PNC Advisors Still Likes the Stock Market - February 2001 Market Insight

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In the Fed we trust

Despite the Fed's aggressive stance to assure longer term economic growth, currently signs of economic weakness are everywhere. Primary contributors to economic decline include the price of oil and natural gas, which reduced the discretionary spending of consumers, as well as the stock market, which may have alarmed consumers while reducing the wealth effect of spending. Of course, the Fed itself was orchestrating a slowdown of activity by draining liquidity from the system. To put liquidity in perspective, this time last year, the annual change in the monetary base was over 15%. Today, it is a negative documenting the substantial decline. We will come close to a statistical recession this year with the first quarter of 2001 slowing to as little as 1% growth on top of a weak fourth quarter in 2000 and lackluster second quarter in 2001. We continue to believe, however, the second half of 2001 will average near normal growth rates of 3.5% as the Fed's policies, possible retroactive tax cuts, and a stronger stock market, will revive consumer and industrial demand.

U.S. Equities: Attractive, especially small- and mid-size companies

With current economic deceleration is likely to continue for the next two quarters, corporate earnings are likely to suffer. This does not, however, mean the stock market must continue to suffer in tandem. While the S&P 500 earnings consensus continues to fall leading into the reporting period, the earnings revision trend has bottomed. Our current forecast for S&P 500 earnings have been downwardly revised to $57.25 in 2000 and $61.00 for 2001, from $57.50 and $62.25, reflecting our outlook for mid-single digit earnings growth this year. We remain positive on our outlook for the equity markets across the range of capitalizations and balanced in our style weighting between growth and value in the large cap universe as the market digests fourth quarter earnings reports. Declining short-term rates should be the catalyst for the cash positions to move to stocks.

Small and mid-sized companies offer special attraction at this point in time. Not only are they historically cheap versus their larger counterparts on a price to book and P/E basis, they will likely maintain double digit earnings growth in 2001 while large companies struggle. We expect the S&P 500 earnings growth to be close to 5% for the year. The consensus estimate for the S&P Mid-Cap 400 is 18.6% and the S&P Small Cap 600 rate is 25.8%. The price earnings ratio to growth rate (PEG ratio) is 4 times for large companies and less than 1 for small companies reflecting an attractive opportunity.

International Equities: Positive returns, mostly currency-related

During the last month, international equity market returns have been positive with the EAFE index up 3.5% and the Emerging Market index up 2.4% due to currency moves. In December, the Euro advanced 8% vs. the dollar and is up 14% from the low point in October. The Yen, however, continues to weaken due to the possibility of another recession in Japan. Most foreign markets will experience volatility until investors better understand the impact of the U.S. economic downturn.

Fixed-Income: Corporate bonds look favorable over Treasurys

Bond investors have been big winners over the past year as interest rates for quality bonds have declined sharply. In the treasury market, we are fairly neutral on the direction of bond prices over the next six months as current prices likely reflect weaker growth and an easier Fed. Opportunity exists in the corporate bond arena as yields on corporate securities reflect good value relative to treasury yields. Quality, however, is paramount as the slower economic growth will continue to pressure profit margins and cash flow. The good news in the high yield market was a telecommunications junk bond issued for the first time in more than six months, possibly signaling the opening of the capital markets to weaker credits again. The high yield market is attractive for aggressive investors.

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