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INVESTMENT MANAGEMENT

NEWSLETTER

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POST IRAQ

A Comparison To The Gulf War

Since the beginning of the year, investors have been preoccupied by the prospect of war with Iraq and now by the war itself. Compounding investor concerns over the geopolitical situation, the economic recovery began to lose momentum. A look back to the 1990-1991 experience may offer an interesting, albeit imperfect, analogy to the current situation.

The cloud overhanging the economy and the equity markets today is in many ways similar to that seen during the Gulf War. The similarities include military confrontation with Iraq, decelerating global growth, sharply higher energy prices, deteriorating consumer confidence, and decreased capital spending.

There are also differences between the two periods. One of the most important is the perceived length and scope of each conflict. By early 1991, it was evident the war would be short-lived and geographically contained within the Middle East. The current situation is not as clearly defined and its duration is unknown, both with regard to military action and subsequent rebuilding of Iraq. Furthermore, the events of September 11, 2001 increased the possibility of retaliatory terrorist attacks outside the region.

The current economic environment also has dissimilarities from that of 1990-1991. In 1991, following a brief recession, the economic recovery was well underway with consumer spending on many discretionary categories rising. Home and auto sales were also rebounding in response to lower interest rates. In contrast, consumer spending in these categories has slowed this year, following significant and sustained strength during the past several years. During the fourth quarter, the economy advanced only 1.4, down from a 4.0% growth rate during the third quarter; and thus far, the data suggests continued softness during the first quarter of 2003. The retail sector, in particular, was handicapped by a confluence of elevated terror alerts, severe winter weather, and deteriorating consumer confidence.

CHART I

Consumer Confidence & Gross Domestic Product

1988-2003

This deterioration in consumer sentiment is important, as it is highly correlated with overall economic activity. Throughout last year, consumer confidence declined and is currently near 10-year lows (See Chart I). In 1990, consumer sentiment also declined precipitously but recovered in early 1991 as the war neared its end. Similarly, consumer sentiment is expected to improve in 2003 with favorable military developments. In addition, this will positively impact the financial markets.

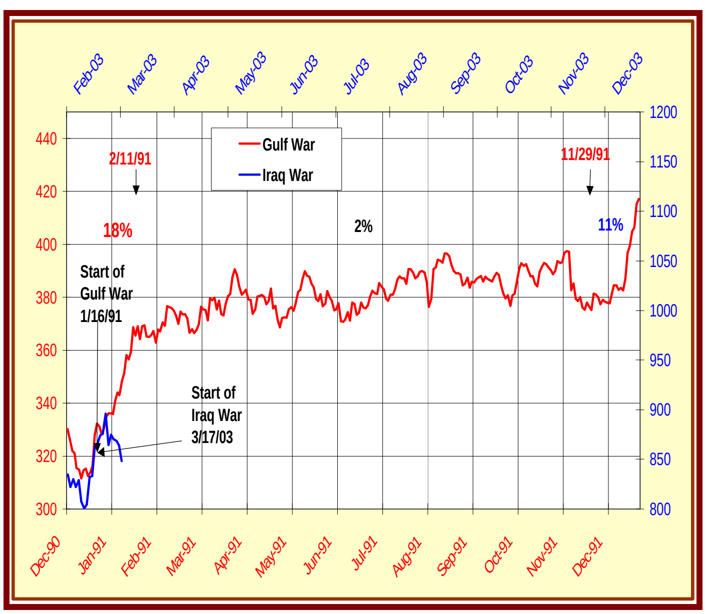
Once the hostilities with Iraq are concluded, the economy should also benefit from a favorable monetary policy and lower crude oil prices. Monetary policy, and money supply in particular, have been important factors in the initial recovery. At the end of 2001, money was growing in excess of ten percent. Even though its growth rate decelerated over the last year, money is still increasing nearly four percent faster than the underlying inflation rate. As a result, interest rates are at the lowest levels in nearly 45 years. This has, undoubtedly, been instrumental in moderating the deceleration in the economy and could avert a "double-dip" recession.

Energy costs declined sharply during the post Gulf War experience. From a pre-war peak of $39 a barrel in 1990, crude oil dropped to $19 by the end of 1991, and the Consumer Price Index dropped from 6% to 3%. If a similar phenomenon develops after the current conflict, it could help sustain the economic expansion in 2003. Lower oil prices free up funds for consumer discretionary spending and manufacturers also benefit through lower material costs.

INVESTMENT STRATEGY

Initially, stocks market reacted negatively to decelerating economic growth and the prospect of war. From the beginning of the year through mid-March, the Standard & Poor's Index declined 8%. This followed a 38% compound decline from the prior three years. Once hostilities were imminent, stocks rebounded; similar to what happened twelve years ago. Despite the quarter-end rally, the Standard & Poor's 500 Index still registered a 3.2% decline for the quarter, while the Dow Jones Average declined 3.7%.

CHART II
S&P 500 Index Performance
Gulf War vs. Iraq War



By year-end 1991, stocks advanced more than 30% from their pre-war levels (See Chart II). More than half of the gain (18%) occurred within the first month. The initial rally was followed by a ten-month period in which the market traded "sideways", advancing only 2%. As economic growth accelerated, stocks rebounded another 11% in December.

In 1991, however, the stock market recovery benefited from a sharp decline in interest rates. Yields for long maturity bonds dropped by a full percent while shorter maturities dropped by more than two percent. In 2003, stocks are unlikely to benefit from further interest rate declines as in 1991. To the contrary, interest rates began to rise from their mid-March lows. Therefore, returns from stocks may not be quite as robust as in 1991.

In the near-term, stocks are likely to continue to be driven by the course of the war. Ultimately, however, investors will focus on fundamentals. Right now, the fundamentals – earnings growth and valuations – are improving. Earnings are growing once again and are expected to rise approximately 7% both this year and next. While valuations are not at historical lows, they are significantly lower than in the late 1990s, and stocks are undervalued considering today's low interest rates. Therefore, the process of increasing the portion of the portfolio allocated to common stock should continue in spite of near-term war uncertainties.

Returns from cash reserves represented an attractive safe haven from pre-war uncertainties and declining stock prices. Such risks have now diminished and minimal returns from cash reserves are not a viable longer-term investment strategy. Furthermore, interest rates could experience a modest rise later in the year. Thus, bond investments should become more cautious as the risk in this sector could increase if inflation rates were to rise.

TABLE I
Market Performance Comparison
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/02	3/31/03	Return
Standard & Poor's 500	880	848	-3.2%
Dow Jones Average	8,342	7,992	-3.7%
NASDAQ	1,336	1,341	0.4%
EAFE Index	953	887	-6.9%
3 Mth U.S. Treasury Bill	1.2%	1.1%	0.3%
10-Yr U.S. Treasury Bond	3.8%	3.8%	1.1%
10-Yr AAA. Tax-Exempt	3.7%	3.6%	1.7%

*Estimate

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