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INVESTMENT BANKERS

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Credit Markets Update

by Michael T. Newsome

Readers of *INSIGHT* are aware that we have held the view for some time that the economic slowdown would be longer and deeper than what most prognosticators have been suggesting. Underlying our fears is a concern that, until recently, consumers had not adjusted their expectations and spending patterns to the cooling economy. Spurred by the events of September 11, an adjustment in consumer attitudes is now underway.

Our theory has been that, over the past several years, the economy has been fueled by a massive investment of speculative capital in the creation of "new economy" businesses, the adaptation of "old economy" firms to the internet, and the Y2K problem. Over a three-year period, hundreds of billions of dollars were raised through the IPO market, from venture capitalists, and in the high-yield market to fund these new, primarily technology and telecom based, businesses. These investments were paralleled by billions of dollars of investment by "old economy" businesses. That capital has been spent (often unwisely) in a manner that stimulated greater activity in most economic sectors.

COMPANIES, BUT NOT BUSINESSES

Unfortunately, many of these "new economy" ventures were not businesses at all. A rational analysis of the venture

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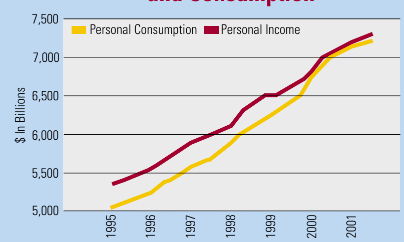
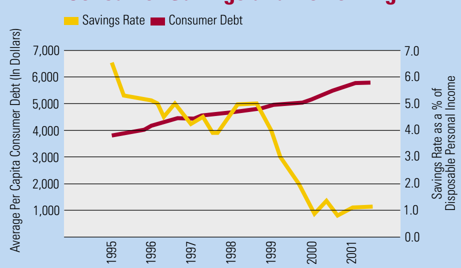
investment activity during this period would characterize much of it as the shameless merchandizing of companies, with minimal economic prospects, in order to transfer the wealth of indiscriminate investors to the

Annual Personal Income and Consumption



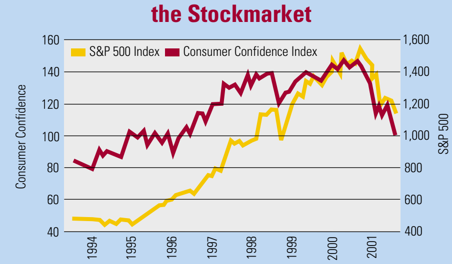
Source: Federal Reserve

Consumer Savings and Borrowing



Source: Federal Reserve

Consumer Confidence and the Stockmarket



Source: Conference Board and WSJ

pockets of promoters (investment bankers and venture capitalists). By March of 2000, economic reality began to reassert itself. As investors came to the realization that many of these "new economy" dogs simply weren't going to hunt, the IPO market basically shut down. In the absence of a public market exit, venture capitalists tightened up. Suddenly, the wellspring of capital ran dry for many nascent "new economy" companies. All across the economy, we've now experienced several quarters of corporate earnings disappointments resulting from slowing product demand and excess capacity, which has resulted in the revaluation of assets and investments. This trend is likely to continue as businesses resize to accommodate the sustainable demand for their products.

SURPRISING STRENGTH

Through this process, the economy flattened, but maintained surprising strength. Much of the economy's resilience can be attributed to the behavior of consumers. For ten years, incomes have risen in an environment of ever-lower unemployment. At the same time, the value of homes and stock portfolios increased at historically unprec-

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edented rates, giving consumers a perception of enhanced personal wealth. Accordingly, personal consumption swelled on the tide of this newfound wealth. Although a robust economy delivered strong growth in personal income, it was not enough to fund the rate of expansion in personal consumption. To maintain spending habits, individuals pared back the rate of personal saving and stepped up the use of debt. There was little necessity to "save," as it was taken care of through the rapid appreciation of financial and real estate assets. Although consumers have had a good run and served as the key driver behind our modest economic growth over the past year, they are not exempt from economic reality. It has been our view that consumers would eventually have to bring spending in line with income, and that this adjustment would have a dampening effect on an already vulnerable economy.

(continued p. 2)

Although, consumer confidence has eroded over the past nine months, it remains strong relative to the average over the past ten years. Maintaining consumer confidence is a prime concern of the Fed. Its principal tool in this effort has been to reduce short-term interest rates a total of 300 basis points through the end of August. The goal has been to bolster the consumer's balance sheet and buying power, by reducing interest costs. This strategy seemed to be working insofar as housing markets and consumer spending remained strong in 2001. Economists and media predicted that the economy had dodged a recession, and resumption of the long-term growth curve could be expected. The conventional wisdom was that the consumer would pull the economy through, aided by the actions of the Fed.

CONSUMER CONFIDENCE SUFFERS

The course of the economy changed with the horrific events of September 11. Beyond the human toll taken, the economy, in general, and consumer confidence, specifically, appear to have suffered a harsh blow. After a four-day halt in trading, the equity markets endured the largest one-week plunge in value since the Great Depression. Although these markets have rebounded in the interim, the promise of war, fears of further attacks, earnings adjustments, and layoff announcements, have stoked economic uncertainty among consumers and investors. Within a week after the attacks, the consumer confidence index dropped 16 points to 97.6, which is 33% below the high point in May of 2000 and the lowest point since 1996.

HOW DEEP THE DOWNTURN?

We suspect that consumers will pare back their spending in the coming months in response to reduced personal economic optimism. This will push the economy into recession. The real question at this stage is how deep and how long will the downturn be? Obviously, there are innumerable positive and negative factors that could have a bearing on the depth and duration of the downturn. Those factors foremost in our minds include:

The goal has been to bolster the consumer's balance sheet and buying power by reducing interest costs. This strategy seemed to be working in-so-far-as housing markets and consumer spending remained strong in 2001.

1. The success of the war against terrorism. Either another round of unsettling terrorist attacks or failure of the U.S. government to respond with some success would further raise anxiety among consumers and investors, and aggravate the downturn. Alternatively, some early success in the anti-terrorist campaign will help to assuage consumer and investor fears.

2. Stimulative fiscal policy by the government. There appears to be a major shift within Washington D.C. toward accelerating government spending, particularly to prosecute the war on terrorism, enhance our security, and lend a hand to severely impacted industries, such as the airlines. Congress may also enact additional tax relief for both businesses and consumers.

3. Accommodative monetary policy by the Federal Reserve. The Fed cut the discount rate by 100 basis points to 2.5% following the terrorist attacks and does not appear to be hesitant to cut further. Lower short-term interest rates are not likely to re-energize business investment in the short-term, but may promote a new round of mortgage refinancing that would enhance the financial health of many consumers.

4. The credit appetite of commercial banks. For some time now we have been in a period of "tight money." Recent events are not likely to make lenders more aggressive anytime soon. In fact, they may be even more reticent to undertake new financing for GDP-sensitive or under-performing companies. However, concern over excessively restricting access to capital may ease some of the pressure that regulators have been applying to banks. Hopefully, as companies stumble in the midst of the downturn, bankers will exhibit a bit more patience and forbearance than we have seen recently.

5. Decline of the U.S. dollar. A possible result of the terrorist war is some loss of confidence in the U.S. economy among foreign investors, which may result in erosion in the value of the dollar. Although consumers may experience higher prices for imported goods and energy, a weaker dollar would strengthen the competitive position of U.S. manufacturers in export markets.

It's too early to make a definitive call as to how long this recession will last, but it is certain that consumer attitudes will be a key factor. To better gauge the direction of the economy and markets, we will be closely monitoring a couple of key consumer indicators: the consumer confidence index, holiday retail sales, auto sales, and housing starts. Going forward, it is our recommendation that business owners and managers preserve liquidity, and build their business plans and capital structures on a conservative footing, rather than anticipating a rapid return to a more robust environment. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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