October 2002
Economic and Financial Market Outlook

Despite the large number of announced layoffs and the negative wealth effect from the stock markets' decline over the last two years, consumer spending has remained surprisingly resilient. In fact, strong consumer spending helped mitigate last year's brief recession, which was due to a contraction in overall business capital spending, particularly for information technology. The primary support for the consumer has been strong housing prices, the significant decline in U.S. interest rates and the huge wave of refinancing that allowed homeowners to reduce their mortgage costs. In addition, some homeowners have also tapped the rising equity in their homes to maintain their spending.

Given their spending trends, consumers did not improve their balance sheets and consumer debt outstanding has risen to very high levels. We are very concerned about the borrowers' abilities to make timely principal and interest payments in a weakening economy. Recent trends are not encouraging. Mortgage and credit card delinquencies have been rising. Consumer confidence, which was rising sharply last winter and spring, has tumbled. There was a net reduction of 43,000 jobs in September, after four months of modest job growth. Furthermore, we expect more layoffs, as companies cut costs to improve their profitability in the face of slow demand. The consumer is, in our opinion, overextended and dependent on ever-lower mortgage rates and higher home prices in order to continue the recent liquefaction and spending boom. Significantly lower rates from these levels are mathematically impossible and housing prices have recently shown signs of topping out in selective markets. Without the support of another refinancing boom in 2003 or significant employment and income growth, we place the probability of a consumer spending slowdown at over fifty percent; hence, the double dip recession has become a distinct possibility.

The U.S. stock market is undervalued, in relation to current interest rates, if the consensus 2003 earnings estimates were to materialize. However, given our economic concerns, we believe the consensus forecasts remain too optimistic. We have and will continue to reduce our clients' exposure to the segments of the economy that we believe are most vulnerable to a possible consumer recession, namely, consumer finance, consumer discretionary spending and other industries with high economic sensitivity. At the same time, we continue to actively search for companies that can grow their revenues and earnings next year, believing that they will be rewarded because of their scarcity value in a low interest rate environment.