

# P E R S P E C T I V E

A Quarterly Review of Economic and Market Developments

Third Quarter 2002

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### ***U.S. and International Economies***

We discuss three possible outcomes for the U.S. economy and remind readers that global economic growth will primarily depend on what happens in the U.S.

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### ***Domestic and International Equities***

We review the dismal performance of the equity markets during the third quarter.

### ***Real Estate***

We examine why the office sector has been so hard hit in recent months.

### ***Global Investment Strategy***

See why we have reduced our bond weightings and have a bias to add to both U.S. and international stocks. We believe investors who "stay the course" will find that the current volatility is creating long-term investment opportunities.

## Staying on the Strategic Course: Opportunities in the Making



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*In the past couple of years, U.S. stocks have moved from a speculative peak to bear market conditions. How has BB&K responded to this widely fluctuating market environment? Why are investment disciplines so important in these volatile times?*

Over the last few years, we have focused on preserving client capital while waiting for opportunities to develop. We have been risk avoiders rather than risk takers. We were cautious during the later stages of the bull market as soaring stock prices separated from underlying value. Despite considerable pressure to conform to "New Era" thinking, we remained confident in our belief in the importance of diversification, value disciplines and staying in tune with our long-term strategies. This adherence to investment disciplines and sound long-term strategies has helped to keep our client portfolios from taking the full brunt of one of the worst stock market declines in history, allowing them to come through a very difficult environment in relatively good shape.

Maintaining investment disciplines and avoiding emotional decisions are the keys to long-term investment success. At the top of the bull market, the pressure to add to stocks was tremendous. After all, in such good times, there didn't seem to be anything to worry about. But, despite the appearance of clarity and certainty, the risk of loss was actually extremely high. All of the good news had been priced into the market, leaving it very vulnerable to disappointments. Today, in contrast, investors have plenty to be worried about. The perception of risk is much higher. As a result, despite better valuations, the pressure now is to abandon stocks. Yet our investment disciplines tell us that, if anything, we are approaching the point where risk taking will likely once again make sense and be rewarded.

*How does being a disciplined investor help you assess the current environment?*

In adverse environments, it is only natural to become anxious and give in to fears of worst-case scenarios. However, this could prove to be as dangerous to long-term investment results as buying into the belief that stocks somehow had become a perpetual money machine. In hindsight, we know how foolish and dangerous that was.

Today, fear and disillusionment pervade the stock market. Our disciplines remind us not to be pulled off course in the emotional gloom of today's circumstances. Does this mean stocks have bottomed? No. Stocks may not have bottomed, not all of the bad news may be fully priced into stock prices, and we may experience more bad news. Emotional overreaction itself could cause stocks to overshoot to the downside. But in these stormy times, the anchor of investment discipline keeps us tied safely to long-term strategies, which are designed to counter even unforeseen risks through a carefully designed mix of assets.

The greatest risk to investment results comes from haphazardly changing strategies by becoming an aggressive investor at market tops or a conservative investor at market bottoms. Although knowing what your risk tolerance is and sticking with your portfolio strategy may be difficult, it is essential to long-term success. We believe this discipline kept us from being swept up in the market bubble and will help prevent us from overreacting on the downside.

*What is your strategy going forward?*

We are patiently waiting for an opportunity to add to U.S. equities. Stocks are becoming more attractively valued, particularly relative to bonds and real estate. If we are correct in assuming that the equity market will retain its central role in our economy, that the market will continue to move in cycles driven by greed and fear and that the U.S. economy and institutions have an enduring resiliency, then periods of cyclical weakness in stocks should be viewed as great opportunities to enhance long-term returns. The only question for investors is, when? This is the most important issue, since cycles can last longer than imagined.

Looking forward, a number of factors suggest we could experience a bounce in the U.S. stock market in the near future. Oversold rallies often trigger short covering, sentiment is very negative, and the Fed is likely to ease in coming months. However, we are waiting until we see the catalysts for a major market turn before moving to an overweight position in stocks. These catalysts include a final capitulation on heavy volume, investors returning to underweighting stocks in portfolios, stocks moving to an undervalued extreme, the resolution of the Iraq situation, declining oil prices, an improving outlook for earnings and post-election tax reform favoring investors and consumers.

## **U.S. Economy**

The third quarter of 2002 proved to be another difficult and trying period for analysts and investors. Stories of corporate malfeasance, fraud and bad judgment remained in the headlines. Uncertainty continued to swarm around the War on Terrorism, impending military action against Iraq and conflict in the Middle East. In addition, the markets were buffeted by an unrelenting stream of weaker than expected economic news. Third quarter growth was probably about 3%. Although this was an improvement over the flat growth of the second quarter, it fell short of the robust recovery many analysts were expecting. Moreover, the outlook for the fourth quarter has faded. Earnings expectations were also constantly revised down during the quarter. According to First Call, at the start of the quarter, the consensus forecast called for a 16.9% year-over-year growth in earnings. By the first week of October, those expectations had been revised down to 5.9%.

This package of events created a background for enormous market volatility. The S&P 500, after rallying 20% off its July lows, was once again testing those lows by quarter end. In contrast, geopolitical risk,

economic uncertainty and stock market volatility helped push U.S. Treasury bond yields down to the lowest levels since the early 1960's, providing another quarter of stellar bond returns.

Looking ahead, economic and market visibility remains hazy. Today's environment seems more uncertain, volatile and unpredictable than usual. In forecasting the future, our multi-scenario approach considers a number of possible outcomes. We strive to make balanced decisions allowing client portfolios to participate in positive outcomes while controlling downside risk in adverse scenarios. The following briefly describes three possible scenarios for the U.S. economy.

1. *Cleansing Cycle/Muted Recovery*: This continues to be our most likely scenario. It assumes that stocks are near their lows, but that both the markets and the economy will be volatile going forward. Typically, market bubbles are followed by a long period of atonement, as investors remain disillusioned and hesitant about buying stocks. This uncertainty creates an environment of increased volatility. It takes time to clean up the accounting scandals, fraud and other problems created by the excessive indulgence that typically occurs at the end of a bubble. However, we are well on the way toward cleaning up the excesses of the late 1990's. The financial markets are pricing in a lot of bad news and value has been restored to equities. In this scenario, we assume that stock prices stabilize and begin to move higher, allowing positive fundamentals to build. The economy continues to grow, supported by low interest rates, low levels of inventories, the positive wealth effect from rising home prices and a bounce in capital spending. Given the financial pain and angst investors have experienced, we would expect many bumps on the road ahead. However, the U.S. economy has faced adversity before and has always recovered.
2. *Vicious Cycle/False Start*: This less likely scenario sees the U.S. economy sliding back into a recession due to a continued erosion of consumer and investor confidence. The consumer, burdened by rising debt, low savings and slowing income growth, is finally forced to retrench. Although rising home prices and refinancing have thus far allowed consumers to continue to take on debt and spend at a hearty rate, much of the benefit of refinancing may be behind us. Even if mortgage rates gradually move lower, at best, refinancing will stay at current levels but won't go much higher. Recently we have seen renewed weakness in the manufacturing sector, signs of a topping out in construction activity, weakness in the labor market and indications that retail sales are softening. Adding to all this is the potential negative economic impact from the West Coast port lockdown. The most important factor in this scenario is the most difficult to predict ... confidence. Many forces are working to undermine consumer and investor confidence. Investors are in shock and have lost confidence. Declining stock prices reinforce this cycle of despair. Perhaps the bear market cannot end until stocks are extremely undervalued and there is a final washout that sends not only individual but institutional investors to the sidelines. Out of this environment will come opportunity; the only question is when?
3. *Cyclical Recovery*: With so many unresolved issues swirling around, it's fairly easy to create a negative economic scenario. Surprisingly, it is not that hard to envision better times ahead either. With all the hand wringing, you'd think the economy was mired in recession. However, despite all the concerns and uncertainty, underlying economic growth remains positive. It feels worse because everything is being filtered through the prism of Wall Street. Wall Street is driving Main Street rather than the other way around. To shift this perception and keep the economy going, sentiment needs to change. Higher stock prices are the quickest way to do this. Given the negative sentiment and oversold market conditions, a powerful rally off the bottom would not be unusual. The early stages of bull markets and even bear market rallies are usually very powerful. A stock market rally would buy time for the positive fundamentals to solidify and be recognized. What would make stocks rally? First, the market is very oversold and ripe to benefit from positive news. Given heavy short selling, an initial rally would be reinforced by a scramble to cover shorts. This could occur due to any number of catalysts: better economic news, more aggressive Fed ease, positive earning surprises after what may be a "kitchen sink" quarter for corporate earnings, improved prospects for investor friendly tax reform after the November elections or a favorable resolution to the Iraq conflict. In short, if we can remove some of the uncertainties overhanging the market, it may lift on its own.

## **International Economies**

In general, international growth is slowing along with U.S. growth. Most leading indicators and measures of consumer and business confidence have turned down. This is in sharp contrast to what we were seeing earlier in the year, when hopes for a global economic recovery were running high. Most countries face the same litany of problems facing the U.S.: falling stock prices, soft labor markets, weak capital spending, and geopolitical concerns. In addition, due to a shortage of domestic demand, both Europe (with the exception of the UK) and Asia have been relying on exports to support growth. The world in essence has been piggy backing on U.S. growth and our appetite for imported goods. With the demise of Japan and the handcuffing of Europe to the Maastricht criteria (limiting deficit spending and debt creation), the U.S. is the only locomotive powerful enough to pull the global economy forward. Foreign economic growth therefore is likely to remain entwined with that of the U.S.

Japan's economy continues to falter, with leading indicators pointing to more weakness. Bank lending and credit creation continue to contract. Stock prices have gone to new lows, which continues to aggravate bank capital ratios. Nevertheless, there is hope on the horizon.

In September, Japan's top bank regulator and head of the Financial Services Administration was forced to retire. He was adamantly opposed to using public funds to bailout banks. His resignation has raised expectations that Japan may finally adopt a plan to resolve the banking crisis. We have been waiting for a major bank bailout and a resetting of the financial system as the preconditions for a secular turn in the Japanese economy and stock market. Although we have been disappointed before, this time it feels like meaningful action will be taken. If the Bank of Japan and Ministry of Finance can close smaller inefficient institutions and increase liquidity at the major banks by monetizing the bad debt on their books, the stage would be set for better times ahead. However, the burden of proof is on the government, given its past record and the entrenched forces against reform.

## **Global Fixed Income**

A steady stream of weak economic news created an ideal backdrop for a bond market rally during the third quarter of 2002. As investors continued to flee equities, bond funds saw record inflows. Even with yields that almost daily posted 40-year lows, investors found the relative stability of bonds more appealing than other options. As a result of this increased demand, long maturity Treasury bonds (those maturing in ten or more years) returned 12.0% for the quarter, the best result since the second quarter of 1969. The Merrill Lynch 7-10 year Treasury Index also posted a total return of 9.0% for the three months.

The more credit-sensitive sectors of the bond market failed to keep up with returns in the Treasury area. Still, corporate, mortgage and non-U.S. debt all had healthy returns ranging from 3.0% to 5.9%. The corporate market finished its first quarter in recent memory without credit blow-ups dominating the news. Nevertheless, the tone in corporates remains weak. While average investment-grade bond yields of 5.6% look very attractive compared to both Treasuries and to equities, corporate bonds continue to exhibit equity-like characteristics, with some of the largest issues (like Ford) acting as a drag on the entire sector. Corporations' lack of pricing power will continue to burden them until the engine for economic growth extends beyond the consumer to increased capital goods and intermediate goods spending.

An even brighter star than the Treasury market so far this year has been the government's Treasury Inflation Protected Securities (TIPS) program of bonds whose principal value is tied to inflation. They have outperformed traditional Treasury bonds (also called "nominal bonds" to distinguish them from the "real" yield derived by TIPS) as inflation-adjusted yields have fallen dramatically this year. Furthermore, a much broader base of investors has become buyers in this market, increasing liquidity and demand for these securities.

## **Foreign Exchange**

Compared with the rest of the financial markets, foreign currencies enjoyed a relatively quiet quarter. The British pound gained 2.3% versus the dollar due in part to the relative strength of the British economy. At the other end of the spectrum, the Canadian dollar eased 4.4% versus the greenback, leading the dollar-bloc lower. The yen weakened toward the end of the quarter in response to a failed auction for the 10-year government debt and negative reaction to the announcement of a plan to purchase shares directly from ailing banks.

## **Domestic Equities**

During the third quarter, the U.S. stock market recorded its worst quarterly performance since the crash of 1987. Geopolitical and economic concerns pressured the markets throughout the quarter, dimming hopes of any sort of economic recovery in the latter half of 2002. Corporate scandals also helped shake investor confidence. In a wild roller coaster ride that saw stock prices decline, recover and fall once again, all broad indices ended the quarter in double-digit losses. The Dow Jones Industrial Average tumbled 17.4%, the S&P 500 retreated 17.3%, the Nasdaq 100 was off 20.8%, and the Wilshire Small Value Index fell 23.1%.

For the twelve-month period ended September 30, 2002, the broad market indices were all in negative territory. The Dow Jones Industrial Average fell 12.5%, the S&P 500 was down 20.5%, the Nasdaq 100 was off 28.7%, and the Wilshire Small Value Index was the best performer, down only 4.1%.

What does this mean for investors? There is a lot of concern, disgust and fear in the marketplace right now. For patient and disciplined investors, these emotions swirling around the marketplace should be seen as a source of opportunity. It is our belief that the domestic equity market may be near a final capitulation. Although we are maintaining our neutral stance, we have a bias toward adding to stocks if the markets continue to weaken. Patient, disciplined investors may soon have a very attractive long-term entry point to the domestic equity markets.

## **International Equities**

International equities were also hard hit during the third quarter of 2002. The MSCI EAFE international stock index (net dividends) fell 19.7% in U.S. dollar terms.

The European stock market exhibited the same volatility as the U.S. stock market. European stocks were hit by a self-feeding decline, as falling equities prices hurt the capital ratios of large insurers, which sold further European equities in response. Defensive issues such as tobacco, food and beverages again outperformed. The worst performing sectors were computers, insurers and industrials.

Japan was one of the better performing international markets, declining only 12.1% in U.S. dollar terms. In September, the Bank of Japan announced a plan to buy equity shares directly from banks. This action was intended to support liquidity in a banking system ridden with bad loans and declining equity assets. The announcement failed to help the Japanese stock market and put downward pressure on the yen.

Emerging markets as a whole performed better than developed markets. Brazil's market and currency plunged, however, as leftist candidates retained strong poll showings in the lead up to the presidential elections.

In spite of the heavy preponderance of negative news, for 2002 year to date, international stocks have performed notably better than U.S. stocks. Foreign equities have also provided risk diversification over that period.

## Real Estate

The U.S. office market recorded a 7.5% vacancy rate during the third quarter of 2000, its lowest vacancy rate in 20 years. Fast-forward 24 months, and the national vacancy rate is approaching 18% at the same point in 2002. This is a dramatically quick downturn by any measure. Since the office sector is probably the most visible component of the real estate market, (comprising 40% of the NCREIF Property Index and 18% of the NAREIT public REIT index), real estate investors have definite reasons to be concerned about this reversal in the office building-operating environment.

What happened? Did the much publicized new “efficiencies” in the real estate markets – lender and developer discipline, and the transparency of information from the public market participation in real estate – that were supposed to prevent significant overbuilding fail to work?

The answer to this question is a classic good news, bad news scenario. The good news is that the real estate markets *were* significantly more disciplined. The development of new office space during the last several years largely just kept pace with actual *new demand* for space. Since 1997, new office supply was added at an annual rate that represented 1% to 3% of total U.S. office space, while at the same time total vacancy rates were *dropping*. Compare this to the 1980's – when new office space was being added at a rate that was several times the pace of the 1990's, for several years in a row, while vacancy rates were already *high and increasing*. In addition, unlike the 1980's, when developers could obtain 100% debt financing, in the 1990's lenders required significant equity from developers to finance a project.

Now, the bad news. In spite of the new-found discipline on the part of real estate investors to not develop too much supply, the good times came to an end as a result of a sudden and dramatic collapse of demand for office space. The increase in the national vacancy rates over the last 18 months was driven by a collapse of new demand and a significant amount of “negative demand” (resulting from tenants putting already leased space back on the market), even as a “normal” amount of new supply came on-line. Negative demand is highly unusual; even during the “bad” times of the late 1980's and early 1990's, the office sector experienced positive net demand.

At the end of the day, the office market finds itself in the same place as it did during the late 1980's and early 1990's – with high vacancy rates – and, at least for now, little if any demand. Although the discipline of the real estate capital markets did improve, it still takes at least 18 to 24 months to actually construct an office building. A lot of things can change in that 24 months. As recent events have proved, a sharp decline in demand can push vacancy rates to double-digit levels despite only modest increases in supply.

Where do we go from here? First of all, we are unlikely to see widespread foreclosures on office buildings on the same scale as during the last down cycle. Owners of office buildings are better capitalized, with less debt than the last time around. Second, forecasts of recovery vary. One prominent investor uses a two-part framework to track the recovery of the office market: Step 1) the point at which vacancy rates stop rising (which most market participants expect won't happen until the later part of 2003), and Step 2) the point when rental rates start to increase, which is not expected until late 2004 or 2005. On the other hand, one major research group at a large real estate investment firm actually predicts average office demand will be *higher* during the 2000's than during the 1990's!

Like all areas of real estate, the attractiveness of investing in the office sector is highly variable across markets and depends on the specific characteristics of individual properties. While there will be an increasing operating pressure in the office markets, many office properties should continue to provide solid investment opportunities for seasoned real estate investors.

Sources: *Green Street Advisors, Institutional Real Estate Letter/Prudential, Merrill Lynch*

## Market Performance

U.S. Interest Rates				
	12/31/2001	3/31/2002	6/30/2002	9/30/2002
<b>Cash Equivalents</b>				
90-day Treasury Bills	1.73%	1.79%	1.67%	1.60%
Federal Funds Target	1.75%	1.75%	1.75%	1.75%
Bank Prime Rate	4.75%	4.75%	4.75%	4.75%
Money Market Funds	2.12%	1.78%	1.66%	1.51%
<b>Bonds</b>				
Long-term U.S. Treasury	5.48%	5.80%	5.51%	4.67%
Long-term AA Municipal	5.22%	5.23%	4.94%	4.60%

Sources: Datastream International and Bloomberg L.P.

Global Bond Market Total Returns (U.S. \$) Through 9/30/2002			
	Quarter	Year-to-Date	One Year
<b>U.S. Bonds</b>			
Merrill Lynch 7-10 year Treasury Index	8.98%	13.80%	12.04%
Merrill Lynch 7-10 year Agency Index	8.14%	14.55%	12.87%
Merrill Lynch 5-10 year Corporate Index	5.54%	8.02%	8.34%
Lehman Bros. Municipal Bond Index	4.75%	9.61%	8.94%
<b>International Bonds</b>			
Salomon Smith Barney non-US\$ WBGI (World Gov't Bond Index), fully hedged	3.30%	5.21%	5.94%

Sources: Bloomberg L.P. and S&P Micropal

Global Stock Market Total Returns (U.S. \$) Through 9/30/2002			
	Quarter	Year-to-Date	One Year
<b>U.S. Stocks</b>			
Dow Jones Industrial Average	-17.44%	-23.14%	-12.51%
S&P 500	-17.27%	-28.15%	-20.47%
NASDAQ 100	-20.80%	-47.18%	-28.69%
Wilshire Small Value Index	-23.14%	-20.15%	-4.09%
<b>International Stocks</b>			
MSCI Japan, net dividends	-12.05%	-4.87%	-10.51%
MSCI Europe (includes UK), net dividends	-22.83%	-26.38%	-18.97%
MSCI EAFE (Europe, Australia, Far East), net dividends	-19.73%	-21.04%	-15.53%

Sources: Bloomberg L.P., Wilshire Associates and S&P Micropal

Real Estate Total Returns (U.S. \$) Through 9/30/2002*			
	Quarter	Year-to-Date	One Year
NCREIF Property Index*	1.70%	5.00%	5.71%

\* Return for latest quarter is an estimate

Source: NCREIF (The National Council of Real Estate Investment Fiduciaries)

Past performance is no indication of future results.

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