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MID-YEAR ECONOMIC UPDATE -- BUSINESS RECOVERY AHEAD

Economic data released since our last client letter in mid-May indicate the economy has done little more than stabilize in the current quarter following the free fall of late 2000 and the first three or four months of this year. Recently, various indices of consumer confidence have begun to show some signs of firming, unwanted inventories on the shelves of manufacturing firms have been largely worked down, initial jobless claims reported by the Bureau of Labor Statistics have leveled off, and the index of Leading Economic Indicators has turned up over the past two months. Nevertheless, severe weakness in the manufacturing sector remains a huge concern - - particularly in the hard hit tech and telecommunications industries. Economists fear that if factory layoffs persist and hours worked continue to decline, consumer confidence could be further undermined and weakness might spread to the heretofore strong consumer sector triggering a broader and longer downturn than is now anticipated.

In our view, aggressive easing by the Fed since early January, $38 billion of tax rebates coming between mid-July and the middle of October, lower energy prices we anticipate over the next few months, a stronger stock market and higher government spending will combine to provide the impetus for an economic rebound commencing later this year. Meanwhile, we expect anecdotal evidence of improved business conditions to emerge this summer, as the lagged effect of earlier interest rate cuts begins to impact the economy and the tax rebates provide a boost to consumer spending. We now estimate these payments will add about 2% to disposable income in the third quarter. If consumers spend one-third to one-half of this money over the next six months, in line with past experience with tax rebates, the effect would be to add 1 ½ to 2 ¼ percentage points to the annualized growth rate in consumer spending in the third and fourth quarters. As a result, we have greater confidence that our earlier forecast of 2 ¾ to 3% real GDP growth in the 2nd half of this year - - up from 1 ½ to 2% in the first half - - will prove to be close to the mark. Inflation is likely to remain quite muted in the slower global economic growth environment we see ahead.

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Analysts point out that beyond year-end there appear to be a number of impediments to stronger growth. Among these are:

1. *The washout in business capital spending*. In retrospect, business investment appears to have overshot on the high side during the boom of the 1990's as corporations overestimated the extent to which returns on capital had risen. This overbuilding may result in a further slowing in capital spending particularly in the information and communications technology areas, where the imbalances are most pronounced, until current excess capacity is worked down.

2. *The reverse wealth effect*. The net decline in stock prices over the past year and a quarter could impact consumer spending as households attempt to increase the amount they save out of income. Just as rising stock prices induced people to spend more and save less as they felt wealthier and more secure in the late 1990's, the subsequent setback is likely to have the opposite effects. Market capitalization is currently about $3 trillion below its peak of $20.2 trillion in March 2000 despite the recent stock market rally.

3. *The effect of job losses on wages and salaries* could offset, to some degree, the effect of the tax rebate leading to weaker than expected consumer spending as joblessness, which lags turns in the economy, increases over the next few months.

These potential obstacles are well known to Federal Reserve policy makers. We, therefore, expect the Fed to ease credit conditions further over the next few months dropping the fed funds rate target by an additional 50 to 75 basis points to 3 ¼ to 3 ½% by the end of this summer. While short-term interest rates are forecast to fall further, we believe longer-term rates have put in their lows for this cycle. In fact, bond yields are likely to rise this autumn as the economy begins to show some strength and inflation fears resurface. We await this development as an opportunity to extend bond maturities.

With the low points of both economic growth and the stock market now behind us, we expect the equity markets to continue their halting advance. Clearly, to date, the recovery in stock prices has been largely *liquidity* driven - - built upon the vast sums of money the Federal Reserve has pumped into the banking system. As yields on short-term investments have fallen, making these instruments less attractive than longer duration, higher risk securities, investors' appetites for stocks have been rekindled and the market has had a sharp snap back from its late March trough. With over $2 trillion in money market mutual funds and high cash positions in defined benefit retirement plans and equity mutual funds, there is still ample liquidity to drive the market further over the next few months. For this recovery to be durable, however, its next phase must be built upon expectations for *higher corporate profits* next year. While unproven at this point, we believe a sustainable corporate profit advance is in the offing.

Shares of companies whose businesses will benefit from a resurgence in consumer spending - - so called *early cycle* stocks - - are likely to be out-performers over the near term. In the anticipation of this emerging trend, we have added in the past quarter new holdings of Viacom and Omnicom, whose businesses are sensitive to shifts in consumer spending. In our continuing effort to appropriately balance equity portfolio allocations between large cap *growth* and *value* shares, the style which distinguishes our firm's investment approach, we remain equally weighted between the two disciplines - - finding attractive purchase candidates in both groups. Equity portfolios under our supervision have recovered substantially since late winter and we expect further irregular advances as signs of better business conditions emerge.

Enjoy the summer.

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