Bellwether CONSULTING

Your Quarterly Update on the Financial Markets

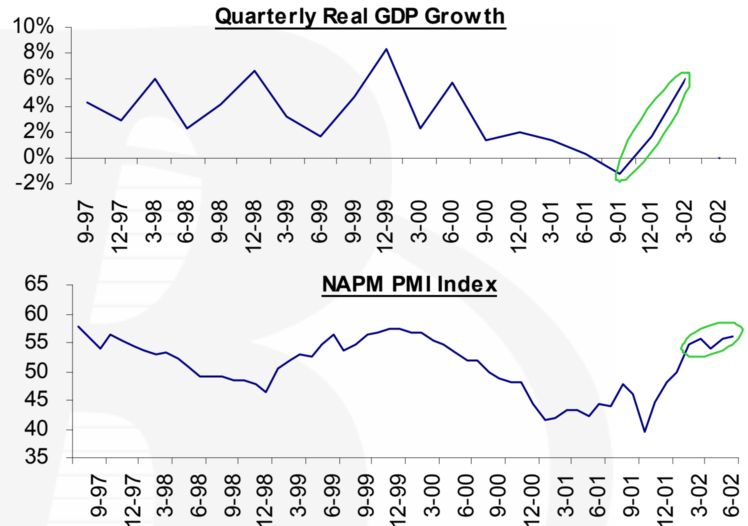
June 30, 2002

2nd Quarter

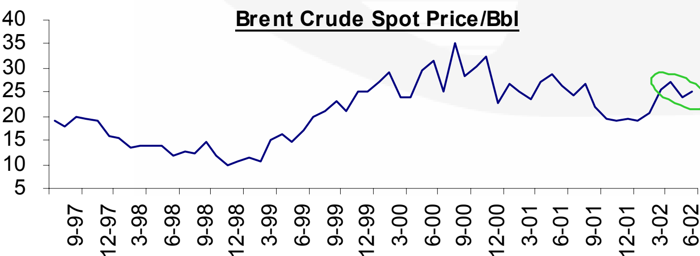
MARKET Recap

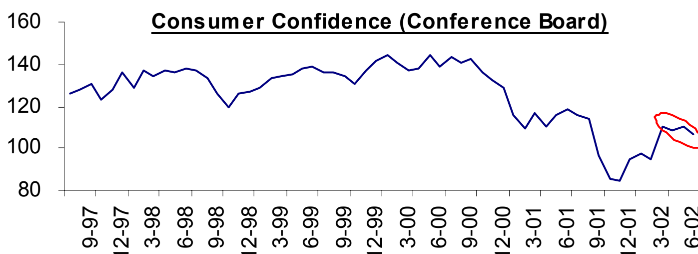
The Economy: *Positive Fundamentals Do Not Inspire Confidence*

Fundamental economic indicators were generally positive throughout the second quarter, providing further evidence of a slow but steady recovery. The U.S. economy grew at a surprising 6.1% annualized rate in the first quarter of 2002, fueled in part by a slow recovery in corporate profits. Economic activity continued to rise in the second quarter, as evidenced by steadily increasing level of the NAPM Purchasing Managers Index, a compound indicator measuring new orders, production, delivery, inventory, and employment. Consensus estimates are for continued, albeit moderated, GDP growth for the second quarter and second half of the year, at about 3.5%. Unemployment leveled off in May at 5.8%. In the face of strong fundamentals, the Fed left interest rates unchanged and announced a balanced posture between growth and price stability.



As discussed in previous issues, we remain focused on oil prices as a major potential threat to the global economy. Oil prices moderated during the second quarter, bottoming out in early June before beginning a seasonal rise. Imports remained strong and stable, despite tensions in the Middle East. Relatively low oil prices and interest rates combine to support expectations of continued growth, although the oil supply remains a significant source of event risk.





Despite good fundamentals, there are reasons to be concerned. Negative news dominates the headlines here and abroad, and early signs of a confidence crisis can be seen. Consumer confidence fell in June (according to both the Conference Board and University of Michigan surveys), erasing gains accumulated since February. New York Fed Governor McDonough downplayed the announcement during his trip to Poland, pointing out that the statistic is volatile. Auto sales fell in May, and other retail sales fell in May as well. Consumer spending buoyed the economy through the recessionary period, and continues to be the primary source of activity as we wait for capital spending to resume in earnest. Our primary concern is potential erosion of consumer spending, driven by fear and belt-tightening in the wake of stock market losses.

The U.S. economy has not been friendly to the dollar either. A combination of low interest rates, poor stock market returns, and dramatic scandals have reduced demand for the U.S. dollar, which depreciated 13.1% vs. the Euro and 9.7% vs. the Yen through the second quarter. The effects of currency fluctuation on the U.S. consumer and the economy are the topic of this quarter's focus piece.

The U.S. Stock Market

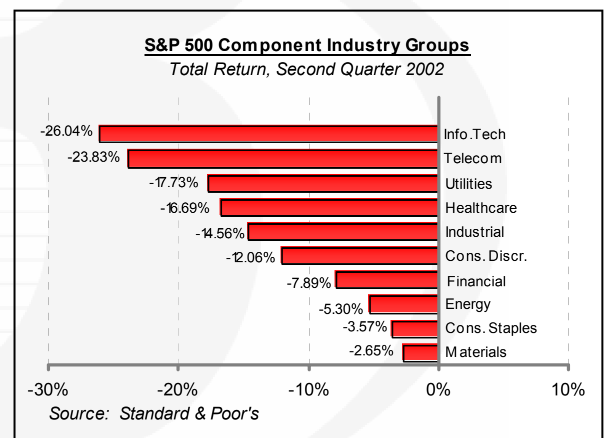
It was a market overcome by a case of the jitters. Growing fears over further terrorist attacks, massive accounting scandals and continued global turmoil kept investor confidence down and investors out of the market, despite economic signals that suggested a slow but burgeoning recovery. All of the major market indices ended the quarter in negative territory, with no sector left unscathed. The S&P 500 lost over 13% while the NASDAQ fell 21%, the worst 2nd quarter performance in the composite's history. Small caps outpaced large caps for the period, and value stocks once again dominated across the board.

Scandal was the story of the 2nd quarter, as another corporate giant revealed its latest attempt at cooking the books. As the quarter drew to a close, U.S. telecom giant WorldCom revealed its $3.9 billion accounting blunder, quickly followed by Xerox's announcement of a $1.9 billion revenue gap. A number of high profile corporate heads left their post this quarter in a trail of scandal, amid allegations from sales tax evasion to creative accounting. In the wake of corporate wrongdoing at Enron, Global Crossing and Adelphia Communications, investors have grown both weary and wary of continued investment in America's companies.

Stock Indices - 2Q 2002 Total Return			
Large cap Stocks		**Midcap Stocks**	
S&P 500	-13.73%	S&P Midcap 400	-9.53%
Russell 1000	-13.46%	Russell Midcap	-9.55%
Growth	-18.67%	Growth	-18.26%
Value	-8.52%	Value	-4.67%
Broad Markets		**Small cap Stocks**	
NASDAQ Comp.	-20.63%	S&P Smallcap 600	-6.69%
Wilshire 5000	-12.61%	Russell 2000	-8.35%
		Growth	-15.70%
		Value	-2.12%

Every S&P 500 sector ended the quarter in negative territory, with, not surprisingly, technology and telecom taking the greatest hits. Nortel Networks tumbled nearly 69%, Lucent Technologies lost 58% and Vitesse Semiconductor fell almost 70%. Telecom lost ground for the sixth straight quarter, as the industry continued to falter from negative news. Lucent announced its sales would decline much more than expected, Sprint had its debt rating lowered to just a notch above junk status, CEO Joseph Nacchio departed an already struggling Qwest Communications, and fiber-optic carrier XO Communications filed for bankruptcy.

The biggest gains were found among defense, consumer and homebuilding stocks: Big Lots rose over 42%; Aetna was up just over 24%, Lockheed Martin gained nearly 18%, Pulte Homes jumped 23%, and Coca-Cola Enterprises rallied around 18%. The Dow Jones Industrial Average suffered less than most indexes in the quarter, falling only 7.8% buoyed by its manufacturing stocks.



Value stocks outpaced their growth peers in all market caps, and small and mid cap stocks held up better than large caps. The Russell 2000 Value Index fell just 2.1%, while the Growth Index lost 15.7%. The Russell 2000 Index lost nearly 8.4%, the Russell Midcap fell just over 9.5% while the Russell 1000 tumbled 13.5%.

Despite relatively low interest rates and improving economic conditions, the stock market has failed to lead the economic recovery as in times past. Investors are extremely cautious during these turbulent times both at home and abroad, and corporate profitability has been relatively unimpressive to date. While we continue to believe the economic recovery will revive corporate profits, we do not expect the recovery to translate into huge stock market gains, as investors now approach the market with more caution and demand reasonable valuations.

The U.S. Bond Market

The bond sector rotated back into favor in the second quarter as a flight to quality took place in spite of positive economic market news. Falling consumer confidence and lack of faith in the equity markets sent investors looking for safe havens to park their money.

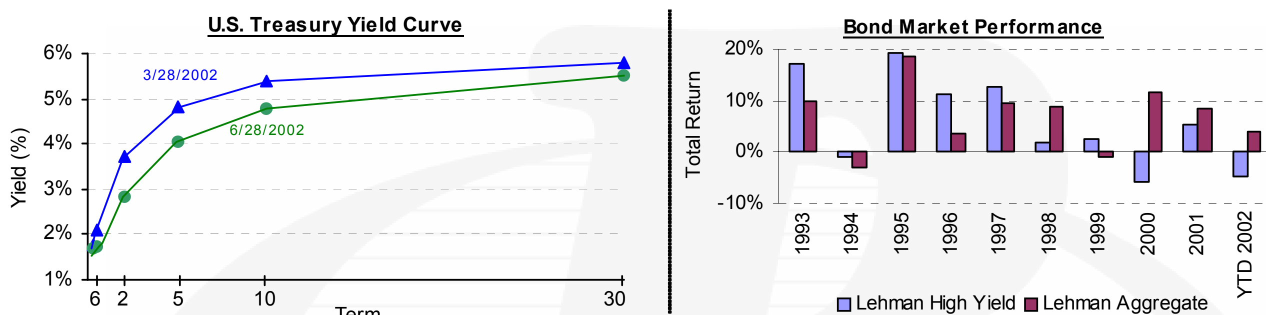
Yields decreased across all maturities during the quarter, spurring a rally in the bond markets. The Fed left the Fed Funds rate unchanged at the June 26 meeting, basing their decision on the recent moderation in the growth of the economy and pushing out any expectations of credit tightening until later in the year. The Fed's inaction put the brakes on any inflationary fears. Yields on the 2 year bond were down 90 basis points for the second quarter and the 5 year bond was down 80 basis points; the long end of the curve was down less, with the 30 year bond falling approximately 30 basis points, flattening the curve.

Long governments were the beneficiaries of the quarter's market volatility. The sector was one the best performing components of the Aggregate, finishing up 6.07% in a reversal of last quarter's lagging performance. Long bonds are more sensitive to movements in interest rates and the 30 basis point downward movement in rates was key to sector performance.

According to Moody's, U.S. corporate downgrades topped upgrades again in the second quarter. There were 172 downgrades ($333b) versus 35 upgrades ($50b). The 5-to-1 ratio, the highest since 1991, continues to indicate that resurgent economic growth has yet to stem the downgrade tide. Most of the downgrades occurred in the energy, telecom and hi-tech sectors and were attributable to falling asset prices, excess capacity and weak capital spending. With the rash of negative corporate news hitting the wires, corporate credit spreads widened out as investors looked to be compensated for switching from the safety of treasuries.

Bond Indices - 2Q 2002 Total Return	
Lehman Aggregate	3.69%
Lehman Interm. Gov't	3.86%
Lehman Long Gov't	6.07%
Lehman Interm. Credit	3.18%
Lehman Long Credit	2.02%
Lehman High Yield	-6.41%

High yield investors remained skittish with concerns over the sluggish equity market and on-going negative corporate news. The sector finished down over 6% for the second quarter reflecting continued softness in the telecom sector. According to SalomonSmithBarney, high yield mutual funds reported $292 million in redemptions for the latest period.



All signs appear to confirm that the economy is coming out of the recession; however this has not been borne out in investor sentiment. We feel a case can be made for rising rates, with interest rates at a cyclical low, driving down bond prices and depressing returns, or a risk-driven reallocation to fixed income, putting downward pressure on interest rates with a corresponding increase in prices. The jury is still out and we expect investors to continue to pay close attention to breaking corporate news.

Overseas Markets

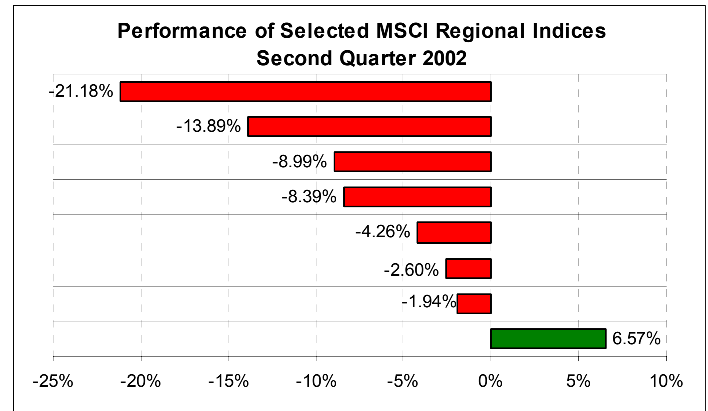
Global markets continued their mixed performance in the second quarter as the Japanese market rebounded while European and Latin American markets continued to post losses.

After showing signs of growth in the first quarter, Europe abruptly changed course. The European market continued to move in lockstep with the U.S. as the sector was down over 4% for the quarter. France and Germany again lead the downward trend in performance in the region. In France, high unemployment continues to feed low consumer confidence. Likewise, Germany's economic recovery was dampened by an unexpected dip in business confidence at the end of the second quarter. Industrial and consumer confidence across the Euroland region was down, but unemployment remained stable at an expected 8.3% rate. Near the end of the period, the Euro strengthened robustly versus the Dollar, but it is unclear whether this will negatively impact recovery in the region. We believe that although the European markets took a slight step back, recovery in the region will continue at a slow pace through the rest of the year.

In Japan, news was better in the second quarter. While Japan's jobless rate rose to 5.4% in May, government data showed that industrial production was up 3.9%, a greater than expected increase. Japan's net exports also increased during quarter, signaling that foreign demand for Japanese goods may be increasing. Given the positive economic news, the sector was up 6.6%. Although there are positive signs for a Japanese recovery, both consumer and corporate spending remained depressed. The Bank of Japan had to intervene in the currency markets to keep the Yen from further strengthening against the Dollar. Prime Minister Koizumi has been ineffective in his attempts at policy reforms and the government may be forced to employ corporate tax incentives as a means of keeping any recovery on track.

The recovery continued around Asia with markets in South Korea and China consistently showing signs of growth. In South Korea, continued strength in domestic consumption has driven the markets. China has thrived on increased foreign investment and demand for goods.

In Latin America, hopes for recovery are thin. In Argentina, the central bank provided details of its monetary program for the balance of 2002. Although the announcement had a slight positive effect on the markets, the International Monetary Fund (IMF) still has not reached an agreement on an aid package. Argentina ended the second quarter down over 33%. In Brazil, positive trade news was unable to prevent poor performance. Brazil posted its largest June trade surplus since 1994, but finished down 25% on both political fears of a left-wing presidential victory and continued weak employment reports. Even Mexico, which seemed to be untouched by Latin American woes, was unable to produce positive second quarter returns. The CPI in Mexico rose worse than expected and exports, other than oil, lagged. Mexico ended the quarter down over 18%.



Focus On: *Currency Exchange Rates*

International investment and trade involve a variety of factors not encountered domestically. One of the most significant is the exposure to foreign currency fluctuations. As U.S. individuals and businesses continue to increase their exposure to foreign markets, it becomes important to understand how foreign exchange rates impact investors, consumers, and the economy.

Simply defined, an exchange rate is the price of one national currency (e.g. U.S. dollar) in terms of another national currency (e.g. Japanese yen). Since 1971, a managed floating exchange rate system has been in effect for most major currencies. The system is termed "floating" or "flexible" because the value of currencies in the foreign exchange market are largely allowed to float up or down according to supply and demand. The "managed" characteristic is that governments, typically through their central banks, are able to actively engage in transactions through fiscal or monetary policy to influence exchange rates. This system has enabled funds to flow easily between different countries.

An appreciation in the value of the currency increases its purchasing power. When the U.S. dollar appreciates versus the yen, Japanese cars and VCR's become less expensive to Americans. When it depreciates, the value of the dollar is reduced, making foreign goods more expensive. There are numerous market factors that impact exchange rates. Any change that alters the quantity of goods, services, or assets bought from other countries relative to the quantity sold to other countries will have an effect on the exchange rate. A few examples are:

- **Short-Term Capital Flows**
  Higher interest rates relative to other countries will tend to attract short-term investments. For example, if interest rates are higher in the U.S. relative to Europe, borrowers in Europe will demand dollars (and supply their currencies) in order to invest in higher-yielding U.S. assets. As more dollars are demanded, the "price" of dollars, or the exchange rate, will increase relative to the investor's home currency.
- **Long-Term Capital Flows**
  Higher expected returns on investments, driven by relative growth rates and productivity, will also attract investors from other countries. If the U.S. markets are expected to yield higher returns than other markets, more dollars will be demanded from foreign investors to fund investment in U.S. assets and the dollar exchange rate will increase relative to other currencies.
- **Inflationary Pressure**
  Upward pressure on prices will tend to make purchases more expensive relative to other countries, driving demand for the currency and therefore its exchange rate, downward.
- **Political Climate**
  Political stability, or a positive change in the political climate, provides investors with confidence about a country and tends to support higher exchange rates.

Currency fluctuations can significantly impact the returns of an international portfolio. To a U.S. investor, the total return on a foreign investment depends on the return of the foreign asset itself (in local currency) as well as the currency's exchange rate relative to the U.S. dollar.

Consider a $1,000 investment in a Japanese stock when the exchange rate is 100 JPY per $1 and the asset value does not change. In this example, the dollar is depreciating relative to the yen, which means $1 can buy less yen. It also means that one

yen can buy more dollars, so the Japanese investment is now worth more in U.S. dollar terms. Similarly, when the dollar appreciates relative to the yen, the investor would experience a loss in dollar terms.

US$	Exchange Rate	Ending Value
$1,000	80 JPY	$1,250
$1,000	100 JPY	$1,000
$1,000	120 JPY	$833

It is possible to experience an overall loss even though an asset gained in value, as the example below illustrates. On average, the stocks in the EAFE index posted a slight gain of 0.48% in their local currency, but when the asset values were translated into U.S. dollars, a loss of 1.55% resulted.

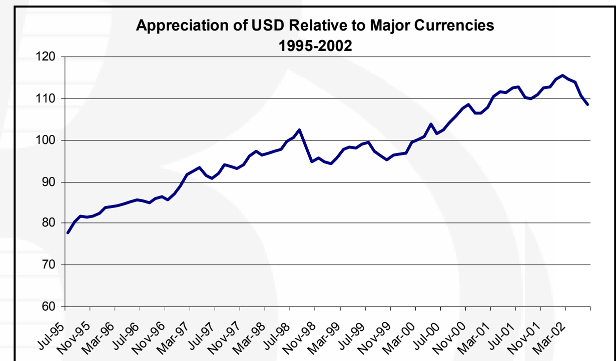
	5-Year Total Return (as of June 28, 2002)		
Benchmark	Local Return	Currency Return	Total Return
MSCI EAFE Index	0.48%	-2.03%	-1.55%
MSCI World Index	1.63%	-1.11%	0.52%
MSCI Japan Index	-7.37%	-0.86%	-8.23%
MSCI United Kingdom	3.08%	-1.79%	1.29%
MSCI Europe	4.74%	-2.27%	2.47%

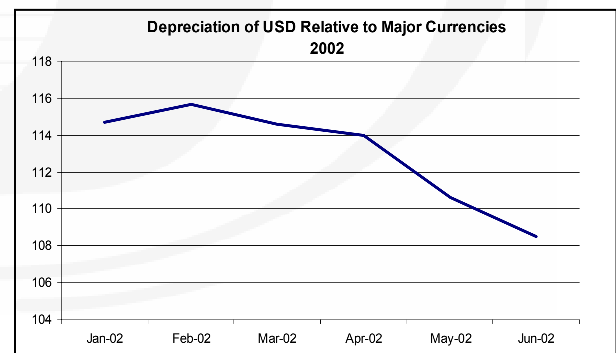
Many managers employ financial techniques, called "hedging" to mitigate the effects of currency fluctuations in their portfolios. They may use forward currency contracts, currency swaps and currency options to manage all or some of the exposure. Others prefer to leave their portfolios unhedged. If you hold an international portfolio in a company-based investment program, or perhaps have a personal investment in an international mutual fund, it would be a good idea to understand the portfolio manager's view on currency exposure.

In recent years, the dollar has been strong relative to major currencies, rising more than 40% since 1995. This is largely attributable to the strength in the U.S. stock, bond and real estate markets relative to foreign markets. Since early 2002, however, there has been downward pressure on the dollar as poor earnings, accounting scandals, low interest rates and a fear of terrorist attacks have hurt demand for U.S. assets. In the second quarter, the U.S. dollar depreciated 9.7% relative to the yen, 13.1% relative to the euro, and 7% relative to the pound.

A continued decline in the dollar would impact segments of the market differently:

- It will be good news for U.S. manufacturers, farmers and other producers, particularly those who export goods or compete with imports. Since a weaker dollar makes U.S. goods cheaper overseas, foreign consumers are likely to buy more U.S. goods. At the same time, imported goods will feel more expensive at home, which should prompt American consumers to forego imports for U.S. made goods. This would be a huge change in behavior for American consumers, who have purchased more goods from abroad than domestically for more than ten years. In 2001, the current account ran a $417 billion deficit, almost 4.5% of GDP. In the first quarter of 2002, the current account measured a deficit of $112.5 billion.
- U.S. based multinational companies would benefit as their overseas operations would increase in value when translated into dollars.
- Consumers may suffer, if the falling dollar triggers inflation. Not only are imports suddenly more expensive, but U.S. producers, facing less competition from abroad, could raise prices. And if inflation fears lead to rising interest rates, then it will be more costly to finance large purchases such as homes and cars.
- Businesses would be pinched if inflation resulted, as higher borrowing costs would cut into profits.





- It's unlikely the impact would be limited to home. Many foreign economies whose recoveries are dependent on exports would also be hurt, as less of their goods would be purchased by American consumers. Japan's recovery, for example, is tied to their ability to export, and a continued weakness in the dollar could prove to be a set-back to its recent economic growth.

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