

SPECIAL REPORT

DECEMBER 10, 2001



ECONOMIC RECOVERY: YES, STRONG RECOVERY: NO

Why the Economy will recover – Huge policy response by the Fed and the Government

An economic recovery for 2002 is foreseen, based on a general belief that demand will improve as a result of the aggressive action by both the Federal Reserve and the Government. Since the start of the year we have had:

- ◆ Ten interest rate cuts which have lowered short term rates from 6.5% to 2% in just 11 months
- ◆ A \$1.35 trillion tax relief package passed May 26 providing \$100 billion in stimulus this year and next
- ◆ A proposed stimulus package of another \$75-\$100 billion next year

The action by the Fed is the most aggressive and early response to a recession in history. Rarely has the Fed started lowering rates before the recession has begun, or lowered them so much or so quickly.

Why the Recovery will not be robust – Structural hangovers from the last cycle

Six factors drive demand in the economy:

1. Personal Consumption; spending by individuals
2. Business Investment; spending by businesses
3. Residential Construction; spending on housing
4. Government spending
5. Net Exports; what we export to other countries minus what we buy from them
6. Inventory change; whether we draw down inventories or rebuild them

1. Personal Consumption: Expect weak recovery

Households entered this recession with high debt levels and low savings rates. They have been bailed out by low interest rates to refinance their debt and tax cuts to help their savings. Thus an improvement, albeit not a dramatic one, can be expected. It seems there is little pent-up demand, because consumption only slowed for a brief period.

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2. Business Investment: Still unwinding the late 90's spending spree

In our view, business spending will be subdued for some time. Companies went on a record spending binge with capex rising to 13% of GDP by 1999, a level not seen in the previous 20 years. Having spent all this money preparing for Y2K, embracing new technology and fighting off the competitive threat from "New Economy" new entrants in their businesses, they have been left with high levels of debt and low levels of profits. Thus, 2002 will most likely be a year of restoring profitability, not spending money.

3. Residential Construction: No downturn, therefore no recovery

It is hard to forecast a big recovery in housing as there has yet to be a downturn. By lowering interest rates so aggressively, the Fed looks to have avoided a housing cycle this time.

4. Government: 4% growth for 2002

We see government spending as one of the mainstays of demand in 2002. US is likely to increase infrastructure, defense and domestic security spending next year.

5. Net exports: No Help, the US will lead the world out.

The US will get little help from the rest of the world in 2002. Having been more aggressive than either Europe or Japan, US growth will likely be faster in 2002, and thus there will be no help from net exports.

6. Inventories: A big help in 2002

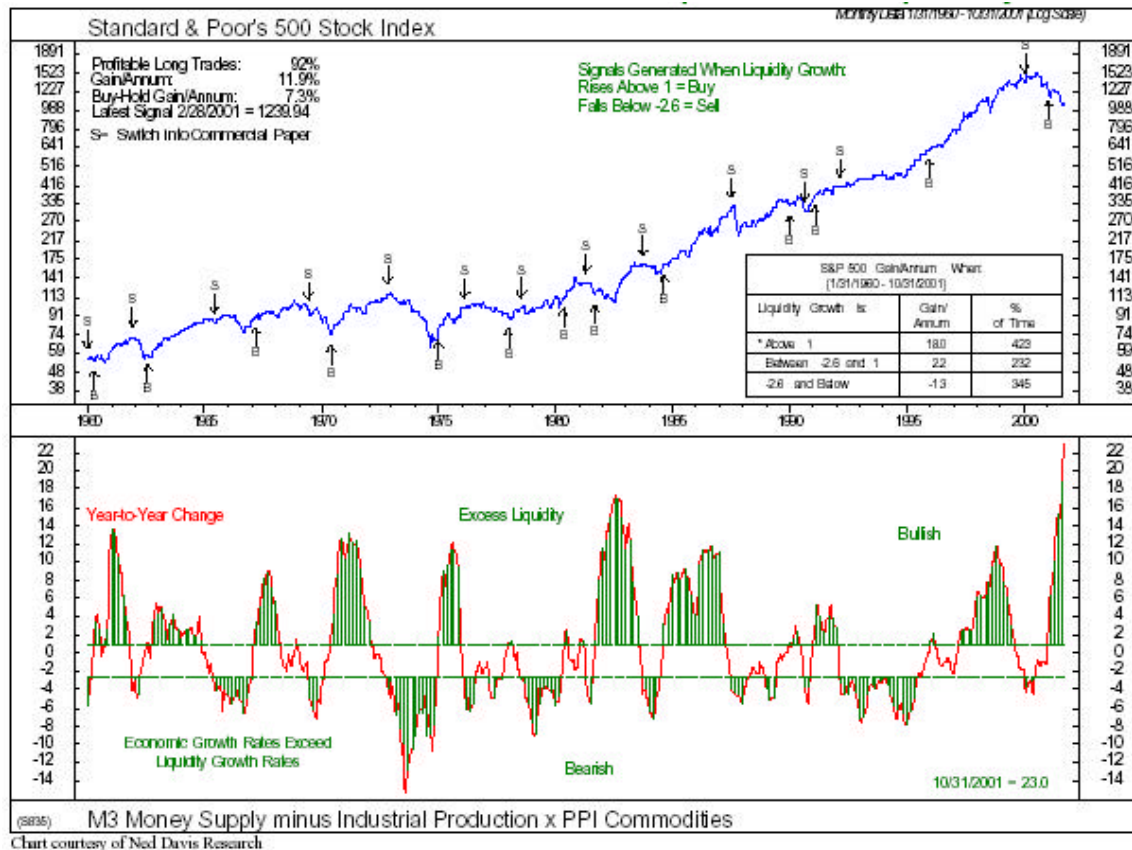
At the turn of the cycle, the last factor, inventories, plays a crucial role. In the early stages of an economic slowdown as sales and orders drop, retailers and manufacturers allow inventory levels to fall in an effort to preserve inventory to sales ratios and conserve cash. If policy makers can, through tax cuts and lower interest rates, stabilize and ultimately stimulate demand, then recovery begins. Inventory accumulation tends to proceed at a higher than normal pace early in the recovery as retailers and manufacturers react to accelerating demand and lower than normal inventory levels.

For the reasons outlined above in our discussion of the business cycle, we think inventory rebuilding will account for over 1% of an overall growth rate of some 4% by the third quarter.

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CHART OF THE WEEK – STOCKS SOAK UP EXCESS LIQUIDITY



One of the primary reasons we like stocks for 2002 is the fiscal and monetary stimulus that has been applied by the government and Federal Reserve this year. When money supply growth (liquidity) exceeds economic growth, the excess liquidity tends to spill over into financial assets like the stock market. One way to spot excess liquidity is to subtract nominal economic growth (Industrial Production times commodity inflation) from Money Supply growth (M3). The periods of excess liquidity, shown on the lower chart, correspond well with stock market uptrends. The chart shows that money provided by the Fed above that needed for economic growth and inflation is bullish for stocks, whereas money insufficient to cover inflation and growth will harm stocks.

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