

# The RORER REVIEW

FALL, 2002

*A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC*

## **MARKET MYTHS**

In last quarter's *Rorer Review*, we argued that the economy would strengthen gradually throughout the balance of the year, even while inflation waned. We based our confidence in the economic recovery on a number of factors, including low, and falling, interest rates, healthy growth of the money supply, rising productivity, a positive turn in the inventory cycle, rising corporate earnings, and favorable fiscal policy. Nonetheless, evidence at the end of September supports the thesis that the economic recovery may be struggling to keep its footing. For one thing, U.S. manufacturing contracted in September for the first time in eight months. Further, evidence is developing that unemployment, currently at 5.7%, is likely to rise in the coming months. Notwithstanding the stagnant job market, certain segments of the economy have held up well. Continued strength in automobile sales and the housing markets has surprised many observers. In fact, the service sector of the economy continued to strengthen in September, marking its eighth straight month of expansion. Overhanging all of this is the threat of war in Iraq and its potential chilling effect on the psyches of the consumer and investors alike.

Nonetheless, we are optimistic that the U.S. economy is not sliding back into a recession and that the economy *will continue to grow* for the balance of 2002 and throughout 2003. The driving force behind this positive sentiment is the phenomenally low interest rates extant in the country today. Short-term

rates have plummeted this year, and the Federal Reserve Board is prepared to lower them some more. As this is written, 10-year government interest rates are at 40 year lows. These low long-term interest rates are triggering a record amount of mortgage refinancing, providing important liquidity for consumers. One of the surprises of this year is how well the consumer has borne up in the face of an historic bear market in stocks. In spite of all the uncertainty created by the deflated technology bubble and the prospects of a possible conflict in the Middle East, the consumer has kept the economy going. Notwithstanding the recent spate of earnings warnings from a handful of U.S. corporations, earnings are growing at a reasonable pace and our expectation is that they will continue to do so for the balance of the year and throughout 2003. Productivity is surging, unit labor costs are down, and profit margins are widening. Corporate America, albeit frustrated by its lack of pricing power in

a highly competitive and virtually inflation-free environment, is extremely lean and continuing to recover from last year's recession.

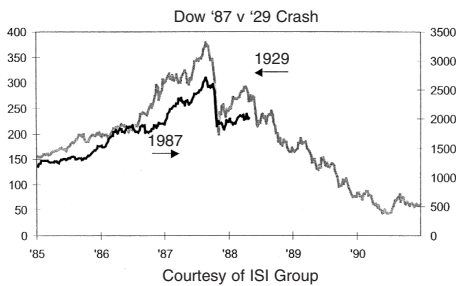
The equity markets have turned in a woeful performance this year and investors are deeply concerned about the future. Amidst the deepening gloom there is a growing consensus that our economy and markets are in for a decade of lackluster growth, somewhat like the Japanese experience of the 1990's. In order to support this thesis, some pundits have compared the price chart of the Nikkei averages of the late 1980's with the NASDAQ price chart of the late 1990's. By correlating the early "up" moves in each index to the peak in prices, this analysis presumes that our markets will continue to track along the preordained (downward) path that the Nikkei has followed for the last decade. It's not a very appetizing roadmap.

Thankfully, the analysis is deeply flawed, and falls into the maw of market myths that are currently making the rounds on TV talk shows and in the financial press. The argument is intellectually appealing to those who are seeking to divine the market's future by looking at a permutation of its past. We recall a similar argument being made following the 1987 crash. The comparison back then was, heaven forbid, with the 1929 crash. The 1987 thesis, using the earlier experience as a guide, was that our own economy would slip into a 1929-style depression and the market crash of 1987 was just the start of our economic and stock market misery. The accompanying chart first appeared in early 1988, tracing both

### **LARGE CAP RELATIVE VALUE EQUITY 10 LARGEST HOLDINGS AS OF SEPTEMBER 30, 2002\***

**Bank of America  
Cardinal Health, Inc.  
ConocoPhillips  
HCA - The Healthcare Co.  
Johnson & Johnson  
MBNA Corp.  
Marsh & McLennan  
Microsoft Corp.  
Pepsico Inc.  
Viacom Inc. - Class B**

market periods through their respective crashes and initial recoveries. Investors who based their 1988 investment decisions on this chart missed the substantial recovery that ensued in the years that followed. They failed to recognize that there were significant structural differences in the economy of 1929 and that of the late 1980's. And that is what creates the myth: the easy analysis is overlaying one chart over another and believing the future lies before our eyes. The more difficult task is to treat the chart comparison analysis skeptically and to delve deeper into the structural differences in the respective economies behind the temporarily correlating stock charts.



The Federal Reserve monetary policy turned sharply restrictive in 1928 and remained tight throughout the early 1930's, even in the midst of the Great Depression. Overlaid on top of that disastrous policy were the infamous Smoot Hawley tariffs, passed by Congress in June of 1930. These tariffs infuriated our trading partners and within two years 25 countries had retaliated with punitive tariffs of their own. Contrast that experience with what occurred following the crash of 1987. The recently appointed Federal Reserve Board Chairman, Alan Greenspan, reacted swiftly to the crisis by aggressively adding monetary reserves and forcing down interest rates. Protectionism did not raise its ugly head, corporate profits remained healthy and the domestic economy continued to grow. And the stock market did not follow the Depression-era script many had predicted.

The Japanese paradigm is equally faulty. Once again, the most important

distinction between the approaches the two central banks took to the post-bubble environment lies in monetary policy. The Bank of Japan was deeply concerned about inflation and continued to raise rates and tighten money for more than two years after the peak in the Nikkei index. Moreover, six years into the downturn, Japan raised taxes and cut government spending. In addition, Japanese corporate culture discouraged layoffs with the result that employment kept increasing even as profits were plummeting in the early 1990's. A decade later, the policy responses to the economic downturn in the U.S. were almost precisely the opposite from what had occurred in Japan. Two years after the market peak, the Fed had cut interest rates aggressively, reducing the Federal Funds rate from 6.5% to 1.75%. Further, in an effort to stimulate the economy, Congress cut taxes and increased government spending. U.S. corporations, for their part, reacted swiftly to the economic downturn by slashing their expenses, reducing their payrolls if necessary. Consequently, domestic corporate profits have rebounded in 2002, in stark contrast to the Japanese experience of the 1990's. Decidedly, the U.S. economy today has little in common with the Japanese economy of ten years ago. And our stock market will respond to what is happening in our economy and to our corporate profits and will not be a slave to what occurred on another continent a decade earlier.

The other myth we would like to address is the "Guru" myth. Human nature is such that each of us would like to know what the markets are going to do in the future. There is no dearth of pundits to satisfy this craving. Every day on television, or in the financial press, so-called experts opine on the market's direction. If one of them happens to make a major prediction and get it right, the adoring investor class may afford that person "guru" status. Although a mere mortal, the guru is a strange animal. Often laboring in

obscurity before lightning strikes, he or she is suddenly thrust into the limelight and is quoted liberally in the financial press and is a much sought after guest on the financial network shows. A book deal might be struck with a major publishing house. A rabid and enthusiastic following develops and hangs on their hero's every word.

In emotional markets such as this one, investors are particularly susceptible to the guru's siren song. It gets sung every day in the financial press and sooner or later people start to believe it. Unfortunately, there are no guru's. It is a cruel myth. No one, absolutely no one, can predict the market's direction or the duration of a market move with accuracy and consistency. Some folks who have obtained cult status through the years include Charley O'Hay, Jim Dines, Joe Granville, Bob Prechter, Elaine Garzarelli, and Abby Joseph Cohen. Each was a superstar in the lore of the stock market forecasting business and each fell from grace, some with a thud and others more gracefully. Beware of the next name that appears on the list, whomever it might be.

One of the strict investment disciplines we employ at Rorer Asset Management is not to attempt to time the market. Time and time again, we have seen this approach fail. Though it might seem tempting in difficult times, such as the present, to run to cash, history tells us that the market rebound comes when it is least expected. Accordingly, we employ our investment disciplines to search out the highest quality companies that have attractive relative valuation and positive earnings momentum. In the long run, we believe that this approach will provide the best returns for our clients.

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\* The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results. The Ten Largest Holdings are not investment recommendations and may no longer be held in an account's portfolio.

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