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Mixed Signals

Slowing growth and continued business strength leave investors uncertain

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So far this year, volatility has characterized the stock market as concerns about rising energy prices, the trade deficit and higher interest rates have generated uncertainty and anxiety in the investment world. The S&P 500's decline of more than 5% through early May raises a legitimate question: Does this performance represent a fundamental change in trend?

Indeed, several factors come into play when examining stock market trends. The health of the economy and the resulting implications for Federal Reserve policy are key influences. Business performance — particularly as measured by profitability and cash flow data — also has a significant impact on stock market performance.

In reviewing these major market influences, we believe that,

overall, the environment remains favorable for stocks. Supporting this view is the continuing strength of the business world, where corporations are well-positioned to continue adding shareholder value. In fact, we believe the remarkable health of businesses will more than offset the effect of a slowing economy and rising interest rates, and result in a favorable backdrop for stocks.

ECONOMY SHIFTS TO SLOWER GROWTH

Recent economic data, including the latest GDP and durable goods reports, suggest there's been a loss of momentum, and the economy is moving toward slower growth or higher inflation, or a combination of the two.

The advanced GDP report esti-

mated that first-quarter GDP growth slowed to a lower-than-expected 3.1%, compared to 3.8% in the fourth quarter of 2004. This reflects a slowdown in momentum and suggests second-quarter GDP may fall to less than 3%. The economy now seems likely to grow slightly below its potential, at a rate of 3% to 3.5%, at least for the short term. This reduction primarily is due to the growing trade deficit and rising energy prices — the two key factors that have deteriorated since the beginning of the year.

What the slowing rate of economic growth does for the Federal Reserve remains unclear. The Fed still has not achieved "neutrality." In fact, if we examine financial conditions, which are the mechanisms through which monetary policy is transmitted to the economy, we find

that long-term interest rates, credit spreads and the U.S. dollar are all lower than they were when the Fed began tightening. On the other hand, the stock market is nearly flat, suggesting the Fed still has room to go, particularly if it is concerned about inflation.

INFLATIONARY PRESSURES BUILDING

Indeed, there are pressures on inflation. Unit labor costs are creeping up, and corporations are raising prices to offset higher commodity prices. In addition, the weaker U.S. dollar is creating higher import prices and some ability for domestic manufacturers to raise their prices. Furthermore, inflationary expectations are increasing, as indicated by the price of Treasury Inflation Protected Securities (TIPS) versus nominal bonds.

Nevertheless, inflation is still reasonably well behaved, from an historical perspective and the Fed's standpoint. We believe the underlying trend in inflation is 1.75% to 2%, when measured by the Personal Consumption Expenditures (PCE) index. That's near the top of the tolerable range for the Federal Reserve, but it is not above the range at which the Fed would consider tightening more aggressively. Therefore, we believe the Fed will retain a measured tightening policy of 25 basis-point rate increases.

Once the Federal funds rate reaches 3.5% to 3.75%, the Fed may take a pause, depending on how economic trends and data are unfolding. Higher energy costs, in particular, will have an impact on Fed action.

FREE CASH FLOW CONTINUES RECORD GROWTH

In terms of profitability and cash flow, businesses continue to deliver remarkably good results. Profit margins hit record levels in the fourth quarter of 2004, and it appears they may be up again in the first quarter of this year. With the majority of the S&P 500 companies reporting, earnings results are nearly 4.5% ahead of expectations. On a year-over-year basis, earnings are up approximately 14%.

Accompanying this record profitability is positive free cash flow, which means businesses have entered this period of slowing economic momentum with liquidity and solvency not seen in more than 20 years. Therefore, they are in good shape not only to endure a slowdown in economic momentum but to continue to prosper in it.

CORPORATIONS POISED TO HEIGHTEN SHAREHOLDER VALUE

Given their liquidity and solvency, which serve to lower risk to investors, corporations are in excellent shape to improve shareholder value. In addition, corporations are increasing their dividends at a healthy pace, as demonstrated by a year-over-year increase of nearly 16% in the first quarter. And those dividend increases have been accompanied by record announcements of share repurchases.

Looking ahead, we believe capital spending should continue to improve. Although the latest durable goods report was unfavorable, the details of the report reveal the disappointment resided in the transportation equipment

and automobile sales areas. Technology spending, on the other hand, experienced double-digit growth — a positive sign for corporate profitability and productivity going forward.

An increase in mergers and acquisitions activity also may enhance shareholder value. M&A activity remains robust, primarily from “financial acquirers” as opposed to “strategic acquirers.” Strategic acquirers are businesses that purchase other businesses to complete or augment their business models and their strategies for shareholder advancement going forward. Financial buyers, on the other hand, are interested in capturing positive cash flow streams and leveraging the company's balance sheet. In effect, they buy a company and unlock some of the value the market hasn't recognized in its current pricing.

BUSINESS BACKDROP FAVORS STOCKS

Given our expectations for economic growth, business performance and Federal Reserve action, we continue to favor stocks over bonds. We expect corporations to continue to enhance shareholder value by keeping liquidity strong, reducing financial leverage, paying out higher dividends, repurchasing outstanding shares, and increasing mergers and acquisitions activity. Thus, we believe equities can withstand the current emotion and trading disappointments accompanying the softness in economic growth.

Stock valuations are below the 20-year average for the equity market, and the market is dipping

toward levels that usually produce rebounds. On a price/earnings basis, assuming reasonable earnings for the next 12 months, the market currently is trading at less than 15 times earnings. Therefore, we believe stocks can outperform and offer superior returns going forward. We remain comfortable slightly overweighting equities and retaining a slight overweight in cash, as a reserve.

Given our expectations for continued weakness in the U.S. dollar, international equity exposure offers a play on the relative strength of foreign currencies. In addition, the overall valuation of international equities is less than the valuation of the U.S. stock market. When we combine these factors with the hope that European markets will stage a rebound, we recommend overweighting international stocks.

The Fed's tightening program is designed to limit the appeal of riskier assets, which initially has been reflected in stocks. Nevertheless, for the Fed to accomplish its goals, longer-term interest rates will have to move higher. This is why we're currently underweighting bonds.

In conclusion, we believe that the economy is still capable of growing at a trend basis for a long period of time. The slowdown in momentum that we're seeing now is not unusual in this mature phase of the business cycle. In fact, we believe that with businesses generating record performance, the negative impact of slowing growth and higher interest rates will be more than offset, and that the stock market is still well-positioned to advance. ■