The Outlook

A.R.Schmeidler & Co., Inc.

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As of August 29, 2002		
Index	**YTD % Change**	**Market Value**
Dow Jones Industrials	-13.5	8,670.99
S&P 500	-20.1	917.80
Nasdaq Composite	-31.5	1,335.77

July 24th Market Rally

The stock market rally since July 24th has lifted the Dow Jones total market index from down 30% since the beginning of the year to down 20%, although the average return for the 26 leading growth mutual funds is still down 22% for the year. **Major institutional investment firms shifted gears and increased asset allocations to equities as the July sell off reached near panic proportions.**

Typically the dividend yields on blue-chip companies go to 6-7% at bear market lows, however with money market funds paying less than 1.5% and many equity securities yielding 3% - more than twice money market rates - stocks should attract investors. For example, El Paso Energy was a classic case of under-valuation when panicked sellers drove the shares down to a 9.5% dividend yield, and it then promptly doubled in share price once the sellers were out of the way. Bear markets produce these kinds of opportunities. At the end of this Outlook we will discuss market dynamics in a little further detail.

The New Corporate-Governance Law is a Positive for the Financial Markets

The just-passed corporate-governance and accounting-oversight law by the U.S. Congress has major consequences for executives, accountants, shareholders and regulators. The bill creates an independent audit-oversight board under the Securities and Exchange Commission, increases penalties for corporate wrongdoers and forces faster and more extensive financial disclosure. The goal of the legislation is to prevent deceptive accounting and management practices and to bring stability to the financial markets. **It will now be much harder for auditors to look the other way in approving faulty corporate**

accounting. The government's new five-member oversight board will have the power to examine audit firms and discipline wrongdoing.

A provision of the corporate-governance and accounting-oversight law includes new criminal sanctions for executives that go well beyond the current Securities and Exchange Commission's rules requiring officers to acknowledge in writing the accuracy of their corporate financial filings. **Under the new law, chief executives and chief financial officers of all SEC-registered companies must attest to the accuracy of their financial filings. If they do so knowing the information is false, they will face fines of as much as $5 million and as long as 20 years in prison.** This is likely to force senior executives to move quickly to ensure their financial reports are correct before signing-off on their accuracy. The SEC has already demanded that top executives at the 1000 largest U.S. companies swear that their most recent financial filings are accurate by August 14, 2002.

The push for having CEOs and chief financial officers personally attest to the accuracy of their results has come directly from the crisis of confidence in corporate responsibility amid scandals from Enron Corp., WorldCom Inc. and others. After a string of major accounting scandals knocked down several companies and undermined stock markets during the past year, the SEC mandated that CEOs would have to swear that their companies' financial statements fairly and accurately reflect their financial condition. Federal securities regulators are carefully reviewing chief executives' sworn statements on the accuracy of their corporations' financial reporting. So far more than a dozen certification statements failed to conform to Securities and Exchange Commission standards. In addition many companies requested extensions for filing their certifications and quarterly reports.

Wall Street's Analysts

The NASD, Wall Street's main self-regulatory agency, is considering a range of allegations made against both Wall Street analysts and their firms. Charges may include securities fraud and violations of NASD rules that bar analysts from making misleading statements to investors. Analysts could face a wide assortment of sanctions, including millions of dollars in fines and other penalties, such as a suspension or a permanent ban from the securities industry. Acting as a bridge between the financial markets and investors, analysts once toiled in obscurity, writing reports on companies, making earnings forecasts and recommending which stocks to buy or sell. However, a few top analysts evolved into Wall Street's equivalent of rock stars, earning huge bonuses and financial media hero worship. The NASD is now investigating analysts' positive research reports on companies where strong evidence indicated from other analysts and authoritative sources that they might be in financial trouble. **The recent stock**

market decline has led to numerous complaints from investors who lost money following the stock recommendations of former star analysts. The concerns are that those analysts' research and investment banking roles created a conflict of interest. As a result, they were overly bullish on companies since they feared that their firms would lose banking fees if they were bearish. The NASD, along with other stock regulators, has issued a series of proposed new rules attempting to curtail analyst conflicts. The NASD's action is sure to bring about a significant change in Wall Street's research community. Under NASD rules an analyst or a broker must have a reasonable basis to make a recommendation to buy a stock. If the basis for the recommendation does not have a reasonable foundation, it is a violation of the rules.

The Economy

The productivity of U.S. workers declined in the second quarter, taking the shine off one of the bright spots of the economy during the past eighteen months. Meanwhile economists are sharply lowering their growth and interest-rate projections, for both this year and for 2003. **The latest Labor Department productivity figures slipped to a 1.1% annual growth rate during the second quarter after an 8.6% annual growth rate in the first quarter. The slowdown came largely because the overall economy suddenly chilled, limiting the ability of companies to attain sufficient output from their workers.** Companies are responding to the new economic climate by cutting employees' overtime and the number of hours worked for the fifth straight quarter. Federal Reserve Chairman Alan Greenspan has based much of his optimism about the economic outlook on strong productivity trends. When workers turn out more goods and services with fewer resources it allows the economy to grow without producing inflation. This in turn makes it easier for the Federal Reserve to manage the U.S. economy. Over the long-term, strong productivity also helps raise household incomes.

While the latest numbers are down, many economists agreed the strong longer-term trend of productivity growth remains intact. In the eighteen months since the economy peaked in March 2001, worker productivity has increased at an average annual rate of 2.9%. That is well above the 1.8% average that followed the previous eight recessions. Mr. Greenspan believes this superior productivity performance has occurred because companies have made big investments in technology that have made them more efficient. Companies also have been aggressive in cutting costs in their efforts to drive profits from efficiency. **Forecasters on average anticipate the economy to grow only 2.3% this year, and increasingly, economists expect weakness to last well into 2003.** Economists expect the economy to grow by 3.2% next year, compared with an estimate of 3.6% a month earlier. **Just a few months ago, many economists**

expected the Federal Reserve to begin raising interest rates by year-end because of an improving economy. Now most say increasing interest rates are out of the question.

Today's Federal Reserve

Because inflation is so low, the Federal Reserve has been virtually flooding the market with money. Some weeks the money supply has grown by as much as a $2.5 trillion annual rate. With 10 year Treasuries yielding 4.2% and mortgage rates poised to fall below 6%, a massive home mortgage-refinancing boom is likely to occur, saving homeowners over $60 billion in mortgage interest expense. Increasing consumer spending and savings would follow as lower cost home equity loans and lower credit card interest rates stimulate economic activity. Rising corporate earnings and the absence of high profile corporate scandals and accounting fraud rumors should also help to restore investors' confidence particularly since many CEOs have had to certify the accuracy of their corporate financial filings by August 14, 2002.

Since global risks remain high, we expect the Federal Reserve to maintain their easy monetary policy. China will continue to be a source of deflationary pressure, and problems in Latin America will continue to fester; another recent troubling economic event was the IMF's $30 billion loan to Brazil. Latin America's problems will almost certainly add further weakness to global economic growth prospects. **Under these conditions increased U.S. government spending and an overall loose fiscal policy will be a necessity. We now expect U.S. federal budget deficits to exist for a considerable period of time.**

Consumer Spending

Corporate scandals and the stock market slump are threatening consumer confidence. **The University of Michigan's index of consumer sentiment fell in July and August. Consumers cited concerns about lower economic growth and higher unemployment for their pessimism.** They also expressed concern that careless corporate accounting and management scandals would hurt the economy. People are also feeling the losses in their equity portfolios and retirement accounts. **So far consumer spending has still remained strong. However, there appears to be an obvious disconnect between the stock market and consumer pessimism on the one hand and actual consumer behavior and spending on the other.**

A weak stock market probably has yet to influence consumer spending because of offsetting boosts from tax cuts, lower interest rates, increased money supply and higher housing prices. It's possible that with investors

now worried about losing stock profits not just from the overheated years of 1999-2000 but also from the 1980's and 1990's, the wealth effect from the decline in equities may become more pronounced. When people feel wealthier, they spend more, generating economic activity. Once they start to feel less well off and have concerns about the future they cut back, and this could cause the economy to slip into recession. Mr. Greenspan is currently striving hard to prevent that from happening.

Market Dynamics

With the short interest on the New York Stock Exchange having risen to a record 8 billion shares from 7.5 billion shares, margin debt declining another $10 billion to $136 billion and record amounts of mutual fund redemptions occurring during July as investors became frightened and panicked, a major market decline took place. As a result insider buying has increased dramatically, and the stage has been set for a rebound. **While there are now more attractively valued companies than there had been, many companies will be challenged to achieve the earnings growth necessary to support much higher stock prices. The dramatic market decline had partly discounted the earnings drag of under-funded pension plans, the expensing of stock options, the reduction of tax revenues for state and local governments, the slowdown in corporate capital spending and higher energy costs, or in other words, a slow-growth U.S. economy if not a double-dip recession.** However, people who today depend on interest income from savings have less to spend because interest rates are so low. This adds to the appeal of good dividend paying equities and interest bearing bonds. In the next Outlook we will discuss some industries and companies that we believe can benefit under these circumstances.