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INVESTMENT RESEARCH™

US Equity Market Monthly Outlook

October 2, 2000 — *The US stock market fell heavily in September with the S&P 500 suffering its worst monthly loss of the year. A bright spot remains, however, as the stock market moves into the seasonally strong fall and winter months. Market breadth worsened substantially in September as the slide in prices was broad-based. Volatility rose as prices dropped. Mutual fund inflows are slowing but remain positive. Bullish sentiment is a bit overdone. Future earnings growth is expected to continue its downtrend. Valuations remain high, particularly if profits have peaked. Small-cap stocks are performing relatively well, while the NASDAQ is down sharply. Overseas stock markets were down in September with emerging markets off the most.*

US Macroeconomic Outlook

The US economy is slowing but continues to be in generally good shape. Q3 real GDP is expected to slow to the 2.5-3.0% area, down from the torrid pace of 5.6% seen in Q2 and 4.8% in Q1.

The US economy is being pushed lower by (1) the Fed's 1.75 percentage point overall rate hike which has taken some wind out of interest-rate-sensitive sectors such as housing, (2) the downward correction in the high-tech stock market sector which deflated the wealth effect somewhat and reduced some of the speculative froth in the economy, and (3) the surge in oil prices which still has the power to curb consumer spending, corporate profits and investment spending, although oil's effect has been muted thus far.

On the inflation front, consumer prices are showing some upward pressure. The August CPI climbed by +3.5% y/y, holding just below the 9-year peak of +3.7% posted earlier this year in March and June. The core index in August accelerated to a 3-1/3 year high of +2.7% y/y.

The Fed doesn't appear to be greatly concerned about the headline CPI index, but the Fed is carefully watching the core index for signs that the surge in energy prices is seeping into generalized inflation pressures. So far, that seepage has been remarkably absent, but such pressure can move slowly and the Fed will remain vigilant. The Fed will also continue to closely monitor the labor market which remains very tight and continues to carry the potential to put up-

ward pressure on wage inflation.

The outlook for Fed policy over the past several months has improved dramatically. Whereas the markets earlier this year were discounting another 125 bp of tightening by early 2001, the market is now discounting a small chance for an easing.

The US interest rate outlook remains generally favorable. The 10-year Treasury Note yield has been trading in the 5.7-5.9% area for the past 2 months. That is at the bottom of the range established by the sharp downmove in yields seen earlier in the summer from the May 7-month high of 6.8%. In early September, Treasury yields moved somewhat higher in line with the sharp rally in crude oil prices, but then moved lower later in the month as energy prices fell into a downward correction. The 3-month Eurodollar rate in September basically remained locked at the 6.6% level.

Meanwhile, the global interest rate picture is mildly bearish. The European Central Bank is generally expected to raise interest rates at least another notch by the end of the year in response to the weak euro, import price pressure, and strong money supply growth. The Bank of England is expected to leave interest rates unchanged over the near-term although there is still a near-majority leaning toward further tightening.

The Bank of Japan is likely to leave its monetary policy unchanged at least through Q1. The BOJ's 25 bp rate hike in early-August was roundly denounced by most Japanese politicians and the BOJ probably won't move again until it is sure that a strong, self-sustaining recovery is in place.

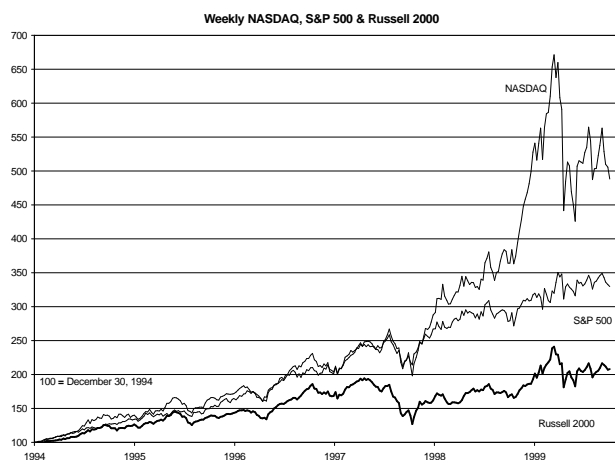
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Technical Picture

The S&P 500 index spent the entire month of September in a steady downtrend from the 6-month high of 1530.09 (posted on Sep 1) to the 2-month low of 1419.44 (posted on Sep 27). On the 6-month high, the index was just 1.5% below the March 24th all-time high of 1552.87. For the month, the index fell 5.3%, its worst monthly performance so far this year. For the year-to-date, the index is down 2.2%. If the S&P 500 shows a loss this year, it would be the first in 6-years, i.e., since 1994 when the S&P fell -1.5%. Since that loss in 1994, the S&P 500 index in the 1995-1999 period gained an average 26.3% per year.



From a seasonal perspective, the stock market is entering the volatile month of October. Over the past 50 years, the S&P 500 has actually risen by an average 0.4% in October versus the average monthly gain of 0.8%. In more recent years, the month of October has been even better with the index rising 6.3% in October 1999 and 8.0% in October 1998. Returns improve markedly in the November to January period which is the best stretch on the calendar. Gains have averaged better than 1.6% per month during those three months, double the average monthly gain.

Market Breadth

Stock market breadth weakened substantially in September after improving to its best level in a year during August. The worsening picture in September pointed to broad weakness in the market, which is a bearish development. For the month, 46 of the S&P 500's 87 sub-indexes fell and 48 were lower on a year-to-date basis. Regarding individual stocks, 260 of the 500 S&P stocks fell in September while only a narrow majority (252) are still up for the year to date.

Momentum among individual stocks worsened as the percentage of stocks on the NYSE trading above their 200-day moving averages fell to a 2-month low of 56% after hitting a 2-1/4 year high of 64% early in the month. The advance/decline line fell back from early September's 7-1/2 month high

(where it was up from March's 12-2/3 year low) as the number of declining issues exceeded advancing issues on a regular basis. The advance/decline *volume* line also dropped to a 2-month low, indicating that volume was flowing into declining shares. Also indicative of widespread weakness was September's 4.7% drop in the Wilshire 5000, considered to be an index of the entire US stock market.

Volatility

Volatility in the stock market rebounded smartly as stock prices slid in September. Volatility and share prices typically follow a well-defined inverse relationship with volatility rising when share prices drop and falling as the market rallies. The CBOE's OEX Volatility Index posted a 4-month high of 27.04% on September 22 where it was up sharply from the late August 14-month low of 18.06%. That low represents the bottom of the range seen over the past four years.

As noted in last month's letter, similar drops in the VIX to 18% or below in 1998 and 1999 were accompanied by short-term tops in the market and that was the case again in August as the drop in volatility likely represented investors' complacency with the stock market's rally. Similarly, investors should watch now for an upward spike in volatility which could represent investors' capitulation on a downside price correction and offer a buying opportunity. The VIX posted a 2-year high of 41.53% on April 14th, for example, which still stands as the low point in the S&P 500 after the March 24th all-time high was posted.

Mutual Fund Flows

Individual investors increased their stock mutual fund investments in August, according to the most recent data from the Investment Company Institute. The data pointed to an inflow of \$23.434 billion during the month, up 35.1% month-on-month and 154.4% year-on-year. According to estimates from TrimTabs.com, inflows into US stock mutual funds during the month of September totaled around \$10 billion, a significant decline from August. A decline in investors' participation in the market was a definite negative factor in September and contributed to the month's weakness.

Mutual fund inflows so far this year are up by 128% on a y/y basis but continue to trend lower since posting a record inflow of \$53.682 billion in February. Most of this year's money flowed in through the first four months of the year. And while August's inflow was the highest in four months, September's will likely be the lowest in a year. Overall, mutual funds continue to attract money but at a slower pace which remains a mildly bearish factor for the market.

Sentiment

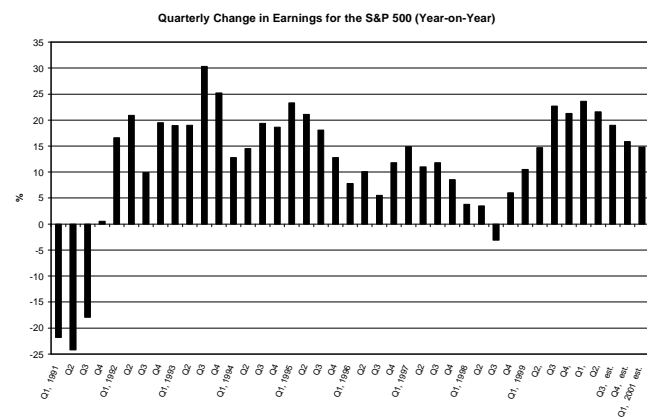
Sentiment in the stock market is fairly high and is a mildly negative factor from a contrarian standpoint. Among investment advisors, bearish sentiment (as measured by the

Investors Intelligence newsletter survey) fell for 4 straight weeks to a 6-month low at the end of September despite the drop in prices. Bullish sentiment, as measured by the newsletter survey, was at a 2-month high at the end of September. Neither measurement is at an extreme but bullish sentiment does seem to be a little overdone.

Another indicator of bullish sentiment, margin debt, rose by 1.2% m/m to \$247.0 billion in August, ending three straight months of declines. The increase in margin buying likely helped fuel the 11.6% advance in the NASDAQ during August. Just as likely, the increase in speculative buying in August made the technology sector vulnerable to the decline seen in September. Still, the total amount of margin debt outstanding amounts to only 1.3% of the stock market's total capitalization where it is down from the 26-year peak of 1.54% set in March.

Earnings

The stock market in the past several weeks has been suffering through a string of warnings from corporations about their earnings. In fact, warnings on earnings ran at a pace about 50% above that seen in Q3-1999. Some of the more high-profile warnings came from DuPont, Eastman Kodak, Intel, Whirlpool, TRW, Lexmark International, Alcoa, Gillette, Sprint, Apple Computer, and Goodyear Tire & Rubber. The warnings were mostly prompted by the weak euro and by slower PC growth.



As a result, the spate of earnings warnings led to a downward revision in expectations for overall earnings in the third quarter. Currently, the market is looking for 16.7% y/y earnings growth for the companies in the S&P 500. First Call is forecasting a final figure of 19.0% which accounts for the typical margin that the actual reports beat the estimates. While 17-19% earnings growth is very strong historically, it is still moderately lower than Q2's 21.6% and the 6-1/4 year peak of 23.6% posted in Q1. Earnings growth is expected to continue to move lower after Q3, i.e., to 15.9% y/y in Q4 and to 14.8% y/y in Q1.

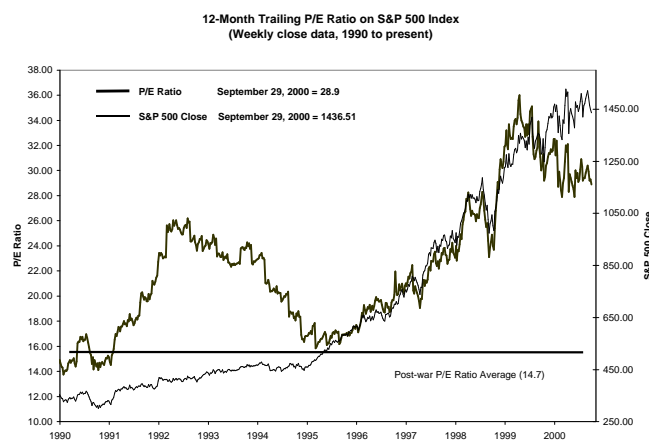
There are several reasons why earnings growth is expected to slow. Many of the companies listed above cited the dollar's big gains against the euro this year as a source of eroded European sales and profits. For example, whereas a single euro in European profits yielded \$1.07 when converted to dollars at the end of September last year, that same euro today is worth only about 88 cents. Other bearish factors for the earnings outlook include higher energy prices (which are increasing expenses) and expectations for slower US economic growth.

Among those sectors generally expected to report poor earnings are the automobile, chemical and consumer products industries. There are some bright sectors, however, with the pharmaceutical, energy, securities, and computer hardware and software industries expected to post solid gains.

Expectations for weaker earnings growth going forward represents a negative factor for the stock market which is still trading at historically high valuations. One positive factor for the third quarter is that stock market in September may have overshot on the downside due to the spate of earnings warnings. Thus, the market may be able to stage a rally on the release of the actual reports which will likely beat diminished expectations.

Valuation

Share prices are still trading at historically rich levels with the S&P 500's 12-month trailing P/E ratio standing at 28.9 at the end of September where it has been drifting sideways, moderately below April 1999's record of 36.0. The index's P/E ratio stands at almost twice the long-term average of 14.7.



Investors have come to accept high valuations but risks remain. With stock prices still generally representing lofty expectations, a bad piece of company-specific news such as an earnings warning can send a stock into a tailspin, even a company as large as Intel. In addition, high valuations combined with the expected slowdown in earnings seem to be putting a lid on prices with the broad stock market basically unchanged on the year.

Sector Analysis

The Russell 2000 index (the benchmark for companies with market capitalizations below \$1.5 billion) fell in line with the broader market in September, dropping 3.1%. For the year-to-date, however, the Russell 2000 is up 3.3% where it enjoys a performance advantage over the S&P 500, the Dow, and the NASDAQ.

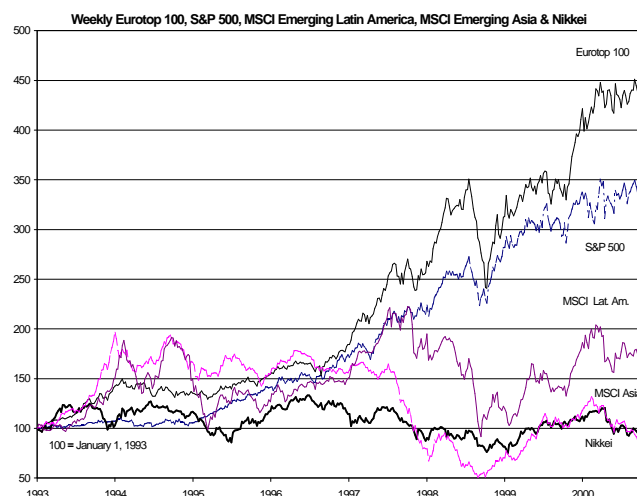
In the bigger picture, however, the Russell 2000 has only recovered about 1/2 of its 28% downside correction from the all-time high of 614.16 (March 10) to the 9-1/2 month low of 441.56 (April 17). The Russell 2000 is still feeling the effects of heavy IPO issuance which has satiated demand for existing small-capitalization stocks. According to Thomson Financial Securities Data, IPO issuance so far this year is up 93.6% over the same period in 1999. The Russell 2000 was also weighed down by September's technology sector slide. Nonetheless, the Russell 2000 is continuing to outperform the S&P 500 this year after beating it in 1999 for the first time in five years.

The NASDAQ moved to the top of its trading range in early September but then sold off to end the month near the bottom of its 4-month trading range. For the month, the index lost 12.7%, surrendering all of August's 11.6% advance. The NASDAQ ended September 28.4% below its all-time high of 5132.52 (March 10) and remains within its downside correction range which represents the biggest bear market since 1973/74. For the year, the NASDAQ is down 9.7%.

Sentiment in the technology sector took a hit after Intel warned on September 21st that its Q3 revenue growth would only be 3-5% versus previous expectations of as much as 10%. The announcement had a particularly negative impact because investors are now focusing more on revenues than earnings in the technology sector. That is because earnings in the technology sector are believed to have been boosted in part over the last few years by the one-time effects of cost-cutting and unsustainable productivity gains from restructuring. Technology sector earnings are also under a cloud from the effects of investment gains and share buybacks, increasing the importance of revenue, or "top line" figures.

Global Performance

In the big picture, European stocks (as measured by the FTSE Eurotop 100) have been consolidating for the past seven months in a fairly narrow range. Shorter-term, the index posted a new all-time high on September 5th but then went into a steep plunge in line with the US stock market before finally settling down 5.0% for the month. On the



year, the Eurotop 100 index is up 0.5% in euro terms but down 11.7% in US dollar terms. The focus in Europe will continue to be on the euro, European Central Bank policy, and the US stock market.

Japan's Nikkei index showed weakness during September and closed the month just mildly above the 1-1/3 year low posted in late July. For the month of September, the index fell 6.6% to extend its year-to-date loss to a total of 16.8%. In US dollar terms, the Nikkei is down 21.3% for the year.

On a year-to-date basis, the Nikkei is the worst performing G7 benchmark stock index (in either local or US dollar terms) and is in fact one of the world's worst performers. Much of that poor performance could be traced to weakness in the technology sector as the JASDAQ lost 9.7% for the month. The broader market was also weak, however, with investors still unconvinced that an end to Japan's economic troubles has arrived. That sent the yen lower during the month and saw overseas money flow out of the stock market for four straight weeks.

Emerging stock markets fell fairly heavily in September and are significantly lower on a year-to-date basis. MSCI's Emerging Markets Asian Index fell 13.3% in September and is now down 30.6% for the year. The Latin American index fell 5.3% in September and is down 10.1% for the year-to-date. Emerging stock markets have been risky investments this year, lagging when the US market rallies and falling faster when US stocks falter.

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