pressure on the currency, Chinese monetary authorities buy enormous quantities of U.S. dollars and dollar-denominated securities on the foreign exchange markets. China and Hong Kong together hold central bank reserves of around $495 billion. Taiwan has piled up $190 billion in official U.S. dollar reserves, while South Korea holds $142 billion. Japan also admits to massive dollar purchases. Consequently, the dollar has sharply depreciated by more than 35 percent against the euro since 2002, by around 19 percent against a basket of other rich countries' currencies, but by only 10 percent against a broader basket that includes emerging-market currencies.

Therefore, the U.S. current account, so far, has not adjusted as expected. The burden of adjustment stays with a few industrial countries that allow their currency to freely float against the dollar, including Canada. This might have depressive consequences on the relative competitiveness of those countries' exports and impede their economic growth, particularly in the euro area and Canada. In addition, if a soft landing of the dollar is blocked, markets might one day overreact and enforce a dramatic drop in the dollar exchange rate with devastating consequences for all international trading partners. ◂

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Financial Forecast

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The past three years have been tough on investors with declining stock market returns and low interest rates. Furthermore, notable companies such as Enron, Worldcom, and United Airlines have gone bankrupt, wiping out the entire stock valuations of these companies. Add to this mix the ethical lapses of some managers and investment advisors, as well as the lack of responsible corporate governance at many companies, and it is easy to see why financial markets are now on edge with investors wondering whom they can trust.

Not all the news is bad: housing demand remains strong and families who own their own homes have seen rapid increases in value in many markets. Low interest rates have helped stimulate the real estate market, allowing homeowners to refinance at low rates and fuel their urges to consume. Since we forecast many of these trends will continue next year, financial markets are exhibiting a new reality.

Interest rates

Interest rates have generally fallen during the past twenty years, due in large part to wringing inflation out of the economy. Since short-term rates have fallen much more than the long-term rates, the yield curve is the steepest that we have seen since the early 1990s. Historically, the spread between short- and long-term rates is a precursor to economic activity—the currently observed high spread is generally followed by an expansion and rising interest rates. Thus, we expect to see a slight rise in interest rates over the next year, with the short-term Fed Funds rate in the 1.75 percent to 2.00 percent range and long-term treasury bond yields in the 5 percent to 6 percent range by the end of 2004. Corporate interest rates will also exhibit small increases next year. Mortgage interest rates bottomed out at about 5.25 percent in early summer and have since increased to approximately 6 percent. We expect mortgage rates to also rise over the next year to a level of 6.5 percent. The prime rate will be near 5 percent by the end of the year.

Corporate Profits

Corporate profits are expected to rise about 9 percent next year as the economy continues to grow and recover from the recession. In fact, third quarter earnings this year are expected to be 20 percent above the level of last year. Corporate profits and cash flows continue to be adversely affected by employee health insurance premiums, which rose 14.8 percent last year, and underfunded pension plans, which stand at a $216 billion deficit for the S&P 500 companies. Since stock market value affects the value of many pension funds, an increasing stock market may mitigate this problem slightly. Global competition remains fierce in many markets—particularly autos, light trucks, and sport utility vehicles—but the continued weakness in the dollar will help exporters remain competitive. In addition, productivity increases will offset gains in labor compensation. Fortunately, the continuing low interest rate environment has enabled many companies to refinance their debt at lower rates and rebuild their balance sheets. Overall, there has been a deleveraging of corporate balance sheets. The generally positive outlook for 2004 will encourage firms to expand capital investment and employment to meet the expected increase in demand for goods and services, as well as replenish reduced inventory levels. We see very few reasons to expect a business slowdown or the cataclysmic deflationary scenario some pundits are forecasting for the U.S. economy.

Stock Market

From the early 1990s to 2000, the stock market experienced an incredible and unprecedented bull run—fueled by increased productivity and declining interest rates due to the drop in inflation. That encouraged many investors to fully commit to stocks as their primary investment asset. Unfortunately, from March 2000 through March 2003, the market (as measured by the S&P 500) lost about 49

percent of its value. Even though the S&P 500 is up more than 30 percent since March 2003, it is still 30 percent below the peak in 2000 and many investors are reluctant to dive back into the market. As the economy continues to improve, we expect to see the stock market also continue to make gains, although at a less spectacular rate than the experience this year. In the long run, we expect the stock market will offer returns 6 percent to 8 percent above treasury bonds, which is in line with the market's historical average performance since 1926, but well below the returns investors were experiencing in the 1990s. As always, prudent investors should continue to diversify their portfolios, guarding against too much exposure to any individual stock, market, or asset category.

Summary

The financial markets have clearly changed in the past decade and a new reality must be accepted. We cannot remain passive—action must be taken to align our business and investment strategies with this new reality. As that great philosopher Yogi Berra once said, "When you come to a fork in the road, take it." ◄

Corporate Governance and Reporting

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Overwhelmingly, company financial statements and tax returns are prepared with integrity by honest managers and audited by competent professionals with proper skepticism. Fraud and misleading reporting barely impact economic projections.

Confidence in financial statements has been damaged, though, because a few people took advantage of trust and position, supported by others who did not carefully guard company assets and the sanctity of financial reports. Unfortunately, examples have been prominent and the media properly made certain we did not miss any.

Financial reporting is self-regulated. Managements prepare reports, interpreting how to report results. Reports are seldom immediately reviewed by regulators and may never be reviewed. Managements' greater fear is that analysts, strike lawyers, competitors, or reporters will find errors in the financial statements. Self-regulation will not change, and there is no need to change it.

Notwithstanding this conclusion, we have learned, or have at least been reminded from recent experiences, that certain aspects of the financial reporting system need to be fixed.

Standards for Financial Reporting

We need to fix Generally Accepted Accounting Principles (GAAP), the benchmarks for financial reporting. Accountants are overwhelmed with the standards setting process.

Financial statement readers want reports on assets and liabilities in a world that is trading elements of assets and liabilities. It is difficult to reduce business complexity to simple, transparent financial statements. Assets and liabilities today are carved into elements, dividing shared responsibility and ownership. For example, engineered transactions like special purpose entities have never been dealt with effectively by those who decide GAAP. Today, two years after Enron, a debate continues over variable interest entities, as companies try to understand a proposed standard that is getting old before it is even implemented.

The standards setting process is emotional and political. Debate is less about accounting theory than the impact on financial position and capital allocation.

To address the GAAP problem, a new law, Sarbanes-Oxley, directed the Securities and Exchange Commission (SEC) to do two things: decide who is in charge of GAAP and whether GAAP should be principles-based or rules-based.

So far, the SEC's answers are weak, perhaps demonstrating the depth of the problem. A year after the passage of Sarbanes-Oxley, the SEC has concluded that the Financial Accounting Standards Board (FASB) is in charge, but the SEC directed the FASB to further develop the conceptual framework of accounting, eliminate bright line tests, manage the convergence of U.S. standards with the rest of the world, and complete other difficult tasks.

The SEC answered the question of principles-based versus rules-based by concluding that standards should really be objectives-based. Companies and auditors continue the journey without a good map.

So far, the SEC's answers are weak, perhaps demonstrating the depth of the problem…

In the meantime, companies and auditors continue the journey without a good map.

Internal Controls

Sarbanes-Oxley addressed a second problem: internal controls over financial reports. Internal controls are activities that assure companies achieve business objectives, not the least of which is good financial reporting. Some companies do not have good internal controls. But even if they do, bad managers can ignore the controls and initiate improper transactions in financial statements.

Internal controls have never been well documented. They develop more from instinct, similar to the way a person dons a coat when it is cold. Documenting instinct seems to add little value. But many risks