

Does it Seem Like Every Silver Cloud has a Dark Lining?

Market Summary

January 2003

With the S&P 500 down 2.6% last month, the stock market's "January Barometer" forecasts a moribund outlook for U.S. equities in

2003. This simple indicator, made famous in Yale Hirsch's *Stock Trader Almanac*, predicts that the January S&P 500 performance is likely to be directionally the same as the full-year returns. As unlikely as it seems, this unscientific forecasting notion does have a fairly good track record. Since 1970, the S&P 500 ended the year up 18 of the 21 years that posted January gains (85%). Of the 12 times the market dropped in January, declines continued for the remainder of the year 7 times (58%).

Does this portend that 2003 will bring the fourth straight year of losses for U.S. stocks? What are the odds? The U.S. stock market has posted negative returns in 31% of the years since 1900. However, during that period the market was down three or more consecutive years only three times, and down four years in a row only once. With those odds, the likelihood that 2003 will be the fourth straight losing year for U.S. stocks should be fairly remote. Right?

Unfortunately, the odds are not insignificant that 2003 will be another down year for U.S. stocks. First, the probability that the market will decline in any given year is about 31%. That's because studies show that the chance of an up or down year is independent of the prior year's market performance. In other words, annual stock market returns are not serially correlated. Secondly, January's weak performance slightly increases the odds that stocks will end lower in 2003.

However, whether 2003 will be an up or down year for U.S. equities may simply be splitting hairs. If U.S. stocks are up this year, we expect that gains will be limited to the mid-single-digit percentage range because the current high P/E's and low investor confidence in earnings projections leave little upside potential for U.S. equities in the near term.

In fact, last month's stock market performance did not seem to reflect several rays of hope on the economic front. Early data indicate that GDP grew 2.4% in 2002 after being flat a year earlier. Sales of new and existing single-family houses both set records in 2002, and the December new home sales hit a

monthly record. The Chicago purchasing managers' survey jumped to 56.0 in January from 51.7 in December, the first encouraging report in some time. The January jobs report showed an encouraging 143,000 increase in new jobs and a drop in the unemployment rate to 5.7%. And inflation remains dormant, with the CPI up only 2.4% in 2002.

Despite these positive economic signs, it seems that every silver cloud has a dark lining these days. Last month, investors were disappointed by reports that the 4th quarter real GDP grew at a scant 0.7% annual rate, due to a slowdown in consumer spending, falling exports and still no pick up in business investment. Additionally, the earnings outlook remains uncertain, with lower expectations for the remainder of the year being set by over half of the companies providing guidance. And markets continue to be held back by hand wringing over heightened geopolitical concerns.

In addition to January declines for large-cap U.S. stocks, virtually all other traditional asset classes produced tepid results last month. U.S. small-cap stocks (Russell 2000) were down 2.8%, international stocks (EAFE unhedged) were off 4.2% in January, and the bond market (Lehman Brothers Aggregate) was up a slight 0.1%. Below investment grade bonds (Salomon High Yield) provided one of the few bright spots in January with returns of 4.5%.

Granted, a single month's results have little significance when considering the long-term prospects of a well-diversified portfolio. However, we continue to believe investors must look beyond traditional asset allocation approaches to meet return objectives going forward, or come to grips with truncated return expectations for the foreseeable future.

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February's Sweet Spot



Market Summary February 2003

This bear market has been brutal on equities and February was no exception. Value was not the flavor of the month in February. Most major value indices were down considerably more than

their growth counterparts. The Russell 2000 Value lost 3.4% in February, vs. a 2.7% drop for the growth benchmark. Among large-cap stocks, the S&P Growth index beat the S&P 500 BARRA Value index by 240 basis points (-2.7% vs. -0.3%). The pattern was repeated among the mid-caps, with the Russell MidCap Growth beating the MidCap Value benchmark, -1.7% to -0.9%. Growth was sweeter still among the tech stocks in February, pushing the NASDAQ to a 1.3% gain for the month.

However, value is still ahead over the longer term, beating growth over the last 1, 3-, and 5-year periods ending in February. The greatest performance differential has been in the 3-year returns of the Russell 2000 Value and Growth indices, where Value gained a (relatively) robust 6.2% over the span, while the Growth index sank 22.3%. That's a 28.5% advantage for value. The NASDAQ has cut even deeper into investors' hearts over the last 3 years, imploding by 30.3% (annualized).

There was no romance to be found among overseas issues in February. The Emerging Markets Free index peeled away 2.8%, and the MSCI EAFE index dropped 2.3% in February. Over the last twelve months, the EAFE index has fallen 17.2%, with emerging markets right behind with a decline of 13.6%. Still, valuations on the unloved asset class of emerging market equities remain attractive. The price / cash flow ratio of emerging markets is 8 times compared to the US market's 12 times. The aggregate PE ratio for emerging markets stands at a multiple of 12 compared to the US market's 18 (based on est. 2002 operating earnings).

So, does this bear (market) have a heart? And where might that sweet spot be? The stock market has been sinking now for 35 months. Everyone is thoroughly beaten down and tired of looking for *the*

place to invest where you can find positive absolute returns. Of late, in traditional equity asset classes, there seems no glimmer of hope, even amongst the small-cap value group, which has been one of the better-performing asset classes during this first bear market in the twenty-first century.

Dismal market indicators are as abundant as spring bunnies these days. The US unemployment rate is close to 6%, savings rates in the US are at 40 year lows, the price of oil has surged, the dollar has fallen, the American consumer is leveraged to the hilt and consumer confidence is in the trashcan. Consumer spending, the engine of growth for the US GDP last year, appears to be slowing this year. We are within hours of war with Iraq, North Korea has been flexing their nuclear muscles, Osama bin Laden remains at large, and growth rates in Europe have stagnated.

With all these dreary statistics circling overhead, whipped investors, spending-strapped educational institutions, and underfunded pension plans are all looking for that elusive alpha—that extra bit of investment return. Many analysts believe that expected returns going forward for the S&P 500 are in the mid-single digits. The dividend yield on the S&P 500 is less than 2%, and the equity risk premium is low. All this makes a compelling case for institutional investors to reduce allocations to traditional equities in favor of alternatives. Traditional equity returns have been pummeled over the last 3 years in comparison to bonds. Suffice it to say that the S&P 500 is down an annualized 14.3% over the last three years and 3.0% over the last 5 years. But more importantly, equity valuations remain high by historical standards. P/E's hover around 28 (based on reported earnings).

The bottom line - February left traditional equity investors heartbroken, again. Bonds, posting wide margins over stocks with their 3- and 5-year returns, and the extremely low interest rate environment we find ourselves in, bode fair warning to buyers of high quality credit. The Lehman Aggregate Bond Index has outperformed the S&P 500 now over the past 7 years (7.7% vs. 5.6% for the S&P 500, annualized) through 2/28/03. Over the last three

years, the Lehman Aggregate bond index has climbed 10.8%. The futures market forecasts short-term interest rates in December at 1.25%, the same rate they are at right now (though they are projected to dip first and then return to 1.25% between now and December).

Should everyone do as Peter Bernstein suggests and throw out the Investment Policy with the bathwater? How about hedge funds? High-yield bonds are quite interesting with spreads as wide as pancakes in some cases. And distressed debt is downright intriguing. Even the famous Omahian, Buffet, is rumored to be buying distressed debt. With lack of confidence resulting from Enron-mania and fudged financial reporting, the distressed debt market has taken on an appealing aura. A large number of companies have recently had their debt classified as “distressed,” and there is a limited amount of capital being invested in this category. Distressed debt may be the icing on the cake for a diversified portfolio.

Looking past traditional equity markets and fixed income, one can see that hedge funds have “hedged” over the last twelve months, as evidenced by their returns. Most strategies measured by Hedge Fund Research (HFR) have outperformed the S&P 500. The HFR Convertible Arbitrage and the Distressed Securities indices warmed investors’ hearts with whopping (by current standards) 11.4% and 7.0% gains, respectively, over the last twelve months through February. The HFR Equity Hedge index, over the same time period, lost 4.7%, but still outperformed the S&P 500 by 9.6 percentage points.

But hedge funds may not be the infallible magic bullet. There have been warnings of the “hedge fund” bubble bursting soon. An estimated 15% of all hedge funds closed their doors in 2002. With a

lot of capital flowing in and with interest rates as low as they are today, they may find it a greater struggle to produce the same level of outperformance as they did last year. Nonetheless, hedge funds remain attractive alternatives to traditional equities and are a great diversification tool.

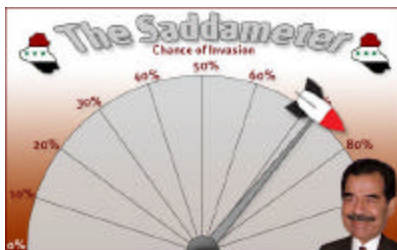
War-related events will likely cause the market to display even more volatility in the coming weeks, leaving well-diversified investors in the best position to ride out a sticky year.



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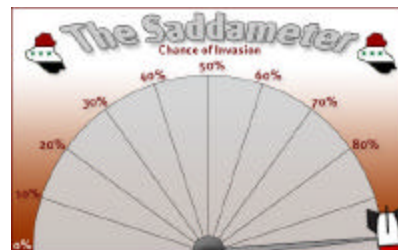
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Q1 2003:

Saddameter Hits 100%



Market Summary

March 2003

Although we only watched war for the last 13 days of this quarter, we spent the previous 77 days watching *for* a war. William Saleton's *Saddameter* (his assessment of the probability of war with

Iraq for Slate.com) started the year at 71%, fluctuated a bit in January, and then steadily climbed. On March 17, it became clear that President Bush planned to deliver an ultimatum to Saddam Hussein as part of a televised address. U.S. equity markets seem to have initially welcomed this partial resolution of uncertainty, rising 3.4%. The invasion followed, and, over the next two weeks, markets experienced increased volatility. By the end of the quarter, only small caps (Russell 2000) were able to hold on to their initial gains. We cannot help but recall what Baron Rothschild said almost two hundred years ago: *Buy at the sound of cannons. Sell at the sound of trumpets.*

Now that the war appears over, what will be the economic effects of this war and the lasting effects of non-diversifiable geo-political risk? These are two entwined issues that we won't be able to investigate fully for some time. We will, however, briefly consider an interesting piece of research from earlier this quarter that was conducted without the luxury of hindsight. In their paper *What Do Financial Markets Think of Iraq*¹, Leigh, Wolfers, and Zitzewitz took a novel approach in their analysis of the role of political uncertainty in financial markets. They used the prices of *Saddam Securities* to generate probabilities of war with Iraq before the fact. Saddam Securities were traded on www.tradesport.com, an Irish online betting exchange quite like the Iowa Electronic Markets where you can bet on political candidates. The

possible bets, or futures contracts, were that Saddam would be ousted by a particular date (the expiration date of the contract) and paid off at expiration only if Saddam's regime was gone. By concluding that the future's price provides a plausible estimate of the probability of war, the authors were able to quantify the effect of war risk on returns and volatility in financial markets. They ended their data collection in mid-February so the study was not retrospective:

- They estimated that a 10% increase in war risk increases the spot price of oil (WTI) by \$1— that is, a \$10 increase in price in the event of war. They projected a barrel price of \$37.50 with war and \$27.50 without, and the disappearance of any price effect in about a year. This resembles the intermediate case scenarios set forth by oil analysts and predicated on the belief that only the supply out of Iraq (3% of world oil) would be significantly affected. This is far less than the shocks of 1973-4 (up \$24 in 2003 prices in 1 month), 1979 (up \$31 in 12 months), and 1990 (up \$18 in 2 months). The price of oil actually rose to about \$40 and then fell to \$28.13 by 4/11/03. At the current time, there does not appear to be a widespread expectation that long run price declines will fuel global growth.
- They projected that a 10% increase in the probability of war would translate into a loss of value of 1.5% for the S&P 500 – that is, a loss of 15% if war broke out. To date this estimate looks extreme. Before the war, the authors viewed the estimated impact as significantly more severe than expected on the basis of macroeconomic analysis alone. They tentatively suggested that the pessimism of U.S. financial markets is due to the factoring in of geo-political risks that are much broader than the Iraq situation. Their results also suggest that it is not so much the case that financial markets demand higher risk premia, but that they expect lower future earnings.

¹ Andrew Leigh, Justin Wolfers, Eric Zitzewitz, *What Do Financial Markets Think of War in Iraq?*, Working Paper 9587, National Bureau of Economic Research, March 2003.

So we come back to earnings and the fact that the economy was already in recession, worried about the shortage of capital expenditures, and nervous about consumer spending. We note the earnings growth that accompanied earlier wars was the consequence of vastly higher levels of defense spending as a percent of GDP. Data from the Office of Management & Budget shows that peak defense spending in World War II was 37.9% of GDP and growth averaged 12%. In the Korean War peak defense spending was 14.1% and growth was over 7% in 1951. The Vietnam War defense spending of 9.4% propelled a boom, but the Gulf War spending of 4.8% hardly boosted growth. Projections for the Iraq war plus other 2003 defense spending are about 4% of GDP. We don't see this as a massive stimulus to broad growth. The good news is that there is no evidence of any of the inflationary effects of earlier wars.

The Fed is optimistic enough to be patient about additional monetary policy moves. On April 11, William Poole, President of the St. Louis Fed, said financial markets would respond to weak earnings or employment data by bringing down long-term interest rates, and solid fundamentals should win out over uncertainty. We are encouraged by the narrowing of corporate bond yield spreads which indicates a decrease in perceived risk and, in turn, an increased willingness to lend to U.S. firms. Productivity is still growing. If employment numbers would only start to improve....

The last quarter was another rough one for investment portfolios. As for U.S. equities, the Dow was down 3.5%, the S&P 500 declined 3.2%, and the Russell 2000 sagged 4.5%. On the other hand, the NASDAQ eked out a gain of 0.4%.

International equities (in \$US) reacted poorly: the EAFE (large-cap) dropped 8.2%, MSCI Emerging Markets Free slid 6%, and Salomon EMI-EPAC (small-cap) decreased 4.8%. The Pacific Rim X-Japan, however, managed a 0.6% increase. In terms of country-specific results, Japan fell another 7.9%, the U.K. lost 8.6%, France sank 11.5%, and Germany plummeted 12.6%. International equity

markets continue to reflect economies that are globally weak.

The quarterly returns in fixed-income markets continue to prove the importance of diversification. The Lehman Aggregate Bond Index rose 1.4%, the Lehman Government Bond Index rose 1.1%, and the Inflation Linked Bond Index gained 2.7%. The Salomon High Yield Bond Index proved better than its name, rising a hefty 9.4% in the quarter as investors decided the higher yields more than compensated for higher risk.

Other positive diversification benefits came from REITS, with the Wilshire REIT index up 1.3%, and commodities, with the Goldman Sachs Commodities index up 4.6%. Most of the hedge fund strategies measured by Hedge Fund Research (HFR) showed gains. The HFR Distressed Securities index gained 4%. The HFR Convertible Arbitrage and Event Driven indexes picked up 4.9% and 2.3%, respectively.

Interestingly, although gold rose to over \$380 in February, it closed the quarter in the \$325 range, down 8% from where it closed at the end of the 4th Quarter 2002. Of course, cash was cash.

We'll no doubt be talking about the impacts of the Iraqi war and rebuilding efforts on global financial markets and society for many quarters to come. In the mean time, we'll be checking *tradesport.com* to see what's trading on the North Korean and Syrian fronts.



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Markets, Like Time, Spring Forward in April

Market Summary

April 2003

At 2 a.m. on April 6th the reading on the face of the clock instantly shot forward one hour (unless, of course, you reside in Hawaii, American Samoa,

Guam, Puerto Rico, the Virgin Islands, most of the state of Indiana, or the state of Arizona). While I doubt that many of you set your alarms to witness this event, I'd wager that most of you took heed of April's leap in the financial markets.

When thinking of April, most of our minds conjure up visions of overcast skies and rain-swollen rivers. It is a necessary month one must endure to bear witness to the coming of May's proverbial flowers. In 2003, however, it was April that blossomed in the form of higher closes for almost every financial benchmark. The benchmark Standard & Poor's 500 Index climbed 8.2% in April, pulling the year-to-date return into black with a gain of 4.8%. Ironically, this was the largest gain for the benchmark since Daylight Saving Time ended in October of 2002. This gain, however, was not large enough to recoup the declines experienced over the prior eleven months. The large company benchmark declined 13.3% over the last twelve months, and 13.0%, annualized, over the last three years.

Value stocks, in general, experienced a greater boost during the month. The S&P 500/BARRA Value index returned 9.9% in April, while its growth counterpart enjoyed a more modest rise of 6.7%. While the growth benchmark has outperformed value by 2.4 percentage points over the last twelve months, it woefully trails value by 9.6 percentage points, annualized, over the last three years. The story, not to anyone's great surprise, is the same for mid-caps and small-caps.

The S&P MidCap 400 index added 7.3% in April and its year-to-date return now stands at 2.5%. While the index's loss of 17.5% over the last twelve months is more severe than their large-cap brethren's, the three-year annualized decline of 2.0% compares very favorably. Small-cap stocks, as measured by the Russell 2000 index, leapt 9.5% during the first month of the second quarter. Despite their precipitous decline of 20.8% over the most recent twelve-month period, their annualized decline of 6.4% over the last three years is half that experienced by large-caps. As with large-caps, the value components of both the mid- and small-cap benchmarks have fared much better over the last three years. To wit, the S&P 400/BARRA MidCap Value and Russell 2000 Value benchmarks have both posted positive returns over the period (6.0% and 7.3%, respectively) and outperformed their growth counterparts by 15.3 and 26.6 percentage points, respectively.

The euro continued its assault upon the besieged U.S. dollar. The euro, valued at \$1.09 at the beginning of the month, gained \$0.028, or roughly 2.6% in April. The euro has gained \$0.0695, or 6.7%, against the greenback in 2003. This has no doubt helped the returns experienced by domestic investors in European securities. The overall weakness in the U.S. currency can be seen in the differential between the returns of the hedged and unhedged Citigroup World Government Bond Index Non U.S. indices. Over the last twelve months, the hedged index gained a respectable 8.0% on falling interest rates, while the unhedged benchmark jumped a staggering 25.8%.

The MSCI EAFE index of large- and mid-capitalization stocks in developed foreign countries soared 9.8% in April. Despite the weakness in the dollar, the EAFE index dropped 16.3% and 15.5%, annualized, respectively over the last one and three years, trailing the S&P

500 over both periods. However, as noted in our First Quarter Research Report, valuations of European equities appear compelling. The Citigroup (formerly Salomon) EMI-EPAC index, measuring international small-caps stocks in developed markets, surged 10.0% during the month. Their year-to-date gain of 4.7% is very similar to that of U.S. small-caps. The rebound in equity markets was not experienced solely in developed markets. The MSCI Emerging Markets Free index sported an impressive 8.9% gain in April, producing a 2.4% return for 2003. As with most equity benchmarks however, it has experienced losses over the last one and three years (-14.3% and -11.2% to be precise).

The U.S. fixed income markets continue to be a source of positive returns for investors. The 10-year Treasury ended the month with a yield of 3.86%, roughly the same as where it ended in March. The Lehman Aggregate Bond Index gained 0.8% in April, and 2.2% for the first four months of 2003. Over the last twelve months, the benchmark returned 10.5%. High-yield bonds continue their surge as the Citigroup High Yield Index jumped 6.8% in April. So far in 2003, the index has returned an impressive 16.8%.

The hedge fund strategies measured by Hedge Fund Research (HFR) all experienced positive returns during the month. The HFR Distressed Securities Index rose 2.9% in April, and 9.6% over the last 12 months. The HFR Equity Hedge Index climbed 2.1%, but is 4.9% lower over the last year, which is not surprising given the direction of equity markets over the period. The best performer for the month was the HFR Event Driven Index, which returned 3.1%.

With regard to the domestic economy, GDP grew at a lackluster 1.6% annualized rate in the first quarter. One-half of the gain was due to a decline in the trade deficit. Business investment

fell 4.2%, continuing a negative trend. Consumer sentiment rebounded to 86.0 in April, likely the result of an end to the major hostilities in Iraq. The unemployment rate rose to 6.0%, as some 48,000 jobs were lost. Finally, import prices experienced their largest decline in history, falling 2.7% in April. This was largely due to a 16.2% decline in the price of petroleum products.

While most of us lost an hour of sleep due to Daylight Saving Time, April's events, both in the markets and in Iraq, are probably allowing all of us to sleep a little better.



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More lustrous than lusty, May doesn't stray

Market Summary

May 2003

The time was ripe for financial markets to go “blissfully astray,” as they had so often done before, and as Queen Guinevere suggests in *Camelot*, is appropriate

behavior in “The Lusty Month of May.” The scene was set to perfection: Indices had surged across all categories in April, as investors sighed relief over the quick American victory in Iraq. The market made an optimistic statement, and in so doing left its big glass jaw hanging out a mile—begging for another of the brutal “haymakers” that for 38 months had followed rallies as surely as Loewe follows Lerner on a theater marquee. But this time it was, at long last, different.

Instead of a vicious left hook, we got a “gorgeous holiday,” including nifty gains of 5.3% in the S&P 500 and 4.7% in the Dow Jones Industrial Average. Bonds were also “brimming with fun,” the Lehman Aggregate index gaining 2.1%, and Treasury Inflation Protected Securities (TIPS) 4.7%. TIPS have effloresced a boggling 46.4% since the “bear” reared its grizzled head in March 2000. High-yield issues also qualified (barely) for place at the Maypole by eking out a 0.3% gain.

Real Estate (the Wilshire REIT Index) made merry with a 5.5% move in May, and now has compiled an immodest 64.4% gain since the bear market's debut in 03/00. Now *that's* location³.

May's gaudiest display came from U.S. small-cap stocks. Russell 2000 growth issues surged 11.3%; and the value shares improved 10.2%. Performance varied inversely to size across all American stock sectors: The Mid-cap S&P 400 index trailed small-caps with a gain of 8.3%; and the S&P 500 brought up the rear with the

mentioned 5.3%. Among components of the large-caps, the S&P/Barra Value index led its Growth counterpart, 7.3%, to 3.3%.

International stocks also partook, and also saw small-caps taking the lead. The Solomon-EMI EPAC small stock index rose 8.5%, vs. a 6.1% gain by the large-cap MSCI EAFE index.

The strong results in April and May bumped every major stock index into positive territory for the calendar year. At May's end, U.S. large stocks were up a very robust 10.4% YTD—value issues leading the way with 11.5% vs. 9.3% for growth. Small caps were up a striking 15.8% for the year, with growth issues leading the way at 17%, vs. 15.8% for small value stocks. Mid-caps and internationals were also well ahead for the first five months.

The stock market, in short, has acted this year (through May) as if it were serious about establishing its October 9 close as the low of the Great Y2K Bear Market. That should make numerologists (and Jeffersonians) happy, for the S&P 500 at the closing bell that day stood at 776.76. Crank that into your cardioids, chaos clubbers.

The next question (there's always a next question) is how “sustainable” all of this is. That is, were the April/May gains anything more than the relaxation of a “war risk” premium that had been built into asset prices in the months before? Econometric data continue to befuddle central bankers, with intractable unemployment figures and declining producer prices prompting ominous mutterings about “corrosive deflation.” The continued upward movement in bond prices is considered to be at least in part an anticipation of another cut in the Fed Funds rate—already at a 42-year low of 1.25%—at the Federal Reserve's Open Market Committee meeting June 24-25

Meanwhile, *The Economist* reports that commodity prices are showing no sign of deflating (at least vs. the dollar). They were up 11.6%, year-over-year, at the end of May.

It's a very different picture in Europe, however. Commodities dropped a startling 12.6% vs. the Euro, year-over-year, as the European Central Bank's short-term interest rate at the end of May sat 125 basis points above that offered in the U.S. The influx of capital seeking these higher interest rates has sent the Euro onto a rampage (reaching \$1.19, intraday, in May), but is less salubrious for European exports. A higher Euro means higher priced European goods, resulting in depressed trade, increased unemployment and a general economic doldrums. This is why some observers are saying the European Central Bank might challenge the Fed to a game of leapfrog on short-term rates.

Exchange rate discord is of course catnip to gold traders, who at the end of May had bid up the price of the yellow bricks by 14.3% vs. the dollar, year-over-year—marginally out-stripping even the Euro over the same time span (source: *The Economist*).

It all adds up to an eventful May. And, however mixed the current signals, optimism springs eternal—for the fall, that is. No less an apostle of understatement as Fed Chairman Alan Greenspan has declared that the economy, after slumping in March and April, appears to have stabilized in May. That means better things by year's end—though perhaps not so good as had been forecast at the end of last year.

Still, peace in Iraq (however delicate), and optimism from Alan Greenspan (however dilute) are a lot to get out of any four-week span. As Julie Andrews/Guinevere melodiously observed, May can be a darling month.



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The Triumph of Liquidity Over Reason



Market Summary

June 2003

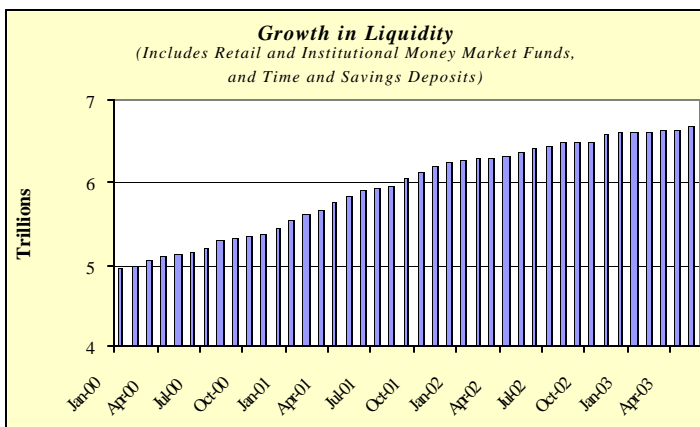
Assets seeking return can create their own return. Since the bear market began in March 2000, the volume of assets in short-term investments has grown by more than 30% (*see chart below*), and these funds are returning less than zero after inflation. We believe growing liquidity, in combination with the prospect of an economic recovery, has prompted investors to embrace a lower equity risk premium, fueling the recent stock rally and, in fact, driving the risk premium even lower. We agree with most economists that an economic rebound is forthcoming, but are less sanguine than most regarding the degree and scope of the recovery. Furthermore, we remain concerned that equity valuations are too high relative to current earnings and historical standards, and that earnings expectations are likely overstated. Therefore, we believe the recent run in stock prices is being propelled more by hope than by a rational reassessment of the risks and rewards for holding equities.

Bond index) posted a meager, but welcome, gain of 2.5% and US high yield bonds gained 10.9% for the quarter, illustrating resurging confidence in US corporations.

While considering these gains, keep in mind that since the bear market began, the S&P 500 has experienced five prior double-digit rallies, each of which fizzled out, leaving stock prices as low as, or lower than, when the rally began. (*See page 6.*) Is the sixth rally any different than the previous five? Is the S&P 500 fairly valued, or even overvalued? Has the economy reached a turning point in this recession? Although we are as hopeful as any, we find scant support for this rally, and are left with the belief that US equities remain positioned to provide low returns in the coming years relative to historical averages.

At quarter's end, the S&P 500's price to earnings ratio (P/E ratio) was in the *low thirties*, based on the trailing twelve months' reported earnings. Hammond Associates' "normalized" P/E ratio, which is based on a 5.5% profit margin applied to sales, is in the *mid twenties*. On the other hand, First Call consensus estimates put the forward-looking P/E ratio (based on operating earnings) in the *high teens*, which is not far from the historical average for the S&P 500. Therefore, using First Call consensus estimates, some analysts argue the S&P 500 is fairly valued.

Given the implications of accepting consensus earnings expectations, a critical examination of this forecast is warranted. Unfortunately, industry analysts' expectations of future earnings appear to be systemically upwardly biased. A study completed by Morgan Stanley indicated that from 1986-2002 the average overestimation of annual earnings was about *6 percentage points*. Our analysis of quarterly earnings expectations from 2000-2002 demonstrates a similarly consistent upward bias,



During the second quarter, domestic and international large-, mid-, and small-cap stocks all achieved double-digit returns, including a gain in excess of 20% for emerging market stocks. US fixed income (Lehman Aggregate

in that expectations have been overestimated in nine of the last twelve quarters, sometimes with margins of error in the low to mid teens. Moreover, consensus estimates are based on operating earnings (not reported earnings). The validity of operating earnings has come under increasing scrutiny over the misclassification of recurring operational costs as one-time events, the expensing of stock options, and questionably optimistic pension fund assumptions.

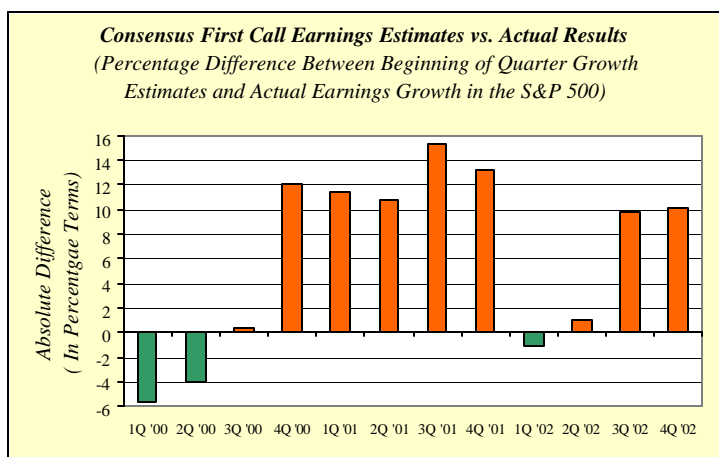
Given these factors, we believe the use of consensus estimates of operating earnings as a basis for determining the S&P 500's P/E is inappropriate. The actual, trailing P/E ratio (based on reported earnings) remains significantly above the historical average, and colossally above average for the close of a bear market. Specifically, the average P/E ratio for the S&P 500 (based on trailing twelve-month reporting earnings) at the troughs of bear markets since WWII is 11, whereas the current P/E ratio is 32.

economists, for the last three years at least, turned out to be excessively high.

While we believe the economy may be poised for a modest recovery, an expectation of 3.8% GDP growth by the end of the year seems too optimistic. The source of such a large amount of expected growth, to us, is elusive. We base our concerns primarily on the diminishing capacity of US consumers to spend. Over the past three years, consumer spending was responsible for all GDP growth, whereas it only constituted two-thirds of the economy; all other economic sectors netted out to less than zero growth. In other words, consumer spending has buoyed the economy in the midst of lay-offs, sharp reductions in capital expenditures, and numerous economic shocks. This is the first recession since 1949 to escape without even a single quarter's decline in consumer spending! How did this happen?

Homeowner equity (market value less mortgage) is at its lowest levels in fifty years and consumer debt as a percent of disposable income is near an all-time high. This is in spite of the Fed Funds rate being at its lowest level since 1958 and mortgage rates being at their lowest levels in more than three decades. Simply put, consumer spending has been supported by an unprecedented run in real estate and the leveraging and re-leveraging of ever-higher residential values. Leveraging a productive asset is common, and offers potential economic dividends. However, leveraging homes adds little, if anything, to the long-term productive and competitive prowess of the US economy, which leads us to question whether or not the short-term fix of low interest rates will cost the economy down the road.

Nevertheless, even though consumer spending has grown, productivity has grown even faster, precluding the need for business investment



Source: First Call, Hammond Associates

According to a recent Wall Street Journal (WSJ) article that surveyed 54 economists, GDP growth is expected to rebound within the next six months, and post an annualized growth rate of 3.8% by the fourth quarter of 2003. However, the WSJ also noted the forecasts of these

(capital equipment and labor) to accommodate growth. Monetary policy (i.e., lowering interest rates) has been successful in sustaining the economy, but has little left to offer. In lieu of continued growth in consumer spending, we look to our government (i.e., fiscal policy) and our trading partners (i.e., exports) to initiate a recovery, but are led to several concerns. Is the recent tax cut (about 1%-2% of the GDP over the next 12 months) sufficient to stimulate the economy in the face of a likely increase in the savings rate? And will our trading partners accommodate our desire to export our way to fiscal health in the face of a declining dollar? Again, we remain cautiously optimistic, but are unable to identify whether these catalysts will pick up where consumer spending left off.

So where does all of this leave us? Well...frankly, it leaves us with mixed thoughts. We are fortunate to be living and working in the strongest economy in the world. Nonetheless, we are concerned about the near-term strength of the economy, and are particularly apprehensive about valuations in the equity market. Over the intermediate-term of five to seven years, equities are likely to produce mid-single digit returns. Over the short term? Over the short term, we're headed to the beach. Enjoy your summer.



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Bonds Belly Flop; Stocks are Potato Salad

Market Summary

July 2003

Of the many hackneyed, semi-literate aphorisms bestowed upon us by Wall Street through the years, our favorite is “Trees don’t grow to the sky.” In one swoop, it demonstrates a trader’s blithe ignorance of botany, physics and atmospheric science, topped with a contemptuous disregard for English syntax*. But the financial bit is correct: No trend persists forever. And so it was, in July, that the bond market, after soaring majestically for so long that gravity was forgotten, abruptly did a belly flop.

For the month, the long Treasury bond nose-dived 9.2%, and the Lehman Brothers Aggregate Bond Index surrendered 3.4%. Even TIPS (Treasury Inflation-Protected Securities), the new gold standard for stalwart strength, took a deflationary hit, falling 4.5%. With large-cap stocks eking out a gain of 1.8% for the month, there was cause once again to speak (cautiously) of a “risk premium”—an inherent bonus—for equity investors. The return on big-cap stocks has exceeded that of the Lehman Aggregate by a fat 13.3 percentage points through the first seven months of the year.

The equity risk premium is supposed to be an enduring feature of the investment landscape, measurable not month-to-month, but in terms of years of even decades. So no fair peeking before Christmas, but if the premium does end the year in positive territory, it will be its first sojourn off the schneid in three years, one shy of the benchmark for bad news, established, not surprisingly, from 1929-32.

So, as bond portfolios dip (some might prefer to say “stabilize” or “equilibrate”), there is consolation in the thought that this is the way it’s supposed to be: stocks outperforming fixed income assets. To re-

establish this relationship, bonds needed to give something back. And with short-term yields below zero (net of inflation), the time was nigh.

Some equity categories made the most of the opportunity, putting on a display worthy of a July 4th picnic, complete with fried chicken and potato salad. Small-cap growth stocks soared 7.6%; small-cap value 5.0%. Mid-caps gained a robust 3.6%. As has been the case all year, large-cap stocks reversed the growth/value relationship seen in smaller issues. Large-cap value gained 2.2% for the month to 1.3% for growth.

International issues also did very nicely, emerging market stocks leading the way with a 6.2% gain. International small-cap stocks gained 3.1%; large-caps gained 2.4%.

And there was news in July that the Price/Earnings ratio of the S&P 500 Index had fallen to 28, from about 32 at the end of 2002 (on trailing 12-month reported earnings). This won’t mollify market bears, who aren’t likely to cry “uncle” until even this new number is cut by half. But for once the drop, modest as it might be, was *for the right reason*. That is, the ratio declined not because prices were down, but because earnings were up.

Unemployment, on the other hand, dropped for the wrong reason: The jobless rate fell in July from 6.4% to 6.2% because the labor force shrunk. Non-farm jobs actually fell by 44,000 in July, after dropping 72,000 (revised from a decline of 30,000) in June.

From the dismal science of econometrics, represented in this case by the National Bureau of Economic Research (NBER), we learned in July that the nation had been out of recession for 20 months. However, for the first time in a generation, a recovering economy had not produced any (net) new jobs—and in fact had eliminated a startling one million paychecks. NBER chairman

Robert Hall, of Stanford University, said he had not seen this unhappy combination since joining the group in 1978. Nevertheless, the Gross Domestic Product is 3.3% higher than it stood at its pre-recession peak at the end of 2000. For the record, the slump officially began in March 2001 and ended in November 2001, the NBER reported.

Economists (and simple arithmetic) assure us that decreasing jobs and increasing economic production mean productivity—output per man-hour—is rising. In theory, this results in higher real wages and more wealth in the long term. In fact, the result is pain in the short term (at least) for those who have no wages.

The Commerce Department's Bureau of Economic Analysis announced in July that the economy had grown at an annualized rate of 2.4% during the second quarter—not a thrilling datum, but significantly better than the 1.5% expected. Much of the economic pick-up was a direct result of government spending, as consumption for the war in Iraq was booked.

Most of the quarterly gain (1.4 percentage points) derived from government spending, but business investment chipped in 0.7 points with its strongest quarterly showing in three years. Consumer spending and investment were both up significantly during the quarter, accounting for the remainder of the gain (2.3 and 0.3 points, respectively). A decrease in inventories subtracted 0.8 points from the growth statistic, and a negative trade balance reduced it by 1.5 points.

If there is a trend line to be drawn through all this data, it will take more powerful regression analyzer than we have at our disposal. The econometricians tell us that business activity “troughed” in November 2001, but that doesn't mean there is a discernible uptrend in the economy, and

there is definitely none in job production. All major domestic equity indices—the Dow Jones Average, the S&P 500, the Russell 2000 and the NASDAQ—insist in one voice that October 9, 2002, was the bottom of the bear market in equities. But that doesn't mean markets were really undervalued then, and it certainly doesn't mean they are cheap now. In fact, the double-digit recovery rates in the stock indices, coupled with rather tepid economic data, and a still-queasy bond market, make for a rather discomfiting brew. Yes, we've heard a second shoe drop, but how many clodhoppers might a bear wear, anyway?

**“El Grande,” a 350-year-old Tasmanian eucalyptus regnans, was, at 260 ft., the world's tallest tree, until June, when it was reported “cooked to death” in a fire recklessly begun by woodchip harvesters who had bombarded the rainforest with napalm. Its height was nearly 4x that of the trading floor ceiling at the New York Stock Exchange, which is about as much sky as many traders ever bother to look at. It is also, by our unofficial estimate, one heck of a lot taller than the buttonwood tree, under whose spreading boughs a group of brokers met one fateful day in 1792 to hammer out an agreement to begin organized stock trading on Wall Street.*



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Every Monday, I Want To Sell U.S. Equities...

(or, "Random Musings of a Baby Boomer")

Market Summary

August 2003

Every Monday, I want to sell all my U.S. equities. That is, I want to sell all my U.S. holdings after our weekly Research meeting, in which our Consulting and Research Departments discuss the global financial environment. We discuss challenges facing institutional investors, such as high spending rates and budget cuts. Inevitably, a common topic that arises is the economic condition of the U.S. and the plethora of ongoing problems that plague its nascent recovery. You've heard the litany: high unemployment rates, stratospheric consumer debt, comatose business investment, low interest rates, anemic job growth, the aging of our labor force, rising healthcare costs, weak corporate balance sheets, overvalued stocks, the government deficit, and the never-ending conflict in Iraq. A Monday morning talk on these topics is bound to ruin anyone's day, much less their week. This dismal list of ailments belies any notion of a "sustainable" U.S. market rebound. With such gloomy forecasts, it's no wonder that after each such meeting -- and they've all been like that lately -- I walk back to my office poised to sell every U.S. security I own.

America's aging work force was one topic at a recent meeting, and now I'm aware that when I retire, around 2030, there will be just over 1.5 workers to support me. Currently, my father has roughly 3 workers to support him. Another depressing stat that hit home is that 24% of the workforce will be between the ages of 30 and 60 in 2030, whereas it peaked at 30% in 1981. As a baby boomer, I don't like to acknowledge that, invariably, the age at which one begins to receive social security will almost certainly be pushed back, FICA taxes may very well double,

and healthcare costs will indubitably decimate what little savings I will have!

There is, however, one optimistic outlook I cling to: Americans have proven they are remarkably adaptable. If anyone can pull this off and grapple with these looming social welfare problems, it's the good ol' U.S. of A. And with the problem approaching more quickly for Japan and Europe, we'll have a chance to learn from their successes and mistakes.

In the U.S., the 6% unemployment figure didn't slow the markets in August. The S&P forged ahead 2.0%, midcaps earned 5.1%, and small-caps gained 4.6%. Their year-to-date returns were uplifting, to say the least. The S&P 500 climbed 16.0%, the S&P MidCap 400 surged 21.7%, and the Russell 2000 catapulted 31.0%. Yet, despite these stellar returns, after reviewing fundamentals, P/Es, business investment, and unemployment, our Research Department finds it hard to say anything positive about U.S. equities on Mondays.

Monday morning conversation takes a different turn, though, when internationals are brought up. The Pacific Rim and emerging market countries command the lion's share of Research's attention. While it is a short observation period, in just the last 12 months, the Pacific EAFE countries have outperformed the European EAFE countries as a whole (\$U.S. denominated), earning 10.0% vs. 8.6% for Europe. Europe's inflexible socialist economies are still struggling to gain traction, but the good news is that they are trading at more compelling valuations than the U.S. Among the Pacific countries, Japan's "rising sun" rose 6.7% over the last 12 months and an impressive 18.4% year-to-date. The EAFE index itself is up a stellar 14.8% year-to-date. International small-

caps, not to be overlooked, walloped their large-cap brethren by climbing 26.8% year-to-date. Emerging market stocks have performed even better, returning 28.9% over the last year. When the topic arises on Mondays, internationals are one of the few favored asset classes.

Bonds have done well over the last 3 years -- the Lehman Aggregate Bond index, with 35% in mortgage-backed securities, is up 8.2% during the last 3 years, annualized. However, quarter-to-date, bonds have declined 2.7%. The summer rise in yields makes fixed income look less pricey, but the threat of higher inflation still has us worried. Furthermore, with a yield on the 10-year of 4.5%, they are not too attractive for those who need to meet a 5% spending rate in addition to inflation and costs. (Growth, too, you say? What growth?) For long-term institutional investors, bonds are not appealing. Interest rates are still very low by historical standards (although they did rise considerably over the summer) and, by and large, there is only one way to go.

More interesting are Treasury Inflation Protected Securities (TIPS), which have a real yield of 2.3% over 10 years, protecting investors against unexpected inflation. Over the last 12 months, TIPS returned 6.4%, compared to the 4.3% rise of the Lehman Aggregate Bond index. High-yield bonds leaped 27.3% over the same time period (Citigroup High Yield Index). Emerging market debt has done marvelously, leaping 30.3% in just the last twelve months. With such a run-up in the last twelve months, and narrower spreads, high-yield bonds are to be handled with care, if handled at all.

REITs have also done wonderfully year-to-date, gaining 20.5% through August (Wilshire REIT Index). Over the last twelve months through August, they were up 16.3%. Our REIT analyst

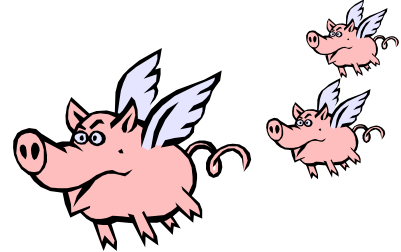
warns that they are now trading at a 10% premium to the underlying value of their assets. Yet, the dividend rates remain attractive. Our REIT analyst also finds real assets such as oil, gas, and timber appealing.

All in all, meetings in August were bearish on U.S. equities, and bullish on emerging markets. The outcome of 2003 is unknown, but this rebound in the U.S. markets is accompanied by so many flawed fundamentals that we just don't have confidence that it will continue. Of course, maybe there is a light at the end of the tunnel. The Cubs could win the pennant, pigs could fly, and the Dow could hit 20,000.



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In September:

Cubs Roaring, Yanks Pricey, Tigers Untamed

Market Summary

September 2003

Just as markets sprang forth in April, so they fell back in September, with the end of summer also marking the end of the summer rally. One factor likely was a full realization that, in Iraq, a

brief and triumphant war has devolved into a peace that is much the opposite. But that is a scenario grimly familiar in the Middle East, and hardly could have come as a shock to financial markets. Traders' early exultation at the American victory had attenuated steadily through the spring and summer, and, after six straight months of market gains, died a natural death.

That is, we were due a negative month, and we got it—in U.S. stocks, that is. World bond markets took their medicine in July, and were quite chipper in September. International stocks, though awash in cheap dollars, partied on.

Here are some monthly numbers: The Dow Jones Industrial Average slid (or “slud,” as the late Jerome H. “Dizzy” Dean often put it) 1.3%; the S&P 500 fell 1.1%, and the NASDAQ 1.4%. Small-cap stocks were down 1.9% in September; mid-caps down 1.5%.

September swoons by the stock indices were mild compared to those, say, of the St. Louis Cardinals or Houston Astros (but then, the DJIA didn't have Kerry Wood fastballs buzzing under its chin). The negative monthly returns did not spoil quarterly marks: the DJIA rose a healthy 3.7% for the 3rd Quarter, the S&P 500 Index was up 2.6% and the NASDAQ turned in a sizzling 10% gain. By category, small-cap stocks rose by 9.1% for the quarter, mid-caps by 6.6%.

Continuing with our marginally forgivable baseball metaphors (we cite seasonal sentiment), international equities behaved like the Chicago Cubs, roaring through September. They must have been swatting Jeff Fassero sliders, which hang like the gardens of Babylon, lush and

tantalizing. Monthly box score: international small-cap stocks, homerun (+4.7%); large-caps stocks, ground rule double (+3.1%), emerging markets, bunt single (+0.7%).

For the quarter, international stocks all pretty much hit for the cycle: with gains of 8.1% for large-caps, 13.2% for small-caps, 14.2% for emerging market issues.

Bonds, as already noted, fared quite well in September. The Lehman Aggregate Index rose 2.7%; Treasury Inflation-Protected Securities (TIPS) were up 3.4%, and the long Treasury bond surged 5.3%. Quarterly marks for the Lehman Aggregate and the long bond were negative (-0.1% and -2.7%, respectively), but TIPS managed to rise 0.4% during the period.

U.S. junk bonds and emerging market debt have for some time behaved more like sky rocketing Internet stocks than fixed income instruments. Domestic high yield bonds gained 3.3% in September, thereby salvaging a 0.96% gain for a 3rd quarter that began with a -2.2% July correction. Emerging market debt gained 3.6% in September, and 2.4% for the quarter, after dropping 3.7% in July.

Both domestic and international high yield securities have posted preposterous numbers for the year to date (23.8% and 22.4%, respectively), and for the trailing 12-month period (34.2% and 40.2%). With such stats, we should call them Barry Bonds.

International fixed income of all sizes and types also has done brilliantly of late, gaining 6.4% in September and 11.1% year to date.

Real estate has been the New York Yankees of investment categories this year—in a class by itself. Its combination of appreciation and yield is available nowhere else among equity securities. It climbed 3.5% in September and 9.9% for the 3rd Quarter. The gain year

to date is a gaudy 24.8%. Like the boys in pinstripes, this asset category has become pricey, but so far has remained productive.

September did present one bugaboo, and it was one grown too familiar: unemployment. As bugaboos go, this one's a doozy, for jobs are the thing by which economic health ultimately is measured. After seven continuous quarters of a rising Gross Domestic Product, our net jobs tally is on Schneider. Employment has risen, but unemployment has risen by more. Net employment reliably increased in previous economic recoveries, usually in proportion to the severity of the preceding downturn.

Data from the Federal Reserve show that payrolls in the private sector (excluding farms) are *down* about a million jobs since the late, unlamented recession decamped in November 2001. The dreaded recessionary "double-dip" has not materialized in the economy, but the unemployment chart has done an inverse "dip" *19 times* since the recession ended, topping its 11/01 mark in every succeeding month but two (January and February, 2002). The worst was June of this year, when the number of people out of work exceeded 9 million for the first time. Economists consider unemployment a lagging indicator, but this is ridiculous.

As would be expected, politicians are looking for scapegoats (a scapegoat is an explanation that excludes the possibility of incompetence on the part of the person seeking the explanation), and America's balance of payments predicament is a fruitful field. The U.S. spends a billion dollars a day in China (source: Morgan Stanley Global Investment Research), and import receipts cover only about 70% of that. That created a \$103 billion deficit last year, according to the Commerce Department—1/3 bigger than our perennially whopping imbalance with Japan. A flood of dollars must be shipped abroad to fund this shortfall, pushing down the exchange value of the greenback. Normally, this would alleviate the situation by making U.S. exports cheaper and its imports more dear. However, China has flummoxed U.S. trade officials by pegging its

yuan directly to the dollar. More irksome to Uncle Sam, China, Japan and a group of East Asian "tigers" (Hong Kong, Korea, Taiwan) appear to be intervening directly in currency markets. *The Economist* reported in its recent Survey of the World Economy that these five nations, exploiting their balance of payments advantages, have squirreled away more than \$1.3 trillion—nearly half the global supply of frog skins—in the (computerized) vaults of their central banks. As was gruesomely demonstrated recently on a stage in Las Vegas, tigers never tame.

Meanwhile, U.S. legislators, scrambling to be seen doing something in the advent of an election year, have introduced protectionist bills in both houses of Congress. The laws would impose punitive tariffs in retaliation for presumed currency manipulation and other predacious practices (shrewd marketing, for example) by China and its cohorts. Less scrutinized are the American consumer's sweet tooth for Asian imports, American industry's growing love of outsourcing and the American government's current fiscal deficit and open-tap monetary policy.

Finally, a word regarding phenomena such as 40% annual bond returns, \$100 billion trade deficits and economic growth with no new jobs: There is one law of economics that works every time (applying of course only in retrospect): *What Can't Go On, Won't*.



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Stocks Stage October Encore

Market Summary

October 2003

A year is a long beauty sleep, even for a big, ugly bear, so small wonder that people are starting to ask if the old bruin that savaged our stock markets is at last truly dead. Not that anyone was likely to dare saying that out loud when the first anniversary of the stock market “bottom” came and went October 9. The bulls wouldn’t want to hex themselves with audacious pronouncements; the naysayers among us (a.k.a. “fundamental analysts”) are rightfully loath to call attention to the fact that those who ignored or bet against them over the past year are richer for it—much richer.

So let us softly take note that the S&P 500 has managed (barely) these 12+ months to remain above its October 9, 2002 close of 777 (surely a propitious number), though there was a very close call when markets swooned again in March. Similarly inviolate, though less numerologically enticing, are the closing prices that same day by the Dow Jones Industrials Average (7286), the NASDAQ Index (1114), and the Russell 2000 Index (327). With their nadirs “established” (touch wood) and “tested” successfully (so far) in March, the indices binged through the spring and summer like frat boys on break. By Halloween just past, the S&P 500 (price only) had soared 35.3%, the DOW 34.5%, the Russell 2000 61.5% (!), and the NASDAQ 73.4% (!!)

since the low was set. How long can a bear sleep? Well, one variety, *Ursus Juvenilis Chicagoansis*, or “Cubby,” seemed for a few magical October days to be on the threshold of answering that question, when, after a 95-year snooze, it poked its nose out of the den to sniff the autumnal air. But that turned out to be merely a somnambulistic sojourn, as the sandy-eyed fuzz ball turned tail and curled up again in blissful oblivion.

Media reports were that it all had something to do with a misdirected foul ball and a curse bestowed by deceased goat named Murphy.

So ask not for how long the bear snores, lest he wake up.

The markets were asking questions of neither bear nor goat as they followed a sizzling September with a rousing encore in October. Up went the price of the S&P 500 (5.5%), the DJIA (5.7%), the NASDAQ index (8.1%) and the Russell 2000 (8.3%). As has been the case all year for stocks, less capitalization meant more performance in October: Even with dividends included, small-cap issues were the clear leader (+8.4%), followed by mid-caps (+7.6%), with big stocks again bringing up the rear (+5.7%).

Also in keeping with the year as a whole, October was a great leap forward for international stocks, as they nosed out U.S. issues in every category. Large-cap international stocks rose 6.2%, small-caps an even 8%. Emerging market stocks took off in October like a Chinese spaceship, rising 8.5% and reaching (we hope) geosynchronous orbit at +43.5% for the calendar year.

Perhaps international stocks are entitled to larger percentage gains in the latter months of this year, for they postponed setting their bear market low until the global market slump in March. Morgan Stanley’s EAFE Index bumped bottom at 824 March 12, and closed at 1171 on Halloween, a tidy gain of 42.3% for just 8½ months, and 23% YTD.

International stock markets shrugged off, at least for now, news that Russian President Vladimir Putin had thrown his country’s richest citizen (and chief rival) into prison. It’s not that the humanitarian sentiments of international stock traders were offended by the old story of a rich Russian chucked into the slammer for nefarious reasons, but the man arrested (at gunpoint) this time was Mikhail

Khodorkovsky, CEO and principal shareholder in Yukos, Russia's largest oil company. A little blood more or less can be winked at; oil is something else. "Vlad the Impaler," read the headline on the *Economist*, slandering Count Vlad Tepes Dracula, Hungary's second most celebrated citizen (after Attila the Hun).

It is almost with relief that we observe that bonds, while not free of volatility, were steady enough in October to provide a welcome element of sobriety. The Lehman Aggregate index backpedaled 0.9%, Treasury Inflation-Protected Securities (TIPS) rose a modest (for them) 0.4%. "High Yield" securities climbed a very un-junky 2.4%, while the long Treasury bond dropped 2.8%. Real estate, continuing its dizzying ascent, was up 1.5%

Unemployment, now the focus of attention for both political and economic reasons, dipped a bit in October, according to the Department of Labor. Total unemployed were below 9 million in October for the third month in a row, and the overall jobless rate dropped to 6.0% (see chart). Squinting at the chart with one eye, we see a suggestion that at least the rise in unemployment has stalled, and the rate perhaps has "rolled over," and begun a long hoped-for decline. We are not chartists, but...

Less encouraging was veteran fund manager (and, like his biblical namesake, all-purpose Voice in the Wilderness) Jeremy Grantham when a *Barron's* interviewer asked the question posed at the beginning of this treatise

(and unanswered since): "New bull market? Bear market rally?"

His answer: "The greatest sucker rally in history."

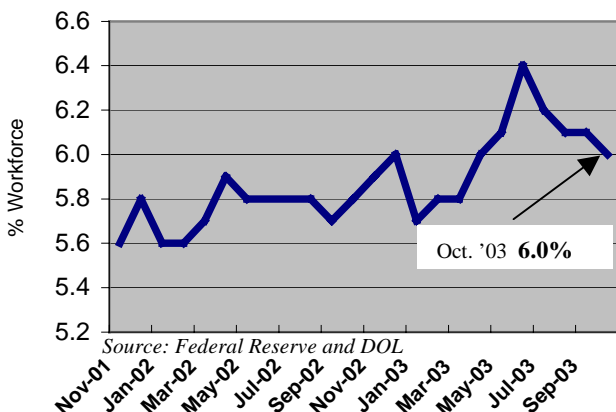
That certainly has the merit of clarity. Statistics supporting Mr. Grantham: the price-to-earnings ratio of the S&P 500, by our calculation, is about 26, higher than ever has proven sustainable. The "q" ratio coined by the late Nobel laureate James Tobin (asset valuation divided by replacement cost less liabilities) is at 1.5 for listed companies. That's where it was just before the 1973-74 bear market, the third nastiest of the century (following our recent debacle and, of course the disaster of 1929-32).

Statistics supporting the "bull" case: The economy is still early in its recovery; the P/E ratio of the S&P 500, based on projected operating earnings, is only 17; next year is an election year, which is traditionally good for the market (even Grantham likes that one).

And anyway, there are a lot of suckers out there, due to their prodigious birth rate, first approximated* a century and a half ago by the famous demographer Phineas Taylor Barnum. What would Mr. Barnum have said about the current state of the stock market? That it's the second greatest show on earth is our guess. We'd call that close.

*381,960 births per year.

Unemployment Rate
(Since Recession)



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World Economies Go Gobble, Gobble

Market Summary November 2003

Just in time for the Christmas shopping season came the announcement that economists, taking a second look at the data, had found us another growth point for the annualized third quarter GDP. We're chugging along at 8.2% says the Commerce Department. Halleluia! That's the best quarterly performance since 1984, the year Ronald Reagan won re-election with the slogan "It's Morning in America."

So let's get happy, get confident, get online (or in line at the mall) and get little Patrick that football helmet, or Stephanie those Birkenstocks—or get dad that Lincoln Navigator—or whatever for whomever. Let's lend it, spend it, send it; we're rolling again!

Or maybe not so fast. Just as we coiled to jump for joy over the good economic news, out comes the Labor Department's employment report saying "yes, but..." Yes, the economy's long-awaited show of strength has nudged unemployment back below 6%. But the old news is that job creation still has not matched that of other (*any* of the other) economic recoveries. Only 57,000 new non-farm jobs were added in a strike-afflicted November; economists had predicted about three times that (the October number was 126,000). Economists promptly began issuing contradictory interpretations. Financial markets promptly became indecisive. Santa Claus promptly furloughed a dozen elves.

The moral of the story: Economists need to come to grips with the soon-to-be-old adage that a closed face gathers no egg. In the prediction business, very often less is more.

Meanwhile, some economies around the world were turning in growth numbers that make America's third quarter look anemic. The "emerging" economies roared along an

average annualized rate of 8.7%, says *The Economist* (citing J.P. Morgan Chase Bank). So, if the U.S. were "emerging," we'd lag the average, even with our most prodigious quarterly growth in 19 years. We modestly propose that these "emerging" nations please emerge, already. The *ing* thing cloy's a bit when applied to economies that consistently lead the world.

As we have learned to expect, the main impetus of growth came from the East Asian tigers, who again took the world by the tail in the third quarter. Taiwan's economy grew an unseemly 24%. Mainland China was nearly as gaudy, rising 18%, and Singapore made it a threesome at the bar with a 17% gain (all figures annualized). Even Argentina broke double digits (+12.5%). However, the U.S. did not lag the entire pack. We doubled Brazil's +4% and, thanks to our late revision, nosed-out Russia's +8.0%. Moscow so far issued no counter-revision of its growth data.

Less impressive was the 1.6% third quarter growth in "the euro area" (*née* Europe), unless you adjust for expectations, which had been zero (those predictions again). We will venture to predict that a growth rate of 1.6% will always be considered better than nothing.

Asia out-performing Europe by an order of magnitude might not be pure coincidence. The euro has appreciated to \$1.20, from 99 cents a year ago, whereas Asian currencies have held steady or risen only slightly versus the dollar. Central banks in the Far East have hoarded greenbacks rather than see their exchange rates rise; China simply pegs its yuan to the dollar. The oxymoronic impression is that a lower dollar value for a nation's currency translates into higher growth for its economy—even in America. Speculators, we presume, are anticipating a happy New Year.

All things considered (albeit superficially), the world economic data suggest an early

Christmas party in November, with U.S. employment figures providing a nod backward to Halloween. In any case, 46 million turkeys* did not die in vain on or about the fourth Thursday: There was indeed reason to give thanks this year.

Financial markets generally affirmed the economic data, but with appropriate caution. The Dow Jones Industrial Average was virtually flat for the month, losing 19 points, or 0.2%. The S&P 500 Index moved ahead a respectable 1%. Smaller-cap stocks were more impetuous, however: the S&P MidCap 400 rising 3.5%; and the Russell 2000 small-cap index 3.6%. Value stocks out-ran growth in both the mid-cap (+4% to +3%) and small-cap sectors (+3.8% to +3.3%).

International stock markets behaved well, suggesting a restrained optimism: The large-cap EAFE Index rose 2.2%; the MSCI Emerging Markets Index 1.2%. The Pacific Rim index dropped 0.3%.

Japanese stocks had a bona fide bad month, losing 3.1%, perhaps reflecting the recent rise of the yen. However, the Japanese market ended the month +28.6% (in dollar terms) for the calendar year.

Bonds indices rose slightly in November, due principally to coupon yields. The Lehman Aggregate Bond Index gained 0.2%; the Lehman Government Bond Index and Citigroup's Inflation-Linked Bond Index both rose 0.1%. Junk was more lustrous, as the Citigroup High Yield Index gained 1.5%.

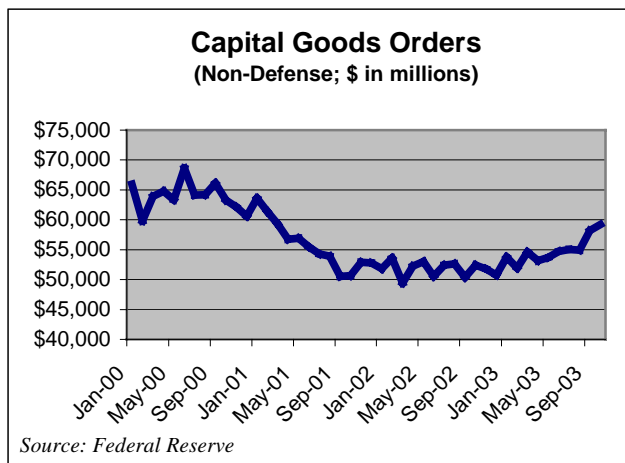
International bonds continued their giddy ride in November, chalking up a nice 2.1% gain, as measured by Citigroup's World Government Bond Index (excluding the U.S.). Emerging market bonds rose 1.3%.

Speaking of giddy rides, the Wilshire REIT Index rose 4.4% in November, and has gained 32.2% this year—6.0% in just the first two months of the fourth quarter.

President Bush seems to have soothed relations with America's trading partners (if

not with steel unions) by lifting 30% tariffs levied 20 months ago on steel imports. The World Trade Organization ruled the tariffs illegal, and the Europe, China and Japan were poised to retaliate with several billion dollars in order cancellations and import taxes of their own. The steel tariffs were themselves a net loser, costing the economy a net \$680 million a year in higher prices and lost jobs—hurting the auto industry especially—according to the Wall Street Journal (quoting the International Trade Commission). The Bush administration says it will now license steel exporters to the U.S., and require prior notice of any surge in supply—a measure designed to prevent “dumping” of excess inventory.

Finally, the Federal Reserve reports evidence that the long-anticipated recovery in manufacturer's orders of capital goods might have begun. November's \$59.2 billion total was the highest since March 2001 (see chart).



*Headcount from American Turkey Federation



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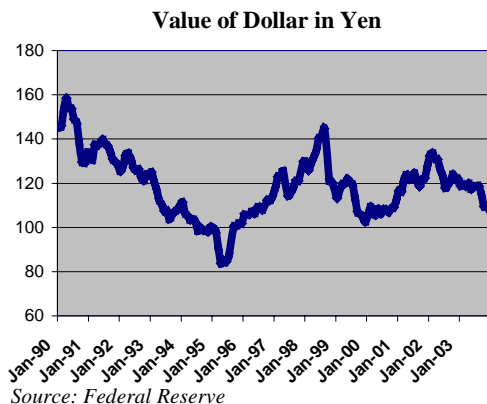
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'03: In Like a Bear; Out With a Dosey Doe

Market Summary December 2003

We'll dispense with the usual claptrap about Santa Claus and portents for the New Year and get right to the big question: What's going to be **THE** event of 2004? Will it be the American presidential election in November? Or might it be the first Chinese Formula One automobile race in Shanghai in September? Right now, the answer presumably would be the U.S. presidential race (or walk, as the case may be). But in ten years the retrospective answer could be very different, if Shanghai becomes the center of the world's auto industry, as the city's decision-makers apparently envision (they're spending \$310 million on a 200,000-seat racing course).

A not-unrelated question: What, in ten years, will we say the big story was in 2003? Will it be the resurgence of the American economy, or the tanking of the American dollar—or the concurrence of the two? These events ran in parallel last year, and strange bedfellows they surely were. A connecting link is the current accounts deficit (\$541.7 billion last year, according to *The Economist*). Together with a projected \$480 billion federal budget deficit,* this presents a picture of an economic recovery funded by \$1 trillion in borrowing.



Our admittedly intuitive guess: Sooner or later, the paths of the exchange rate and economic

indicators, such as employment growth, will begin moving more in synch. But when, and in what direction?

Meanwhile, our grasshopper economy, if that is what we have, is fiddling brilliantly, and the markets are dancing gleefully to the tune. This New Year's Eve might have been a unique opportunity to see market traders and practitioners of the dismal science tipping a glass together and joining hands for a dosey doe. Last year's tax cut seems to have worked; consumers are spending every dime of it. And another \$100 billion is in the pipeline for 2004. Business investment grew at an annual 13% rate in the third quarter, and the economy created an estimated 278,000 jobs in the last five months of the year (though that amounts to 2.4 million fewer than existed at the beginning of the 2001 recession). *The Economist's* poll of (who else?) economists finds a consensus estimate of a 4% (annualized) fourth quarter growth rate for the U.S. GDP, and 4.5% for 2004.



In short, the remarkable 8.2% economic surge in the 3rd quarter last year is regarded as bona fide. Certainly the stock markets look at it that way. The S&P 500 Index gained 5.1% in December, and the Dow Jones Industrials Average bolted up 6.9%. Likewise, the NASDAQ rose 2.2%, and the Russell 2000 Index 1.9%.

But the champagne toast should be reserved for the yearly index returns, which were

spectacular: The S&P 500 rose 28.7%, the DOW Industrials 28.4%, the NASDAQ 49.6%, and the Russell 2000 47.3%.

International stocks also did fabulously well last year: Large-caps (MSCI EAFE) rose 38.6%, small-caps 52.9% and emerging market stocks 55.8%.

The Lehman Aggregate bond index was more reserved, turning in a sober and respectable 4.1% gain. But junk bonds made a spectacle of themselves, soaring 32.3%, which, on a Breathalyzer, qualifies as legally (in fact, fatally) intoxicated in all 50 states, the District of Columbia and Puerto Rico. International emerging market debt wasn't exactly tee totaling, either, in 2003, rising 28.8%.

Of course, if you're measuring in euros rather than dollars, you can clip 18% off these returns. Still, anyone who postponed a Parisian shopping trip to leave her money in the stock market for the year was appreciably *le plus de chic* for it (*très plus*, if the money was in small-caps).

So *Quo Vadis*, world markets?

We must take recourse to the venerable *Stocks, Bonds, Bills and Inflation*, published annually by Ibbotson Associates. The data show that "breakout" years—i.e., eruptions at the terminus of "bear" markets—invariably have been succeeded by at least a respectable performance the next year. The lowest for large stocks was -1.4% (total return) in 1934, which came on the heels of the biggest year yet recorded for large-caps (54.0%). The only breakout year to be followed by a *better* year was 1942, an election year that marked the end of the Great Depression and the beginning of wartime spending. Markets rose 20.3%, then followed with 25.9% in 1943, when it became clear that we not only were going to spend ourselves silly during World War II, we were going to win it.

So here we go again: 2004 is an election year, and we are spending ourselves silly. There's

even a war on. If history is a guide**, this year's market performance figures to be solid, though unspectacular (somewhere between 1934 and 1943). No big move, up or down. If markets rise, they'll remain well within sight of the unaided eye. If they fall, precedent declares they'll not tumble far—a matter of twisted ankles, not broken legs.

But a good crash helmet is an indispensable bit of accoutrement for the prudent cyclist, or investor.

Happy New Year.

**Source: Congressional Budget Office spending estimate for fiscal 2004.*

***The SEC says history is not a guide. History says much the same about the SEC.*



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