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IT *WAS* DIFFERENT THIS TIME

One of the more famous quotes of Sir John Templeton, for whom many of us at Centurion Alliance had the privilege of working for, was, "The four most dangerous words in the English language are 'This time it's different'". In making this comment, Sir John was referring to the wild claims of never-ending economic bliss made near the top of bull markets. A study of history, however, indicates the comment has been equally applicable during the rampant pessimism which pervades the investor psyche at the depths of bear markets. At least this was true until **the third quarter of 2002 when the normal relationships between the economy, corporate profits and the trend of stock prices was broken in a manner never seen before.** There is widespread agreement the US economy expanded at a 3-4% rate in the third quarter and this follows three prior quarters of economic growth, which have averaged a growth rate of about 3%. Economists believe the US economy bottomed in November 2001, almost a full year ago. This expansion in economic activity that followed has been somewhat below the rate seen in past recoveries, but the recession it followed was quite shallow as well. Despite this very reasonable economic backdrop, the S&P 500 is currently approaching the second-worst annual loss in the post-World War II period. Through the first three quarters of 2002 the S&P 500 has fallen 28.2%, while its worst full year since 1946 was in 1974 when the index fell 29.7%. To have such a dramatic fall in stock prices while the economy has been growing at a reasonable rate is unprecedented. Table 1 highlights just how extraordinary this decline has been versus historic norms for the US economy after the start of an economic expansion.

Likewise, corporate profits began to improve months ago. Profits actually rose slightly in 2002's second quarter and are widely projected to have increased in the 5-8% range in the recently completed third quarter. Moreover, the expectations are for even better growth in the fourth quarter of 2002 with profits likely to be 12-17% higher than the previous year. **While many companies (particularly those in the technology and telecommunications industries) are experiencing falling profits, the average company is actually experiencing improved profitability.** Again, it is unprecedented for such a dramatic sell-off in share prices to occur when profits have actually been improving.

In our last letter we also pointed out that there had never been a time in the post-war period that stock prices had failed to achieve a positive return after a quarter where the returns had been as bad as those seen in 2002's second quarter. Once again, the unprecedented occurred. As shown in Table 2, not only did share prices decline, but the decline was even worse than the second quarter of 2002 and the sixth worst quarterly return in the entire post-war period! In fact, 33% of the nine worst quarterly

TABLE 1

THE S&P 500'S TOTAL RETURN
AFTER THE START OF ECONOMIC EXPANSIONS

Expansion Starts	3 Months Later	6 Months Later	9 Months Later	12 Months Later
11/30/1927	0.7%	17.8%	24.2%	45.8%
03/31/1933	88.9	72.2	79.0	92.5
06/30/1938	7.4	17.3	-1.4	-1.4
10/31/1945	12.6	14.8	10.9	-7.3
10/31/1949	8.1	16.4	16.9	30.1
05/31/1954	3.4	20.1	30.3	35.7
04/40/1958	9.7	20.3	31.0	37.2
02/28/1961	5.7	8.9	14.9	13.5
11/30/1970	11.9	16.1	16.3	11.3
03/31/1975	15.3	2.7	11.6	28.3
07/31/1980	6.0	9.0	13.0	12.8
11/30/1982	8.1	19.9	22.7	25.5
03/31/1991	-0.3	5.0	13.8	11.0
12/31/2001	0.3	-13.2	-28.2	?
Mean	12.7	16.2	18.2	25.8
Median	7.8	16.2	15.6	25.5

SOURCE: NED DAVIS RESEARCH

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declines in the S&P 500 since 1946 have come in the last five quarters, and 40% of the ten weakest quarters have occurred in the last seven quarters. It has indeed been an extended period of misery for investors.

TABLE 2

13%+ QUARTERLY DECLINES IN THE S&P 500 AND THE FOLLOWING QUARTER'S PERFORMANCE SINCE 1945

Quarter Ending	% Decline	Next Quarter's % Increase
9/30/46	-18.8%	+2.3%
6/29/62	-21.3	+2.8
6/30/70	-18.9	+15.8
9/30/74	-26.1	+7.9
12/31/87	-23.2	+4.8
9/28/90	-14.5	+7.9
9/28/01	-15.0	+10.3
6/28/02	-13.7	-17.6
9/30/02	-17.6	?

Source: ISI Group

What Then is the Market Thinking?

When viewing recent trends in share prices we are reminded of the Old barb that "the market has successfully predicted nine of the last five recessions". At times the market gets carried away with emotion and makes mistakes in pricing both stocks and bonds. Might this be just such a time, thereby offering wise investors an attractive long-term investment opportunity? Or is the market, through these never before seen developments, actually communicating something far more ominous?

Clearly, one reason for the market's dreary state is the many corporate corruption scandals that erupted in late 2001 and the first half of 2002. Coming on the heels of the sharp retreat in share prices, these revelations soured many investors on the capital markets. Enormous media attention left the impression that most corporations were guilty of malfeasance and this, while clearly false, certainly played a role in the remarkable slide in share prices in the third quarter. **As we anticipated, the SEC's certification process showed that almost all companies' results were indeed legitimate. Still, a lingering suspicion remains in the minds of many investors that corporate earnings in general are not to be trusted.** It is unfortunate the sins of a few corporate chieftains have had such negative repercussions on the many companies managed with integrity. In this case, emotions seem to have triumphed over the facts.

Similarly, despite the fact that virtually every economic report indicates the economy as a whole continues to grow at a somewhat below-average, yet reasonable, pace for an economic recovery (see Chart 1), investors seem convinced this is not the case or at least it cannot possibly continue. Again, the financial media has greatly aided and abetted this pessimistic thought process with a torrent of negative spin on even the most positive of economic reports. It is not surprising that many investors remain under the impression that the US economy is still in a recession. Portions of the economy are indeed facing difficult times, but this has offsetting benefits to other, larger parts of the economy, which are booming. Interest rate sensitive sectors of the economy (housing, autos and related industries) are currently enjoying boom times, because of the low interest rate environment that weak business investment trends and low inflation rates have allowed.

More recently, while the fear of terrorism has waned, the specter of war with Iraq has weighed on investor confidence. While war always involves uncertainties, the market is likely blowing concerns about the potential outcome of a war with Iraq out of proportion. As seen after the collapse of communism, peace is good for the world's financial markets, and we expect a positive market impact once the situation in Iraq is resolved.

Given that the economy and corporate profits are growing, the market's harsh reaction can only indicate the average investor feels these trends will soon reverse. This too, however, does not square well with the current data. For example, share prices and economic activity typically are both well correlated with the rate of growth in liquidity in our economic system. Liquidity growth has actually been high and rising in recent months thus providing a favorable impetus to growth (see Chart 2). Moreover, we know low interest rates have almost always been an effective means of spurring economic growth, generally with a lagged effect. Both short- and long-term interest rates have been low and falling steeply for some time suggesting a powerful force for current and future economic growth has already been put in place. In addition to these monetary policies which are very pro-growth, fiscal policy has also shifted into a growth mode as federal and state budget deficits also have an expansionary impact. Finally, inventories have been whittled to the bone, suggesting that the simple end to the rapid liquidation process could add significantly to future economic growth. Should inventories begin to be rebuilt, 2003's economic growth could

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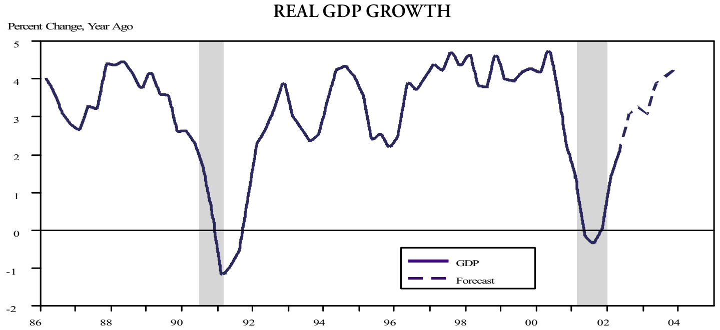
actually be surprisingly rapid. Accordingly, absent an exogenous debt- or terrorism-linked economic crisis, it would seem difficult for the economy to fall back into recession or for corporate profits to begin to drop again given this stimulative economic backdrop.

Yet, despite such evidence, the market appears to be anticipating a further dramatic decline in economic and corporate growth. US Treasury yields have plummeted and gold prices have risen as investors have fled to perceived safe havens. Yield spreads between Treasuries and more risky corporate bonds have expanded and stock prices have fallen sharply in an environment (rising profits and falling interest rates) when they would normally increase. As the continued retreat indicates, the market has discarded normal indicators and fears that something more ominous is unfolding. Let's dig deeper and examine some of the potential scenarios which are frightening investors and might be causing these unusual reactions.

CHART 1

RECOVERY ON TRACK

REAL GDP GROWTH

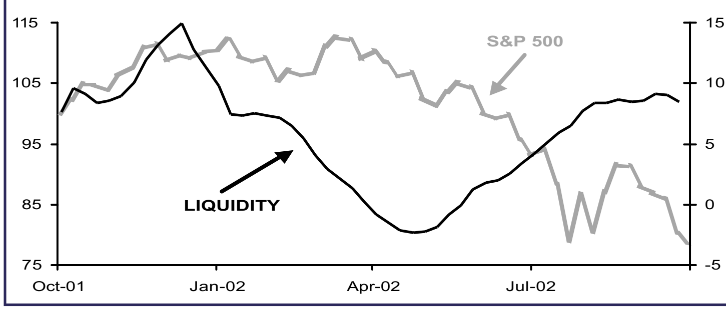


SOURCE: BUREAU OF ECONOMIC ANALYSIS, MERRILL LYNCH

CHART 2

LIQUIDITY GROWTH & THE S&P 500

S&P INDEXED AT 100, 10/1/2001, LIQUIDITY = M3+CP 4WK AVG 13WK % CHG



EURO-SCLEROSIS, HARI-KARI, LATIN LEFTISTS AND DEFLATION

While we can see many reasons why the average investor is overreacting to the situation in the US, this does not mean we are wearing rose-colored glasses. There are many legitimate concerns of a global nature which are troubling, as there always have been throughout the history of investing. Wise investors do not ignore these risks but attempt to properly understand them and position themselves accordingly.

The first area of concern is the prospect for a renewed recession in Europe. Unlike the US, monetary policy in Europe has been somewhat restrictive. The new European Central Bank (ECB) seems determined to convince the world that it is an inflation fighter of the highest order. As a result, the ECB has continued to fight the previous war, inflation, while forgetting to look ahead to the next, declining economic growth. The restrictive monetary policy stance of the ECB is further compounded by limitations on the flexibility of fiscal policy. Europe also faces what has become known as "Euro-sclerosis", structural economic impediments that clog its arteries of growth, such as labor laws making business management difficult, costly socialistic domestic policies and high taxes. While all these factors may contribute to a potential double dip in Europe, the impact on the US should, by itself, not be so severe as to thwart our economic rebound. If left unaddressed, these policies may well lead to a 2003 European recession and a weaker Euro. We suspect, however, that the ECB will soon alter its policy to a more accommodative stance. It may also change its rules to allow for a more expansionary fiscal policy as well. Not surprisingly, European stocks have performed as poorly as US stocks so far this year.

Japan continues to be a source of potential trouble. The unprecedented recent decision by the central bank to purchase stocks from the nation's weak banks indicates how desperate the situation has become. The reason for this maneuver is that the bank's capital positions are so poor they could not contend with falling Japanese share prices. Accordingly, the central bank seems to

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be predicting a fall in Japanese equities, as equity positions must be removed from bank balance sheets before the decline occurs. Oddly, Japan remained among the world's best performing markets this year, despite the seemingly unending economic malaise the country has endured. Given what has happened elsewhere in the world's securities markets, the performance of the Japanese market lends credence to the thought that the government manipulates Japanese stock prices. Be that as it may, the real problem for investors to contend with is whether we can avoid a major meltdown of the Japanese financial system, which may have global ramifications. Recent rumors abound that some action will again be taken to deal with the country's massive bad loan problem. Eventually, this will have to occur, but it is an action with consequences, such as corporate bankruptcies and a weaker yen. Still, these difficulties are likely to be largely contained within Japan's borders even as the country seemingly continues down a path of economic hari kari.

Trouble is also brewing south of the border. Argentina already collapsed into a disastrous pit of debt-induced depression. Now, Brazil is on the verge of electing a leftist president whose socialist leanings already have the country's bond and currency markets careening. Should the markets lose faith in the new president because of his socialist tendencies (many of which he is now backing away from), economic disaster for the country may not be far behind as Brazilian debt would not be able to be serviced. If a default was to occur, some impact on the world's largest banks would be unavoidable, but it is not likely to reach the scale of the Latin American debt fiasco that occurred in the 1970s. Indeed, some European banks may be more at risk from a Brazilian financial debacle than most large US banks. While the impact of a Brazilian meltdown would be more significant to the world economy than the Argentinean problem, it would not likely be a significant enough event to cause a serious global destabilization.

The growing fear of deflation is perhaps the greatest threat to US economic prosperity as well as the best explanation of the odd behavior of our financial markets recently. Like the oil industry in the 1980s, the technology and telecommunications industries are now clearly suffering through a deflationary environment. Many investors are worried that falling demand and prices will spread throughout the entire economy and a 1930's style depression will envelop the US. It is feared the high debt levels built up due to dubious spending during the recent bubble could lead to widespread defaults and a financial industry crisis as many companies and individuals would be unable to service these debts under deflationary conditions. While this risk needs to be monitored closely, there does not appear to be a strong probability of such deflationary conditions spreading beyond the technology and telecommunications areas. Moreover, the Federal Reserve is aware of these risks and would quickly pursue dramatic actions to avoid such difficulties. Many believe the Fed will soon cut interest rates, signaling its intent to forestall any deflationary developments. Likewise, at the first sign of deflation, Congress would likely take legislative action to incentivize write-offs of unproductive plant and equipment, promote investments in new facilities, and provide inducements to save and reduce debt. Deflation is politically unacceptable, as it would cost most politicians their jobs. That is one reason it has been so rare an occurrence and its somewhat more acceptable counterpart, inflation, has been more prevalent.

In our view, the greatest risk to our more optimistic outlook is that growing pessimism leads to a self-fulfilling prophecy of renewed economic weakness. While we continue to monitor this and other risks to our investment outlook, **we currently believe the relatively slow recovery in economic growth and corporate profits in the US, already well underway, will continue, and there is even a chance it will accelerate in 2003**. Additionally, Asian economies outside of Japan have been expanding at a healthy rate fueled in large measure by strong domestic demand and vibrant intra-regional trade flows. We anticipate that these trends will continue, offering new investment opportunities for your portfolio.

SAFETY IS VERY EXPENSIVE, RISK IS CHEAP

One year ago, just after the September 11 attacks, we used a similar title in our letter to clients. In view of the extreme fears at that time, we thought investors were overpaying for "safe" assets and giving away "riskier" assets. At that time, we were still in a recession and most thought it would get far worse as a result of terrorism. Just the opposite occurred and equities provided very impressive returns in the fourth quarter of 2001 and our clients' portfolios significantly outperformed. Currently, the US economy is well out of recession, terrorists seem largely ineffective, and in the words of FDR, "The only thing to fear is fear itself." Nevertheless, share prices are now lower, plus gold and US Treasury bond prices have risen dramatically. Chart 3

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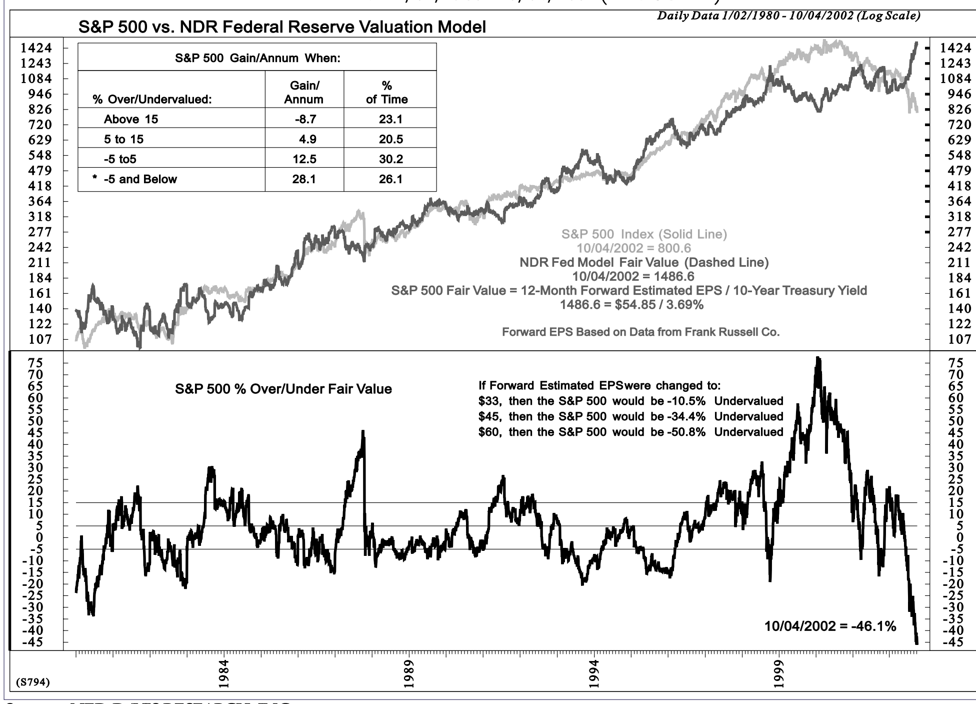
shows just how cheap stocks are relative to 10-year Treasury bonds. This simple yet effective model devised by Alan Greenspan measures how overvalued or undervalued stocks are given the level of long-term interest rates. As can be seen, stocks are in record undervalued territory as price-earnings ratios have uncharacteristically fallen sharply even as bond yields have collapsed to record lows. In essence, this model tells us the market is assuming S&P 500 earnings of under $30 per share next year while the consensus forecast currently calls for earnings of more than $54 per share. Clearly the market is forecasting some type of unpredictable, cataclysmic event. While consensus estimates are often too optimistic, the market's highly pessimistic implied earnings forecast appears to be simply outlandish. **As fears diminish in coming months, bonds are likely to lose some of their current allure and equities should regain a good portion of the investor respect they recently lost.**

CHART 3

S&P 500 VS. NDR FEDERAL RESERVE VALUATION MODEL

DAILY DATA 1/02/1980 - 10/04/2002 (LOG SCALE)



SOURCE: NED DAVIS RESEARCH, INC.

One manner of determining the appreciation potential of a market is to forecast its earnings and its P/E multiple and multiply them. For the S&P 500 let's assume a below-consensus 2003 EPS estimate of $50 per share. With negligible inflation, interest rates at very low levels and earnings in a recovery mode, a P/E of 20x would not be out of line with historic norms. Thus a reasonable price target would be 1,000 on the S&P. This represents 25% upside from the level seen at the beginning of October of approximately 800. Taking a longer-term view, if S&P earnings were to grow at slightly less than 7% annualized over the next five years to $70 and a P/E of 20 can be achieved, the S&P 500 would rise to the 1,400 mark, 75% higher than current levels. This represents almost a 12% annual return to equities over that period, far superior to the returns that could likely be achieved from bonds. Therefore, "risky" assets like stocks now appear to be cheap while "safe" assets like US Treasury bonds appear very expensive.

REASONS FOR OPTIMISM

If today's investors had not suffered through the long, painful bear market, a different view on the attractiveness of today's share prices might exist. Share prices are at their lows and are 50-75% off their highs. The economy has been growing for the past year. Corporate earnings have already begun to recover. Inflation is hovering in the 1% range. Interest rates are at all-time lows and price-earnings ratios are significantly below the normal level for this type of economic environment. Pessimism still pervades the market, keeping investor expectations quite low and therefore easier to exceed. Money market funds are flush with cash. Many companies are selling at low multiples of the net cash on their balance sheets. Monetary and fiscal policies are favorable. Business inventories are at record low levels and, while the possibility of war exists, stocks have generally performed well during wars. In view of the facts, we are of the opinion this is a time to be optimistic about the long-term outlook for equities.

We provide a list of potential catalysts for a rally in Table 3. The market is currently massively oversold and primed for recovery The weight of evidence is overwhelmingly in favor of positive results being achieved from this point forward. October is known as a month of disastrous sell-offs, and the current black mood on Wall Street may yet lead to another such time of irrational

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panic. Of course, each of these past sell-offs represented superb buying opportunities for long-term investors. While remaining watchful for indications that something different is happening this time, we believe the most likely scenario is for the economy to continue to recover and for share prices to move higher over time as the unwarranted and intense level of fear begins to recede. We have raised some cash in your portfolio in order to take advantage of any Leader stocks that might fall to ridiculously low levels in relation to their long-term earnings power during any panic selling climax. We also remain poised to raise further cash if we can see that our optimistic approach may be invalid.

During difficult periods like this, when the markets are acting in ways that defy logical analysis, we appreciate your confidence in our ability to deliver superior investment performance over the long term.

TABLE 3

POTENTIAL CATALYSTS FOR A STOCK MARKET RALLY

- Consistent evidence of growth in economic reports
- Surprisingly good corporate earnings reports
- Increasing optimism of future prospects from CEOs
- Further Fed easing as well as pro-growth Fed comments
- Pro-growth legislation
- Resolution of the Iraq issue
- Evidence of a bottom in the tech and telecom sectors

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