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Kramer's Corner

The Bulls and the Bears: Fighting their Way Through October

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Monday, October 07, 2002
By Hilary Kramer

FOX NEWS

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ADVERTISEMENT The first week of October was a real downer as all three indexes -- the Dow Jones Industrial Average, the Standard & Poor's 500 stock index and the tech-heavy NASDAQ -- extended their consecutive weekly losses to six with declines of 2.3, 3.2 and 4.9 percent, respectively. Why does our market continue to tumble? One reason is uncertainty over the prospect of war with Iraq. But it is also concern regarding third quarter results. At the end of each quarter -- the third quarter having ended on September 30 -- companies publicly announce their financial results for the preceding three months. What is the problem? Profit warnings came this week from EMC, the data storage company, drug maker Schering-Plough, the usually invincible Bank of New York and aircraft maker Boeing. Now the first big week of third-quarter reports starts on October 7 and continues throughout the month -- the expectation of bad news is just another factor dragging down the stock market.

It is as if there is a tug of war between the positive and the negative news affecting the markets.

Looking at the bright side of the equation, consumers are taking advantage of low interest rates in order to refinance their mortgages. Their newly found cash is being spent on big-ticket items such as new cars and major home renovations. In fact, US auto sales in August surged 13 percent to the highest level of the year. Additionally, Lowe's, the home improvement retailer, has said that it plans to grow earnings by 19-20 percent over the next two years, with revenue up 18-19 percent.

Lower monthly mortgage bills have also brought a mostly carefree attitude to consumer's everyday spending that continues, in spite of the economic and geopolitical storm clouds. This is evident from the huge quantities of products being bought at the checkout counters of our local Costco or Wal-Mart. In fact, Costco's sales in its most recent quarter were \$12 billion, an increase of 10 percent. While sales for Costco's fiscal year which just ended on August 31 were 37.9 billion, up 11 percent from the previous year. Wal-Mart had similarly spectacular news with their quarterly sales of \$59.7 billion, up 13.1 percent while their earnings per share for the same quarter were up a whopping 23 percent.

In the short run, Washington is providing stimulus by spending money on building up defense and homeland security. All of which has created jobs and new projects throughout the country. Meanwhile, efforts to repeal the Bush tax cut have fizzled, therefore guaranteeing that more money will be added to the spending mix over the long term.

The Longest Bear Market in 60 Years is about to End

So, as we suffer through the longest bear market in 60 years. The stock markets, after recuperating in August, saw September retest and break through the July 23rd low of 7702 on the Dow. The Dow now sits at a four-year low and the NASDAQ has reverted to where it was in 1996 -- retracing all of the gains of the 90s bull market.

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So, moving forward, who will win the tug of war? The bears or the bulls?

First, the bearish side

The economic recovery has been sub-par. Consumers have started to cut back on the extensive spending that was the one positive beacon during the three-quarter recession of 2001. Businesses have continued to make significant and severe cuts in capital spending on equipment, expansion projects, new facilities and production plants. Capacity utilization is still at only 76 percent. So lots of companies across all industries are producing much less than they are capable of putting out into the market. That is the albatross of businesses' predicament today. Companies paid big money to expand-- only to find the demand didn't meet the expectation. Other data tell the bearish tale:

- Although the unemployment rate fell to 5.6 from 5.7 percent, the lack of job growth and the lengthening of the time spent unemployed sends a negative signal to the recessionary recovery process.
- Furthermore, first-time claims for unemployment benefits increased more than expected as the total topped 400,00 for the sixth straight week in a row
- As for consumer confidence, the Conference Board survey shows growing pessimism among consumers. The most recent report said that the consumer confidence index in August fell to 93.3, the fourth consecutive monthly decline and its lowest level since last November 2001. Consumers, whose spending accounts for two-thirds of all economic activity in the United States, grew more cautious in the second quarter as a wave of corporate accounting scandals, a stock market slide and the rampant hiring freeze made people more anxious about the economy's direction.
- Although consumer spending in the second quarter grew at an annual rate of 1.8 percent, this was significantly weaker than the 3.1 percent we rejoiced over in the first quarter of this year.
- Businesses, facing stock market distress and economic uncertainties, cut spending on new factories, office buildings and other structures. Business spending fell 2.4 percent during the second quarter of 2002; the seventh quarterly decline in a row. Business spending on technology is now expected to be flat this year; this is following the 10 percent drop in tech spending in 2001 from the \$979 billion spent in 2000.
- New home building dropped 2.2 percent in August, the third straight month of declines and the early indications for September point to an even larger decline.

Second, on the bullish side

But, the positive news is overshadowing the negative as evidenced in the following:

- As for the economy's growth, the second quarter GDP was revised upward, to 1.3 from 1.1 percent.
- Average wages inched up 0.3 percent in September after a flat August. For the past year, income is up 3 percent.
- Even with all the concern over earnings, third quarter profits are actually expected to improve showing an overall gain of about 8 percent, year-over-year, and 15 percent in the fourth quarter.
- Meanwhile, the Commerce Department reported that after-tax profit of United States businesses rose at a rate of 1.7 percent in the second quarter. Although this is down from the 2 percent growth in the first quarter, it is still a meaningfully positive number.
- The Commerce Department also reported that orders for durable goods -- items that are expected to last more than three years -- dipped by 0.6 percent in August from the month before. This reflected a decline in demand for cars, communication equipment and machinery. But this decline comes after a huge jump of 8.6 percent in July, so even this "slightly" negative number is encouraging.
- Sales of new homes climbed to a record seasonally adjusted annual rate of 996,000 in August, representing a 1.9 percent increase from July. In fact, housing is the bright spot of the economy. Low mortgages are enticing buyers. Rates on 30-year fixed mortgages dropped in September to a new low of 5.99 percent. The home values continue to rise -- hopefully balancing out the losses that so many have felt in the stock market. In fact, in August, the average price of a new home rose to 2.1 percent to \$221,000. By region, sales in August of homes in the West rose by 7.4 and in the South, sales were up 1.3 percent.

The Fed's Next Move: Lowering Rates

Worried about the economy and the possibility of war with Iraq, the Fed, during their September 24 meeting, decided to hold the Fed funds rate steady at 1.75, a 41-year

low. But in a rare move, two members publicly dissented, saying they favored a rate cut, which would have been the first in 2002. Expectations are rising that we may see a rate cut at the November Fed meeting. The Fed said:

"To be sure, a further significant weakening in economic prospects---for example---that might be associated with additional deterioration in financial markets might well call for a policy response."

What was so significant about the Fed's decision for leaving the rates unchanged at 1.75 percent? The Fed pointed to the tensions with Iraq. The Fed said "considerable uncertainty" persists about a rebound in business production and a pickup in hiring partly because of "heightened geopolitical risks."

Looking ahead, the question that now puzzles us is whether or not a 12th rate cut -- taking us down to 1.5 percent or lower -- would really make much of a difference on the economy. After all, bigger even than the Fed is the great wild card of 2002 -- a possible war with Iraq. In fact, any move by the Fed now could be deemed "a dollar short and a day late".

The Bottom Line is a Bright Future

The American economy has been battered by recession and terrorism. The expectation of a poor earnings season is weighing heavily on the market. Most likely, too, a war is coming. But it's even more likely that we'll come out of the war further ahead than when we started. But in the meantime, the basic principles of asset allocation, balanced portfolios and conservative yet foresighted investing are the best guidelines. Don't panic and sell just because your favorite company reports bad earnings -- and a stock price to match -- these past three months. Nothing is certain in this world, but investors who look ahead, plan ahead, and think ahead are most likely to find themselves enjoying the long-term security of asset appreciation.

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