Stamper Capital & Investments, Inc.

"Focusing on Upside Potential with Downside Protection Since 1995."

January 2002 Market Commentary

2001 Recap

As we forecast, 2001 turned out to be a rough ride similar to 2000 when the equity markets took their major drubbing, but this time it was the economy that went down. In late 2001, the National Bureau of Economic Research officially dated the recession as starting in March 2001. This dating is interesting since very few economists had forecast the recession before it had started in March or even before it was officially recognized in November. Now many market commentators are forecasting a rebound in early 2002 - a forecast we disagree with. Our 2001 forecast was that, "we, along with the Economics Department at UCLA, expect that the U.S. will be in a recession sometime this year (2001)."

We believe the direction of the equity markets is the best indicator of the coming state of the general economy. Accordingly, we believe our forecast of the stock market top in 2000 is much more significant than our forecast of the downturn in the economy, which officially occurred in early 2001 and is continuing. Either way, both of our forecasts were ultimately based on the fact that the high yield, junk bond (taxable) market had been crumbling for some time (since mid-1998). In January 2000 we said, "this credit crunch (in junk bond financing) and the accompanying spread widening [of taxable junk bonds versus high quality bonds] may be the first signs of an economy dropping into recession."

As for Bonds in 2001, short term interest rates of high quality bonds dropped substantially as the Federal Reserve lowered interest rates an unprecedented eleven times in one year. However, long term interest rates as measured by the U.S. Government, 30 year long bond went up by 20 basis points to 5.60% at the end of 2001. Both of these results happened to be in line with our forecast where we said, "…if the economy continues to weaken, the Fed will likely continue to lower [short term interest rates] and long rates will probably rise not fall." We also forecasted that "low quality bonds will continue to have problems," which they did. In fact, the default rate on low quality bonds was its highest since 1991.

One other comment on 2001 - September 11th. Many people in the media are blaming the weakness in the economy on the tragic crime of September 11th, 2001. While we agree that this shock has aggravated the economy, weakness in the economy began to show up as early as in 1998 with a peak in the advance decline line and with the credit crunch in the high yield, junk bond (taxable) market. Next, in early 2000 the Dow, S&P, and NASDAQ all toped and began falling. The NASDAQ had fallen from around 5055 at its March 2000 peak to around 1630 by its first major low in April 2001. The 68%

drop in this major index could have plunged the economy into recession all by itself. All negative economic events occurred well before the September 11th tragedy and are related to very long term trends in social psychology and the economy.

Looking forward to 2002 - The Year the Recovery Doesn't Begin
Some market and economic prognosticators are forecasting a quick bounce out of the recession and an accompanying rise in the prices of equities. We disagree with both of those forecasts for several reasons.

The Economy - Although the current recession has already lasted as long as the average post war recession (ten months), we have yet to see any substantial indications of a turnaround. We see this economic turndown as different than all previous post World War II recessions. It is much more similar to what has been going on in Japan, which has been in a depression since 1989 and is now facing deflation, and like 1929 and the 1930's in the U.S. In fact, the U.S. is now in a period of disinflation and could be in deflation by the end of the year.

We believe the most distinctive characteristic of these periods is the huge mal-investment prior to their depression periods. The run up in equity prices in 1929 in the U.S. and in the late 1980's in Japan and recently in the late 1990's in the U.S. are all similar and represent manias where many investments were made without regard to valuation.

You might remember back in 1995 (I believe) when Alan Greenspan was talking about "irrational exuberance" - the Dow was around 4700 at that time - it is currently around 10,000 - more than double that "irrational" level (9-23-02, I finally found the actual date of Greenspan's remark - it was on 12-5-96 and the Dow was around 6,500; thus, while later and higher than I remembered, the point is still accurate and turned out to be very useful.). In addition, the Federal Reserve has lowered short term interest rates and unprecedented eleven times in one year (2001). Greenspan has taken this move because he realizes how susceptible the economy is to a prolonged downturn as those poor investments are liquidated.

Over $5 trillion in stock market value has already evaporated - we believe that investors who participated in those losses will be reallocating their remaining wealth and future incomes substantially differently than in the past, possibly creating a ripple effect that will cause similar economic problems for others. We believe this reallocation process will take several years and will be a more painful process than all previous post-war recessions.

One very good indication of the future severity of this recession is the bankruptcy and collapse in the investment value of Enron - a decrease of approximately $66 billion in equity and $30 billion in debt at a minimum. This is the largest bankruptcy in America's history; the magnitude of this collapse should give us an idea of how long and difficult this recession is going to be.

Equity Prices - Prices of most equity securities are still very high - even though many of them have already dropped considerably. The easiest way we know of to realize this is to look at price earning ratios and at dividend yield ratios. We have touched on this method several times over the past few years. In our 2001 market commentary, we highlighted that the current multiple of dividends for the S&P 500 was at 86x compared to an average of 25x over long periods of time. Based on those calculations, the Dow, which was then at 10,500, was overvalued by around 71%. Today, the Dow is slightly lower at 9,891. However, company earnings are much lower now than then, so in fact, on a price/earnings basis, the Dow is actually trading quite a bit higher. Accordingly, we believe equity prices are still considerably overvalued and face substantial erosion in value.

Bonds - The yield curve is now very steep with short rates low and long rates higher. Because short rates are so low (1.58% for the 3 month U.S. T-bill), many are going to be tempted to invest in longer bonds or in low quality bonds. Because we think the economy will continue to weaken, we recommend avoiding most low quality bonds - these are best left to the experts. As for long, high quality bonds, we believe long interest rates bottomed in November shortly after the Federal Reserve announced cessation of the U.S. Government long bond. Since that time the yield on the long bond has risen by approximately 50 basis points from 4.80% to around 5.30% today. We believe the curve will continue to steepen with another interest rate cut by the Fed at the short end and with longer rates continuing to drift upward. Accordingly, we recommend higher quality, shorter duration bonds.

Summary - Equity levels continue to be exceedingly high. The economy will remain in recession throughout 2002. Low quality bonds will continue to perform poorly. Short interest rates will go a bit lower and high quality, long rates will drift higher. The safest values are in shorter term HIGH quality bonds or HIGH quality money market accounts. We continue to believe SAFETY is the watchword for this decade.

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Stamper Capital & Investments, Inc. has been the sub-adviser to this Fund since October 1995 and B. Clark Stamper, our President, has been its Portfolio Manager since June 1990.

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