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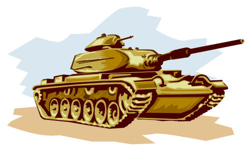
Economic Commentary

March 31, 2003

Unsteady as She Goes

It's war 24/7! It has the country's nearly 100% attention and well it should. Precious lives are at risk. Most everyone knows someone who is "in harms way". On the other hand, those of us who are responsible in making decisions concerning the financial markets, must apply much of our attention to the economy – United States and Worldwide. This is where CPAI is concentrating major effort. Furthermore, the war has very little to do with the economy's performance and the direction of the financial markets. The fixation on Wall Street saying that all things associated the war are the only influence on price movements, is ludicrous. We have the feeling that "the street" has found this to be a perfect cover for their ineptitude. The *story* is: 9/11 caused the economy to go south and the war is causing the stock market to stay down or get worse. The *real truth* is: we are in a serious worldwide recession, which is getting worse, not better. Signs of trade wars, boycotts, and tariffs are becoming more apparent.



The globalization model, as it is presently structured, is not working. Asia, primarily China, is exporting to everyone and buying from no one. Japan is exporting to the U.S. and buying from no one – not even themselves. Their savings rate is 20% plus and their population is aging rapidly. Europe is hopeless. Their costs are too high, their welfare system is stifling and they are likely the most anti-free trade people in the world. Then there is the United States. Whereas our "normal" share of world GDP is 33% or so, since 1995 we have accounted for 64% of the cumulative increase in such. What's more, we have done it on borrowed money both internally and externally. Our savings only recently started to increase from a near zero in 2001 in the consumer sector, but is declining in the business and government area. It presently stands at 1.6%. Something has to give. Who knows for sure? We don't as yet, but are working hard to find out. Slow to no growth seems likely in the U.S. Thus our conservative stance.

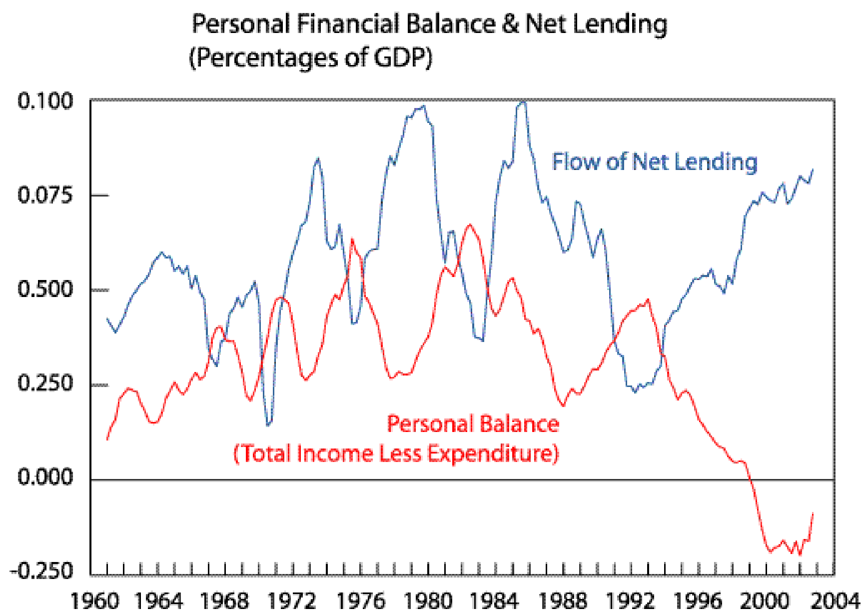
The one thing the United States needs more than anything else is a huge cut in corporate taxes. Will the politicians in Washington see this? Of course not. Why corporate tax cuts? Individual tax cuts help China and no tax cuts lead to more inefficient government spending. The double burden of regulation and high taxes are grinding our business people into the ground. Cutting costs through layoffs and mergers might temporarily help a certain company – but on a macro sense, this reduces corporate revenues. Also, corporate profit margins are at 50-year lows and from 1997 to 2001 we had the sharpest declines in profits since the 1930's.

The bubble economy of 1995 – 2000, which was fed by the Federal Reserve, had plenty of company in creating our current problems. To name a few:

1. Massive government regulation and complicated tax law
2. Accountants and Lawyers hired to find and implement loophole strategies
3. Wall Street's magnificent selling (killing) machine
4. Rock star corporate leaders

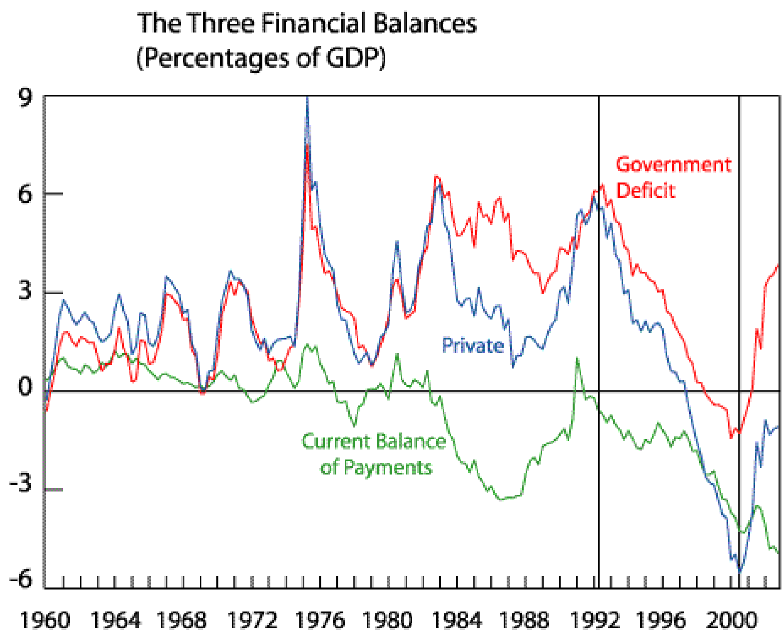
And then, of course all of us who bought into the "Alice in Wonderland" scenario, and sent stock prices to unprecedented heights. We all should have known that when the President of the United States was "not" having sex in the Oval Office with a girl his daughter's age, something was "rotten in Denmark". We must realize that a bubble economy crash is not fixed in a year or two. We are in for a long period of restoration, which remains unrecognized by the financial markets.

As the first quarter of 2003 comes to a close, it appears as if the growth in the economy will be considerably less than the 1.4% of the fourth quarter of 2002. Anything less than 2% will not be helpful in adding jobs or profits. On a worldwide basis just a few Asian countries are growing above this level, primarily China. The oft-repeated notion that the war is the reason the consumer is not spending is mostly in error. The mostly correct reason is the heavy level of debt. The following chart from the Levy Economics Institute illustrates this point. Note the increase in net lending associated with personal expenditures exceeding income. This all got underway during the bubble years and is now being corrected. Many have said (even the Federal Reserve believes so) that lower interest rates make the debt less burdensome. This, of course, is true. However, more debt at lower rates still causes problems, particularly when debt levels continue to rise. Further, the oft-repeated notion that the war is the reason business is not investing, is mostly in error. The mostly correct reason is the lack of profits and pricing power.



Our economy is "dead in the water" and it's hard for us to believe that Wall Street economists don't see this. We wonder if they are acting somewhat in the manner of analysts who continued to call for higher and higher stock prices when they knew or should have known better. Of course, there is hardly a non-Keynesian in all of Wall Street, so maybe they just flat don't know any better. What we as investors should have learned from the bubble and its financial markets aftermath is that one needs to obtain non-Wall Street information. "The street" is a huge selling machine from top to bottom. It doesn't mean that, for example, account executives at the local level are not doing their best. It's a manner of garbage in, garbage out! Independent non-commission research and portfolio management needs to be used if one is to hopefully avoid major mistakes. Even then it will be difficult. Yes, we know it is self-serving to make such comments, but let's face it, all those who are commission based are obtaining their research from this huge merchandising machine. Some time ago we suggested it might be smart for interested persons to obtain a copy of our white paper: "A License To Steal".

In summary, the U.S. Economy is weak and remains in recession. No significant upturn is yet in view. Europe is in the same shape and Japan remains in a decade plus serious recession. It is really difficult to find a bright spot anywhere. It will come, of course, but not very soon in our opinion. Please note the following chart, again from the Levy Institute.

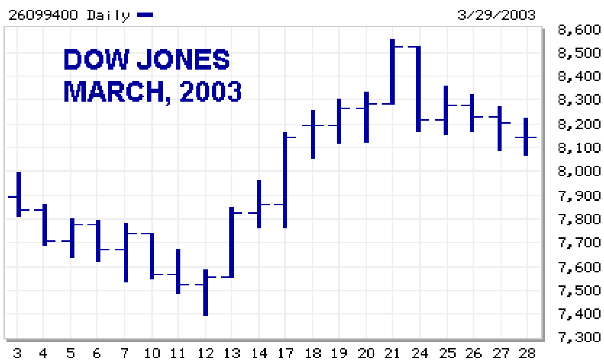


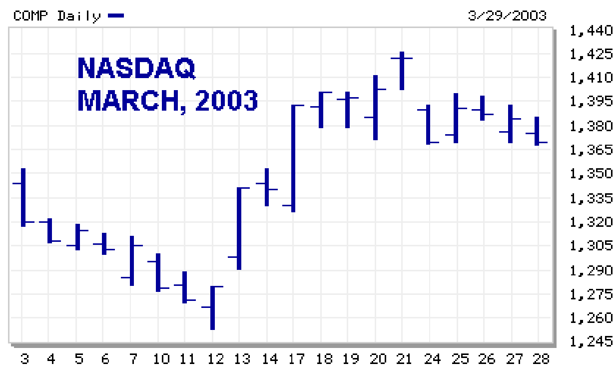
This chart tells the real story of the 1990's and gives one a perspective as to what took place during this economic period and why we are now paying the price. If you might remember, we have repeatedly drawn attention to the fact that with the tax increase of 1993, the Federal government was balancing its budget on the backs of the private sector. Please note that the government deficit, which was 6% of GDP in 1992-3, went to a small surplus in the final years of the decade. At the same time the private economy that had a surplus of 6% of GDP in 1992-3, went to a deficit of near 6% of GDP in 1999-2000. How then did the economy do so well during this period? They did it by borrowing more and more money (both the business and the consumer sectors). As the Federal Government was sucking (a la Ross Perot) the private economy dry during the 1990's, the only way those in the private sector could satisfy their spending habits and needs was by borrowing aggressively. The last several years it has been done primarily by increasing the mortgages on their homes. What's wrong with this? At some point debt becomes an unbearable burden which then restricts spending and that's probably where we are now. The private sector must restore its balance sheet or go broke. There will be some of both, of course, and in so doing the U.S. economy is going to be weak. At the conclusion of restoration, good growth will return but we believe that is not months, but years away.

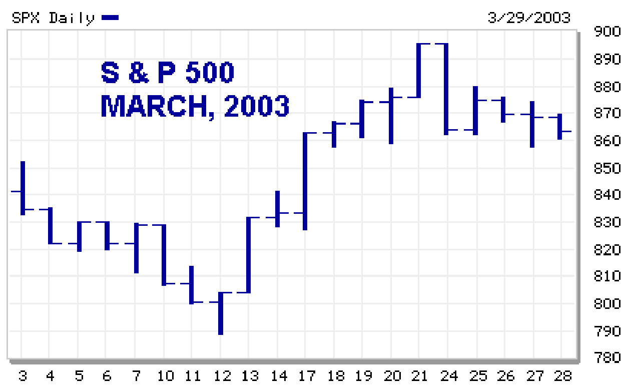
Stock Market

This market remains overvalued. The S&P 500 is selling at 30 times 2002 reported earnings of $28 and 22 times the 2003 consensus estimate of $39. In past times, 1929 & 1987 for example, market tops were 20 times earnings. Does this mean we are still in a topping process? Probably. The forward price earnings ratio is likely even higher than 22 as we suspect 2003 earnings will be less than $39. In all probability, much less. This has been our verbalized opinion since the mid 1990's. As an asset class, it needs to be de-emphasized. These next three charts come from Pierre

Rinfret's web site. Pierre, our old friend, calls March of 2003 the greatest bear trap in his 79 years, including the 1930's. Pierre is a man who should not be faded. We have no doubt that astute traders may be able to make this market work for them. There will also be start-ups and some value stocks that might well deliver good returns. But for those of us whose approach is long-term in nature, asset allocation away from common stocks is appropriate.







Bond Market

Anything other than **Government Bonds** presents a risk one should not take at this phase of the business cycles. You might have noted that new issues of corporate bonds are much in demand. The reason? Investors are starved for yield. As the rating services continue to downgrade corporate securities, their interest rate spreads or differences versus Treasuries interest rates, continue to rise. Many believe recovery is underway and credit ratings will be improving soon – don't believe it! We consider the purchase of those bonds a serious mistake. If one would approach the bond market from a total return basis, one would find that the long government bond presents a great value. We hear many say the very steep Government yield curve (low short term rates and high long term rates) is an indication that a strong economic recovery is certain. Again this is an economic misread. We expect a flat to possibly inverted yield curve when Wall Street understands where we are in the business cycle. If this happens, as we believe, great total returns will come our way.

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