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December 4, 2002

DJIA: 8742.93

SPX: 920.75

NASDAQ: 1448.96

IN SEARCH OF A GOOD CHRISTMAS

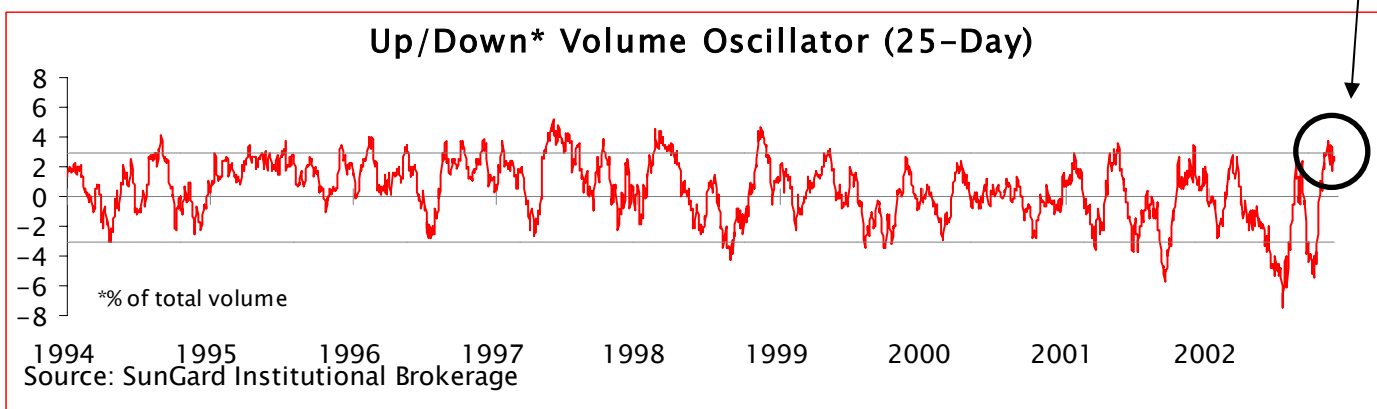
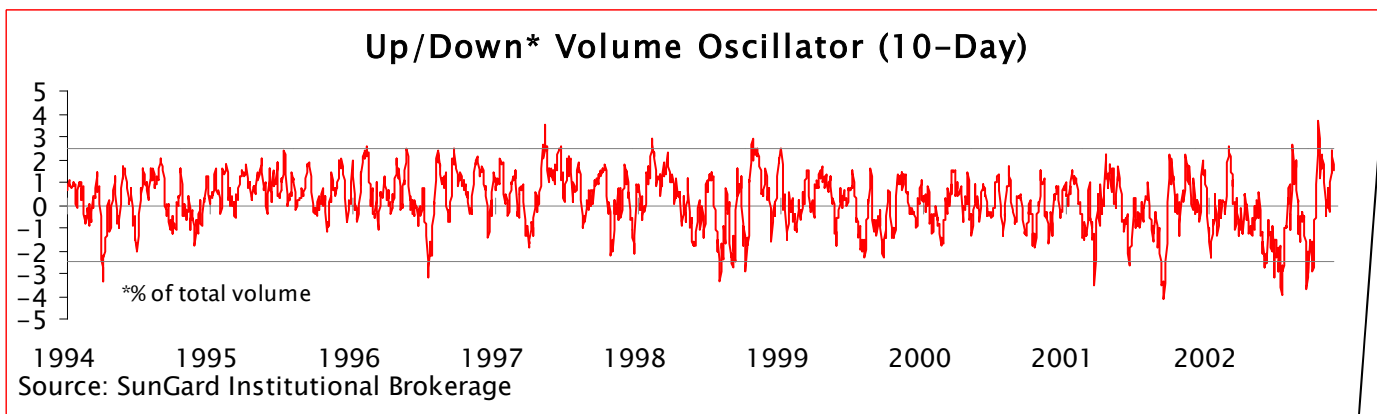
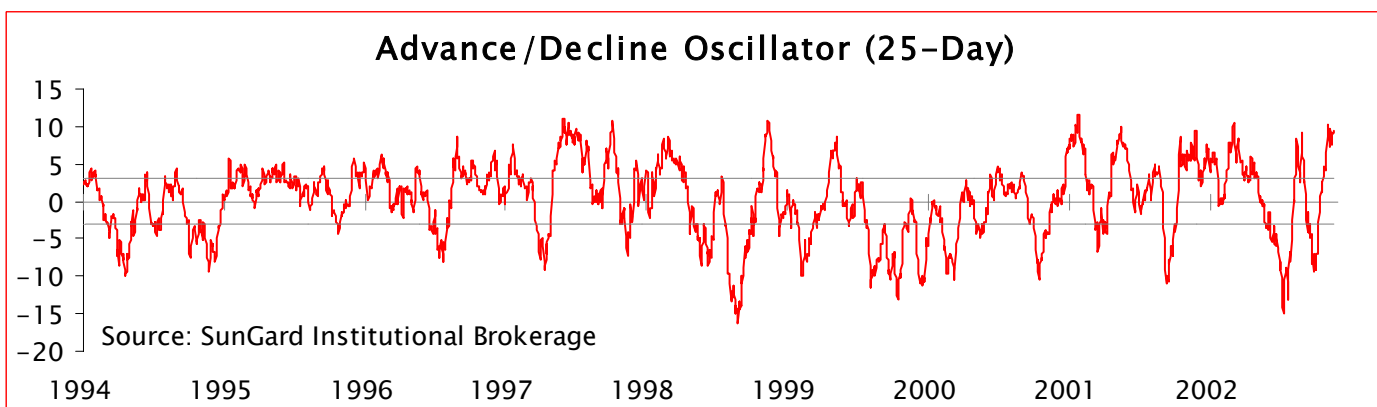
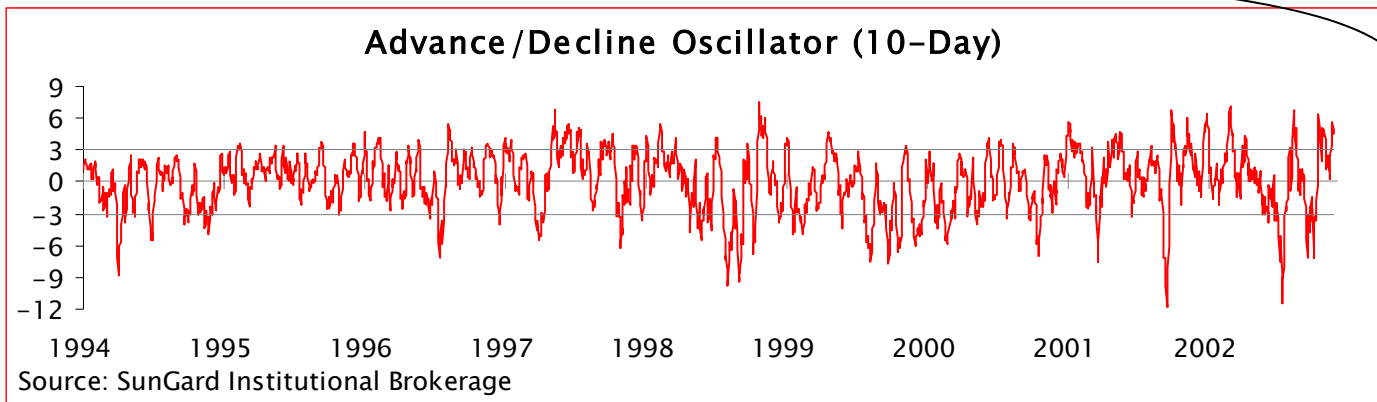
- It wasn't the timing of the rally that surprised us, as much as its personality. We tend to forget that for many investors, the stock market is as much a game as it is a serious investment process. In this vein, technology – the most depressed sector during the early October season – represented the best trading “play” in anticipation of a year-end rally. The high valuations in technology appeared irrelevant.
- But this “play” has been completed. The DJIA, SPX, and Nasdaq Composite are facing their long-term downtrends, best represented by the 200-day moving averages at 9168, 981, and 1492, respectively. In short, the difficult part is here. The Nasdaq Composite Index has toyed with its 200-day moving average in three of the last four trading sessions, but so far, without any success of bettering it. Cisco Systems (CSCO – \$14.52), a key technology bellwether stock, is attempting to hold its 200-day moving average (\$14), but looks wobbly to us.
- Our favorite cycle-defining breadth oscillator has been waffling at the overbought range for two weeks, but has been unable to record an extreme or steady overbought reading.
- We introduce a new liquidity measure this week that implies a stock market peak is likely in December.
- Recent data indicates equity mutual funds had outflows of \$7.71 billion in October (\$7.5 billion in domestic equities), while foreign investors sold \$6.5 billion U.S. equities in September. When we sum the flows of these two investors on a 12-month basis, the results have an uncanny resemblance to the Nasdaq Composite Index. What is notable is that over the last 12 months, equity funds have experienced net outflows of \$6.65 billion, whereas foreign investors have been buyers of \$43 billion of U.S. equity. This helps to explain why the trend in the dollar is important to the supply/demand balance for equities.

- Much of the recent rally, in our view, has been professional investors shifting assets from long-term assets (value stocks, healthcare) to short-term assets (low-priced tech/telecom shares). It has not come from individuals who are generally the source of a more stable trend. But this institutionally-driven rally may soon be over given that equity mutual fund cash was 5.1% in October and probably declined substantially in November. Note that the record low of 4% cash was recorded in March 2000, at the peak.
- The household sector's asset mix is changing in 2002 due in large part to price performance. But it is also a result of the public's growing interest in real estate and fixed income securities. Despite the implication of many forecasters that money market fund assets represent a huge untapped source of demand for stock, money market funds have actually seen withdrawals of \$145.7 billion year-to-date. Equally important is the fact that only 46% of money market fund assets are retail-oriented, according to Federal Reserve data. Institutions and corporations control the remainder.
- The consumer is critical to the economic forecast for 2003. The recent Fed rate cut, coupled with fiscal stimulus, are surely stabilizing factors. But will these pluses offset a possible peak in real estate prices, 2002 stock market losses, and a weak job market? We are not convinced. There will be a major focus on retail sales in coming weeks, since Christmas could be a last hurrah for consumers who may be tapped out after a strong year of auto and home purchases. Some of the year-over-year comparisons on consumer income and retail sales look encouraging, but could be distorted by post-September 11 data.
- It will all come down to jobs. We are encouraged by the two consecutive weeks of initial unemployment claims under 400,000. But the surrounding data is still worrisome. Continuous claims remain high, a six-month average of announced layoffs is trending higher and Help Wanted ads fell to a new cyclical low in October. These factors may be behind the second half slump in consumer confidence. All three confidence indices (Confidence Board, University of Michigan, and UBS) have fallen sharply, but ticked up in November. Was this the stock market rally, or something more sustainable? More time is needed to know for sure. But we believe the anticipation of good news is already priced into stocks. What may not be in today's stock prices are: earnings warning season, deepening Iraqi tension, or worst of all, a weak Christmas selling season.

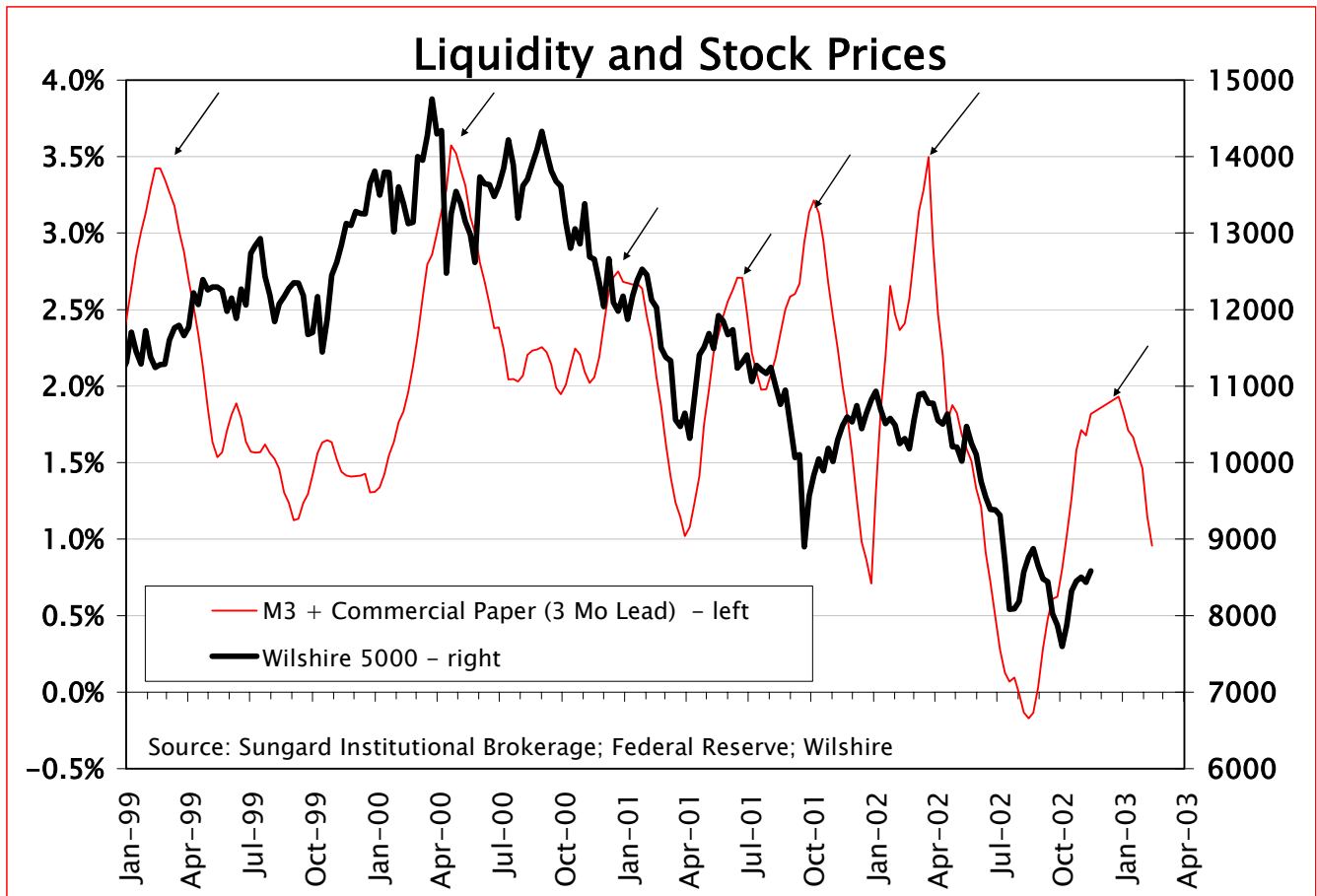
The easy part of the rally is clearly over as all three indices approach their 200-day moving average lines. The NASDAQ Composite is the most interesting to watch, since this is where market action has been concentrated, and its moving average is close at 1492.



It has been two consecutive weeks of waffling in and out of overbought territory for most of these indicators. Our favorite indicator, at the bottom of the page, has been exciting to watch, but has not been able to generate an extreme or stable overbought reading.



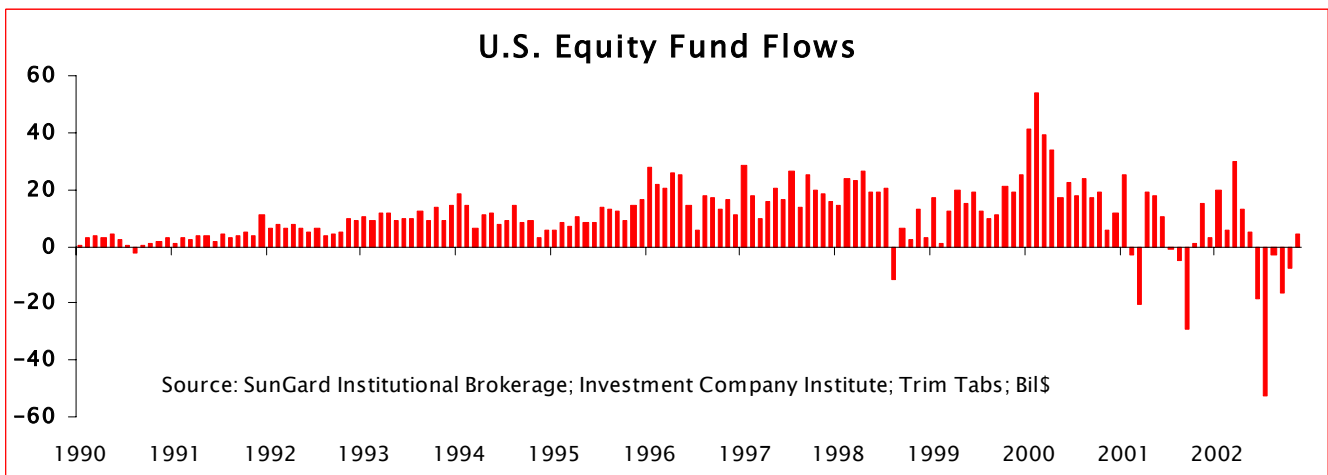
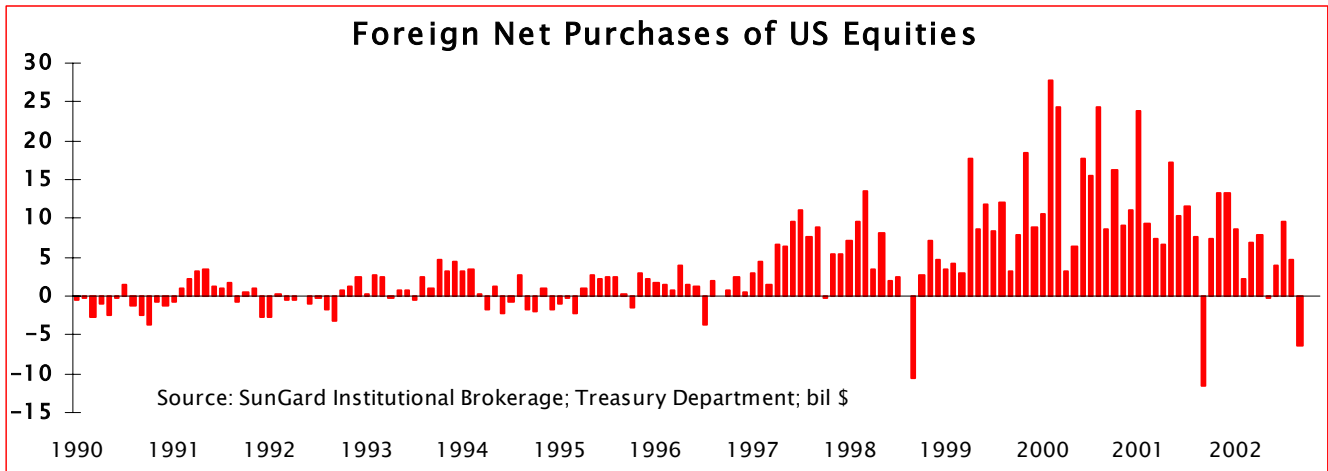
This liquidity measure is another favorite. A peak in liquidity tends to precede a peak in the stock market by approximately three months. A table of recent liquidity peaks is included below. Four of the six previous liquidity peaks (marked by arrows in the chart) were timely forecasters. The October 5, 2001 liquidity peak was distorted by 9-11-01. The liquidity peak made in September suggests a stock market peak around December 22.



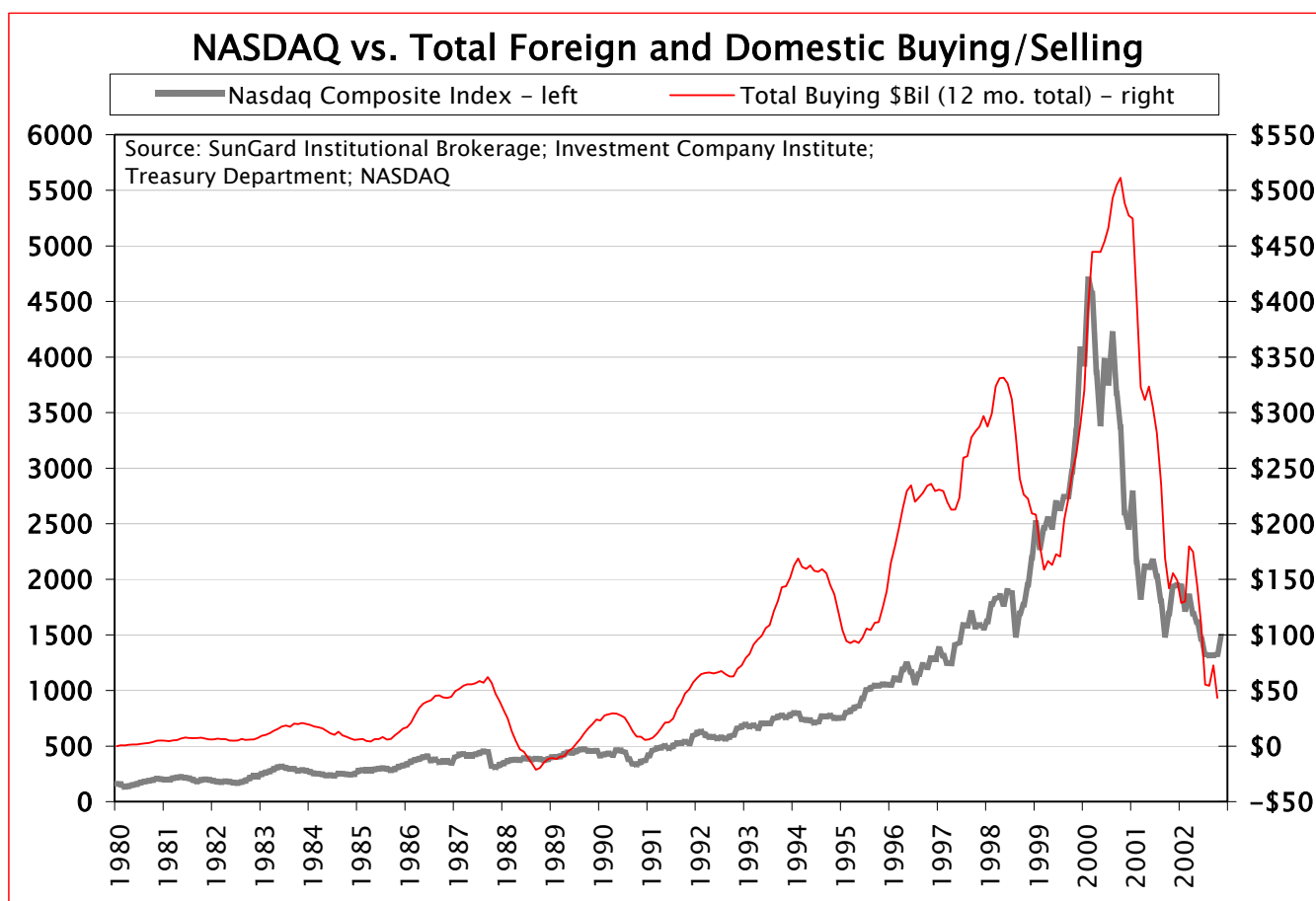
Forecasted market peaks by liquidity	Actual peak in Wilshire
February 19, 1999	none
April 28, 2000	April 24, 2000 (14751.64)
December 29, 2000	December 8, 2000 (12666.54)
June 22, 2001	May 25, 2001 (11923.52)
* October 5, 2001	none
March 22, 2002	April 19, 2002 (10635.05)
? December 22, 2002	??

* impacted by post September 11, 2001 liquidity surge

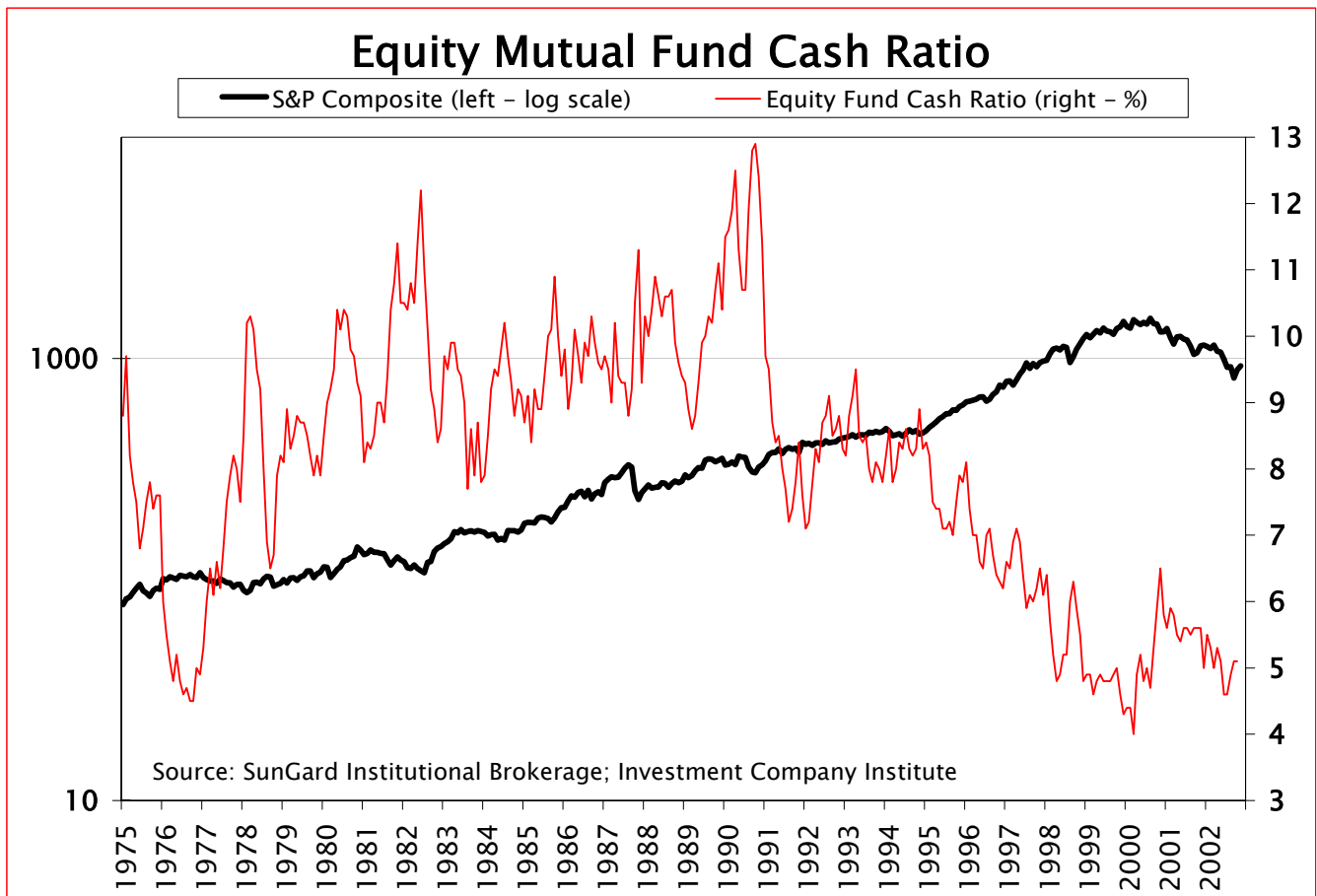
Foreigners sold \$6.5 billion of U.S. equity in September. In the 12 months ended in September, foreigners were net BUYERS of \$71 billion of stock. Equity mutual funds experienced outflows of \$7.71 billion in October. In the 12 months ended in October, equity funds had net OUTFLOWS of \$6.65 billion.



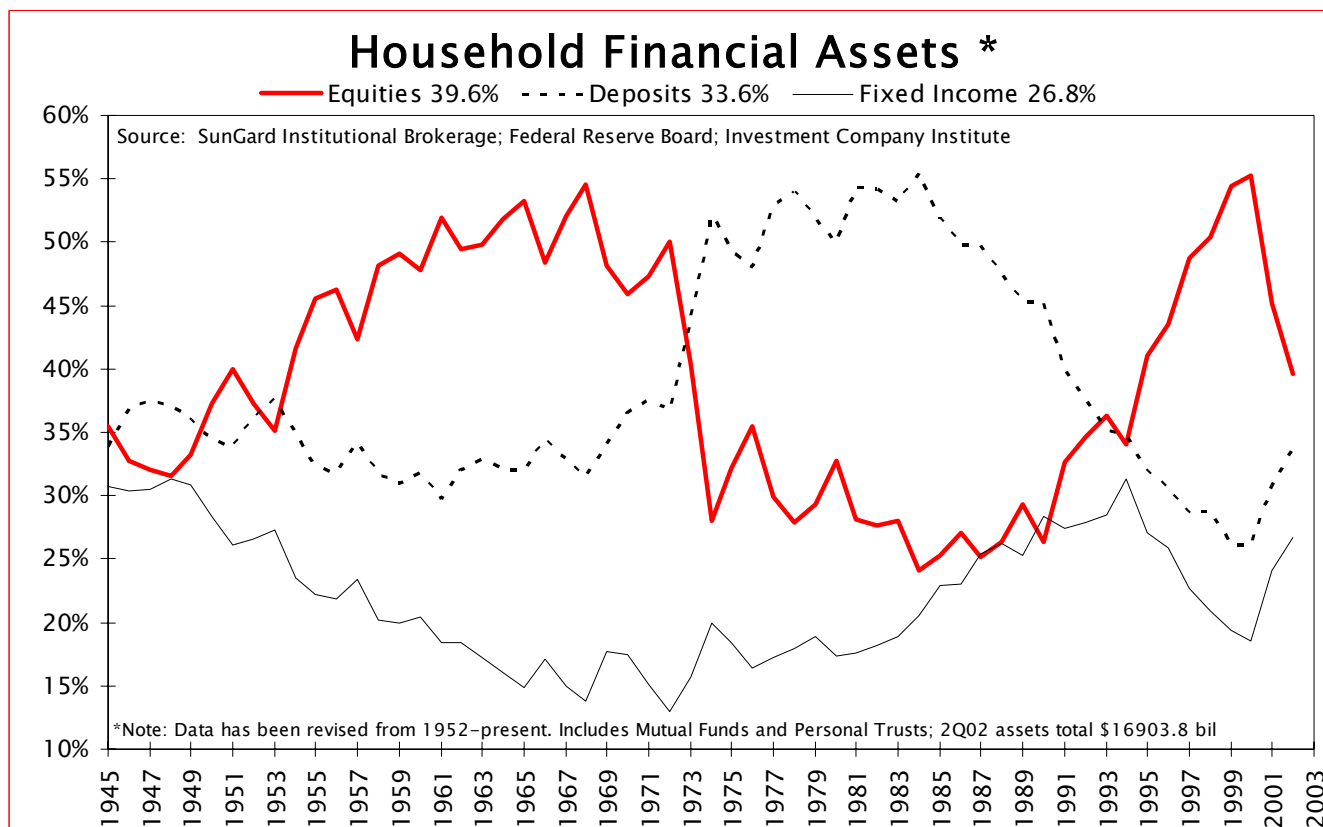
If we sum up the foreign and mutual fund numbers (adding in an October estimate of modest sales for foreign transactions), we get the following result. The comparison of this net buying/selling to the NASDAQ Composite Index is striking. It should be noted that the sum of net buying has remained positive this year due primarily to foreign transactions. Again, this explains why the trend in the dollar is a major factor in the supply/demand balance for U.S. stocks. A weak dollar would be a plus for U.S. exporters and the economy, but it would be a negative for stock performance, at least in the intermediate term.



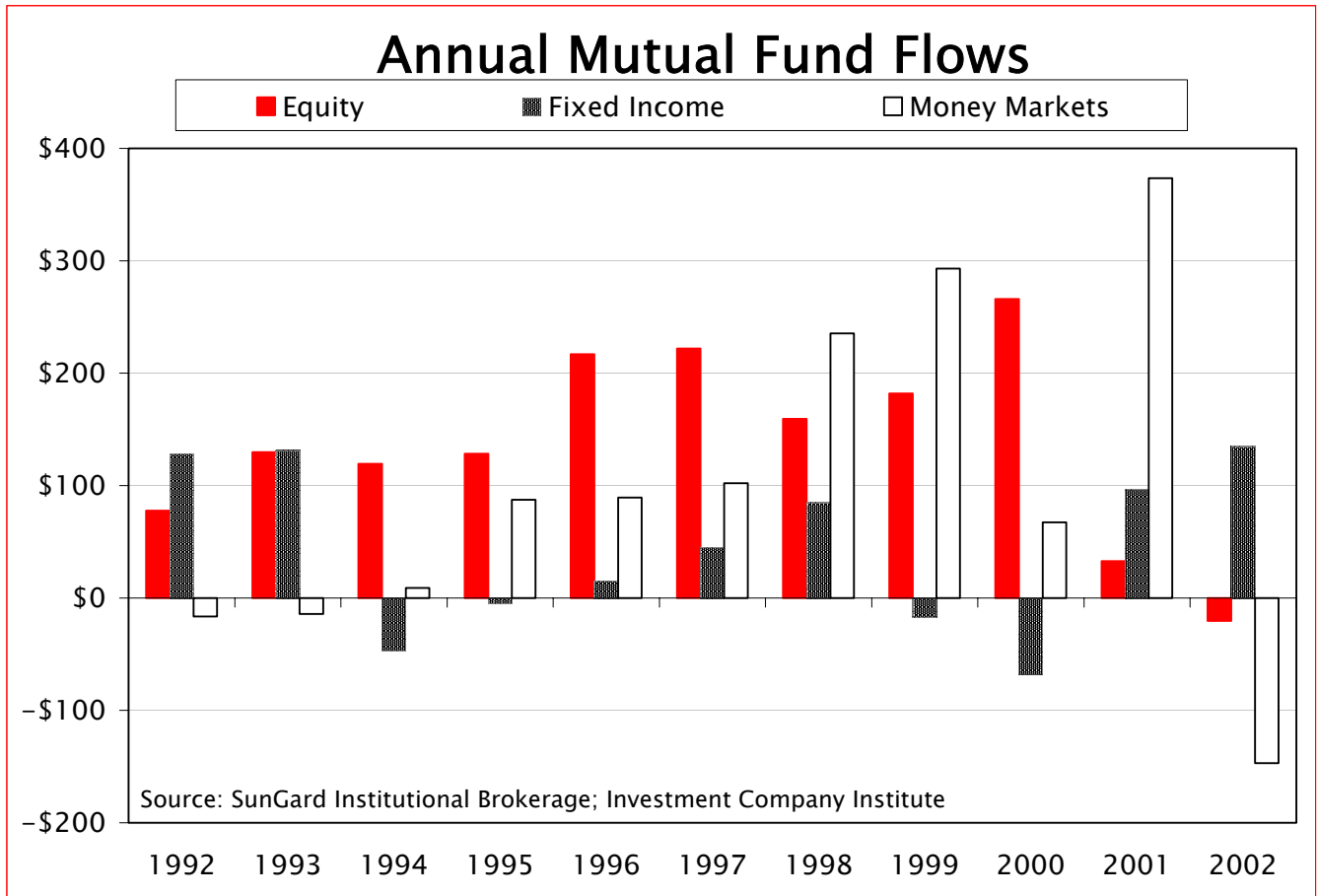
We believe that much of the year-end rally was due to shifts in institutional portfolios. Low-priced technology stocks were bought while value stocks were sold. But this is a short-term tactic, not a long-term strategy. A bull market typically begins when investors are flush with cash. This is not true of the mutual fund industry where the equity cash ratio was 5.1% in October, and likely fell in November. The all-time low of 4% in the liquidity ratio was recorded at the market peak in March 2000.



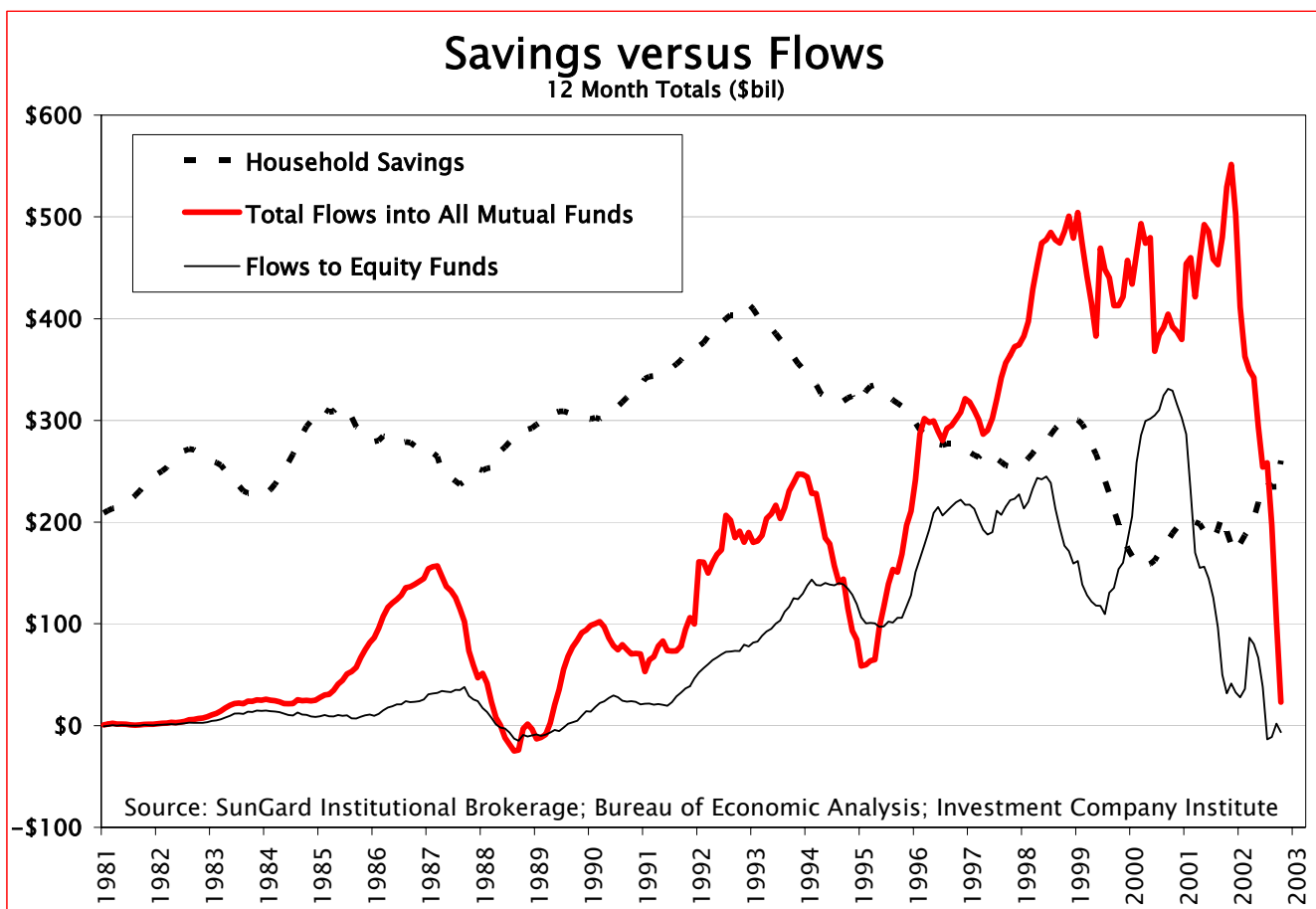
While the household sector has seen cash rise as a percentage of its financial assets, this has been driven more by declines in equity prices than by money market fund flows. The Household Financial Asset Mix is fairly balanced today with 40% in equities, 27% in fixed income and 34% in cash. Although this cash ratio may sound high, note that at the beginning of the last bull cycle in the early 1980s, cash represented more than 50% of assets. In 1990, at the beginning of the last cycle, cash represented 45% of household financial assets. Despite the low returns on cash, it is also important to note that cash has dramatically outperformed stocks for over three years. And while the equity ratio at 40% might appear low, we believe investors require an incentive to acquire more stock. This would be possible if either the earnings outlook improves or the dividend yield increases.



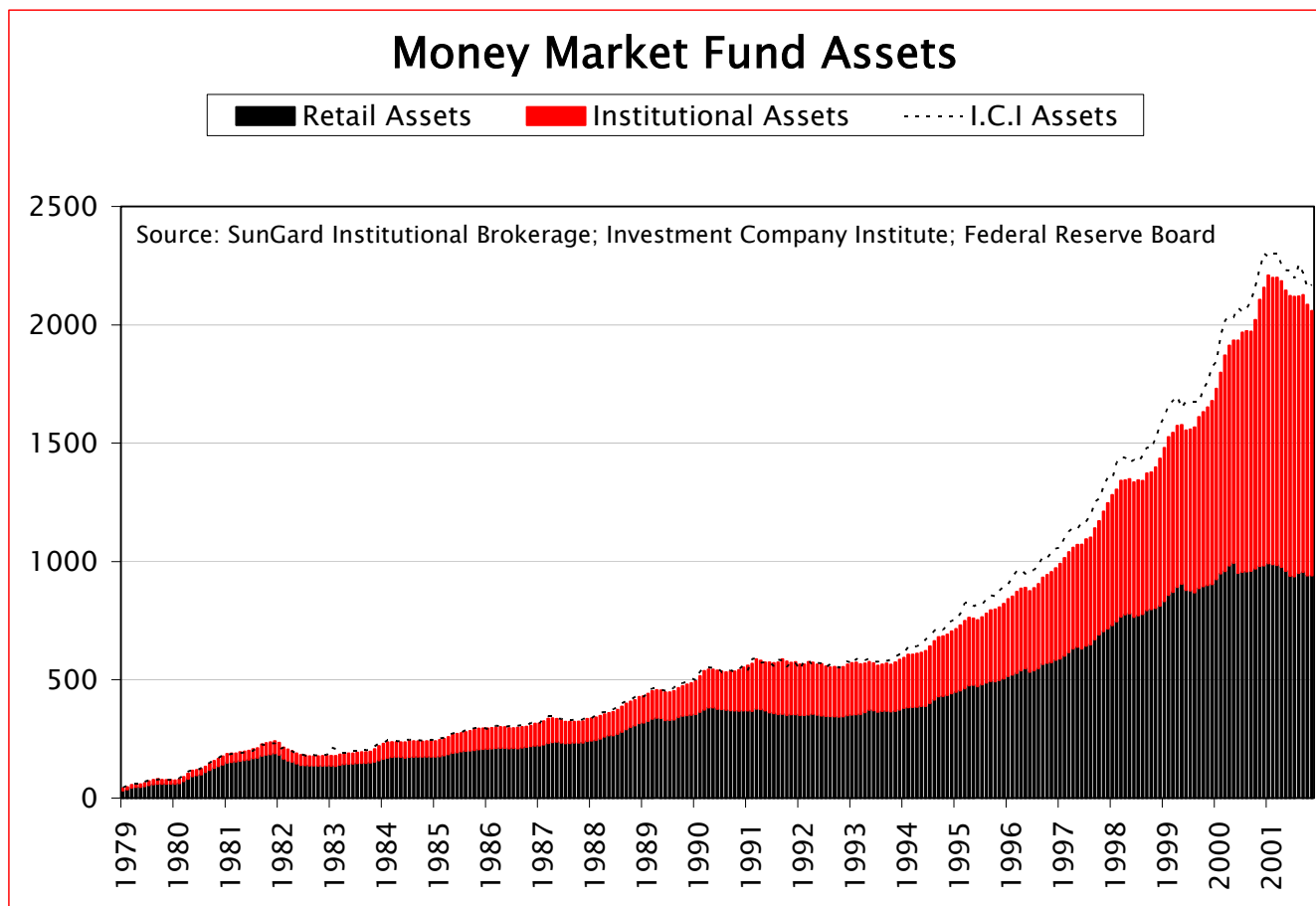
Note that while cash as a percentage of assets has increased this year, money market funds have experienced huge outflows. One explanation for the big redemptions could be that cash was needed for down payments on real estate purchases. The financial asset class of choice in 2001–2002 has been fixed income.



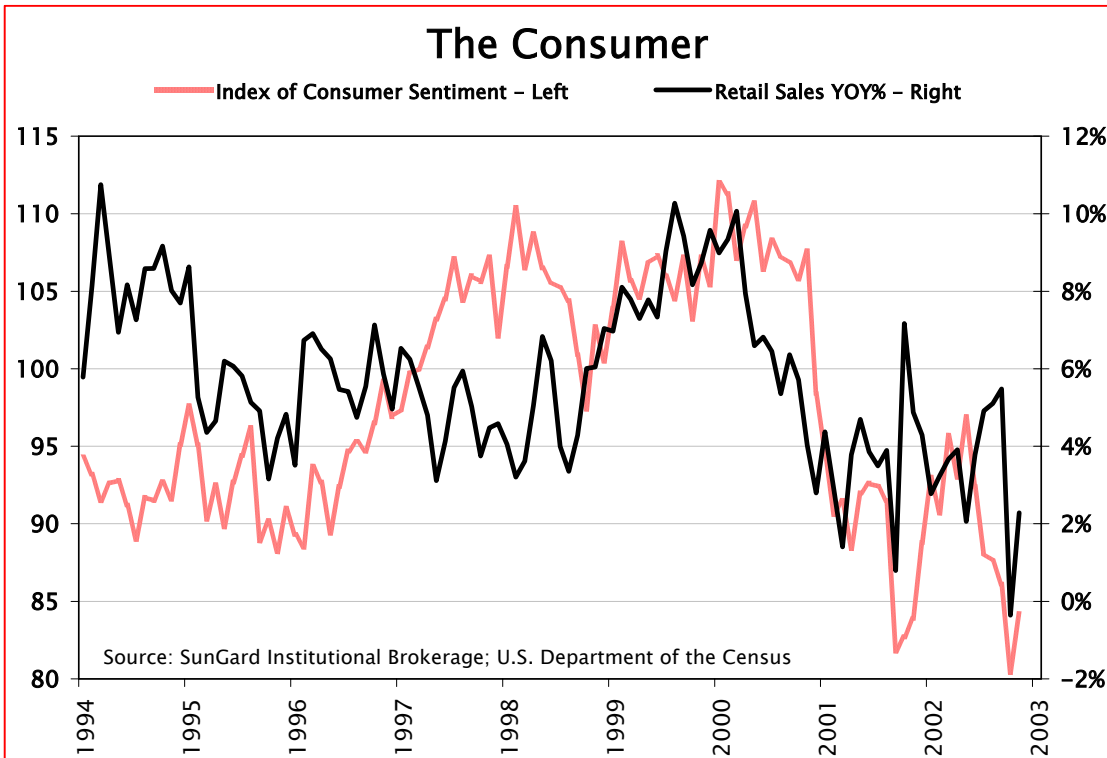
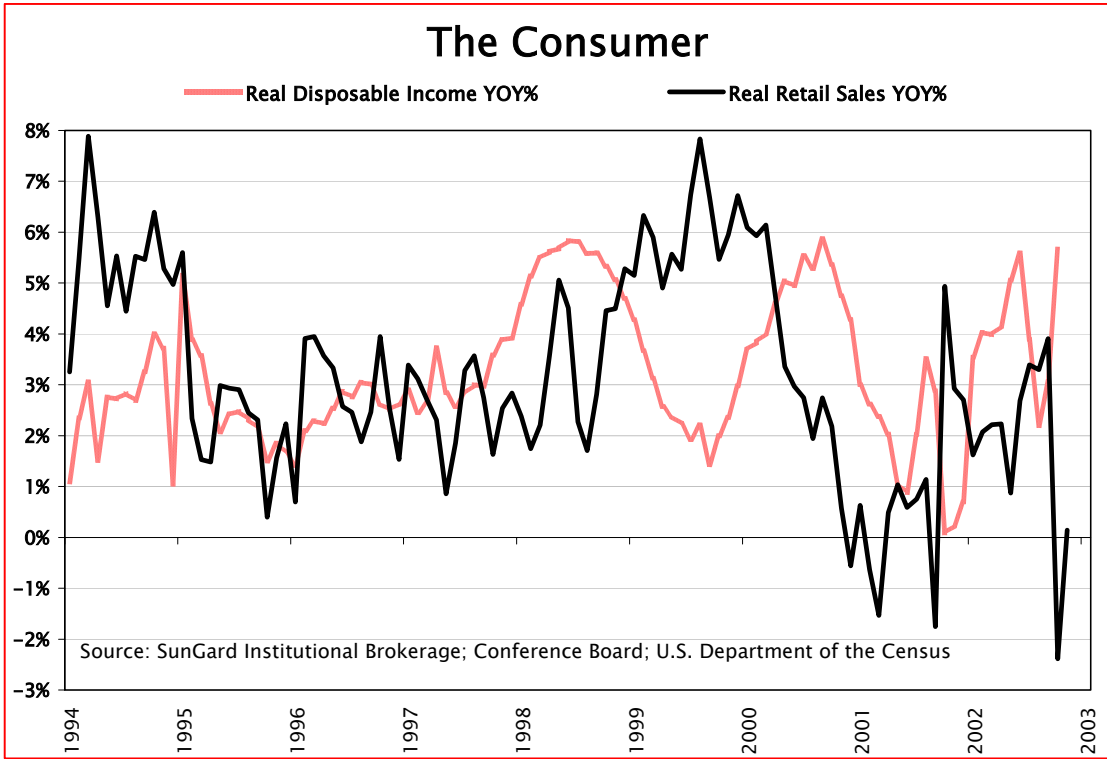
A favorite chart used to depict the bubble of the late 1990s is this one, which overlays household savings on mutual fund flows. The mutual fund industry was experiencing inflows GREATER than all household savings from 1996 through 2002. Equity fund flows were greater than household savings from late 1999 through early 2001 – a classic sign of excess and leverage typical of a late-stage bubble. The good news is that this has changed. Savings are on the rise, and in recent months, savings exceed the flows into mutual funds. This is the first step toward building household liquidity.



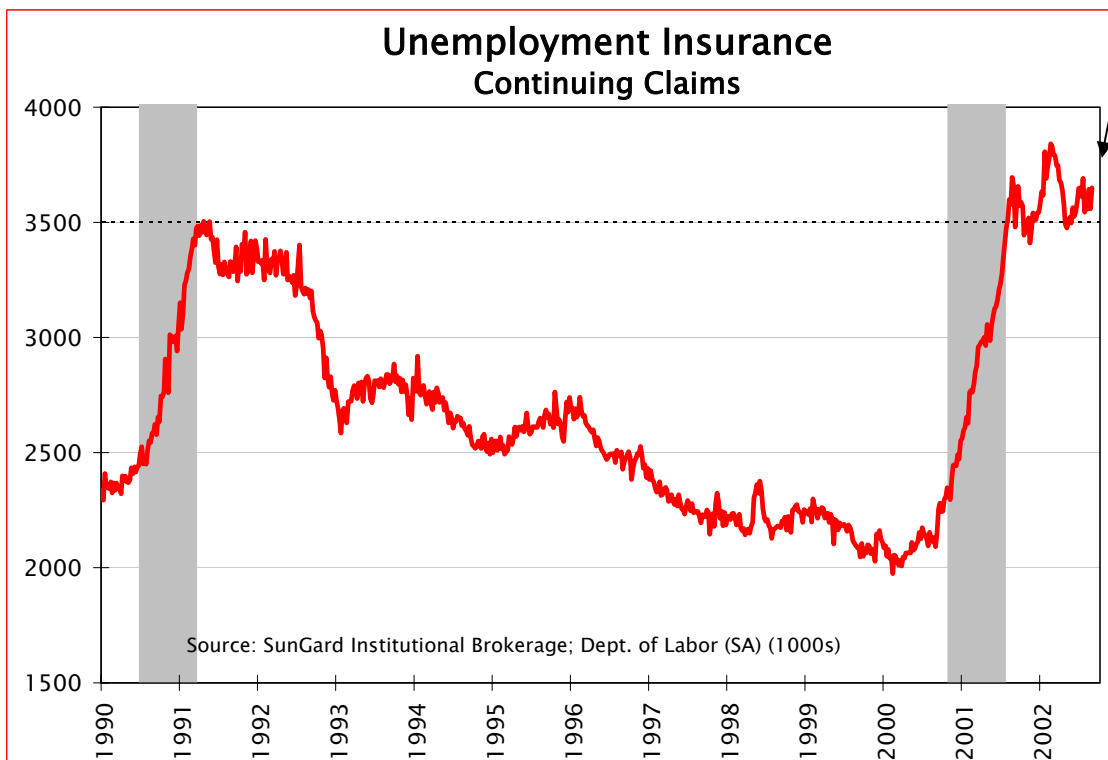
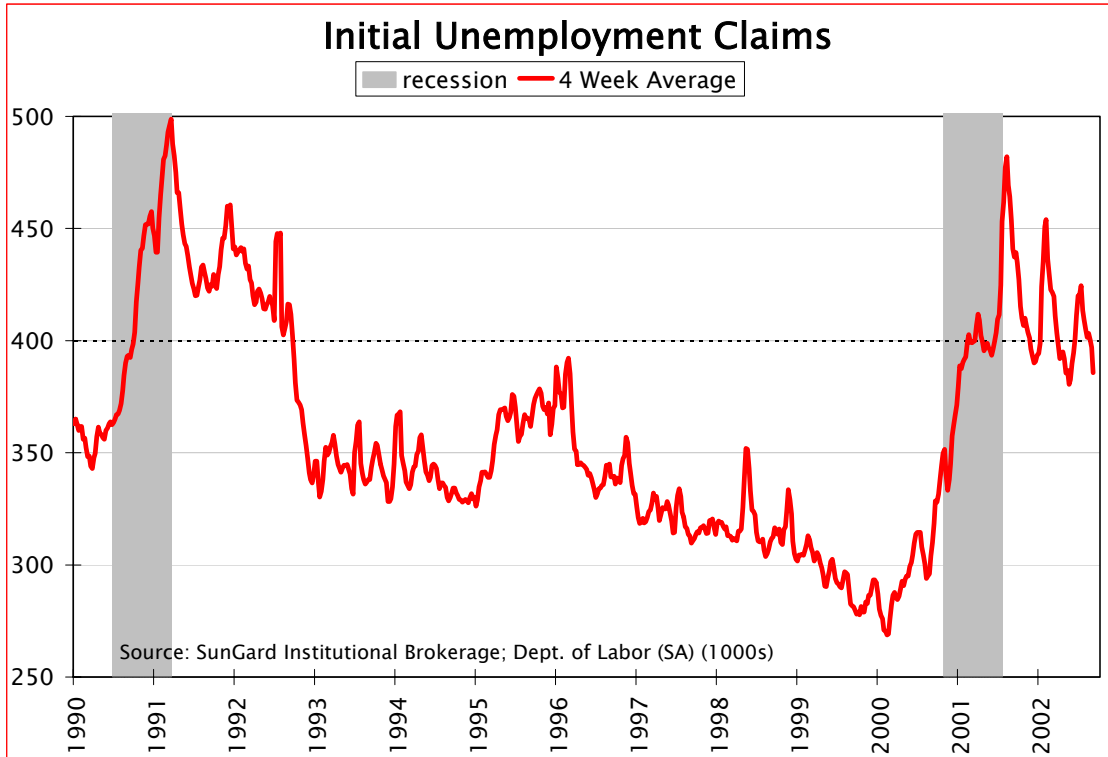
But while many forecasters are looking at money market fund assets as a ready pool of money to move into equities, few are looking at the changes taking place in the money market fund industry. Money market funds are increasingly used by corporate treasurers and institutions to manage cash flow. Institutions currently represent 54% of all money market assets according to the Federal Reserve.



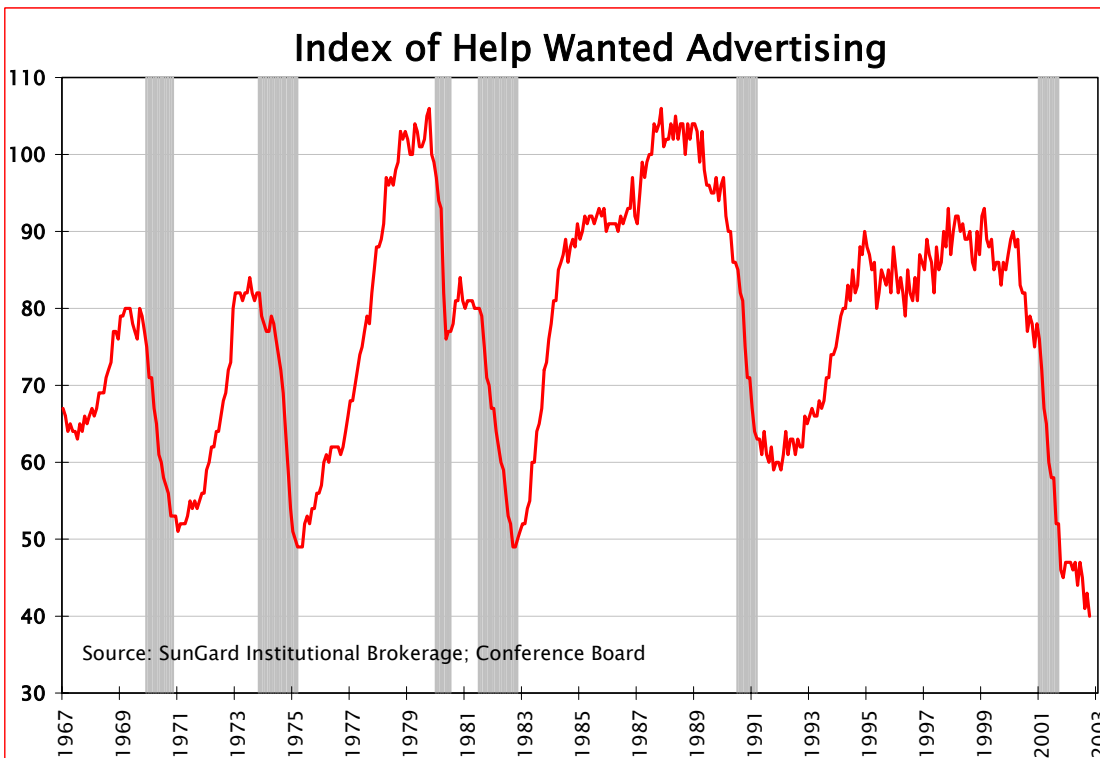
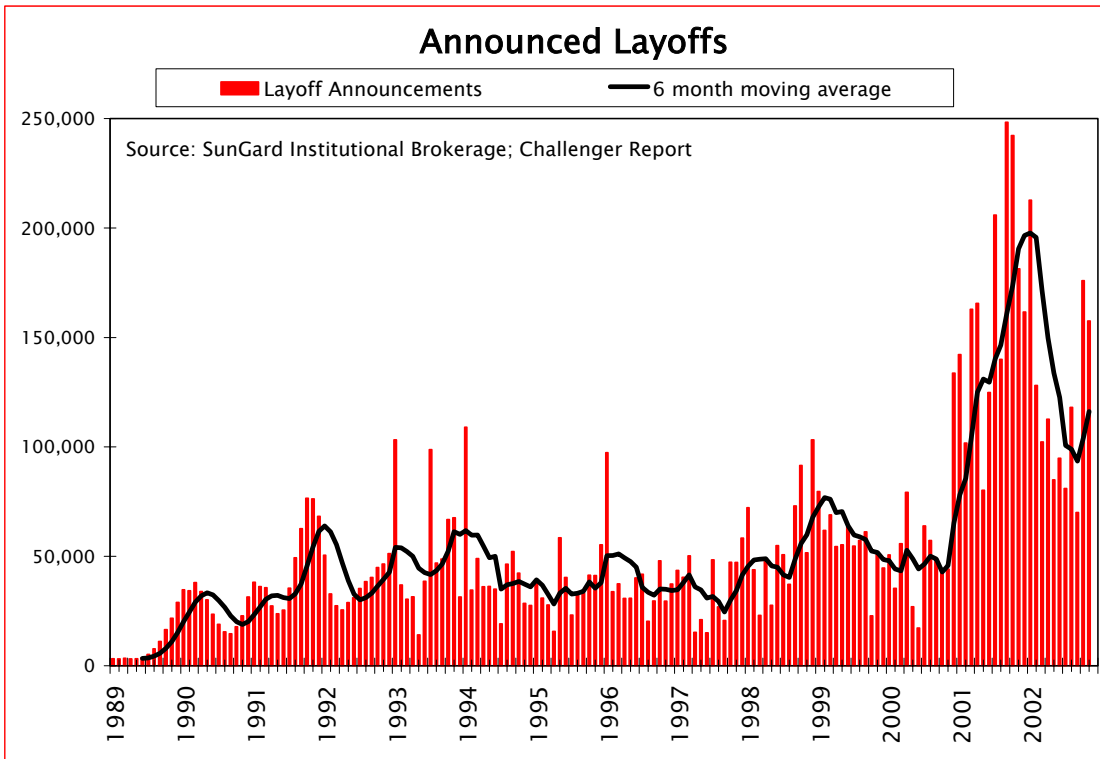
Retail sales slowed on a month-over-month basis in October, but improved in November. The year-over-year comparisons shown here are encouraging but could be distorted by a weak 4Q01. This is also true of real disposable income which has easy comparisons after 9-11-01. Consumer confidence also ticked up, but less convincingly.



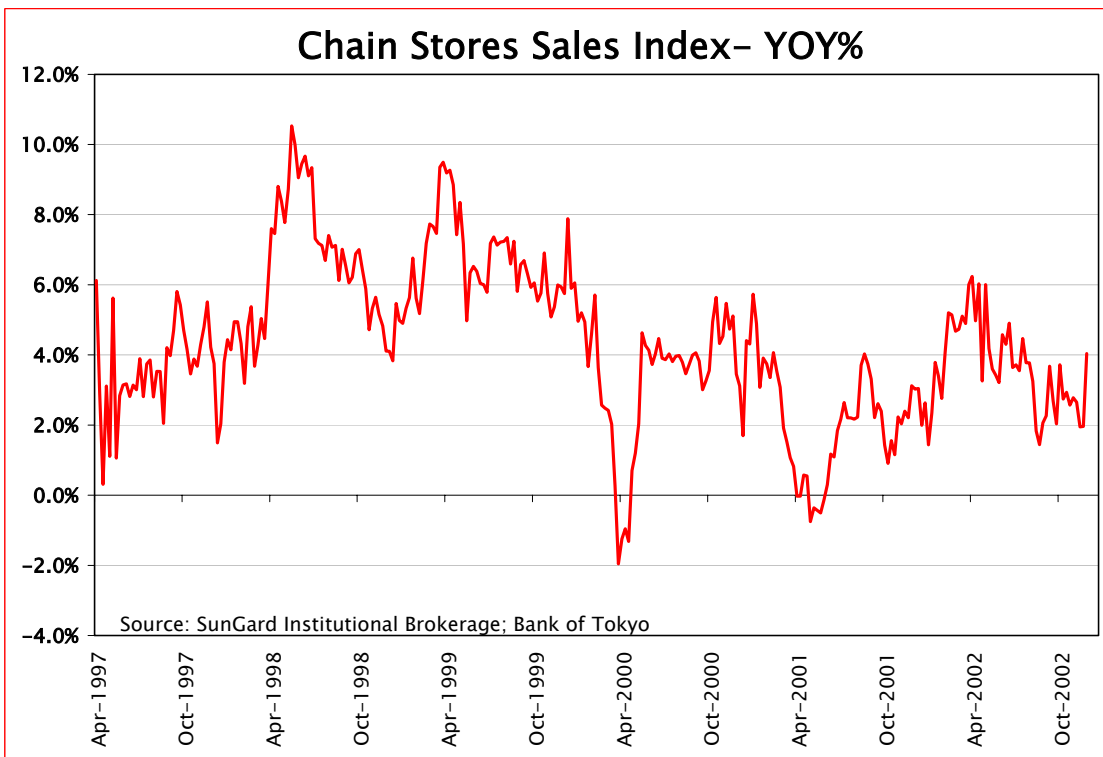
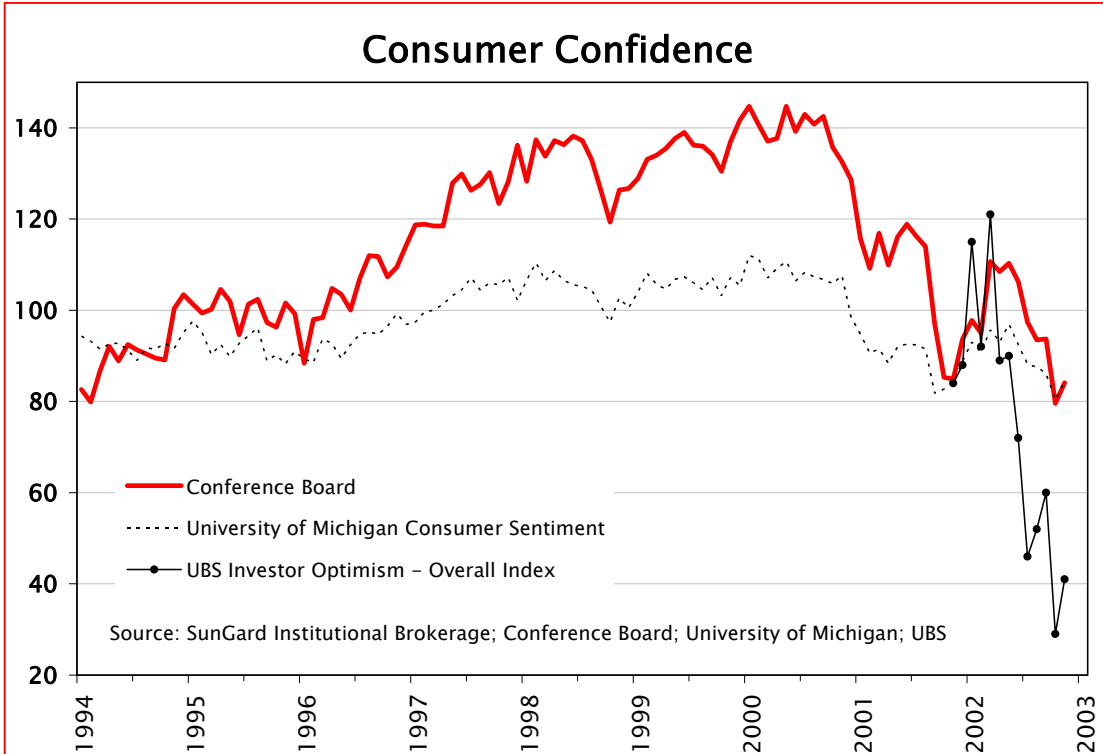
Again, we believe incomes and confidence depend upon jobs. Initial unemployment claims were under 400,000 for two consecutive weeks. However, continuous claims remain relatively high and frustratingly trendless.



And while the media depicts the Challenger Layoff numbers as positive, due to a decline month-over-month, the six-month moving average is clearly headed higher once again. Help Wanted ads hit a cyclical low in October, implying that jobs are difficult to find.



While we continue to emphasize jobs and initial unemployment claims as a market moving statistic, we believe that consumer confidence and weekly chain store sales will be very important to the market in coming weeks. A bah-humbug Christmas season will damage investor confidence.



S&P 500 Operating Earnings by Economic Sector: Bottom-Up Estimates as of 11/25/02

	2000	2001 % Chg		2002 % Chg		'02 P/E	2003 % Chg		'03 P/E
S&P 500	56.16	38.85	-30.8%	46.93	20.8%	19.88	55.98	19.3%	16.66
S&P 500 - Consumer Discretionary (Sector)	9.73	5.91	-39.3%	9.62	62.8%	20.66	10.82	12.4%	18.37
S&P 500 - Consumer Staples (Sector)	9.74	10.52	8.1%	11.90	13.1%	17.13	12.84	7.9%	15.88
S&P 500 - Energy (Sector)	15.37	14.15	-7.9%	10.17	-28.2%	17.90	11.77	15.8%	15.46
S&P 500 - Financials (Sector)	21.94	19.73	-10.1%	22.06	11.8%	14.29	25.58	16.0%	12.32
S&P 500 - Health Care (Sector)	12.78	14.07	10.1%	14.97	6.4%	21.48	17.02	13.7%	18.89
S&P 500 - Industrials (Sector)	11.59	10.00	-13.7%	10.53	5.3%	18.94	12.10	14.9%	16.48
S&P 500 - Information Technology (Sector)	13.45	(3.52)	NM	3.70	NM	69.18	8.61	132.5%	29.75
S&P 500 - Materials (Sector)	7.92	3.82	-51.7%	4.70	23.1%	26.11	7.48	59.0%	16.42
S&P 500 - Telecommunication Services (Sector)	10.12	4.40	-56.5%	6.10	38.6%	19.05	6.71	10.0%	17.32
S&P 500 - Utilities (Sector)	11.70	12.26	4.8%	10.15	-17.2%	9.49	9.87	-2.8%	9.76

Quarterly Breakdown

	2001 Q1A	2001 Q2A	2001 Q3A	2001 Q4A	2002 Q1A	2002 Q2A	2002 Q3E	2002 Q4E	2003 Q1E	2003 Q2E	2003 Q3E	2003 Q4E
S&P 500	10.73	9.02	9.16	9.94	10.85	11.64	11.65	12.80	12.62	13.84	14.35	15.18
S&P 500 - Consumer Discretionary (Sector)	1.33	1.61	1.20	1.78	1.82	2.58	2.29	2.93	2.19	2.79	2.53	3.30
S&P 500 - Consumer Staples (Sector)	2.36	2.59	2.78	2.79	2.72	3.06	3.24	2.88	2.86	3.25	3.45	3.28
S&P 500 - Energy (Sector)	4.80	4.62	2.89	1.84	2.07	2.57	2.57	2.95	2.80	2.83	3.04	3.10
S&P 500 - Financials (Sector)	5.51	4.81	4.33	5.08	5.83	5.29	5.09	5.85	6.06	6.29	6.49	6.74
S&P 500 - Health Care (Sector)	3.52	3.49	3.61	3.44	3.61	3.59	3.75	4.02	4.09	4.06	4.32	4.55
S&P 500 - Industrials (Sector)	2.52	2.93	2.33	2.23	2.48	3.08	2.43	2.54	2.66	3.21	3.06	3.18
S&P 500 - Information Technology (Sector)	(0.23)	(2.79)	(1.24)	0.74	0.53	0.63	0.75	1.79	1.74	1.99	2.17	2.71
S&P 500 - Materials (Sector)	1.09	1.31	0.90	0.52	0.90	1.43	1.17	1.20	1.48	2.08	1.92	2.00
S&P 500 - Telecommunication Services (Sector)	1.01	0.60	1.50	1.29	1.28	1.25	2.02	1.55	1.54	1.64	1.72	1.81
S&P 500 - Utilities (Sector)	3.25	2.73	4.05	2.22	2.93	2.31	3.03	1.88	2.31	2.18	3.25	2.14

Sources: Standard & Poor's

KEY

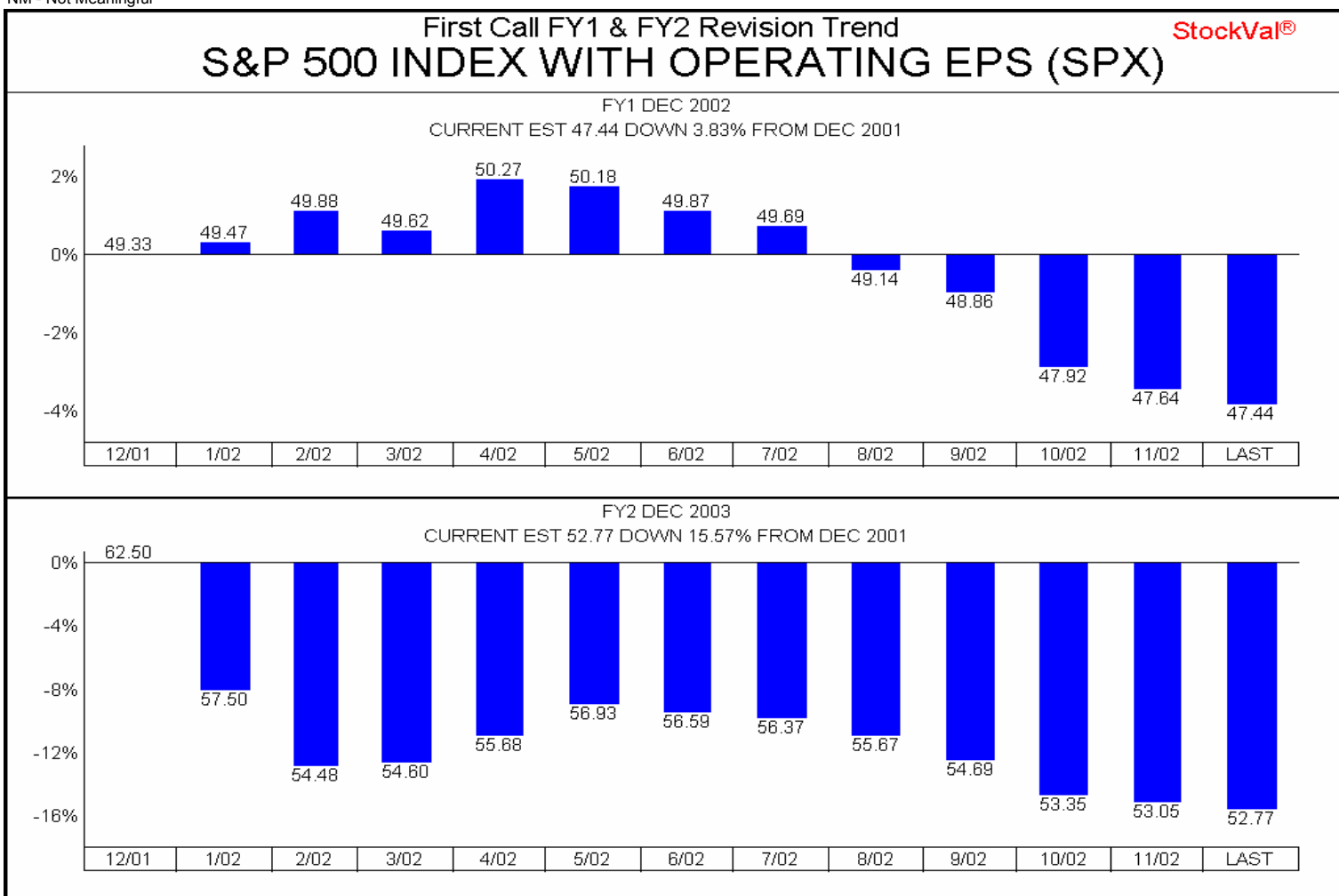
A - Actual

P - Preliminary

E - Estimate

NM - Not Meaningful

Estimates continue to fall for '02 and '03.



Forecasts

Asset Allocation

	Recommended	Normal Range
Stocks	45%	40-90%
Bonds	30%	15-45%
Cash	25%	5-30%

Recommended S&P Sector Weightings

Overweight	% of S&P	Neutral	% of S&P	Underweight	% of S&P
Healthcare	14.46%	Consumer Discretionary	13.93%	Financials	20.35%
Utilities	2.56%	Industrials	11.29%	Telecom Services	4.24%
Energy	5.64%	Materials	2.78%	Technology	15.79%
Consumer Staples	8.96%				
REITS	NA				

Economic and S&P Earnings/Dividends Forecasts

	S&P 500 Price*	S&P Reported EPS	S&P Operating EPS	Dudack Forecasted Operating EPS	EPS YOY %	PE Ratio	Divd Yield	GDP Annual Rate	GDP Corp Profits after tax w/ IVA & CC	YOY %
1995	\$615.93	\$33.96	\$37.70	\$37.70	18.7%	16.3X	2.2%	2.7%	\$457.80	14.5%
1996	\$740.74	\$38.73	\$40.63	\$40.63	7.8%	18.2X	2.0%	3.6%	\$530.40	15.9%
1997	\$970.43	\$39.72	\$44.01	\$44.01	8.3%	22.1X	1.6%	4.4%	\$596.60	12.5%
1998	\$1,229.23	\$37.71	\$44.27	\$44.27	0.6%	27.8X	1.3%	4.3%	\$538.60	-9.7%
1999	\$1,469.25	\$48.17	\$51.68	\$51.68	16.7%	28.4X	1.1%	4.1%	\$558.00	3.6%
2000	\$1,320.28	\$50.00	\$56.13	\$56.13	9.8%	23.5X	1.2%	3.8%	\$528.70	-5.3%
2001	\$1,148.08	\$24.69	\$38.85	\$38.85	-30.8%	29.6X	1.4%	0.3%	\$532.30	0.7%
2002 E	\$920.75	\$31.46	\$46.94	\$45.29	16.6%	20.3X	1.4%	2.2%	\$606.00	13.8%
2003 E	~~~~~	\$37.88	\$55.99	\$49.00	8.2%	18.8X	2.2%	3.9%	\$680.00	12.2%
2001 1Q	\$1,160.33	\$9.18	\$10.73	\$10.73	-23.2%	21.9X	1.4%	-0.6%	\$489.20	-8.9%
2001 2Q	\$1,224.42	\$4.83	\$9.02	\$9.02	-39.4%	26.0X	1.3%	-1.6%	\$508.30	-5.9%
2001 3Q	\$1,040.94	\$5.23	\$9.16	\$9.16	-35.4%	24.8X	1.6%	-0.3%	\$490.90	-7.4%
2001 4Q	\$1,148.08	\$5.45	\$9.94	\$9.94	-25.3%	27.8X	1.4%	2.7%	\$640.80	26.2%
2002 1Q	\$1,147.39	\$9.19	\$10.85	\$10.85	1.1%	29.4X	1.4%	5.0%	\$595.20	21.7%
2002 2Q	\$989.82	\$6.87	\$11.64	\$11.64	29.0%	23.8X	1.5%	1.3%	\$571.30	12.4%
2002 3Q P	\$815.28	\$9.06	\$11.65	\$11.65	27.2%	21.0X	1.7%	3.1%	NA	NA
2002 4Q E	\$920.75	\$6.34	\$12.80	\$11.15	12.2%	NA	NA	NA	NA	NA
2003 1Q E	~~~~~	\$11.41	\$12.62	\$12.25	12.9%	NA	NA	NA	NA	NA
2003 2Q E	~~~~~	\$9.41	\$13.84	\$12.00	3.1%	NA	NA	NA	NA	NA
2003 3Q E	~~~~~	\$9.59	\$14.35	\$12.25	5.2%	NA	NA	NA	NA	NA
2003 4Q E	~~~~~	\$7.47	\$15.18	\$12.50	12.1%	NA	NA	NA	NA	NA

*2002 year-end and 4Q prices are actual as of 12/03/02.

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