Bellwether CONSULTING

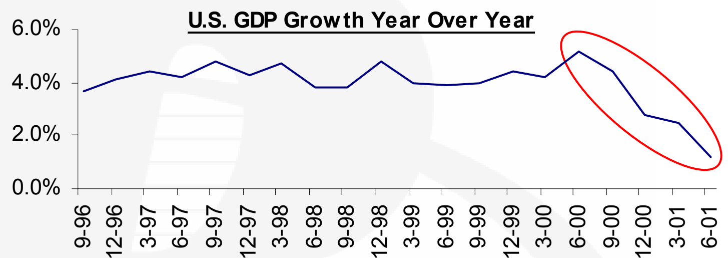
Your Quarterly Update on the Financial Markets
September 30, 2001

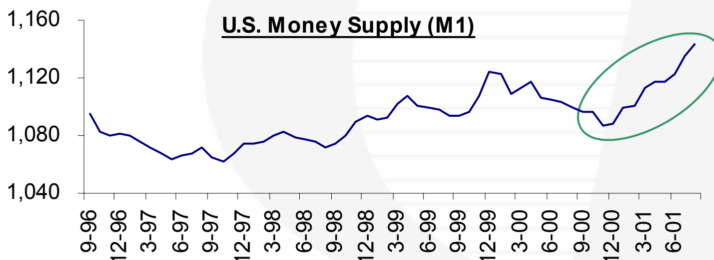
3rd Quarter

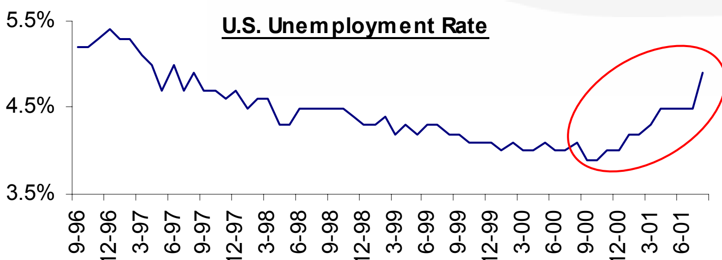
MARKET Recap

The Economy: *Stimulus Programs Shift to High Gear*

September 11th resolved debate about the short-term outlook. Economic statistics are not yet available to directly measure the impact of the attack, but data from before the attack reveal a weakened economy flirting with recession. Second quarter GDP growth, a key measure of economic activity, was revised to 0.3% in September, its lowest point since 1993. This extended the trend of slowing growth shown in the graph of yearly data. Consumer spending was holding up but confidence was down, and the effect of reduced business activity was beginning to show in the unemployment rate. Corrective actions were already underway including both monetary and fiscal stimulus programs (seven interest rate cuts before the attack and a sizeable tax rebate program). Debate over next steps was frothy among Fed governors trying to balance the risks of recession and inflation, and within Congress where additional stimulus programs threatened the budget surplus and spending.







Immediately after the attack government authorities poured money into the economy through open market activities, interest rate cuts, and relief spending. Since then the focus has been on limiting the depth and duration of what is certainly a global recession. The virtual 4-day shutdown of the U.S. economy will likely shave 1-2% from 3rd quarter GDP. Beyond that, consumer spending will be impacted by psychological factors and increased unemployment. Our own opinion is that consumer sentiment will not lead to a spending falloff of the magnitude experienced during the Gulf War, unless we see highly dramatic military action or additional large-scale terrorist attacks. Increasing unemployment concerns us more; layoffs dominate the headlines, spreading outward from the ailing airline industry. The current rate is 4.9% and climbing, but that rate is below levels seen during other economic downturns, leading us to expect and hope that government intervention will limit the recession to 2001.

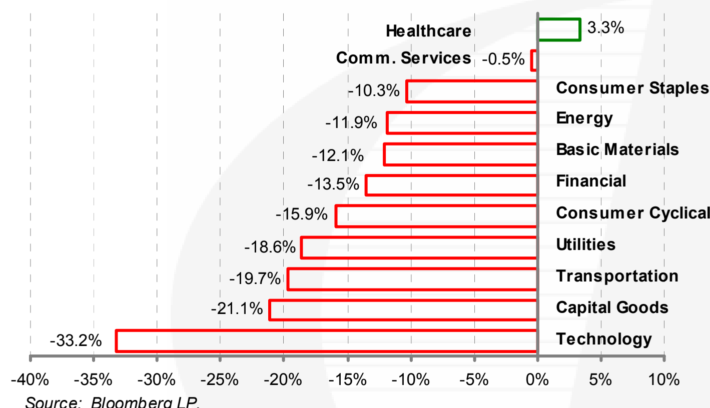
Support for deficit spending to boost the economy is currently strong but not unlimited, nor should it be. Looking ahead to 2002, we are concerned that success in the campaign against terrorism may not be followed by a return to fiscal discipline, although inflation hawks and those focused on Social Security will help keep spending in check. In the short run, look for partisan debates on the form of $75 - 150 billion in outlays to boost the economy, e.g., how much should be through targeted spending vs. broad spending vs. tax cuts? The lull in political maneuvering has been refreshing, but resuming policy debates is part of returning to normalcy.

Even more than usual, unforeseen events will drive the economy next quarter and next year. Proceeding cautiously and securing support from moderate Arab states has pushed down oil prices, abating for now a big threat to recovery. Our view at the start of a very interesting 4th quarter is that the Administration, Congress, and Federal Reserve have managed the crisis well.

The U.S. Stock Market

The recovery experienced by the U.S. stock market in the second quarter stalled in the third quarter as the market experienced the largest quarterly drop since the fourth quarter of 1987. Investors had few opportunities to profit. Almost 80% of the stocks in the S&P 500 declined and of the 11 industry groups in the index, only one, Healthcare, was in positive territory (at 3.3%). The story was just as grim for smallcap and midcap stocks, where all industries were negative. Technology stocks were the hardest hit across the board, with small and midcap stocks losing just under 30%, and largecap stocks losing 33%.

Stock Indices - 3Q 2001 Total Return			
Largecap Stocks		**Midcap Stocks**	
S&P 500	-14.68%	Russell Midcap	-17.86%
		Growth	-27.80%
Russell 1000	-15.23%	Value	-11.55%
Growth	-19.41%	**Smallcap Stocks**	
Value	-10.95%	Russell 2000	-20.79%
		Growth	-28.08%
		Value	-13.33%



Of course, the events on September 11th contributed to the market slide. From September 10th to the end of the quarter the Dow lost 8%, the S&P 500 almost 5% and the NASDAQ over 11%. Not surprisingly, airline stocks and other travel-related issues suffered significantly during this period - Boeing declined 23%, U.S. Airways by 60%, Disney lost 21%, and Royal Caribbean Cruises lost 50% of its value. However, the attack was not the singular cause of the performance slide; stocks had been retreating well before the attack. Corporate profits were falling, corporate spending was severely reduced, and returns for the S&P indices were negative for July and August as well as September. Investors responded by pulling out of equities. The Investment Company Institute (ICI) reported net outflows from domestic stock mutual funds of $1.7 billion for August, versus $2.4 billion in net inflows in July.

Despite the largely negative results, investors could find glimmers of good news. Defense stocks such as Northrop Grumman and Raytheon Co. and gold mining issues Placer Dome and Newmont Mining returned over 25% for the quarter. SBC Communication (+17%), Procter and Gamble (+14%) and AT&T (+13%) were the strongest performers in the Dow, and WorldCom (+6%), Immunex (+5%) and Biogen (+2%) were the only positive performers in the NASDAQ 100.

The quarter ended on a strong note, with the Dow and S&P up over 7% and the Russell 2000 index gaining 6.8% during the final week. Even the beaten-down NASDAQ enjoyed a rally, increasing 5.3%. Though these gains had little impact on the largely negative performance for the quarter, it could be an indication that some investors have begun buying again – attracted to the low prices of many high quality stocks. In this environment it's impossible to predict if the value seekers will be able to support the market or if the political and economic uncertainties will drive prices even lower in the coming months. Investors will be looking for direction from economic data and the headlines.

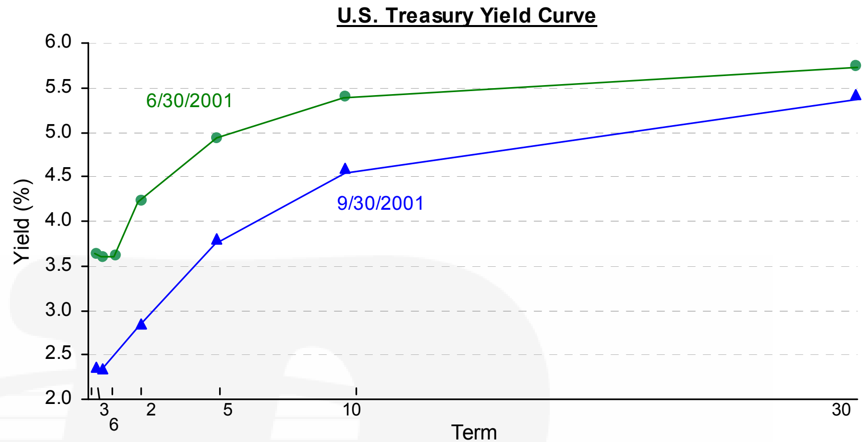
The Bond Market

Bonds were outperforming equity indices during the quarter prior to September 11, with long government bonds leading the pack. A 25 basis point reduction of the Fed Funds Rate on August 17, albeit with a weakening bias, seemed to be a signal to the market that the Federal Reserve was nearing the end of its intervention. The events of September 11 changed that. Quick response by the Fed to inject liquidity into the market and lower rates, in concert with central banks worldwide, worked to keep inflation in check, lowering yields on the long end of the curve (in the near-term).

Bond Indices - 3Q 2001 Total Return	
Lehman Aggregate	4.61%
Lehman Interm. Gov't	4.97%
Lehman Long Gov't	6.73%
Lehman Interm. Credit	4.15%
Lehman Long Credit	2.85%
Lehman High Yield	-4.23%
Lehman Global ex U.S.	7.47%

Domestic economic events prior to the attack were already causing credit spreads to widen, with questions surrounding consumer confidence and corporate earnings increasing the risk premiums investors require to invest in corporate issues. The spreads on the generic 10-Year Treasury versus 10-Year AAA Industrials widened from 87 basis points (0.87%) in the second quarter to 109 basis points (1.09%) in the third quarter, factoring in the impact of the attacks on the market. The attack triggered a flight to quality, and the Fed stepped in to lower rates by ½ percent as a quick fiscal stimulus.

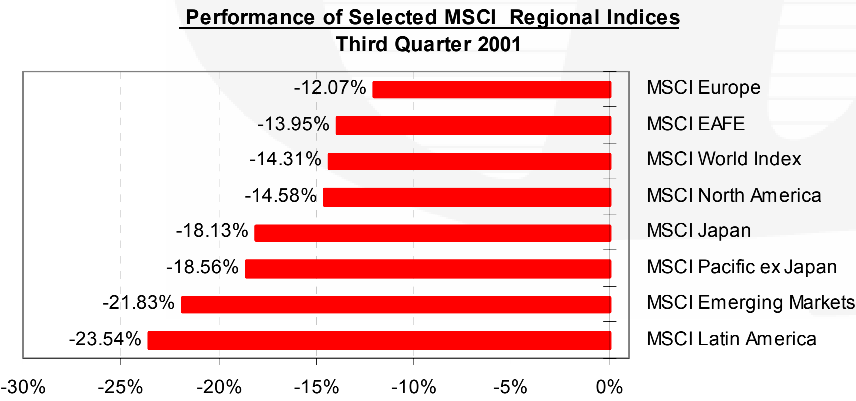
The attack sent a ripple through the economy like none other in recent history, with many credit sectors coming under pressure. Most notably, the airline sector was negatively impacted with many companies either downgraded or coming under close scrutiny from the bond ratings agencies. The automotive, media and hotel sectors also ended the quarter under credit watch. The high-yield segment of the market has been severely impacted. Spreads widened significantly on high-yield bonds as the demand dropped sharply the last 3 weeks of the quarter.



As year end draws closer, we expect to see continued Fed intervention to create monetary stimulus and keep confidence buoyed.

Overseas

Global markets were under considerable pressure during the third quarter, seeming to continue following the U.S. domestic market. Germany and France again led Europe lower. Both had downward earnings growth revisions during the second quarter and economic news in the third quarter did nothing to help abate the problems. The downturn in demand since September 11 has further hurt the European economy. Germany had seemed poised for rebound with business confidence rising in July and August, but the attacks dampened both business and consumer sentiment. Similarly, in France, consumer spending and business confidence decreased while unemployment rose to 9% from 8.9% between July and August.



Japan's woes continued as well. A recent survey on Japanese business confidence showed that it continues to slump. The world's second-largest economy has been hurt by a slowdown in U.S. consumer demand and a strong dollar. Unemployment was 5% in both July and August with the potential for further job cuts in the face of depressed earnings growth. Japan continues to be troubled by the bank sector, where bad loans continue to call into question the viability of many banks necessitating further intervention from Prime Minister Koizumi. Elsewhere in Asia, Taiwan, Singapore and Korea continue to suffer from the downturn in the IT sector and are expected to contract along with the Japanese economy.

Mexico and Latin American emerging markets continue to falter. Mexico exports approximately 85% of its goods to the U.S. and will suffer greatly from an extended slowdown in U.S. consumer spending. Depressed oil prices have also hurt the Mexican economy. The Brazilian Real, one of the weakest currencies in the world, depreciated 4% in the week after the attack as investors lost confidence in the currency. Both Brazil and Argentina have also had their growth projections severely cut since early September – with Argentina now projecting negative growth for the year.

Focus On: *Economic Indicators*

With economic data becoming headline news, a renewed understanding of the various economic indicators can help you put today's market, and its impact on your plan, into the appropriate perspective. Indicators are widely used to determine the direction of current and future economic activity. Investors and analysts follow various indicators of economic activity to evaluate and forecast the direction of the economy, anticipate changes in economic policy, and help formulate investment strategies.

The ultimate goal of economic policy is to generate economic activity with stable prices. Indicators that directly measure growth in activity and prices are the ultimate scorecard. Growth in GDP and the Consumer Price Index are the most widely quoted indicators, and they are excellent for determining the past health of the economy. Trouble is, they are difficult to measure and are always released after the fact. Economic activity and prices drive performance of the stock and bond markets, so investors want to know the direction of economic change before it occurs. The emphasis, then, is often placed on *leading indicators* of economic activity. The Conference Board publishes these economic indicators, as well as coincident and lagging indicators.

Leading Index Indicators	Coincident Index Indicators	Lagging Index Indicators
• Average work week of production workers in manufacturing • Average initial weekly claims for state unemployment insurance • New orders for consumer goods and materials, adjusted for inflation • Vendor performance (companies receiving slower deliveries from suppliers) • New orders for non-military capital goods, adjusted for inflation • New building permits issued • Index of stock prices • Money supply: M2 adjusted for inflation • Spread between rates on 10-year Treasury bonds and Fed funds • Index of consumer expectations	• Manufacturing and trade sales • Employees on non-agricultural payrolls • Industrial production • Personal income minus transfer payments	• Average duration of unemployment • Inventories to sales ratio, manufacturing and trade • Change in labor cost per unit of output, manufacturing • Average prime rate • Commercial and industrial loans • Consumer installment credit to personal income ratio • Change in consumer price index for services

Widely regarded as a barometer of economic activity over three to six months, the Conference Board's Index of Leading Economic Indicators (LEI) is designed to predict turning points in the economy -- such as recessions and recoveries. By tracking economic data like the index of leading indicators, investors will know the economic backdrop for the markets. The stock market likes to see healthy economic growth because that translates to higher corporate profits. The bond market prefers less rapid growth and is extremely sensitive to whether the economy is growing too quickly, causing price inflation.

While investors may follow leading indicators to help formulate strategies, the usefulness of the LEI for trading in stocks is limited, because stock prices themselves are a leading indicator. By the time the index of indicators has given a signal, stock prices may have already changed. Also it is important to note that the LEI is far from perfect, occasionally missing a downturn or signaling a recession that does not materialize. While it may not perfectly forecast economic conditions, it does influence (and therefore forecast) actions of the Fed and other regulators that impact the markets.

One leading economic indicator that receives special attention is the measure of consumer confidence. Consumer confidence affects spending, which has an impact on corporate profits and levels of employment. The Consumer Confidence Survey is based on a sample of 5,000 U.S. households and is considered one of the most accurate indicators of confidence. Consumer spending accounts for two-thirds of the economy, so the markets are always dying to know what consumers are up to and how they might behave in the near future. The more confident consumers are about the economy, the more likely they are to spend. With this in mind, it's easy to see how this index of consumer attitudes gives insight to the direction of the economy.

Two measures of confidence are the Consumer Confidence Index (CCI) and Consumer Sentiment Index (CSI). The CCI is published monthly by the Consumer Research Center of the Conference Board (www.conference-board.org) and the CSI is published monthly by the Survey Research Center of the University of Michigan (www.umich.edu.) Both indexes provide indicators of consumer attitudes by focusing on 1) consumer perceptions of business conditions, 2) consumer perceptions of their financial condition, and 3) consumer willingness to purchase durables, such as automobiles, homes, and other big ticket items.

An increase in confidence forecasts that consumers will increase spending, which leads to economic growth. Confidence is a two-way street, however. Consumers look to businesses for growth and increasing employment while businesses develop their strategy around consumer spending patterns. A reduction in consumer confidence and consequently a decline in the demand for goods and services may impact businesses, which will have to contract, laying off workers and cutting payrolls.

In addition to the Consumer Price Index (CPI) and Gross Domestic Product (GDP) measures, understanding some of the other market moving indicators is also helpful. For example, durable goods orders reflect the new orders placed with domestic manufacturers for immediate and future delivery of factory hard goods. Orders for durables show how busy factories will be in the months to come, as manufacturers work to fill those orders. The data not only provides insight to demand for things like refrigerators and cars, but also business investment going forward.

Housing Starts measure the number of residential units on which construction is begun each month. Each time a new home is started, construction employment rises, and income will be pumped back into the economy. Once the home is sold, it generates revenues for the home builder and buying opportunities for the new homeowner such as appliances, furniture, and landscaping. Trends in the housing starts data carry valuable clues for the stocks of home builders, mortgage lenders, and home furnishings companies. Commodity prices such as lumber are also very sensitive to housing industry trends.

The National Association of Purchasing Managers survey is a composite diffusion index of national manufacturing conditions. Readings above 50% indicate an expanding factory sector. The NAPM gives a detailed look at the manufacturing sector, how busy it is and where things are headed. Since the manufacturing sector is a major source of cyclical variability in the economy, this report has a big influence on the markets. More than one of the NAPM sub-indexes provide insight on commodity prices and clues regarding the potential for developing inflation. The Fed keeps a close watch on this report which helps it to determine the direction of interest rates when inflation signals are present in the data. As a result, the bond market is highly sensitive to this report.

Personal income is the dollar value of income received from all sources by individuals. Personal outlays include consumer purchases of durable and nondurable goods, and services. The income and outlays data are another handy way to gauge the strength of the economy and where it is headed. Income gives households the power to spend and/or save. Spending keeps the economy growing. Savings are often invested in the financial markets. The consumption (outlays) part of this report is even more directly tied to the economy. Consumer spending accounts for two-thirds of the economy, and can give a good indication of where the economy is headed.

The employment situation is a set of labor market indicators. The unemployment rate measures the number of unemployed as a percentage of the labor force. Non-farm payroll employment counts the number of paid employees working part-time or full-time in the nation's business and government establishments. The average workweek reflects the number of hours worked in the non-farm sector. Average hourly earnings reveal the basic hourly rate for major industries as indicated in non-farm payrolls. Employment data gives the most comprehensive report on how many people are looking for jobs, how many have them, what they're getting paid and how many hours they are working. Labor productivity is a direct driver of both business profitability and consumer sentiment; these numbers are key to understanding the current state and future direction of the economy. They also provide insight on wage trends, and wage inflation is high on the list of enemies for the Federal Reserve.

To learn more about these and other economic indicators, visit a few of the many informative sites on the web: www.conference-board.org (the Conference Board), www.nber.org (National Bureau for Economic Research), www.dismal.com (the Dismal Scientist), www.econlinks.com (Dr. T's EconLinks), www.aier.org (American Institute for Economic Research), or www.economic-indicators.com. Many of these sites provide links to other valuable resources of economic data that can help you navigate through the wealth of information being reported almost daily in the headlines of your local newspaper.

Bellwether Consulting LLC
2 Yorkshire Drive, Cedar Grove, NJ 07009
www.bellwetherconsulting.net

Copyright © 2001 All Rights Reserved.

Bellwether CONSULTING