

THE DECISION MAKER



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It is not surprising that congressional Democrats were unable to make a major issue out of the U.S. economy during the recent midterm election. The performance of the American economy during the past year has been miraculous. The economy grew more than 3.0% this year despite the terrorist attacks of Sept. 11, a stock-market decline equal to 90% of gross domestic product, major corporate scandals and the strong prospect of war in the Middle East.

Economic pundits have focused on the risk of a double dip when they should have been noting the economy's resilience. The economy was in recession before the terrorist attacks because of the unraveling of the great telecom and information technology capital-spending boom that had driven growth during the late 1990s....

There is no simple way for the Bush administration to rationalize the slowdown in the economy since it took office. But when one considers the scope of the shocks which have occurred during the past two years... it is difficult to imagine a more benign scenario than the 3.0% growth in output that the economy actually enjoyed during the past year.

The resilience of the economy in the face of so many shocks is also grounds for optimism about its long-term performance. The American economy still contains powerful growth engines, which will blossom again when the excesses of the late 1990s and the threat of terrorism fade away.

*"Economic Miracles," BARRON'S Editorial Commentary, December 30, 2002
—David Hale, Chairman, Prince Street Capital,
former Chief Economist for Kemper Financial Services*

The biggest unreported story of 2002 has been the vitality and growth of the U.S. economy. U.S. economic strength was certainly not front-page news in the face of a collapse in global equity markets and increasing geopolitical instability. Global turmoil has catapulted terrorists and rogue governments onto the world stage as major players in a high stakes struggle pitting good versus evil, modernity versus religious fanaticism, and economic and individual liberty versus totalitarian control by the state. Add to this witches brew the collapse of confidence

erupting out of the corporate scandals and bankruptcies that followed in the wake of Enron and Arthur Andersen. Finally, Wall Street was made to walk the plank after the credibility of a large number of its well-paid analysts was flushed down the drain along with their strong buy recommendations.

Anyone who relied primarily on the popular media for their "news" and did not view it in the context of recent economic history probably would not suspect that the U.S. economy has

fares so well over the past year. Showcasing the well orchestrated perp-walks of greedy corporate executives and staging a press conference to announce indictments of miscreants or juicy settlements to “protect investors” is better theater than talking about less sensational, but far more significant, topics such as GDP growth or the unheralded upturn in corporate profits.

In November of last year, the U.S. Commerce Department issued a revision of GDP for the third quarter of 2002. Real economic growth was revised *up*—from 3.1% to an annual rate of 4.0%. In fact, the U.S. economy has had four consecutive quarters of real economic growth. Corporate profits bottomed in the fourth quarter of 2001 and rose throughout 2002. Yet the U.S. stock market and most major global markets performed worse in 2002 than they did in 2000 and 2001, which were also negative years for most world bourses. For the first time in ninety years, the U.S. stock market failed to move upward during an economic recovery. This failure is even more amazing given that interest rates are the lowest they have been in fifty years. Is there a disconnect between the markets and economic reality or have investors been behaving rationally in anticipating a more negative economic future?

In some respects the behavior of the markets has been quite rational. This is particularly true of the Nasdaq, which is heavily dominated by technology stocks. From their peak in the first quarter of 2000 through the end of 2002, the Nasdaq declined 74%, while the S&P 500 and Dow Jones Industrial Average declined 43% and 29%, respectively. The biggest bubble of speculation occurred on the Nasdaq, and it has had the greatest fall. But why, in addition to the unwinding of the speculative excesses that culminated in a manic bubble in 2000, did stock prices perform worse in 2002 than in the previous two years?

One of the primary reasons that stocks fell off the table in 2002 was the belated recognition that corporate

profits collapsed during the second half of 2001. It was not until very late in 2001 and early 2002 that the depth of the decline sank home with investors. And the bad news about corporate profits rolled in as the quicksand of corporate and accounting scandals sucked in ever more participants. High profile bankruptcies and growing fears of credit worthiness brought gridlock to the credit markets for below investment grade corporations. Leveraged companies that had relied on their continuing ability to access the bond and equity markets for capital found the trap door of illiquidity slammed shut on their hopes for survival, much less future growth.

The drop in corporate profits (which had undoubtedly been overstated in past periods) and the crisis of confidence engendered by fraud and an overzealous investment banking community were exacerbated by the continued uncertainty stemming from geopolitical turmoil. The constant fear of another terrorist attack, the very real threat of a war in Iraq, and the renewed stirring of another psychotic despot in North Korea continued to rattle the nerves of even the most steeled of investors.

Yet the end game in Iraq is drawing closer. It would not be a great surprise to wake up one day and hear a news flash that Saddam has spirited away with a few of his closest friends to another country in the Mideast. Our first guess would be Libya, with his good friend, Muammar Qaddafi, agreeing to keep Saddam corralled in exchange for some sort of assurances that Qaddafi would no longer be *persona non grata* in the civilized world. Those who believe this is wishful thinking might take note of a front-page article in the January 3rd *Financial Times*, which quoted some highly placed Arab officials. In the face of a growing U.S. and U.K. military buildup and resolve, Arab governments are signaling increased interest in persuading Saddam to exit. One official stated, “One option is for [Mr. Hussein] to depart. He’s not thinking about it now, but it could be different when the



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Americans are serious about the alternative of war." Even more revealing about coalescing Arab government thinking was another official statement, "If he accepts, there will be a land for him. Where he goes is not a big problem..."

Should Saddam fall, with or without the use of external force, as seems increasingly likely, his departure would send strong signals to the other kingpins of the "Axis of Evil." President Bush's pronouncement of an "Axis of Evil" was initially viewed with disdain by many observers, both here and around the world. We suspect they are a little less smug after growing signs of nefarious collusion among the primary culprits, most recently, North Korea. A regime change in Iraq would have the potential to accelerate the budding emergence of a more secular government in Iran. It would also undermine a major source of support for terrorism operating in Syria and carried out through Hezbollah and Hamas. In short, Saddam and the present Iraqi regime would be a large domino that would fall on fellow travelers in the Mideast. And a forceful change of the government in Iraq would help to focus the mind of Kim Jong-il, the megalomaniac

lording over poverty stricken but militarily dangerous North Korea, on the potential consequences of his actions.

The Chinese, too, would seem to have a vested interest in putting Kim Jong-il back in a bottle. The Chinese economy has been growing at a very rapid pace in recent years. Walk up the aisles of Wal-Mart and many other retailers and notice where many of the products are manufactured. "Made in China" tattoos everything from apparel to electronics. A recent spot on a cable network highlighted the large number of Chinese who are snow skiing. They are buying cars, furniture, and many of the fruits of economic production. Houston's tallest import is a bright and talented 22 year old, Yao Ming, the newest Houston Rocket, whose exploits are sponsored by Yanjing Brewery and watched by millions in China via satellite TV broadcasts. In 2008, China will host the winter Olympics. Benefiting from a strong economy and booming exports, the Chinese are beginning to enjoy the good life. China does not want some rogue dictator precipitating a move that would encourage Japan and other U.S. allies in the region to go nuclear or seek a greater U.S. military and/or nuclear presence in the area, especially since China's long-term goal is to push the U.S. out of the Pacific region. For now, it is more fun to go skiing or watch Yao dunk the ball than it is to have a military skirmish in your own backyard, especially if you have to worry about radioactive fallout. As North Korea's chief economic backer and quasi-supporter, we suspect the Chinese will work hard to defuse the machinations of Kim Jong-il.

If we are more sanguine about the defusing of tensions at hot spots around the world, it is based as much on an assessment of what could go reasonably well as it is on the possibility of what might go wrong. We believe there is a growing recognition among nearly all governments that terrorism and despots damage the entire world community. Even

government officials of non-democratic nations have much to lose if “things get out of hand.” It is perhaps impossible for institutional money managers to invest on the assumption that Armageddon is imminent. We think the risks in the global political environment are very real, but they are manageable. The world will deal with its malcontents. Those countries that do not participate in the positive fruits of economic globalization will become increasingly marginalized. We look for renewed growth as the fear so prevalent in the wake of 9/11 gives way to new hope that the global problems we face are not intractable.

It would seem that the geopolitical background has weighed on investors to such a degree that they have indeed ignored not only the recovery in corporate profits but also some tea leaves that are signaling better times ahead. We think these fears, although understandable at this stage, are overdone. At a time when risk is underestimated, misperceived, or misunderstood, investors are typically the most confident, and the potential for future equity returns is very low. Likewise, at those times when risk is widely recognized and understood, the opportunity for potential equity returns is much greater. Today, risk is widely recognized and anticipated.

Looking more closely at today’s economy and markets, there are a number of positives. The unemployment rate is around 6.0%. Although it may rise a bit more, looked at from another perspective, the employed rate is 94.0%, a figure that Alan Greenspan only a few years ago said was probably the level at which the economy was reasonably efficient. In October, stocks sank to five-year lows. Over many decades, a major market low has occurred every four years.

The third-year Presidential cycle effect should not be dismissed either. Since 1939, the S&P 500 has not declined in the third year of a President’s term. The conventional wisdom is that Presidents prime the pump so that their party can benefit from



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an economic upturn as elections near. The Bush Administration, emboldened after Republican gains in November, is pushing for economic growth and new tax incentives. The proposed acceleration of income tax cuts and the elimination of the double taxation of dividends should cheer most equity investors and help all stocks, not just those that pay dividends.

The last time that the S&P 500 declined for three years, 1939 to 1941, the U.S. was on the brink of WWII. Following the attack on Pearl Harbor in December 1941, the U.S. achieved its first major victory against the Japanese at the Battle of Midway in early June of the next year. Following 1941, the S&P 500 registered four straight double-digit gains averaging 19% annually. Similarly, the uncertainty surrounding the prospect of military action in Iraq should dissipate quickly once Saddam is removed, leading to a more positive market environment.

An even more compelling reason why the potential returns for stocks appear more attractive than they have for some time is the relatively unattractive potential from alternative investments. Interest rates on money markets and savings accounts in many cases are less than 1.0%. Bonds, which have turned

in a relatively good performance over the past few years, offer historically low rates of return and can be expected to decline in value as credit demand accelerates and interest rates rise as the economy strengthens. Real estate, whether commercial or residential, appears expensive. Plenty of commercial space is on the market, and residential real estate is showing signs of slowing its rate of ascending prices, especially at the higher end. As interest rates begin to trend upward, the impetus that the housing industry has received from the boom in refinancing will wane, further cooling off what has been a favorable environment for residential realty. Finally, more esoteric instruments like commodities would seem inappropriate except for the most nimble of trading professionals. Most investors would be ill advised to place a significant amount of their life savings into futures contracts on industrial and agricultural commodities such as copper, lumber, orange juice, and pork bellies.

Still, although alternative investments are far from compelling, investors have continued to shy away from stocks. Even though the yields on short-term instruments barely register on the rate meter,

investors have accumulated over \$6.0 trillion in cash equivalents. True, there is concern about the war on terror, but this is not exactly new news. An additional factor weighing on the equity market is the pervasive belief that equity valuations are, if not excessive, far from cheap. For much of the technology sector, this may still be the case. But for the broader market, the underpinnings for valuation and future earnings growth are very promising.

In what may well be the real economic story of 2003, two key and interrelated developments should lead to a further and significant expansion in corporate profits in coming years— strong productivity growth and a declining dollar.

Over the last two decades, whenever U.S. interest rates have been relatively high and/or the U.S. dollar has been overvalued vis-à-vis other key currencies, major problems for U.S. corporate profits usually developed. High interest rates in the face of slowing inflation attract foreign capital and contribute to a stronger dollar. A dollar that is too strong ultimately erodes U.S. competitiveness because it makes imports

CORPORATE PROFITS ON THE RISE
S & P 500
 (OPERATING EPS)

QUARTER	2001	Change	2002	Change	2003	Change
1	\$10.73	-23.0%	\$10.85	1.0%	\$12.50E	15.2%
2	9.02	-39.0%	11.64	29.1%	13.50E	16.0%
3	9.16	-36.0%	11.63	27.0%	13.00E	11.8%
4	9.94	-24.0%	12.88E	29.6%	14.00E	8.7%
YEAR	\$38.85	-31.0%	\$47.00E^(a)	21.0%	\$53.00E	13.0%

^(a) Includes \$4.00 per share from FASB elimination of goodwill charges

Source: International Strategy and Investment



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cheaper and makes it more difficult for American businesses to export. As profits suffer, the equity markets eventually respond accordingly.

In recent years, the dollar has experienced a period of strength that lasted through the early part of 2002. The Federal Reserve raised interest rates in the late 1990s. From mid-1999 to early 2000, the Fed raised rates six times even though they were probably too high in mid-1999. The Fed's excessive fear of Y2K and inflation was unwarranted. With inflation low and interest rates high, foreign capital flowed to the U.S. and helped drive the dollar higher. The euro, which had its inaugural on January 1, 1999, at \$1.17 to €1.0, illustrates the importance of currency exchange rates in the global economy. By the close of 2001, the euro had collapsed to \$0.89 to €1.0, a 24% decline. A U.S. product that cost 1,000 euros in early 1999 soared to 1,240 euros in three years. American manufacturers were faced with intense pricing competition and found themselves at a competitive disadvantage. But while businesses struggled to preserve their markets, the American consumer thrived on cheaper imports. An import from Euro land that cost \$1,000 in early 1999 plummeted to \$760 as 2001 drew to a close. The strong dollar contributed to a surge in imports from around

the globe while American manufacturers battled to preserve their profits. The inability to raise prices in the face of intensive competition was a major contributor to the profit decline of 2000 and 2001. That profits did not decline any more than they did and have begun to recover is testament to a key to future strong profit growth—the significant growth in U.S. productivity.

Over the past year, productivity, which has been enjoying robust improvement for some time, experienced its highest growth in over 30 years. This growth is the result of the significant investment in technology and equipment that American businesses have made in order to stay competitive. As workers learn to utilize this technology even more efficiently and additional capital investments are made, productivity should continue to increase. This highly important growth in productivity will combine with another key factor, a shift in the dollar's fortunes. These two developments may well result in another long period of improving corporate profits.

From its peak of 2001, the U.S. dollar has declined 20.3% against the euro. It will probably continue to move lower. The U.S. current-account deficit is approximately 5% of GDP, a level that historically puts pressure on a nation's currency. The Federal Reserve will not raise interest rates until employment levels begin to show meaningful and sustainable improvement. With interest rates low, capital will flow to higher yielding foreign instruments, further weakening the dollar. Another source of weakness for the dollar will come from benign neglect by the new Bush economic team. President Bush and his advisers will give lip service to a strong currency, but they will be pleased to see the dollar drift downward. Finally, concerns about a war footing and increased defense spending, along with costs of a budget stimulus package, are creating unease about the potential for greater inflation and a weaker currency. Taken together, these developments

portend a meaningful decline for the greenback. If the dollar returns to the levels it held when the euro began trading in early 1999, it would decline another 10%.

A lower dollar and strong productivity, coupled with a stimulus package and tax cuts, could result in soaring corporate profits much like those we saw between 1993 and 1997. U.S. businesses would be highly efficient, and at the same time they would begin to recapture both domestic sales as imports become more expensive and overseas markets as their exports become less costly for foreign buyers. Corporate margins would widen as volumes increase and pricing power returns.

Thus, from this perspective, arguing that the valuation of equities is not particularly compelling may be like driving forward while looking in the rearview mirror. We think the emerging improvement in corporate profits is already reflecting the improvement in productivity and the erosion of the dollar's strong run through 2001. With each passing quarter, the improvement in corporate profits will become more apparent, with positive results for equities.

While recoveries from previous post WWII bear markets have averaged 33% in nine months and 42% in 15 months, we believe this market may be somewhat different due to continuing concerns about terrorism and the "show-me" mindset of traumatized investors. Nevertheless, the aforementioned widely held recognition of risk seems to have frozen many investors who seem to be awaiting greater clarity and certainty before capitalizing on present opportunities in the equity market. The lows of early October may well have been the lows of this bear market. We think there are many stocks that will not return to their 2002 lows but will continue moving higher in price as they discount the inevitable swinging of the pendulum of corporate profitability.

The Wall Street Journal, in its editorial of January 2nd, offered a concluding perspective with which we heartily agree:

[T]he U.S. economy remains the main engine (along with the Chinese growth machine) striving to keep the rest of the world's head above water.

Looking ahead, economic policy may also be improving. The White House... is preparing pro-growth tax cuts, free-trade talks are gaining speed after last year's U.S. steel tariff blunder, and a GOP Congress is unlikely to lay on many new regulations. With any luck, and a decisive war victory, 2003 is poised to be a year of accelerating growth.

Historians may find the last three years merely a pause in the economic Renaissance of the past 20 years, in which globalization, the collapse of the Soviet empire, the Internet and biotech revolutions, and the conversion of China to Adam Smith all played big roles. All of these trends are still in play, notwithstanding the worst efforts of Osama bin Laden. Left out of this dynamic, growing world have been the Arab nations and the northern half of the Korean peninsula, but the New Year offers reasons for optimism on that score as well.

Corporate malfeasance should move to the back page and will soon become yesterday's news. The geopolitical environment is not without promise of reasonable and perhaps quite positive resolution. Corporate profits, despite the hand wringing of the media, have turned up and should continue to improve, perhaps surprisingly so. We believe the future will handsomely reward judiciously made equity investments.

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Sources: *The Wall Street Journal*; *Financial Times*; *Barron's*; Bloomberg; International Strategy and Investment

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