grade only*

Short-term risk-free interest rates now hover just below 2.5%, which is *lower than* the past year's rate of inflation. A more common relationship sees a positive spread of 2% or higher. Similarly, the 10-year T-bond's 4.6% yield is only 2% over trailing inflation, compared to the more usual 3.5-4% spread. Perhaps the inflation rate will move to zero, although it never has. If not, the next big move in underlying interest rates is likely upward.

Domestic Equity Melts Down

Table 4 summarizes the recent carnage of this bear market. The 3rd quarter was a time of across-the-board equity market weakness. The tendency has been to correlate this with the actions on September 11th, but U.S. stocks had already lost considerable ground in the quarter when the horrific attacks in New York and Washington stunned the world and triggered a swift global selloff in equities.

In fact, most of the 3rd quarter's weakness occurred prior to that fateful day. The large-cap S&P index dropped 10.8% from 7/1/01 through 9/10/01. It declined "only" 4.7% from 9/17 to quarter's end. The same was true of small-cap stocks, as the R2000 index fell 14.1% though 9/10, then 8.1% during the remainder of September.

After reversing itself during a relatively strong 2nd quarter, the "*value beats growth*" premise returned intact across the market cap spectrum during the 3rd quarter. Nonetheless, even top performing large value stocks posted a terrible 10.7% decline. A liquidity driven "flight to size" favored large-cap stocks post-September 11th. That aside, small-cap value has provided dominant returns during the past two years.

Table 4. Equity Returns by Style/Market Cap

Periods ended 9/30/01; indices are cap-weighted

	Sept.	3rd Qtr	Y-T-D
Growth			
Large Cap	-8.6	-17.6	-29.5
Mid Cap	-16.5	-27.8	-37.2
Small Cap	-16.1	-28.1	-28.0
Value			
Large Cap	-6.0	-10.7	-13.6
Mid Cap	-9.5	-11.6	-8.7
Small Cap	-11.0	-13.3	-2.3

Table 5. U.S. Equities - Sector Performance

Periods ended 9/30/01; returns are cap-weighted

Sector - *% of S&P*	**Non-S&P 3Q01**	**S&P 3Q01**	**S&P 12 Mos.**
Technology - *15%*	-42.7%	-33.2	-62.3%
Financial - *18*	-5.1	-13.1	-13.7
Health Care - *16*	-17.4	3.1	-1.6
Utilities - *10*	-18.1	-5.9	-20.2
Consumer Staples - 9	-8.0	3.6	12.3
Energy - *7*	-19.1	-11.6	-14.3
Retail - *7*	-17.3	-11.3	-6.3
Consumer Srvcs - *4*	-30.0	-31.9	-31.1
Business Srvcs. - *2*	-30.5	-15.4	-23.1
Capital Goods - *2*	-20.5	-15.6	-11.0
Raw Materials - *2*	-15.3	-13.9	9.5
Combined Sectors	**-20.6%**	**-14.7%**	**-26.7%**

Data Source: Vestek

Sector selection during the quarter mattered, as it almost always does (see above). In the S&P500, the moribund information technology sector got more so, "recession-proof" consumer staples and health care firms attracted investors, and some utilities were perceived very positively (specifically – big telecom services firms, like the Baby Bells). Differences in small-cap land focused on health care (much weaker) and financial services (much stronger).

International Markets Drop

International equity exposure once again failed to provide investors with much needed diversification from the turbulent US markets. The MSCI EAFE index only managed to slightly outpace the S&P 500 (about 70bps) during the third quarter.

Even before the events of September 11th, the market was dominated by concerns of economic slowdown in the US and Europe, and the continued weakness of the Japanese economy. Since the terrorist attacks, increasing risk aversion on the part of investors has become evident.

As reflected in Table 6, the US Dollar weakened considerably during the quarter, providing a moderate offset to what were poor local currency returns. The foreign exchange markets were also characterized by a flight to quality during the month of September, with the Swiss Franc and the Euro gaining the most ground versus the Dollar.

The yen, despite intervention by the Bank of Japan to weaken it, appreciated versus the Dollar. Given Japan's current economic conditions, global fixed income managers we've spoken to expect further action by the BOJ if needed to prevent the yen's continued appreciation.

Table 6. International Investor Markets

	3rd Quarter 2001		**Year to Date**	
	Return In US$	**Currency Return**	**Return In US$**	**Currency Return**
MSCI EAFE	**-14.0%**	**5.8%**	**-26.3%**	**-3.1%**
MSCI Europe	*-12.1*	*6.8*	*-27.1*	*-3.0*
Germany	-21.9	7.6	-33.3	-3.0
UK	-7.4	4.5	-19.4	-1.6
MSCI Pacific	*-18.2*	*3.5*	*-24.8*	*-4.5*
Japan	-18.1	4.7	-24.8	-4.1
Australia	-16.4	2.9	-13.6	-11.2
Emerging Mkt	*-21.6*	*-3.9*	*-22.9*	*-8.3*
Mexico	-20.5	-4.5	-0.5	1.0
Brazil	-29.2	-13.5	-37.4	-27.0
Taiwan	-27.2	-0.2	-27.9	-4.1

Data Source: Capital Guardian

Emerging markets began the quarter with a 13% performance "lead" over the developed markets year-to-date, but lost ground (down 12% in dollar terms since September 11th) as investors avoided the sector's perceived country and liquidity risks.

Another way to evaluate international equity returns is from a cross-border industry group viewpoint. The most heavily weighted sectors in MSCI EAFE are as follows –

Table 6. Foreign Equities - Sector Performance

Periods ended 930/01; Performance in US$ Terms

Sector - % of EAFE	3rd Qtr	Y-T-D
Financials – 25%	-14.3%	-26.2%
Consumer Disc. – 13	-24.3	-29.4
Industrials – 10	-18.8	-30.2
Health Care – 11	-0.6	-11.2
Telecom Services – 9	-12.3	-38.7
Info Technology – 6	-32.8	-55.7
Consumer Staples – 8	-2.2	-10.3
Energy – 8	-4.1	-4.4
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Combined Sectors	**-14.0**	**-26.3**

Data Source: Capital Guardian

Against this backdrop, non-cyclical stocks (like consumer staples, and healthcare) fared best along with defense stocks. Telecommunications services names also rebounded after the attacks. Showing weakness were airlines, the consumer discretionary sector (in particular hotels, leisure and automobile stocks) and information technology names. The global "flight to quality" caused small cap names to underperform large caps.

In Conclusion . . . Work the Problem

We've observed a current tendency to reference most economic and financial results in terms of pre- or post-September 11th. While we all shall never forget that day, we do wonder whether current corporate profitability, interest rates, and investment returns *two years from now* will be dominated by September 2001.

The domestic equity markets have been on quite a run since the September 21st selling climax. The S&P index has advanced 12% as we go to press, to 1085. That equates to about 23 times trailing 1-year earnings (depending on 3rd quarter reporting), a reasonable figure **if** market interest rates don't rise and companies achieve the same level of profitability as we move forward through a recession. Tough assumptions to get comfortable with, but possible if monetary and fiscal policy work as expected.

We're not recommending long-term investors stake out a bearish or bullish position at this point, because we don't know which set of assumptions to use. Instead, we suggest you unemotionally "work the problem," by carving out a safe position, then using that as a point of departure from which to extend up and out the risk-taking curve. If we're not in a secular bear market (read: 1930), then major opportunities to turn increasingly bullish will present themselves.

See you next quarter!

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