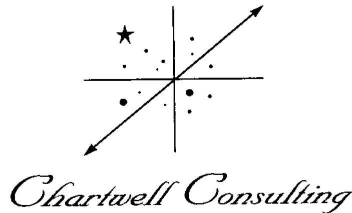


CHARTWELL REVIEW

July 12, 2002 — **SECOND QUARTER 2002** — Volume IX, Issue No.2

THE SUM OF ALL FEARS

Three years ago, our title could be easily explained for most investors by one thought – "do we have enough equity exposure, especially to the tech, telecom, and media sectors?" Nothing else seemed to matter.

Now, the list of our fears is very long –

How will ongoing terrorist activity affect us? Can we win our declared war against it?

Will our monetary and fiscal policies be successful, or simply raise inflation issues?

Will a declining U.S. Dollar negatively impact our domestic investments?

Can we ever trust corporate managements not to defraud us, or were Worldcom, Enron, Tyco, Adelphia, et al just tips of an iceberg?

Will corporate earnings rise soon enough, and fast enough, to end this bear market?

If equity markets really do "climb a wall of worry", they may have enough ammunition to explode to the upside.

Table 1. Index Benchmarks

	Q2	Trailing Returns *			
	2002	**1Yr**	**3Yr**	**5Yr**	**10Yr**
S&P 500	(13.4)	(18.0)	(9.2)	3.7	11.4
Large-cap Stocks	(14.7)	(20.5)	(11.5)	2.9	11.1
Mid-cap Stocks	(9.5)	(9.3)	1.1	7.5	12.7
Small-cap Stocks	(8.4)	(8.6)	1.7	4.5	10.9
International Stocks	(2.0)	(8.9)	(6.0)	(0.8)	6.2
T-bills (3 month)	0.5	2.8	4.7	4.9	4.8
1-3 Year Gov't Bonds	2.5	7.0	7.0	6.6	6.1
Aggregate Bonds	3.7	8.6	8.1	7.6	7.4
High Yield Bonds	(7.0)	(4.4)	(2.1)	1.1	6.3
Global Bonds, hedged	2.8	5.7	6.8	7.6	8.2
CPI, annualized	0.7	1.2	2.7	2.3	2.5

* Annualized trailing returns for periods ending 6/30/02.

Table 2. Average Mutual Fund Returns

	Q2	Trailing Returns *			
	2002	**1Yr**	**3Yr**	**5Yr**	**10Yr**
US Large-cap Core	(13.4)	(19.1)	(9.4)	2.1	9.6
US Small-cap Core	(7.8)	(4.0)	7.9	7.3	12.3
International Equity	(2.9)	(10.1)	(5.3)	(0.7)	5.7
Emerg. Mkt. Equity	(7.4)	1.3	(3.7)	(7.3)	1.0
Balanced/Hybrid	(6.9)	(8.6)	(2.1)	4.1	8.7
Inv. Grade Bonds	2.7	6.7	6.8	6.4	6.5
Government Bonds	3.9	7.9	7.1	6.6	6.4
High Yield Bonds	(4.7)	(3.6)	(3.2)	(0.5)	4.8

* Annualized trailing returns for periods ending 6/30/02.
Source of fund's data: Lipper

Copyright @2002 Chartwell Consulting(USA) LLC All rights reserved.

Changing Lanes

We caught up recently with our three "evil" friends – Seeno, Hearno and Speakno. They were each traumatized by second quarter developments. Of the three, Hearno is the worst off. He sees the equity market's extreme weakness (see table 1) as clear evidence that stocks will continue to decline. Most investors share this belief, and have plenty of reasons to back it up. Many of Hearno's colleagues also believed the equity markets would continue to *rise* after the three extraordinary years 1997-99, and had plenty of reasons to back it up.

Seeno views the equity market's extreme weakness as clear evidence that stocks will rebound. Just like last quarter, he figures all the bad news is now out and its time for equities to sharply rebound. Not too many investors seem to share Seeno's rose-colored optimism.

There are a growing number of investors who acknowledge the merits of maintaining a strategic exposure to stocks, but are intrigued by the prospect of "selling the market" whenever they perceive weakness. In short, tactical asset allocation is back in fashion. As a caution to these investors, we offer the following –

Table 3. Cost/Benefit of Market Timing

Periods ended June 30, 2002; indices are cap-weighted

	Last 5 Years
Return of the S&P 500, p.a.	3.7%
Return of the S&P 500, if you *miss the **WORST** 5 months*	14.4
Return of the S&P 500, if you *miss the **BEST** 5 months*	-4.3

Minority Report

Everyone was excited by the 1st quarter's big story - the surprising 6.1% rise in real GDP. All the details of this are now in. Primary contributors to the quarter's surprisingly high growth rate were –

- Personal consumption spending +2.4%;
- Change in inventories +3.4%;
- Fixed Investment (0.1)%;
- Government spending +1.2%;
- Net Exports (0.8)%.

Investor focus during the *second* quarter was on discerning the next big moves for the two mainstay elements of economic activity – personal consumption spending and fixed investment. Hardly the stuff of headlines.

2Q Growth

Inventory re-build adds very little to sustainable growth, so economists are still worried the consumer will take a break, after carrying our economy for so long. Based on data through May, consensus expectations are for real GDP growth to have moderated substantially in the 2nd quarter, to around 2.4%. Those surveyed for the Wall Street Journal's mid-year economic forecast expect 2nd half GDP growth in the 3.5% range, with no "double-dip" recession in sight. These are very low growth numbers compared to prior recoveries, but the slump was also mild (the economy's slump, not the slump in corporate profitability).

2Q Consumer & Corporate Spending

Growth in personal consumption is the largest component of GDP growth. It, in turn, is a function of three items:- growth in disposable personal income, less interest payments and personal savings.

Disposable personal income rose at only a 1.1% nominal annualized rate during the quarter ended May 2002 (latest data available), after rising 3.7% the prior 3 months. At the same time, the personal savings rate has risen in 2002 to a fairly consistent 3.0% of disposable income (versus an average of only 1.4% during 2001), as the consumer re-builds his liquid asset base.

An increased savings rate is a long-term positive, but it means less current personal spending. This rose at an annualized rate of only 0.8% during the 3 months ended May, or less than the increase in disposable personal income.

Copyright @2002 Chartwell Consulting(USA) LLC All rights reserved.

The consumer may finally be underspending their income. This is consistent with 2nd quarter consumer confidence reports, which pointed to an increasingly cautious outlook even though current circumstances were judged to be okay.

The other linchpin of economic growth is fixed investment, both residential and corporate. The former is for housing, and growth has been robust indeed. After an understandable decline of 4.6% in last year's 4th quarter, residential fixed investment jumped *14.6%* in 1st quarter 2002. With mortgage rates back to their lowest point in 30 years, new home sales continued to set records in the 2nd quarter (up 8.1% in May).

It is corporate fixed investment that remains "punk", as they say, with only faint signs of stabilization. Investment in the commercial structures area remains in a free-fall, declining by 22.8% in real terms during the 1st quarter of 2002 compared to the preceding period. Yet, real investment in the much larger area of equipment and software finally rose (a very modest 0.1%) in the 1st quarter, after 5 consecutive declines.

▫ *2Q Production and Capacity*

Industrial production rose 0.2% in May (latest data available), the fifth consecutive monthly increase. It is up 2.0% since the December 2001 low point (but off 1.4% since May 2001). Despite the recently increased activity, inventories during the early part of the 2nd quarter declined to their lowest levels since October 1999. Factory orders, a more forward-looking measure of activity, also rose in April and May.

Increased production without inventory build-up suggests that manufacturing activity will continue to rebound. A series of reports late in the quarter underscored this thought. Most important was the Institute of Supply Management's June survey of purchasing managers, in which 56.2% of participants reported that manufacturing activity has increased, and inventories were too low. This marked the 5th straight favorable ISM survey.

▫ *2Q Employment*

Investors are anxious for confirmation that business activity is expanding, in the form of higher employment levels. This didn't happen during the 2nd quarter, just as it had not during the first. Some pundits are calling it the jobless recovery, but labor markets almost always lag behind changes in real economic activity. This is due to the determination of employers to boost output $ per employee $ (productivity) rather than the *number* of employees (overall labor productivity rose a very sharp 8.3% in the 1st quarter, and will again rise during the 2nd).

Employment was 134.05 million persons in June, down slightly from May but up more than 100,000 persons from the March low point. Since June 2001, a million fewer people are employed. The unemployment rate was reported out at 5.9% for June.

▫ *2Q Inflation*

Consensus is that inflation hasn't been an issue for many years, and won't be. As we see it, the 2001 recession knocked prices for a loop, just as they were about to become the next big concern. The following table reveals how rising price pressures in 2000-1 have dissipated in 2002.

Table 4. Inflation Breakdown

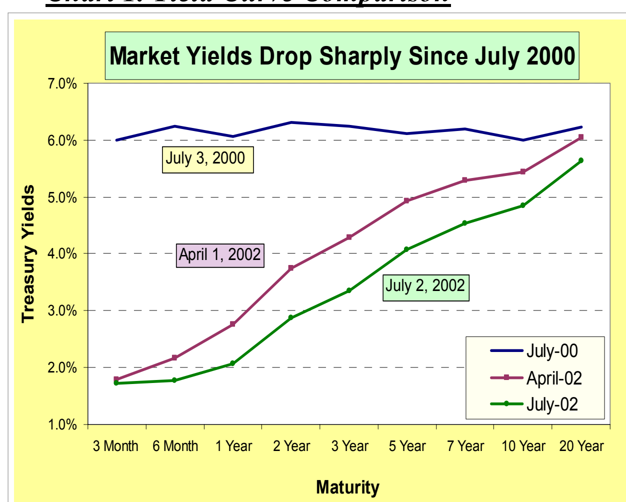
% change during the 12 months ended -	**May 2002**	**May 2001**	**May 2000**
CPI, all	***1.2%***	***3.6%***	***3.1%***
- Housing	2.2	4.6	2.9
- Transportation	(3.4)	4.0	6.2
- Medical Care	4.7	4.6	4.0
- Energy	(13.3)	15.8	14.6
---------------------	------	------	------
PPI, all	***(2.7)***	***3.8***	***3.9***
- Consumer Goods	(3.5)	4.7	4.9
- Raw Materials	(15.8)	12.9	18.5

Copyright @2002 Chartwell Consulting(USA) LLC All rights reserved.

Bonds in Black II

As evidence of a *slowly* recovering economy took shape during the quarter, investors became much less concerned about the Federal Reserve taking back its last round of rate cuts (those made after 9/11). Market yields in the 1-3 year maturities began drifting down sharply in April, and ultimately declined 67 – 95 basis points for the quarter. This is an enormous proportionate move, when you consider that the 1-year Treasury note started the 2nd quarter at a yield of only 2.76%.

Chart 1. Yield Curve Comparison



Ultimately, the downward pull of falling short rates had a similar effect on 5-20 year maturities, as Chart 1 reveals.

The interest rate environment is quite different, and much more benign, than just two years ago. The Fed's aggressive easing accounts for the 40-year low in short-term rates. However, long-term yields are more a function of market attitudes. Much of the quarter's 115 basis point drop in the 10-year T-bond's yield, to only 4.79% at quarter's end (and 4.57% today), was because of a flight to safety; away from both low quality fixed income holdings and low returning equity securities. But, with long-term inflation averaging 2.5%, and the economy now growing (slowly), it is reasonable to expect the long bond's yield will spend more time nearer 5.50% during the next two years, than 4.50%.

Results of the 2nd quarter's fixed income activity are outlined in Table 5. It was a very good quarter (and year) for taking interest rate and currency risk. It was a very bad quarter for investing in almost any bond rated less than 'A'.

Table 5. Fixed Income Sector Returns

Periods ended June 30, 2002; indices are cap-weighted

	2Q02	1 Year	3 Years
Aggregate Bonds	*3.7%*	*8.6%*	*8.1%*
US Treas, long	6.0	9.1	8.5
US Gov't, all	4.4	8.8	8.0
Mortgages	3.4	9.1	8.4
Aa Credit Bonds *	4.4	10.0	8.9

Baa Credit Bonds *	1.5	5.2	6.3
High Yield Bonds	(7.0)	(4.4)	(2.1)
Global Bonds	11.7	14.0	4.5
Global Bonds, Hdgd	2.8	5.7	6.8

* *investment grade only*

Road to Perdition

Table 6 summarizes the second quarter's domestic equity returns, broken down into market cap and "style" sectors. There are only two printable words that come to our minds as we review these figures – capitulation and confidence (actually, lack thereof).

Table 6. Equity Returns by Style/Market Cap

Periods ended June 30, 2002; indices are cap-weighted

	2Q02	1 Year	3 Years
Growth			
Large Cap	(18.8)	(26.5)	(17.5)
Mid Cap	(18.3)	(26.4)	(9.2)
Small Cap	(15.7)	(25.0)	(9.6)
Value			
Large Cap	(10.2)	(13.3)	(6.2)
Mid Cap	(4.7)	1.9	5.2
Small Cap	(2.1)	8.5	12.1

Copyright @2002 Chartwell Consulting(USA) LLC All rights reserved.

The domestic equity market has left all investors with an extreme sense of vertigo. We've been so tossed around by events of the last two years, it's very hard to tell which end is up. At points like these, information entering the marketplace is not always rationally distilled and acted on. From that standpoint, the investing climate is similar to the months surrounding the millennium – only reactions are the polar opposite. The following helps illustrate how domestic equity markets reached their present state: -

	6/30/00	6/30/02
S&P 500 Index Value	1455	983
- % change, prior 2 years	+28%	-32%
Trailing Operating Earnings	$55.59	$42.19
- % change, prior 2 years	+24%	-24%
Current P/E, weighted avg.	26.2x	23.2x
Current P/E, median	14.3x	18.9x
Current 10-Yr Bond Yield	6.18%	4.79%

As of June 2000, two years of rapid earnings growth had resulted in an even faster rising market index, the weighted P/E of which dramatically exceeded the median P/E. The latter fact was attributed to the very high valuations of the largest 10% market cap stocks compared to P/E ratios of the remaining 90%.

Now, two years of sharply falling earnings have resulted in an even faster falling broad market index. The weighted P/E of the S&P index is now lower and much closer to the median P/E, because the prices and earnings of the largest market cap stocks have ended up being weaker than that of the remaining 90%.

In effect, the "efficient" marketplace did an absolutely terrible job of pricing equities two years ago, because it naively extrapolated past earnings, which had represented a "blow-off" period, particularly for the largest market cap companies. It makes one wonder whether the irrational exuberance of 1999-2000 has simply been replaced with irrational pessimism.

Table 7. S&P 500 Sector Scorecard

Sector (*% of S&P*)	2Q02	YTD 2002	5 Years, p.a.
Info Tech *(15)*	(27.5)	(31.6)	(0.4)
Financial *(20)*	(7.9)	(5.2)	6.9
Health Care *(14)*	(17.4)	(17.2)	5.9
Utilities *(3)*	(17.8)	(15.7)	(0.3)
Consumer Staples *(10)*	(3.6)	4.6	2.3
Energy *(8)*	(5.5)	3.0	3.9
Consumer Disc. *(14)*	(12.2)	(10.2)	7.5
Industrials *(11)*	(14.7)	(16.0)	2.2
Telecom Services *(4)*	(24.3)	(36.0)	(6.0)
Raw Materials *(3)*	(2.7)	7.5	(0.9)
S&P 500	**(14.0)**	**(13.8)**	**2.3**
S&P Growth	(17.0)	(17.4)	1.5
S&P Value	(11.2)	(10.3)	2.2

Periods ended June 30, 2002; indices are cap-weighted; price changes only

Capitulation and lack of confidence is evident when we look at Table 7. For the first time in our collective memory, each sector index of the S&P 500 fell during the 2nd quarter. Equity investors could not find any area they collectively wished to rotate into, even modestly, despite rising projected earnings for many of these sectors.

In the mist of all this carnage, stocks of very few *industries* provided investors with black ink during the 2nd quarter. They included – packaged foods producers (+4%), REITS (+1%), managed health care operators (+14%), apparel retailers (+3%), homebuilders (17%), and metals/mining (+6%).

Episode II: Attack on the Dollar

Developed international markets continued to outpace US equities in the second quarter, although broad market indices were unable to finish in positive territory. After posting positive returns in April and May, international markets turned negative in June on concerns the slowing US economy and corporate accounting scandals would have repercussions abroad.

Copyright @2002 Chartwell Consulting(USA) LLC All rights reserved.

Table 8 illustrates 2nd quarter international markets' performance was largely driven by the slide in the US$, which fell 13% against the Euro, 11% against the Yen and 7% versus the Pound.

Table 8. International Equity Markets

Cumulative % returns for the periods ended June 30, 2002

	1Q02		One Year	
	Return In US$	Return In Local Currency	Return In US$	Return In Local Currency
MSCI EAFE	**(1.9)**	**(11.1)**	**(9.2)**	**(18.5)**
MSCI Europe	*(4.3)*	(13.7)	(7.4)	(19.0)
- Germany	(6.5)	(17.4)	(13.0)	(25.4)
- UK	(5.5)	(11.7)	(6.9)	(14.1)
MSCI Pacific	*4.3*	*(4.2)*	*(13.3)*	*(17.2)*
- Japan	6.6	(3.6)	(16.6)	(19.9)
MSCI EMF	**(8.4)**	**(9.4)**	**6.2**	**1.3**
- EMF Asia	(5.9)	(10.6)	16.2	11.6
- EMF Latin	(21.2)	(9.3)	(20.0)	(4.4)
- EMF Europe	(9.8)	(10.1)	(8.3)	(5.9)

Data Source: Capital Guardian

Among developed countries, only New Zealand posted a positive return in local currency terms. But, after accounting for the US Dollar's decline, every developed market country except Finland beat the S&P 500 during the quarter. Japan's +6.6% return was highest among major markets.

During the quarter, the Bank of Japan intervened in currency markets to curb the appreciation of the yen, which could derail an export-led recovery. Other Pacific Rim markets fell only modestly, as economic news remained positive for the region. European markets slipped even though economic news was also positive. Inflation has remained low and this has tempered concerns over imminent interest rate increases. In Emerging Markets, Latin American was the weakest due to heightened political concerns in Brazil.

Sector performance in Europe tracked generally with that of the U.S., as Information Technology, Telecom Services and media companies were very weak. Consumer staples (food & beverage), materials and utilities firms were strong performers in Europe and Japan.

Where Do We Go From Here?

Over the next two years, investor markets will ultimately resolve the crisis of confidence regarding corporate governance and honest financial reporting (we'd jail offenders).

To us, the most important fundamental issues during the next two years are the path of the U.S. Dollar (and its impact on inflation) and the rapidity with which corporate operating earnings again reach mid-1999 levels.

But, the equity markets have now become undeniably cheap. Under the twin conservative assumptions of moderately rising long-term interest rates and a *slower than expected* rebound in operating earnings, we estimate the S&P 500 index (today's value = 927) will be up 18-30% inside two-year's time. Developed international markets, with their "advantage" of being priced in non-$ currencies, should outperform these figures. While these returns may pale in comparison to 1995-99, they will handily exceed fixed income alternatives.

Accordingly, we recommend institutional investors with at least a two-year horizon (which should be most everyone) actively keep equity allocations at the neutral level of their particular strategic target asset mix, or higher, even if that means shifting money into equities.

See you next quarter!

Natalka Bukalo

Richard Shaffer, CFA