Sather Financial Group, Inc.
Registered Investment Advisor

Second Quarter 2001 Commentary

Things May Be Improving, But We're Not Out Of The Woods Yet

Thankfully, the second quarter of the year was much improved compared to the first three months of the year***. The S&P 500 increased 5.4% for the quarter, but is still down more than 7% for the year***. And despite showing good gains for the ***quarter the NASDAQ is still down 12.5% year to date***. Over the past fifty two weeks the S&P 500 is down 16% and the NASDAQ is down 46%. The most recent quarter has definitely given a bottom to the stock market however investors should not expect spectacular gains any time soon.

Since the beginning of the year ***the Federal Reserve has aggressively lowered short term interest rates on six separate occasions*** in an effort to spur economic recovery and growth. It is important to note however that ***while short term rates have decreased substantially long term rates (based upon the 10 year U.S. Treasury) have actually risen 10%***. Furthermore, it is interesting to note that although the interest rate cuts are designed to boost the economy the stock market is lower today than it was when the Fed began lowering rates on January 4th. A logical person would question why this is. When the Fed lowers interest rates the true effect of that economic stimulus is not felt immediately. Typically ***a move in interest rates takes six to nine months to trickle down*** through corporate America. Given this, it is unreasonable to expect the full impact of these rate cuts to be felt any sooner than the fourth quarter of the year. We remain hopeful that the health of the economy is better than what many predict. ***Our outlook continues to see very low growth in Gross Domestic Product, but no recession.***

Another facet to review is the historical perspective of market declines such as the one we have recently experienced. On average, the market requires about fourteen months to recover from a "bear" market. However, in assessing this bear market an important distinction must be made—when did it start? Many investors are under the impression that the market decline began in March of 2000. And if you add fourteen months to that one would presume that we should be escaping from the clutches of the bear any day now. However, only technology and telecom stocks began their precipitous fall in the spring of 2000. The broad market did not begin its decline until January of 2001. ***Adding fourteen months to January puts a recovery somewhere around March of 2002***. This timeframe would also make sense when you add nine months on to the most recent interest rate cut.

Going forward ***we continue to see low interest rates, low inflation, an increase in crude oil inventories and a subsequent decrease in gasoline prices***. Other positive factors to evaluate include the Consumer Confidence Index in June hitting its highest level of 2001, a slight rebound in durable goods orders and a healthy increase in new home sales. While these are all good things they must be taken in context. Unfortunately, the ***individual savings rate is now a negative 1%*** whereas ten years ago the savings rate was 8% of income. Furthermore, over the past three years the annual ***growth rate in real disposable personal income has dropped from 5% to only 2%***. As a result of these factors it is unlikely that consumer spending alone is going to pull the stock market out of its current slide.

What is it going to take to get the stock market back on its feet? The easiest and best solution is solid corporate earnings. It is my impression that many investors think that because the stock market dropped that it is therefore a bargain. Far from it***. The S&P 500 for instance still trades at a Price to Earnings ratio of 27***. While this valuation figure is below its highest mark the current P/E ratio is ***still well above the post World War II average of 15.3***. The market should probably trade at a higher P/E ratio today than its average due to our low inflation and low interest rates. However, the fact of the matter remains that going forward stock market investors should have realistic expectations.

Realistic expectations most likely mean 7% to 8% returns out of stocks over the next ten years. This figure is derived from corporate earnings as a percentage of GDP increasing about 3% annually, having about 3% inflation and dividends of about 1.2%. Add those up and your looking right at a 7%+ return out of stocks. If I am wrong and returns are higher than I'll gladly take the increased returns. But for planning purposes I would not want to bet on the market doing much more than 7% or 8%. For the remainder of the year we'll have to wait and see how the market is going to behave***. It is quite likely however that the Fed may continue to lower interest rates.***

If you have any questions or comments please drop by or give us a call.

Sincerely yours,

Dave Sather, President
Certified Financial Planner