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## Earnings Speak Louder than Words

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Tuesday, October 29, 2002

By Hilary Kramer

FOX NEWS

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**ADVERTISEMENT** There is now an encouraging sign that we may be able to avoid a double dip recession. Why? Because we are more than halfway through the earnings season and reports from companies in the S&P 500 are running better than expected. In fact, earnings have grown for two straight quarters, sequentially and from a year ago. Even better, it looks like they will do the same in the fourth quarter.

Furthermore, of the 255 companies that have already reported third-quarter earnings, 60 percent beat estimates, and 28 percent met them. Indeed, that's just above the average for the last eight years! And even with a few key economic reports bringing less than rosy news, the stock market recovered in October, brining Wall Street and all investors a happy gift: a four consecutive week rally on the Dow Jones Industrial Average.

### Mixed Signals from our Economic Reports

But, in terms of earnings, we also have to look at the other side of the equation. As unexpectedly strong as our earnings are coming in, this third-quarter is being compared against a very weak third quarter in 2001. The U.S. was in a recession and had suffered the worst act of terrorism in our history.

Furthermore, the economic reports released during October showed that our industrial economy is still trying to pull out of its two-year-old slump. Orders for durable goods—big-ticket items such as steel, industrial machinery, furniture, and cars—plunged 5.9 percent in September, the biggest monthly decline in a year. This sharp drop in orders for non-defense capital goods was viewed as disappointing news to Wall Street.

Additionally, the Federal Reserve said that industrial production declined by 0.1 percent in September, its second consecutive drop after emerging from a 15-month decline. The bright spot in that report was that high-technology output for the third quarter rose 1.1 percent and was up at a 7.7 percent annual rate. This could be a real godsend for companies such as Cisco, Applied Materials and Intel. These are all leaders in their respective industries, but have suffered so severely from the sharp decline in global technology spending.

The unemployment report certainly gave the street a mixed signal. There was a markedly lower rate of unemployment -- 5.6 percent -- but there were also 43,000 fewer jobs. Although many did cheer this drop which was only a few months ago inching towards 6 percent, there is another way to interpret the news: many people have simply given up looking for work and dropped out of the workforce, at least temporarily.

With fewer people working, consumer confidence is likely to take a hit as well as consumer spending which certainly does not bode well for a strong recovery.

The news that was the most concerning was the retail sales number -- which fell 1.2 percent in September. The U.S. consumer has long been the life-blood of our economy. Consumer spending accounts for about two-thirds of the U.S. economy.



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So news that consumers were holding tightly on to their wallets was a bit jolting to Wall Street. Amid preparations for war in Iraq and a stock-market sell off, shoppers for the most part stayed home in September, resulting in dreary and uninspiring sales increases at even the country's strongest retailers.

The sentiment is that disappointing retail sales is evidence that the pace of economic recovery is slowing sharply. The report also pointed towards a holiday season that will be even more anemic than previously forecast. The problem there is that this may invariably translate into less than stellar fourth quarter earnings.

Although retailers were facing relatively easy comparisons with sales from a year ago, which were hammered by the Sept. 11 terrorist attacks, even fast-growing discount retailers Wal-Mart Stores Inc., Target Corp. and Kohl's Corp. reported surprisingly soft September sales.

Wal-Mart, of Bentonville, Ark., said September same store sales increased 3.3 percent, but Wal-Mart had originally predicted an increase of between 4 and 6 percent for the month. The big negative surprise was the steep sales drop at Kohl's, which after 17 consecutive months of same store sales increases, posted a 3.2 percent decrease in same store sales.

The disappointing retail sales numbers raise the question of whether U.S. consumers are finally putting away their credit cards. Given the fragility of the economy, a slowdown in spending could push the economy back into recession.

### **Good news: Cash is on the Side Lines and Investors have a Safety Valve**

If there is a bright side to the two-and-a-half-year exodus from equities which has taken our country's wealth from \$18 trillion down to \$10 trillion, it is the mass of investors who already have left the party and now have a percentage of their savings in cash. In fact, since 2000, money has flooded into uninsured cash accounts—certificates of deposit, money market funds and even checking accounts. As a result, money-market-fund assets equaled almost 28 percent of the market value of the Wilshire 5000 index as of September 30. The last time this ratio stood so high was in 1982, the very year the late, great bull market of the 1990s was born!

A horde of cash on the side lines also represents a chance for the bulls to really run as investors have some cash available to feed and possibly create a sustaining rally. The big money managers themselves are part of this sweeping trend. In the latest *Barron's* poll of institutional money managers, they reported holding only 59 percent of their assets in equities, down from 69 percent in the spring survey, and levels in the mid-to-high 70 percentile in earlier polls. At the same time, bonds now account for 26 percent of their assets under management, up from 18 percent last spring. Cash levels have risen to 14 percent of the average portfolio, up from about 5 percent in polls conducted in the late 1990s.

What is so significant is that managers indicated their plan to bring their assets invested in equities up to 67 percent over the next 12 months, while drawing down their fixed-income and cash holdings. The poll also looked into the predictions on the bond market which has benefited the most from the stock market's meltdown – bond funds brought in a record \$28.09 billion in new cash in August. Interestingly, managers are worried that bonds will lose their buoyancy. Fewer than 4 percent were bullish about the outlook for U.S. Treasuries and a startling 57 percent were bearish! Corporate bonds fared better; 25 percent of the managers still like them, while 30 percent consider the asset class overvalued.

### **The Consumer's Balance Sheet is Looking Over-Leveraged**

Consumer balance sheets are beginning to create nervousness on Wall Street. Current consumer indebtedness is higher than it has been in more than 20 years. Rising debt levels could pose problems for both homeowners and mortgage lenders in the future. Mortgage debt has risen to 88 percent of personal income, and consumer credit now equals 19 percent of personal income. Together these obligations equal 107 percent of one year's annual salary.

The news isn't all bleak. Nationwide, incomes are rising and interest rates are low, meaning many households especially the wealthiest are able to manage their high debt loads. Plus, the Federal Reserve recently issued a report saying that the debt binge might finally be slowing. The Fed report indicated that consumer borrowing rose at an annual rate of 2.9 percent in August, a sharp slowdown from the 7 percent rate in July.

### **Real Estate May Be Vulnerable**

The whisper on Wall Street and the blunt front page articles of business magazines--such as the October 28th edition of *Fortune* entitled "Is Real Estate Next?"--all imply that property prices are vulnerable to a significant setback in the next 12 months. Certainly, some real estate will do better than others, but all the indications point to a bubble in both the residential and commercial real estate markets.

Home prices are important because many households have been tapping into the value of their homes by taking out home-equity loans or refinancing their mortgages and taking out cash in the process. Because the values of their homes are rising, they have been able to take out cash without putting a serious dent in their overall wealth. If prices start to slip and homeowners -- of which there are 68 percent in the country -- begin to feel less rich, they might try to cash in on their real estate, in a mass exodus, creating a bubble that could burst like what we saw with the NASDAQ.

Additionally, rising property taxes in states and municipalities that are seeking to close budget gaps, and lower investment returns, are seen as possibly causing distress for the real-estate market.

In fact, all of this speculation on the real estate bubble, has brought pressure on Fannie Mae, which is now seen as overvalued. In fact, controversy has swirled around this government-sponsored mortgage-finance concern since August, when management disclosed that the so-called duration gap, which measures the balance between cash flows from the company's liabilities and assets, was beyond targeted range for a second consecutive month.

The stock has since recovered on strong quarterly results but it may very well become ensnared in an eventual mortgage-market slowdown or a deflating real-estate bubble. Bottom line: Fannie Mae has so many institutional holders that when the selling begins, the floor may give way as sell orders for Fannie Mae rush into the trading pits. What does this mean? Fannie Mae's stock price could soon be taking a nose dive.

### The Bottom Line Comes Down to Trusting Your Money Manager and Yourself

So, what is the bottom line? Earnings are looking better, but our economy is not yet out of the woods. The economic reports are shaky and there is a looming fear of a real estate bubble ready to burst. In the meantime, the commitments that Washington made to us last summer -- cracking down on accounting fraud, enforcing accounting standards, prosecuting wrong-doers -- still have yet to pan out.

So, that is why it is important to invest in companies that have been around for a while and which will survive every part of a market cycle. In fact, it is important to keep in mind that we are simply in a market cycle that will pass. Recovery is only around the corner. The objective is to make it through any and all cycles with your wealth intact and your nerves unshaken.

How to do this? First, stay well diversified between fixed income and equities and make sure that there is an international component to your portfolio. The key is to invest in companies that you know, such that you can understand what they do and what their real future prospects might be -- it's easier to deceive investors about a claimed 1,000 percent future increase in fiber optic demand than it is to misrepresent the popularity of Wal-Mart and Costco or the demand for Cheerios and Tylenol or even the number of subscribers to Sprint's cell phone service and to Echostar's Dish Network.

All you have to do is look at the parking lots or in people's kitchen and bathroom cabinets and at the cell phone hanging from their belt or the TV that is in their living room and the truth will be staring back at you. And from such simple truths comes the larger truth: if people are buying the company's products, the stock will do just fine.

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