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### SUMMARY

- September 11<sup>th</sup> tragedy shakes markets, consumer confidence.
- Economic recession likely.
- Federal Reserve cuts rates for the ninth time this year.

### THIRD QUARTER 2001 REVIEW AND OUTLOOK

The quarter just ended was one of the worst in most investors' memories. All major market indices posted sharp, double-digit declines and continue to be in bear market territory for the year to date. The gruesome attacks in New York and Washington clearly took a toll on the market, but there was a year-and-a-half long downtrend in place prior to September 11th.

Well before September 11<sup>th</sup>, the economy was slowing, unemployment was rising, and consumer confidence was on the wane. Corporate earnings have been poor for several quarters, and the setbacks have not been limited to the technology sector. There was some debate about whether or not the economy was going into recession, but the debate was largely based on one's definition of recession. Clearly, there has been a significant decline in economic activity, and the

#### Year 2001 Stock Market Performance

	Third Quarter	Year to date
S & P 500	-15.0%	-21.2%
Dow Jones Industrial Average	-15.8%	-18.0%
NASDAQ Composite	-30.6%	-39.3%
Morgan Stanley EAFE	-14.3%	-27.6%

fallout from the attacks will prolong the economic weakness.

The Federal Reserve has lowered interest rates now nine times this year and pumped massive amounts of cash into the financial system in the wake of the attacks, but there is some concern whether lower rates are having the desired effect. On the heels of the longest peacetime economic expansion ever, quite possibly the eventual downturn could be significant. The

*(Continued on page 2)*

## Third Quarter 2001 Review and Outlook (continued)

*(Continued from page 1)*

tremendous build-up of corporate and consumer debt over the past seventeen years may lead to deeper economic troubles if the current recession proves to be persistent. The effect on the economy of falling interest rates lags the actual cuts, and we are only now approaching the time when the cuts should begin to have an impact.

After September 11<sup>th</sup>, already declining Treasury yields plummeted for short to intermediate maturities. The yields on the 2 and 5-year Treasuries are lower now than in October of 1998, and the 10-year yield stands around 4.5%. Yields on long Treasuries and corporate bonds have been more stubborn, but clearly the flight to quality has driven Treasury prices higher. The prevailing wisdom is that inflation is not a near term threat, and there is even talk of global deflation and a collapse in energy prices.

The outlook for the stock market remains cloudy in the near term, but there are a number of conditions in place that favor a period of relief from the downtrend of the past eighteen months. Stocks are cheaper now than at any time in the past three years. The price-to-earnings ratio on the S&P 500 based on trailing earnings stands at 20, which is down from a peak of 31. Many technical indicators point to a drastically oversold market poised for a sizable bounce back. Investor sentiment has reached extreme negative levels as indicated by a

spike in the put-call ratio above 1.0. The number of bearish advisors exceeds bullish ones for the first time this year. Such extremes in negative sentiment usually occur near market bottoms. Finally, we have entered the time of year when stocks generally provide better returns. The period from October through April has on average each year offered far superior stock market returns than the period from May through September. In fact as the chart below illustrates, over the last 51 years the cumulative gain from the May to September period was only 8% while the gain from the October to April period was over 5000%!

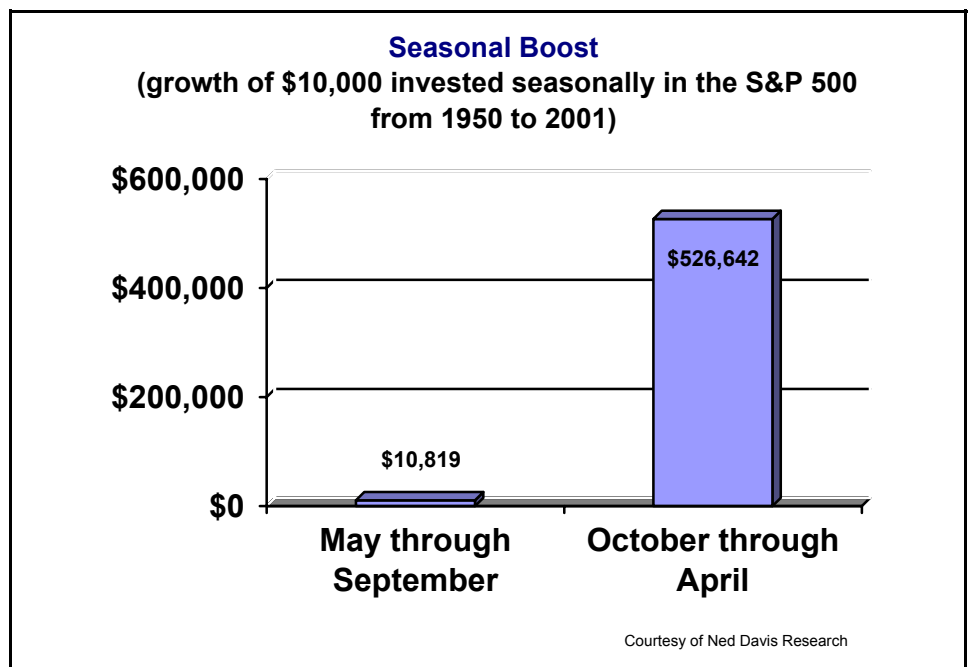
The bear market has proven its credentials up to this point and may well be ready to step back. While stocks remain expensive based on historic P/E ratio averages, a good

argument may be made for higher P/E's in a low inflation, low interest rate environment.

A catalyst is needed now to restore some confidence in the bull. Stabilization in corporate profits, some indications that the economy has turned the corner, or even some nonfinancial event to bring more definition to the post-attack geopolitical scene could do the trick.

We continue to have in our favor the resources and determination of the most powerful and democratic nation in the world. The combined forces of government, private enterprise and individual fortitude will get our economy back on track and resolve our issues of national defense and security in ways that preserve and honor our unique American heritage.

-Whitney Brown



## Tragedy and the Market

The terrorists' attacks that occurred on September 11, 2001, will have lasting effects on Americans for years to come. The impact on the U.S. economy and the stock market could have a less durable effect than most people anticipate. History shows that long-term impacts on the economy and stock markets should be minimal.

Despite numerous rate cuts by the Federal Reserve, the U.S. economy was in a bad state prior to the September 11<sup>th</sup> attacks. Unemployment was climbing; consumer confidence, already trending lower, suffered a sharp drop the first week of September; housing starts, the last positive note in our economy, had begun to fall; and

corporate profits were deep in their worst slump in 40 years. What's more, for the first time since the mid 1970's economies around the world were receding at the same time. The events of September 11<sup>th</sup> have accelerated all of this.

The primary force depressing the economy before the terrorist attacks was the slide in capital spending. Until companies have a chance to sort out current demand, they will have little incentive to increase their spending or hire new employees.

The short term effects on our economy will largely be dictated by the outcome of any military action that the U.S. will undertake. Most economists feel any extreme action

should be short lived. Historically, virtually every economic challenge the U.S. has ever faced has resulted in a powerful recovery.

As to the stock market, history reveals some interesting information in response to tragic events. Ned Davis Research determined the impact of 28 different crises on the Dow Jones Industrial Average, from the fall of France in 1940 and the bombing of Pearl Harbor in 1941 to the Kennedy assassination in 1963, the Gulf War in 1991, and the previous World Trade Center bombing in 1993.

The effect on the market has been similar in each of these events. The Dow traded down in the

*(Continued on page 4)*

### CRISIS EVENTS, DJIA DECLINES AND SUBSEQUENT PERFORMANCE

Event	Reaction Dates	Date Range % Gain/Loss	DJIA Percentage Gain Days After Reaction Date		
			22	63	126
Fall of France	05/09/1940 – 06/22/1940	-17.1	-0.5	8.4	7.0
Pearl Harbor	12/06/1941 – 12/10/1941	-6.5	3.8	-2.9	-9.6
Truman Upset Victory	11/02/1948 – 11/10/1948	-4.9	1.6	3.5	1.9
Korean War	06/23/1950 – 07/13/1950	-12.0	9.1	15.3	19.2
Eisenhower Heart Attack	09/23/1955 – 09/26/1955	-6.5	0.0	6.6	11.7
Sputnik	10/03/1957 – 10/22/1957	-9.9	5.5	6.7	7.2
Cuban Missile Crisis	10/19/1962 – 10/27/1962	1.1	12.1	17.1	24.2
JFK Assassination	11/21/1963 – 11/22/1963	-2.9	7.2	12.4	15.1
U.S. Bombs Cambodia	04/29/1970 – 05/26/1970	-14.4	9.9	20.3	20.7
Kent State Shootings	05/04/1970 – 05/14/1970	-4.2	0.4	3.8	13.5
Arab Oil Embargo	10/18/1973 – 12/05/1973	-17.9	9.3	10.2	7.2
Nixon Resigns	08/09/1974 – 08/29/1974	-15.5	-7.9	-5.7	12.5
U.S.S.R in Afghanistan	12/24/1979 – 01/03/1980	-2.2	6.7	-4.0	6.8
Hunt Silver Crisis	02/13/1980 – 03/27/1980	-15.9	6.7	16.2	25.8
Falkland Islands War	04/01/1982 – 05/07/1982	4.3	-8.5	-9.8	20.8
U.S. Invades Grenada	10/24/1983 – 11/07/1983	-2.7	3.9	-2.8	-3.2
U.S. Bombs Libya	04/15/1986 – 04/21/1986	2.6	-4.3	-4.1	-1.0
Financial Panic '87	10/02/1987 – 10/19/1987	-34.2	11.5	11.4	15.0
Invasion of Panama	12/15/1989 – 12/20/1989	-1.9	-2.7	0.3	8.0
Gulf War Ultimatum	12/24/1990 – 01/16/1991	-4.3	17.0	19.8	18.7
Gorbachev Coup	08/16/1991 – 08/19/1991	-2.4	4.4	1.6	11.3
ERM U.K. Currency Crisis	09/14/1992 – 10/16/1992	-6.0	0.6	3.2	9.2
World Trade Center Bombing	02/26/1993 – 02/27/1993	-0.5	2.4	5.1	8.5
Russia Mexico Orange County	10/11/1994 – 12/20/1994	-2.8	2.7	8.4	20.7
Oklahoma City Bombing	04/19/1995 – 04/20/1995	0.6	3.9	9.7	12.9
Asian Stock Market Crisis	10/07/1997 – 10/27/1997	-12.4	8.8	10.5	25.0
U.S. Embassy Bombings Africa	08/07/1998 – 08/10/1998	-0.3	-11.2	4.7	6.5
Russian LTCM Crisis	08/18/1998 – 10/08/1998	-11.3	15.1	24.7	33.7
<b>Mean</b>		<b>-7.1</b>	<b>3.8</b>	<b>6.8</b>	<b>12.5</b>
<b>Median</b>		<b>-4.6</b>	<b>3.9</b>	<b>6.7</b>	<b>12.1</b>

Days = Market Days

Courtesy of Ned Davis Research 9/11/2001

### Tragedy and the Market (continued)

*(Continued from page 3)*

immediate aftermath of these crises an average of 7.1%, only to rally and finish ahead an average of 3.8% a month later, 6.8% three months later and 12.5% six months later. In other words, virtually the entire loss in reaction to such events was typically made up three months later and surpassed six months after.

Economic shocks seem to have had the biggest initial impact on the Dow. The Arab oil embargo in 1973 sent the Dow down 17.9% in two months. The Hunt Brothers silver crisis of 1980 caused a drop of 15.9%. The Dow lost 11.3% due to the drop of the Russian ruble and the collapse of Long Term Capital Management in 1998. In each of these instances, except the oil embargo, the Dow came back over the next six months with gains between 25 and 35% as the Federal Reserve flooded the economy with liquidity.

The most analogous period to our current situation was the Persian Gulf conflict from late 1990 to early 1991. The U.S., then as now, was in an economic slowdown, characterized by weakening corporate profits and falling stock prices. Iraq, at the time, was thought to

possess chemical and biological weapons and Americans feared great losses in a war with Iraq. The Dow sank 4.3% in the three weeks between the issue of the U.S. ultimatum to Iraq to get out of Kuwait and the actual outbreak of hostilities. Once U.S. bombs began dropping, and an official war was declared, the Dow began a 20% rise.

Although economic conditions are similar now, during the Gulf War the U.S. had a well-defined enemy to target. Terrorists are a more elusive bunch. While extremely dangerous, terrorists lack the military strength of nations. The patriotic fervor we have seen in the U.S. since the attacks has been phenomenal. Whether this newly rekindled faith in America will lead U.S. stocks higher will depend on stabilizing economic conditions, improving corporate profits, and how the U.S. ultimately deals with these terrorist acts. Short-term market action may be erratic and limited. In the long run, the U.S. economy will recover and common stock prices will continue to rise.

-Watt Dixon

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