

July 9, 2001

Hardwired

"Near term economic outlook poor. Average stock moving higher."

You won't see these two phrases together in the headlines of the financial media. These two thoughts seem too incompatible to be connected. As we write this quarterly letter, many companies are warning of lower earnings for the second quarter and offering little positive guidance for the next couple of quarters. In spite of the negative economic and corporate news, the average stock in the New York Stock Exchange has actually been moving higher for the past six months.

Chart 1 below shows the New York Stock Exchange Index (NYSE) and the NYSE Advance/Decline Line. The darker line is the NYSE Index; it is weighted by market capitalization, and; therefore, gives much greater emphasis to the larger companies. The lighter line is the Advance/Decline Line; it measures the number of advancing stocks versus declining stocks on a daily basis. Because the A/D Line measures the action of stocks irrespective of their size, we use it as an indicator of the price trend of the average stock in the index.

Chart 1

NYSE Index & NYSE Advance/Decline Line 12 Months Ending July 3, 2001

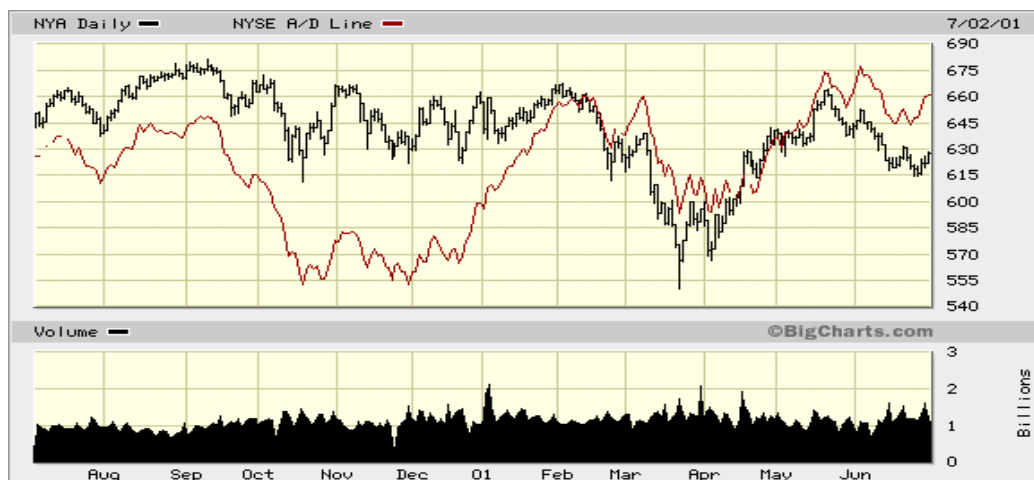


Chart 1 shows that large corporations, which dominate the NYSE Index, are stuck in a sideways trading range, while smaller to mid-sized companies, which make up the vast majority of companies in the index, are trending higher. With all of the bad news in the market over the last several months, the fact that the average company is moving higher comes as a surprise to most people.

Low Tech and Cheap

At first glance, other characteristics of these companies that are bucking the trends of economic and earnings worries are also surprising. The first characteristic of the average stock is that most are in businesses that are very sensitive to the economy, such as banking, finance, capital goods, energy, food, and retailing. Since we are in an economy that is, at best, sputtering along, for so many of these stocks to be moving higher is counterintuitive. Another characteristic is that they are cheap. That is, they are selling at much lower price-to-earnings ratios than the multinational companies that dominate the NYSE Index. These low-tech companies were largely left behind in the great bull market of 1997-1999. In a stock market of sky-high P/Es in recent years, it makes sense that these low P/E stocks would have their day. Other similarities of the average stock, however, are extremely confusing. During 2000, they had poor earnings growth, and their earnings were very erratic. These are not characteristics that you normally find in the top performing stocks. Indeed, these are characteristics that you usually find in the poorest performers. Most of these companies have struggled during the last couple of years because they are highly sensitive to interest rates and the economy. You might say they are "hardwired" to the US economy. Thus, the Federal Reserve's series of rate increases beginning in mid-1999 sent most of these hardwired companies lower long before their actual earnings began to slow. Investors apparently foresaw that the Fed's actions would eventually slow the economy and squeeze profits.

Honest Indicator

Chart 2 below shows that the sideways movement of the NYSE Index has actually been in place for at least two years.

Chart 2

NYSE Index and NYSE A/D Line 24 Months Ending July 3, 2001



The action of the average stock, however, has been a much different story. Over the past two years, it has been particularly revealing about the real health of the US economy. ***We believe the price trend of the average stock over the last six months is now signaling an important***

shift in the direction of the economy. Before we talk about what we think the trend of the average stock is saying today, let's briefly review what it has revealed over the past two years.

- June 1999: The economy is very strong and tech mania is aflame. The Fed initiates its first interest rate hike. The average stock falls immediately into a downtrend.
- April 2000: The average stock halts its downward trend.
- May 2000: The Fed ends its series of rate increases approximately one month after the average stock leveled off. **The clear message here is that the price action of the average stock correctly anticipated that the Fed was near the end of its rate increases.**
- September 2000: The NYSE Index hits a new high, and curiously, the average stock plummets. **The average stock is unfazed by the last gasp of the tech craze.**
- October 2000: Third quarter release of GDP growth reveals a dramatic slowdown in the economy. **The price action of the average stock in September 2000 correctly anticipated the trouble brewing in the economy.**
- December 2000: The average stock breaks out of its trading range and starts higher.
- January 2001: In a surprise move the Fed begins cutting rates, **again anticipated by the uptick in the price of the average stock a month earlier.**
- March and April 2000: When the full extent of the tech-wreck becomes apparent, the average stock holds well above its December lows, while the NYSE Index collapses to a new low. **While the investment media and pundits were screaming "recession," the average stock begins to anticipate a soft landing.**

Over the last two years, the average stock's price action has acted as an honest indicator of the economy and the sustainable trend of corporate earnings. We believe its positive price performance since the first of the year, in the face of bad news day after day, is suggesting that the Fed's very swift and sharp rate cuts will soon result in an improving economy.

More Evidence

Our confidence in this prediction is bolstered by the action of another indicator: the Regional Bank Index. Among corporations, no industry is more hardwired to the economy than the regional banks. In most cases they are the first line providers of capital to all but the very largest companies. Likewise, banks are the last line of capital when corporate America stumbles. When corporate America wins, the banks win. When corporate America loses, the banks lose.

Chart 3

Regional Bank Index and NYSE Advance/Decline Line 12 Months Ending July 5, 2001



Chart 3 shows the Regional Bank Index (darker line) and the Advance/Decline line, which is our proxy for the average stock (the lighter line). The most important message this chart reveals is that **the Regional Bank Index, like the price of the average stock, has made a succession of higher highs in the face of very poor economic news during the first six months of this year.** In our minds, the action of this index is strong evidence that credit worries resulting from the weak economy are being discounted. **Because the Regional Banks, like the average stock, are hardwired to the US economy, we believe their strong performance offers further evidence that the US economy will avoid recession and soon begin to improve.**

Multinational Company Headwinds

Everything we have talked about so far relates to the average stock, which we have described as smaller, slower growing, and more economically sensitive than the major multinational companies that dominate the popular indexes. **Can we extend the good news we see coming for the economy and the average stock to large multinational stocks? The short answer -- no. We would, however, quickly add that we do not think size is the major issue. The real determinant of growth potential in the year ahead is domestic business versus international business.** We think an improving economy in the United States is coming very soon. We are less excited by prospects around the world.

Recent statistics show that roughly 40% of the total earnings of NYSE companies are generated outside the United States, with most of that coming from the top 100 companies. Multinational companies have outperformed more domestically oriented companies for the last decade because their foreign sales and earnings have been growing faster than they have at home. Most major foreign economies now appear to be weakening, and no foreign central bank has been as aggressive as the US Federal Reserve in cutting rates to stimulate their economy. Finally, the rise in the US dollar, relative to other major currencies, hurts US multinational companies in two ways: (1) It depresses foreign sales because more pounds or yen are required this year than last to buy the same US made goods. (2) When US corporations bring profits made in pounds and yen back to this country, they are worth less than last year.

Investment Strategy

We believe the unfolding divergence between the US and the international economies will last at least a year and perhaps longer. Because of this, earlier in the year we began adding more domestically oriented companies to our clients' portfolios. Our goal is for the portfolios to have less dependence on foreign business than that of the major stock market indexes. We estimate that currently our portfolios derive nearly 40% of earnings from outside the US; we expect to continue this transition until the portfolios reach a point where their international earnings are in the range of 25% to 30%. While this is not a major shift, we feel this will position the portfolios to more directly participate in the recovery of the US economy. If we thought this current trend would be short-lived, we would just wait it out. But to stay put when the evidence now appears so clear is no longer wise. As the economy starts to show signs of improvement, we expect to see an acceleration in certain sectors that are already beginning to form uptrends. These are:

Banks, Savings & Loans, and Financial Services: We have been adding regional banks to our portfolios for the past six months and are currently overweighted in the Financial sector.

Retailing and Home Improvements: As consumer confidence rebuilds with an improving economy (and consumers receive their tax rebate checks), so will consumer spending. Our portfolios are well represented here, but look for us to add at least one other quality, domestically oriented retailer.

Other areas we expect to benefit from an improving economy are **Auto Parts, Media, Publishing, and Entertainment**

Energy: It will take several years for the supply of gas and oil to catch up with the current demand. That makes the Energy sector an attractive place for us to remain invested, even though most energy companies are international in scope.

Biotechs: As we described in our last quarterly letter, technological breakthroughs should keep the biotech industry outperforming the market over the next several years and will be an area for us to emphasize.

A Little More Evidence

While in this letter we built the case for a recovering economy and stock market, there are other statistics that come to the same conclusions from a different direction. Research by Standard & Poor's identified nine occasions since 1961 when profits of the S&P 500 companies declined for at least four straight quarters. Six of the nine were associated with recessions and three with economic soft landings. Eight times (out of nine) the S&P 500 index began recovering a quarter before corporations reported their worst profit declines. The average lead-time for the index was a little more than two quarters. June concluded the third straight quarterly decline in the current slowdown. As this letter is mailed, corporations will begin to report their second quarter 2001 earnings. You can bet the media will continue to highlight the bad news. But to find out where the economy is headed, we will have our eyes fixed on the hardwired companies we have spoken of here. We think the time is very close when they will begin to show signs of improving.

Blessings,

Greg Donaldson

Mike Hull

