



Economic and Financial Market Outlook for 2002

January 30, 2002

After a rocky U.S. economy and stock market last year, we expect both to be better in 2002. The 2001 recession was driven primarily by a slowdown in the capital spending boom that reached exaggerated levels in late 1999 and 2000. Capital spending was 50-70% over normalized trend lines during this period, fueled by Y2K concerns, the Internet and telecommunications hype. While U.S. capital spending fell in 2001, it remained above normalized levels and we could see continued contraction in 2002. Information Technology (IT) capital spending was the primary beneficiary of this spending boom, as investors provided financing to a broad range of companies, based on speculative business plans. These fledgling companies spent the funds wildly on office space, advertising and technology equipment. As a competitive response, large, established companies also spent tremendous sums on various Internet initiatives, in order to prevent the Internet companies from stealing their customers. Coincidentally, most companies and enterprises were also preparing for the millennium computer problem (Y2K) and ramped their IT spending in order to replace servers, PCs, hubs and routers on the theory that this replacement was the easiest, most reliable and most cost effective solution. In total, IT spending surged to unsustainable levels. We are, in our opinion, returning to more normal levels of capital spending. 2001 was not the abnormality; 1999 and 2000 were. Given this view, we remain cautious on the near-term demand and profitability prospects for the information technology companies.

The consumer side of the economy has been surprisingly strong. Boosted by low interest rates and despite rising (but modest) unemployment, the great American consumer has remained resilient and continued to buy new homes, cars, and other consumer goods at non-recessionary levels. The refinancing boom has contributed to this spending by allowing consumers to lower their mortgage payments and/or take cash out of their home equity. These cash flows have been largely redirected to purchases of consumer goods. With interest rates, in our opinion, having seen the lows for the cycle, this refinancing boom should begin to cool. The combination of higher interest rates and higher unemployment should cause the consumer economy to slow. With limited catalysts for strong growth in the economy, we expect a sluggish recovery with the last quarter of the year being the strongest.

While U.S. stock market returns have been negative two years in a row, corporate profits have also declined approximately 20% from their peak. Our proprietary valuation work indicates that the market is modestly undervalued versus low inflation and low interest rates. The combination of lower stock prices and lower interest rates has more than compensated for lower profits. Although we are not expecting sharply higher overall stock prices in 2002, stocks usually begin moving higher in anticipation of a stronger economy and better earnings. With that in mind, we expect that most stocks have seen their 52-week lows and that stocks could be poised to move higher in late 2002 and 2003. We continue to look for solid companies with above average growth prospects, selling at attractive valuations and believe this philosophy will continue to produce attractive long-term returns.