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SUMMARY

- Earnings reports continue to be below expectations.
- Small and mid-cap stocks fare better than large caps.
- Strong U.S. dollar hampers large cap profitability.
- Federal Reserve continues to lower interest rates.

SECOND QUARTER 2001 REVIEW AND OUTLOOK

For the first time in over a year all the major U.S. market averages logged positive returns for the quarter. The market found a bottom in late March and early April, resulting in a sharp rally through most of April and May. June saw the market give back a good portion of the gains, but the averages held well above the lows. Despite the good second quarter showing, the major averages are still down for the year to date. Poor corporate earnings continue to take the blame.

Quarterly earnings for the S&P 500 have declined year over year for the past three quarters and are expected to do so for the third quarter of 2001. Analysts do not expect positive earnings growth until the last quarter of this year. Much of the decline in earnings growth may be attributed to the economic slowdown brought on by the last cycle of interest rate increases and sharply higher energy prices. The contraction of wealth brought about by the serious market decline since March of 2000 may also be playing a role in moderating demand from the

Year 2001 Stock Market Performance

	Second Quarter	Year to date
S & P 500	+5.5%	-7.3%
Dow Jones Industrial Average	+6.3%	-2.6%
NASDAQ Composite	+17.4%	-12.5%
Morgan Stanley EAFE	-1.7%	-15.5%

consumer.

On the subject of interest rates, the Fed is currently in one of its most aggressive easing cycles ever, having cut short-term rates six times in the past six months for a total of 275 basis points. The Federal discount rate has dropped from 6.0% to 3.25% in that time. Believing that inflation is in check, the Fed remains biased toward additional rate cuts to ward off further economic weakness. During the same six-month period, long-term rates have risen slightly. The market has probably

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Second Quarter 2001 Review and Outlook (continued)

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begun to anticipate the end of this rate easing cycle and the eventual acceleration of economic growth. The higher long-term rates indicate that in time inflation may again become a concern as the economic cycle repeats itself.

For large multinational corporations the strength of the U.S. dollar continues to dog profitability. The dollar remains above its trading range of the past 15 years against other currencies and shows little evidence of weakening. When the dollar is unusually strong, profits earned abroad are diminished when translated into domestic currency. Some of the strength in the dollar may be due to a lack of confidence in the ability of the Euro

to succeed as the European central currency. Other strength may be due to general economic weakness abroad relative to the U.S. *Please see article on page 3 regarding the economic and political situation in Japan.*

While the strength of the dollar bodes ill for large multinational corporations, it has been just what the doctor ordered for small and mid-cap issues. They have enjoyed a renaissance while the large caps have lagged. Their businesses tend to be more domestically oriented and less susceptible to the negative impacts of the strong dollar and economic weakness abroad. It is very interesting to note that while the major market averages, dominated by the largest companies have been in

decline, the median stock has fared relatively well. This represents a reversal of the trend of recent years and is much more in line with historic norms. There is strong evidence that the outperformance of the small and mid-cap issues is a trend that may persist for some time to come, at the expense of the large cap issues.

Looking ahead, the market usually bottoms prior to the trough in earnings by about six to nine months. If that is the case, then we may have already seen the worst of the market action for the year. The upside may be limited because stock prices as gauged by P/E ratios are still high. Previous market bottoms have seen single digit P/E's for the S&P 500, but the current P/E is still above 20,

not even in the teens! *Please see chart at left.* The market seems to have become more value-conscious, and the recent performance of the more reasonably priced small and mid-cap indices supports this concept. It may be some time before the large cap stocks come to the fore again, and a rebalancing in favor of issues with more reasonable P/E's and better upside potential may be in order.

-Whitney Brown



The Japanese Stock Market

Over the last ten years, the developed stock markets in Europe, Australia, and the Far East (EAFE), as well as the emerging markets, have underperformed U.S. stocks. The Japanese markets have been the weakest of all the markets comprising the EAFE. Japan has had essentially zero annualized growth. Although the larger European markets –

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France, Germany, Italy, and the U.K. – show lower returns than that of the United States when measured in U.S. dollars, returns in these European countries were actually very similar to the U.S. returns when measured in their respective currencies.

The biggest question facing foreign investors focuses on Japan. Specifically, will Japan be able to resolve its bad debt problems, restructure inefficiencies in its companies, and increase profitability? The Japanese political environment has improved over the last several months largely due to

reforms planned by its new Prime Minister, Junichiro Koizumi. A major problem over the last 10 years plaguing the Japanese banking system has been bad loans. Koizumi has promised to force banks to clean up their bad loans within three years. A government reform program known as the Resolution and Collection Corp, that was founded years ago, would be strengthened and put into action. The RCC would buy any bad loans that banks can't dispose of and would then try to re-package these loans into securities that could be sold to investors. This is borrowing on an idea from the savings and loan workout of the early 1990s in the U.S. The plan also calls for privatizing public corporations and perhaps privatizing the postal system as well. Koizumi also promises to avoid heavy government spending to prop up the economy, a strategy that has been tried many times in the past decade.

The plan is short on details and has several hurdles it must clear to be a success. The first obstacle to overcome will be the election of Koizumi. Currently he is serving in a temporary position of leadership due to the resignation of former Prime Minister Mori. In addition to the re-election of Koizumi,

other challenges include Japan's \$1.2 billion in corporate debt and an economy that could be slipping into the fourth recession in ten years. Koizumi, if elected, will have his work cut out for him in a country that historically has been resistant to change. Koizumi has brought about a new hope for the Japanese economy. Enthusiasm for him is showing in popularity

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polls, and the people of Japan seem ready to embrace a new leader with new ideas.

The Nikkei index has shown some signs of strength lately, largely due to the popularity of Koizumi's planned reforms. If Koizumi can accomplish what he has outlined, an economic recovery in Japan may be possible. Although Japan is home to some of the world's greatest companies, it would appear things will get worse for Japanese stocks before they get better.

-Watt Dixon

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