

INSIGHT & OUTLOOK

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Introducing Our Quarterly Commentary

Since this is the first quarterly commentary produced by Patton Albertson & Miller, it seems appropriate to share with clients our philosophy about this publication. First, let's describe what it is not. It will not routinely regurgitate market statistics such as closing S&P500 and NASDAQ levels; monthly, quarterly, or year-to-date performance; or price-to-earnings or market capitalization data.

We believe our clients have ample sources in print or on the

internet which supply such information. The purpose of our commentary is to give clients a better understanding of how Patton Albertson & Miller assesses the overall investment climate. Many of our conclusions will conflict with conventional, mainstream thought of Wall Street and Washington. As value investors we are accustomed to being "contrarians" at times and we trust clients will appreciate some of the insights we have on occasion.

We believe humility is a great virtue in short supply in the investment world. We will strive to be humble in our assessments of the financial markets. The future is unknowable. Uncertainty is inescapable. Investors have no choice but to wrestle with probabilities and trade-offs. In the full knowledge of all that, we genuinely solicit client comments, observations, and questions regarding anything contained herein.

Running Out of Ammo?

Greenspan and the Little Big Horn

On June 25, 1876 General George Armstrong Custer's command of 212 Seventh Cavalry troops suffered annihilation at the hands of several thousand Sioux and Cheyenne Indians near a small river called the Little Big Horn. Given the overwhelming numbers against him, Custer's survival was a long shot, but running out of ammunition certainly tipped the balance against him.

It would be incorrect, however, to assert he lost because he ran low on ammo or that with unlimited ammo he and his men could have emerged victorious. The seeds of Custer's defeat were sown hours and days before as his tactical and strategic mistakes put him in a position that fateful summer afternoon where just escaping

with a portion of his troops would have been a major accomplishment.

So what do Custer and his defeat at the Little Big Horn have to do with Chairman Greenspan of the Fed? Well, on June 25th of this year Greenspan orchestrated the thirteenth reduction in the Fed Funds rate to a multi-decade low of just 1%. Some economists expressed concern that the Fed was nearly out of ammunition i.e. room to cut interest rates. We doubt it will make much difference. Greenspan's situation, like Custer's, is the culmination of many bad decisions made over an extended period of time.

The Great Asset Bubble of the Nineties

Aggressive interest rate cuts

have been ineffective in stimulating economic recovery because the Fed is confronting the aftermath of an historic asset bubble. And the U.S. asset bubble can be laid squarely at the feet of Greenspan's monetary policy.

In essence, from about 1994 on he permitted a stupendous expansion in corporate, consumer, and mortgage credit, unsupported by domestic savings. This credit explosion led to:

1. Reckless investment in telecommunications, technology, and the internet.
2. Surging personal consumption with a concomitant collapse in real savings.

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3. Record deficits in our current account with foreigners.
4. Wildly inflated stock prices and
5. A merger and acquisition frenzy totaling over \$3 trillion from 1998 to 2000, more than the total of the preceding 30 years.

Hangovers and Bogus Cures

Unfortunately there are no painless solutions to an asset bubble. It has given the U.S. economy a serious, nasty hangover.

Malinvestments need to be worked down, savings and consumption need to adjust, and excessive debt needs to be reduced. The Fed and the politicians in Washington, of course, want none of that.

Accordingly, the Fed has kept the credit spigots open (particularly mortgage refinance credit) with its ultra low interest rate policy. This is akin to treating a morning hangover with a stiff shot of whiskey for breakfast. For their parts, the Administration and Congress seem all too happy to re-embrace deficit spending. It didn't take them long to fall off the fiscal responsibility wagon.

The Dollar's Long Shadow

We doubt either monetary or fiscal policy will have the desired effect of lifting the U.S. economy into a sustainable growth trajectory. A crucial weak link is the dollar exchange rate. Foreign gross holdings of dollar assets exceed \$9 trillion. Our current account deficit is piling up \$1.5 billion per day, over \$500 billion per year. That's more than 5% of gross domestic product. America's over consumption problem is reflected in that 5%.

Rather than encouraging more consumption which will only exacerbate the trade deficit, the authorities should be promoting more saving. Money market rates below 1% are not the way to do that.

As the dollar's value erodes against foreign currencies (it's down more than 19% versus the Euro this past year), foreigners at some point will tire of their foreign currency losses and begin to reduce their purchases of our financial assets. The process is well along in the stock market, but foreigners (primarily Asian central banks) are still big buyers of our bonds. When that changes it will force the adjustments that Greenspan, the Administration, and the Congress are trying mightily to avoid.

Investment Observations

What investment observations can we draw from this broad overview?

First, a strong second half recovery is unlikely. The economy probably will continue to just muddle along as it has the past few quarters.

Second, many investors' expectations for a broad recovery in corporate profits will be dashed. Selectivity and a keen focus on price will remain important for stock market success.

Third, foreign financial markets might provide greater returns for both stock market and fixed income investors. A large part of their potential out performance will be due to currency effects related to the weaker dollar.

Fourth, world financial markets will probably become more volatile as investors maneuver to redeploy their funds to countries, sectors, and asset classes which are most likely to provide satisfactory returns.

Patton Albertson & Miller looks forward to the challenge of assisting our clients through these interesting times. Unlike Custer, we will take the offensive only when we perceive the odds to be in our favor.

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The statements expressed in this newsletter are the opinions of Patton Albertson & Miller, LLC and do not represent specific investment recommendations or results.

