A.R.Schmeidler & Co., Inc.

The Outlook

October 2002

As of October 17, 2002		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	-17.4	8,275.04
S&P 500	-23.4	879.20
Nasdaq Composite	-34.8	1,272.29

The Relentless Bear Market

The relentless bear market of six straight down months has eliminated more than $8 trillion of market value since the decline began two-and-a-half years ago. The market is now at one of its most oversold levels ever. Investor's Business Daily publishes a daily mutual fund index of 26 leading growth equity funds. As of yesterday, it is down 26.5% for the year and the Dow Jones Average has declined 17.4% this year. **To believe that this is not likely to affect U.S. economic activity is unrealistic considering that the $8 trillion decline is almost 80% of one year's gross domestic product.**

Global Economic Weakness

Global economic growth is more dependent on the United States than at anytime during the past decade. **Each economic region has lost its growth driver.** Brazil, the engine of growth for Latin America, has faltered. Japan, the world's second largest economy, continues in its deflationary mode, still unable to effectively handle its banking problems. This leaves China as the growth driver of Asia and the leading source of worldwide deflation. Moreover, Europe is no longer able to depend on Germany and France to enhance global growth prospects. On the contrary, Germany may be on the verge of a significant policy mistake as it shows signs of slipping into recession while the government considers tax increases and spending cuts to reduce its budget deficit in order to conform to the agreed fiscal discipline required by the stability and growth pact of the European Union. At the same time, European Central Bank President William Duisenberg again indicated that Euro zone interest rates should remain unchanged. On the other hand, France, to honor its election tax cutting pledges refuses to meet its obligations under this same pact. Mr. Duisenberg made clear that each government has to spur recovery by pursuing tax and labor market reforms. The European Central Bank is quite concerned that the stability and

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growth pact is at risk. This is occurring while German unemployment is rising, putting more pressure on the financial system.
The financial systems of all the major economies are coming under increasing stress. Credit downgrades are rising, delinquency rates are moving higher and global equity markets have been hitting new lows. To make matters worse U.S. investors have lost confidence in corporate behavior and are facing continued downward revisions of earnings for the third quarter and an uncertain outlook for the fourth quarter. **Some of the issues presently weighing on the markets are:**

- **A war against Iraq…**
- **Declining consumer confidence…**
- **Reduced business spending…**
- **Pension fund rate of return assumptions that are too high ranging from 8% to 10% per annum and must be reduced. Corporations will have to take money out of profits to add to their funds, thus reducing reported earnings.**
- **State and local governments' budgets moving into deficit…**
- **Rising mortgage delinquencies…**
- **Proforma earnings results being reported versus actual earnings results, which tend to put a better face on earnings reports…**
- **Energy prices that are too high with oil near $30 a barrel and natural gas over $4 per mcf.**

Under these conditions, estimating next year's earnings is particularly challenging. Many investors now feel that equity securities must sell at extremely attractive prices in order to cause them to be enthusiastic about buying.

The Equity Market is Oversold

The S&P 500 has declined approximately 25% for this year and almost 50% from its peak. During July, $51 billion were pulled out of mutual funds, a record amount of cash, as investors could no longer put up with such dramatic declines. Is it possible that this long, painful bear market is almost over? The technology bubble has still not fully deflated as evidenced by the heavy and costly debt burdens which continue to plague the telecom sector. In the attempt to reduce costs, telecom and related companies have been laying off employees to bring costs in line with revenues. **With October being the end of the year for most mutual funds, tax selling could put additional pressure on overall market valuations. However, the equity market was so oversold, and the short-interest was so large that a significant market reversal is occurring at the present time.**

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Fixed Income-Credit Risk

Barrons' confidence index, which is the ratio of the yield of the highest-grade bonds to the yield on medium grade bonds, has declined to the lowest level in many decades. **Rising individual and business credit risks have affected bank and insurance equity valuations. If the corporate-bond market continues to lead the stock market down, then equity prices could come under further pressure.** However the lead-time has been about two to four months which would mean that by early next year, if the corporate-bond market stabilizes, we could see the end of this phase of the stock market decline.

With investor confidence badly damaged by Wall Street's conflicts of interest and corporate scandals, many investment strategists view the market as significantly undervalued, particularly so when based on their estimates of next year's earnings. From our perspective we do not accept the view that next year's earnings will be materially better than this year's. **Corporate profits continue to be at risk**. **Since the market will reflect bad news before it occurs, this bear phase will be over while the outlook could still appear to be difficult. At that time great values will have been created for long-term investors. Portfolio structure should encompass the following areas - energy companies, defense companies, insurance companies, high dividend-yielding quality equities, and select technology companies. Should deflationary forces persist as we expect, U.S. Treasuries Bonds should benefit as interest rates continue to decline.** Investment flows into China are expected to continue as China continues to build a manufacturing powerhouse creating continuing deflationary pressures on the global economic system.

Consumer Spending

The stock market continues to take a toll on Americans' household net worth. **Economists now worry that a sustained decline in household net worth could cause consumers to sharply cut back on spending.** Household net worth is a measure of total assets such as homes and retirement funds, minus liabilities such as mortgages and credit card debt. Current consumer spending, while healthy considering the soft economy, still is growing at only about half the rate it did during the late 1990's. **The negative wealth effect from the stock market has slowed consumer spending and hurt the economic recovery.**

Expectations for Future Economic Growth

Expectations for future economic growth are highly uncertain as the recovery remains in question from quarter to quarter. **Business demand is uneven and erratic, export demand is weak, and state and local governments are struggling financially.** The Federal Reserve's latest survey of business

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conditions has found significant economic weakness. The report known as the "beige book" was not weak enough to push the Federal Reserve to lower interest rates at their September 24th meeting. The Federal Reserve is hoping that once concerns over a weak stock and corporate-bond market subside, low interest rates will propel the economy back to a reasonably healthy growth pace by the end of the year. The "beige book" found residential real-estate markets and automobile sales both strong, but conditions elsewhere generally were sluggish or declining. **With the job market still weak and consumer spending power being eroded by high energy prices, near-term growth in consumption depends more and more on home equity refinancing and modest growth in real income for those who are working.** The latter story is mainly one of increasing productivity, which allows for higher real wages without inflation. Home equity refinancing depends on low interest rates and rising home prices.

The Federal Reserve

The consumer sector accounts for more than two thirds of the nation's gross domestic product. September retail sales were weak; it was the third consecutive month that consumers held back on spending amid doubts about the economy and fears of a war against Iraq. These concerns do not bode well for the important holiday shopping season just ahead. We expect consumer spending to slow during the fourth quarter. Should the economic data begin to show even weaker performance, the chances would improve for the Federal Reserve to cut interest rates further. **The Federal Reserve Board's recent decision to leave interest rates unchanged reaffirms the belief that borrowing costs are low enough to keep the U.S. from falling back into recession. However the Federal Reserve is leaving the door open to a possible interest rate cut later on this year if the economy continues to show weakness.**

Conclusion

The leading stock market averages have fallen to lows not seen in over five years. The markets are focused on uncertainties regarding the state of both the domestic and the international economy. **The two-and-a-half year bear market has brought many equities down to price levels that should be rewarding when the economy begins to recover. The globalization of markets and low-cost foreign competition make it more important than ever to direct investment dollars to the companies with strong balance sheets, dominant market position and superb management.**

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