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The RORER REVIEW

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

SWEET SPOT

Any good athlete knows all about the sweet spot. That is the small space on a golf club, tennis racquet, or baseball bat that delivers the most efficient result when striking the ball. The result of a direct hit on the sweet spot is that the ball travels further with more energy than if the point of impact is slightly adrift of this perfect spot. In this issue of ***The Rorer Review***, we argue that a convergence of events is occurring that will have an enormously positive impact on economic growth in the U.S. economy. We liken this confluence to an economic sweet spot, one that is to be savored. First, we take a brief look at history so we can understand how we got here in the first place.

Journey back in time with us to the summer of 1979. There was an economic malaise in the air. The stock market, as measured by the Dow Jones Industrial Average, had peaked three years earlier at about 1000 and had been shuffling about in the 800 range for most of the year. Inflation, as measured by the Consumer Price Index, was on the verge of surpassing 9% and appeared to be getting worse with each passing moment. Short-term interest rates had been in "double digit" territory at 10% since the beginning of the year, apparently not high enough to stop the inflation juggernaut. President Jimmy Carter, unhappy with how Fed Chairman Bill Miller was dealing with the problem, fired him in July and nominated Paul Volcker as his replacement. Volcker was a mountain of a man and an imposing figure at 6 feet 7 inches, and he figured he had a big and dirty job ahead. One of the first things he did after being confirmed was to declare that inflation was "public enemy number one." In September, the CPI surpassed 12%. The battle was joined.

The newly minted Fed Chairman set targets for the growth of the money supply and started to push short-term rates up in earnest. By October he had had enough. On Saturday, October 6th, he held a news conference announcing that the Fed was raising the Discount Rate, the interest rate charged by the Fed on loans to its member banks, a full percentage point to 12%. The Federal Funds Rate, the overnight rate banks charge one another, soared from 11% to 16% in a flash. Mortgage rates followed suit, rising from 10% to 13% in a matter of weeks. The bond and stock markets cratered. Shortly thereafter, traders dubbed the news conference "The Saturday Night Massacre" due to the spectacular effect it had on the markets and on expectations for the future.

Paul Volcker, hated at the time for the angst he caused, has since been hailed as perhaps the greatest central banker of the 20th century. His dramatic move in October of 1979 served notice around the world that the Fed would no longer tolerate inflation.

Twenty-four years later, the world has changed. Mr. Volcker's successor, Alan Greenspan, in an extraordinary about-face, placed a remarkable, if not as spectacular, bookend on his predecessor's concerns on the evils of inflation when he stated on May 21st of this year: "the probability of an unwelcome fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation." A new mantra has been born. Mr. Greenspan, after preaching about the threat of inflation lo these many years, has served notice to the world that the Fed *will not tolerate a fall in inflation*. He wants inflation to *rise!* What was feared before is now embraced. He went on to say: "We cannot say that there is a severe increasing concern of deflation. Nonetheless, even though we perceive the risks as minor, the potential consequences are very substantial."

Long-time readers of these Reviews may recall that we have been skeptical of the threat of inflation for the last five years. Throughout this

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

Bank of America
Cardinal Health, Inc.
Comcast Corp. - Class A
Hewlett-Packard
Marsh & McLennan
MBNA Corp.
Microsoft Corp.
PepsiCo, Inc.
US Bancorp
Viacom, Inc. - Class B

period, we've argued that interest rates were too high and that economic growth was not to be feared as an automatic harbinger of inflationary pressures. We've railed against the Phillip's Curve theory, heretofore popular with some Fed governors, which posits that there is a correlation between falling unemployment levels and rising inflation. Our skepticism stemmed from the notion that technological advances were contributing to a dramatic increase in productivity throughout the global economy and that many old theories concerning inflation and employment levels were destined for the economic dustbin.

Deflation is a bad thing. It last occurred in the U.S. economy in the 1930's. More recently, it has occurred in Japan over the last decade. In a deflation, prices drop and the value of the underlying currency rises. On the surface this may seem like a good thing. Certainly, as consumers, we would like to pay lower prices for things and have the currency in our pockets be more valuable today than it was yesterday. But the extension of this thesis is that a deflation discourages consumption because consumers know that by waiting they will be paying less. Consequently, deflation is devastating for business. First, sales slow because consumers postpone their purchases to a later time. In order to stimulate sales companies are forced to cut prices, thereby crimping profits. As profits disappear, business is forced to cut costs by cutting production and reducing its workforce. Unemployment rises. Recession migrates into depression and a vicious cycle is born. Interest rates sink to almost zero and the stock market goes into the ashcan and stays there. Economic growth is nonexistent. The bad news bears, thriving on all the human misery, rush to publish "How to Survive..." books that quickly vault to the top of the New York Times Bestseller list.

Well, this is a "bad news...good news" story. The bad news is that deflation is catastrophic and debilitating. The good news is that all this talk about it happening in the United States is arrant nonsense. That is to say that we believe that there is absolutely no credible threat of deflation occurring in the U.S. economy anytime in the foreseeable future. No chance!

On the contrary, as mentioned in the preamble, we would argue that the U.S. economy is moving into a sweet spot where everything is likely to go better than is currently expected. In fact, we would posit that the economy is now at a turning point. Yesterday's talk was of sluggish growth, disappointing earnings, rising unemployment, and the grim possibility of deflation. Tomorrow's talk will be of a rebounding economy replete with better than expected earnings, rising capital expenditures, and rising employment. And here's the really exciting part: while this growth is materializing, the Fed will accommodate and stimulate the growing economy *by keeping interest rates far lower far longer* than they would have at any time since Mr. Volcker declared war on inflation back in the 1970's. That's the sweet spot, and we are looking forward to taking advantage of it as it unfolds.

The markets sense that the turning point is at hand. In the second quarter, the equity market delivered its strongest quarterly return since 1998. Moreover, the securities of companies that will benefit from an economic rebound generally outperformed those of companies that have less cyclical exposure. Corporate bonds handily outperformed U. S. Treasury securities as investors showed an increased willingness to take on risk, a sure sign of growing confidence in an economic rebound.

In recent ***Rorer Reviews***, we have outlined a long list of reasons why we believe a strong recovery will materialize in the second half of this year. Some of those include robust productivity, low interest rates, record-setting refinancings, the strength of housing, a turn in the inventory cycle, and intensely favorable monetary and fiscal policy. In the last three months, quite extraordinarily, the economic stimulus package has strengthened even further. An additional tax cut package was passed in May that is expected to pump more than $225 billion into the economy in the next two years, $50 billion of which will occur in the current quarter alone. Moreover, the second quarter saw interest rates fall even further as the Fed lowered the Federal Funds rate a 13th time to 1%, with longer rates, including mortgage rates, following suit. During this period, bank loans picked up, the money supply expanded and the dollar fell further, thereby stimulating foreign demand of U.S. goods. Our judgment is that the current round of economic stimuli operating on the domestic economy is unprecedented in U.S. history. Accordingly, we expect the economy to rebound smartly, accompanied by an even stronger rebound in earnings from a productive, though lean and hungry, corporate America.

At Rorer Asset Management, we believe that an improving economy is likely to increase valuations of the companies that comprise corporate America. With an improving economy, we will employ our disciplined investment process to focus on those companies that are trading below their historic norms relative to the market that we perceive will be beneficiaries of the cyclical upturn at hand.

July 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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