

SPECIAL REPORT

DECEMBER 3, 2001



WE'RE BACKING STOCKS FOR 2002

- ◆ As we prepare for 2002, the first decision that must be made relates to asset allocation or the choice between different types of investment classes. As studies have shown, the distribution of assets between stocks, bonds and cash has a much bigger impact on overall portfolio performance than individual security selection. **Approaching the New Year, our conviction is that stocks will outperform bonds and cash in 2002.**
- ◆ In terms of numbers, we think that the stock market, as represented by the S&P 500, can return between 10-20% from current levels. Our 2002 year-end forecast for the S&P 500 is 1300, a 14% increase from the November 30th level. This compares very favorably with likely cash returns of 2-3% and bond returns which for both Treasuries and more risky bonds will do well to have total return that equals their yields, since we expect some modest declines in bond prices.
- ◆ As our enclosed illustration shows, bonds have significantly outperformed stocks over the last two years and as a result, *have matched stock returns for the last five years*. Few people in 1997 would have believed that stock returns would be no better than their dull bond cousins in the following five years. It is entirely normal for bonds to outperform stocks during periods of economic slowdown and recessions, but **it would be unprecedented since the Great Depression for stocks to underperform bonds for three consecutive years. We do not think 2002 will break the precedent.**
- ◆ Last week the major stock indices made little progress. This is not surprising because they are all approaching levels of important technical resistance. For each of the Dow, NASDAQ and S&P500, the 200-day moving average is just above current levels. There are many ways to define bull and bear markets, but in our view one of the clearest ways to determine the market's trend is to look at the direction and gradient of the 200-day moving average.
- ◆ As you might expect, the NASDAQ has the most powerful downtrend, followed by the S&P 500. Neither has been able to rise above their 200-day averages since they fell below them in October 2000. The Dow is a different case --its 200-day average's decline is less steep and the index was well above its 200-day average for much of the first quarter and again in the early summer. A decisive break above this key moving average and sufficient momentum to change its direction to an uptrend is the next stage in the transformation from bear to bull market.

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- ◆ While we believe this will happen in the coming months, **we would not be at all surprised to see the market back down from current levels** and retrace one-third to one-half of the move from the September 21st bottom to the recent highs. Should this occur, such a move for the S&P 500 would present another chance to further increase equity weightings in the 1050 – 1100 zone.
- ◆ Regarding NASDAQ and technology, the rise since October has been stunning, and once again leaves valuations alarmingly high. Traditionally these stocks have done well when their fundamentals are improving, as they seem to be currently, but we foresee caution and profit taking from growth managers. **Our perception is that there is a lot of “hot” trading money currently in the tech sector, which will sell as soon as momentum turns down.**

CHART OF THE WEEK – AN EXCEPTIONAL 2 YEARS FOR BONDS



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STOCKS TO MAKE A COMEBACK IN 2002

We find it a cause for concern to see the record sales of bond funds and the corresponding redemptions of stock funds in the 4th quarter of 2001 following a historic period of bond outperformance. This has all the hallmarks of the tendency of retail investors to buy what has been working. Though nothing against well-run bond funds as a component of a balanced portfolio, **we once again advise “care and caution” to investors who are selling stocks and buying bonds in the 4th quarter of 2001** -- the same caution we advised to investors who were selling bonds and buying stocks in the first quarter of 2000, when stock mutual fund sales were booming and money was exiting out of bond funds.

Stock and Bond Fund Flows

	First Quarter 2000 Net New Cash Flow	Fourth Quarter 2001 Net New Cash Flow*
Stock Mutual Funds	\$129.1 billion	-\$28.6 billion
Taxable Bond Mutual Funds	-\$19.7 billion	\$19.5 billion

*September and October only

Source: Investment Company Institute

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