Economic and Capital Markets Commentary and Outlook – November 2001

Commentary – A Slew of Bad Economic News, Heightened Fears, and War on Terrorism

- The economic news keeps getting worse as consumers and businesses sharply curtail spending and fears remain high due to expectations of further terrorist attacks in the U.S. Retail sales, existing home sales and durable goods orders have all fallen recently, well below expectations.

- On the consumer side, retail sales declined sharply during the month with only those retail outlets accustomed to and structured for discounting showing sizable gains. Business expenditures have dried up, as most companies have shifted their focus to cutting overhead expenses.

- Jobless claims continued to grow during the month of October due to weakening labor market conditions. The four-week moving average of initial unemployment claims, as of the October 25 release date, surpassed the 500,000 mark for the first time since the Gulf War in 1991. This is strong evidence that the U.S. is now in a recession.

- The sales of existing and new homes have weakened significantly since the September attacks, even as interest rates continued to move lower. Job fears and uneasiness over further possible attacks has placed the brakes on home buying, the one key area of strength prior to September 11.

- The stock market has discounted much of the negative news. Most investors now acknowledge that the U.S. economy is in a recession and will not recover until the second or third quarter of next year. Stock returns in most sectors during the month of October continued to bounce back from the declines posted the week that the stock market re-opened after the September 11 attacks. Profit recovery expectations, together with bargain hunting, pushed stock prices higher.

- Third-quarter corporate profits fell below analysts' expectations for most sectors, and earnings estimates for fourth quarter 2001 and 2002 were revised lower. Recent performance in the stock market suggests that many expect a "v"-shaped recovery in profits in the first half of next year.

- In the U.S. equity market, the best-performing stock groups during the month of October have been the small- and mid-cap growth sectors. Large-cap growth stocks also reversed their recent trend by moving higher on the heels of a big bounce in technology stocks. The laggards over the last month were the "defensive" stock plays such as utilities, consumer staples and health care stocks.

- The overseas markets rallied during the month of October as a number of bargain hunters began to move back into those markets. As in the U.S., many investors expect corporate profits to rebound during 2002 and, unlike in the U.S., many expect corporate profits to hold steady through year-end 2001.

- Bonds posted higher returns on further expectations of rate cuts and lower growth forecasts for 2002. In addition, foreign investors continued to buy Treasury and agency securities due to the uncertainty surrounding the war in Afghanistan and the global economic slowdown.

Outlook – We Are Optimistic Based on Monetary and Fiscal Response So Far

- Based on the recent deluge of bad economic news along with falling consumer and business confidence, it is reasonable to be pessimistic about future prospects for the global economy and capital markets.

- Our investment process allows us to focus on the fundamentals and what is quantifiable and known. Predicting various scenarios based on the outcome of the current war on terrorism is not only impossible, but also counterproductive.

- Based on what is marginally predictable and quantifiable, we are optimistic. Attractive valuations, earnings that are already being written off for the third and fourth quarters, and the strong, swift monetary and fiscal response by both the U.S. Fed and many other central banks around the globe since September 11 should provide the necessary stimulus to get the economy growing again.

- We do not minimize the horror of the attacks on the U.S. and the fears brought on by the ongoing anthrax scare and the announcement of possible further attacks. The U.S. economy and stock market will continue to be resilient. Just look at the nuclear scares that overshadowed this country during the Cold War and, more specifically, the Cuban missile crisis.

- In economic terms, the U.S. economy represents over $30 trillion in physical assets and nearly $100 trillion in productive assets. The estimated loss of $100 billion due to the attacks and war on terrorism and the targeted $100 billion plus for government spending and tax cuts is a small fraction of the overall economy.

- The U.S. has a long history of responding to economic crisis through substantial readjustment and reallocation of resources. This strength, along with the will, optimism and innovation of the American spirit, is sure to move the U.S. economy back on track, sooner rather than later.