

# ECONOMIC AND CAPITAL MARKETS COMMENTARY AND OUTLOOK

## July 2002

### MARKET REVIEW AND STRATEGY SUMMARY

**Stocks Decline Over 13% amid Accounting Scandals and “Bubble” Hangover.** U.S. stocks fell over 13% during the second quarter, extending losses that began in early 2000. The performance of stocks from their peak in 2000 has now matched the peak-to-trough losses posted in the last secular bear market of 1973 and 1974. Stocks are also on track to post losses for a third consecutive year, the worst run since the Great Depression of the 1930s.

While the similarities are apparent, it is also important to note the relevant differences between this market and those of the 1930s and 1970s. Following the bear market of the 1930s, the U.S. economy witnessed several years of deflation and after the early 1970s, stagflation. Today, although corporate profits have compressed and consumer confidence is at a new low, the U.S. economy continues to improve, with real GDP

growth expected to finish the year near 3%. The big questions now are the direction of stock prices, interest rates and corporate profit growth.

Several factors have weighed heavily on stock prices over the last 2½ years. High valuations, inflated expectations and revelations about the integrity of published profits all pushed stock prices lower. The strongest negative impact on stock prices has come from the crescendo of accounting restatements in the corporate sector, which has triggered an overall loss of trust in American companies. There have been over 1,000 corporate earnings restatements since 1997, and it now appears that some of the high returns posted in the late 1990s were based on false accounting information.

Skepticism over corporate profits is nothing new. Major cases in the past, such as Penn National, soured investors on equities when they occurred. The difference this time is that the current spate of accounting restate-

ments due to fraud or shady accounting is more widespread. During the 1980s and 1990s, corporate managers and board directors were focused, sometimes obsessively, on enhancing shareholder value, using any means possible to boost the share price of their companies. The importance of this goal was often amplified by the fact that share price was a key component of the compensation formula for key executives. Some of them, it is now apparent, crossed over the line between legal and illegal in pursuit of that goal.

**The Great Disconnect – Part II.** In previous commentaries, we spoke of the “disconnect” between U.S. economic growth and U.S. corporate growth. This year, the U.S. economy has continued to surprise on the upside, with real GDP gaining over 6% on an annualized basis during the first quarter and nearly 3% during the second quarter. At the same time, corporate profits continue to decline and to surprise analysts on the downside, and the negative surprises have been exacerbated by the falsified accounting reports.

Typically, recoveries in economic growth are synonymous with recovery in corporate profits. The recovery in corporate profits (yes, there is a recovery underway) is currently one of the weakest on record, but at some point, corporate profits will catch up with real economic growth. The outlook for a sustained economic recovery looks promising, although it may be less robust than many expect. The consumer continues to spend, interest rates and inflation remain low, and the labor market shows sign of stabilizing. The consensus of both private and public economists is that real GDP growth will finish the year 2.8% higher and grow at a 3.6% annual rate in 2003. Inflation expectations remain low with the CPI expected to finish the year up 1.6% and to increase to 2.5% in 2003. Corporate profits, coming off severely depressed levels, will probably grow slightly faster than the economy in the short-term, as the sector catches up to the real growth in the economy.



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But even with a reversal in profit growth and economic growth, stocks are still under pressure from valuation compression. Stock valuations are still high by any measure or standard of comparison. It will take time for valuations to compress and for stocks to return to “fair value.” However, although valuations for the overall market are high, there are opportunities within the market for extra return where valuations are less lofty and the potential for income generation, more prominent.

**The New Normal: An Era of Balanced Risk and Rewards.** Investors who have come to expect 12%-14% annual returns in stocks (or even 10% annual returns) are most likely to be disappointed in the next decade. The equity risk premium, or the extra return awarded to stock investors over a 10-year Treasury bond, is likely to be near 3% over the coming decades, not the 6%-7% level that accrued to stock investors over the past 70 years. Current yields on

the 10-year Treasury bond trade near 4.7%-5%. A risk premium of 3% on top of current bond yields suggests a long-term nominal return for equities of 7.5%-8%.

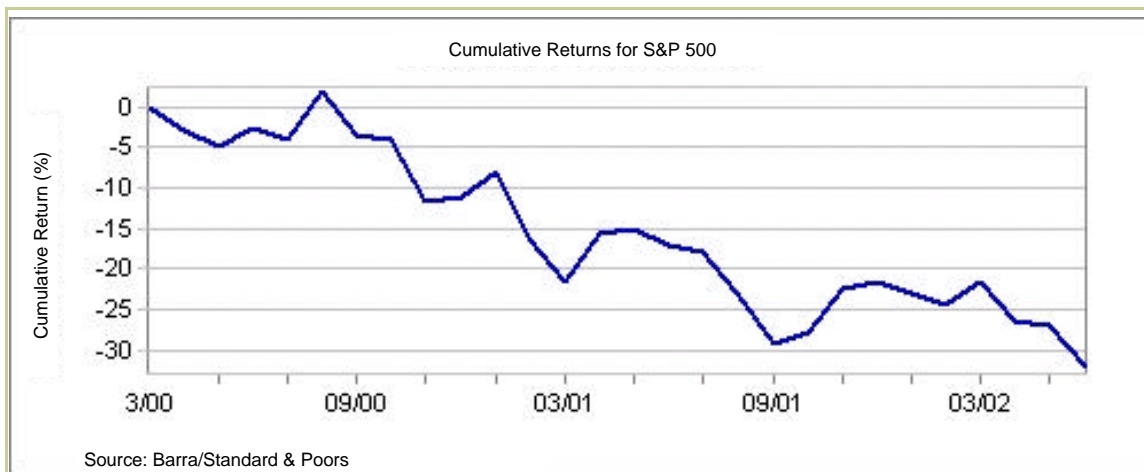
The equity risk premium should be derived on forward expectations and current investment fundamentals, not by extrapolating history. We derive the 3% equity risk premium by evaluating the three primary attributes of return for a stock: dividend yield, earnings growth rate and change in valuation. The first, dividend yield, is the current dividend yield in the stock market (1.5%). Next, the earnings growth rate is best estimated using nominal GDP growth forecasts. Finally, one must predict whether valuations (p/e ratios) will expand or contract. Assuming that valuations remain near current levels (fair valuation), a 1.5% average dividend yield and a 5.5%-6% earnings growth rate suggest that stocks are more likely to return 7%-7.5% per year in the coming decade.

Future bond market returns are a function of starting yields (current yields) plus the effect of a change in interest rates. Throughout the 1980s and 1990s, bonds posted superior returns relative to historical norms. The average annual return in the bond market over this period was over 13%. During the initial stages of the bull market, in 1981, bond yields were high and interest rates proceeded to fall precipitously over the next 18 to 19 years. The current yield on the 10-year Treasury bond hovers between 4.7% and 5%. Interest rates are not expected to decline from their current historic levels nor are they expected to rise dramatically over the next decade, as inflation should remain under control.

What are the implications of a 7.5% nominal return in stocks and 5%-5.5% nominal returns in bonds over the next 10-plus years? For individual investors, it means reevaluating the assumptions previously used to project portfolio returns and, in many instances, reallocating assets to include a better-diversified mix of global stocks and bonds. For institutional investors, such as pension funds and endowment funds, it means a reevaluation of asset assumptions, discounted liabilities and spending rates. For corporate officers, it means reworking cost of capital assumptions and their potential impact on future projects and capital spending.

Mediocre returns in the future also mean that investors will be tempted to take on more risk to achieve extra return. The migration to hedge funds will probably continue, even though most will not generate the extra returns promised, especially after fees and taxes. Real assets and income-producing assets, such as metals, real estate and REITs, will probably receive more attention in this environment. Attention may turn to overseas markets and the personal savings rate is likely to increase. The new watchwords will be “diversification” and “transparency”.

**What Works and What Doesn't.** There are opportunities for investors in an environment of mediocre market returns. Now is the first time in recent memory that skilled stock pickers can add extra return to overall



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market expectations, as many stocks trade with favorable valuations and earnings prospects. In terms of risk control, active money managers are no longer held captive to managing portfolios that are measured relative to a risky and concentrated market index. Stock market indexes, such as the S&P 500, are no longer dominated by one or two sectors, as was the case in the late 1990s when technology and telecommunication stocks accounted for over 40% of the market. The types of investments that should lead in this new environment are those that are not only transparent and understand-

able, but that exhibit reasonable valuations relative to proven earnings growth. Smaller- to mid-cap value stocks, REITs, high-quality bonds and hard assets, such as direct property, all fit this description.

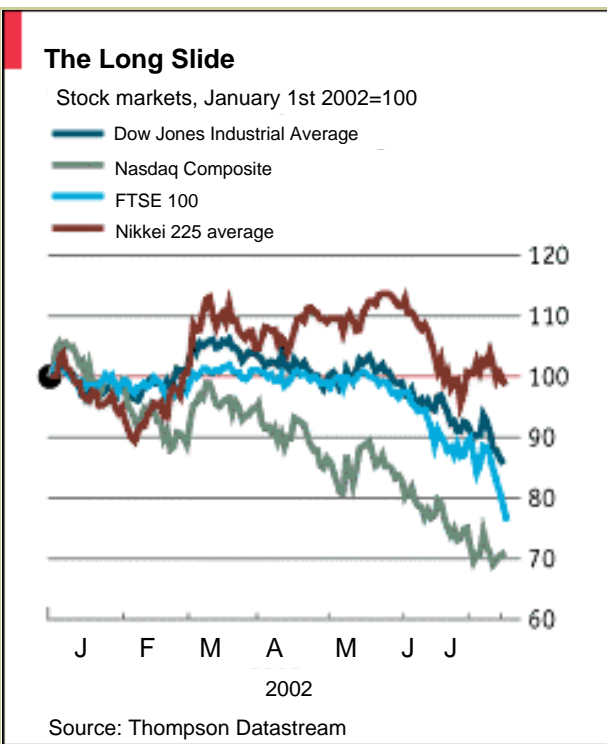
There are assets that will disappoint investors and produce returns well short of overall market expectations. Overvalued stocks with a long timeline for profit recovery (technology and telecommunications), investment strategies based on earnings expectations without regard for price, momentum strategies and 100% market-based strategies (passive/index funds) are just a few areas that will surely disappoint in the coming decade. These were the same areas and strategies that led stocks higher during the late stages of the bull market in the 1990s and that were largely responsible for creating unrealistic investor return expectations.

**Lockwood Investment Strategies – Emphasis on Diversification, Value and Income-Producing Assets.** With Lockwood's new recommended investment strategies, we focus on balancing our proprietary long-term capital market risk and return forecasts with investors' long-term financial objectives and risk tolerances. The diversified investment strategies range from the most risk-averse, with an emphasis on income generation, to the riskiest, with an emphasis on maximum growth of principal. The following is our current outlook with respect to each recommended strategy ranging from the most risk-averse to the most risky.

**Current Income:** The primary objective of this strategy is to provide total nominal returns slightly above the yield of a relatively risk-free 10-year Treasury bond while minimizing the loss of principal. A ma-

jority of total return is generated through income return. Currently, we recommend a diversified mix of bonds and stocks, with emphasis on the highest-quality, intermediate sector of the bond market. Specifically, we currently recommend an 80% allocation to high-quality U.S. bonds, 10% to U.S. large-cap equity, and 10% to the REIT sector of the stock market. The expected target return for this strategy falls between 5.5% and 6.25% and target risk, as measured by standard deviation of return, between 5% and 7.5%. Lockwood suggests that there are potential opportunities to earn extra return within this strategy without incurring additional risk. These include a predominantly active management approach with a bias toward intermediate Treasury notes/bonds and a slight exposure to high-quality corporate bonds in the fixed-income portion of the portfolio. For the equity portion, we recommend a bias toward lower valuation and less volatile, income-producing assets.

**Growth and Income:** The primary objective of this strategy is to provide total nominal returns between the long-term expected return of a diversified high-quality bond portfolio and that of a broad stock market index portfolio with a level of total risk closer to a diversified bond portfolio. Nearly 50% of the portfolio's projected return should be generated from income return and the rest from capital gain return. Currently, we recommend a diversified mix of bonds and stocks, with emphasis on the highest-quality intermediate sector of the bond market. Specifically, we currently recommend a 60% allocation to high-quality U.S. bonds, 20% to U.S. large-cap value equity, 10% to U.S. large-cap growth equity, and 10% to REITs. The expected target return for this strategy falls between 6.25% and 7.5% and target risk, as measured by standard deviation of return, between 7.5% and 11.5%. Lockwood suggests that there are potential opportunities to earn extra return within this strategy without incurring additional risk. These include an active management approach with a bias toward intermediate Treasury notes/bonds and a slight exposure to high-quality corporate bonds in the fixed-income por-





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tion of the portfolio. For the equity portion, we recommend a bias toward lower valuation and less volatile, income-producing assets.

**Conservative Growth:** The primary objective of this strategy is to provide total nominal returns near the expected return for the U.S. stock market with the potential for slightly less downside risk versus the total stock market. The total return from this strategy is derived from a balanced mix of income and capital gain return. Currently, we recommend a diversified mix of bonds and stocks, with a slight emphasis on a diversified mix of global equities. Specifically, we currently recommend a 40% allocation to high-quality U.S. bonds, 20% to U.S. large-cap value equity, 10% to U.S. large-cap growth equity, 15% to U.S. small/mid-cap equity, and 15% to international equity. The expected target return for this strategy falls between 7.5% and 8.5% and target

risk, as measured by standard deviation of return, between 11.5% and 15.5%. Lockwood suggests that there are potential opportunities to earn extra return within this strategy without incurring additional risk. These include an active management approach with a bias toward intermediate Treasury notes/bonds and a slight exposure to high-quality corporate bonds in the fixed-income portion of the portfolio. On the equity side, we recommend a bias toward lower valuation and less volatile, income-producing assets. This strategy should also include moderate exposure to core small/mid-cap stocks and moderate exposure to international stocks, with an emphasis on the developed markets of Europe and minimal exposure to Japan and the emerging markets.

**Moderate Growth:** The primary objective of this strategy is to provide total nominal returns slightly

above that expected for the total U.S. stock market with the potential for slightly less volatility than a 100% S&P 500 Index-like portfolio. Currently, we recommend a diversified mix of bonds and stocks, with emphasis on a diversified global stock portfolio. Specifically, we currently recommend a 20% allocation to high-quality U.S. bonds, 25% to U.S. large-cap value equity, 15% to U.S. large-cap growth equity, 20% equally split be-

tween U.S. small/mid-cap value and growth stocks, and 20% to international equity. The expected target return for this strategy falls between 8.5% and 9% and target risk, as measured by standard deviation of return, between 15.5% and 18.5%. Lockwood suggests that there are potential opportunities to earn extra return within this strategy without incurring additional risk. These include an active management approach with a bias toward intermediate Treasury notes/bonds and a slight exposure to high-quality corporate bonds in the fixed-income portion of the portfolio. In the equity portion, we favor a bias toward lower valuation and less volatile, income-producing assets in both the U.S. and abroad. International equity exposure should emphasize the developed markets of Europe, with minimal exposure to Japan and the emerging markets. Small-to-mid-cap exposure in the portfolio should be split between active small-value and small-growth approaches.

**Growth:** The primary objective of this strategy is to provide total nominal returns above the expected return for the total U.S. stock market (1.5%-2.5% gross) with the potential of equal or slightly higher risk than a 100% diversified U.S. equity portfolio. The majority of expected total return is derived from capital gain return. Currently, we recommend a diversified mix of global equities. Specifically, we currently recommend a 30% allocation to U.S. large-cap value equity, 25% to U.S. large-cap growth equity, 20% equally split between U.S. small/mid-cap value and growth stocks, and 25% to international equity. The expected target return for this strategy falls between 9% and 10% and target risk, as measured by standard deviation of return, between 18.5% and 24.5%. Lockwood suggests that there are potential opportunities to earn extra return within this strategy without incurring additional risk. These include an active management approach with a bias toward intermediate Treasury notes/bonds and a slight exposure to high-quality corporate bonds in the fixed-income portion of the portfolio. In the equity portion, we favor a bias toward lower valuation and less volatile, income-producing assets in both the U.S. and abroad. Interna-

Lockwood's Proprietary Long Term Estimates		
Asset Class	Expected Return	Expected Risk
<b>Equity:</b>		
Core Equity	8.70%	21.99
Large Cap Value	9.36%	20.41
Large Cap Growth	7.86%	23.43
Small Cap Equity	11.69%	35.30
REITS	8.67%	18.55
International Eq - Dev	9.29%	23.66
<b>Sector</b>		
Consumer Services	5.95%	15.77
Financials	11.33%	30.90
Health Care	10.27%	27.06
Technology	12.20%	46.83
Utilities/Energy	7.35%	21.19
<b>Fixed Income:</b>		
US High Qlty Bond	5.27%	4.56

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### THE ECONOMY AND INTEREST RATES

#### The U.S.

Real GDP growth was surprisingly strong during the

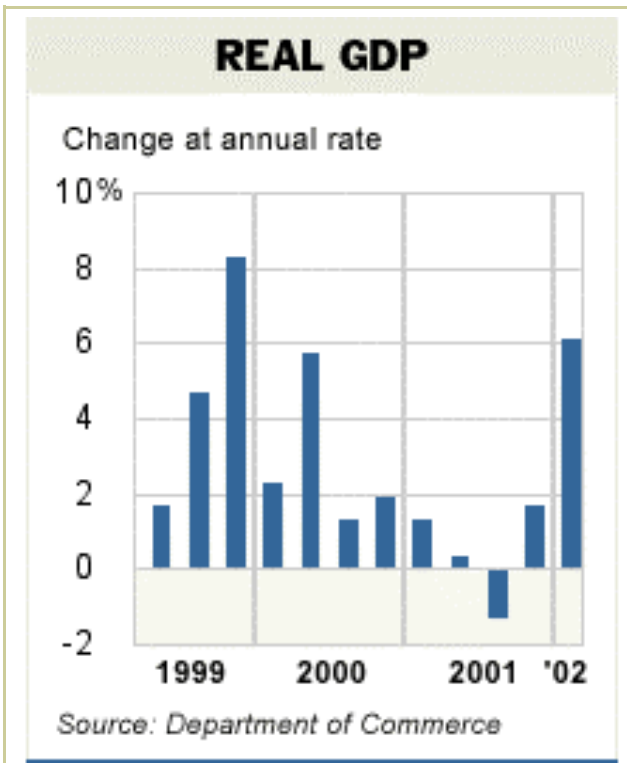
first quarter, up 6.1% on an annualized basis. Second-quarter growth numbers will not be released until the end of July. Current estimates for second-quarter growth are down to a 2.9% annual rate. Most of the decline in growth is expected to come from lower numbers on the consumer-spending side, softness in residential real estate, and a much smaller contribution from business inventories. Areas of improvement include a slight increase in business fixed investment and less drag from trade. The consensus now expects 2002 real growth to be 2.8%, and more robust growth to return in 2003 with expected real economic growth of 3.6%. Real growth is expected to move higher during the third and fourth quarters of this year. Despite expected softening in the consumer-spending area, expenditures in the government and corporate sectors are expected to move higher during the second half of 2002. Business investment has already shown signs of improvement in the manufacturing area. The expected softness in consumer spending is based on a declining stock market and an increase in jobless claims. Corporate profits still lag the nominal growth rate in the U.S. economy, with some improvement expected in the third and fourth quarters. Any continuation in business spending, of course, will depend on how high corporate profits move over the next six months.

Consumer spending still accounts for over two-thirds of all economic output. Personal consumption has remained resilient throughout the recent downturn and, most likely, will not experience any post-recession rebound as seen in previous recoveries. Consumer spending has remained strong since the decline in equities began in March of 2000, thanks to the large expansion in wealth that resulted from

the record bull market of the '80s and '90s, rising real incomes and declining interest rates. The current bear market in equities has severely impacted wealth for many equity investors and weak corporate profits have forced companies to increase layoffs, slowing real income growth. Interest rates are at historic lows and are likely to move higher rather than lower from this point forward. Corporate profits and real economic growth will have to merge at some point and it is more likely that the former will begin to show signs of improvement, as we move toward the end of the year. Any slight increase in inflation may be a good sign for corporate profit growth, as most sectors cannot improve profit margins only by cutting costs. The weakness of the dollar may help move inflation slightly higher and improve profit margins for companies that are dependent on exports.

The labor market remains weak. However, there have been some minor improvements recently, as the unemployment rate dropped to 5.8% from 6% in April. Service-producing companies continue to add jobs and manufacturing payrolls fell in June, but it was the smallest decline in 1½ years. Personal income rose in May along with a modest rise in industrial production. The most visible layoffs have been in the telecommunication and technology sectors, but job layoffs have stabilized in many other industries with slight gains in a few. The unemployment rate may peak at 6% or slightly higher before we begin to see improvement in the job market in 2003. The consensus expects that, by year-end 2003, the unemployment rate should stabilize near 5.5%.

Housing starts have weakened recently, but consumer demand remains strong. Housing starts fell in March and April, matching their low in October of last year. Existing home sales surged in April (7%) and new home sales moved 1% higher. The housing boom continues due to historically low mortgage rates and a negative stock market. Has the residential real estate market hit a peak? Prices may not continue to appreciate at the rates experienced over the last several years, but the sector should remain strong. Interest rates and real income levels are expected to move only slightly higher in 2003.



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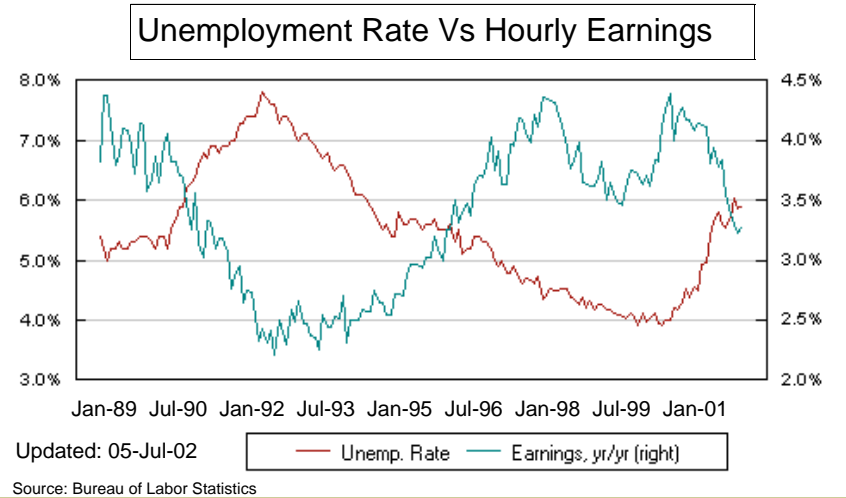
There have been comparisons of this market and its relationship to the U.S. economy to the bursting of the Japanese bubble, the long period of deflation following the Great Depression, and the stagflation following the 1973-1974 bear market. While some parallels can be drawn from each scenario, this market and economy are quite different. The U.S. economy is slowly recovering, job productivity is strong, and inflation and interest rates remain low. Leverage is not widespread in the U.S. economy. In the consumer sector, overall debt as a percentage of disposable income has moved lower and

the savings rate has moved higher. In the corporate sector, debt levels are high in certain industries, but not all. Many firms in the telecommunication and airlines industries continue to struggle with rising debt obligations while many others have effectively managed the quality of their balance sheets. The Fed has managed inflation well, through prudent monetary policy, and interest rates remain at low levels. In 1973 and 1974, interest rates and inflation were moving higher and real growth was stagnant. More industries are global today than in the early 1970s. Shifting opportunities abroad and fewer barriers to entry have allowed these multinationals to maintain or expand profit margins even during times of economic duress in the U.S.

### Europe

Economic growth in the Euro region continues to improve, albeit slowly and at a much lower pace than in the U.S. In the two largest economies of Europe, Germany and France, real growth is only expected to move 1.4% higher in 2002 and to improve slightly in 2003 to 2.5%. Unemployment rates remain high in the region, and consumer and business spending are expected to remain sluggish well into 2003. The recent strength of the Euro will certainly hurt export-oriented companies, but keep inflation levels low. Many of the same corporate problems in the U.S. telecommunication industry are present in Europe. Other sectors in Europe, such as the banking sector, have been hurt through loan exposure to telecommunication companies.

In Germany, real GDP growth finally turned positive

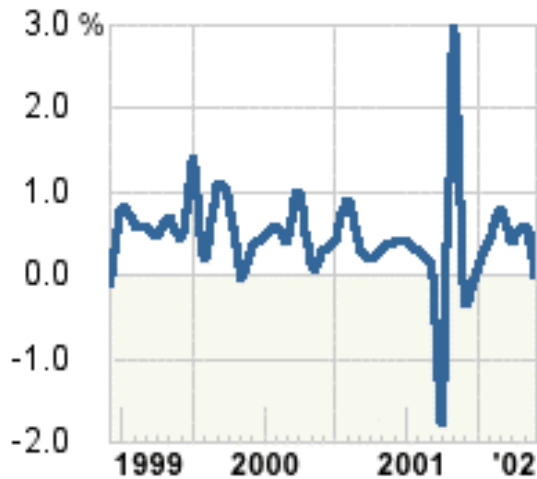


during the first quarter, following declines in the last half of 2001. Most of the improvement in real growth in the first quarter was attributed to stronger external demand, while the domestic economy remained in recession. Export growth contributed significantly to the growth rate during the first quarter, while the biggest detractor was inventory change. In the consumer sector, private consumption contracted 0.3% on a year-over-year basis. Business investments declined over 8% on a year-over-year basis, with the biggest declines in machinery and equipment contracting. Manufacturing orders have recently shown signs of improvement, with factory orders up 2.3% in April.

The economic growth rate in the U.K. slowed during the first quarter (+1.0% on a year-over-year basis). The biggest detractor to positive growth during the quarter was a decline in the manufacturing sector. Retail sales have remained positive and housing sales robust. Interest rates are expected to inch higher in the coming months due to strength in the consumer sector, improvement in industrial production output, and depreciation of the Sterling relative to the Euro. Real GDP growth is expected to finish 2002 at a 1.8% annual rate of growth and to increase to 2.8% in 2003. Household consumption is expected to slow slightly in 2003 and gross fixed investment is expected to turn dramatically higher. The labor market in the U.K. is one of

## CONSUMER SPENDING

Personal consumption expenditures, change from previous month, seasonally adjusted



Source: Department of Commerce

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the strongest in the G-8, with the national unemployment rate running at only 3.3% on an annual basis and expected to remain steady throughout the remainder of the year and well into 2003. Interest rates are expected to edge higher into 2003 with the three-month interbank rate moving from 4.4% to a level near 5.3% and 10-year Gilt yields moving only slightly higher from 5.3% to 5.4%.

### *Japan*

The preliminary estimate for first-quarter growth in Japan was 1.4% (quarter-over-quarter), following a 1.2% contraction in the fourth quarter of last year. The first-quarter growth was the strongest in over two years and the first positive number in a year. Private consumption and net exports were the two biggest contributors to growth in the first quarter. Business investment was the biggest drag on growth during the quarter. Exports grew 6.4% (quarter-over-quarter). Maintaining this rate of export growth will be difficult given that the Yen appreciated over 7% relative to the U.S. dollar from its low in February to the beginning of June. A stronger Yen versus the dollar will make exports more expensive and complicate the fight against deflation and negative growth.

The recent signs of economic growth may not be sustainable. The labor market in Japan is weak, deflation is still present, and Moody's Investor Service recently downgraded the country's credit rating. In May, Moody's lowered Japan's government debt rating two notches from Aa3 to A2. The basis of the downgrade was Moody's dire forecast of Japan's inability to stem the deterioration in the country's domestic debt situation. Household consumption and

business spending remain weak and are not expected to improve much in 2003. The unemployment rate remains high, by historic norms, and is expected to inch even higher in 2003. Deflation is prominent in Japan with the CPI now at -0.9% on an annualized basis and only expected to improve to -0.5% in 2003. The bank debt problems have not gone away or even been adequately addressed and consumers continue to save. The federal deficit is growing and there are few methods left that the local government can employ to help stimulate the sick economy.

### *Emerging Markets*

Two major themes dominate the emerging markets: the economic and political contagion spreading across Latin America stemming from problems in Argentina and the economic improvements now visible in East Asia. The economic turmoil that has afflicted Argentina over the last several years has now spilled over into other Latin American markets such as Brazil, Paraguay and Uruguay. The East Asian economies have made significant economic progress since the crisis in 1997-1998. Real growth has moved higher, currencies have stabilized, and domestic demand has improved.

In Brazil, domestic debt levels have swelled to over 55% of GDP, the local currency (the Real) has rapidly depreciated versus the dollar, and bond yields now trade at a 17% premium to U.S. Treasury yields. Interest payments, on primarily domestic debt, are nearly 9% of GDP. The falling U.S. dollar and declining stock markets around the globe have not helped matters. Recent regulatory changes have also added to the pain in Brazil. Local investment funds are now required to mark their assets to market. GDP declined 0.7% (year-over-year)

during the first quarter. Consumer prices have begun to creep higher with the local CPI up 7.8% in May. Short interest rates are nearly 19% and the stock market has declined nearly 37% year-to-date on a U.S.-dollar basis. Even though the economic situation in Brazil has worsened, the problems there are not as severe as in Argentina. The Real floats freely unlike the local currency in Argentina, which is pegged to the dollar. There are over \$15 billion in dollar reserves on hand with the IMF, local policy makers are well-seasoned and there is a surplus in the fiscal budget. The immediate focus on Brazil, at home and abroad, is on the presidential election in October. The favored candidate is Jose Serra, a traditional conservative. The challenger, a liberal candidate, is Luiz Inacio Lula da Silva. Many are concerned that if Silva is elected, the national debt will mushroom and, potentially, throw the country's debt into default.

Since the last crisis in East Asia (1997-1998) that began with the devaluation of the Thai Baht, most local economies in the region have made considerable progress due to sound fiscal and monetary policies. These improvements have helped to lower inflation and interest rates while increasing local demand. Real GDP growth has reversed its slide since the crisis, with the economy of Thailand growing 3.9% on a year-over-year basis during the first quarter; Korea's GDP, up 5.7%; and growth in the Philippines, up 3.8%. Industrial production has also moved higher in the region and consumer prices have moved lower. Inflation is well-below 3% in many of these local economies, a far cry from just over four years ago. All are running a positive trade balance and current account. Currency reserves have been replenished to pre-crisis levels. A number of factors have contributed to improvements in the region. Early on, the IMF's strict plan of tight fiscal and monetary control imposed discipline and results. Debts have been paid down, short-term currency debt has been repaid, and most currencies in the region are no longer pegged to the dollar. Export growth has been robust and domestic demand consumption has improved. There are concerns, however. Most growth has been export-

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driven and many of the local governments are now spending freely in an effort to boost local demand.

### PERFORMANCE

#### U.S. Equity

The U.S. stock market, as measured by the S&P 500, declined over 13% during the second quarter. It was the worst quarterly result since the third quarter of 1990. Stocks have declined over 32% from their peak in March 2000 to the end of June 2002. The downward momentum in stock prices continues and, if stocks close out 2002 in negative territory, it would be the first time since 1929 - 1932 that stocks declined for three consecutive years (During the 1929-1932 period, stocks declined four straight years). Negative sentiment grows daily on discoveries of accounting irregularities and fraud. At the same time, investors are witnessing one of the worst profit recessions on record. Valuations remain high and it is hard to see any catalyst that would prompt a swift and lasting reversal in sentiment. Companies in many industries, especially technology and telecommunication, are seeking to improve margins by cutting costs. Pricing power remains weak and inflation is moving even lower. Concerns are now directed at consumption expenditures and the labor market. People who are employed spend money. Those who are not employed or at risk of being unemployed do not spend money. Declining profits, a weak labor market and a stagnant stock market are forcing more investors to save rather than spend or invest.

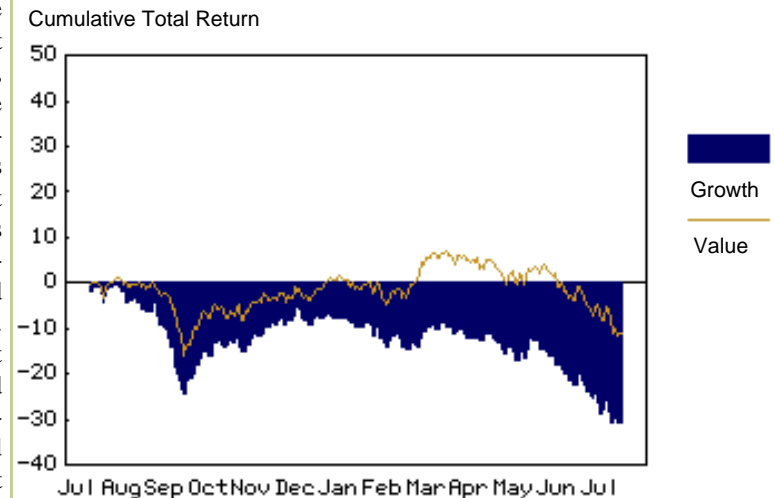
There have been few places to hide in this bear market. Income-producing equities have been the best perform-

ers, with high-yielding REITs leading the way. Smaller-to-mid-size value companies have taken less of a hit than most of the market. The hardest-hit areas of the market have been those same groups that led the market higher during the peak stages of the bull market. Sentiment is so negative that a skeptical investing public is looking at even "good" companies with caution. In this respect, the market is probably a bit oversold relative to underlying investment fundamentals. No one knows where the bottom is, even though many pundits have recently given their opinions on the subject.

The current bear market and the equity mania that preceded it can now be compared to previous bubbles and bursts such as the Wall Street crash of 1929, the Japanese bubble in the 1980s, the collapse of the Nikkei in the 1990s, and the bear market of 1973-1974. As mentioned earlier, there are significant differences between this market and previous boom-bust markets. However, history may provide us with some valuable insights going forward. Investors who participated in the stock market in the 1980s and 1990s experienced volatility, but mostly on the upside. The 1987 crash was quickly followed by a long run-up in equities. The same could be said for the period after the summer of 1998 (Russian crisis). Investors have been conditioned to expect that buying on dips will always be rewarded with higher gains down the road. This market is different. Valuations are high and earnings are weak. The fundamentals do not yet justify projecting an extended bull market in equities.

The fall of the NASDAQ Index is a good example of what happens following euphoria and mania. Here, history may be a good guide. Looking back to the crash in 1929, the Dow closed at 381 points (September 3, 1929). Within 27 months, it had lost 80% of its value. Twelve years later, it was still down 67% and did not recoup all of its losses and return to 1929 levels until 1954, 25 years later. In Japan, the Nikkei peaked at 38,915 at the end of 1989. Within 27 months, the Index had fallen 50% and 12 years later, it was down 73% (current level). Compare the recent action of the NASDAQ market. The Index peaked at 5,048 in March 2000. It had risen 285% to that level in three years but, within 27 months, it had lost 71% of its value and continues to fall. Future stock returns look attractive on an inflation-adjusted basis, but don't expect the market to produce consistent, year-after-year, double-digit returns. Until valuations come down and earnings improve, stocks are likely to trade sideways for awhile. The longer-term trend suggests single-digit returns for stocks in a range between 7.5% and 8.5%.

Vestek 1000 Growth vs. Value



07/2001 - 07/2002

(C) Vestek

Source: Vestek Systems

# ECONOMIC AND CAPITAL MARKETS COMMENTARY AND OUTLOOK

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Accounting fraud and irregularities are already priced into the market. Current investor sentiment reflects a loss of trust in corporate America, affecting local and foreign buyers of U.S. stocks. The good news is that many parties are already taking prompt action to remedy the problem. From congressional hearings to quick responses by CEOs on Wall Street, the problem is being dealt with properly and fully. Rating and reporting agencies have also been quick to act. For example, Standard & Poor's now includes "core" earnings for all companies in its indexes. Core earnings refer to after-tax earnings generated from a corporation's principal business or businesses. This measure starts with as-reported earnings and includes stock option expense and pension expense. The remedy for this problem has begun, and the results should enhance shareholder value down the road.

Most sectors of the stock market declined during the quarter. The best-performing sectors were shelter, consumer non-durables, raw materials and energy. For the six months ending June 2002, the best-performing sectors were shelter, raw materials, consumer non-durables and consumer durables. Strength in the shelter sector this year can be attributed to strength in the real estate sector. Low interest rates and negative returns in alternate asset classes have shifted money flow toward direct investments in real estate and residential real estate-related purchases, such as furniture and building supplies. Paper and pulp companies and homebuilders were the best performers in the sector last quarter and over the last six months. Stocks such as KB Home, Louisiana Pacific Corp., Pulte Homes and Simon Property Group were up over 25% over the last six months. Companies in the raw materials sector have benefited from a steady increase in the prices of metals such as gold. Gold prices

have reached their highest levels in years. Increased uncertainty in financial markets and a lack of attractive alternatives have prompted many investors to invest in real or hard assets such as metals, precious gems and real estate. Stocks of major mining companies such as Newmont Mining and Barrick Gold posted strong double-digit returns during the first half of the year. Consumer-related stocks, both durables and non-durables, provided a respite from the negative results posted in many other sectors. Stronger-than-expected household consumption in light of a stagnant stock market and weakening labor market resulted in higher revenues in the consumer-related groups. The consumer durables sector moved higher due to gains in GM, one of the largest companies in the sector. Auto-related companies, such as auto parts providers and tire companies, generated gains as well. Consumer product companies benefited from steady consumer purchases and a weaker U.S. dollar. Many of these same companies generate a large portion of total revenue from overseas operations. A weaker dollar relative to the Euro and Yen has meant positive returns once revenues in foreign currencies are converted into dollars.

The worst-performing sectors during the quarter were technology, capital goods, utilities and consumer services, and for the six-month period ending in June 2002, capital

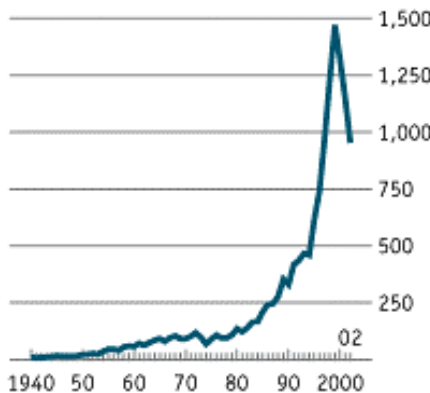
goods, technology, utilities and consumer services. The stocks that led the market higher during the peak of the bull market in 1998-2000 are the same stocks leading the market lower in 2002. Most all companies in the technology sector have posted negative results since the beginning of the year, a trend that started in April 2000. The hardest hit are those firms in the telecommunication business. PC and chipmakers have also fared poorly, as businesses have not yet returned to investment spending in the tech area. Both sectors suffer from the excess capacity built up during the 1990s. The poor performance in the capital goods sector during the quarter and six months ending in June can be attributed to the negative results of one company—Tyco International. Tyco accounts for over 40% of the sector based on market capitalization. The company and its CEO are under investigation for accounting irregularities and misappropriation of funds. Weakness in consumer services can be attributed to poor financial results from many companies in the sector, such as AOL Time Warner. The company represents 30% of the sector due to its large size (market value).

### U.S. Bonds

The bond market continued to benefit from negative

### The Bubble Bursts

S&P composite index  
1941-43-10



FTSE 100  
January 3rd 1984=1,000



Source: Standard & Poor's; Thomson Datastream

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sentiment in stocks and concerns that economic recovery may not be sustainable. Bonds continued to be one of the best performers during 2002. Bond yields moved lower during the quarter, as economic indicators hinted that the U.S. economy was not out of the "recession" woods. The flight to safety and decline in yields favored investments in intermediate- and long-term U.S. Treasury issues. Corporate bonds suffered some of the same travails as stocks. Short-term interest rates remained near 60-year lows, as the Fed stood pat on interest rates. The effect of a 2½-year bear market in equities, a weaker labor market and low inflation has prompted the Fed to hold steady on interest rates. Several pundits suggest that the Fed may be poised to raise rates in the near future as the economy regains strength and the forces of inflation become more apparent. Any hike in interest rates now would not only derail stocks further, but possibly place a constraint on the few bright spots in the economy--the consumer and, more specifically, the housing market.

Global inflation is dormant. The focus of concern now should be on deflation, not inflation. Global competition, weak commodity prices and slack global demand place more downward pressure on pricing, not vice versa. Short-term rates and bond yields may move slightly higher as the weaker dollar raises the possibility of importing higher inflation. This may be only temporary, unless the dollar moves into a free-fall relative to the Euro and Yen. The odds of that happening are small. More than ever, given the increase in uncertainty due to unrest in the Middle East and the threat of global terror, the U.S. dollar remains the global currency of choice. Interest rates should trend near their current levels with the odds favoring slightly higher yields as the economy returns to its long-term growth rate.

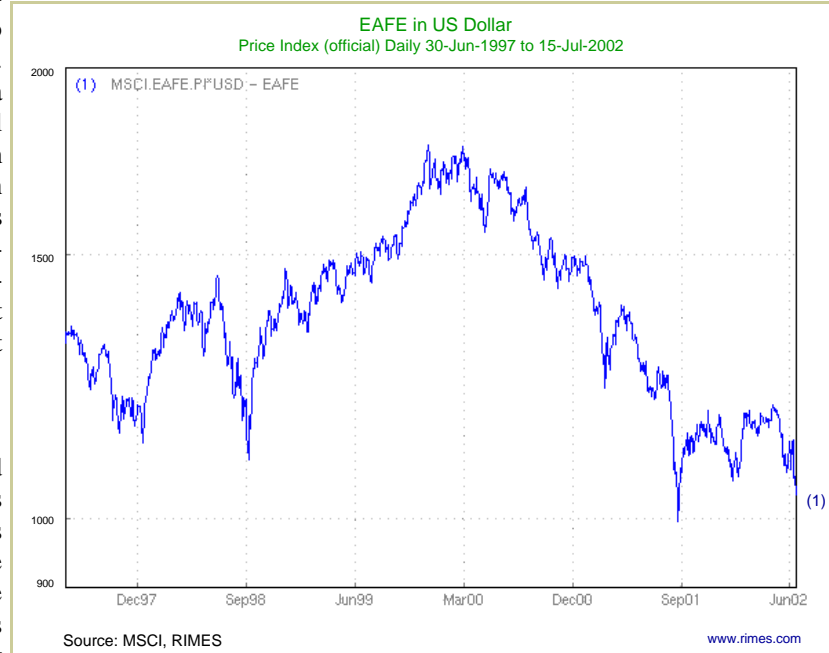
The best-performing areas of the bond market during the second quarter were high-quality, longer-maturity bond issues. The best-performing sector was U.S. long-dated Treasury securities followed by long-dated agency securities. The worst-performing sector of the bond market, by a long shot, was the high-yield bond sector. Short-term issues posted only slight gains for the quarter, as short rates remained essentially unchanged. Longer-maturity issues benefited from a sharp decline in yields and a spike in bond prices during the quarter, as investors fled the equity markets to the safe haven of U.S. Treasury securities. Bad news in the equity market has translated into good news in the bond market, especially Treasury securities. Much of the corporate bond sector was exposed to the same travails as the stock market. Corporate malfeasance has had a huge impact on bondholders, as well as stockholders. Yield spreads on corporate bonds (especially high yield issues) over Treasury bonds widened dramatically over the quarter. Investors also recognized the attractive value in the bond market relative to stocks despite the current low yield levels.

### *International Equity*

The overseas equity markets finished the second quarter and first six months of 2002 well ahead of U.S. stocks mostly due to a large decline in the value of the U.S. dollar relative to the Euro and Yen. Local market returns fell nearly as much as the U.S. market

during the most recent quarter, but maintained their leadership gap over the last six months. Economic growth in both the Euro region and Asia has been less than robust, growing at an even lower rate than in the U.S. Stock market valuations are also stretched in Europe and earnings are on fragile ground in Asia. Some of the same ills impacting corporate America have impacted stock returns overseas. In Europe, the telecommunication industry has been hit hard by excess capacity, a growing debt burden and lower revenue. Corporate malfeasance has also affected several European companies. The falling dollar has hurt several export-oriented, foreign-based firms, as their products and services become more expensive to U.S.-dollar buyers. Low real rates of growth, high unemployment rates, high stock market valuations, and low inflation have made it difficult for companies to boost revenues and expand profit margins.

In the Euro region, stocks moved lower on both a U.S.-dollar basis and local-currency basis. Two of the three largest markets in Europe, Germany and France,



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posted single-digit losses during the quarter, with only Switzerland posting a gain. In Germany and France, real growth has been stagnant and unemployment high. At the same time, inflation has remained low, not allowing companies to raise prices in order to raise revenues. Local domestic demand has been weak and signs of weakness in the manufacturing sector are still present. The best-performing Euro markets, near the peak of the bull market in equities, are the same markets leading the major non-U.S. indexes lower. Finland and Sweden posted double-digit losses on a U.S.-dollar basis during the quarter, even after accounting for the currency gains of the Euro relative to the dollar.

The largest market outside of the U.S., the U.K. (now larger than Japan on a market-capitalization basis) posted a loss of over 5% during the quarter. Some of the contagion from the U.S. market has affected sentiment in the U.K. The one bright spot, as in the U.S., has been the strong residential real estate sector and housing-related industries. Low interest rates and a strong labor market have contributed to a strong rise in house sales in the U.K. The local currency (Sterling Pound) has also appreciated relative to the dollar over the last six months. However, these gains have fallen short of the gains of the Euro and the Yen versus the dollar.

Japanese stocks moved higher during the quarter mostly on the heels of a stronger Yen relative to the dollar. The Yen appreciated 10.58% versus the dollar during the second quarter and 9.46% over the last six months. Local market returns moved lower during the quarter. Both the U.S. Fed and monetary authorities in Japan stepped in to buy dollars and sell the Yen in an effort to quell the negative impact on local Japanese exporters. Valuations remain rich in Japan and corporate profits

are non-existent. The local government has done nothing to address the underlying structural problems in Japan. Instead it has chosen to apply the same old Band-Aid approach that failed to work in the past. Time is running short in Japan and, unless real structural reform takes place, the next decade will likely be as miserable as the past one.

The top-performing markets during the quarter on a U.S.-currency basis were Greece, New Zealand, Austria and Japan. The worst-performing markets on a U.S.-currency basis for the quarter were Finland, Sweden, Singapore and Germany. The top-performing markets on a local-currency basis during the quarter were New Zealand, Greece, Austria and Japan. The worst-performing during the quarter on a local-currency basis were Finland, Spain, France and Norway.

The emerging markets continued to retain their title as one of the most volatile asset classes. Performance in the asset class reversed the strong gains posted during the first quarter. The strong reversal was a result of double-digit losses in Latin America. The economic and financial ills that have affected Argentina over the last several years have now spilled over into the rest of Latin America. Markets such as Brazil, Chile and Mexico posted big losses during the quarter. Stock markets of East Asian countries, such as Indonesia, posted gains during the quarter due to an increase in export growth within the region and improving economic fundamentals. Losses in many of the stock markets in the developed economies around the globe, high stock market valuations, and heightened uncertainty due to accounting scandals and threat of domestic terror have increased investor risk aversion. In this environment,

investors are more concerned with preserving capital than with searching for superior returns at the cost of higher risk. The emerging markets fall into the latter category. Economic problems in Argentina have now spread to Brazil and have impacted capital market returns in almost all markets in the region.

The top-performing emerging markets during the quarter on a U.S.-currency basis were Indonesia, Jordan, Colombia and China. The worst-performing emerging markets for the quarter on a U.S.-currency basis were Argentina, Brazil, the Philippines and Mexico.

### MARKET VALUATION & EARNINGS

#### *The U.S.*

The aftereffects of the burst in the bubble and of high valuations in the stock market have been compounded by investor uncertainty and skepticism surrounding accounting irregularities and corporate malfeasance. Most models of valuation rely on the assumption that company financial statements are accurate and transparent. Unfortunately, the “game playing” that took place in the late 1990s to boost earnings and stock prices has placed the reported financial statements of several companies in question. There may be more accounting surprises to come, which raises the level of uncertainty in the stock market. However, most of the problems have already been priced into the market. The SEC has now required that the CEOs of the largest 1,000 companies start signing off on the accuracy of financial statements by October, and be held personally responsible (including the possibility of jail time) for any discrepancies. Wall Street firms have also responded proactively by suggesting that better disclosure be mandatory, such as properly accounting for executive stock option expense. In the end, investors will benefit from the additional transparency in financial reporting and more emphasis on core earnings from the operations of principal businesses. Standard & Poor’s already has begun reporting core earnings for all companies in the S&P 500 Index, properly accounting for items such as pension and stock option expenses.

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The stock market bear is now 28 months old and valuations are still high by all measures and comparisons. Simply put, valuations will improve when stock prices move lower and earnings and yields move higher. Earnings for the aggregate stock market can only grow as fast as the overall economy before inflation. The consensus expects real GDP growth to return to a 3.5%-plus rate of annual growth by 2003, and inflation is only expected to creep up to a 2.5% annual rate. A 6% nominal growth rate equates to a long-term earnings growth rate of 6%. Given current price levels, this does not imply a long-term return on stocks near the historical average. Current stock market valuations are still expensive no matter what measure is applied. Price-to-earnings ratios are high whether top-down earnings (strategists), bottom-up earnings (security analysts), as-reported earnings, operating earnings, proforma earnings and/or trailing earnings are included. As of March, the 12-month 2002 bottom-up p/e ratio (based on operating earnings) was 25 vs. 24 for top-down, as-reported earnings over the same period. Price-to-earnings ratios fall below 18 when considering expected earnings through 2004.

Not all of the stock market is expensive relative to expected earnings growth. Certain sectors and pockets of stocks currently trade at sizeable discounts to overall stock market valuations. Sectors such as consumer staples currently trade at 19 times 2002 earnings with earnings expected to grow 14% year-over-year. The financial services sector currently trades at 14 times 2002 estimated earnings. Earnings are expected to grow 22% in 2003. Small- and mid-size value companies also trade at a discount to the overall stock market in terms of valuation. The market's focus now is on reported earnings (demonstrated),

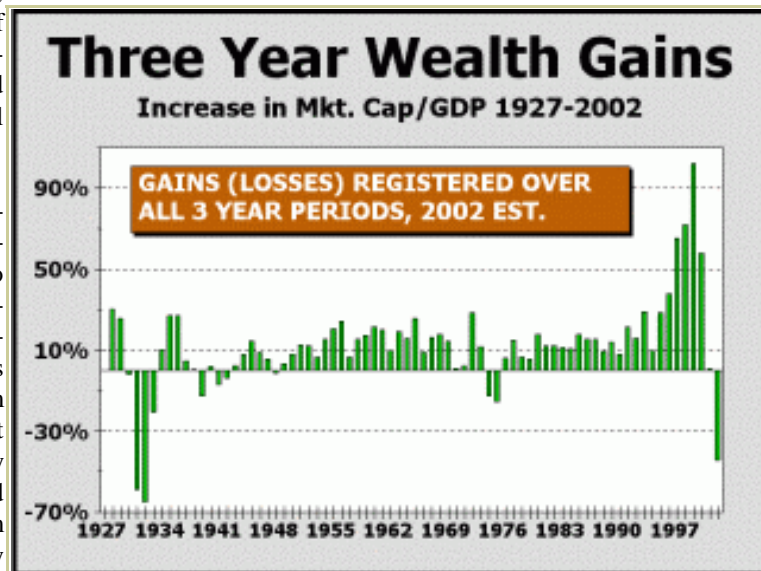
not estimated earnings. Basic industry stocks should also fare well, as industrial production continues to climb and capacity utilization rates continue to improve.

The current recession in corporate profits is one of the worst on record. The "as-reported," bottom-up earnings per share at the end of 2000 was \$50 per share for the S&P 500. Earnings took a nosedive in 2001 with the as-reported EPS at \$24 per share for the S&P 500. Consensus estimates for 2002 call for \$35 earnings per share. This implies that the market expects earnings to move moderately higher during the last half of this year. The as-reported earnings per share estimate for 2003 is \$46 per share for the S&P 500. For equity investors, one- and two-year earnings forecasts are interesting, but not very useful. A more useful measure of expected return is a combination of current valuation levels (dividend yields and p/e ratio) and the long-term expected growth rate of the overall economy.

The most important measure for projecting future investment returns is the equity risk premium. The equity risk premium is also central to calculating the cost of capital, valuing companies and stocks, and appraising capital investment projects. Many investment professionals argue that the historical risk premium (long-term difference in returns between the stock market and a risk-free asset such as a 10-year Treasury bond) is the most appropriate and least biased estimate of the future premium. The problem with this approach is that the resultant equity risk premium has always exceeded investors' "go forward" estimates. Stock market outcomes

are influenced by many factors. Those that were repeatable in the past may no longer be repeatable in the future (i.e., today's markets are global and active 24/7). The best explanation for the large risk premium in the past may be the unprecedented surge in productivity growth and efficiency. Reality exceeded investor expectations. Corporate cash flows grew faster than investors had anticipated and this extraordinary growth has already been built into stock prices.

A better measure of risk premium is to arrive at the expected return on stocks by evaluating current valuation levels, predicting the long-term rate of earnings growth for the stock market, and estimating the change in valuation levels from the current period to the end-of-forecast period. The expected risk premium is derived by subtracting the current yield on a 10-year Treasury bond from the estimated return on stocks. In today's market, valuations are high by historical norms (high p/e ratios and low dividend yields) and the long-term earnings growth rate is comparable to the long-term expected GDP growth rate (before inflation). Given this scenario, valuations are more



Source: HD Brous & Co.

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likely to compress than to expand. This suggests that a fair estimate of the return on stocks over the next decade and beyond is 7.5%-8% before inflation. The expected risk premium is somewhere near 3% (7.5%-8% less the 5% current yield on the 10-year Treasury bond).

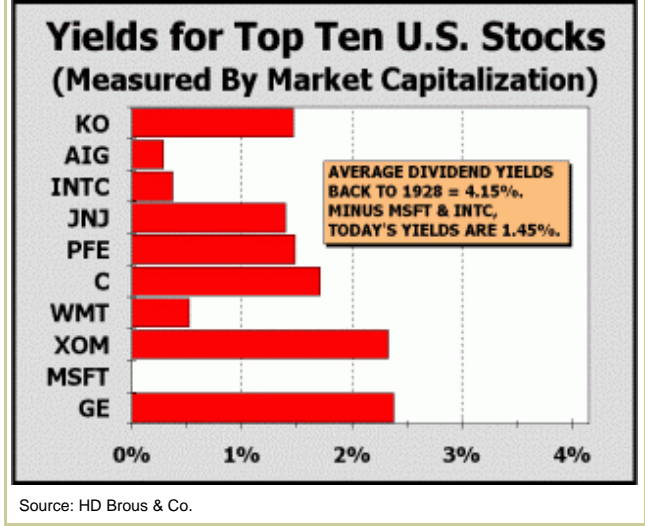
## Europe and the U.K.

Investment fundamentals in the Euro region and the U.K. suggest that stocks are still slightly overvalued relative to earnings growth expectations. Earnings growth is expected to move marginally higher over the next 12 months based on signs of recovery in the manufacturing and household sectors. Longer-term, returns in the Euro region are expected to be only slightly higher than in the U.S., based on current valuation levels and predicted long-term growth rates.

Stocks in the Euro region currently trade at 21 times next year's estimated earnings growth. The current dividend yield in the Euro region is 2.58% vs. 1.5% for U.S. stocks. Longer-term growth rates in the region are expected to grow at a rate comparable to that in the U.S. There are a number of potential negatives to growth over the next several years. The unemployment rate remains high throughout much of Europe and the cost of social and pension programs is increasing. Valuations may also compress a bit over the next several months. The real opportunities in the Euro region and the U.K. over the next several months will be in specific areas such as housing, building-related and basic industry stocks. For U.S. investors, the real potential is the opportunity that Europe and the U.K. provide for extra return on a stock-specific basis and the risk reduction provided when these assets are combined with a diversified U.S. equity portfolio. The U.K. has now surpassed Japan as the second-largest stock market in the world. It was only 14 years ago that Japan was the largest stock market in the world. Japan's economy is still the second-largest in the world behind the U.S.

## Japan

Investment fundamentals are still irrelevant in Japan, overshadowed by the overwhelming structural problems that exist in the local economy, especially the banking sector. Deflationary forces have also destroyed the potential for positive returns in stocks as real interest rates have soared. Real yields are higher than nominal yields, making it even more difficult for debt to be reduced in the banking sector. The consensus of economists expects a pick-up in real economic growth in 2003. The consensus also expects a strong reversal (positive) in earnings growth over the next 12 months. This may not seem



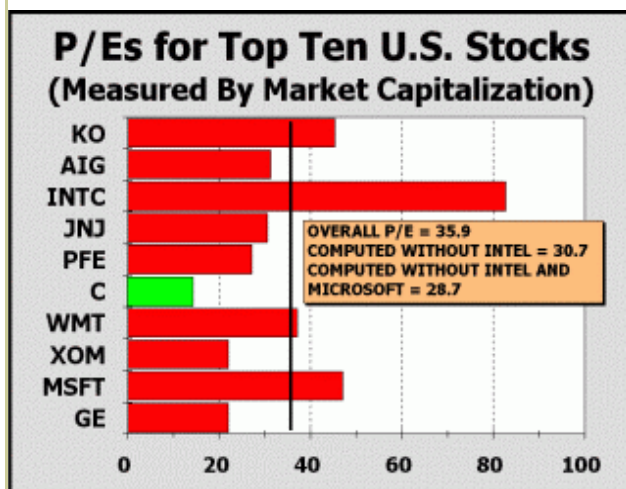
Source: HD Brous & Co.

unreasonable, given that earnings growth for Japanese companies has declined more than 102% over the last 12 months. Valuation measures such as p/e ratio are irrelevant, given that the earnings growth rate is negative. On a "go-forward" basis, based on the next 12 months earnings forecast, the p/e ratio is slightly higher than 26, still expensive by any comparison.

We do not side with the consensus on Japan. There are likely to be individual companies that grow their earnings over the next 12 months and become competitive on a global basis. However, an expectation that the overall earnings for the market will move sharply higher over the next 12 months and beyond is misguided. The discrepancy is in the forecasted real rates of economic growth for Japan. Business spending is still constrained as companies continue to focus on the expense side of the balance sheet. Household expenditures have improved slightly, but are still weak. The Japanese still save more than they spend or invest. The government sector is in no financial condition to increase spending as deficits continue to grow and deflation continues to dominate.

## Emerging Markets

We generate risk and return estimates in each of the emerging markets, but have little faith in the output, as



Source: HD Brous & Co.

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data is less than reliable. In many of the emerging markets, analyst coverage is sporadic or nonexistent. Systematic or market risk will probably continue to dominate the direction of most individual stocks in the emerging markets, many of which rely on outside capital for growth.

Recent debate on the emerging markets has focused on whether they should be considered as a separate asset class. At Lockwood, we believe the most prudent approach is to consolidate developed and emerging foreign markets into one asset class, and most recent mandates for international equity exposure have been fulfilled by hiring an active manager to run a hybrid portfolio with investments in both developed and developing markets.

### APPENDIX

#### Lockwood's Proprietary US Five Factor Model

Jul-02

Factor (1=best case; 5=worst case)	Rating	Comment
<b>Valuation (40%)</b>		
P/E Valuation Models	4	<b>Stocks Still Expensive!</b> Stock Valuations are Still High
Expected Equity Risk Premium	4	3.0% vs 6.05-7.0% Historical ERP
Discounted Cash Flows	4	Low Dividend Yld, Normal Growth Rates & P/E Contraction
Fed Model (Earnings Yield vs 10 Yr Yield)	3	Moving Toward Fair Value vs Bond Yields
<b>Average</b>	<b>3.8</b>	Stocks are Still Expensive
<b>Earnings (20%)</b>		
Earnings Outlook	3	<b>Some Earnings Improvement ~ Less Than Market Expectations</b> Some improvement ~ 3rd & 4th Qtr
Earnings Revision	3	Downward Revisions are slowing
Earnings Surprise	3	Should begin to see positive surprises pick-up
Earnings Dispersion	4	More Accounting Surprises??
Long Term Growth Rate	3	Expect Reversion to Long Term Trends
<b>Average</b>	<b>3.2</b>	Earnings Recovery is Evident But Pace Will be Gradual
<b>The Economy (20%)</b>		
<b>Growth</b>		
Real GDP Growth	2	Improvement Due to Massive Inventory Liquidations
Consumer Spending	3	Strained due to employment picture and wealth declines
Industrial Production	3	1st Signs of Recovery Since March 2000
Employment	4	Not near the end of the layoff cycle
Corporate Profits	4	Business & Consumer Spending Still Weak
Housing	3	Signs of weakening
Auto/Truck Sales	2	Record Sales due to 0% Financing & Lease Deals
<b>Interest Rates</b>		
Monetary Policy	2	Fed Stands Pat ~ Market has Discounted Rate Hike
Short Rates	2	Bottomed Out!
Long Rates	3	Future Inflation concerns?
<b>Inflation</b>		
CPI	1	1.7% Current & 2.2% Forecasted
PPI	2	Still no pricing power
Commodity Price Index	2	Stable
<b>Taxes</b>		
Fiscal Policy	4	Bigger than expected deficits
<b>Other</b>		
US Dollar	5	Dollar weakness
Net Exports	4	Some improvement with weaker dollar
<b>Average</b>	<b>2.8</b>	
<b>Risk (10%)</b>		
Corporate Debt	3	Default rates slowing - expect consolidation
Consumer Debt	3	Levels are stabilizing
Govt Debt	4	No more budget surplus!
Margin Loans	1	No speculation in this market
<b>Average</b>	<b>2.8</b>	
<b>Technical (10%)</b>		
Bull/Bear	1	Extreme negative sentiment - a positive
Mutual Fund Redemptions	3	Strong Pick-up in Equity Fund Purchases - Capitulation?
Cash Balances	2	Money Market Assets Down, But M2 Still Strong
Consumer Sentiment	3	Declining
<b>Average</b>	<b>2.3</b>	
<b>Total Weighted Ranking:</b>	<b>3.4</b>	<b>More Downward Pressure on Stocks vs Bonds</b>