



PERSPECTIVES

A REPORT FOR CLIENTS OF TD PRIVATE CLIENT GROUP - PRIVATE INVESTMENT COUNSEL

Beyond Soundbites

Since the reporting of financial news has become an industry unto itself, with an array of newspapers and financial news specialty channels vying for attention, investors are deluged with endless, often conflicting reports about the economic and market outlook. In this issue, we'll go behind the headlines and outline some of the points not making the front page.

First, let's recap events since our last edition:

Iraqi War Impact – In the last issue of Perspectives (On the Brink of War, February 2003), we indicated that the impending conflict in Iraq would reduce investor uncertainty, resulting in a shrinkage of the political risk discount assigned to stocks and the war premium assigned to oil and gold. Events unfolded pretty much according to the script, with oil falling from \$ 36 to the current \$26 and gold dropping from \$356 to \$320 before rebounding to \$340 in response to renewed weakness in the U.S. Dollar. Meanwhile, stocks rallied and in April the TSX, S&P 500 and EAFE* rose 3.91%, 5.60% and 7.31%, respectively, in Canadian Dollars.

Let's now examine some current soundbites making the news.

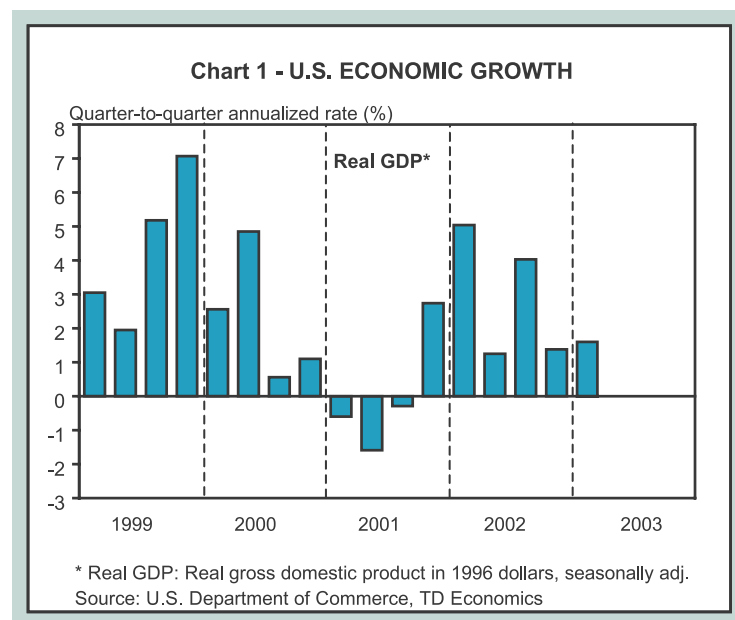
Corporate Earnings Aren't Growing – Generally, earnings rise sharply from the depths of recession, often increasing 20% in the year after the trough. This is not happening, as the pace of economic recovery in the U.S. is slower than normal, at a modest rate of 1.6% in Q1 of 2003 (See Chart #1). Nonetheless, **recent earnings growth has been better than forecast. With about 80% of S&P 500 having reported Q1 earnings, the average year-over-year increase has been 12% versus estimates of 8.5%.** Canadian earnings growth was more muted, about 8.5% at latest count, due principally to higher comparable numbers in the period one year ago.

Earnings Quality is Lousy – The issue typically cited here is that earnings growth, especially in the U.S., has been achieved by cost cutting, not sales growth. The inference is that since costs can't be cut indefinitely, earnings will not grow further. What's missed in this analysis is that **American corporate belt tightening has sharply increased productivity, improved operating leverage and allowed profits to rise on modest increases in volume.** Specifically, productivity growth of 4.8% in 2002 was the highest in decades. So, while the U.S.

economic recovery is sub-par and earnings growth may well slow from the pace of the first quarter, growth should persist throughout 2003.

Rising U.S. Unemployment Spells Recession – The U.S. has had three consecutive months of job losses – February, March and April – an event that often signals an impending recession. In fact, the U.S. lost 525,000 jobs over that period, certainly cause for concern. As illustrated in Chart #2, jobs lost were greatest in February and lessened in March and April as the Iraqi conflict came to its conclusion. While job growth may be anemic for months as companies keep a lid on expenses, we will likely see some improvement and recent job losses should not presage a recession.

Rising Consumer Debt Will Sink the U.S. Economy – Consumer debt (mortgages, credit cards etc.) has steadily increased since the 1980's and currently stands at about 110% of disposable income in the U.S. This is the headline number and is clearly worrisome although further analysis makes it less so. The debt burden, which measures debt servicing costs (principal and interest) as a percentage of disposable income, is 14%, the same high level last reached in 1986. While this too is concerning, particularly when interest



*Europe, Australasia and Far East

rates are low and debt servicing costs should be lower, roughly half of the 14% is being used to pay down principal. This, in turn, reflects the fact that most new debt has been in the form of mortgages as Americans have taken advantage of low interest rates to increase the U.S. home ownership rate to 68% from 64% in 1995. Thus, **Americans are not going into debt to buy groceries but rather to purchase homes and can divert some of their current principal payments to cover interest costs if need be.**

A related concern is the effect rising interest rates would have on American consumers' ability to service their debts. About 76% of U.S. consumer debt is mortgages with the balance being credit cards and short-term loans. **In the U.S., most home buyers take out mortgages at rates fixed for up to 30 years. When rates fall, households can re-finance at lower rates but if rates rise, the borrower is under no obligation to re-finance at higher rates. Thus, most Americans with a mortgage are little affected by rising mortgage rates.** While this is not true for credit card debt, those rates tend not to fluctuate a great deal and anything but a sharp rise in interest rates would have a modest effect on those borrowing costs.

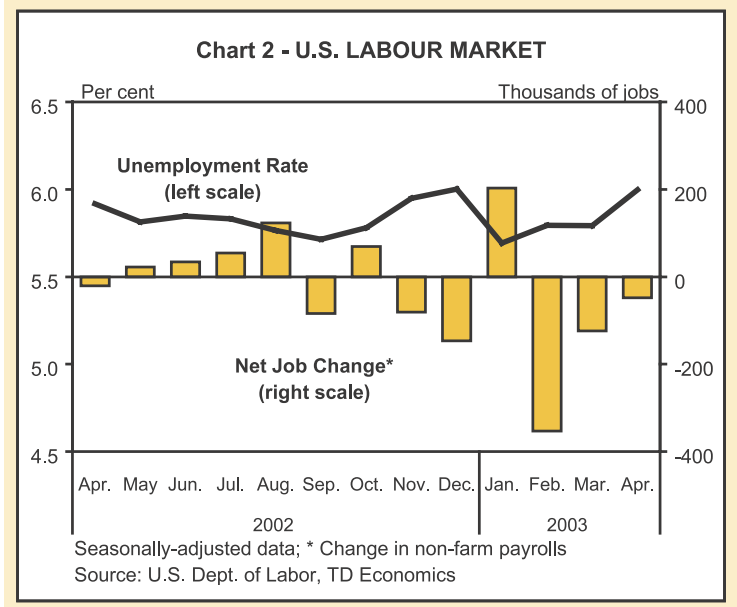
Incidentally, contrary to popular belief, Canadians' consumer debt load is slightly higher than that of Americans at about 112% of disposable income. Also, Canadians' mortgages, which amount to 70% of our consumer debt, seldom have rates fixed for more than five years so rising rates will have a greater impact on Canadian households than their counterparts stateside.

The U.S. Federal Deficit Means Trouble Ahead – The Bush Administration's decision to fund the war on terrorism while cutting taxes will result in large U.S. deficits for at least a few years, causing fears of a dramatic increase in government debt levels. This is a legitimate concern. Ironically, the same observers were, just three years ago, forecasting U.S. Federal surpluses as far as the eye could see and repayment of the U.S. Federal debt within two decades. Both then and now, extrapolating based on short-term trends is risky business and generally inaccurate. Often forgotten is the fact that **the U.S. Federal Government's balance sheet is in relatively good shape with Federal debt equal to about 35% of U.S. GDP compared with 45% at the end of the Gulf War, for example. So, while persistent, large deficits could spell trouble down the road, the present situation is not dire.**

Investors Have Shown Little Inclination of Coming off the Sidelines – This is correct. Currently, there is tremendous cash sitting on the sidelines. To illustrate, money market mutual funds in the U.S. now have about **\$2.2 trillion in assets** which is equal to 28% of U.S. stock market capitalization (as measured by the Wilshire 5000). This is a very high figure and compares with what was felt to be a high level of 17% in February 1991 after the Gulf War. Interestingly, very recent statistics show the first significant flow out of U.S. money market funds in some time, with about \$100 billion flowing out of money market assets and moving into other investments such as stocks. **Since U.S. money market fund yields are well below 1% and bond yields are at 40 year lows, look for more movement from these asset classes should equity markets continue to firm up over the course of the year.**

Overall, while the media covering the financial news does a very good job, probing beyond the headlines can often yield different conclusions.

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