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## The Capital Markets Outlook: Time to Think Positively

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**IS THE ECONOMY IMPROVING?** Getting worse? Or going nowhere? Can we have confidence in any forecast, given the threats of geopolitical instability we face? All good questions. Yet despite the obvious uncertainties, our research points strongly to better times.

### Summary: Why We're Optimistic

- Corporate America's financial foundations have been refortified.
- The U.S. banking system has come through this downturn in great shape.
- The financial condition of the U.S. consumer is much stronger than widely portrayed.
- Two main drags on economic growth—declining foreign trade and low investment in plants and equipment—are poised to turn up.

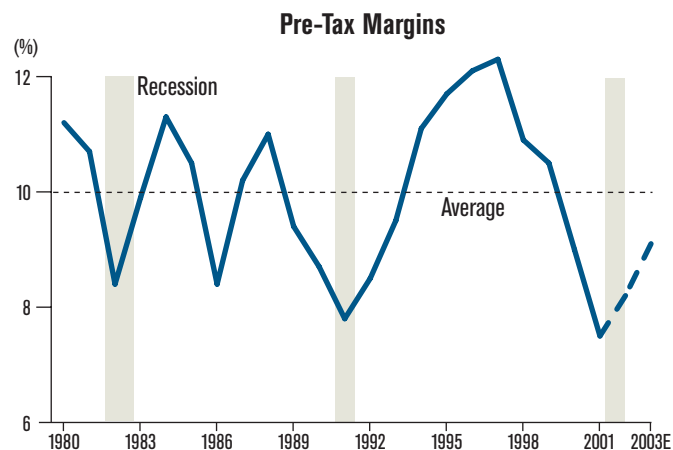
**Corporate America's financial foundations have been fortified over the past three difficult years.** Aided by extremely low interest rates, highly effective cost-cutting, and a surge in worker productivity, corporate profit margins have turned upwards despite the sluggish economy (*Display 1*).

**Cash on hand has risen to record levels** as a percent of all corporate assets, debt-to-equity ratios have returned to pre-boom levels, and free cash flow—that's cash coming into companies with no immediate need to spend it—appears to be headed toward a new record (*Display 2*).

**The U.S. banking system has come through the economic downturn in great shape as well.** The shareholder capital underlying bank loans is now at a modern-day high. Banking industry profitability is more than double the level of the last recession. Loan losses in

Display 1

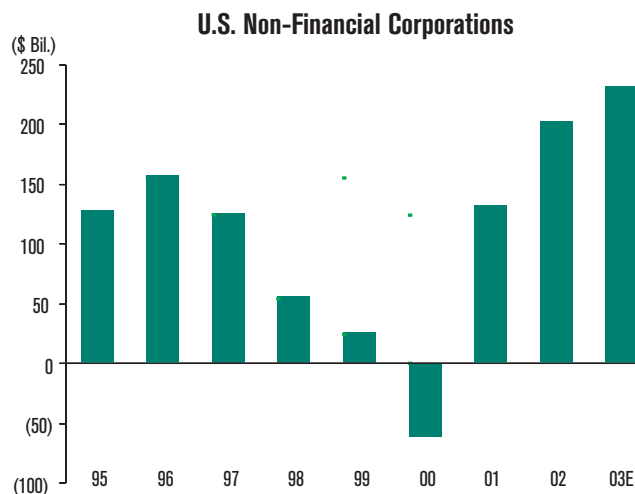
### Profit-Margin Recovery Already Under Way



U.S. non-financial corporations  
Source: U.S. Department of Commerce

Display 2

### Free Cash Flow Expected to Reach Record High



Source: FRB & Alliance Capital estimates

relation to banks' earnings assets are well below those of prior peaks. The cash deposits that provide the money that banks lend are growing strongly. In all, the risk profile and liquidity of the banking system is impressive (*Display 3*).

Display 3

### Banking System Very Strong

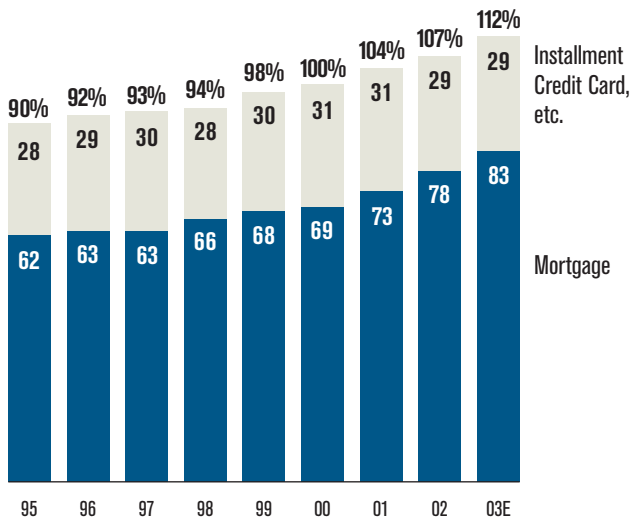
	Last Recession 1989-91	Current Recession 2000-02
Equity as % of Assets	7.1%	9.1%
Return on Assets	55 b.p.	130 b.p.
Loan Losses	157 b.p.	100 b.p.
Growth in Core Deposits	14%	19%

Perhaps most importantly, the consumer sector is doing considerably better than widely portrayed. It is true that consumer debt has risen faster than income in recent years owing to the rapid growth in mortgages (*Display 4*).

Display 4

### Growing Consumer Debt Linked to Mortgages

Debt as % of Disposable Personal Income

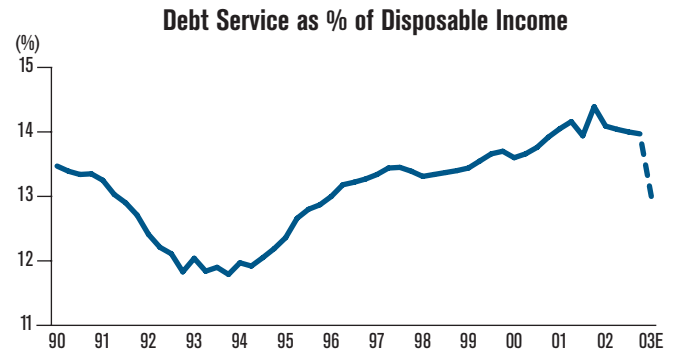


Source: Federal Reserve Board and Alliance Capital estimates

Yet mortgage payments as a percent of disposable income are actually falling as existing loans are refinanced at today's much lower interest rates. In addition, installment loans and credit-card debt have actually fallen in relation to personal income. So rather than teetering on the brink, as some reports would have it, U.S. households' wherewithal to finance continued growth in spending is very much intact (*Display 5*).

Display 5

### Interest-Rate Drop Trims Consumer Debt Burden



As of May 12, 2003

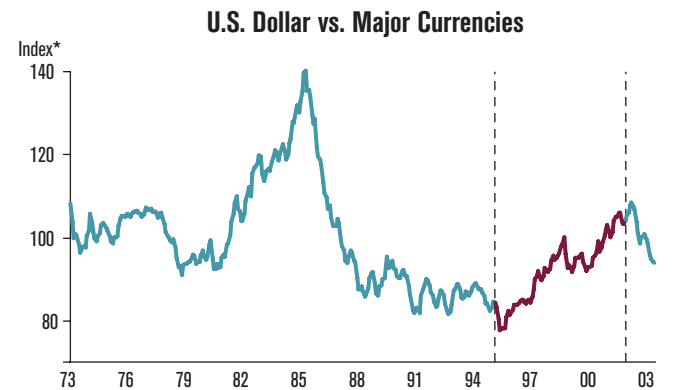
Source: Federal Reserve Board and Alliance Capital estimates

The two main drags on economic growth, deterioration in foreign trade and a decline in investment in plants and equipment, both seem poised to turn up, possibly quite sharply. The foreign-trade story could be the biggest development of all. What we're experiencing here is actually the unwinding of the last trace of the late-Nineties bubble economy, when the U.S. was widely seen as the paragon of industrial success. Foreigners couldn't get enough of U.S. investments at the time, whether in stocks, bonds, or direct investment in property, plants, and equipment.

Their insatiable appetite for U.S. assets—and thus U.S. dollars—drove the value of the dollar ever higher. Between 1995 and 2002, it rose more than 40% in relation to the currencies of our principle foreign trading partners. And while that was nice if you were an American visiting Paris or if you were planning to buy a Toyota, it progressively undermined the competitive position of U.S. businesses in world trade by making our goods and services increasingly expensive when paid for in currencies such as the euro or yen (*Display 6*).

Display 6

### Currency Moves Often Large and Sustained



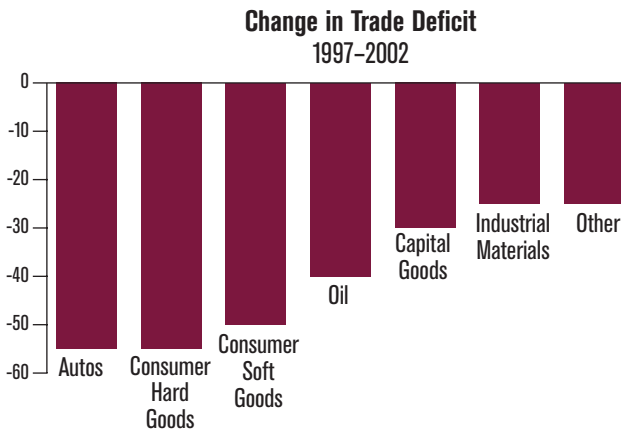
\*U.S. trade-weighted index through April 30, 2003

Source: Federal Reserve Board

To make matters worse, the faster growth of the U.S. economy caused Americans' spending power to increase at a higher rate than foreigners', so that we were importing more and more of their output just as they were able to import less and less of ours. By late last year, the difference in what we import and what we export reached an annual rate of some \$500 billion—the largest trade deficit ever run by a single country (*Display 7*).

Display 7

### Deepening of Trade Deficit

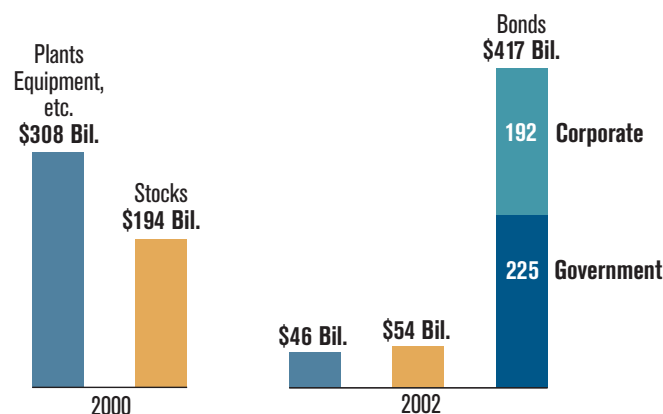


Source: Department of Commerce

**Now we have the following situation:** Foreigners must invest \$1.5 billion in the U.S. every day—including weekends—to make use of the surplus of dollars they are receiving from trade. This comes at a time when they no longer want to invest anywhere near that amount in the U.S. Foreign direct investment in plants and equipment has fallen 85% from the peaks of 2000 (*Display 8*). And interest in buying our stocks has fallen by almost as much. Meanwhile, our bond yields are the lowest in the world except for Japan.

Display 8

### Foreign Investment Turns to Low-Return Assets

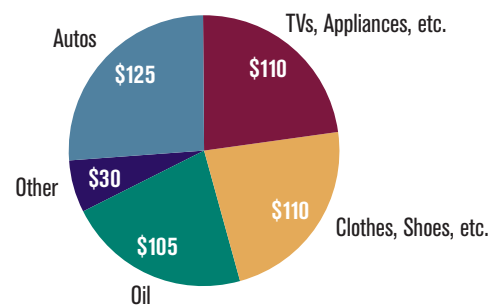


Source: Federal Reserve Board Flow of Funds

As a result, they've begun to sell their dollars in the currency-trading markets, driving the value down. In time, the weakening of the dollar will improve U.S. businesses' global competitiveness, fostering a turnaround of the import/export ratio, tempering the flood of unwanted dollars in foreign hands, and stabilizing currencies. But this stabilization won't happen quickly, because the trade deficit is concentrated in certain parts of the economy where it will be difficult, sometimes impossible, to reverse (*Display 9*).

Display 9

### High Inertia Sources of Trade Deficit: 2002 (\$ Billions)



Source: Federal Reserve Board and Alliance Capital estimates

**Oil is a prime example:** The U.S. can't produce all the oil it consumes. Thus, the trade imbalance will persist no matter how cheap the dollar gets. We've also dismembered most of our manufacturing facilities for consumer products like clothing, shoes, and TV's. Our largest trade deficit—in autos—will decline only grudgingly, as foreign companies resist ceding market share and instead build U.S. production facilities to lower their cost structure. This is a good thing, but it's a process that will take time. While the U.S. still has advantages in producing certain capital goods, which is a large category, on its own it can't arrest the deficit quickly. And so dollars will probably keep pouring out of the country for some time, whether foreigners want them or not. This is an unstable condition, and could result in the dollar falling a lot more and for a lot longer than generally expected.

### WHAT IF THIS SCENARIO ACTUALLY HAPPENS?

Here are some likely outcomes:

- Since the U.S. imports about 30% of the goods it consumes, and import prices will rise as the dollar weakens, some upward pressure on inflation can be expected.

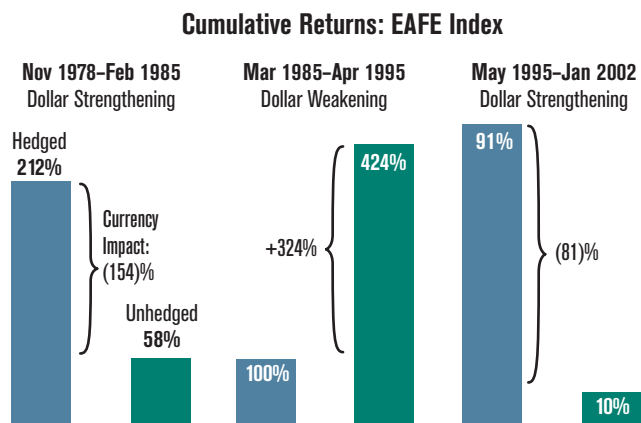
- Profit margins of U.S. producers will likely increase as the pressure of competing against cheap imports recedes.
- Foreigners will start buying U.S. property again, just as they did during the last period of a very cheap dollar, when the only way they could compete with U.S. businesses was to move their production operations here.
- The trade balance will gradually decline, helped especially in categories where we retain product leadership, leading to faster U.S. economic growth.

**All things considered, each of these developments looks promising for U.S. businesses in the long run.**

The significance to investors is multifold. Perhaps the most important implication is that investors should have some capital invested in non-dollar assets whose value will rise as the dollar falls. The effects on investment return can be very large. For instance, over the 10-year period ending in mid-1995 (the middle bars in Display 10), investment returns in foreign stocks as measured in dollars were four times larger than the local market return, owing to the sharp rise in the value of foreign currencies relative to the dollar during that period.

Display 10

**Currency: A Major Impact on Stock Returns**



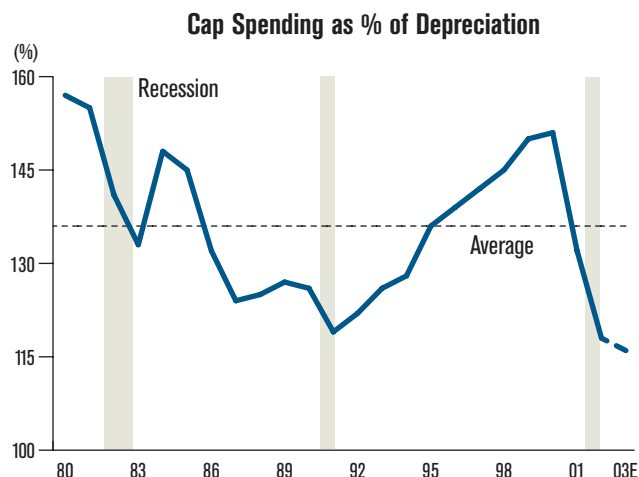
Source: Datastream, MSCI, and Bernstein

Aside from foreign trade, one of the biggest barriers to a faster rate of economic growth has been the depressed state of business investment in plants, equipment, and inventory. As a percent of depreciation, the level of such investment is now at a modern-day low. Business spending, however, is ultimately responsive to trends in profitability and the availability of free cash flow. The improvements highlighted above suggest strongly

that an upturn in spending will soon develop, which from today’s depressed levels could be quite substantial. For instance, a recovery in spending to its average relationship to depreciation would add some \$200 billion to economic output (Display 11).

Display 11

**Capital Spending Extremely Depressed**



U.S. non-financial corporations  
Source: Federal Reserve Board and Alliance Capital estimates

A similar picture applies to inventories. All along the supply chain from suppliers to manufacturers and distributors on to retailers, inventories are extremely low—for the same reason as capital spending, and with the same effect on the economy. And so once businesses develop the faith to replenish their inventories, GDP growth will get two major boosts at the same time (Display 12).

Display 12

**Stimulants Fueling Faster Growth**

	Recovery Potential	% of GDP
Trade	\$300+ Bil.	3%
Capital Expenditures	200	2
Inventory	50	–
<b>Totals</b>	<b>\$550 Bil.</b>	<b>5%</b>

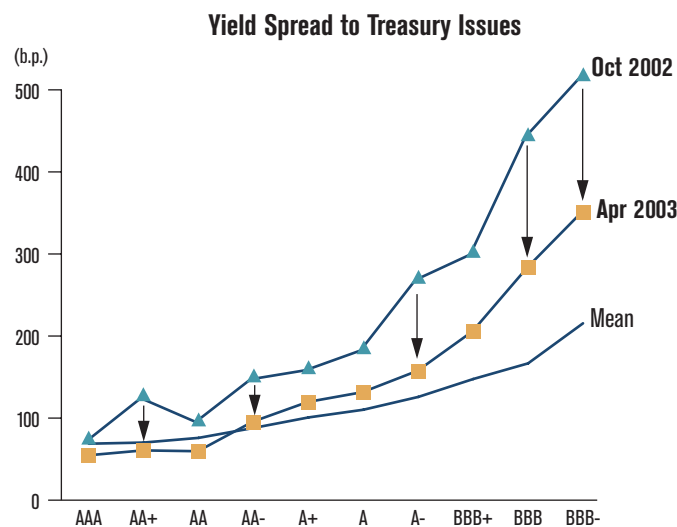
Source: Alliance Capital estimates

There’s also the potential boost from increased exports, which could further turbocharge GDP growth over the next four to five years. Put it all together and the case for much faster economic growth in the next few years seems pretty solid.

**Still, at the moment few are forecasting any such thing.** Most prognosticators are focusing only on the problems. Just the same, the capital markets seem to already be signaling that something good is going on:

- The difference in yields between high-quality and lower-quality bonds has dropped decisively. Within the investment-grade range, the gap in yields is back to normal. Even among the lower grades, yield spreads are only moderately above normal except in truly distressed industries like telecommunications and power. And remember that the standard of comparison here is Treasury yields, which are now at 45-year lows. Which means that even lower-quality companies can borrow money without paying through the nose—adding yet more momentum for recovery (*Display 13*).

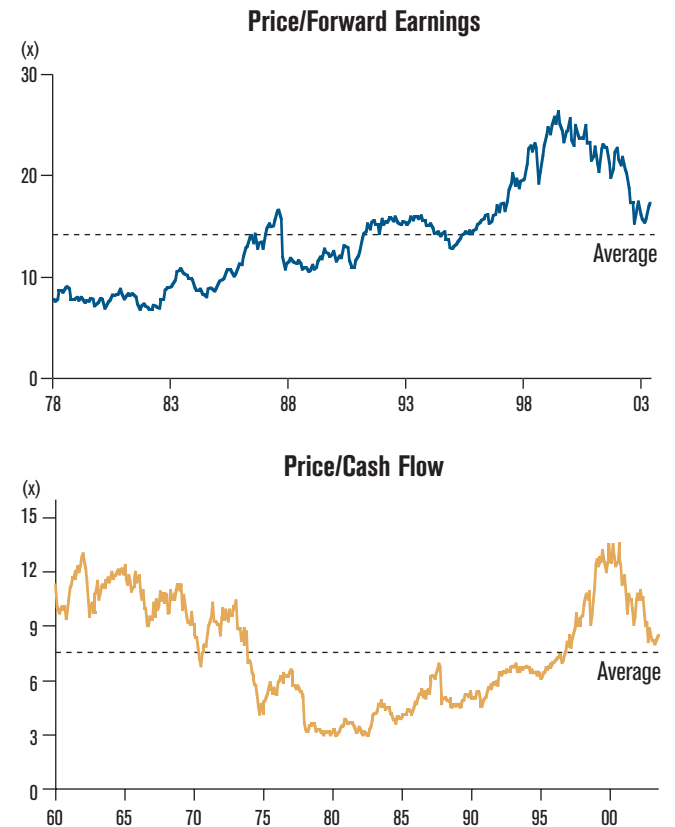
Display 13  
**Credit Default Fears Abating—Spreads Declining!**



Mean and standard deviations calculated using monthly data from 1990-2002  
Source: Salomon Smith Barney  
Treasury securities provide fixed rates of return as well as principal guarantees if held to maturity. Investment returns and principal value of a mutual fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

- Stocks, too, have begun to respond. At this writing, market averages have climbed at high-single-digit rates this year to date and are nearly 20% above their troughs. Based on the standard measures of investment value—stock prices in relation to company sales, earnings, cash flow, and book value per share, stocks are now a bit more expensive than usual. But they're still a lot cheaper than bonds. You still pick up an unusual amount of extra return potential when you move from risk-free money funds into stocks (*Display 14*).

Display 14  
**Equity Valuations Return to Historical Norms**



Through April 30, 2003  
Source: Standard & Poor's and Bernstein

**And so while there's less risk aversion in the markets than there used to be, there's still a lot to capitalize on.** In fact, the very investments that have been among the best bets in recent times—long-term Treasury bonds, which are backed by the government's full faith and credit and yield a lot more than shorter-term T-bonds—actually seem to us an area to avoid. Their long maturities could bring a high risk of loss when interest rates rise, and in the meantime you're not being paid enough to make such a prospect worth your while.

In sum then, certainly where the economy is concerned—we at AllianceBernstein are optimists.

**We see a number of powerful forces pointing to faster economic growth ahead:**

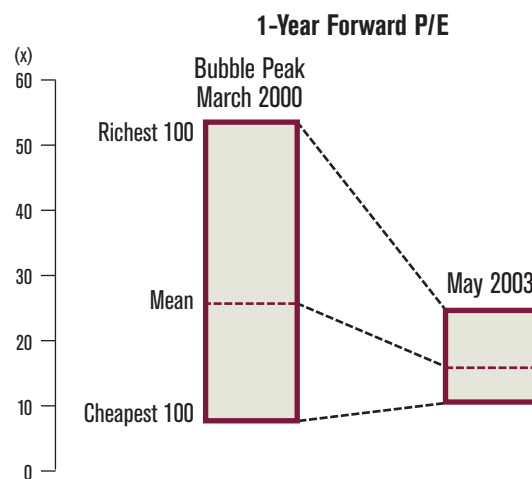
- More cash on hand everywhere
- Less pressure on household budgets from interest and loan repayments
- Falling tax rates

- Rising corporate earnings
- The prospect of a sharp upturn in business investment
- A further fading of the abnormal risk aversion that's marked the business and investment environments in recent years
- And, in our judgement, a return to making money in stocks

On that last point, make no mistake: We're talking about growth stocks and value stocks. After three years of post-bubble misery, growth stocks' prices have come down to earth; the valuation premiums accorded many high quality growth stocks have returned to historically low levels (*Display 15*). **Thus, attractive investment prospects apply to both styles of investing, suggesting that a balanced allocation to the two is now a sound strategy.**

Display 15

### Valuation Differentials Compress



Source: Standard & Poor's and Alliance Capital estimates

## What Should Investors Do Next?

Given all the economic and market research detailed above, we think there are four important things for investors to be thinking about in connection with their portfolios:

1. **Consider building the equity allocations** in your portfolio. Earnings' improvement and better economic conditions point to a stronger market.
2. **Beware of longer-term bonds**, which may suffer should interest rates rise from their current levels. With the lowest rates we've seen in over 40 years, the opportunity to make money on bonds is greatly reduced. Some investors may not fully understand the risk to their portfolios should rates increase from the current levels.
3. **Build the allocation to foreign stocks** in order to capitalize on any further weakening of the U.S. dollar and for diversification purposes. Valuations in overseas markets look even more attractive relative to U.S. stocks.
4. **One proven wealth management strategy is to maintain a balanced portfolio**, which includes stocks (domestic and foreign, growth and value), bonds, and other asset classes such as real estate investment trusts to achieve more consistent results while also controlling portfolio risk (volatility). Rebalancing portfolios back to normal levels insures that investors buy low and sell high.

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