



# EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

## NEWSLETTER

October 2003

### **LOWER INTEREST RATES AND TAXES**

*Can they Invigorate the Economy?*

**I**ronically, the first phase of the economic recovery began in the quarter immediately following the September 11<sup>th</sup> attack. The rebound was ignited by a combination of plunging interest rates and tax rebates, which led to a \$500 billion increase in the economy in two years. But, the acceleration out of the recession was uneven and failed to generate enough momentum for the recovery to maintain itself.

The impact of the 2001 stimulus package was muted by:

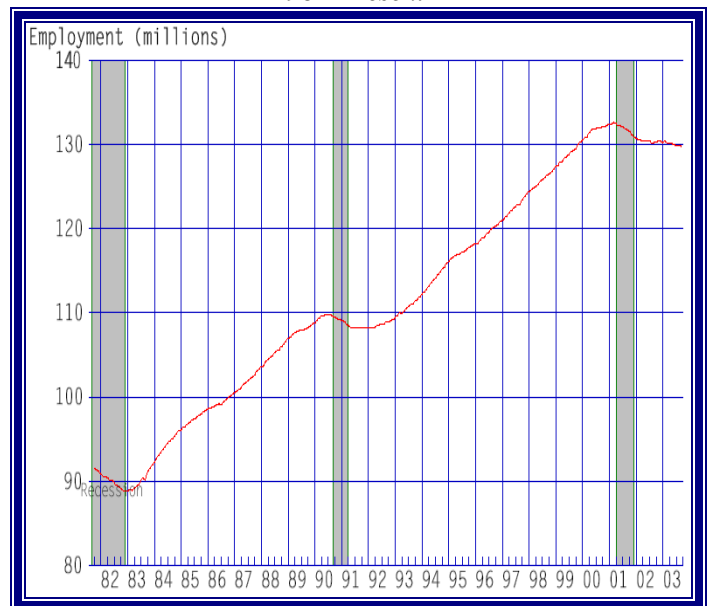
- 1) September 11<sup>th</sup>, distressed a number of cyclically sensitive industries such as travel and leisure.
- 2) The technology and communications sectors continued to struggle with excess capacity and a weak demand.
- 3) Our balance of trade deteriorated by approximately \$185 billion over the last two years. Had that not happened, economic growth would have exceeded 3.0% rather than the actual 2.3%.

The combination of these factors contributed to a weakening job market. Throughout the first two years of the recovery, employment declined and the economy lost 500,000 jobs! Typically, employment continues to decline during the initial phase of an economic expansion, but usually starts to increase within 6 – 9 months after the recession (See Chart I). This time, the lag has been considerably greater, setting the stage for a second round of stimulus.

This year, an even stronger dose of monetary and fiscal stimulus was instituted to re-accelerate the economy. The Federal Reserve pushed short-term interest rates to their lowest levels in nearly a half century and accelerated

money supply growth up to 8%, far exceeding the underlying growth rate in the economy. In addition, Congress enacted the largest tax cut in the Nation's history. These changes re-accelerated the economy; however, their full impact can take up to a year or more.

**CHART I**  
**U.S. Employment**  
*1982-Present*



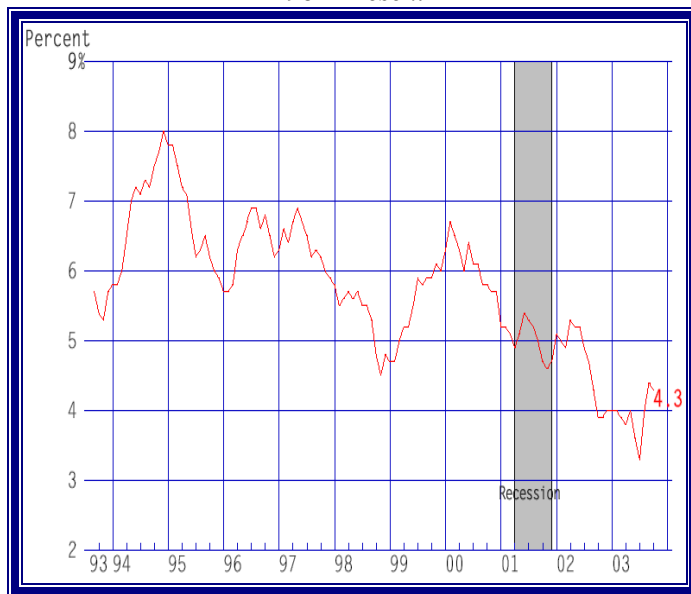
On this basis, the outlook for the balance of this year and 2004 remains encouraging. In addition, a 10% decline in the value of the dollar over the last twelve months should help reverse some of the deterioration that took place in our trade balance over the last several years. A cheaper dollar will make our goods more price competitive, increase production in our Nation's plants, and renew employment growth. Therefore, as the economic recovery becomes

more entrenched next year, growth rate could accelerate into the 3.5% - 4.0% range.

## INVESTMENT STRATEGY

This suggests that a divergence could develop in the relative performance between the bond and stock markets over the next year or so. Bonds, which generated handsome returns during the three-year bear market in stocks, have moved into an economic environment that could become quite challenging.

**CHART II**  
**10 yr. Treasury Yield**  
1982-Present



Bond prices declined during the third quarter in response to a half percent increase in most intermediate- and longer-term taxable rates (highlighted on Chart II). Looking forward, the combination of the 2003 tax cuts and the cost of the war in Iraq will undoubtedly escalate the Federal deficit and pressure the fixed income markets further. Thus, bonds could face additional risk.

The Standard & Poor's Index closed the third quarter at 996, 14.7% higher than at the beginning of the year (including the re-investment of dividends). These stock market gains occurred as investors anticipated the benefits of fiscal and monetary stimulus on corporate earnings. The recently completed third quarter had a modest gain of 2.5%, as stocks faced a head wind of rising interest rates.

**CHART III**  
**S&P 500 Trailing Price-Earnings Ratio**  
1987-Present



In spite of the first half increase, valuations appear reasonable and the speculative bubble from the late 1990's has been removed (Chart III). Because there has already been a significant increase in earnings, the price-earnings ratio for the Standard & Poor's Index rose modestly this year. The Index is currently selling at 19.7 times trailing earnings, but earnings are expected to increase at near double digit growth rates for the balance of this year and throughout 2004. Looking further ahead, this translates to a multiple of 17.2 times projected earnings for next year, which is consistent with historical price-earnings ratios and reasonable given the current interest rate environment. Accordingly, stocks are now selling at a level from which further price appreciation can accompany the growth in profits.

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

MARKET INDEX	12/31/02	9/30/03	Return
Standard & Poor's 500	880	996	14.7%
Dow Jones Average	8,342	9,275	13.1%
NASDAQ	1,336	1,787	33.8%
EAFE Index	953	1,109	15.8%
3 Mth U.S. Treasury Bill	1.2%	.9%	.9%
10-Yr U.S. Treasury Bond	3.8%	3.9%	1.7%
10-Yr AAA. Tax-Exempt	3.7%	3.5%	4.2%

\*Estimate

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