

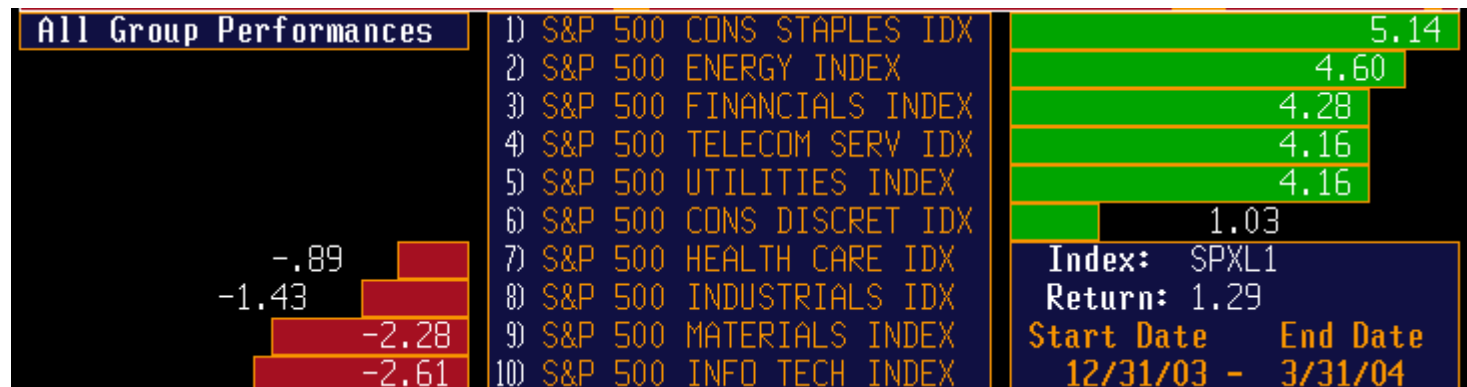
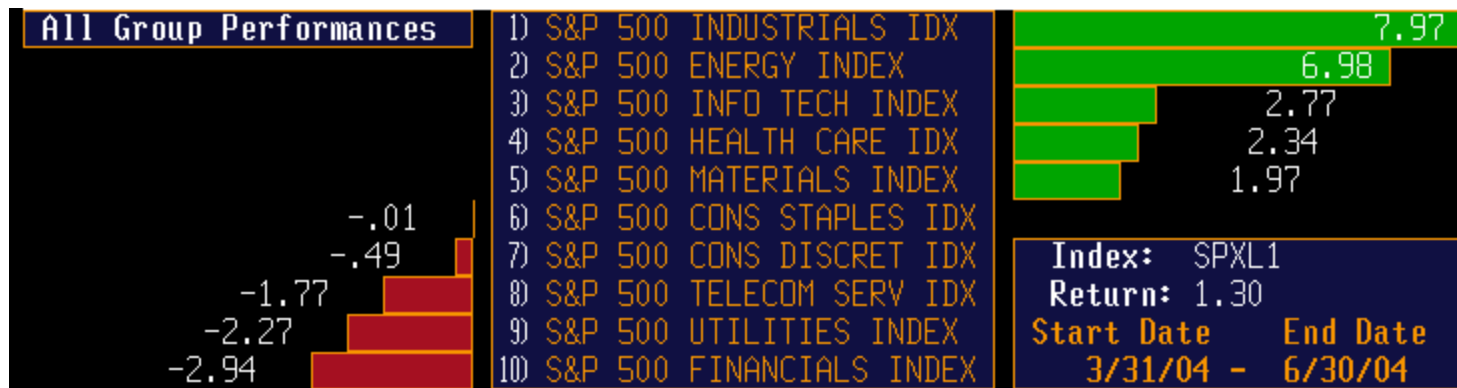
# Economic Outlook

*August 19th, 2004*

JAMES E. LANDAU, CFA

# Second Quarter Sector Performance

- Second quarter sector performance rotated – only energy stayed near the top. Finance moved from third best to the bottom. Rate hike expectations hurt multi-line banks and capital market-related stocks. Specialty finance and insurance did better.



Source: Bloomberg

# Second Quarter Size Effect

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- During the quarter small cap leadership flattened but mid cap stocks or stocks with capitalizations between \$4 and \$10 billion, especially on the value side, led the market.
- Typically, slowing economic and earnings growth portends an end to small cap overachievement. Over the past five years small caps have outperformed mega caps by 56%, but leadership rotated to midcaps in the second quarter. Will large/mega caps be the next leading category?

Index	2 <sup>nd</sup> Quarter	Year to Date Through 6/30
Russell Top 200 Value	+0.5%	+2.5%
Russell Midcap Value	+1.7%	+7.2%
Russell 1000 Value	+0.9%	+3.9%
Russell 2000 Value	+0.9%	+7.8%

Source: Bloomberg

**INDEX DESCRIPTIONS**

Frank Russell Company produces a family of 21 U.S. equity indexes. The indexes are market cap-weighted and include only common stocks domiciled in the United States and its territories. All indexes are subsets of the Russell 3000 Index, which represents approximately 98% of the investable U.S. equity market.

**Russell Midcap Index**

Measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 24% of the total market capitalization of the Russell 1000 Index. As of the latest reconstitution, the average market capitalization was approximately \$4.2 billion; the median market capitalization was approximately \$3.2 billion. The largest company in the index had an approximate market capitalization of \$13 billion.

**Russell Top 200 Index**

Measures the performance of the 200 largest companies in the Russell 1000 Index, which represents approximately 76% of the total market capitalization of the Russell 1000 Index. As of the latest reconstitution, the average market capitalization was approximately \$53.4 billion; the median market capitalization was approximately \$28 billion. The smallest company in the index had an approximate market capitalization of \$13 billion.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410  
 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2004 Bloomberg L.P.  
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# Dividend Payers Not Favored in the Second Quarter

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- Although dividend yielding stocks stopped losing ground, they did not play meaningful catch-up through June 30, 2004.
- Worries about accelerating Federal Reserve hikes hurt financials and other higher yielding stocks.

S&P 500 Yield Group	Average Yield	2 <sup>nd</sup> Quarter Return
1 <sup>st</sup> Quartile	3.4%	+0.4%
2 <sup>nd</sup> Quartile	1.9%	+3.6%
3 <sup>rd</sup> Quartile	0.7%	+2.3%
Last Quartile	0.0%	+3.6%

Source: StockVal

# From June 30, Higher Dividend/Quality Leading

*through July 31, 2004*

- After a high-beta run, the market tends to appreciate value, quality, and yield.
- This may be starting to take hold.
- High dividend yield was the only strategy that worked in July. High beta had the worst return.
- High-quality doing better but mixed.

Top 50 S&P Companies by	1-Month Return	3-Month Return	YTD Return
Dividend Yield	+0.3%	+3.2%	+2.4%
Low Price/Earnings	-1.5%	+3.2%	+5.7%
Small Size	-6.4%	+1.8%	+3.5%
Beta	-13.8%	-7.3%	-14.8%

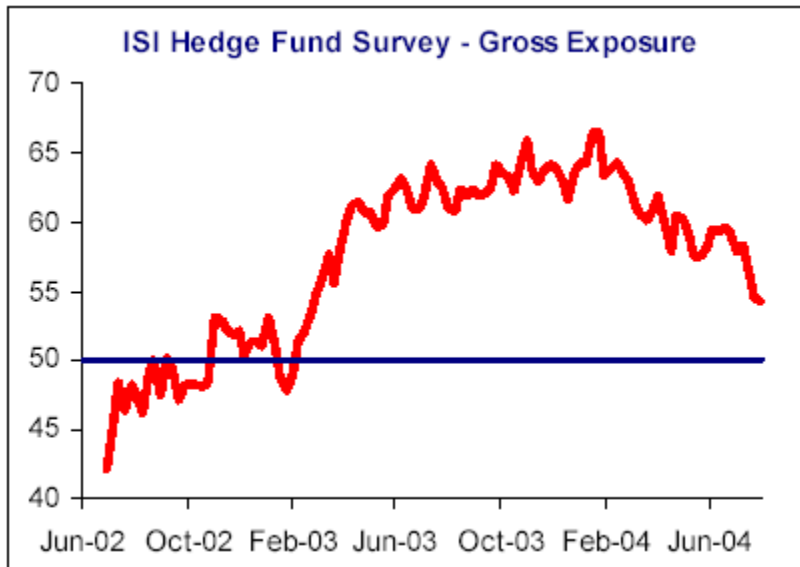
Merrill Lynch Quality Indices	1-Month Return	3-Month Return	YTD Return
A+	-2.6%	-0.5%	-0.2%
A	-2.6%	+2.7%	+3.3%
A-	-3.4%	+0.6%	-0.3%
B+	-3.7%	+0.3%	+1.3%
B	-3.8%	+1.9%	+5.1%
B+ or Better	-3.3%	+0.8%	+1.2%
B or Worse	-6.6%	-1.6%	-0.5%

Source: Merrill Lynch

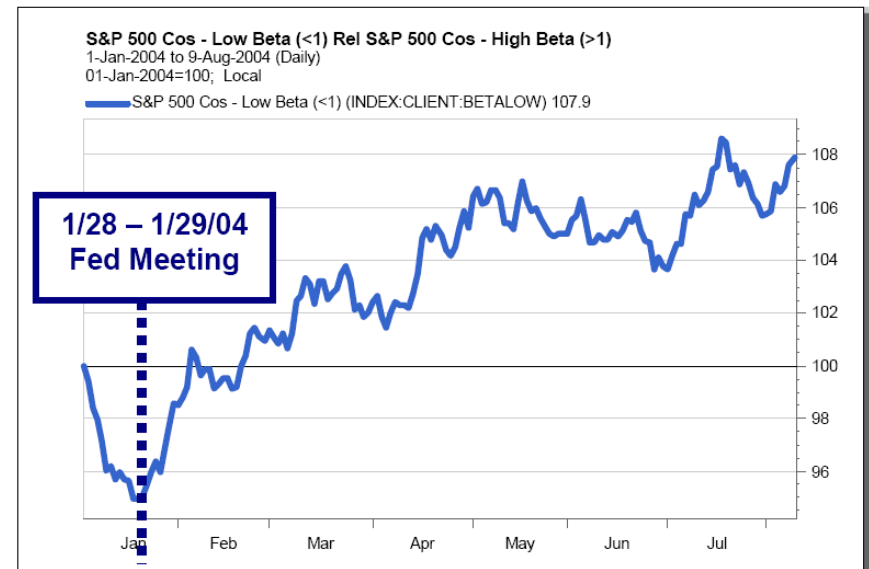
# High Beta on the Way Out?

*through August 5, 2004*

- Investors, fearful of missing the cyclical recovery, continued to bid up shares of more cyclical companies early in the year, but with the profit cycle peaking or at least decelerating, the resulting uncertain earnings growth has started to induce investors to seek lower risk again.
- This may accelerate as highly geared investors, i.e., hedge funds, unwind the purchase of risky assets.



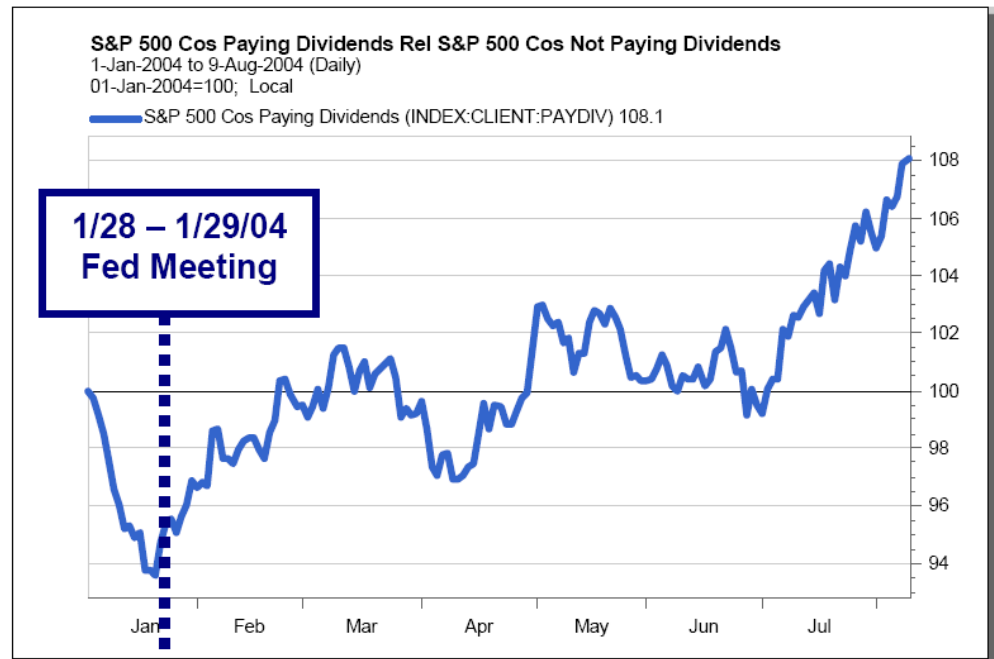
Source: ISI



# Newsflash: Dividends Payers Beginning to Lead

*through August 2, 2004*

- Renewed terrorist threats and high oil prices reminding investors the importance of capital preservation.
- Since quarter end, yield stocks have outperformed.
- With prospective rising interest rates, multiple expansion will be difficult. Companies paying higher dividends and especially those who can grow their dividend should perform well.

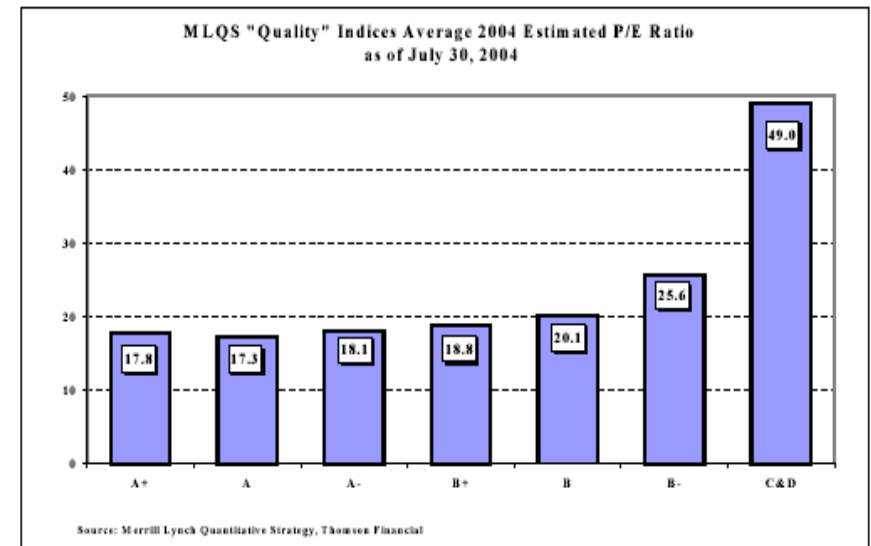
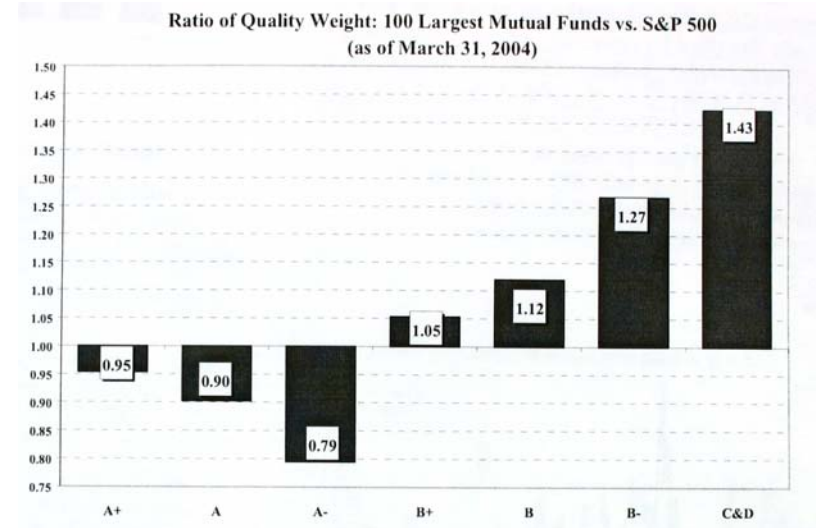


Source: ISI

# High-Quality Stocks Under-Owned and Undervalued

- Higher-quality stocks offer higher dividends (A rated stocks average 1.8% yield, B- rated stocks average 0.8%, C&D rated average 0%)
- But, mutual funds still favor low-quality, low-yielding stocks – S&P 500 C&D rated stocks overweighted 43%. A+, A, and A- rated stocks underweighted 5%, 10% and 21%, respectively.
- Brokers tout growth stories, helping to create speculative fervor, but too few espouse the benefits of high-quality.
- This phenomenon has led to A+ (high-quality) stocks being 30% undervalued relative to B- (low-quality) stocks.
- In profit decelerating phases, higher-quality outperforms. A+ rated stocks gained +63% on average in last three profit downturns.

Source: Merrill Lynch

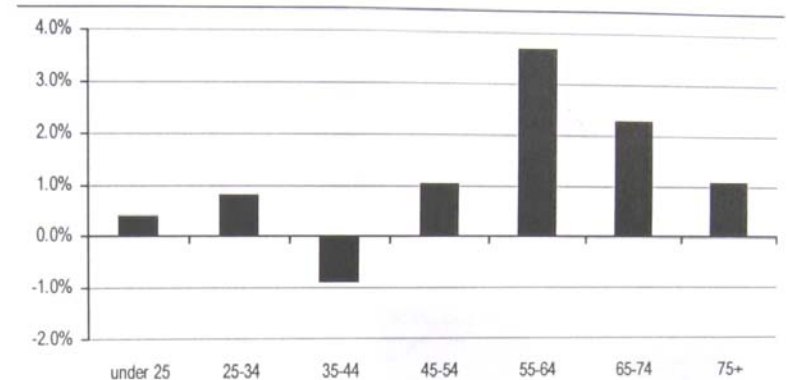


# Dividend Constituency Growing

## *Will dividends gain more respect?*

- The growth stock boom started in 1958 when for the first time the yield on stock dividends fell below bond yields. Especially in the last decade shareholders preferred companies stock price appreciation to dividends.
- Dividends still have little constituency, but it's growing. With Democrats possibly gaining control of the White House/Congress, raising dividend taxes to former levels may be viewed as necessary to reduce budget deficits. This not a sure thing, however. The U.S. is the only major industrialized country to impose double taxation on dividends, and aging baby boomers increasingly demand higher after-tax dividend yield.
- Baby boomers are increasingly becoming aware of the difference in risk between capital gains and dividends. Profits (without payout to shareholders) are not necessarily what you get.
- Shift in executive compensation away from options to restricted stock and prospective FASB requirement to expense stock options favor higher dividend payouts.

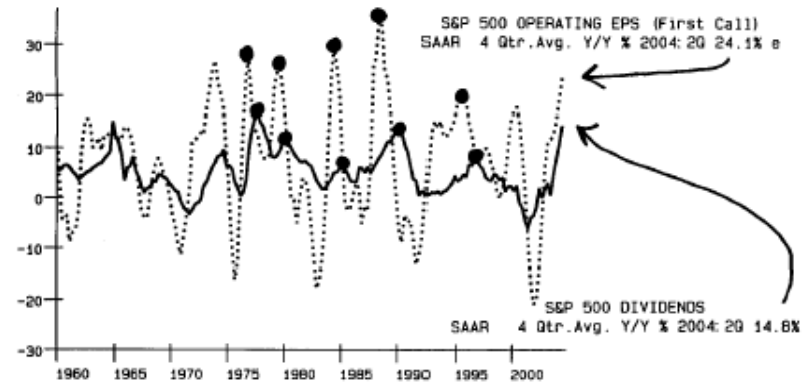
Chart 6: U.S. Population Annual Growth Rate, by Age Group, 2002-12E



Source: U.S. Census Bureau

# Room for Dividends to Grow

- The tax change and demands from shareholders influencing corporate dividend policy. The number of S&P 500 companies paying dividends has increased to 375, the highest number since 1999, compared to 351 at the end of 2002.
- Dividend payout ratio at the end of the second quarter only 30% (before MSFT announcement), but historical average closer to 50%.
- MSFT's \$32.4 billion dividend was the biggest on record. Cash in the S&P Industrials is now at \$555 billion compared to \$260 billion at year-end 1999.
- Earnings growing faster than dividends -- more announcements to follow.



Source: ISI

# Does Higher Yield Always Mean Lower Growth?

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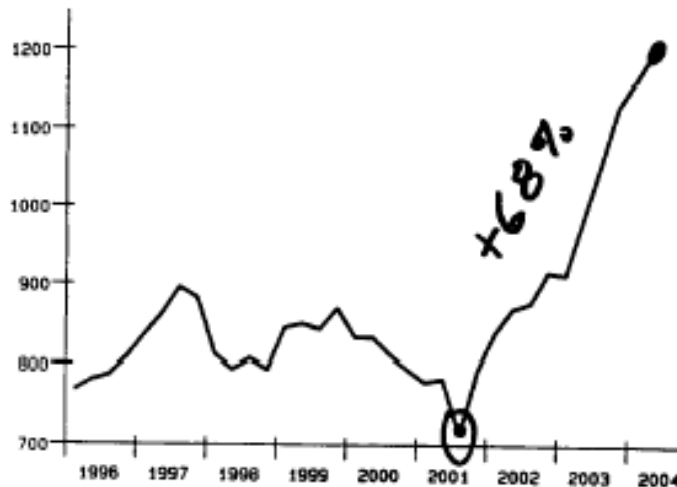
- Microsoft's dividend announcement may point to fewer opportunities. Twenty-five years ago MSFT paid consultants \$10,000 to create the DOS operating system, now they'll spend tens or hundreds of millions for a better spell-check program.
- Penalty for overinvestment can be severe – remember collapse by Cisco, Nortel, and JDS Uniphase. Higher profit retention did not improve earnings growth rates in the 1990s.
- Dividend payouts in the 1960s (a comparable period to today's inflation and productivity environment) averaged 56% and GDP growth averaged 4.5%
- GE and Johnson & Johnson pay healthy dividends and have grown faster than the economy for decades.
- McDonald's started to perform better after they've slowed restaurant construction and paid a higher dividend.
- The proliferation of mediocre ideas for corporate cash flow leads Peter Bernstein to conclude "Companies with higher payout ratios will have higher earnings growth rates in the next five years. The evidence is very powerful."

Source: Revising the Rules of Investing ,The resurgence of dividends according to Peter Bernstein. By Evan Simonoff

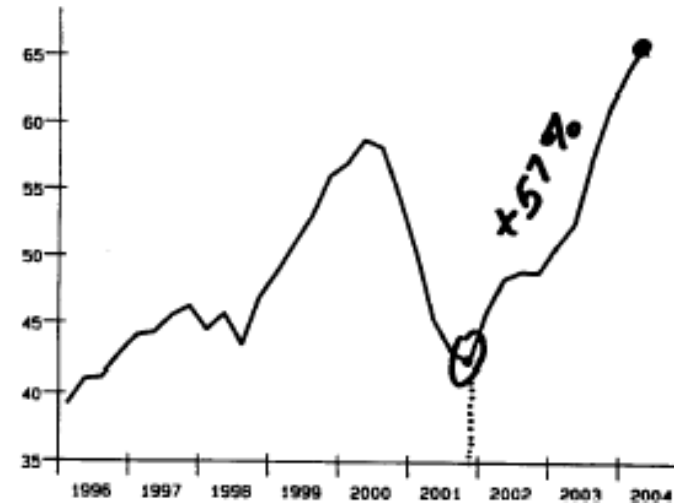
# Regardless of Definition, Profits are at Record Levels

- Economist-defined earnings up +68% from the 2001 recession low and S&P operating earnings up +57%.
- Both were up around +13.% quarter over quarter – impressive but decelerating from the first quarter.

U.S. CORPORATE PROFITS B.T. ADJ IVA & CCA  
2004: 2Q \$1203.0 e



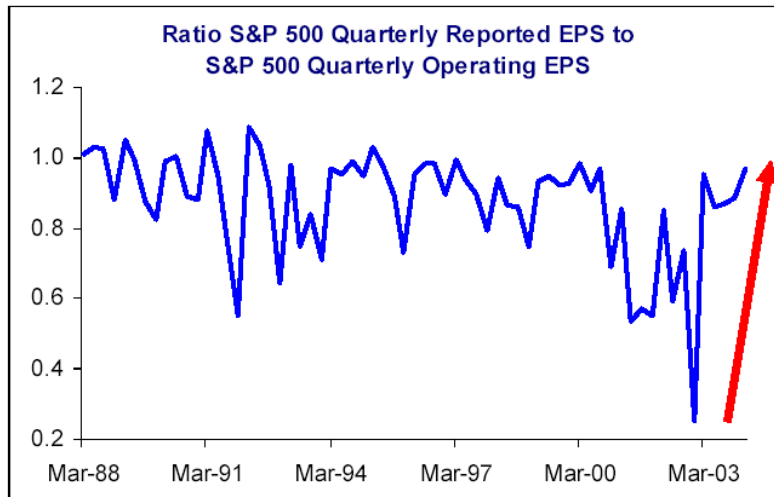
S&P 500 OPERATING EPS (First Call)  
SAAR 2004: 2Q \$66.15 e



Source: ISI

# Impressive Earnings Growth Rates

- For three quarters, analysts have consistently underestimated year over year earnings growth. Unwilling to extrapolate the good news, analysts, at the end of the earnings season, estimated the upcoming quarter's earnings at around 15%, but each time profit growth measured around +26%. Are 3Q04 estimates too low?
- Energy sector helping profit growth but does not account for outsized profits. Energy sector comprises 6% of index and contributes 7% to the index earnings.
- Earnings improvement moving in tandem with earnings quality



Source: ISI

## S&P 500 Operating EPS Y/Y % First Call Tally of Analysts' Estimates

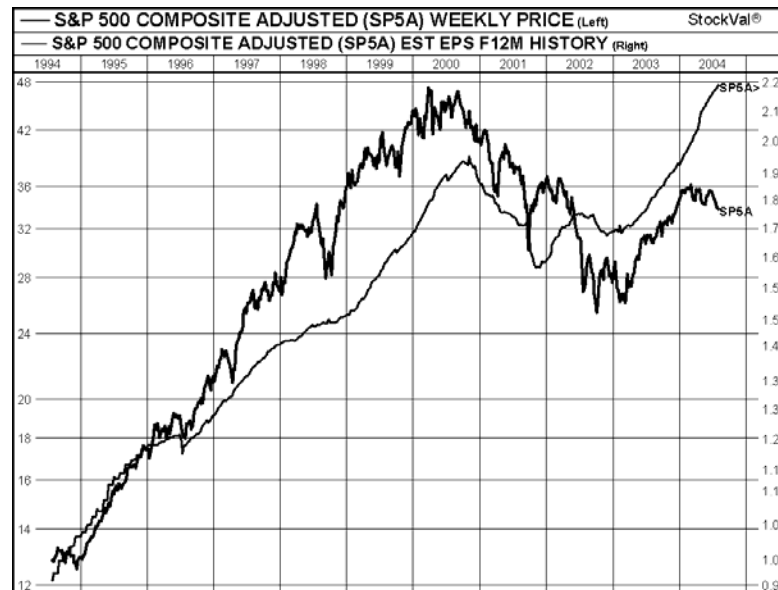
Jan 30, 2004	2003 4Q 26.3%	→	2004 1Q 14.0%
Apr 30, 2004	2004 1Q 26.5%	→	2004 2Q 16.8%
Jul 30, 2004	2004 2Q 25.9%	→	2004 3Q 14.7%

# Disconnect between Earnings and the Market?

- Earnings have moved to new highs but stocks are consolidating due to earnings growth deceleration, the uncertain election, and terrorist anxiety.
- Eventually stock prices follow earnings, but strong quarterly earnings does not always mean a good market. Since 1951, 46 quarters have had y/y earnings gains exceeding +20%, but the market declined 16 times or 37% of the time.

## Negative S&P 500 Q/Q Performance when EPS Growth Y/Y has been +20%

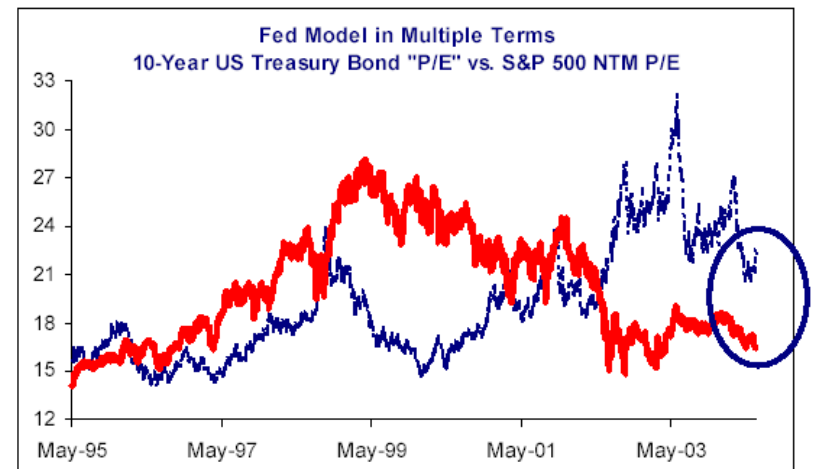
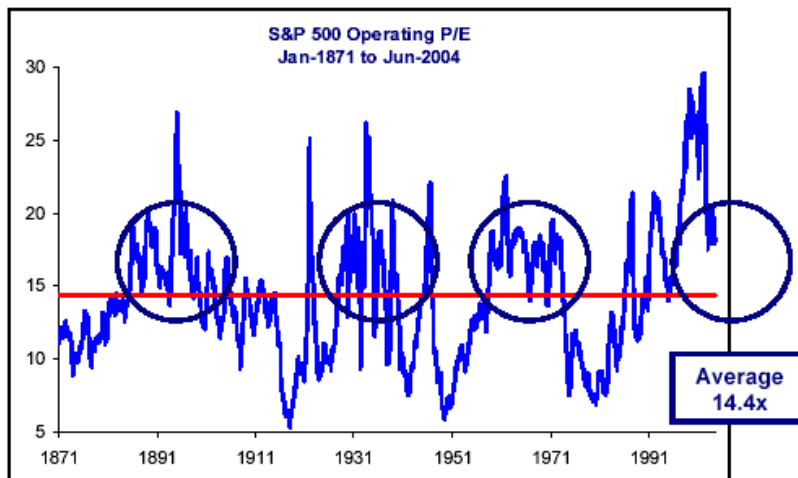
Qtr	Y/Y % EPS	Q/Q % S&P 500
Mar-62	25.0%	-2.8%
Mar-73	25.3	-5.5
Jun-73	26.5	-6.5
Dec-73	26.0	-10.0
Sep-78	27.1	-6.3
Mar-83	23.3	-1.2
Dec-83	23.3	-0.7
Mar-84	44.4	-3.5
Jun-84	29.1	-3.8
Dec-87	61.8	-23.2
Sep-88	23.0	-0.6
Jun-93	26.1	-0.3
Dec-94	22.9	-0.7
Sep-99	24.1	-6.6
Jun-02	29.0	-13.7
Sep-02	26.7	-17.6
Jun-04	29.6*	-1.1



Source: StockVal, ISI

# What About Valuation?

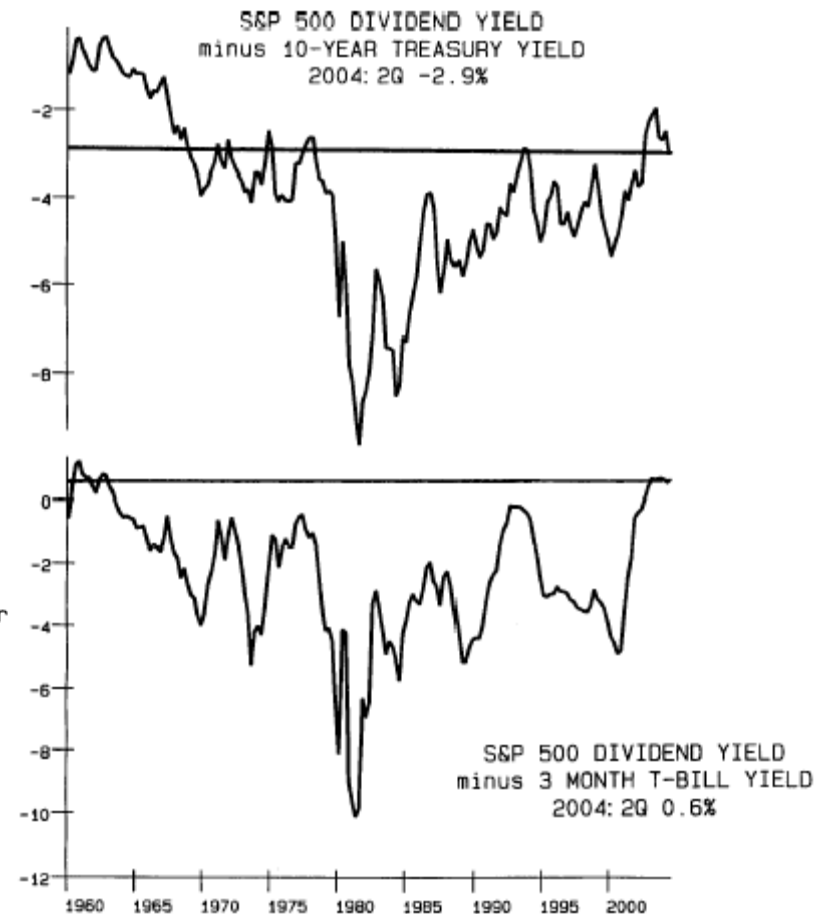
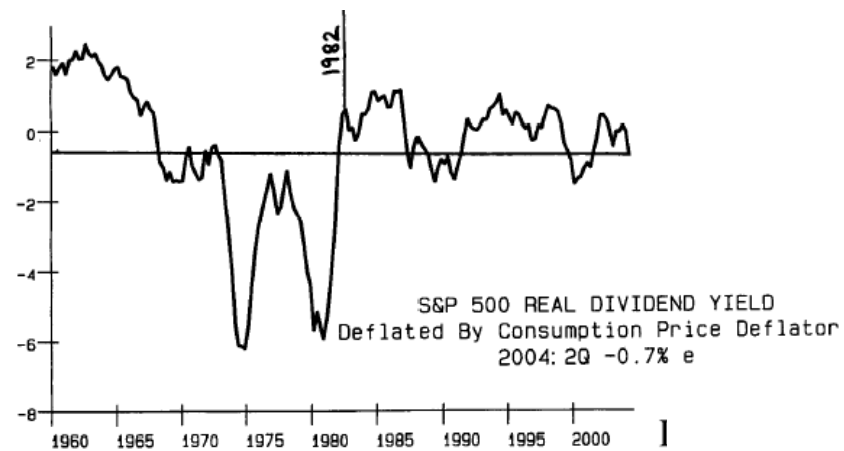
- Multiple expansion will be difficult, but the market doesn't appear expensive either. Lower tax rates and inflation should slow the slide in P/E ratios. P/e's at level of six years ago.
- With Fed's measured pace of tightening, stock and bond multiples drifting apart. At a 4.3% yield, the ten-year bond multiple is at 23x, compared to stocks at 16x.



Source: ISI

# Valuation Measured by Dividend Yield

- Valuation based on dividend yield reveals attractive stock valuation relative to bonds and cash.
- Real dividend yield or dividend deflated by inflation about average compared to history.



Source: ISI

# Economic Outlook

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*as of August 6, 2004*

	<u>2004E</u>	<u>2005E</u>
<i>Real GDP</i>	3.7 %	3.3 %
<i>Inflation (CPI)</i>	2.5	1.9
<i>Industrial Production (Mfg)</i>	4.5	3.5
<i>Real Consumer Spending (PCE)</i>	3.2	2.9
<i>Real Capital Spending (NRFI)</i>	8.5	7.0
<i>Unemployment Rate</i>	5.5	5.3
<i>Corporate Profits (S&amp;P 500 open)</i>	21.0	9.0

Note: All data except unemployment rate are year-over-year annual percentage changes

PCE = Personal Consumption Expenditures

NRFI = Non-residential Fixed Investment

Source: BCM

# GDP Forecast

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## The Negative Case

- Lack of momentum going into Q3
- Higher interest rates
- Sticky oil prices
- Past the peak in corporate profits
- Slowing residential building activity
- High level of inventory building will drag on economy remainder of year
- Job growth disappointing in July
- Japan “miracle” unraveling, slowing China
- Fed started tightening cycle
- Money growth anemic – U.S., Japan, Europe
- Tax cuts behind us
- Terrorism

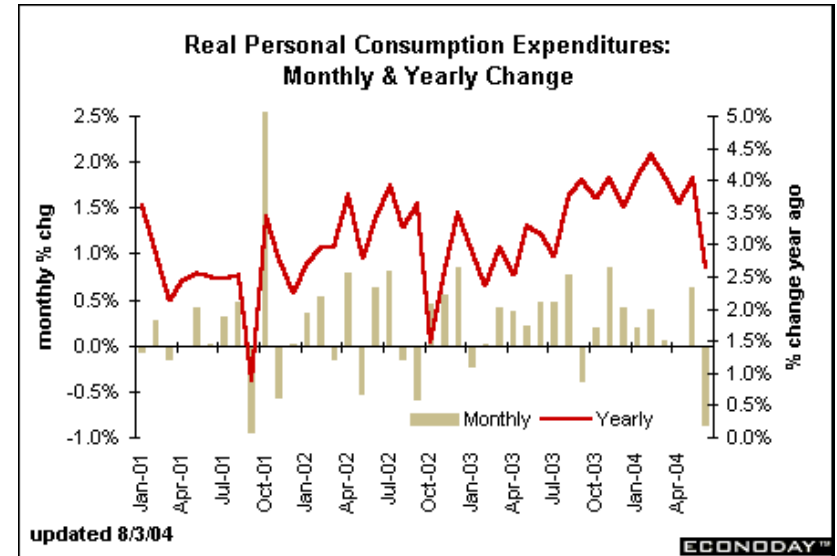
## The Positive Case

- ISM data continues to be strong
- Automakers cut production after lack of incentives caused sales plunge in June, but auto sales rebounding and production stabilizing
- Gasoline price surge pinched consumer spending in second quarter but price surge unlikely to be repeated.
- Income gains solid
- Home sales burst likely to bolster household goods spending
- Europe has not hit soft spot like U.S.
- Fed will slow tightening

# Soft Spot in the Recovery

- Front-end of the economy (Consumer Spending) encountered weakness in the second quarter – especially in June:
- Second quarter annualized consumer spending growth up only +1.0%, down from the previous quarter's +4.1% and the worst since the second quarter 2001.
- June consumer spending sank -0.7% m/m, -- worst decline since Sep 2001. Consumer spending fell to +2.6% y/y from +4.1% -- the softest pace in 14 months.
- June spending weakness broad based. Durables down -5.9% (worst in 17 years), non-durables down -0.3%, and services subdued at +0.2%.

- Is June a blip or the start of a new trend?
- Renewed incentives helped auto sales rebound to over 17 million from under 15 million. Consumers appear able to spend but will only do so at the right price?

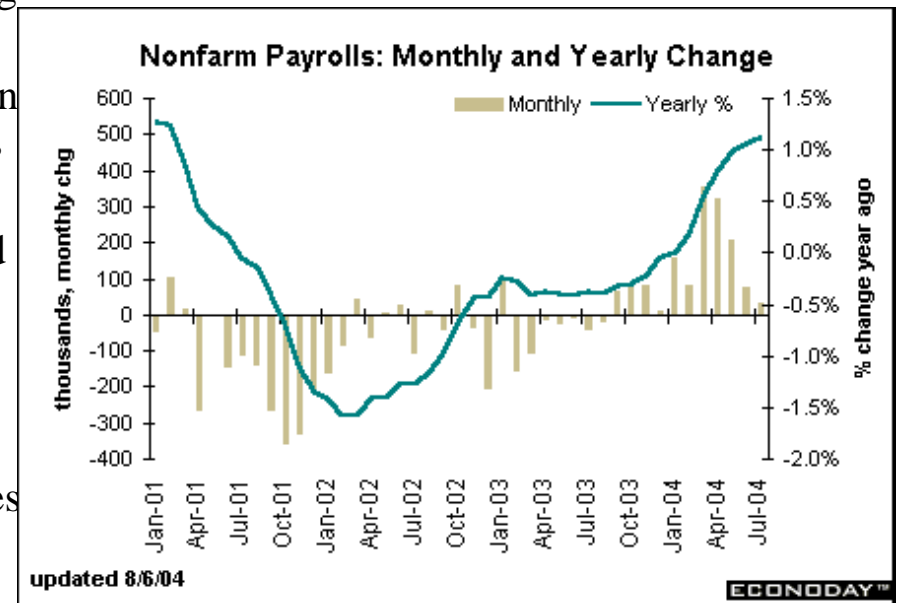


Source: Econoday

# July's Jobs Report Did Not Clarify Outlook

- July payrolls gain a measly 32,000. (At least 150,000 needed for healthy economy, and early stages of recovery typically exceed 250,000.) Job losses totaled 19,000 in retail, 23,000 in finance. Previous months adjusted down by 61,000 – points to decelerating economy.
- Worst monthly non-farm payroll gain in 1988, 1994, and 1999 tightening cycles was 121,000.
- Further blurring the outlook, household survey employment jumped 629,000, eclipsing 577,000 work force gain – dropping unemployment rate to 5.5%, but full-time job rate still at 5.6%
- Job gains made in lower paying services (leisure/hospitality) and part time, but latest growth in hourly earnings and average hours not bad.

- Overall, a negative report and if coming months prove disappointing the jobs picture could be an election negative for the current administration, but rate hikes may be deferred.



Source: Econoday

# Payrolls Understated?

- A decade ago, payroll gains were initially reported below actual job gains.
- For the months August 1992 through January 2005, only 4 months overstated revised changes. Revised figures averaged 93,000 higher.
- Monthly average upward revisions averaged 148,000 in the spring and summer of 1993. (Like 2004, 1993 was the third year of recovery.)

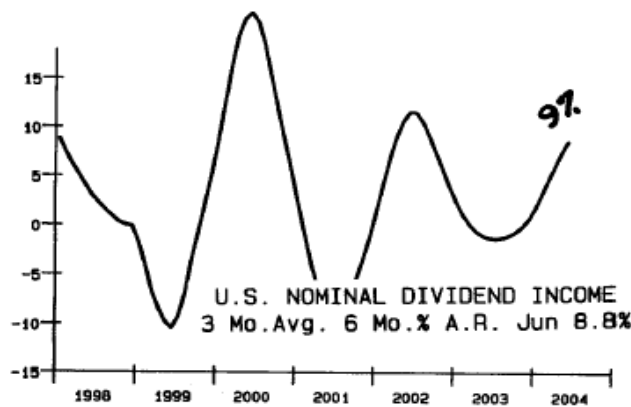
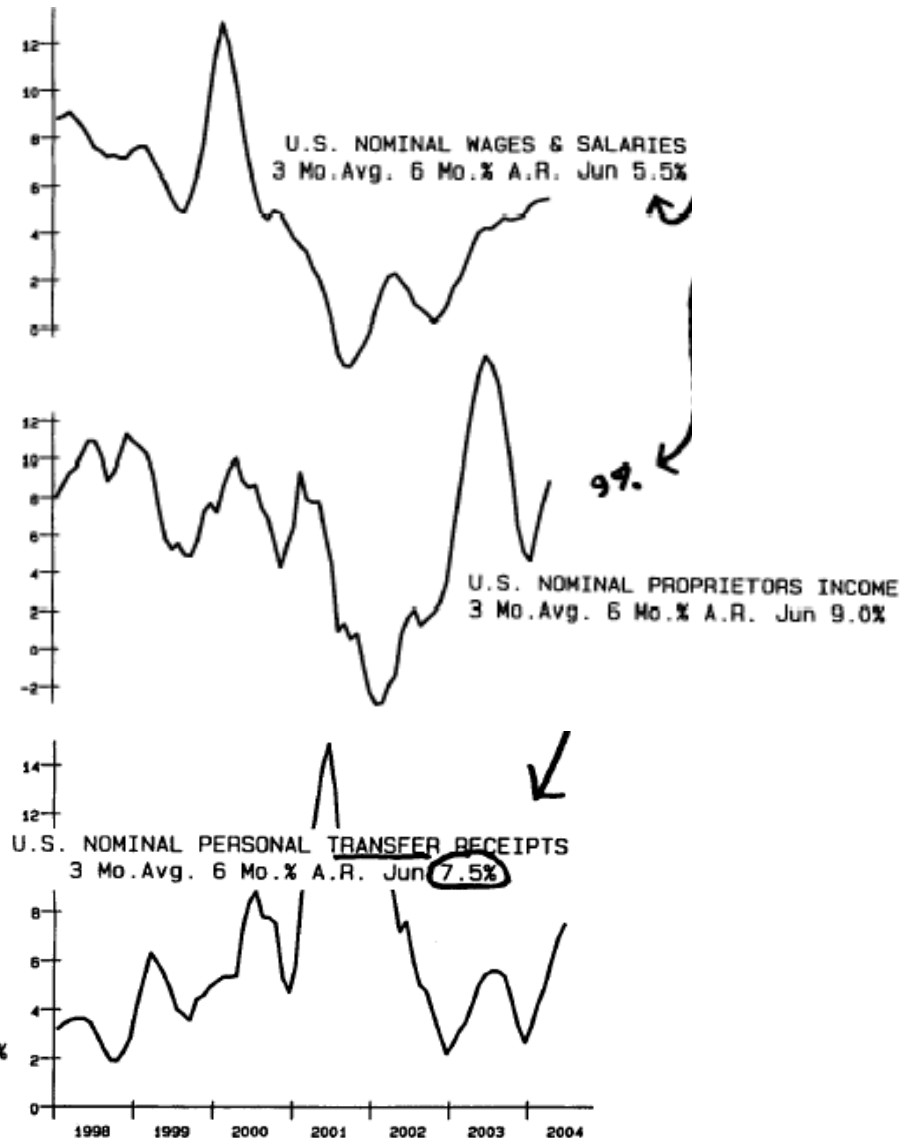
**Payroll Employment**    M/M Change, Thousands

	<u>INITIAL</u>	<u>REVISED</u>	<u>GAP</u>	
1992 Aug	-83	137	220	} 142
Sep	-57	37	94	
Oct	27	173	146	
Nov	105	144	39	
Dec	64	213	149	
1993 Jan	106	307	201	} 148 ←
Feb	365	237	-128	
Mar	-22	-46	-24	
Apr	119	307	188	
May	209	273	64	
Jun	13	164	151	
Jul	162	300	138	
Aug	-39	159	198	
Sep	156	240	84	
Oct	177	279	102	
Nov	208	263	55	
Dec	183	302	119	
1994 Jan	62	270	208	
Feb	217	192	-25	
Mar	456	468	12	
Apr	267	357	90	
May	191	339	148	
Jun	379	310	-69	
Jul	259	359	100	
Aug	179	303	124	
Sep	239	354	115	
Oct	194	206	12	
Nov	350	425	75	
Dec	256	270	14	
1995 Jan	134	321	187	
<b>AVERAGE</b>	<b>163</b>	<b>255</b>	<b>93</b>	

Source: ISI

# Income Growth

- Personal income growth strong, but slowing. The biggest component, wages and salaries, while still good, shows deceleration.
- Lifting personal income includes transfer receipts, dividend income, and proprietor's income. These tend to have lower spending propensities.
- Will income growth become soggy with huge fiscal stimulus behind us?

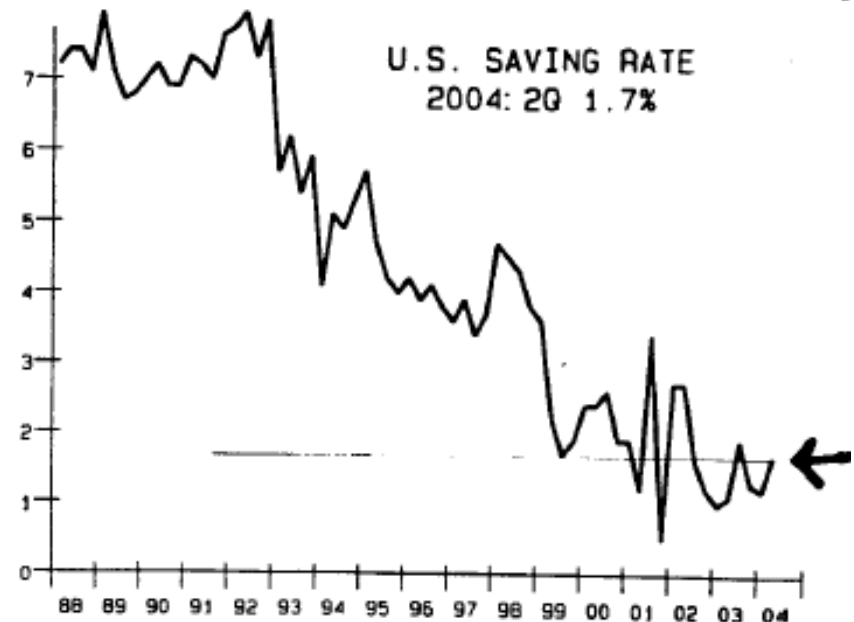


Source: ISI

# Income Growth Crucial to Spending

## *No help expected from savings*

- With what seems like a semi-permanent high energy environment and fading tax help in 2005 (AMT, marriage penalty, end of \$1,000 child credit), maybe consumers will begin more meaningful balance sheet repair.
- Clearly, spending will depend on income gains (or more asset appreciation).

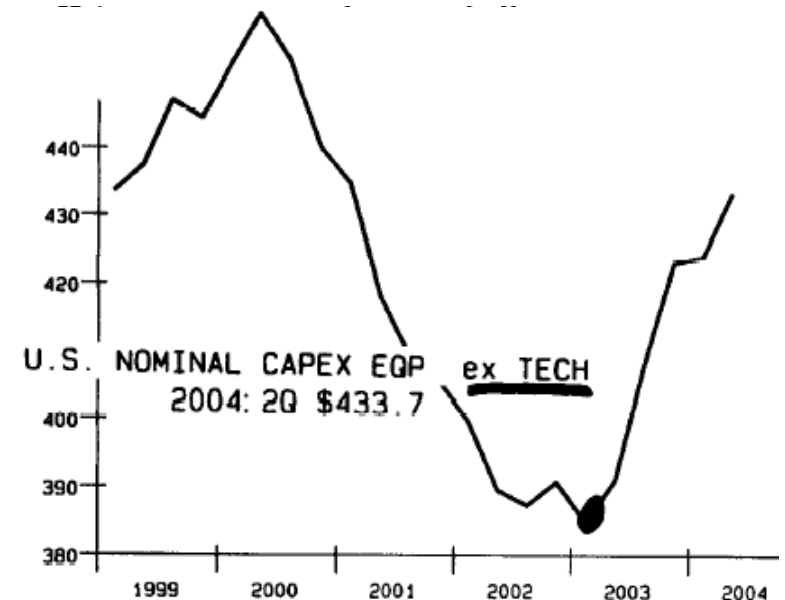
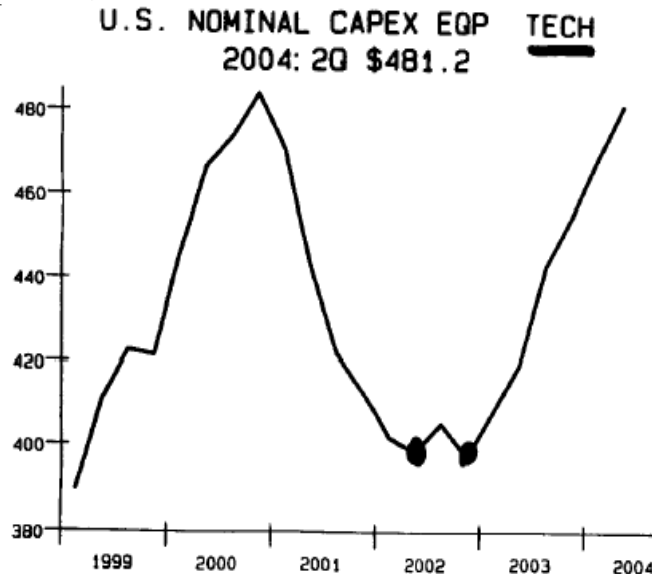


Source: ISI

# Front End Weaker, but Back End Strong

## *Capex still moving higher*

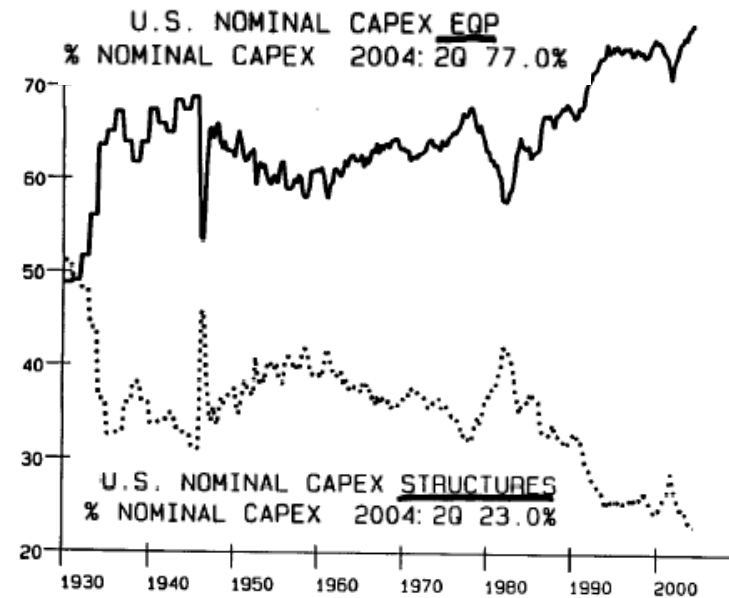
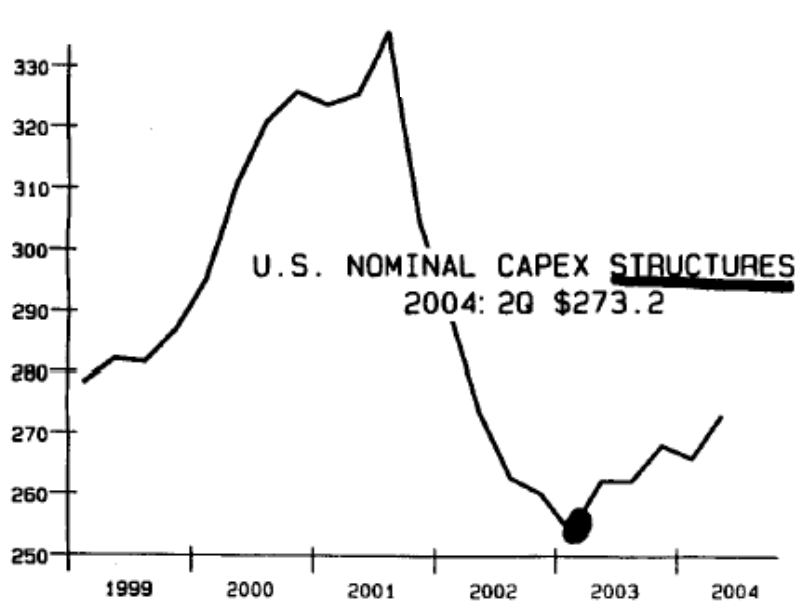
- All forms of capital expenditures (technology, equipment ex technology, and structures) still improving in the low interest rate and strong corporate profit environment.
- Technology up +21% from low, near 2000 peak, boosted by computers, software. Communications improving but still far below peak in 2000. Non-tech powered by construction machinery, trucks, oilfield equipment, and agricultural machinery.
- Accelerated depreciation may boost capex spending second half of the year, but will probably mean slowing in 2005.



Source: ISI

# Building Capital Expenditures Improving, but Slower

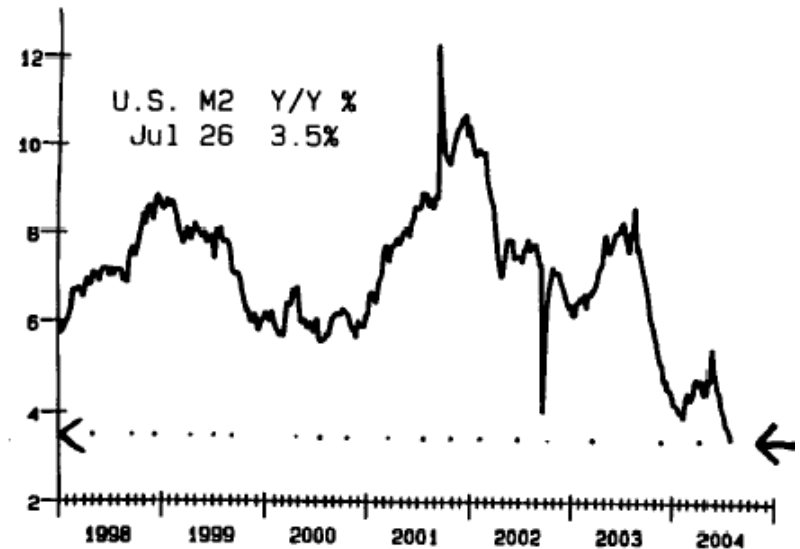
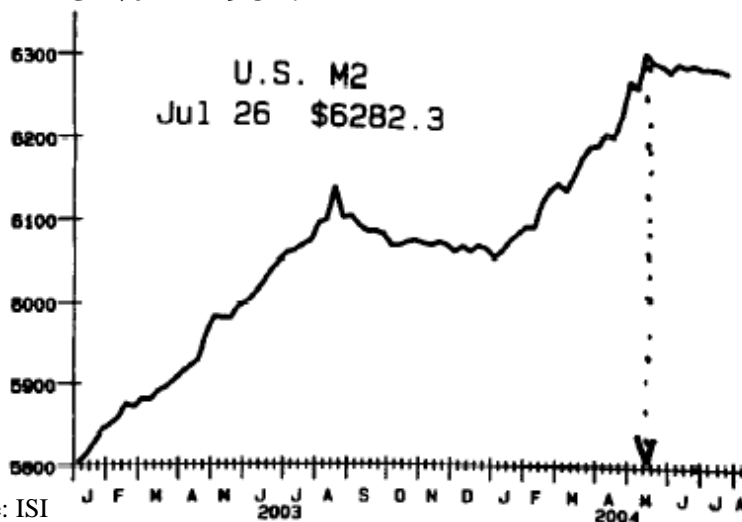
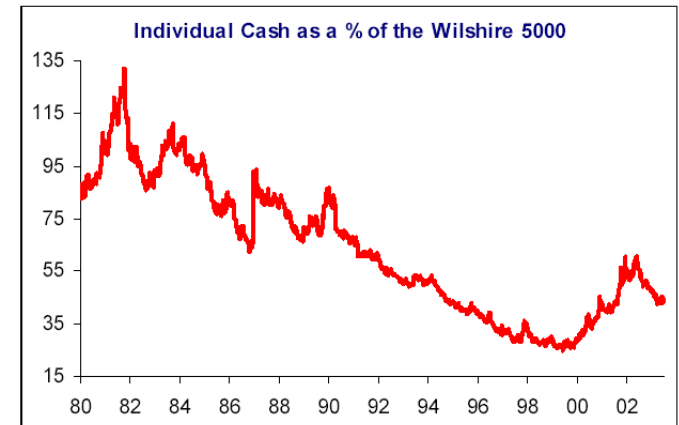
- Structures capex continue to improve from a year over year rate of -21.8% in the third quarter of 2002 to +4.2% in the second quarter 2004. This trend should continue. Healthcare and mining structures responsible for improvement.
- Structures are not as big a piece of total capex anymore, down to 23%, compared to 77% for equipment, of which, tech equipment is the biggest piece. Technology represented only 10% of total capex 40 years ago, but now accounts for over 50%.



Source: ISI

# Slow Money Growth

- M2 unchanged for about 10 weeks. The y/y growth rate of 3.5% is lowest in almost a decade.
- Less mortgage refinancing and other consumer loans, but business lending still strong – probably due to inventory building.
- Less liquidity means less boost for stocks. Cash as a percent of market cap at 44% versus 131% in 1982.



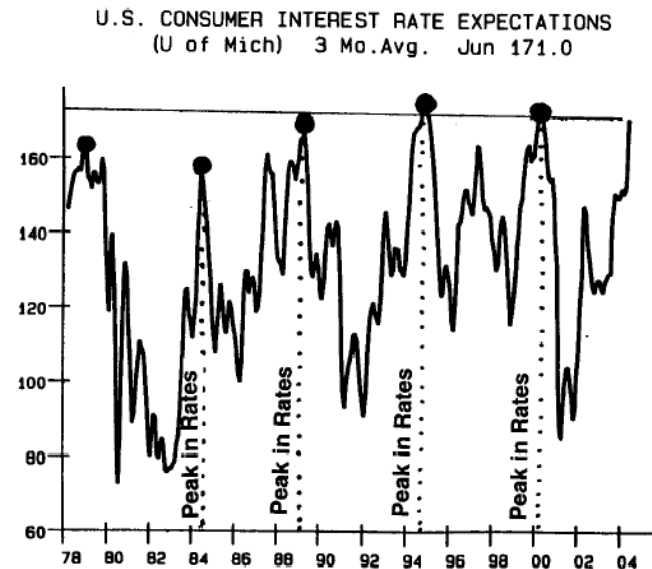
Source: ISI

# Interest Rates

- Speculators are betting heavily on a further rise in longer term interest rates. The net short position in Chicago Board of Trade 10-year treasury futures is the largest since the inception of the contract in the 1980s. Institutional bond manager durations are at record lows.
- This may make it easier to rally on bond friendly news and more difficult for bonds to sell off on bond-unfriendly news.
- Rates don't typically peak, however, until consumer rate expectations peak.

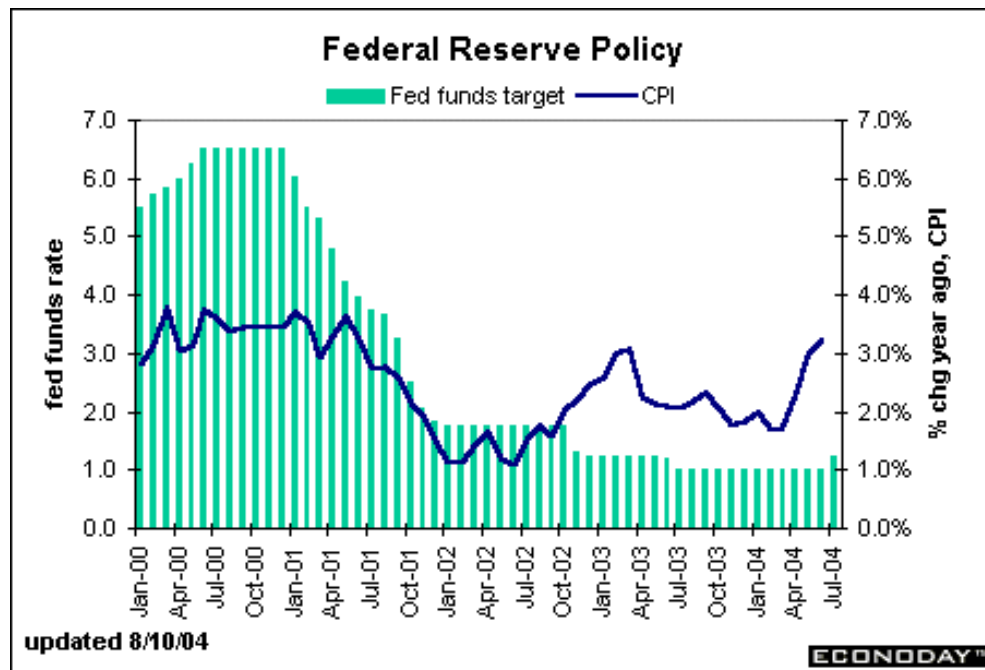


Source: RBS Greenwich Capital, ISI



# Interest Rates

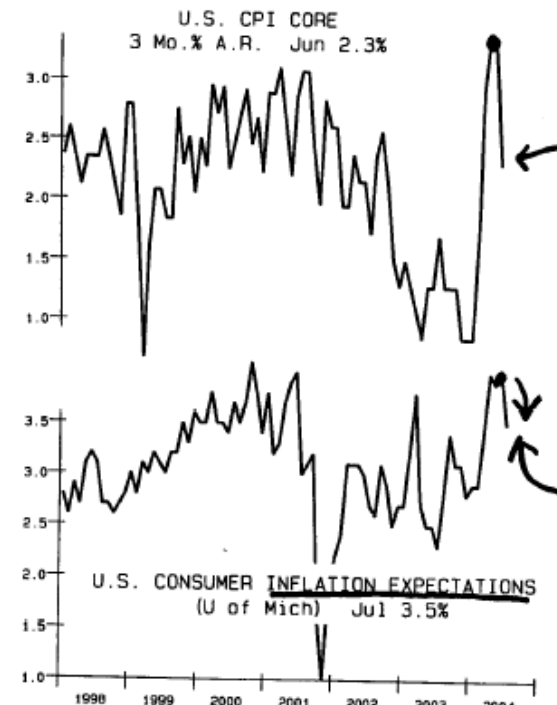
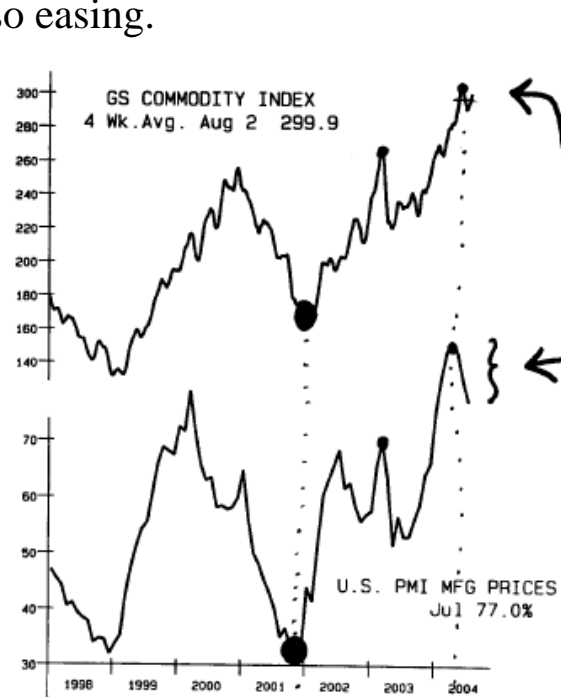
- The Fed tightened another 25 basis points in August to 1.50%, plans to continue “measured” pace.
- While the Fed still expects the recovery to strengthen, they did acknowledge softness in output and labor, blaming it on high energy costs.
- Fed rarely mentions energy prices, last mentioned in May 2003 referencing pre-War price hike. Fed may be fearing higher inflationary expectations, and may be uncomfortable with negative real rates.



Source: Econoday

# Inflation

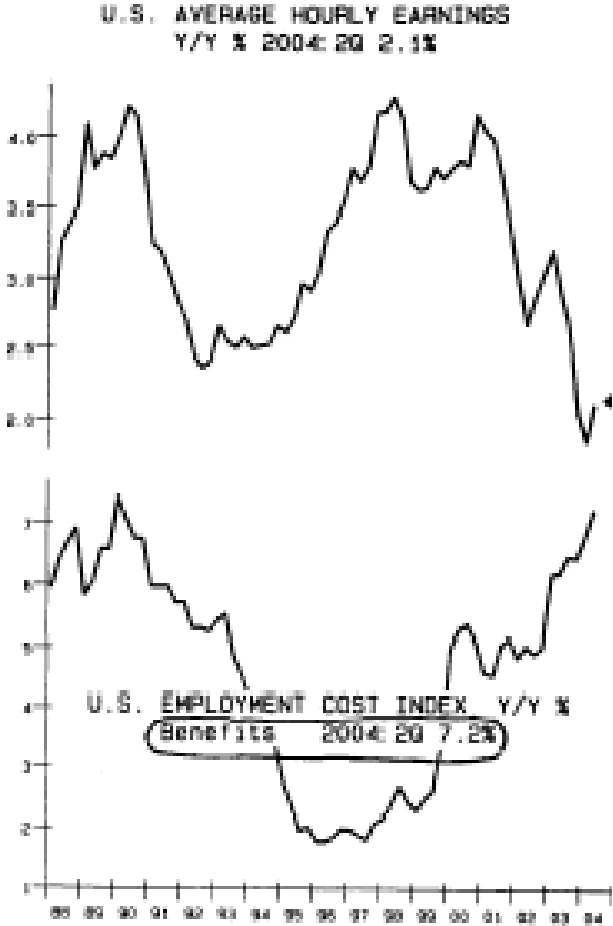
- Inflation ramped up this year due to oil and improving corporate pricing power, but increase likely temporary.
- Core CPI which excludes food and energy spiked as well, but slowed dramatically in June with the slowing economy. Other measures also slowed including PMI prices paid, farm prices, and plateau in the GSCI. Consumer inflationary expectations also easing.



Source: ISI

# Labor Cost Flattening Out

- Although hourly wage growth muted at 2% y/y, the numbers understate employment cost because they don't include the 7% y/y benefit cost increase.

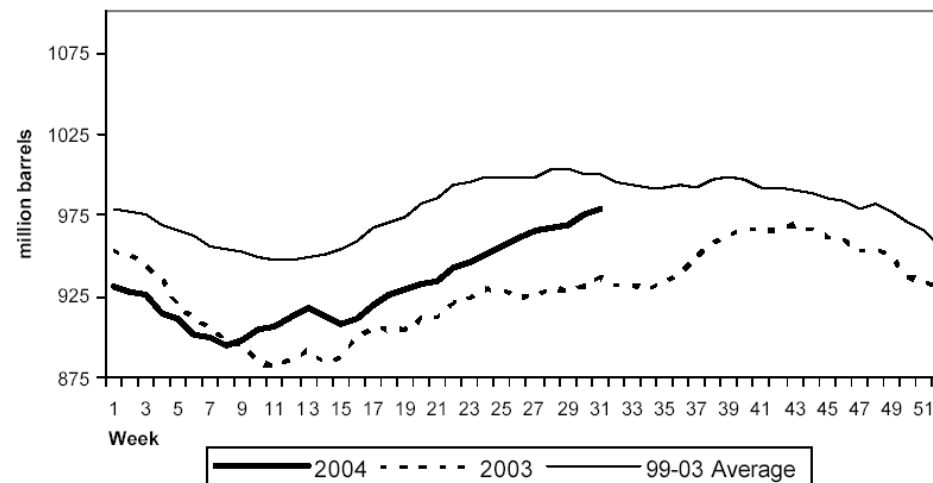


Source: ISI

# Oil Prices High, but...

- Oil prices high due to worries about Russian supply disruption (Yukos), increasing Chinese demand, OPEC communiqués indicating limited excess capacity, Venezuela referendum, and fears of infrastructure terrorism.
- However, two new Saudi fields should boost production by 800,000 b/d and crude supplies far above 2003 levels and steadily increasing since February. Russia indicated Yukos will continue to produce and export, and domestic gasoline demand falling.
- Wildcards: Chinese demand, Venezuela, terrorism

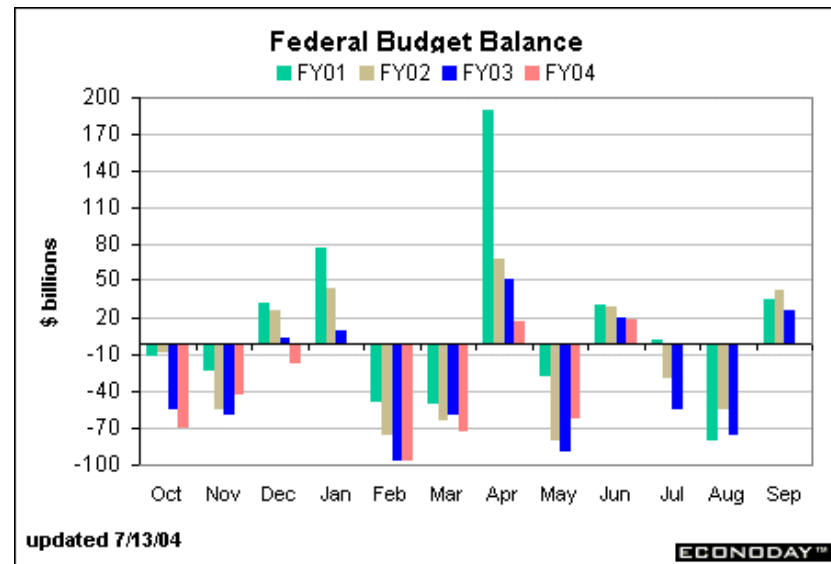
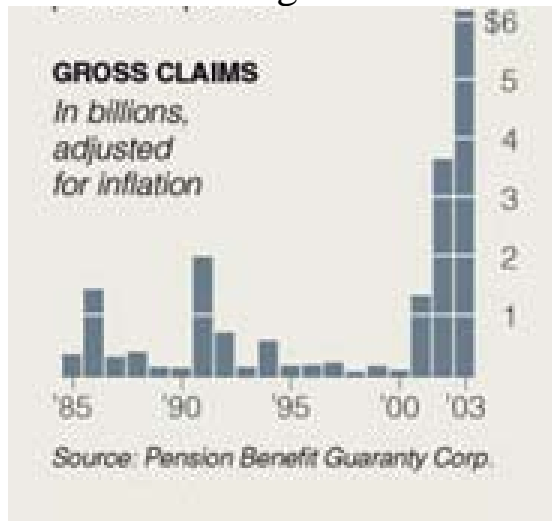
TOTAL CRUDE OIL & REFINED PRODUCTS



Source: Lehman Brothers

# Fiscal deficit

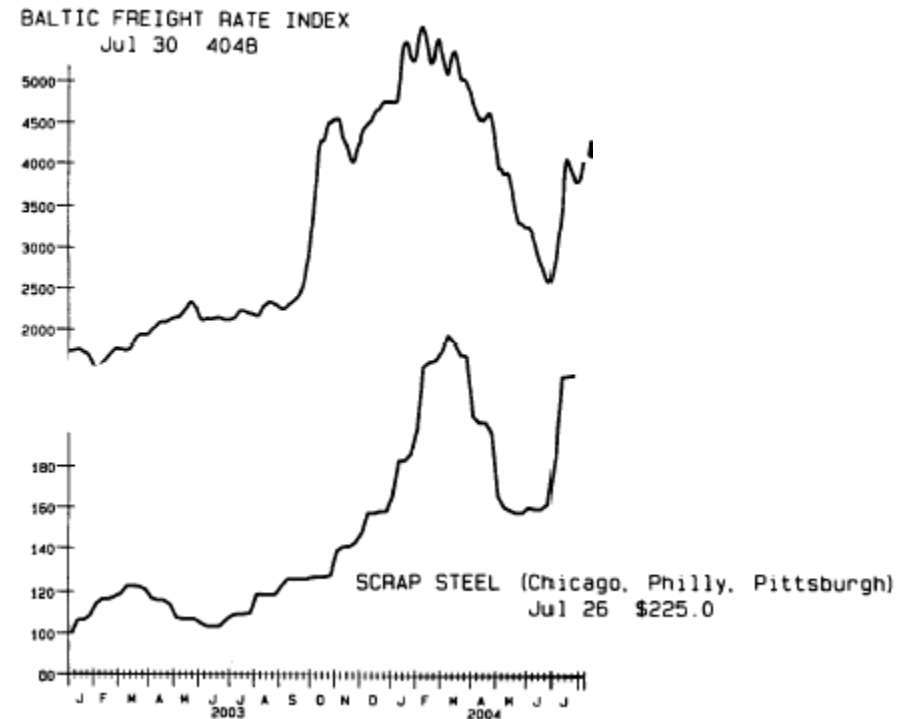
- Next unexpected costly fiscal item may be PBGC (Pension Benefit Guaranty Corp). Taxpayers bailed out the S&L at a cost of \$150 to \$200 billion. Although costs will be deferred due to nature of pension payouts, some fear PBGC could cost a similar amount.
- United Airlines may be first to default on pension obligation costing PBGC \$5 billion. Industry obligation totals \$31 billion.
- PBGC already has debt, covering 3200 failed pensions in 30 years, but claims have been accelerating.



Source: NY Times, Econoday

# China

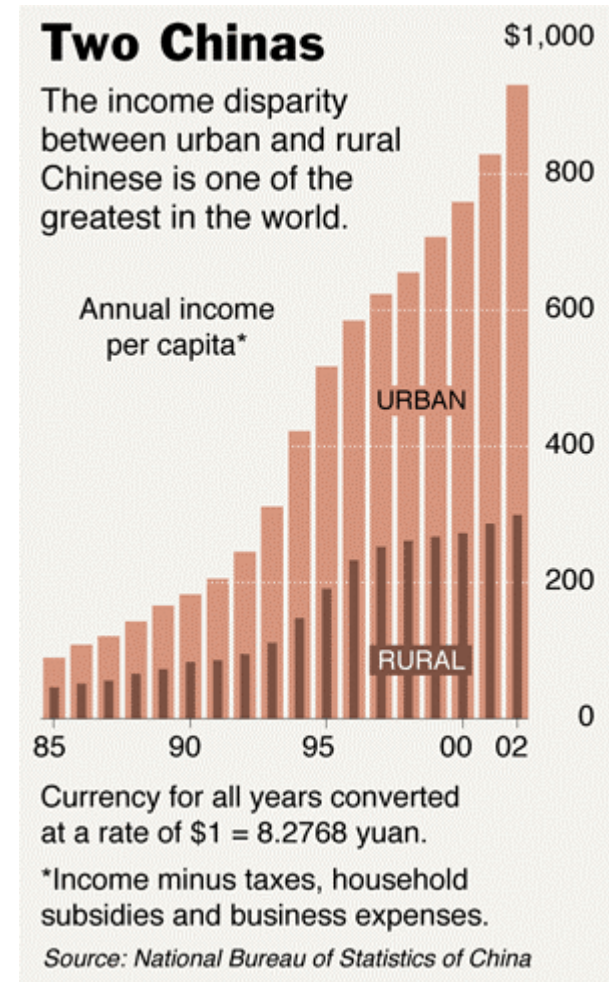
- Although China's driving up commodity prices from steel to oil, they are still a deflationary force for finished goods due to incredibly cheap labor.
- Back end of economy weakened (2<sup>nd</sup> quarter industrial production at 12.5%, down from 20% earlier this year), but front end still strong (2<sup>nd</sup> quarter retail sales +17%). Autos slipping.
- Relaxed austerity measures by central government and resurgence in the Baltic Freight Rate suggests China's slowdown ending, but China still vulnerable.
- With over 750 million peasants, social stability demands faster growth.



Source: ISI

# China Risks

- Banking sector may see problems – about 40% of outstanding loans impaired according to S&P. A full write-off on non-performing loans and recapitalization could cost \$650 billion, about 40% of GDP. (China's economy is approximately 15% of U.S. size).
- In spite of growth, China's wealth distribution widening – those classified as destitute poor earning less than \$75 increased 800,000 to 85 million last year.



Source:UBS, NY Times