Goelzer Investment Management
Economic & Market Review and Outlook
October 4, 2001

The world is a changed place. We have heard these words repeated countless times since the tragic events of September 11. And most certainly the pain we have all felt, the damage done to our economy, productivity and national psyche will impact our lives in immeasurable ways, for an indeterminate period of time. Viewed from a slightly longer perspective, the past 18 months have witnessed an unparalleled swing in the financial markets from unbridled enthusiasm and incomparable optimism to fear and trepidation. From a period of explosive growth and high expectations to economic contraction and uncertain forecasts. From incessant talk of New Economy and New Paradigm in March of 2000 to widespread predictions of recession and worse as the third quarter of 2001 drew to a close. And throughout, as it always has, the stock market functions on two levels, as a real time gauge of sentiment and as a discounting mechanism, reflecting anticipation of things yet to come. After having experienced the most difficult market in many respects since the Great Depression, capped by the worst quarter for the Dow Jones Industrial Average since the fourth quarter of 1987 and the second-worst quarter for the beleaguered NASDAQ ever, we have reason to be hopeful, as we outline below. 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 the economy and earnings, or lack thereof, is fully priced into the market, and, as reflected by recent market gains, investors have begun to focus on the expected recovery.

The Economy

- Prior to the attacks of September 11, the U.S. economy was beginning to show early signs of stabilizing, as excess inventories were being worked down in classic textbook fashion, setting the stage for an increase in manufacturing, the hardest hit sector of our economy. While the *timing* of this recovery is now clearly less certain, two matters have become clearer in our minds. First, the events of September 11 appear to have tipped us into recession in a classic sense (two consecutive quarters of negative growth in GDP). Second, the sheer scale of economic stimulus, both monetary and fiscal, domestic and global, following the attacks will likely work to blunt its duration and severity.
- The Federal Reserve cut interest rates by another 1.25% during the third quarter, of which a full 1.0% has occurred following the events of September 11. The federal funds rate, the central bank's target for overnight bank lending, now stands at 2.50%, its lowest level since the time that John F. Kennedy was president. The Fed has now cut interest rates nine times this year, for a cumulative ease of 4%, an unprecedented move under current Chairman Alan Greenspan.

Outlook: Policy makers around the globe are pulling no punches in their effort to restore economic growth in the face of recent events. The combination of unprecedented monetary easing and massive fiscal stimulus in response to the terrorist threat should, in time, work to stabilize the economy and set the stage for renewed growth in 2002. Congress has approved or is currently debating a combination of further tax relief and a government-spending package estimated to exceed $125 billion. While the Federal Reserve may cut interest rates again by the end of the year, the consensus is that this current easing cycle is winding down. The outlook now shifts to the depth and duration of the current economic downturn and the timing of the coming recovery.

Stock Market

- The final week of one of the worst months, in one of the worst quarters in stock market history held out a glimmer of hope for equity investors. Markets rebounded somewhat from the steep losses suffered during the first week trading resumed following the attacks on the World Trade Center and Washington, DC, as investors searched among the rubble of the stock market looking for bargains. For the quarter, the Dow Jones Industrial Average fell 1,655 points, or nearly 16%, marking its worst showing since the fourth quarter of 1987. And, the Dow's decline is mild by comparison. The NASDAQ Composite, home to many former high flyers, suffered a stunning 31% loss during the third quarter, and has now retreated over 70% from its peak in March of 2000.
- While companies across a host of industries, especially many operating in technology-related and economically sensitive sectors of the economy, continue to warn of earnings weakness, we are seeing early signs that business conditions, while anything but robust, may be stabilizing. Positive announcements from high profile leaders such as General Electric, Cisco Systems and Dell Computer were well received by investors, helping to restore badly shaken confidence.
- Unforeseen events emanating from our military response in Afghanistan may alter our current thinking, but the market appears to have factored in much of the negative news regarding corporate profits. As mentioned last quarter, future earnings will compare very favorably to the unexpectedly weak showing of the past few quarters. Thus, we continue to believe that the expectation bar has been substantially lowered, and the stage is set for a shift to positive results relative to expectations as we move into 2002.
- Liquidity, at high levels prior to the attacks, has now, not surprisingly, moved into record territory. The ratio of money market fund assets to the Wilshire 5000 Index now exceeds the prior record high that occurred in 1982, just prior to the great bull market of the 1980s and 1990s. One key difference is that money funds provided double digit returns back then, while today a money market funds yielding 2.50% is hard, if not impossible, to find.

Outlook: Recent events and their potential impact on economic activity and, in turn, corporate earnings and stock prices have left investors searching for direction. While the timing of the absolute low in stock prices only becomes clear in hindsight, important market bottoms have several factors in common, which we have also witnessed in recent days. These factors include bad economic news, aggressive Fed ease, high levels of fear and uncertainty and significant selling on heavy volume. In the words of Tom Galvin, Chief Equity Strategist at Credit Suisse First Boston, psychology has clearly been impaired by recent events, but the combination of low expectations and record liquidity have historically been the critical seeds for new bull markets, as dark clouds eventually pass. The climax selling on heavy volume during the week trading resumed following the attacks may very well represent the low point of this brutal decline. 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 favorably. The unknown remains the timing and magnitude of this anticipated recovery. Our best guess at this time is a fairly robust recovery from the current, very depressed levels by mid 2002.

Bond Market

- Aggressive cuts in interest rates by the Federal Reserve designed to jumpstart the sputtering economy, coupled with a flight to quality by nervous investors have resulted in the lowest yields on U.S. Treasury securities with maturities of 5 years and less in nearly 40 years.
- Two-year Treasury yields have fallen by nearly 2.5% since January, resulting in very nice total returns for holders. Interestingly, longer-term bonds have not fared nearly as well. Yields on Treasury securities with maturities of 10 years have declined by just 0.5%, while thirty-year Treasury yields are virtually unchanged for the year, at approximately 5.4%. Given our view that we will see some recovery in the economy in 2002, we are reluctant to lock in yields at these levels, preferring instead to look to the corporate and agency markets for enhanced return opportunities.
- 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 fourth quarter of 1998. Where appropriate, we took advantage of these yield spreads by purchasing investment grade corporate bonds with maturities in the 4 to 7 year range. This move has served us well thus far, as yield spreads have contracted significantly since our purchases.
- We continue to believe the best relative value can be found 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, especially at the short end of the curve, as we move into the latter months of 2002. Bonds with intermediate maturities should perform relatively well under this scenario.

Outlook: Despite recent events, our view on the bond market remains relatively unchanged from last quarter. That is, while current economic weakness and a desire by the Fed to stay ahead of the curve may warrant a further Fed interest rate cut prior to year-end, to perhaps a 2.00% Fed Funds rate, the combination of monetary and fiscal stimulus, and a new wave of mortgage refinancing activity will allow the economy to stabilize and psychology to improve as we move into 2002. These factors will likely lead to *higher* Treasury yields as we move into the latter half 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 8847.56 S&P 500 1040.94 10 Yr. US Treasury 4.54%