A.R.Schmeidler & Co., Inc.

The Outlook

January 2002

As of December 31, 2001	
Index	**YTD % Change**
Dow Jones Industrials	-7.10
S&P 500	-13.04
Nasdaq Composite	-21.05

The Standard & Poor's 500-stock index ended 2001 down –13.04% the second straight year the index fell more than -10%. The Nasdaq composite index which includes many information technology and biotechnology stocks, performed even more poorly, losing -21.05 % after a -39.3% loss in 2000. The average stock mutual fund fell -11.9%, but growth stock mutual funds, the most widely held type of stock mutual fund investment, slid -17% in 2001.

U.S. Economy

A year ago few forecasters realized how sharply the U.S. economy would turndown and how severe the impact would be on corporate profits and on many stocks. Now the important question for the global economy is the timing and strength of a U.S. economic recovery. We believe that the recovery will be more sluggish and erratic than has been the norm; notwithstanding the fact that inventories are now beginning to be rebuilt giving the appearance that the economy is starting to recover. The surprisingly strong NAPM report indicating that new orders and production in the manufacturing sector have improved in combination with an improvement in December retail sales has lent support to the notion of an economic upturn. **What makes the outlook so difficult to determine is the fact that there are powerful deflationary forces in the system that will continue to work against the positive dynamics that have been established by the government's aggressive monetary and fiscal policies.** In spite of the failure of the last session of Congress to pass a tax reduction bill, the prior tax relief legislation will reduce tax rates in 2002. The challenge this year will be to build equity portfolios around companies that generally have strong balance sheets, positive operating cash flow and an improving earnings outlook.

A recent survey of chief financial officers of U.S. companies indicated that they expect the recession to stretch into the second or third quarter of this year. Sales and earnings remain weak for most companies, and most expect only a modest improvement for their business over the next six to nine months. **The recession continues to be a business-led recession brought about by a sharp contraction in capital spending which hit technology, telecommunications, and manufacturing relatively hard versus the overall economy.** Corporate capital spending usually is viewed as critical to long-term business survival but is often based on whether the current economic times are good or not.

Credit Conditions

Despite the Federal Reserve's eleven interest rate cuts last year, many companies trying to borrow money find credit tight. Enron's collapse has created issues for the credit markets. In November Enron Corp. was burdened by nearly $40 billion in debt and forced into Chapter 11 bankruptcy by creditors. The accounting firm Arthur Andersen LLP, Enron's outside auditor, failed to uncover serious errors that reflected undisclosed leverage in Enron's financial statements. The financial markets are concerned as to what might happen if there are more companies like Enron out there and the economy continues to weaken.

There now is a widespread consensus that at the very least the nation needs stricter accounting rules to force companies such as Enron to do a better job of disclosure. **The financial system remains sound, but we expect investors and debt-rating agencies to raise the bar for financial reporting.** Companies that have strong balance sheets and are on track to boost cash flow this year will be rewarded with easier credit terms and a higher stock price. The strong companies also will find themselves well-positioned to increase their market shares and improve their cost structures by buying weaker companies for little or no premium over existing stock valuations.

Profits

We believe that corporate profits are going to be under pressure for the entire year. One of the things that corporations have given us over the last several years, even during good times, is huge write-offs and unexpected liabilities that never seem to stop. This year is probably not going to be much different. One of the big surprises may be that pension fund liabilities have increased dramatically in many cases as investment rates of return over the past two years failed to meet pension fund assumptions. The difference between actual rates of return and the assumed rates of return must be made up from corporate earnings. If this proves to be the case, what investors might have to accept are corporate profits at lower levels than they now expect.

Federal Reserve

The Federal Reserve has cut short-term interest rates below 2% for the first time in 40 years and left the door open for more cuts. It has remained skeptical that the recession is coming to an end. Continuing its most aggressive rate cutting in decades, the central bank reduced its target for the federal-funds rate last month to 1.75% from 2%. Federal Reserve officials had feared the economy could go into a free fall in the wake of the September 11th terrorist attacks, and are relieved it did not, giving them the freedom to cut last month by only a quarter point. The Federal Reserve also appears to want to counter expectations that interest rates will be heading up this year. The bond market has priced in a slight chance for a 12th rate cut from the Federal Reserve when the Federal Open Market Committee meets in late January.

Zero-Interest-Rate Financing and Low Mortgage Rates

Automobile zero-interest-rate financing and the low mortgage rates have helped car sales and home building. The automotive and housing sectors were two of the few bright spots in the economy last year. The housing market put on a particularly solid performance last year, and it continues to be an area of the economy that will probably hold up remarkably well in the face of the recession. Automobile sales and home building have hardly experienced a slowdown and therefore will not lead a broad U.S. economic recovery this year. The automobile and home building industry may even settle back this year from their heightened performance in 2001.

Energy

So far the fears of a plunge in oil and natural gas prices following the September 11th terrorist attacks have not been totally realized. Oil and natural gas prices have held at profitable levels despite some visible weakness in demand. Now worries are turning to OPEC's and Russia's ability to restrain production in a weak global economic environment. Russia, where oil production is on the rise, will remain a problem for OPEC for the foreseeable future. OPEC currently produces about 40% of the world's oil. If the supply-demand balance for oil and natural gas is maintained, the consensus opinion regarding prices is that they will stay around current levels. **While oil and natural gas stocks have bounced off the bottom of their recent lows, the risk–reward for owning the companies that we like in the energy sector remains very reasonable and continues to be of strategic importance for investment portfolios.**

Economic Indicators

The debate on Wall Street is how weak corporate earnings really will be this year. Although quarterly comparisons for the next two quarters will be negative, the optimists are hoping that since earnings have been soft for the past two years, it will be easy for corporate profits to start showing strong gains as the economy climbs out of the bottom of the recession. In reality there is no guarantee that the economy has stabilized or that the weakness will not intensify this year. The December employment report indicated that the unemployment rate now stands at 5.8% – the highest level in six years. Despite the continued decline in payrolls, the report also suggested the rate of change is abating. While the employment situation may still become worse before it gets better, it is important to remember that employment is a lagging economic indicator. Lagging economic indicators are not good at predicting the future.

The leading economic indicators, which often foretell the future, are beginning to register more pluses than minuses. Six of the ten components in the November leading economic indicators were positive. This does not mean that the U.S. economy has bottomed or is about to come roaring back to life. It does suggest that thanks to a variety of factors, the government's monetary and fiscal stimulus is finally showing up in the data. Consumers seem largely undaunted by high unemployment and lingering uncertainty about the strength and timing of an economic turnaround. The unemployment rate is up, but it is not historically high, and many companies continue to add jobs. The sharp drop in interest rates, the absence of inflation, and lower energy prices have increased the buying power of the average household. Another plus for the economy is the sharp decline in business inventories. They have been falling for the past twelve months and had a 1.4% plunge in October. The record number of cars sold in October helped clear out huge amounts of inventory and prompted car makers to announce plans to increase production. Finally, the Federal Reserve has been pumping liquidity into the economy at a fast and furious pace. The M2 money supply, adjusted for inflation, is growing at one of the fastest rates in the past thirty years. The banks are flush with cash and quite willing to lend money to credit worthy customers that have strong balance sheets and positive cash flow.

Interest rates matter, as evidenced by the 24% rise in October auto sales driven by zero-interest-rate financing. American consumers slowed their buying of cars in November and December from October, but still pushed sales for 2001 to the second highest level ever. If 30-year mortgage rates again drop below the 7% level, cash coming out of consumers' monthly mortgage payments from refinancing could be significant. This would allow for both household debt reduction and increased spending potential. U.S. companies will also enjoy added financial flexibility from lower long-term interest rates as they reduce their interest expenses and extend maturities.

Europe

While the U.S. is fighting a recession and a war on terrorism, Japan and Europe are fighting serious internal structural problems that retard growth. It often appears at times that they are losing. **With unemployment rising and important elections in Germany and France less than a year away, we believe the odds now favor interest rate and spending initiatives that will appease voters**. Europe's Central Bank has provided too little economic stimulus too late, which could push jobless votes to move further to the left in search of stronger socialist leadership. This unfortunately could further undermine the euro as markets become concerned that the Maastricht Treaty guidelines for limiting deficit spending and inflation could be in jeopardy. For most Europeans, the euro now becomes reality for the first time, as they surrender their marks, lire, francs and nine other currencies.

Japan

Japan continues to slip deeper into a recession. **Most of Japan's economic indicators do not look good, and there are indications that the situation could get worse.** Exports, which have been key to pulling Japan's economy out of recession in the past, are shrinking as demand for goods falls in the U.S. and Europe. Corporate earnings are plummeting and could fall further as accelerating price declines undermine profits. Japan is struggling to cut back on the massive government spending that propped up much of their economic growth over the past few years. There are signs that the widespread weakness in Japan's economy is provoking the corporate restructuring and bad-debt cleanups long considered a prerequisite for Japan's economic recovery. Meanwhile, the jobless rate in Japan rose in November to 5.5% and the yen continued to sink to new lows against the U.S. dollar. These conditions could weaken further as China becomes a more formidable competitor.

China

China formally became a member of the World Trade Organization on December 11, 2001. **Many U.S., European and Japanese companies will now lose quota protections and face stiffer competition from China.** China now can ship its goods to the U.S. using the same low tariffs America grants to most other trading partners. The main achievement of the agreement is China's guarantee to give foreign companies greater access to Chinese consumers. It will particularly help pry open the Chinese market to many foreign technology, telecommunication and financial service companies. Other items covered in the agreement are the right of foreign companies to choose a joint venture partner instead of requiring them to accept partners chosen by the government, and the accelerated timetable for the issue of licenses for U.S., European Union and

Japanese companies to do business in China. The ability of U.S., European and Japanese companies to shift manufacturing to China from higher-cost countries will have a significant disinflation/deflationary effect on the global economy. The overall U.S. consumer price index (CPI) will probably increase less than 0.5% in the upcoming twelve months, the smallest increase since 1959. **The disinflation/deflation effect from China on the global economy will continue to put considerable pressure on pricing and corporate profits.**

Stock Market

Stock multiples are probably too high for the stock market to have a sustained rally this year without a significant improvement in the U.S. economy and corporate profits. However stable interest rates and excess liquidity in the U.S. economy have continued to support the stock market. The stock market should remain at current levels in this stage of the investment cycle until better economic results and improved corporate profits take some of the pressure off high valuations. We see the prospect of an additional interest rate cut by the Federal Reserve and a meaningful fiscal stimulus package crafted by the U.S. Congress as being helpful if these occur. A stable U.S. dollar versus the euro and the yen and sustained lower energy prices are also important catalysts for a U.S. economic recovery this year. The best that can be expected from American consumers is that their spending continues at a steady pace, keeping the U.S. economy afloat, and in the process buying the time needed for a turnaround in other sectors of the economy. Economic growth will be considerably more difficult to achieve this year if consumers decide to cut back on spending in order to increase their savings rates or pay down household debt.

Conclusion

The key to a real U.S. economic recovery is the ability of American companies to increase their capital spending in order to expand workers' productivity at an accelerated rate. In the 1990's U.S. companies enjoyed unusual profit growth from productivity gains from capital spending on new equipment and information technology. The productivity of the U.S. worker is now probably 30% above that of other industrial nations because of those investments. Some respected economists argue that the sharp increase in capital spending in the 1990's led to unsustainable economic growth and brought about an old-fashioned boom/bust cycle. **We believe the clearest sign that the recession is in fact finally over, and that the economy has entered into a period of expansion will be when businesses once again begin to increase capital spending on new equipment and information technology.** Orders for high-tech equipment, which plunged more than 50% between May 2000 and September 2001, rose in both October and November. Businesses generally need a strong profit potential and a good business environment before they decide to increase capital spending substantially. The companies that generally have strong balance sheets, positive operating cash flow and an improving earnings outlook will be the first to increase their capital spending.