

The RORER REVIEW

WINTER, 2002

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

THE BREAKING DAWN

*How oft the darkest hour of ill
Breaks brightest into dawn.
Euripides*

He moved uneasily amongst the shadows in the pre-dawn hours, wondering if he were being followed. Furtively rounding the corner, he turned up his collar in a futile attempt to keep the developing mist from enveloping his very being. Shivering, he stopped, quiet now, listening for telltale footsteps. There were none. "This is strange," he thought. "No one knows I'm here."

Still not moving, many thoughts crossed his mind. He wondered why he was being ignored, even scorned. He remembered seeing the headlines: "Fed Cuts Rates An Unprecedented 11 Times...To No Avail." He mused about the National Bureau of Economic Research having declared recently that the U.S. economy is in recession. He managed a weak smile as he thought about the irony of that!

He wondered about the pessimists, those who denied his very existence. Their arguments were, and are, well known and continue to receive wide attention in the nation's financial press. Their view is that the tragic events of September 11th toppled a floundering economy into a recession that will likely endure into 2003. The evidence, they argue, is

everywhere. The unemployment rate recently rose to 5.8%, its highest rate since April of 1995, and will likely rise further as we move through the winter and into the spring. Payrolls are continuing to decline, a clear sign of ongoing recession. Over 1.1 million jobs were lost in the last four months of 2001 alone, the worst reading in 21 years. Every single day brings news of more layoffs from corporate America and their devastating impact on people's lives. Even America's strongest companies continue to shutter factories. Retailers are closing stores or announcing plans to open fewer stores than had been planned only six months ago. The consumer, representing two-thirds of the economy, is fully sated and tapped out from a decade of over consuming. Lastly, in this new era of the global economy, Argentina and Japan seem to be in real trouble. The

former seems poised to default on its national debt and devalue its currency. The latter is mired in a prolonged recession with no end in sight. Further deterioration in either economy could cause an economic crisis and the resultant fallout could easily spread to other countries and eventually affect other economies around the world, including our own.

He thought about the pundits' jeremiads and his mien grew serious. "I'm here," he bellowed at the top of his lungs. "Can't you hear me? Can't you see me?" He heard his words echo through the canyons of the city and wondered if anyone had heard. He thought: "If they hear me, they're not listening!" As the echoes faded away, he heard only the sound of silence once more. But, he looked up and noted that the dawn was starting to break and that the air was clearing. "I've got to keep moving," he thought. "I've got to let people know I am here!"

He started to meditate about the irrefutable proof of his genesis. He thought about the most important reason first: in calendar year 2001, the Fed had lowered interest rates 11 times. The Federal Funds, or overnight borrowing, rate had declined from 6.5% to 1.75% in the span of 12 months. "Incredible," he thought. "This kind of stimulus has never occurred before!" And then he reflected about the pessimists who

LARGE CAP RELATIVE VALUE EQUITY 10 LARGEST HOLDINGS AS OF DECEMBER 31, 2001

Citigroup Inc.
Electronic Data Systems
Fannie Mae
General Dynamics
Intel Corp.
Marsh & McLennan
MBNA Corp.
Pepsico Inc.
Phillips Petroleum Company
Viacom-B

were arguing that the stimulus was akin to “pushing on a string” and that the aforementioned job statistics were evidence of this. “They are forgetting,” he reasoned, “that there is an important *lag effect* between when interest rates are lowered and when their stimulative effect starts to take hold in the form of increased economic activity. Typically, it has taken about one year for this to occur.” And then, smiling, he recalled that the Fed started lowering rates in January of 2001, about one year ago! And his smile broadened even further when he considered that the central banks of the world were all acting in concert to stimulate their own economies at the same time.

While thinking globally, he recalled how important the price of energy is to the economies of the world. He noted that the price of crude oil had fallen over 40% since the autumn of 2000. He remembered how upset consumers were at the beginning of 2001 when they had to pay nearly \$2.00 a gallon for gasoline and when heating oil prices were so dear that they had to curtail their spending on other items. “With the price of energy in the ashcan,” he chuckled, “consumers will have more funds available for other things, be they necessities or luxuries. This pullback in the price of energy is like a giant tax cut and will therefore help to jump start the economy!”

“Speaking of tax cuts, I’d almost forgotten that Congress passed a tax reduction package last summer! As I recall, it was to be phased in over several years, and this year’s benefit amounts to about \$38 billion. That alone would raise economic growth by an important amount. But there’s

more. Following the September 11th terrorist attacks, Congress passed an emergency package that will boost spending by about \$25 billion in 2002. And on top of that Congress approved an \$18 billion rescue package for the nation’s airlines.”

A smile creased his lips as he realized what the combination of monetary and fiscal policy meant to his very existence and to his feeling of self worth. Pausing, he raised his eyes. Indeed, the sky seemed brighter and the mist and fog had cleared.

His thoughts turned to the economy itself. His eyes glazed over as he thought of past capital spending cycles and the overcapacity spawned in the economy by the Y2K phenomenon. He thought about the technology bubble in the stock market and how it caused the cost of capital to go to zero for many “dot.com” entrepreneurs and the misallocation of economic resources that ensued. He realized that the market, in its wisdom, had corrected the excess. In the natural course of events, rationality had returned. As he thought about it some more, he noted that as the market wrung the excesses out of the economy, inventory liquidation was occurring at an incredible pace. Then it hit him like a ton of bricks! He remembered that over the last decade a three-year inventory cycle had unfolded. He observed that periods of inventory liquidation had occurred in 1992, 1995, 1998, and again in 2001. In fact, he remarked that the inventory drawdown in 2001 had been far more severe than in any of the previous instances. “What if,” he mused, “businesses realize that inventories have been drawn down too far?” He noted that, in each of the previous cycles, inventory restocking

had provided a substantial lift to the economy as companies scrambled to replenish their shelves. “My heavens,” he thought. “This could be a big plus for the economy all by itself!”

The gloom of night had passed. The dawn had broken. As the first rays of sun danced on the morning horizon, he ran euphorically through the streets shouting his message to anyone who would listen. “I am alive. I am here now. Not tomorrow, not next week, not next month. Now! I am the economic recovery, born from fiscal stimulus, favorable monetary policy, and positive economic cycles all occurring at the same time. At first, I might stumble a bit, but my legs will grow stronger as time passes. Ignore me at your peril!”

Epilogue

At Rorer Asset Management, we believe that the recession has ended and are adjusting our portfolio strategy accordingly. As always, we will adhere to our strict disciplines to guide us as we make our investment decisions. We acknowledge that there may be some bumps in the road along the way to recovery and we are mindful that there are several areas of concern both in the U.S. and abroad. We will keep a watchful eye as events unfold.

January 1, 2002

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