SPRING, 2002

The RORER REVIEW

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

THE ROAD LESS TRAVELED

Two roads diverged in a wood, and I—
I took the one less traveled by.
Robert Frost

She moved uneasily in the quickening light as the dawn was breaking, certain that she was being followed. Furtively rounding the corner, she pressed herself against the damp wall and crouched in the shadows in an attempt to make herself less visible to those who were pursuing her. Shivering, she stopped breathing for a moment, quiet now, listening for telltale footsteps. They were close, but receding. She knew she had eluded them again, at least for now.

Still not moving, many thoughts crossed her mind. She wondered why she was perceived to be such a menace when she thought of herself as a weakling. "I am nothing," she thought. "I am frail and weak. I'm so small I practically don't exist, yet they treat me like a pariah, like a threat to their very way of life."

Readers of last quarter's ***Rorer Review***, entitled "The Breaking Dawn," might have a sense of déjà-vu all over again that they have seen these words before. In that piece, we took a metaphorical and somewhat whimsical journey by personalizing the developing economic revival. Some readers opined that we breathed life into the rebound, but were disappointed that we stopped short of actually giving it (him) a name. Though the notion of a strong economic recovery was scorned then, it has credence now. Indeed, with each passing day, it is more and more apparent that the recession of 2001 is over and that we have embarked on a dramatic new era of economic growth. Unemployment seems to have peaked at 5.8%. Fewer layoff announcements dot the journalistic landscape and corporate earnings surprises are more likely to be positive than negative. The markets have enjoyed a robust recovery from their lows of last September and a new optimism pervades the land. Who, then, is our diminutive heroine in the opening paragraphs?

She stepped back into the shadows as the sirens grew louder. She watched the vehicles race by. It was the Feds! She knew that the breaking dawn increased the risk of being discovered. She had heard that ***HE***, throwing all caution to the wind, had raced through the streets pounding his chest and proclaiming his existence. She shuddered when she thought about it. She knew that as recognition of his strength spread throughout the land they would fear her even more. She wept as she thought about the injustice of it all, and knew that she would have to stay in the back alleys and move about furtively on less traveled roads.

Yet, she was a realist. She remembered about all the arcane economic theories that had driven domestic policy decisions for the last 50 years. She knew all about Professor Phillips and his famous Phillips Curve. His theory posited that economic growth leads to falling unemployment and that at a certain level of unemployment there had to be a trade-off between falling unemployment and rising inflation. Now, with the economy strengthening, she knew that unemployment was likely to fall in the coming months. She smiled at the prospect of more people working. But her smile turned to a frown as the sound of recurring sirens reminded her that they were looking for her, wary about what she might do. She shook her head and sighed. She knew that the pundits, in a predictable Pavlovian response to an improving economy, were forcefully calling for the Fed to raise short-term interest rates. She knew that some long-term interest rates had already climbed and that mortgage rates were higher now than they had been only several months earlier. "What a shame," she thought. "All of this is so premature! I hope that they come to their senses and realize that I am not the threat they think I am."

LARGE CAP RELATIVE VALUE EQUITY
10 LARGEST HOLDINGS AS OF MARCH 31, 2002

Fannie Mae
General Dynamics
Intel Corp.
Johnson & Johnson
Marsh & McLennan
MBNA Corp.
Pepsico Inc.
Philips Petroleum Co.
United Technologies
Viacom Corp. - Class B

She realized that some recent statistics might have frightened them. She acknowledged that some commodity prices had turned up, fueling fears of a revivival in inflation. Gold, historically a reasonable inflation barometer, was knocking on the door of $300 an ounce, well up from its recent lows in the area of $260 an ounce. Copper, too, had been strong recently. And, while the average citizen might be unaware of the prices of those commodities, she knew that this was not the case with the price of oil and its attendant effect on the price of gasoline, which had climbed steadily since the beginning of the year. Consequently, it did not surprise her that U.S. consumer inflation expectations had rebounded strongly during the first calendar quarter.

Nonetheless, she didn't buy the argument that the recovery in these commodities was forecasting a return to strengthening inflation. If anything, she felt sickly and weak. She realized that the economic slowdown of 2001 had unduly depressed these commodities and their recent moves reflected the growing confidence people had in the health of the economy. Moreover, she believed that the price of oil, the ongoing strength of which posed perhaps the biggest threat to inflation, was well ahead of where it should be based on supply and demand fundamentals. True, she acknowledged that OPEC and Non-OPEC producers had agreed to maintain January production cuts through June, even in the face of a global economic recovery. Nonetheless, she knew her history well and realized that the producers were likely to cheat on their promises and produce above their quotas to enhance their revenues. The biggest threat of higher oil prices from the current level of $26 a barrel, she conceded, was the prospect of escalating conflict in the Middle East. Should that threat diminish, she thought the price of oil would probably retreat to the $20 to $21 range.

She fell to the ground, gasping for air. She knew that her vital signs were steady, even rising. The Core Consumer Price Index for February was up +.3% on a month over month basis and up +2.6% on a year over year basis. She felt that the supposed strength was temporary and an illusion. "*I am a sorry excuse for inflation*," she thought. "Many economists think I'm getting stronger, but my strength is ebbing and will for the foreseeable future. Don't they realize that productivity has turned up and is growing rapidly? Don't they realize that there is a significant amount of unused capacity in the manufacturing sector? And don't they understand that unit labor costs are falling? How about the strength of the dollar over the last year? Don't they realize that strength in the dollar diminishes me? Most of all, I'm confused that they seem to be ignoring history. Don't they realize that every economic recovery since 1971, all four of which occurred when the threat was much greater than today, has been characterized by falling inflation for at least 6 months and often much longer? Why do they expect me to be stronger than my parents and grandparents? I'm their progeny, but I've never lived up to their expectations. If I die, I suppose that they'll put my story on the cover of a national news magazine."

Epilogue

Needless to say, we at Rorer Asset Management view any imminent threat of inflation with a great deal of skepticism. We acknowledge that this view is not popular and in expressing it we are taking a lonely road, one less traveled by most observers and expert economists. Moreover, we believe that the recent rise in long-term yields has been overdone and expect that the second quarter will usher in lower rates than exist currently. For the record, the yield on the 10-year U.S. Treasury Note is 5.41% at the current writing. The primary risk to this forecast relates to the developing crisis in the Middle East. Should the current conflict continue to escalate, or if the US were to invade Iraq, the price of crude oil would rise further and inflationary pressures would intensify.

Regardless of what happens in the international arena, we expect that the domestic economy will experience a slowdown in the second quarter from the robust pace of growth it has enjoyed since the beginning of 2002. Several factors will contribute to this. First, as noted above, long-term interest rates have spiked recently, taking mortgage rates higher. Accordingly, fewer homeowners will enjoy the benefits of refinancing their mortgages in the months ahead than has been the case since the beginning of the year. Second, also noted above, the price of oil has risen sharply with the result that Americans are paying substantially more for gasoline now than just a few months ago. Unfortunately, this will act as an indirect tax on consumer purchasing power. Last, several central banks have recently raised short-term interest rates and there is a widespread expectation that the Fed will follow suit in the coming months. Were short-term rates to rise, this would undoubtedly have a deleterious effect on economic activity.

Notwithstanding the foregoing, we are very optimistic about the economy in 2002. We believe that the second quarter slowdown will be temporary and that the balance of the year will bring renewed and vigorous non-inflationary growth, accompanied by dynamic earnings acceleration across corporate America. As this occurs, we will continue to rely on our strict investment disciplines and relative value style of investing to identify the most compelling investment opportunities for our clients.

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