GSI Market View

2nd Quarter 2002

A light at the end of the tunnel? No doubt there will be. But how long is the tunnel? The current state of the market tells us that we are not there yet. The nature of this decline in the stock market is similar to Chinese water torture---the daily down drip tears at the fabric of investor minds.

Market psychology is difficult to measure. Yet it is very important to the near-term direction of the stock market. As of this writing it is extremely negative for all those reasons we hear and read daily in the media. It can change quickly however. Market timers are often tripped up by the speed of change and their ability to recognize it. The only way we know to relieve the pressure of negative market psychology is to look at the fundamentals and determine how they relate to the long-term; unless they deteriorate the stock market will stabilize and improve. At this time most fundamentals are very positive.

Core wholesale prices for the month of June were reported up 0.2%. Inflation is not a factor now, and it is hard to believe that it will be in the foreseeable future. Some argue that the dollar will continue to decline against a basket of foreign currencies; to defend the dollar we will have to raise interest rates. Why, we would ask? Inflation is low and our Federal Reserve is not trying to stifle economic growth. Its expansionary policies encourage it. The offset to currency decline is superior relative growth accompanied by low inflation.

Growth is proceeding nicely. Q102 was characterized by strong GDP growth (up 6.1% annualized). Inventory rebuilding produced this high number. Q202 is expected to slow because sales did not draw down inventories to acceptable levels. But as Business Week notes, even if 2nd quarter growth slows to 2%, we would experience 4% growth for the first half.[1] This is a strong number for our economy.

Then what about the second half of this year? The Purchasing Managers' Index rose nicely in June to 56.2% from 55.7% in May which means our economy is expanding. Inventories have again dropped and are in need of replenishing. Consumer spending popped up in June after a weather-related soft May. Both Wal-Mart and Target sales gains for June exceeded expectations by 1% or more. Thirty- year mortgage rates have recently dropped below 6.5%, and that threshold is expected to encourage a new wave of refinancings. It was recently reported that the average home price in the Twin Cities rose 12% year over year to $188,900; what refinancers generally do is use higher valuations to borrow additional funds for personal spending. Personal income is rising. Business Week cites "the nascent turnaround in capital spending as shown by the government's April and May data on shipments and orders."[2]

So, the fundamentals appear to be strengthening, but investor psychology is lousy. However, stock valuations have become more attractive. At some point investors will stop selling and begin dipping into the marketplace. Warren Buffett's Berkshire Hathaway, along with others just saw fit to invest $500 million in Level 3 Communications, Inc., a fiber optic carrier, no less. For the first time in his investment career has Mr. Buffett contracted technology fever?

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[1] Business Week, July 15, 2002
[2] Ibid