



The Quality of Recovery in 2002

The Enigma of Spending Behavior in 2002

The National Bureau of Economic Research determined that a recession began in March 2001. That pronouncement has been treated as an afterthought by investors. The second year of broad equity index declines that lasted until September 21st was underscored by the continuing collapse in the high tech sector. Since then, a 40% plus rally in the NASDAQ has occurred, despite the horrors of 9-11. **The fundamental issue for 2002 is whether the equity malaise is over---or is there more to come?**

Security markets ultimately must reflect underlying fundamentals, but what will the fundamentals be in 2002? The shape of recovery will reflect private and public sector spending decisions in 2002 and 2003. In turn, those decisions will be highly influenced by the expectations of future economic recovery and the impact of economic policy changes on households and firm expectations. The difficulty in assessing spending behavior begins with what to use as suitable benchmarks for spending in 2002. Selecting 2001 as a reference point may be treacherous because in so many ways, 2001 was quite unusual. It was a year of striking adjustment to underlying economic fundamentals; it was a year of extraordinary economic policy decisions; and, it was a year in which terrorism became a part of the American economic landscape. Although many will wish to forget 2001, for most of us it was an unforgettable year.

2001 Benchmarks

While the economy's investment boom collapsed in 2001, truly significant changes in the economy began in 2000 as the tech and telecom sectors collided with the reality that sales without earnings represent a fundamental inconsistency. Quite early in 2000, there were signs of an economic shock as consumer spending slowed and industrial production came to sharp halt. The shift was subtle in the beginning, but it gathered continuing momentum through QIV 2000. By then, credit began to get rationed, particularly to many of the former 'stars' of the tech boom. The era of 'zero cost' equity capital came to a halt as equities were beaten down, and the credit markets got tough with many would be borrowers who had formerly found easy borrowing conditions. Credit was available for only the most credit worthy, and as 2000 ended, credit markets had a 'winner take all quality.' Greenspan worried profusely about the 'rest' and said so in December, 2000.

As a result, the Fed's monetary policy response to the growing economic slowdown was aggressive, almost without precedent. Short term interest rates fell dramatically, offsetting the yield inversion that had begun in 2000. Yet, at the end of 2001, long term yields were not much different than they had been at year-end 2000, although the yield curve has become much steeper. The collapse of short rates and the reduction in mortgage costs spurred home building as the economy experienced a "re-fi" boom. Re-fi may also have helped other types of consumer spending from slowing more than it did in the face of stalling job growth and rising unemployment. Still, consumer spending **growth** was significantly reduced, continuing a trend that had begun in 2000. As a result, inventories ballooned in 2000 and 2001 was characterized by huge reductions in business inventories. This trend continued even into QIV2001 as the slowdown in spending has exceeded many business forecasts. The counterpart to this spending slowdown and inventory reduction was a dramatic, and somewhat unforeseen, fall in corporate profits. Cutting payrolls, inventories and investment spending was the response by firms to this



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dramatic fall in profits, but a quick rebound in profits seems unlikely at this point. U.S. industrial production declined throughout 2001, continuing a trend begun in early 2000 while the unemployment rate rose to 5.7%, the highest since October 1994 (5.8%).

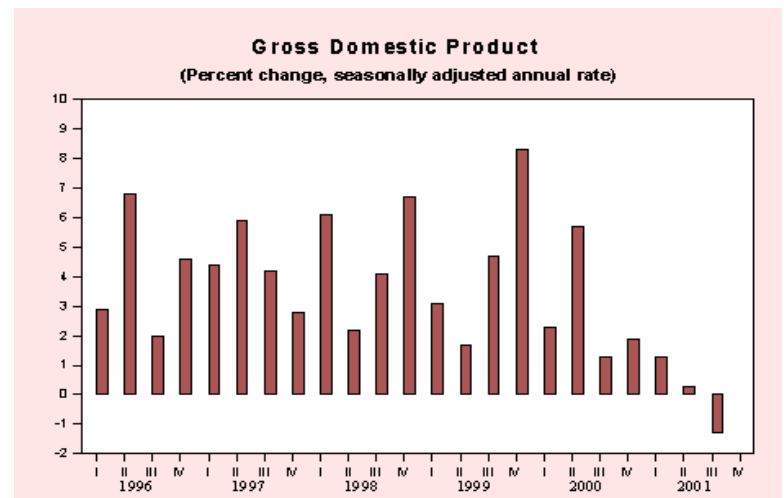
The U.S. recession has turned into a global downturn as the U.S. economy "shipped" its recession abroad. While U.S. exports fell, U.S. imports fell further, 'cushioning' the slowdown in U.S. GDP, but pushing many countries into recession-like conditions. Asian 'tech' exporters were hit severely by the U.S. downturn, on top of the continuing lack of growth in Japan. Euroland has also found it was not as insulated as its policy officials had previously stated. The European Union, while not officially in recession, found its economic growth running down to an estimated 1.5% growth rate. The NAFTA trading partners of the U.S. were also pushed into recession.

The Fed began to attack the slowdown with vigorous moves in January 2001, and the equity market took the attitude that the 'problem' could be resolved readily with prompt monetary policy. Unfortunately, the slogan "Don't fight the Fed" trapped many portfolio managers who disregarded the issue of a 'long and variable lag' to monetary policy, and the uncharacteristic nature of this recession---an investment boom collapse.

A fiscal stimulus was enacted 'early,' in the year that has clearly helped households from a complete buyers strike, but a second package failed to gain needed Congressional support even after the terrorist attack of 9-11. Federal spending did help to cushion the downturn and that will carry through 2002 with marked increases in various Federal programs including a significant rise in defense spending. An immediate result of 9-11 was the abrupt stop in spending by households and firms on many items (particularly travel and entertainment services). However, housing continued at a brisk pace and the auto industry initiated a 'zero cost financing' program that is likely to force total light vehicle sales to its second best year ever.

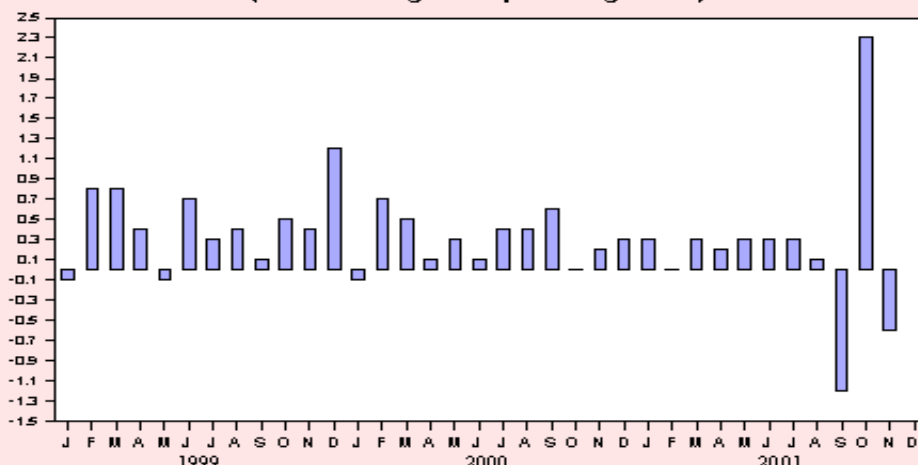
When the economic history of 2001 is finally written, it may turn out that the biggest economic impact of 9-11 was to galvanize the Fed to become even more aggressive than it had been. Fed Funds have fallen 175 basis points since the August FOMC meeting's shift to a 25 basis point cut that then seemed to signal the Fed was slowing its vigorous pace.

The heady pace of monetary easing, the prompt and vigorous leadership response to terrorism and hope that the worst of the profit recession was either over or soon to end has given rise to a very decent equity rally since late September. In addition, the slowing of worldwide economic growth and the continued growth of non-OPEC oil exports has turned the oil tax into an oil subsidy. OPEC's control may have been





Real Personal Consumption Expenditures
(Percent change from preceding month)



fundamentally weakened by the growth in non-OPEC supplies. In addition, a late winter has added to the decline in petroleum product demand that accompanied falling travel and tourist expenditures. As a result, the U.S. enters 2002 with fallen crude and natural gas prices and unusually cheap gasoline prices. This is another support for consumers in 2002. The question to ask is whether there is enough support to

keep consumers spending at high levels---in spite of depressed levels of personal saving? When will GDP begin to grow again how vigorously will ultimately be related to both consumption and investment growth and the latter also depends on corporate profits?

GDP in 2001

GDP in Q3 was adjusted downward .2 to -1.3% in the last revision, but GDP in Q4 remains something of a mystery because of the recent **high variability of personal consumption expenditures**. Some expect **PCE** to rise at better than a 3.5% annual clip in QIV. That may severely undermine forecasts of 3% or more **declines** in Q4 GDP made shortly after **9-11**. Across the board, GDP estimates for Q4 have been revised upward with some analysts now claiming that GDP may **not decline at all in Q4 because of the large rebound in consumer spending**. The **9-11** attack triggered a huge cutback in consumer spending, but 'zero cost financing' programs by the auto industry inspired a sales boom. "Up-down" behavior of **PCE** after the September collapse can be seen in the graph of Real Personal Consumption Expenditures (from the BEA).

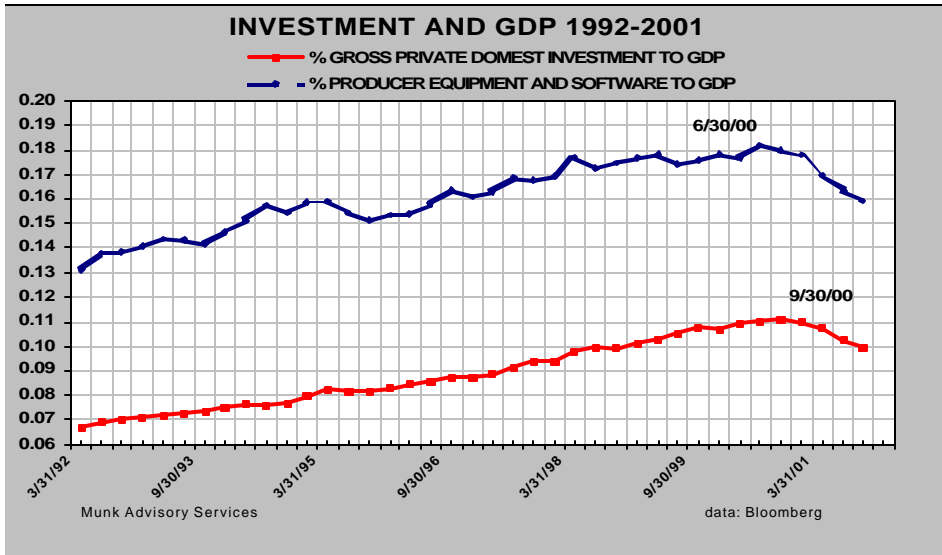
It appears, however, that November showed another month-to-month decline and Christmas shopping reports are unclear. While consumer spending may indeed stabilize in Q12002, it will clearly be at levels significantly below the 5+% growth of the boom years, leaving the quality and timing of recovery in 2002 somewhat unclear.

What is likely to be critical for the recovery in 2002 is **investment spending** because this economic disturbance was intensively influenced by its collapse. It is not only the spending collapse, but also the huge buildup of capital during the prior boom that must be worked through before private domestic investment can expand at a reasonable pace. If consumer expenditures do not grow significantly in 2002, investment spending on producer equipment and software will be restrained. **This makes the consumer the key for 2002, and it underscores the object of Fed policy in 2001--- maintain consumer and housing expenditures until the investment boom collapse has ended and private domestic investment spending begins again.**

During the investment boom, gross private fixed investment soared to over 18% of GDP with huge increases recorded in the tech sector. Over the same period, investment in producer equipment and software as a fraction of GDP rose from a low of 6.7% (Q1992) to 11.1% in QIII 2000.

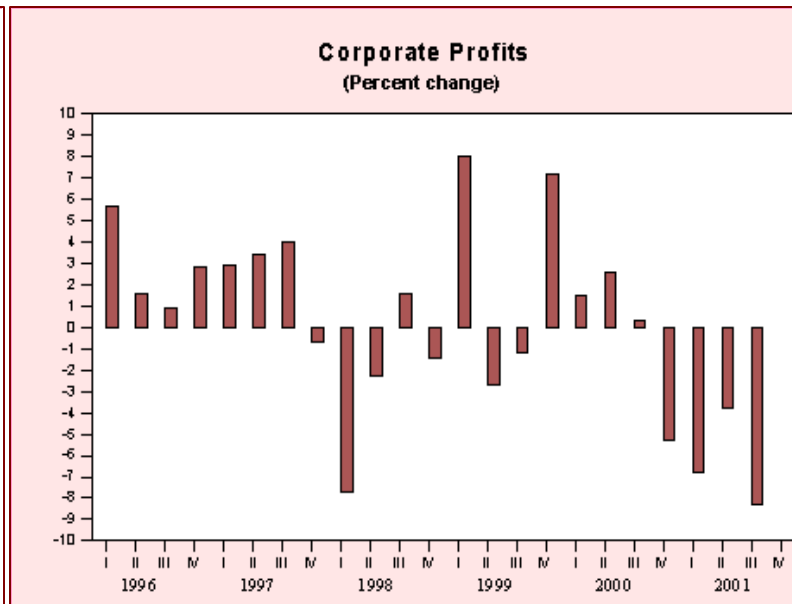
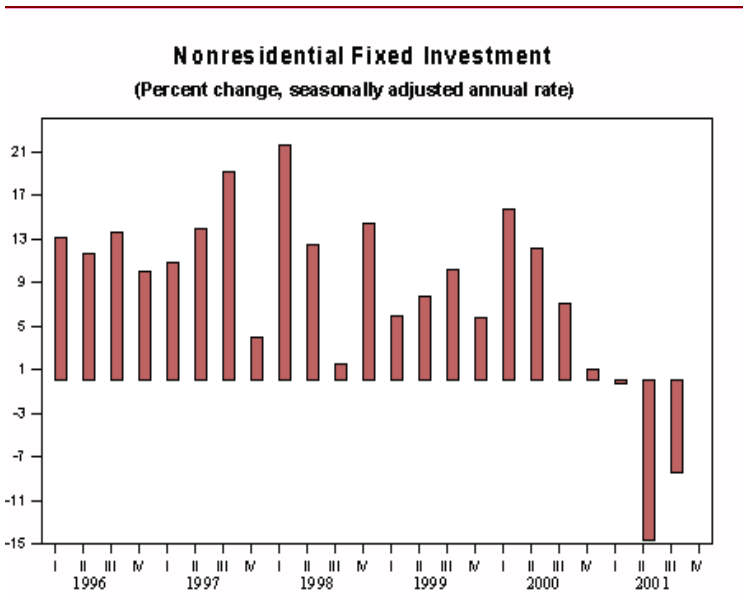


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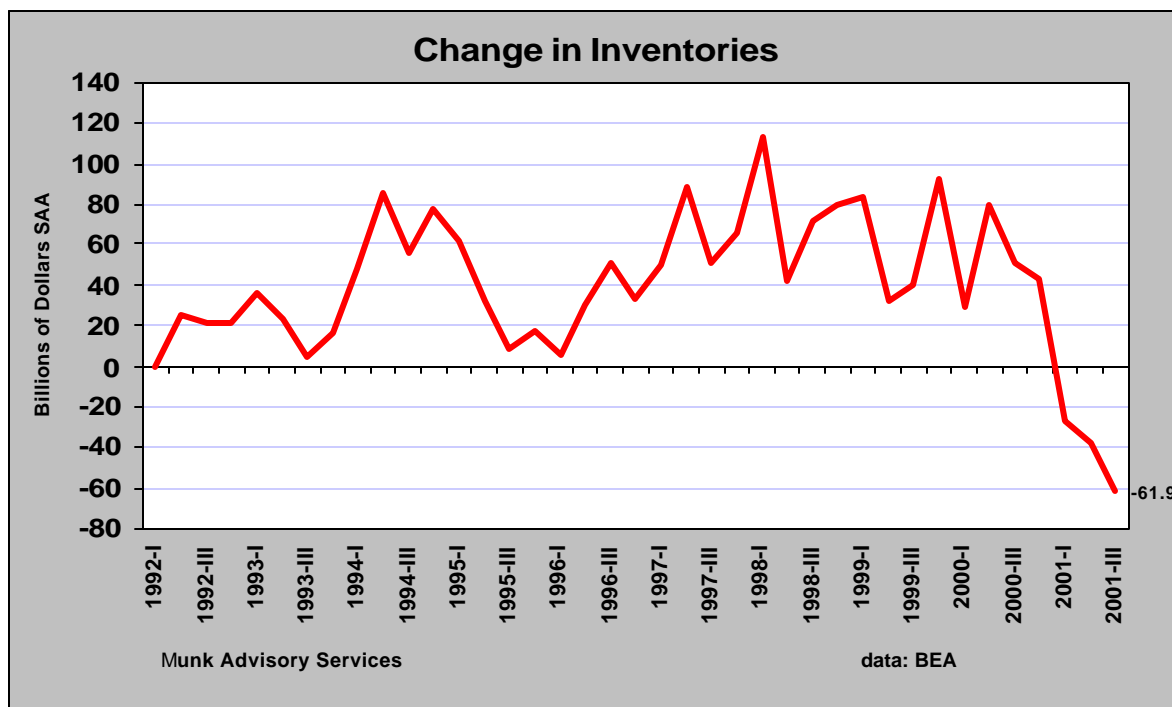


While investment soared, the **return to capital** seemed to have faltered as early as late 1997. Thus the appellation “profits recession.” The collapse in business spending became evident by QIII-IV 2000 and 2001 was characterized by an enormous collapse in business profits. The ensuing “profits recession,” has evidently reduced nonresidential fixed investment. Both the investment boom collapse and slower consumer expenditures have had global repercussions because of the impact on exports of intermediate and final goods procured through global supply chain management. For this reason, this

recession has appears to have been ‘synchronized’ throughout much of the world economy.



The marked change in behavior of corporate profits was reflected in the erosion of equity prices since March **2000**, particularly in the NASDAQ...at least until September 21st. Thereafter, investors looked ‘through’ the current torment—perhaps as far out as 2003. The sequential collapse in corporate profits beginning in QIV 2000 has been dramatic and unrelenting, and QIV 2001 is expected to show further declines, perhaps exceeding that of QIII. How quickly investment spending revives is very dependent upon business expectations of a profit recovery and the extent to which **further inventory reductions must occur to adjust corporate balance sheets to expected revenues and costs.**



The adjustment of business inventories will surely shape the character of the recovery in 2002 precisely because of the massive inventory reductions in 2001. Inventories have been sharply slashed (by nearly \$60B in QIII and an expected \$80B in QIV). The projected recovery in 2002 will be led by some inventory rebuilding, but clearly that is only a partial recovery. Investment spending in the business sector must revive to give duration to the recovery. However, business investment in new plant and equipment as well as additional inventory will occur only if the consumer spending becomes both stable and predictable, and that depends upon the re-building of consumer balance sheets.

Put another way, the great mystery of 2002 will be the personal savings rate. In fact, the large differences between analysts as to the shape of the recovery in 2002 and 2003 revolve around their **assumptions on the consumer saving rate. If it rises dramatically, it is hard to forecast a vigorous recovery. If it does rise, will economic policy change to offset the implied reduction in aggregate demand?**

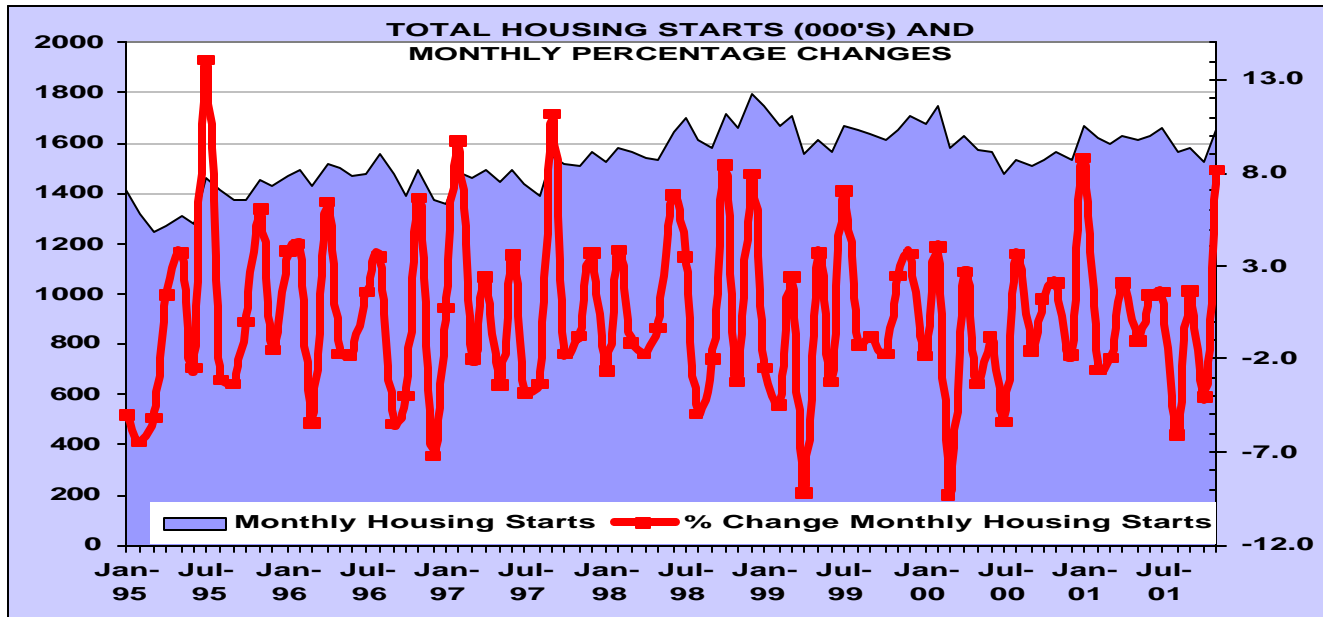
The personal saving rate has declined precipitously during the later phases of the Long Boom. Apparently the continuing rise in asset prices (equities and housing) made consumers feel comfortable spending nearly all of their personal disposable income. However, beginning in QIV2000, that zeal for buying relented and when the Attack came in QIII, personal consumer expenditures fell and the savings rate rose dramatically. **The key question for 2002 is how quickly the personal saving rate will return to the levels of 1996-1998 (somewhere between 4-5%) or to the 6-8% levels of 1986-1995?** How important this can be for GDP growth in 2002 is illustrated by the fact that in QIII 2001, personal consumption expenditures amounted to \$6.4 Trillion (1996 Chained Dollars) while personal disposable income was approximately \$7.6 Trillion. A change of 1% in the savings rate amounts to more than a \$70 Billion change in spending. Were the savings rate to return to a 6% level, the impact on consumption would be huge. Few economists believe that a return to a 6% savings rate is imminent, but a gradual return to 4%, perhaps over the next 6-8 quarters would represent a substantial downward pressure on GDP growth and a substantial disincentive to strong business investment demand.

Consumer behavior is not only important in its own right, but as a precursor to changes in monetary and fiscal



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policy. It is the possible change in consumer behavior that lies at the heart of determining how strong monetary and fiscal policies need to be to offset the effects of shocks to business investment demand. Business investment is not the only component of investment. Residential investment is also a significant element in total spending, and it has held up remarkably well under the influence of strong monetary actions in 2001. Not only has housing held up, but also low mortgage rates have permitted significant refinancing to occur. In effect, some of the buildup in equity value has been

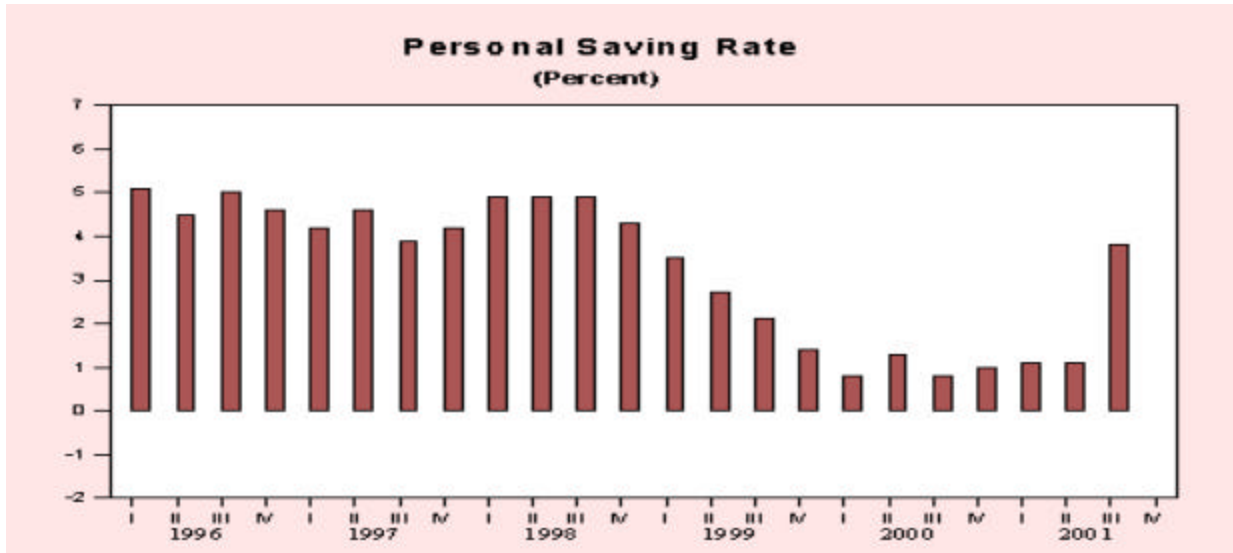


“taken down,” by consumers, probably to finance other elements of consumption. Can that pace be continued? We doubt it because mortgage rates have risen quickly in the past 60 days and employment is falling. **Increased housing demand is not consistent with the current trend in these two variables.**

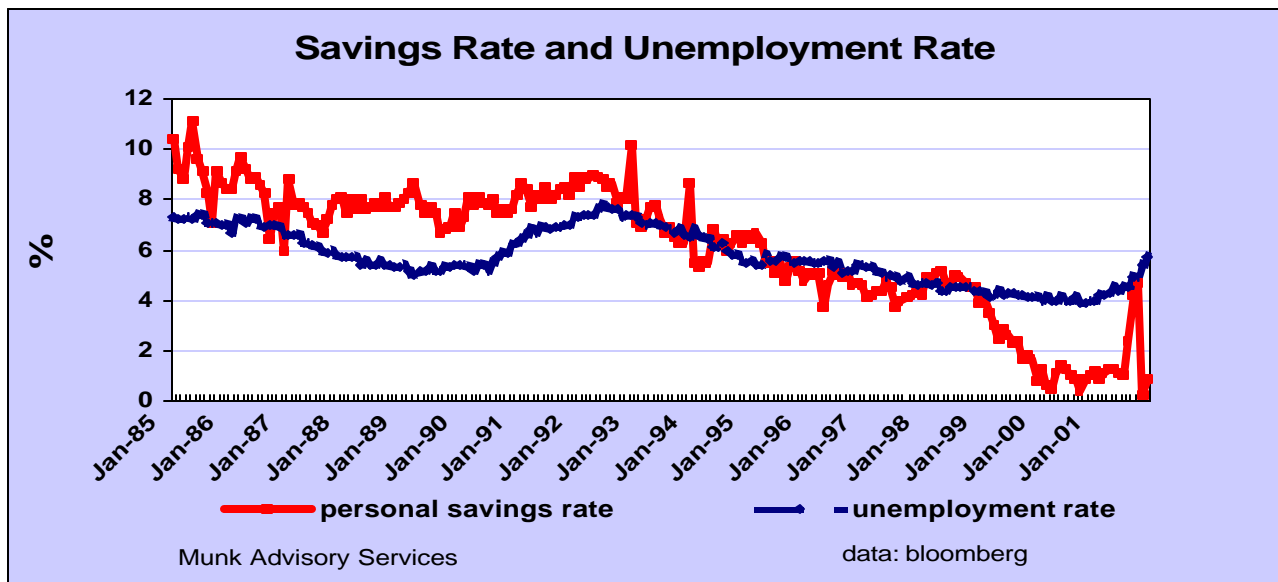
A key test for 2002 will be whether the “refi” boom ends and current consumption must now be financed by personal income, rather than through the drawn down of previous home equity build-up that may have allowed some maintenance of consumption patterns. This is essentially an issue of how much debt can the consumer sector bear as the adjustments in employment, interest and dividends that have accompanied this downturn take place. This also serves to isolate some of the key elements of the policy environment as we enter 2002.

The Fed has cut interest rates a total of 475 basis points beginning with the early January 2001 cut. Eight of those cuts were for 50 basis points while the remaining three, including the last cut on December 12th, were 25 basis points. **It seems apparent that FOMC deliberations at the last meeting were focused on whether the economy was beginning to “bottom out,” but no less, on the likely actions of the Congress with regard to further fiscal steps.** Since then, the Congress adjourned without taking further steps. Further efforts on fiscal expansion must come either from the Fed or from Federal and State spending actions that can be taken within the confines of respective Federal and State budgets. There is already an evident Federal ‘speedup’ in defense spending some of which will improve the investment outlook of certain firms. Some of that spending has and will continue to spill over to the damaged tech sector. What is clear, however, is that at this stage in the cyclical process, income maintenance by consumers becomes critical, which in turn means, how much further job loss will occur until the rebound begins?

What are the latest reports on Consumer Spending telling us with regard to GDP in Q4 2001? Does a more optimistic



'finish' at year-end portend a better Q1 2002? Recently, consumer confidence seems to have turned upward. Both University of Michigan and Conference Board data appear to indicate that consumers are more 'optimistic,' as they look forward. That may turn out to be a fragile reed because 'forward expectations' can deteriorate. Forward expectations are heavily influenced by current conditions in the labor market. Once the Christmas buying season is over, the consumer will have to adjust to continued rising unemployment. For the past several weeks, initial unemployment claims seemed to have slowed their rise and some analysts have concluded that this portends better employment conditions. **We continue to believe, however, that the unemployment rate will rise well into 2002 as firms try to shore up profits and become more accustomed to a 'looser' labor market.**





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The Energy Shock of 2002—a tax refund

Since 1997, crude oil and other energy prices have been on an roller coaster path from the \$20-25 range of 1997 to the \$10 lows of late 1998 and then back above \$35 in late 2000. In similar fashion, natural gas has had an up-down ride from the \$2's to \$10 and then back to the mid 2's currently. What's different today is the role of Russia. OPEC could press worldwide consumers when there was insufficient 'spare capacity'---particularly in OPEC except for Saudi Arabia. In the last few years, particularly as a result of the huge crude oil spike, the fortunes of Russian oil companies have been rebuilt and there are now sizeable increases in Russian crude production and delivery capacity for world markets. Further, 9-11 has turned Russia into an ostensible ally of the West in the fight against terrorism. Russia's interests may now have shifted toward creating more outlets for its crude and natural gas output. By supporting the U.S. in its anti-terrorist campaign, Russia may also be creating a more hospitable environment for further energy resource development through foreign investment. These factors contribute to Russia's observed reluctance to join OPEC's recent efforts to restrain worldwide crude oil production. This may be more than a 'cyclic event,' and if it is, it portends a likely return to a \$17-21 crude price range. In fact, a plus \$20 environment may be out of reach for 2002 if winter in the U.S. and in Europe turns out to be rather mild. A mild winter will mean less of a winter draw in inventories. When the spring 'shoulder season' comes, oil prices could drop further unless OPEC is sufficiently challenged to significantly reduce output. Even if winter is just normal, it could be that energy prices will not retard consumption as 2002 develops.

Global Factors in 2002

In our survey last year, we had projected a better Europe and a foundering Japan. As it turned out, Europe was only better by comparison (perhaps 1.5% growth as compared to perhaps 1% in the U.S), while Japan foundered despite hopes stirred by the Koizumi Government. The unusual phenomenon of a well-regarded Japanese politician intrigues some analysts and provokes mild optimism that true reform can occur. We are more than wary. One is reminded of the old saw that there is no end to the punishment of good deeds. Maybe that should be the maxim for investors in Japan. The punishment meted out to those with hopes for a better day in Japan has been severe indeed! We do not foresee much reversal on that front. If reform comes, it will only come only through a crisis that triggers a general election and decapitates the existing LDP. Short of that, Japan will not be an engine for world growth. Instead, it will be a caboose that slows down the train of world growth in 2002.

Yet, something has been changing in Japan and there are portents of even greater change: **the value of the yen**. It will be a weaker currency in 2002 a source of difficulty to other parts of Asia. Those difficulties are minor in comparison to the great risk to the world economy if a collapse of the Japanese Government **bond market** occurs. If JGB yields begin to rise, a clash over monetary control will ensure. The Bank of Japan will be forced to become the residual buyer of Japanese Government paper---giving up any pretence of operating a truly independent monetary policy. In the United States, the economy is in the hands of the consumer. In Japan, it will be the holders of government bonds that will play the pivotal role. If Japanese savers head for the exits, the Japanese Government has nowhere else to turn but to **massive inflation**. There is no time left to amortize the bad debts or hope that commercial bank profits can be sufficient to re-capitalize the banks. If JGB's collapse, they will just be floated away on a rising price level. **How and when this occurs is a principal uncertainty for 2002. It is a catastrophe waiting to happen, but it's timing impossible to predict. It will be an Asian Shock with far reaching global implications.**

Euroland is another issue entirely. One must be struck by the diversity of economic conditions in the EU as well as the diversity in response of the EU consumer. In France and Italy, they spend. In Germany they save. It is hard to conceive of a monetary policy that can fit large and small countries, and there is no centralized fiscal policy. Fiscal policy is even more political in the various countries of the European Union than it is in Washington---if that is possible. Furthermore, there are major elections in both France and Germany this year. The politics of reform in Europe are not a positive force for growth. Euroland can grow---but only slowly. It will be dependent more on U.S. performance than EU policy makers wish to admit. We should expect another year of testy confrontation with the ECB. The decline in



inflation in Europe and around the world suggests that the ECB has more policy room, but how they will use it is not yet clear. The ECB also wages a political battle with politicians over structural reform and a move to more competitive markets. The problem is that the ECB focuses its monetary policy only through the aperture of a price stability target and does not believe that monetary policy can or should be used to produce growth. This is a recipe for more controversy and less policy response leading up to the French and German elections. Lots of uncertainty and a thick policy fog will be the European contribution to world growth. All this, despite rather reasonable prospects for the UK, but there also, a policy fog is emerging as the Blair government makes even more deliberate moves to join the Euro and give up its independent monetary policy.

From a global point of view, it may be the "periphery" of the Global Economy that will count much more in 2002. That periphery includes China and Russia with a backdrop of the many renditions of "Don't Cry for Me Argentina." China will watch the lack of progress in Japan with great interest. Korea, whose exchange rate we normally think of as 'pegged' to the yen, will also be watching. If a JGB crisis emerges in Japan, Korean exchange rate policies (monetary policy) will be put to a test. Korea has already begun to revive and the recent tech equipment orders have helped Korea as they have helped Taiwan, but that suggests their economic fortunes are heavily mortgaged to the U.S. high tech sector. This makes global economic synchronization another vulnerability for 2002.

The fundamentals of Korea require more debt restructuring and more financial reform. Korea is markedly different from Japan---they are actually trying to reform their financial economy and determined leadership has produced some serious progress on structural reform. The Chaebols will never be the same. What happens in Japan and China will be very critical for Korea. A weakened Japan may move Korea closer to China, but Japanese exchange rate problems are not a trivial obstacle to a healthy revival in Korea.

China now represents the pivot for Asia. It is drawing in substantial investment from Taiwan and increased 'business migration' from Taiwan (including Taiwanese working on the Mainland). This may be the ultimate solution for the Two Chinas----economic integration simply overriding political distance. China appears able to maintain real GDP growth rates above 7% while it attempts to restructure its weak companies. It is a continual balancing act, but China has a huge advantage in the size of its internal market. It is far less export dependent for growth than any other Asian country and in a fragile world economy that is a plus. China certainly has learned what the costs can be from delaying financial reform. It has only to look at Japan to see the dangers of 'going too slowly!

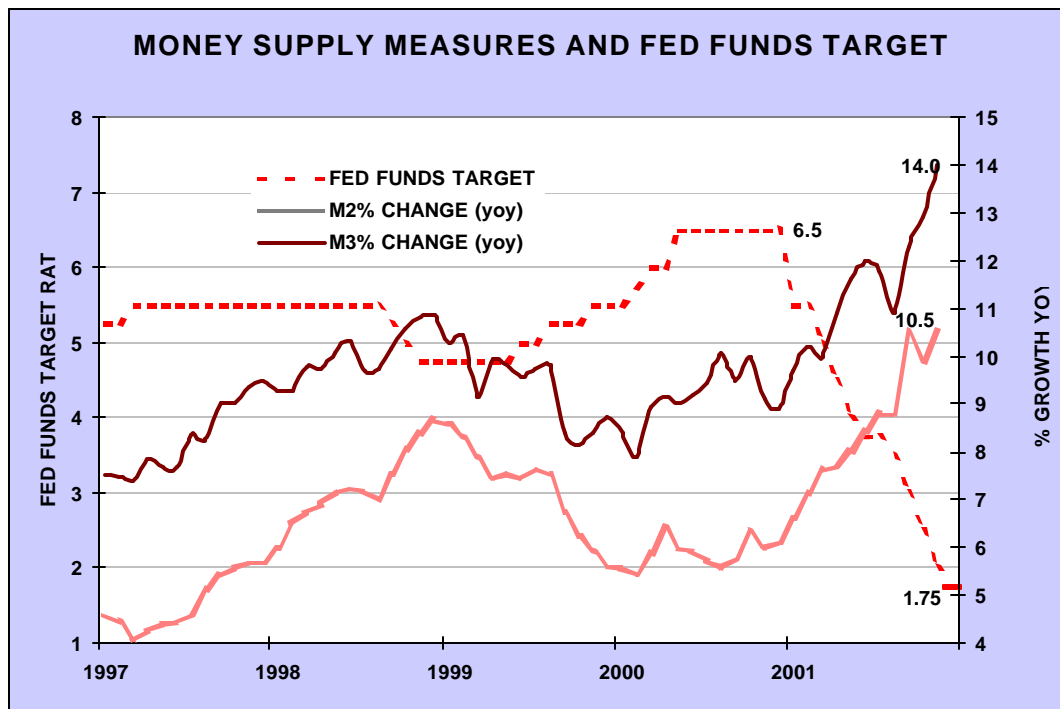
Russia may be the 'surprise' for 2002. The Bush-Putin agreement on terrorism, together with promising developments in the oil sector, augur for a change in attitude in Washington. Russia is re-defining its own economic interests and perhaps more importantly, the methods needed to attain those interests. Washington cooperation can bring substantial benefit. Natural resources, a reasonably well-educated population and increasing internal political stability are forces that frequently lead to sustainable economic growth. The stability test may be the oil market over the next year. If Russia stays away from an OPEC agreement to restrict output, look for a more cooperative attitude by this Administration. A more cooperative attitude would be a stimulus to investment in Russia and, in turn, to more rapid economic growth.



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The Fed's "Reel-In" problem:

The Greenspan Fed has tried to 'manage economic growth,' although they often deny that monetary policy is orchestrated in this fashion. The Investment Boom Collapse and the 9-11 attack have placed future Fed policy in a straightjacket. They dare not tighten too soon or the recovery of investment demand could be aborted and the U.S. could then suffer a 'double-dip' recession as in the early 1980's. On the other hand, as the graph below indicates, monetary growth rates have reached rather stunning levels that are not consistent with long run price stability. Many analysts have argued that the recent, sharp rise in equity prices beginning at the end of September was a direct result of highly stimulative monetary policies. The 'long and variable lag' problem is hardly over...it has produced a major timing problem for the Fed. When will the Fed commence the shrink of liquidity that has been its principal weapon against this recession? Furthermore, how much does the Fed need to take back? While no Fed official claims that monetary aggregates are reliable proxies for measuring the ease or tightness of monetary policy, the long-term relationships between changes in the rate of growth of various 'monies' and change in GDP are well established. However posed, the Fed cannot ignore the implications of the graph above. It is another event waiting to happen.



Summary Forecasts

- 1) The U.S. will be the main driver for global growth in 2002, but the recovery will be weaker in the first half than in the second half.
- 2) The U.S. economy will bottom out in Q12002, but the return to high growth levels of 1997-1999 will be restrained by consumer 'retrenchment' as consumers seek to raise their savings rates and moderate the rate of growth of consumer debt.



- 3) The 'inventory cycle' that has been a major depressant to growth in 2001 will reverse in Q12002—that is the 'rate of decrease' will be lower than in IV2001 and therefore 'growth positive.' That will give some impetus for growth in Q1-QII 2002, but longer term, private domestic fixed investment must revive to produce more enduring growth.
- 4) Already scheduled tax reductions for 2002 will provide some offset to consumer attempts to save more.
- 5) Even with lower rates of growth to consumer expenditures, Q12002's 'inventory rebound' should provide some leveling off in the fall in Industrial Production and eventually, its gradual rise.
- 6) The Fed will return to a neutral bias sometime in Q12002, but will not be pressed to raise its Federal Funds target until QII or QIII 2002. The yield curve will flatten as short rates rise modestly. The Fed will have to face a substantial task of "reeling in" because the growth rates of various monetary aggregates are too high to achieve reasonable price level stability.
- 7) The trajectory of GDP growth in 2002 will be upward, but we are doubtful that the US will achieve a sharp "V" recovery in FH2002
- 8) By 2003, real GDP will grow at close to the 'new' trend growth of 3.25-3.5%, but the composition of demand will show a smaller ratio of fixed private investment to GDP, a higher personal savings rate and a larger ratio of Government expenditures to GDP. This suggests that rate of growth of productivity will be lower than the 'boom' period.
- 9) Fed Watching will take on a new dimension, as the Fed begins to 'reel-in.' How much and how fast will be the watchwords for QII/QIII 2002.

2002 WILL BE A CHALLENGE FOR ALL OF US
HAPPY NEW YEAR