FALL, 2003

# The RORER REVIEW

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

## SWEET SPOT REDUX

**WE** remain unabashedly positive on the economy. Last quarter's ***Rorer Review*** argued that we were on the cusp of embarking upon a kind of economic nirvana, a "sweet spot" if you will, of economic growth brought about by an historic confluence of monetary, fiscal and cyclical events. Recent trends have reinforced our positive view and we expect the fourth quarter of this year and all of 2004 to deliver a solid expansion in the economy, accompanied by strong earnings growth from corporate America.

We acknowledge that skepticism abounds. Some pundits are arguing that the recovery cannot be sustained until there is a meaningful improvement in job creation, something that has been lacking so far in the nascent recovery. Consumer confidence appears to be waning, perhaps affected by the fact that payroll jobs are down several percent from their pre-recession peak. Layoff announcements abound. The skeptics go on to argue that the consumer, largely responsible for sustaining the recovery until now, is "tapped out." The high price of energy is draining his resources, particularly as we move into the winter heating season. Moreover, the refinancing boom is behind us and, in hindsight, will have provided only a temporary lift to the highly levered consumer. Lastly, they argue, the fragile recovery is significantly endangered by the U.S. federal budget deficit, which looks like it is headed to the stunning level of $500 billion next year.

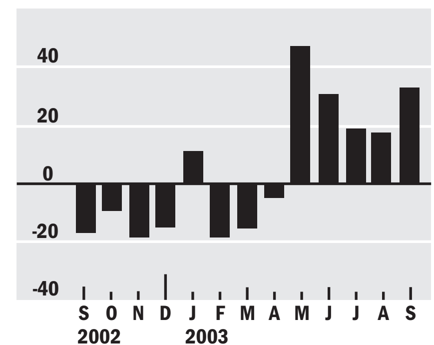
We believe that each of these arguments will recede into the background over the next year. As this is written, there is developing evidence that the employment picture is brightening. While manufacturing jobs continue to migrate overseas, significant job growth is occurring in construction trades, retail, financial services, health care, education, and the hospitality industries. Further, as noted in the nearby chart, temporary employment has turned up and this has consistently been a reliable lead factor for payroll employment. Moreover, corporate earnings are improving rapidly, providing fuel for an upturn in employment. Lastly, we are experiencing an unprecedented divergence between the growing strength in the economy on the one hand and the slippage in payroll employment on the other. In other words, the lines are going in opposite directions when pure logic dictates that they should tend to go in the same direction. The pessimists argue that payroll declines will drag the economy down. We argue just the opposite: the strengthening economy, notwithstanding record productivity, will bring the payroll numbers into positive territory in the not too distant future. It is possible that the unemployment rate, currently at 6.1%, could have an up tick in the coming months, but we believe it will be lower 6 and 12 months from now.

**LARGE CAP RELATIVE VALUE EQUITY**
**10 LARGEST HOLDINGS AS OF SEPTEMBER 30, 2003***

**Cisco Systems, Inc.**
**Comcast Corp. - Class A**
**Hewlett-Packard**
**Lowes Co.**
**Marsh & McLennan**
**MBNA Corp.**
**Microsoft Corp.**
**Nextel Communications, Inc. - Class A**
**United Technologies Corp.**
**Viacom, Inc. - Class B**

**Signs of Life**

Change in temporary employment, in thousands




Source: Labor Department via Economy.com

The high price of energy is always a potential concern to the consumer, because it is not generally a purchase that can be deferred. Thus, high prices for heating oil and gasoline act like a consumption tax, taking marginal dollars out of consumer pockets that could have been used elsewhere. Last winter, a convergence of events caused the price of crude oil to surge to over $35 a barrel. First, the United States

endured an abnormally cold winter, causing demand to soar. Second, Venezuelan oil workers went out on strike last December, causing the world's fifth largest oil producer to seriously curtail production. Last, the impending war with Iraq forced prices higher as oil traders imagined a worst case outcome to the impending hostilities. Certainly these unrelated events had a collective negative impact on the economy, though other stimulants kept it growing through this difficult period. Lately, the price of crude has slipped to about $30 a barrel, even though OPEC ministers recently agreed on a cut in production to keep prices up. Interestingly enough, the majority of OPEC countries continue to cheat on their production quotas as they seek to maximize revenue. Further, production in Iraq, home to the world's second largest oil reserves after Saudi Arabia, should easily surpass pre-war production levels in 2004. Finally, Russia is a major oil producer and is looking to increase production considerably in this and in future years. Our belief is that the increased supply of crude, due to the factors mentioned above, is likely to keep the price of energy stable to lower throughout the balance of this year and next. Needless to say, external factors, such as an act of terror or additional labor strife, could change that outlook, but on balance we believe that energy prices are more likely to help than impede the economic recovery.

The refinancing boom peaked this summer and mortgage applications for refinancing are now back to the much more muted level of that which existed in the early part of 2002. Some would argue that the decline of this activity spells trouble for the consumer because the stimulus to spending that this activity provided was a "one time" event. It is true that many homeowners took advantage of the record low interest rates to extract a "cash out" option from their mortgages. However, about 20% of those who refinanced their loans opted for lower monthly payments, thereby providing some ongoing stimulus for the economy. Further, it is worthwhile noting, even after the recent backup in rates, that 30-year mortgage rates, hovering around 6% today, are lower than they have been for the entire last decade through the end of 2002.

Lastly, we would like to address the ballooning budget deficit and its potential effects on the economy. The current estimate is for the budget deficit to reach $400 billion for fiscal 2003, or roughly 3.7% of GDP. The bad news is that these are big numbers and potentially frightening. The good news is that a budget deficit of this magnitude represents a *substantial stimulus for growth*. The U.S. Government is the largest purchaser of goods and services in the world. If Uncle Sam is using credit, which is what a deficit represents, to purchase those goods and services, he is purchasing more than he would have were he not using credit. In other words, he's buying more automobiles, computers and labor than he otherwise would have. This is stimulative to the economy in the short to intermediate term because it is creating economic activity where none would have existed otherwise. A look at recent economic history bears this out. Deficits of this magnitude, as measured by a percentage of GDP, occurred in 1976, 1983 through 1986, and 1991 through 1992. In the years following each of these periods, the economy rebounded smartly from its previous muted activity. In fact, the 1991-1992 era launched the "grand daddy" of post-war expansions. In the short term, then, budget deficits provide *stimulus* to a recovering economy. In the longer term, the hope is that the strengthening recovery will stimulate sizeable revenue growth so that the budget deficits will diminish and eventually disappear.

The equity markets recognize that a substantial economic recovery is at hand. Since the beginning of the year, the S&P 500 Index has advanced +13.2% and the more speculative NASDAQ is up +33.8%. As one might expect at the end of a devastating bear market for equities, the more volatile and the more speculative companies performed the best through this initial surge from the debilitating lows of last October. What is perhaps even more interesting is that companies *without* earnings and those that *don't* pay dividends tended to outperform those companies *with* earnings that *do* pay dividends over this period. Our judgment is that this is not sustainable. We are heartened by the growth in earnings emanating from corporate America as the economy continues to gather strength. Over the longer term, equity valuations have always had a direct correlation with earnings and we have no doubt that this axiom will reassert itself as the economic recovery matures in the years ahead. Going forward, we believe that investors will refocus their investment strategy toward high quality companies with strong earnings momentum. We expect that our clients will be direct beneficiaries of this migration in that our disciplined investment methodology starts from a universe of high quality companies that demonstrate attractive relative value and positive earnings momentum. This process, which is designed to outperform market returns over time with less volatility and risk, has experienced periods of underperformance from time to time in the past, but the disciplines have proven successful over the long term and we expect that they will do so in the future.

October 1, 2003

* 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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