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Second Quarter 2001 Investment Outlook

"The U.S. economy has slowed faster than anyone anticipated and while it initially appeared to be a one-to-two quarter phenomenon, signs of softness in both Asia and Europe indicate that the slowdown may extend beyond the next two quarters. In response to the slowing economy and the resulting impact on capital spending, Cisco recently announced a series of actions designed to reduce expenses and align resources with areas of profit contribution." *Cisco CEO John Chambers discussing recent conditions in the network equipment industry.*

"The U.S. economic downturn over the past several months clearly affected our revenue and profit growth more than we anticipated, due to a sharp downturn in completed transactions in the last few days of the quarter, and the current economic uncertainty continues to limit our visibility going forward." *Oracle CFO Jeffrey O. Henley discussing results after the company's recent earnings release.*

"The tough economy has put tremendous pressure on fourth quarter sales performance and increased competition for share of the consumers' wallets. While home improvement is a high priority for our customers, they are also facing immediate and dramatic pressures in a number of areas, including record cold weather and rising energy costs, investment losses, higher interest rates, and increasing consumer debt levels. We expect that many of the same economic factors affecting sales in the current quarter will persist in the first half of fiscal 2001, arguing for a cautious near term outlook." *Home Depot CEO Robert Nardelli's commentary during the company's 4th quarter 2000 earnings announcement.*

The Charles Schwab Corporation announced today that due to continued economic uncertainties and difficult market conditions, it plans to take additional steps to reduce operating expenses. "With a slowing economy and weakening corporate earnings, our clients are facing the most challenging market environment in many years." *Charles Schwab President and Co-CEO David S. Pottruck in a recent press release.*

These comments are just a handful of what has been an almost daily occurrence of companies issuing earnings warnings due to weak economic conditions. The sharpness and severity of this downturn is now well documented. Along with a sharp and severe economic downturn, equity price declines accelerated as the first quarter drew to a close. Benchmark equity indexes fell across the board as the heavy weight of profit warnings and cautionary comments by companies across many economic sectors finally took their toll on virtually every market sector, including blue chip stocks. The S&P 500 Stock Index dropped by 15% and the Dow Jones Industrial Average by 7% for the quarter. Growth stocks were particularly hard hit as the average growth stock mutual fund declined by almost 25% during the quarter. The Nasdaq Market Index has now declined by more than 70% from its high reached just last year and many companies within the index have declined by more than 90% within the past twelve months. Internet related IPOs and small telecom service providers have been amongst the worst performers with dozens of former high-fliers such as eToys, WinStar Communications and Priceline.com either forced to shut down operations or on the brink of bankruptcy. To compound matters, investors were faced with increasing anxiety over the financial viability of such former market leaders such as Lucent, Xerox and AT&T.

Shifting to the view ahead, for the short-term outlook, there are two schools of thought. The optimists think we are in a slowdown, but not outright recession. The pessimists see the downturn in the manufacturing sector infecting the whole economy. While the economy slowed very sharply at the end of last year, the latest indications at least hint that activity is stabilizing. The quarter just ended likely produced little or no growth in GDP after a 1% rise last year's fourth quarter. Given the lags inherent in implementing monetary policy decisions, the economy only recently faced the full brunt of the Fed's earlier restraining efforts. As a result, even with lower interest rates expected, we face the likelihood of further negative economic fallout. The slowing in the labor market is likely to be at the core of the economy's near-term sluggishness. A wide array of leading labor market indicators (shortening workweek and overtime, rising layoff rates and jobless claims, and narrowing employment diffusion) has suggested the slowing in net hiring and the rise in unemployment has further to run. This week, the index of help-wanted advertising tumbled five points, dragging its growth rate down to minus 22%. Historically, sharp declines of this magnitude typically signaled an end to job growth within three to six months.

While it is easy to classify the manufacturing sector as recessionary, we see just enough gains in consumer spending, housing, and government services to offset declines in manufacturing. As sharp as the downturn in manufacturing has been, we must remember that it represents less than 30% of GDP. And while the fundamentals for the consumer are mixed, they may be resilient enough to keep the economy from a sustained downturn. Consumer spending and income growth look positive and it appears that first quarter consumption will be up at a 2.5% to 3.0% annual rate. In addition, surveys indicate that consumer confidence seems to have stabilized in the month of March. However, we've gotten some hints from retail analysts that consumer spending during March may be weakening and job growth is clearly slowing. We also know that the stock market declines are eroding household wealth (we will comment more on this issue later as it relates to the economy and the so-called "wealth effect").

Fortunately, something constructive is being done about this economic turmoil. While the Fed has been harshly criticized for moving too slowly to steady the economy and the stock market, they have been cutting rates at a steady, if not aggressive, pace. Short-term rates have declined by 150 basis points in the first quarter and all indications are that the Fed will continue to cut rates further in order to stimulate economic activity. So far this year the Fed has eased more aggressively than in the 1990–91 recession, but we believe policymakers have more work to do. We expect a 50 basis point cut at the next FOMC meeting in May and would not rule out an inter-meeting cut if warranted by economic conditions. We have to remember that just as monetary tightening had a lagging effect on slowing the economy last year, monetary easing will have the same lagging effect this year. However, there are some early signs that interest rate cuts are beginning to work. We had record issuance of corporate bonds in the first quarter and mortgage refinancing is running at a very high level.

In light of the severity of asset value deterioration in the past year, we wish to comment on the "wealth effect" implications for the economy. While much has been made of this issue, historical evidence supports a more mild effect on spending decisions than is widely assumed. Most consumers take a very conservative view of short-term changes in net worth, as the lagged response to years of accumulating wealth in the 1990s demonstrated. It's doubtful that either the last of the bubbling up in equities in late 1999-2000 or the more recent collapse is factoring heavily into saving and spending decisions. Recent economic events have most certainly unnerved both consumers and businesses, but the economic impact will likely be less pessimistic on actual spending decisions.

What does all of this mean for the financial markets? We believe we are poised for a "bear market" rally in stocks that could last awhile. Technology and some of the financials should have the biggest bounce because they are the most oversold. Our reasons are as follows: First, we had a medium-sized selling climax last week. Second, markets, particularly Nasdaq, have had big declines and a lot of bad news has already been discounted. Don't be surprised if some bad earnings reports due out in the next several weeks are met with buying interest, the reverse of what happened last fall when good earnings reports were met with selling pressure. Third, central banks around the world are beginning to understand the severity of the economic downturn and have begun lowering interest rates. We believe the European Central Bank has finally woken up to the weakness in Europe and is going to begin an easing cycle. Finally, stocks are no longer overvalued. While they are still not overly cheap, the huge overvaluation has been corrected. Bottom-line is that given how quickly and how far markets have fallen, it makes sense to look for a rally here. Unfortunately, it is likely to be followed at some point by some further downside. Bear markets have always ended with either a true selling climax or capitulation, which by definition means undervaluation. We have had neither thus far. Other indicators that would flash signs of a market bottom would be increased share buyback and increased merger and acquisition activity.

Times like this are often healthy for the long-term health of our financial markets. Excesses get purged from our economy and leading companies with the best vision, business models and management teams consolidate their positions and extend their industry dominance, gaining market share against the weaker players within the industry. Just as "irrational exuberance" created excessive valuation levels for stocks last year, excessive pessimism is creating outstanding investment opportunities for those investors who have perseverance and a long-term perspective. In today's market environment where literally hundreds of financially sound companies are trading at less than $10 per share, a discerning investor using sound fundamental security analysis and good business sense could expect to identify a number of exceptional investment candidates. Rather than succumb to the fear that grips many investors at critical junctures such as now, we urge our clients to review the attached guidelines and stay the course. These guidelines listed on the back of this page were extracted from a financial website and we thought they may be useful in addressing the emotional issues we have all been grappling with for these past six months. This should assist in keeping us focused on rational decision-making in a difficult and challenging environment. In periods of market volatility, it's vital to stay focused and pursue a disciplined investment approach consistent with your own personal goals and tolerance for risk. Just remember, the US economy is highly adaptable and continues to be structurally sound. Although the present situation appears bleak, we believe there is light at the end of the tunnel.

Top 10 Tips to Weather Market Volatility

Volatility is an unavoidable element of investing. How should concerned investors prepare for volatility? Our top 10 tips may help.

1. **Stay Calm.** Short-term losses occur when the market dips, but they shouldn't cause panic. Many investments are designed for long-term growth and do encounter occasional drops in value. If you remind yourself to stay the course in light of these short-term drops, your investing experience should become much more comfortable.
2. **Consult your Financial Advisor.** Since markets evolve and your personal goals may change with time, one of the best ways to keep your investments on target is to meet regularly with your Financial Advisor to discuss ways to keep your financial plan on track.
3. **Keep your perspective.** If your original financial goals are still valid, think carefully before you abandon them, simply because of negative market activity. You and your Financial Advisor spent a lot of time creating an investment portfolio based on your risk tolerance, time horizon, and financial goals. Quick, reactionary decisions could prevent you from reaching your goals.
4. **Understand the risks you face.** When you're investing, the most common risk is market risk, which is the possibility that you may lose some or all of your investment in real terms, or that your investment may not increase in value. Several factors may influence the amount of risk you can comfortably accept in your portfolio, including your age, family situation, employment, income, and financial goals.
5. **Review your asset allocation.** New market trends may spur you to take a complete inventory of the components of your portfolio. The process of balancing asset classes in a portfolio determining what percentage should be placed in cash, what percentage in bonds, and what percentage in stocks-is called asset allocation.
6. **Review your investment strategies.** You should examine the actual design of your portfolio to see if it's still structured to meet your financial goals, particularly when confronted by periods of market volatility.
7. **Emphasize diversification.** Keeping a diverse portfolio means you spread your investments among different classes of assets (e.g., stocks, bonds, and cash equivalents) so that they work together to help build your wealth, while affording some protection from downturns in any specific asset class. As a result, you are diversifying your assets and avoiding the potential risks associated with "putting all your eggs in one basket."
8. **Consider using dollar-cost averaging to avoid market-timing decisions.** This strategy involves investing a specific sum of money at regular intervals; for example investing $200 every month. This allows you to buy more shares when prices are low and fewer shares when prices are high. Although dollar cost averaging does not assure a profit to protect against loss in declining markets, it can reduce market timing concerns. However, because such a strategy involves periodic investments, you should consider your financial ability and willingness to continue investments through periods of low price levels.
9. **Ladder your fixed-income securities.** This strategy involves spreading the total dollar amount of your fixed-income investments among securities with different maturities. Laddering is designed to help your fixed-income portfolio perform well in both declining and rising interest-rate environments.
10. **Stay on target.** Market downturns are inevitable, but they needn't spell disaster if you plan ahead and structure your portfolio and your financial strategy accordingly. Because market conditions can change rapidly, you and your Financial Advisor should stay in close contact. Be sure to keep your Financial Advisor abreast of any significant changes in your personal financial circumstances. Your Financial Advisor has the expertise and resources to assist you in choosing investments to help manage risk and keep you on track toward meeting your financial objective.