



Investment Commentary

November 25, 2002



Bob Doll is President and Chief Investment Officer of Merrill Lynch Investment Managers (MLIM). He joined MLIM in 1999 and has held a variety of senior management positions. Merrill Lynch Investment Managers has more than US\$450 billion in assets under management.

- For the first time in almost five years, the Dow Jones Industrial Average (DJIA) was up for the seventh week in a row, up nearly 3% on the week to close at 8,805. Both the S&P 500 and Nasdaq showed positive returns for the week, with the S&P 500 up 2% to close at 931 and Nasdaq up 4%, again leading the way, closing at 1,469.
- What is the reason for the gain? Many believe it is a response to the Fed's interest rate moves of a few weeks ago, which were aimed at improving economic growth and substantially lowering the odds of deflation. In addition, there is a lot of talk about all the liquidity being provided and the substantially reduced return on cash, which is forcing investors out of low-return assets into longer-dated assets.
- The group action was also more of the same, a bifurcated week where energy, healthcare, consumer noncyclicals and consumer cyclicals, representing about half the market, was flat. But the 6.5% in the technology sector, 5% in telecom and 4.5% in industrials more than made up for that flatness.
- The United States continues to outpace the markets of other developed countries. The U.S. market is up 2.5%, the UK market rose less than 2%, and Japan is up only 0.5%.
- In fixed income markets, the yield on Treasuries continues to rise while the spread between Treasuries and corporate high-yield issues continues to contract. The yield on the 10-year Treasury note now stands at 4.18%, up from 4.03% a week earlier. The decline in the high-yield spread is now more than 200 basis points in seven short weeks. The spread between Treasuries and high-yield issues peaked at almost 11% in early October; it is now down under 9%. This is as investors are getting more confident in the corporate sector, including high yield, and more comfortable with the economy.
- So where do we go from here? Well, the bear story would be that this is just like the fourth quarter of last year when the market was oversold after 9/11 and we experienced a substantial fourth quarter rally. The same thing is happening now. The concern is that Nasdaq is leading the way, up more than 30% since early October, while at the same time earnings estimates for the tech-heavy Nasdaq continue to come down. For technology, in particular, estimates for the fourth quarter over year-ago levels are up 17%. Estimates have dropped by half since October 1, when expectations were up 32%. The estimates for next year's earnings for technology are following the same trend: At mid year estimates were up 52%; by October 1, up 40%; and now only up 34%. As the bears would say, the fundamentals are deteriorating and valuations are getting extended.
- The bulls would argue that with the DJIA and S&P 500 up more than 20% from their lows and Nasdaq up more than 30%, Nasdaq has gone past its August highs

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and the S&P 500 and DJIA are getting very close. It would seem that the difference in this equity market rally is a substantial gain in high-yield and corporate bonds, which raises the probability that October was the low. We lean to the bullish side; however, we recognize that after more than a 20% gain in a short time the market is entitled to a rest at some point. We believe that the path of least resistance has moved from down to up.

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