

Economic and Market Review
March 2002

It's springtime in Washington, DC, and with our beloved cherry trees set to blossom once again, the signs are all around us that the long cold economic winter of 2001 is over and new growth is on the way.

The economic recovery appears to be gaining momentum, with most economists now expecting growth in Gross Domestic Product (or "GDP," the broadest measure of economic activity) to exceed 4% in the current quarter, up from a 1.4% increase in the fourth quarter of 2001.¹ Prior to that surprising year-end number, the consensus had called for GDP to *contract* by 1.5% in the fourth quarter, and to grow a modest 2% in the current.² The upward revisions result from a sharp recovery in the manufacturing sector, a sustained housing market, and continued strength in consumer spending.

The labor market, which continued to whither even as other economic indicators began to bud, is finally showing signs of stabilization. The U.S. added 66,000 jobs in February, reversing the negative trend that began last July. Also, the unemployment rate dropped to 5.4%, the lowest it has been since October of last year.³ While mild winter weather surely aided jobs growth in the construction and housing sectors, we were especially impressed by the number of new service jobs (+97,000) in the month. These figures bode well for strength in consumer confidence and spending. However, we do anticipate that periodic layoff announcements in the near term will cast a few shadows of doubt upon what we believe is the start a positive longer-term trend.

Still, a few clouds linger on the economic horizon. At least some of the recent GDP growth was driven by inventory replenishment, as the excessive corporate stockpiles of 2000 had been worked down to unsustainably low levels. This pent-up corporate demand contributed to the better-than-expected economic numbers we have seen recently, but the pace may slacken as purchasing managers become satiated. Also, many industries are still plagued by excess capacity, though we are increasingly encouraged by corporate efforts to restructure and improve profit margins. While we believe the worst is behind us, we anticipate a somewhat more moderated growth rate in the coming quarters than we are seeing in the current.

Inflation, the bugaboo of recoveries past, thus far remains under control. The core rate of inflation is now running at an annualized rate of 2.6%, or about 1% less than it was this time last year.⁴ As Fed Chairman Alan Greenspan noted earlier this month, "underlying inflationary cost pressures should remain contained" as we progress into the year.⁵ We should point out, however, that the pace of inflation has accelerated from the low levels experienced mid-recession. Prices for clothing and new homes are growing about 50% faster than the core inflation rate, and the cost of medical care may rise more than 10% this year as health insurers jack up their premiums.⁶

Industrial prices are rising too. The Journal of Commerce's Commodity Price Index has risen 8.5% since early February, and other commodity-based price indexes confirm the updraft.⁷ We are of the belief that, as far as corporate profits go, a little inflation may be a good thing. U.S. corporations, particularly those in the manufacturing sector, have not been able to raise prices for the past 19 months. Burgeoning inflation should finally give manufacturers the flexibility to raise selling prices (remember those inventories to which they have added) and spur profit growth.

The financial markets are also signaling a recovery. Stock prices have risen substantially since the post-September 11th lows. Basic industries (energy, construction materials, packaging) have been the best performing sectors so far this year, while telephone stocks have been the worst.

Though we have not yet seen corporate earnings growth at a pace that fully justifies the rise in equities, we know that the stock market likes to look forward, not backward, and it is generally a reliable indicator of things to come. (Sometimes it gets a little too optimistic, sometimes a bit too pessimistic, but on average it really is just right.) **Recent revisions to S&P 500 earnings estimates have indeed turned upward for the first time in two years**, adding fundamental support to the price action.⁸ And with almost every corporation cleaning up its books to avoid the perception of scandalous accounting, we are increasingly satisfied with the quality of earnings being reported.

We believe the Fed will begin raising interest rates later this year. The modest inflationary upturn, coupled with the unnecessary economic stimulus package recently passed by Congress (too much, too late – but politicians are not known for their economic prowess, especially in an election year!) has forced the Fed to adopt a less accommodative stance. We do not think the Fed intends to slam the brakes on the economy before it has a chance to expand; rather, the Fed's actions should moderate the pace of growth (yes, we will still grow) to a more sustainable, non-inflationary level.

With the economy heading toward sunnier days, **we are cautiously optimistic** that corporate earnings and stock prices will continue to move higher, albeit in fits and starts, as we move further into the year.

Mitchel B. Schlesinger
Chief Investment Officer

The foregoing represents the opinion of the author only, is subject to change at any time, and is not intended as a basis for any particular investment strategy. Data sources:

1 *The Economy at a Glance*, Argus Investment Research, March 18, 2002, et al.

2 *The Economy at a Glance*, Argus Investment Research, December 2001, et al.

3 *Employment Situation Summary*, Bureau of Labor Statistics, US Dept. of Labor

4 *Consumer Price Index*, Bureau of Labor Statistics, US Dept. of Labor

5 Testimony of Chairman Alan Greenspan, semiannual monetary policy report to Congress, March 7, 2002

6 *Consumer Price Index*, Bureau of Labor Statistics, US Dept. of Labor

7 *Teeing Up For A Rate Hike*, Argus Investment Research, March 19, 2002

8 *Back in the Black*, Galbraith, et al., Morgan Stanley Equity Research, March 2002