

## Fall Commentary 2003

### MARKET COMMENTARY

The equity markets continued their march upward during the third quarter. After two and a half years of gloom, it has been with great enthusiasm that the markets have risen. The market bottomed last October, making this bull market about a year old. Technology has been a leading sector in the market's rally, and that hopefully portends a recovery in the Golden State.

Levels of unemployment are the highest they have been in ten years. However, since it's been ten years since we've had an economic downturn, that makes sense, and unemployment is below the level reached in June 1992 (7.8%). Also, unemployment is a lagging indicator. When unemployment peaks, the recovery is usually on its way. Given that we peaked in June of this year (6.4%), the economic scales are weighted towards recovery. The expanding estimates for GDP growth strengthen this opinion.

Globalization and exportation of labor costs have impacted employment conditions. In the manufacturing sector, this structural shift has largely occurred. It is beginning to happen in the service sector. We would expect unemployment to retain its cyclical nature, but the expected aggregate levels may gradually slide upwards. If the slow ebb of jobs overseas became a torrent, it would change our GDP expectations for the U.S. but also increase our interest in companies with international sales that could take advantage of rising disposal income in other countries.

When looking at the markets, one perspective to take is a market cycle perspective.<sup>1</sup> According to this viewpoint, the market begins to turn up as interest rates continue to decline but earnings recover. The expected growth of earnings becomes positive while the change in interest rates remains negative, allowing valuations to expand rapidly. We've seen this with the brilliant recovery in the market. The next stage is when interest rates begin to climb

U.S. Civilian Unemployment Rate - Seasonally Adjusted



Source: Bureau of Labor Statistics, <http://www.bls.gov>

<sup>1</sup> Steven E. Bolten, "Stock Market Cycles - A Practical Explanation", Connecticut - Quorum Books, 2000.



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though earnings increase at a faster rate. As long as the increase in earnings is greater than the increase in interest rates, prices generated by discount models can increase. In these terms, there's room left in the rally.

Moreover, when there's strong buying interest, prices can still increase. For August, flows into stock mutual funds totaled \$22.9 billion while \$9.8 billion came out of taxable bond funds and net cash flow from money market funds was -\$20.2 billion. Year-to-date, \$79.7 billion has been put into stock mutual funds as compared to a -\$2.5 billion for the same period in 2002.<sup>2</sup>

The crescendo at the top of a market is like the tree that falls in the distant wood. No one hears it (some might claim acute hearing and argue otherwise), but it still makes a noise. We note the signs of speculation. The National Association Securities Dealers (NASD) sounded the alarm on margin interest on September 15<sup>th</sup>, warning investors about the risks of this strategy. The market P/E multiple is about 20, which is above average. Yet, as we move into the new year, we roll forward into what is expected to be higher earnings and thus multiples will drop.

Downside catalysts to the broad market would be rising prices in oil or a sharp rise in interest rates. Oil normally fluctuates between \$20 and \$30 a barrel. The price of crude has remained around \$30 for almost a year. For industrial firms and cyclical companies, energy is a major component of their expense structure. If oil were to move to a higher pricing tier, for example between \$30-\$40, this would negatively impact these businesses, and thus the economy.

A quandary is the low level of interest rates. The FED's assault on interest rates have dropped rates back to the level of the late 1950's, which then was followed by a period of rising yields that ended with the replacement of Paul Volcker by Alan Greenspan in 1987. As explained in our Summer 2003 issue, the low level of interest rates increases price risk in bonds, and a rise in rates would have a negative impact. Rising interest rates would also change expectations

of corporate profitability and could adversely affect stock prices. Leaving interest rates low is inflationary, but raising rates too soon may choke the recovery.

## LMC STRATEGY REVIEW

We do not know exactly where a top or likewise a bottom is, therefore, we do not employ a strategy that relies on precise market timing. Instead, we mitigate the effects of the bull/bear cycle by buying at low valuations. We don't chase stocks because unlike a majority of mutual funds managers, we don't have to be fully invested and we can wait for opportunities that offer the best risk/return potential. We also are watchful for exit points for our holdings. When the market's valuation outruns underlying business prospects, we will consider selling.

While the run-up in the market has lowered the number of bargains that we are seeing, we have purchased stocks across a variety of sectors that include insurance, utilities, technology, telecommunications, and healthcare. In addition, we are taking profits on positions that have participated in the rally and which we believe are close to or at full valuation.

Regarding fixed income, for the most part, we have stayed on the near to intermediate part (five to ten year maturities) of the yield curve. We would, however, consider moving further out along the curve if yields continue to rise. We've had the opportunity to purchase 10 year agency bonds at yields above AAA corporates. Historically, the relationship is the reverse, and we see this as an anomaly caused by three simultaneous factors: agencies need to adjust their balance sheet as people change their mortgages, the potential for congressional tinkering, and the European community's public statement that they sold off their holdings.

The stock market is in a confirmed bull rally, and an election year is on the horizon. We will continue to selectively buy in both the fixed income and equity areas while looking for signs of maturity in the accelerating economic recovery.

The information and opinions in this newsletter were prepared by Lehrer Management Co., Inc. These materials are for general information only, and are not suitable for all investors. Market conditions are subject to change without notice and therefore market trends and opinions change.

<sup>2</sup> Investment Company Institute, [http://www.ici.org/stats/mf/trends\\_08\\_03.html](http://www.ici.org/stats/mf/trends_08_03.html)