

SPECIAL COMMUNICATION #6

OCTOBER 15, 2001



AS GOOD AS IT COULD HAVE BEEN

- ◆ In our view, the magnitude of the market's rally from the lows made in September is a very good omen. That the stock market has mostly recovered all the ground lost in the week following September 11th so quickly is a "best case" outcome that we are happy to see. Especially as it has happened in the face of abundant negative corporate and economic news and ample evidence that September 11th will cause a sharp rise in unemployment and thus add the consumer to the existing recession in manufacturing.
- ◆ It appears that policy makers, both the government and the Fed, have provided sufficient news for investors to hope for a recovery in 2002, that they are willing to ignore the bad news around them. Certainly we have never seen such an overwhelming policy response to a crisis in such a short time. Since a global recessionary spiral is in nobody's interest, there appears to be the perception that policy makers are doing the "right thing".
- ◆ Some market specialists believe that all of this makes the September 21st lows look increasingly like the bottom. From a fundamental perspective, we believed that the S&P 500 was cheap below 1000, but were also aware that it could have become cheaper in line with previous historical bear markets.
- ◆ Technically, the signs are also encouraging, but we still have a number of important tests before the bear market's obituary can be published. Another strong week taking us above the April lows would turn those levels from resistance into support. Should we have a correction, then, as we discuss below, the magnitude of the re-tracement will be significant.

STRICTLY A TECHNICAL PERSPECTIVE – HITTING MAJOR RESISTANCE

Following the recent stock market rally, in which the losses in the week after September 11 were essentially recouped, the market is now at the resistance from the April lows (see chart of the week). The market's technical performance has been impressive over the past two weeks, especially as it managed to shrug off news of further expected terrorist attacks and reports of anthrax infections late last week. However, enthusiasm for a continuation of the current rally should be constrained by several factors: The market's primary trend is still negative; the market has reached a significant zone of resistance following a brisk rally off the September lows; and overbought readings have been generated by several market indicators.

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We recently suggested conditions to determine if there was some improvement in the technical picture. We mentioned seeing the S&P 500 and the NASDAQ rising with conviction above lows made earlier this year – 1100 and 1620 respectively – and the Dow Industrial Average moving above 9000, taking it back into its 2 year trading range. So far, the fulfillment of such technical qualifications has been mixed. The Dow peaked at 9432 – a rise with conviction. The Nasdaq, while rising above 1600, has paused at 1720. The S&P 500 has almost made it to 1100. In sum, because of the mixed picture, it may be too early to signal an “all clear” for the market. While it is hard to imagine an event worse than September 11 in the months ahead, in the last three weeks the bulls have dominated and have chosen to discount only the good news of policy stimulus. How well the market holds up when the bears become aggressive again is to be seen.

From here the market will likely do one of four things: shrug off the bad news and continue to move higher; form a pattern of consolidation around current levels; partially retrace the recent rally; or move down to new lows. According to technicians, a likely scenario is a partial retracement of the rally, the magnitude of which could be as mild as one-third, as severe as two-thirds, or a more typical onehalf retracement. These have historically been levels at which a correction would hold. A drop below the two-third retracement levels – roughly 1010 for the S&P 500, 8630 for the Dow and 1500 for the Nasdaq – would be a warning that the September lows could be retested or lower lows could follow.

Given the overbought conditions the market reached last week and our expectations for a partial retracement of the rally, we look for market stabilization around the retracement levels as an aid to identify “entry” points (see Chart of the Week).

Interest rates and bond diversification

Short-term rates are likely to head lower. Many expect an additional 25 basis point cut in the fed funds rate to 2.25% in November. Another 25 basis point cut in December to 2.0% is also possible, but we believe the likelihood for further cuts thereafter diminishes, as economic recovery becomes more visible. In this environment we can envision 10-year bond yields down to 4%. At the height of the financial crisis in the fall of 1998 that yield fell to as low as 4.1%.

We also believe that a full recovery next year is somewhat dependent on the success of US actions to counter terrorism in the coming weeks and months. We expect risk premiums to remain high during times of high uncertainty. This should continue to benefit risk-free and low-risk securities, especially over the near term, as concern over bio-terrorism, plunging retail sales and weak anticipated third quarter earnings dampen investors' appetite for risk.

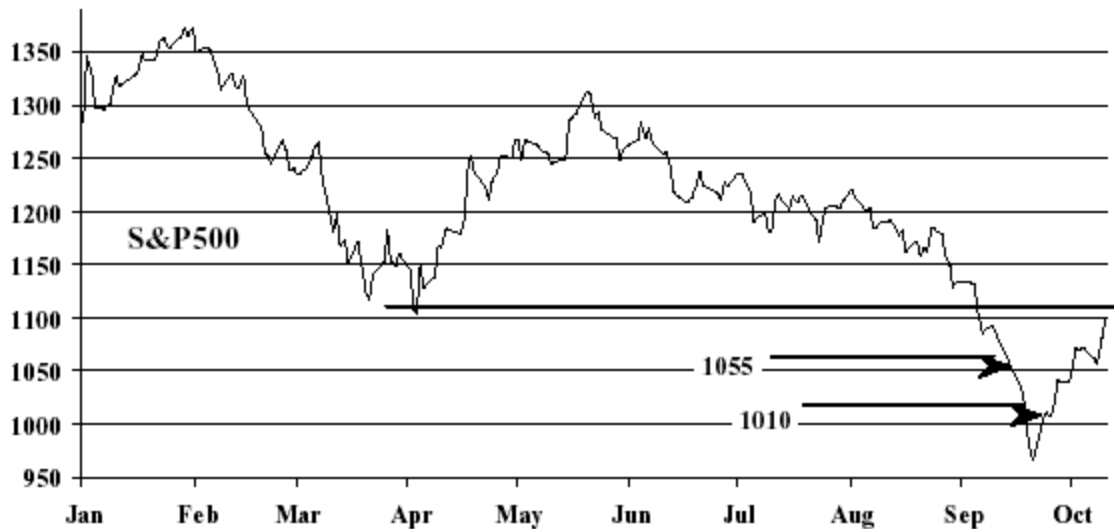
Treasuries have outperformed stocks for almost two years in a row and it should be noted that peaks in bond prices coincide with strong inflows into bond mutual funds, which have been occurring lately. Also, bonds are currently overvalued compared to stocks. We would advise all investors to hold bonds as insurance against the recession lasting longer and going deeper than we currently foresee., but would maintain an overweight in stocks at this point.

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Within the bond market we believe better value can currently be found in medium to long term maturities. Inflation should not be a major concern given weak energy prices and the weak economy. Fixed income securities outside of Treasuries should be considered. Although risk aversion benefits Treasuries, low-risk securities with attractive yields may also be found in agency paper and high-grade corporate debt. For investors in the 28% tax bracket or higher, tax-free yields are attractive at the moment.

RESISTANCE AND RETACEMENT LEVELS A TECHNICAL PERSPECTIVE



This chart of the S&P 500 composite provides a graphic view of target levels mentioned above.

Prepared by: Rod Smyth – Chief Investment Strategist, First Union Securities and **CONSULTIVA INTERNACIONAL, INC.**

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