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<u>Third Quarter 2001 Investment Outlook</u>

As we take stock of where we stand halfway through the year, there appears to be an attitude adjustment going on in the investment community. The past several months have witnessed one of the most significant adjustments to corporate earnings expectations over a six to nine-month period of time in the history of our economy. The following describes (perhaps in oversimplified terms) the forces that have buffeted the stock market so far this year: the Fed surprised us with rate cuts in early January of this year in the hopes that easing would help turn the economy around. That kept the stock market in fairly good shape through the end of January. Then, companies' first-quarter earnings problems and pre-announcements took center stage, determining the market's downward direction in February through March. In early April, the Fed provided us with another surprise rate cut and that carried the markets on an upbeat note into May, but any hope was promptly deflated by another bout of earnings worries and companies' second-quarter pre-announcements. Increasingly, the disappointing earnings news isn't just in the areas of technology or semiconductors or communications. It's broadening into other sectors of the market. There have been disappointments in retailing, pharmaceuticals, consumer products and even among some financial services companies. All of this implies that the earnings problems are spreading. And it's hard to see how earnings will improve before the fourth quarter. The third quarter, once again, could be dominated by more bad news on the earnings front, particularly in August and perhaps even September.

Investors here and abroad seem unusually apprehensive about the course of the US economy and the timing of the recovery in corporate earnings. The economic data released in June do not seem to augur a second half recovery, certainly not one starting in the summer. Slower economic growth abroad certainly does not help US exporters and multinational corporations. However, the single greatest concern among US investors today is probably the consumer. Auto and retail sales have held up relatively well this year, but if that were to change, the slowdown or recession could be prolonged. If consumption were to weaken more sharply in the face of lower household wealth and deteriorating labor market prospects, this would likely inhibit the inventory correction currently ongoing in the business sector. Already, this adjustment is proving more drawn-out than widely expected a few months ago. Although business inventories were flat in April, the inventory/sales ratio rose further as sales plummeted.

To mixed market reaction, the Federal Reserve Board broke its string of aggressive half-point interest rate cuts with the announcement of its quarter-point reduction in the federal funds rate and the discount rate at the conclusion of the June 26-27 Federal Open Market Committee (FOMC) meeting. The Fed's statement read very much like its last one, noting that inflation should remain contained and that risks were weighted toward economic weakness. Specific concerns were repeated about corporate profits, capital spending, consumption and international economies. The Fed has chosen to slow its easing pace at a delicate time in the business cycle. There are a number of hints of economic stabilization, but the labor market still appears to be deteriorating and corporate profit woes intensified in recent weeks. Recent employment statistics continue to suggest that corporations have not finished laying off workers in this downturn, judging from the half-million increase in total unemployment claims over the past three months and declining consumer perceptions of job availability. Although the layoff pace may have stopped rising, it remains relatively high, and a collapse in help-wanted advertising suggests a much slower re-absorption rate.

Clearly, the Fed's action took place in the context of generally weak economic signs that had emerged in the past month; indeed, talk of a recession has become more common again. Nevertheless, a few hints that better economic times might lie ahead have also begun to emerge in leading economic indicators - particularly the financially oriented ones. When the economy first slowed sharply last November and December, the term "recession" was widely bandied about. Then as quarterly GDP results continued to show a positive - although very slow - growth rate, its prevalence faded. Now the frequency of usage has picked up again. A host of indicators have pointed to very weak economic conditions in the past several months and second-quarter GDP could be negative, yet the size of the Fed rate decrease was less than the last time. Investors must therefore infer that the Fed must be encouraged by signs of stabilization in some of the recent macroeconomic data or perhaps the Fed governors believe that the 250 basis points of interest rate cuts already in the pipeline will begin to have a healthy effect - albeit a lagged one. Even if some investors were disappointed at the magnitude of this latest rate reduction, we believe that the door being left open to further easing was probably a more important takeaway from this particular FOMC meeting (in our view, there probably will be another 25-basis-point cut in August.) In fact, while all eyes have been on the Fed, the other "background" development that may be just as important is that energy costs are running below year-ago levels. Whether through the positively sloped Treasury yield curve, the laggard performance by drug and other "defensive" stocks, or the outperformance by cyclicals, the market is clearly voicing its confidence in the Fed and in an earnings/economic recovery late this year.

Our own view is that the US economy will begin to recover in the second half, but not until the last quarter of the year. The US is likely in the midst of a mild recession that will probably last through the third quarter. By the fourth quarter a 2.5% real GDP gain is expected and projections are for 4% real economic growth from late this year through late 2002. It should be said, however, that this forecast represents a relatively quick turnaround. Typically, a change in monetary policy takes a long time to work. In the past 20 years, the US economy has peaked 15 to 18 months after the Fed has begun to tighten. Bottoms take a little less time, but a shift to easy money has typically taken a year or longer to stimulate recovery. Thus, we think many investors are still too optimistic about an immediate second-half recovery.

Nevertheless, comments from Oracle that its worst quarter may be over, at the same time that AOL Time Warner suggested that advertising revenue is stabilizing, affirmed what we gathered from recent investment conferences – that business is improving, or that the rate of deterioration is slowing. While negative developments at Nokia and Nortel dominated recent headlines, our research has actually begun to identify the occasional positive bit of news from company presentations. Of course, last year, company managements themselves seemed to be the last to know, but it was bottom-up anecdotal information that provided the earliest clue when the worst of the Asian devaluation contagion was over in the fourth quarter of 1998. Last week, I/B/E/S (an earnings estimate service) calculated that there are modestly fewer negative pre-announcements (as a percentage of total pre-announcements), and modestly more on the positive side, during this earnings confessional season than that of the first quarter.

In the meantime, while it may be difficult to remain patient, we'll continue to watch and wait for signs of stabilization, and hopefully signs of improvement, in the economy. In the stock market, one barometer we believe might be worthwhile keeping an eye on is the Dow Jones Transportation Average. Economists fully expect lower interest rates, lower taxes and lower energy costs to boost the economy. One of the first sectors that would likely respond is the transportation sector. After all, if consumers are going to buy more products, those products must be shipped somewhere. And, of course, lower energy costs will help transportation companies on the cost side. If the Dow Transports are not acting like conditions are about to turn, then that may be a strong indication that most investors don't envision a better economic period ahead.

During periods of strong market performance, investors often display a willingness to pay for potential good news many quarters into the future. During periods of uncertainty, the forecast horizon gets shorter and shorter, partially explaining the market's recent weakness. However, easier monetary policy, fiscal stimulus, lower energy costs, and the anticipated economic and profits recovery that should ensue are bullish for stock prices. We therefore believe investors should be positioned for the recovery and not get emotionally sidetracked by market gyrations as the bear-market bottoming process continues. After suffering through declines during the past fifteen months, it would be a shame to miss out on the opportunities that are surely at hand in the recovery phase. We continue to advocate proper balance in our client portfolios across asset classes and well-diversified equity portfolios of high quality growth stocks with attractive valuation characteristics.