



Midyear 2002
Economic and Financial Market Outlook
June 28, 2002

The U.S. economy is in recovery. Inflation remains subdued. Interest rates are low. We expect corporate profits will begin their recovery in the second half of the year. With the stock market as measured by the S&P 500 down approximately 35% from its March 2000 highs, equity market valuations are now reasonable versus low inflation and low interest rates. This combination of factors would generally cause us to be optimistic about the outlook for equity returns, but numerous other issues are tempering our enthusiasm for stocks.

We are not moving towards aggressive weightings in stocks given the following negative factors that could derail the economic and equity market recovery. Terrorism could strike again resulting in more senseless and tragic loss of life. The Israeli and Palestinian situation could spill over into a larger Middle East problem that results in a disruption of energy supplies. Audited corporate financial statements could become totally discredited, if the revelations to-date are merely the tip of the iceberg versus a final purge. Given where companies are in the calendar and the auditor replacement cycle, we believe that the vast majority of corporate shenanigans have now been revealed. The growing U.S. capital demands and trade deficit could result in a significantly weakening dollar. There are plenty of items to monitor; hence, we are more cautious than the current bullish economic fundamentals might warrant.

Nonetheless, the combination of favorable factors has allowed us to deploy more money into the equity markets over the last couple of months. We are moving clients' portfolios that are underweighted in their long-term equity targets towards the median of their long-term targets. We are taking advantage of the third straight year of double digit declines in stocks (as measured by the S&P 500) to buy on weakness. We are finding more values now than we have found in years and think that investing some (but not all) reserves is prudent.

On a sector note, we have modestly increased our clients' investments in technology stocks, with plans of buying more as opportunities present themselves. We have recommended modest technology stock exposure for the past 20 months, which has allowed our clients to weather the storm better than most. Given the NASDAQ composite is down 70% and numerous technology stocks are down 80-90% from their highs, we have been actively searching for opportunities. We as a firm are still underweight technology companies as compared to the S&P 500, but we are selectively buying (where appropriate) strong companies with leadership positions in their markets in anticipation of 2002 being the bottom in technology capital spending and 2003 having a modest recovery. With P/E (price-to-earnings) valuations in the single digits and/or companies selling near net cash, we are finding fundamental value.

We believe the worst is over for the equity markets after this grueling two and a half year decline. The economic recovery is unfolding as we expected and, we believe, economic growth will drag stock prices higher even in the face of numerous macro concerns. In our opinion, cautious and realistic optimism is warranted.

