Goelzer Investment Management
Economic & Market Review and Outlook

July 6, 2001

Experience has shown us time and again that investors tend to overreact on both the upside and the downside, and as this quarter's positive performance illustrates, stock prices were deeply oversold in the earlier months of this year. The stock market's year-long decline came to an end, at least temporarily, as both the Dow Jones Industrials and S&P 500 managed positive returns for the quarter, as investors took the opportunity to accumulate stocks at significantly lower prices. A combination of continued aggressive rate cuts by the Federal Reserve, early signs of economic recovery and the anticipated benefits of tax relief later this year contributed to the somewhat more upbeat market sentiment. Despite a continuing stream of profit warnings from corporations across the economy (we are now in the thick of the earnings confessional period, where companies own up to the fact that their earnings might not meet expectations), an increasing number of investors are beginning to believe that the market reached a bottom in March of this year. Human nature is to assess the current environment and extrapolate its continuance for the foreseeable future. For long-term investors, reacting to this tendency can be dangerous to your financial health. In our opinion, a strong case can be made that much of the bad news regarding earnings, or lack thereof, is fully priced into the market, and investors will soon begin to focus on the expected recovery in the economy and corporate profits in the latter half of this year and into 2002.

The Economy

- The U.S. economy, while in the midst of a steep economic slowdown, is beginning to show the initial signs of an upcoming recovery. The Index of Leading Indicators, a key gauge meant to predict future economic performance, rose 0.5% in May, the biggest gain in 17 months. Manufacturing orders for consumer goods and materials held steady in May, a possible sign of recovery for the manufacturing sector, which has been hit the hardest by the economic slowdown.
- In another sign of strength, consumer confidence rose in June for the second month in a row. The Consumer Confidence Index is now at its highest level this year, indicating that consumers are more optimistic regarding business and job prospects, and thus more likely to increase spending.
- The Federal Reserve cut interest rates by another 1.25% during the second quarter. The federal funds rate, the central bank's target for overnight bank lending, now stands at 3.75%, its lowest level since April 1994. The Federal Reserve has now cut interest rates six times this year, and this latest rate cut, on June 27, was only a quarter of a percent (versus five prior cuts of one half of one percent), implying that the Fed may believe the economy is entering a recovery phase.

Outlook: While the Federal Reserve may cut interest rates further by the end of the year, the consensus is that this current easing cycle is winding down. The outlook now shifts to whether or not the economy can stage a recovery in the upcoming quarters. We continue to believe the Federal Reserve rate cuts will come into full effect in the fourth quarter of 2001 and the first quarter of 2002, following the usual six to nine month lag. In addition to the rate cuts, the economy will benefit from the recently passed tax cut, which will result in 95 million tax rebate checks being sent to taxpayers beginning in July. As a result of this economic stimulus, we believe the U.S. economy is on track to grow 1.8% this year, with much of the growth coming in the fourth quarter of the year. This represents a sharp decrease from the 5% growth rate of 2000, but it is well out of recession territory.

Stock Market

- After reaching very depressed and oversold levels during the first quarter, the market regained some of its losses as investors began anticipating a recovery in the economy and, in turn, corporate profits later in the year. While the S&P 500 and the Dow Jones Industrials gained during the quarter, for the first half of 2001 the two indices remain down 7.2% and 2.7%, respectively.
- Companies across a host of industries, especially many operating in technology-related and economically sensitive sectors of the economy, continued to issue earning warnings in the second quarter, but the market appears to have factored in much of the negative news regarding corporate profits. Second quarter profits are expected to fall 17.4%, which would represent the worst three-month performance for earnings in 10 years. However, with such poor performance, future earnings will compare very favorably to the lowered results for these past few quarters. Thus, we continue to believe that the expectations bar has been substantially lowered, and the stage is set for a shift to positive results relative to expectations as we enter the second half of 2001 and move into 2002.

- Liquidity continues to be high with over $2 trillion invested in money market accounts. As a portion of this money returns to stocks, it should provide a catalyst for higher equity prices. In fact, the value of money market assets equal 14.5% of the total market capitalization of the New York Stock Exchange, a number similar to that of the 1990 market bottom.

Outlook: The key question remains whether the positive results of the second quarter mark the beginning of a sustained rally or merely a brief interlude before further downside pressure. The key to the stock market is earnings growth, and we believe that earnings for 2001 have been so depressed that, assuming the economic recovery we envision materializes, the 2002 numbers will compare very favorably. Combine this with the high liquidity in money market accounts awaiting reinvestment and the expected rebound in the economy, and the result is a favorable picture for the stock market in coming months. The unknown remains the timing and magnitude of this anticipated recovery. We expect equities to show modest improvement in the next few quarters resulting in a positive performance for the full year 2001.

Bond Market

- As we discussed last quarter, in January of this year, corporate/treasury yield spreads had widened to the largest levels in over a decade. This widening was in large part a flight to quality move into intermediate Treasuries, taking their yields to the lowest levels since the 4th quarter of 1998. Where appropriate, we took advantage of these yield spreads by purchasing investment grade corporate bonds with maturities in the 4-7 year range. This move has served us well thus far, as yield spreads have contracted significantly since our purchases, reflecting a consensus view that our economy will avert recession and, as such, prices of corporate bonds were unjustifiably cheap relative to Treasuries.
- We continue to find the best relative value in the intermediate sector of the yield curve. If the economy responds to the monetary and fiscal stimulus as expected, we would anticipate slightly higher yields as we move into 2002, and bonds with intermediate maturities should perform relatively well under this scenario.

Outlook: Our view remains unchanged from last quarter. That is, while current economic weakness may warrant a further Fed interest rate cut in the near-term, the combination of monetary stimulus, tax relief and record levels of mortgage refinancing activity will allow the economy to stabilize and psychology to improve as 2001 unfolds. These factors will likely lead to *higher* Treasury yields as we move into 2002, in our view. With this view in mind, we have maintained our focus on maturities in the 3-5 year range, which have benefited from recent moves by the Fed to lower interest rates. As the economy shows signs of improvement, we anticipate the corresponding rise in bond yields to provide an excellent opportunity to extend maturities at more attractive yields.

DJIA 10502.4 S&P 500 1224.4 10 Yr. US Treasury 5.38%