



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

January 2002

THE REBOUND

What Should We Expect?

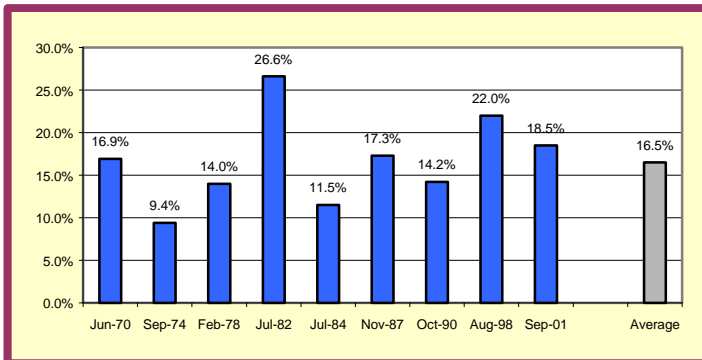
Looking back, it appears the bear market bottomed on September 21st. The decline during 2000 and 2001 was one of the longer and deeper declines experienced in the last quarter of a century, displaying many of the characteristics traditional to bear markets in terms of depth, duration, and despair. Similar to the others, the conclusion of this bear was punctuated by a dramatic event (Table 1).

TABLE I
Events Surrounding Market Bottoms

Market Trough	Crisis
2001	WTC and Pentagon Attacks
1998	Russian default
1990	Gulf War
1982	Double digit interest rates
1975	New York City default

The rebound from the September 21st trough also parallels the aftermath of other bear market bottoms (see Chart I) in terms of the magnitude of initial recovery. In eight recoveries since 1970, the S&P 500 Index (S&P) had an average advance of 16.5% three months following the prior

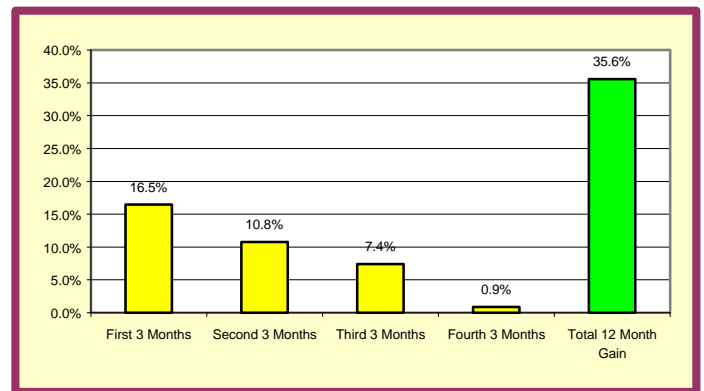
CHART I
Rebound 3 Months After Bear Market Troughs
1970 - 2001



trough. On December 21st, three months after trading resumed subsequent to the attack, the S&P closed 18.5% above its September low. Thus, the fourth quarter stock market rally was consistent with initial recoveries from prior bear markets.

These rebounds tend to anticipate recoveries in the economy by about a half-year. Rather than await confirmation that economic conditions have improved, investors react to the economic stimulus, oversold conditions, or other events that should lead to recovery. Thus, confirmation of a stronger economy often occurs after substantial gains in the stock market have already occurred. For example, the eleven-interest rate cuts by the Federal Reserve in 2001, last summer's tax rebates, and a decline in business inventories are expected to eventually produce improved economic conditions by mid-year.

CHART II
Rebound 1-Year After Bear Market Troughs
1970-2001



Elaborating further on the nature of rebounds from bear markets, Chart II shows the average gain in the S&P for each of the four quarters following its trough. This quarterly sequence suggests what may be expected over the next several quarters. On average, 43% of the twelve-month advance (16.5% of 35.6%) came within the first three

months. In the subsequent two quarters, prices advanced further, but in progressively diminishing amounts. By the fourth quarter, the gains became marginal. Therefore, if one assumes that September 21st marked the market trough, investors should not ignore the increase in stock prices that could still follow.

PORTFOLIO STRATEGY

In spite of the fourth quarter rise in stocks prices, the S&P closed the year 25% below its March, 2000 peak, reflecting continued investor caution and weak corporate profits. While most economists are predicting an economic recovery during the first half of 2002, these expectations are not yet supported by the data. Initial indications of an upturn in the economy may still be months away.

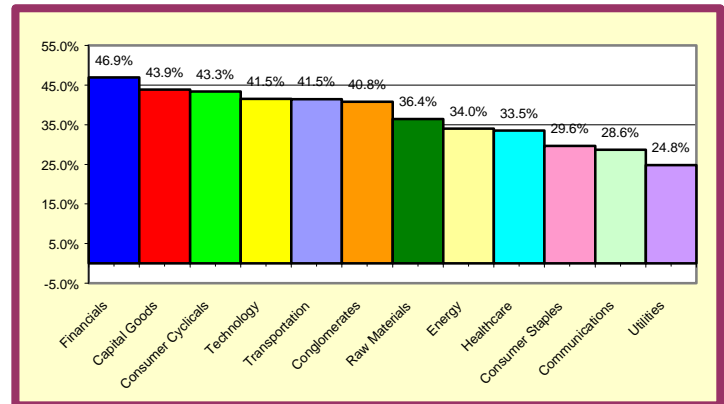
This period of transition from economic decline to recovery is fraught with crosscurrents and conflicting economic data that contribute to near-term stock market volatility. Thus, if the recovery is less vigorous than expected, stock prices could retrace some of last year's fourth quarter gains before the rally is more firmly established.

Therefore, at the outset of 2002, portfolios should have a balanced diversification between the more volatile cyclical sectors and the more stable sectors of the economy.

In general, the largest gains following a bear market trough tend to be in the most volatile and cyclically sensitive sectors as shown in Chart III. Allocation of funds to the cyclically sensitive sectors takes advantage of above-average returns that often occur during the first year of a stock market recovery. The average gains for the eight rebounds since the 1969-70 recession exceeded 40% in the financial, capital goods, consumer cyclical, technology, transportation, and conglomerate sectors. Those were also the sectors that declined the most during the prior bear markets.

Conversely, sufficient economic risk exists that it is advisable to mute this investment exposure with more defensive companies in the utilities, consumer staples, and healthcare sectors. While these sectors tend to have less of a rebound, such companies can still contribute to long-term investment returns and, at the same time, help the portfolio absorb short-term volatility.

CHART III
12 Month Sector Performance
After S&P 500 Bottom (1970-98)



Interest rates will also play an important role on market volatility this year. The Federal Reserve aggressively lowered interest rates last year to cushion the economic decline. This helped the stock market maintain relatively high price-earnings ratios despite declining profits. After all, low bond yields and paltry returns from cash reserves, were not compelling alternatives to stock. Should interest rates rise in 2002, it could curtail some of the normal gains expected from the first year following a bear market trough.

Rising interest rates could pose more of a burden on bonds. From the stock market peak in March 2000, the ten-year Treasury bond yield fell from 6.5% to a cyclical low of 4.2% on November 7th. This yield drop generated substantial returns for bondholders (tax exempt bonds did not fare as well). Since then, however, the ten-year yield advanced to 5.0%, and bond prices retraced some of their recent gains. When the economy firms later in the year, there could be additional pressure on interest rates, and a more conservative fixed income strategy would be appropriate.

TABLE II
Market Performance Comparison
(Including Interest and Dividend Income)
*Year to Date**

MARKET INDEX	12/31/00	12/31/01	Return
Standard & Poor's 500	1,340	1,148	-11.9%
Dow Jones Average	10,787	10,022	- 5.4%
NASDAQ	2,577	1,950	-21.1%
EAFE Index	1492	1155	-23.0%
3 Mth U.S. Treasury Bill	5.9%	1.7%	4.5%
10-Yr U.S. Treasury Bond	5.1%	5.0%	5.9%
10-Yr AAA. Tax-Exempt Bond	4.3%	4.4%	3.5%

*Estimate

Investment Management/Financial Consulting

7241 Southwest 168th Street, Miami, Florida 33157

Phone: (305) 232-4000 Fax: (305) 235-1920

www.earlfooteassociates.com