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### SUMMARY

- Equity market lacks clear leadership.
- Technology issues undergoing correction and repair.
- Bond yields spike higher during May, then retreat.
- Federal Reserve foregoes rate hikes at its June meeting.

### SECOND QUARTER 2000 REVIEW

Stock market action for the second quarter of 2000 was all down as the topping-out that began in mid-March turned into a rout. The encouraging rally in the Dow proved short-lived as it succumbed to the sharp declines brought on by selling in the NASDAQ and S&P 500. The NASDAQ paid dearly for the excesses of the recent past, suffering a 37% decline from its March 10<sup>th</sup> high to its May 23<sup>rd</sup> low. In the face of higher interest rates, equity values could not continue to rise as investors were forced to reconsider unrealistically high price-to-earnings multiples.

The markets have recovered some lost ground since the lows of the quarter, but the market trend has been neutral, at best, for the month of June. While technology shares undergo the painstaking process of correction and

	Second Quarter	Year to date
S & P 500	-2.9%	-1.0%
Dow Jones Industrial Average	-4.3%	-9.1%
NASDAQ Composite	-13.3%	-2.5%

repair, little else has emerged in the way of market leadership. The positive action in utilities, energy, and consumer staples is an obviously defensive move by investors seeking a safe haven. For now, the health care sector appears to be the momentum players' surrogate for technology.

For the quarter, the S&P 500 sustained the least damage, down 2.9%. The Dow Jones Industrial Average finished down 4.3%, and the irrepressible

*(Continued on page 2)*

**Second Quarter 2000 Review (continued)**

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NASDAQ began clambering out of a very deep hole to finish down 13.3%.

Although bond yields spiked higher in May, they retreated to finish the quarter little changed. Treasury yields are lower now than at the beginning of the year, and the secular downtrend remains intact. Corporate bond yields, on the other hand, are on the rise, with the spread between corporates and Treasuries at levels not seen since the fall of 1998.

For the quarter, the ten-year Treasury yield finished at 6.02% nearly unchanged from 6.01%. The thirty-year Treasury finished at 5.89%, again, nearly unchanged from 5.84%. The yield curve continues in a hump-backed formation indicating that

the markets anticipate rising inflation and interest rates in the

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near term but not over the long term.

The Fed's campaign to slow the economy to a sustainable growth rate appears to be finally taking hold. The economic expansion continues intact but at a slowing pace. Higher interest rates have put consumer spending under the Fed's thumb as demonstrated by moderation in home building, auto sales, and retail sales. Many experts

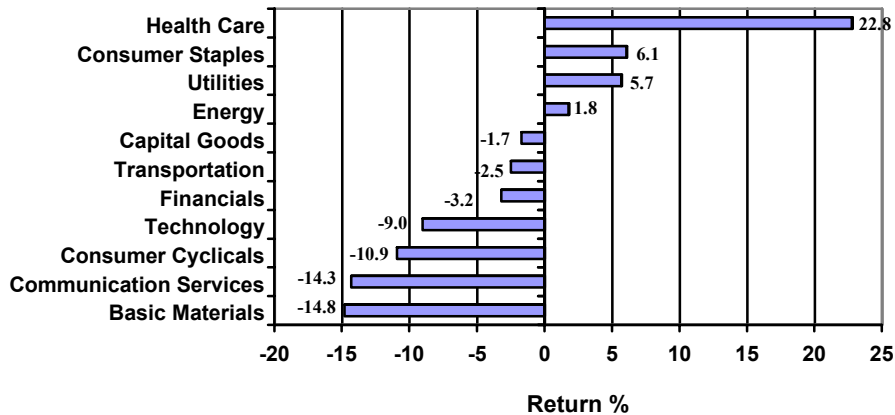
believe that the Fed has successfully engineered a soft landing, slowing the growth rate without causing recession.

Only time will tell, but if inflation remains in check, the Fed may well have finished raising interest rates for this cycle. In spite of oil prices reaching highs not seen since the Gulf War, inflation remains tame, due in large part to rising productivity keeping labor costs under control. The Fed chose to stand pat at its June meeting but could hike once more in August for good measure. It is unlikely that there would be further rate hikes after the summer because of the upcoming presidential election.

While moderating economic growth and the end of the credit-tightening cycle bode well for continued prosperity, a recent spate of disappointing earnings announcements has given us a taste of things to come in a slower paced economy. Lower growth of GDP means slower growth of corporate profits. That may be a negative for equities that have been priced with a much more optimistic outlook in mind. On balance, we expect stock prices to finish the year higher, but further advances will be fraught with continued volatility and more selective participation.

-Whitney Brown

**Second Quarter 2000  
S & P 500 Performance by Sectors**



## Corporate Debt Surge

Corporate debt has soared in recent years to record levels. During the past five years, corporations have increasingly used debt to finance: (1) Stock buybacks to prop up earnings per share; (2) Mergers and acquisitions, which allow companies to report higher earnings and take advantage of write-offs to reduce taxes; and (3) Capital spending, in order to increase productivity and, thus, profitability in the face of rising costs and lack of pricing power.

The chart below shows that non-financial corporate debt has

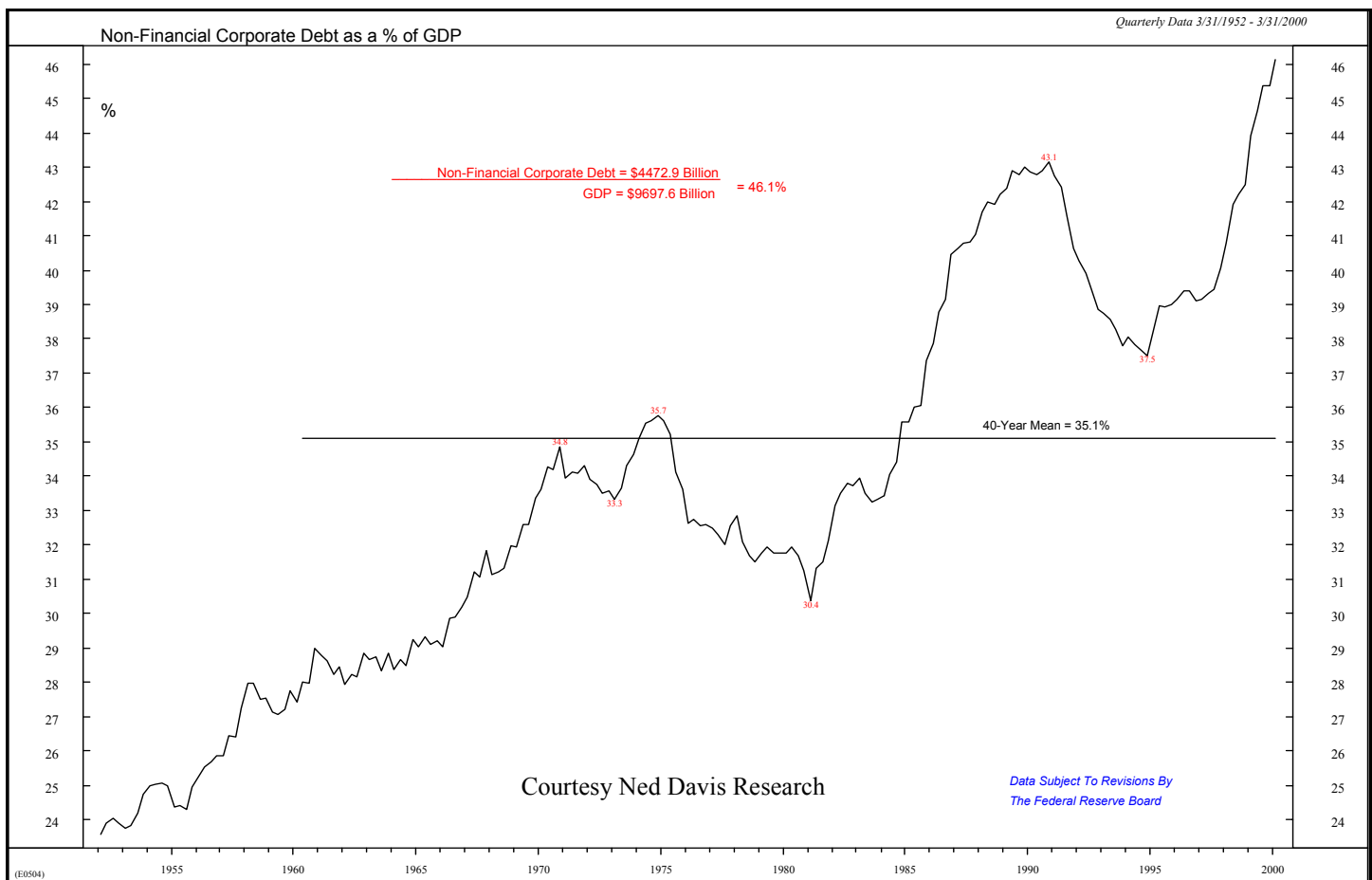
reached record levels as a percentage of GDP. While corporate debt service is currently manageable, downgrades and default rates have been rising, indicating growing financial stress in the system.

An economic slowdown greater than expected could exacerbate the problem. Corporations would then cut back on debt-financed spending, which would reinforce the slow-down in business activity. Although economic forecasters expect a soft landing (slower growth/no recession), investors should be

aware that the enticing yields on corporate debt have some negative implications.

Interest rates have been consolidating in a wide band for the past nine months, after rising sharply during the previous year. With many companies experiencing increasing financial strain, corporate bond rates have been rising much faster than Treasury rates. Therefore, selected high quality corporate bonds are becoming increasingly attractive alternatives to Treasury issues.

-Walter Dixon



**Taxable vs. Tax-exempt Bonds**

When constructing bond portfolios for our clients, generally we use three types of bonds: *corporate bonds* whose interest is taxable for federal and state income taxes, *Treasury Notes* whose interest is federally taxable but exempt from state income tax, and *municipal bonds* whose interest is exempt from both federal and usually state income tax. Which type used in an individual's portfolio is determined by the income tax bracket. For the year 2000 a single taxpayer hits the 28% bracket when taxable income exceeds \$26,250; and a married couple filing jointly reaches 28% when their taxable income exceeds \$43,850.

Currently a 10-year U.S. Treasury Note is yielding 6%, a 10-year AA corporate bond is yielding 7.2%, with 10-year AA municipal bonds yielding 5.1%. Using a 28% federal tax rate and a 5¾% state tax rate, the after-tax yield is as follows: Treasury 4.3%, corporate 4.9%, and

municipal 5.1%. You can see that even though the municipal bond has the lowest interest rate, in the 28% tax bracket it has the highest after-tax return. The higher your income tax bracket is above 28%, the better value municipal bonds are.

Currently, the yield spreads (difference in interest rate yield between bonds of like maturity) between municipal bonds and Treasury Notes are narrow, making municipal bonds more advantageous. However, when the yield spread widens, it can be better to own Treasury Notes or corporate bonds, even after paying the taxes.

At Dixon, Hubard & Feinour, we are continually monitoring the relative yield spreads between Treasury, corporate, and municipal bonds and are aware of our clients' tax situation. In that manner, we can manage their bond portfolio to maximize the after-tax return.

- Stebbins Hubard

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