Stamper Capital & Investments, Inc.

"Focusing on Upside Potential with Downside Protection Since 1995."

January 2003 Market Commentary

2002 Recap

Our Forecast for Year 2002 was accurate in three major categories out of four.

For 2002 we said, "Equity prices are still considerably overvalued and face substantial erosion in value." What Happened? - Prices of equities dropped substantially in value:

The DJIA declined by 15%
The Russell 2000 declined by 22%
The S&P 500 declined by 23%
The NASDAQ declined by 32%

Our 2002 economic forecast was, "The Economy would remain in Recession throughout 2002…..2002 [was] the Year the Recovery Doesn't Begin." What Happened? - We will not know the official state of the economy for 2002 as proclaimed by the National Bureau of Economic Research (NBER) for several months; however, most Americans will already agree that 2002 was very weak. Even if gross domestic product (GDP) is slightly positive for the year it will not offset the decline in value of the stock market, the increase in unemployment, the plunge in consumer confidence, rising office vacancy rates (currently around 16% and rising) and what will probably turn out to be the weakest retail Holiday Season in several decades. I suspect that several months after the fact, everyone will agree that 2002 was another down year in a very large recession that began in 2001 (or earlier).

We were also very correct in forecasting that lower quality bonds would fair poorly - we recommended "...avoiding most low quality bonds…because we [thought] the economy would continue to weaken."

Our 2002 forecast for short term interest rates was, "Short interest rates will go a bit lower…" That is exactly what happened, helped somewhat by the Fed lowering the Discount Rate by 50 basis points to 1.25%.

For long term interest rates in 2002 our forecast was incorrect. We expected long rates would "drift higher." They did at first, rising from around 5.50% to 5.80% in April 2002; however, the dropped for the rest of the year settling in around 4.90%.

Forecast for 2003

First, we do not like to be pessimistic - we would rather be optimistic; however, to be most professional, we must be realistic and reflect what we are seeing, not what we want to be seeing.

Where we are now (January 2003) - Most of the items we have been concerned about over the last few years have yet to resolve themselves. We computed fair value on the Dow Jones Industrial Average to be around 3,400 back in January 2001 based on average multiple of dividends and earnings (see our January 2001 Forecast). Recently, Bill Gross, of Pimco, chimed in with a DJIA average valuation level of 5,000. In our fourth quarter of 2002 newsletter, THE WEALTH PRESERVER, we spent a fair amount of space devoted to two articles "Self-Reinforcing Cycles" and "The Recession is Starting to Worsen - Asset Prices Could Gap Downward." In these two articles we detail the many problems that are starting to surface and how they could create a downward self-reinforcing cycle. Items of concern that could create this negative interrelation are: Credit downgrades by the rating agencies (S&P and Moody's), Decreased Corporate Credit Lines, Increasing Office Vacancy Rates, Worsening International Financial Markets (Japan and the Far East, Venezuela, Argentina and South America), and Increasing Unfunded Liabilities of Defined Benefit Pension Plans. All of these situations are continuing to worsen, exacerbating each other and financial asset values at the same time.

In early November 2002, we received a delay of the downturn with the Fed lowering rates; however, *the key point is that Mr. Greenspan lowered the Discount Rate an unexpected 50 basis points for a reason -he could tell the economy was weakening again.* After the accompanying reprieve, which lasted about three weeks, we saw the weakest holiday sales season in at least several decades - and that is in terms of revenues. We do not really have to wait for profits to be reported to know how the retailers are doing - terrible - I am not just talking revenues but profit margins. *What are normally after-Christmas-sale markdowns and advertising started before Thanksgiving!!!* Even with those during-the-entire-Christmas-selling-season markdowns, unit sales and revenues have been dismal. Thus, Christmas sales are poor and profits are going to be much much worse. We are seeing huge markdowns, not just on computer products but on clothes, automobiles (Chrysler is offering zero percent financing for FIVE YEARS on many of its SUV's), and electronics (Staples is giving away phones and fax machines if you purchase certain printers - they have to give them away.) I have seen reasonable leather jackets for sale in the local Ralph's Grocery Store for only $16!!! Ralph's also had 24 inch color television sets for $100.

What does this all mean? We think it means there is a vast overcapacity of manufacturing capacity worldwide. For example, the Wall Street Journal just ran an article about how the plants in China that are (or were) producing shoes for Nike and New Balance are now using their excess capacity to produce identical knockoffs (made in the exact same plants) which are sold at dramatically lower prices. This overcapacity (increased supply) is now being combined with lower demand due to the consumer being either completely "spent," out of credit, or afraid of the future as reflected by the recent dramatic drop in U.S. Consumer Confidence to a nine year low. We believe this overcapacity causing an excess of supply in the face of diminishing demand is across the board - in most industries and that it is causing the general price level to drop.

In our fourth Quarter 2001 newsletter, THE WEALTH PRESERVER, our cover article, "DEFLATION - The Unspoken Watch Word of the New Decade" detailed our concerns that the U.S. economy would slip from disinflation to deflation. In addition to many other related items, we said, "It may turn out that the new paradigm of the communications revolution (the internet) has increased this process of deflation by increasing efficiency, lowering the profit margins of businesses and forcing a reshuffling of financial asset prices and, even more unfortunately, employees. Of course, in the long run, this will increase the world's standard of living; however, the process of working through a lowering of prices and salaries and liquidating bad investments made during the high-tech boom of the late 1990's will most likely take several years at the shortest."

A key point we would like to make is that we believe no amount of easy money by the Fed will heal this process. The problem is poor investments, which have resulted in gross overcapacity, financed with record leverage (including trillions of derivatives) that is now being liquidated. Also, even while the FED has lowered short term interest rates and has been flooding the banking system with new money, it has not been leaking into the economy but into the real estate sector; thus, lowering mortgage rates, causing refinancing and the residential real estate bubble *(a clue that it is a bubble is that commercial real estate did not participate on the upside like residential real estate)*. At the same time credit has been contracting. For example, in the corporate sector, debt of failing companies has evaporated completely or been monetized at cents on the dollar. Enron had about $50 billion in debt which went to zero. US Airways, which expects to come out of bankruptcy soon, had about $10 billion in debt; its unsecured creditors (including bondholders) are going to get around 2 cents on the dollar in stock (and that is if the new stock is valued where they think it will trade). United Airlines just entered bankruptcy with about $22 billion in debt; its unsecured debt holders will also likely get a couple of cents on the dollar. Another key is that this credit contraction is taking place in all major economic sectors. For example: oil & gas (Enron), telecom (Global Crossing), high tech (almost all Dot Com's), airlines, retailers (Kmart), shipping companies (Laidlaw), insurance (Conseco) and cable operators (Adelphia). Record corporate and personal bankruptcies and cautious lenders are causing credit (loans) to contract faster than the money supply is increasing, and, combined with record mal-investment is causing the price level to drop - this situation is a classic "credit contraction." In a large credit contraction like this one, you experience deflation.

A good example of deflation is "the burger war." McDonald's Corp. and Burger King have been duking it out hard since September of 2002 when Burger King cut the prices of 11 menu items to 99 cents. McDonald's responded by lowering eight items to 99 cents. Most of the mark-downs were around 50% - something that was around $2 is now $1.

Ordinarily, you might think this is just a "price war" but it has been going on for four months now and is continuing. In fact, on January 2, 2003 Burger King announced it was lowering the price on its "whopper" to 99 cents. In addition, the lower prices (and cash flows) have pushed one of Burger King's largest franchisees, AmeriKing, into Chapter 11 bankruptcy in December 2002. At the same time, McDonalds' reported its first quarterly loss since the Company sold shares to the public in 1965. Thus, we conclude it is not just a price war, it is deflation - neither of them can maintain their sales volumes (and revenues) without lowering prices. If this situation were not the case, they would not drive each other to bankruptcy of franchisees and ruin long term financial reporting records - in other words, they really had no choice but to lower prices.

Declining sales and profits of the recording industry is another clue. Sales of compact discs, etc. have now declined for two years in a row. Of course, some of it is because of unauthorized digital CD burning. I think that a big reason is because the quality of the product has sunk to a new low. However, when put in the context of what is going on in most other major industries, it is simply deflation. Few are going to spend $18 on a new CD every month like they had been doing during the roaring 1990's.

Another example of this situation is in the airline industry. Airlines have had to cut routes and fares, yet are still losing revenues and cash flow (most have no net profit). In addition, most airline fee hikes (such as for oversized bags and for ticket changes) have been cancelled - price hikes do not stick during deflation.

If only one industry or two were experiencing these types of problems, our conclusion might be different; however, that is not the case - across the board there is no pricing power, it is definitely a buyers market and the buyers are not buying so price levels are beginning to drop. Thus, **we believe deflation is here now**. We believe everyone else will come to that conclusion later in 2003.

Looking forward in 2003 - All of the above is, of course, old news, but probably organized and presented a bit differently than in the major media. Two similar subjects that will most likely impact 2003 are: State Budget Deficits and Unfunded Pension Fund Liabilities.

Recent big news is that *the States of the United States of America have around $100 billion in aggregate budget deficits*, which they have to balance. Cuts (combined with increased state income and other various taxes) will begin to be felt as the reduction of services and the loss of jobs and benefits over the next couple of months. Unlike the tech meltdown, these cuts are going to be directly felt by the average family. This realization by the general public (even though not reported in the general media) is probably a key reason for the dismal holiday selling season. Now, it is not just those high flying high tech and dot com people who are being laid off but its going to be teachers, administrators, healthcare workers (and benefits), etc. - the general public - it is unlikely that anything will be left unscathed and I think the general public is sensing it and has begun pulling in their horns.

Another very significant news of great financial importance that has been under-reported in the media is the problem Pension Funds (and their guarantor's) are having, i.e. *"The Pension Fund Time Bomb."* The short version to this multi-faceted problem presents itself on three fronts:

> 1). Dramatically overstated profits & and dramatically understated long term liabilities in companies with defined benefit pension plans (all allowed by U.S. accounting rules) are just now beginning to wreak havoc.
> 2). Many companies with Defined Benefit Plans are failing and the beneficiaries will not be getting 100 cents on the dollar.
> 3). Companies will continue to owe steadily increasing "defined" benefits even as their ability to pay for them is lessening.

Bloomberg columnist, David Evans, points out that according to a study by CS First Boston, *if pension liabilities had been more conservatively included in financial statements, the aggregate earnings for the S&P 500 would have been 69% lower than the companies reported for 2001.* (Thus, curiously, our valuation model based on fair value earnings multiples, as shocking as it was, probably underestimates the downside for the equity market since we did not adjust for this incredible revelation.) Current accounting rules require the statements to be brought back to reality after several years, which is why we are now seeing billions of dollars of shareholder "book" equity being vaporized and cash taken out of Company coffers into the "funded" portion of the defined benefit plans. The situation has already caused several large companies to be downgraded - both Ford and General Motors to BBB, for example.

As for the pensioners, they could be in trouble if their company/guarantor goes into bankruptcy as many have over the past couple of years. Sometimes the company/guarantor of a pension plan continues to sponsor and fund the plan when it comes out of Chapter 11 bankruptcy reorganization (when the unfunded portion is small relative to the funded portion). However, if the guarantor does not keep sponsoring the plan, the unfunded pension plan debt is generally deemed to be senior unsecured debt of the company/guarantor during bankruptcy. (In the case of US Airways, the unsecured debt received 2 cents on the dollar - however, so far, US Airways is going to emerge and continue their pension plan). In the case that the Company no longer sponsors the plan, to the rescue comes the Pension Benefit Guarantee Corporation (something like the FDIC for pension plans). Now, the PBGC limits its bailout on a per person basis - basically, higher earners are going to get pensions more like what lower earners are going to get - with the maximum at $42,954 per year (currently). Recent examples of companies with plans the PBGC took over are Anchor Glass, Petrie Stores, and Acme Metals. O.K. that is the back drop - next is the key. *The PBGC had reserves of only $7.7 billion as of September 30, 2001* (according to Bloomberg's Mr. Evans). Many of the Companies that are failing now have unfunded pension liabilities of billions of dollars. I believe that US Air has around $3.3 billion and that UAL has around $5 billion in unfunded pension fund liabilities, for example. Importantly, in mid-December 2002, PBGC announced that it is taking over the pension plan of Bethlehem Steel which has an unfunded liability of $ 4.3 billion. *Just a few of these larger plan takeovers by PBGC and they will be out of* *reserves* - this most important part of the story that will probably hit the general media later this year, after it first starts making the rounds in the business news. Thus, these defined benefit plans will continue to be a weight around healthy companies; will result in downgrades and bank covenant violations for weaker companies; will complicate emergence from corporate bankruptcy; will end up paying less benefits than pensioners originally expected; and will probably bankrupt the government insurer (unless it, itself, is bailed out as was the FSLIC - Federal Savings & Loan Insurance Corporation - during the late 1980's/early 1990's - then it merged into FDIC I believe).

Finally, Our 2003 Forecasts - With all of this as the backdrop for our forecasts, you can probably fathom that **we do not believe in an economic recovery in 2003**; on the contrary, we believe there will be a point of recognition by the general public that the economy is not coming back until major problems are corrected. Correspondingly, based on that forecast and our view of the equity markets still being historically very much overvalued, **we are continuing to be very negative on stocks, expecting percentage drops more like 2002 (which were more damaging to more equity indices) than 2000 or 2001. In addition, we continue to recommend that lower quality bonds be avoided** - we do not think you are compensated for the risk. (If you disagree with our economic forecast, we would recommend high yield taxable bonds over high yield municipal bonds since they are trading much cheaper on a relative basis; however, we do not like either category given what we are seeing). Related to all of this, **we think the real estate bubble has pretty much topped and is starting downward** (it definitely has here in Santa Cruz and the rest of Northern California). As for interest rates, the Fed may be able to keep high quality short rates down but it does not control the long end of the curve. The continuing credit contraction may result in longer term lenders demanding more and more to lend out further on the curve (thus, less supply of credit) and the demand for credit will remain very strong as lenders try to hang on during the liquidation phase of the business cycle. In addition, the U.S. dollar has been falling. Generally, we believe the dollar is falling because foreigners are selling dollars - actually, they are selling their U.S. dollar denominated bonds (increasing their supply) for dollars and then converting their dollars into various foreign currencies. We believe these **supply/demand imbalances could cause high quality, long term interest rates to rise** from their current forty year lows. In addition, we believe any tax cut on corporate dividends, rather than helping equities go up (as politicians are hoping) will result in bonds being less attractive and trading off. Thus, **we do not recommend longer bonds but like high quality bonds with little interest rate risk.** Because we believe deflation is here, we expect gold should top shortly (or has topped) around $355 per ounce and will drop when the public realizes the problem is deflation. However, related to that drop we expect we could see new forty year lows (taking out the March 2001 low of $272 an ounce) before we see a new bull market in the precious metals (which could begin by the end of 2003). **As in our previous forecasts, we continue to believe SAFETY is the watchword for this decade.**

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Stamper Capital & Investments, Inc. has been the sub-adviser to this Fund since October 1995 and B. Clark Stamper, our President, has been its Portfolio Manager since June 1990.

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