

# The RORER REVIEW

WINTER, 2004

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

## **MORE TO COME!**

For the last year or so, the *Rorer Review* has argued that a confluence of economic events would lead to dynamic economic growth, both domestically and in the global economies. In our summer edition, "Sweet Spot," we argued that deflation, a threat that the Fed had argued was credible, taking interest rates to 40-year lows along the way, would not occur in the United States in this economic cycle. In the fall edition, "Sweet Spot Redux," we opined that the high price of energy, the end of the refinancing boom, and the ballooning federal deficit would not sidetrack the developing economic recovery. The good news is that so far we have been right. The really good news is that there's more to come. Much more.

2004 looks like it will be a spectacular year for the economy, sporting robust GDP growth accompanied by low interest rates. The phrase "jobless recovery," abundantly mentioned in the financial press only several months ago, will disappear from the lexicon altogether as the year progresses. Business confidence will continue to improve. Capital expenditures will rise. Corporate profits will climb to record levels. Consumer sentiment will remain high. Indeed, we are on the brink of a global economic boom.

As always, there are caveats, any of which could dynamically alter the positive outcome we envision. First, we have the "ism's," terrorism and protectionism. Second, we have the threat of substantial further weakness in the dollar. Third, somewhat related, we have the threat of

rising interest rates.

Late last year, the government raised the U.S. national terrorism alert to "High Risk." Since then, there have been several high profile flight cancellations of international flights. Clearly, the threat of terrorism has sadly become a way of life in America. Nonetheless, we believe that we are winning the war on terrorism, though we acknowledge that occasional battles may be lost along the way. Any significant domestic act of terror would certainly have a chilling effect on our economy. Unfortunately, there is no way to predict when, or if, an incident may occur.

Protectionism, like terrorism, is the enemy of free markets. Almost two years ago, the United States slapped steel tariffs on Europe and Japan, both of which threatened retaliation. In early December, President Bush rescinded the tariffs, well in advance of their expected expiration dates, thereby averting a trade war. However, only several weeks earlier, the Administration

had imposed quotas on a variety of Chinese fabrics in a partial response to a \$100 billion trade deficit with China. Some sort of retaliation may be forthcoming. We expect that these skirmishes will not escalate into a full-scale trade war but recognize that increasing evidence of protectionism will not be received well by the markets.

The weakness of the dollar, if it doesn't go too far, is beneficial for the U.S. economy because it makes American goods and services less expensive abroad. Coupled with a synchronized global upturn, the dollar's weakness will contribute to a substantial rise in U.S. exports this year. However, if the dollar's slide should turn into an avalanche, foreigners may lose confidence in our economy and bail out of their dollar denominated assets. This would put upward pressure on interest rates and increase inflationary pressures at the same time. Several weeks ago, OPEC announced that it would not raise production quotas even though the price of crude is above its target range. Their rationale is that the dollar's weakness is resulting in less oil revenue for their members than otherwise would have been the case. Our hunch is that further weakness lies ahead for the dollar, but that the decline will be orderly and won't affect markets or confidence in the U.S. economy.

We have seen the lows in interest rates for this cycle. While the Fed has held short-term interest rates at their lowest levels in 45 years, the bond market has responded to the strength in the economy with falling prices and therefore higher interest rates. The 10-year Treasury bottomed in June at 3.11%

### **LARGE CAP RELATIVE VALUE EQUITY 10 LARGEST HOLDINGS AS OF DECEMBER 31, 2003\***

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

and today yields about 4.25%. Nonetheless, the Fed has pointed to slack in the economy, robust productivity and intense global competition as key themes likely to keep inflation at bay well into 2004, if not 2005. Accordingly, in pronouncement after pronouncement, the Fed has inferred that it will not be raising short-term rates in the near future. Thus, we continue to be in an economic “sweet spot” with robust economic growth accompanied by low inflation and low interest rates. However, and we believe this is an unlikely outcome, should the Fed feel the need to start to defend the dollar against further weakness, it may choose to raise short-term rates as one of its policy options.

The economy finished 2003 on a very strong note, and we see no signs of a trend change as we head into 2004. In fact, there is lots of evidence that growth may accelerate in the New Year. We base our optimism on a number of factors, namely global economic trends, market price indicators, the heroic consumer, and the equity markets.

The economies of the world are flourishing in unison, lending strength to one another and therefore, by extension, to our own economy. China is the poster child for this expansion and is now the leading source of economic growth in the world. Chinese officials are targeting a *quadrupling* of GDP from 2001 to 2020. India is not far behind. Japan is on the rebound. Thailand, South Korea, and Western Europe are all exhibiting exceptional growth leading to a synchronized global recovery that will boost corporate profits the world over. Our multinational companies will be huge beneficiaries of this trend.

Market price indicators are wonderful barometers for the economy because they represent the collective wisdom of investors around the globe. Two of these that we find particularly useful are the yield curve and commodity prices. The yield curve represents the spread between the yields on

long-term and short-term Treasury notes. At the current writing, the spread between the 10-year and 2-year note is near its highest level in a decade. A wide spread in these rates is a harbinger of a strong economy. The last time the spread approximated its current reading was in the latter part of 1992 at the start of the longest economic expansion in post war history. While we don't have the courage to suggest that the current expansion will emulate that of the 1990's, we are confident that the current yield curve is predicting a strong continuation of the growth the economy experienced in 2003. Another indicator of strong growth ahead is the strength of commodity prices. The Commodity Research Bureau Index, a broad based index of commodity prices, recently hit its highest levels in 15 years. Reflecting price levels for industrial and precious metals, fuel, lumber, and agricultural products, rising commodity prices are a function of the demands of growing economies. From time to time in the past, rising commodity prices have led to increasing inflationary pressures. However, in an interesting twist to historical relationships, the booming economies of China and India are resulting in huge demand for commodities that are recycled into low priced finished goods thereby putting *downward* pricing pressure on the end products exported to the rest of the world.

The consumer, representing two-thirds of the economy, is alive and well, despite the call of many pundits for his imminent demise. Many had thought that the end of the refinancing boom in the face of a jobless recovery would cause a consumer retreat. In fact, the opposite occurred. Retail sales, home sales, and automobile sales all remained aloft throughout 2003. Moreover, 2004 looks even better. While the tailwind from home refinancing is retreating into the distance, its ancillary benefits remain and will benefit the economy for years to come. The tax package of 2003 is on the cusp of delivering twice the benefit to the consumer in 2004 that it did in 2003, a total estimated

to be \$92 billion. On top of this, the employment picture is improving. Layoff announcements are on the wane and unemployment claims are falling. The unemployment rate recently declined from 6.0% to 5.9% and we expect it to fall further as the recovery continues to gather steam in the months ahead. In short, the consumer will remain a hero in 2004.

Lastly, the equity markets sense that economic growth will accelerate in 2004. The last three quarters of 2003 witnessed strong performance in all market indices, with investors showing a near-gluttonous appetite for companies that are expected to be beneficiaries of a strong economy in the future. One of the market anomalies of 2003 was that companies *without* earnings handily outperformed those companies *with* earnings. *This will not stand!* 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. We would like to assert, again, that 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

January 2, 2004

\* 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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