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SUMMARY

- Stocks finish down for the year.
- Bond prices surge as long term interest rates drop.
- Slower growth, but no recession.
- Market decline brings investor expectations back to reality.

YEAR 2000 REVIEW AND OUTLOOK FOR 2001

The stock market declined broadly throughout the fourth quarter, and the expected year-end rally never materialized. The major market indices all finished with losses for the year for the first time since 1990 and only the second time since 1981. Recapping the major indices, the S & P 500, which represents the broader market, including a substantial dose of technology, finished the quarter down 8.1%, bringing the full year loss to 10.1%. The NASDAQ, dominated by technology stocks, suffered its worst year ever, off 30.8% for the quarter and 39.3% for the year. International markets fared little better with the Morgan Stanley EAFE off 4.5% and 16% for the quarter and the year, respectively. The Dow Jones Industrials suffered least, up 0.8% for the quarter and down 6.2% for the year. The bright spots for the quarter included health care, transportation and basic materials.

The bond markets provided some relief from the difficult equity markets. Bond investors saw long term interest rates drop sharply and prices surge in the fourth quarter as investors sought the relative safety of Treasury bonds and high quality corporate bonds. The yearlong downtrend in rates continued, and the trend appears poised to test the

Year 2000 Stock Market Performance

	Fourth Quarter	Year 2000
S&P 500	-8.1%	-10.1%
Dow Jones Industrial Average	+0.8%	-6.2%
NASDAQ Composite	-30.8%	-39.3%

lowers from 1998. The rate on the ten-year Treasury finished at 5.12%, down from 6.36% at the same time a year ago.

The economic and political outlook remains rather benign, although the stock market's recent performance would imply otherwise. The Federal Reserve's campaign to prevent inflation by raising short term interest rates is now paying off, perhaps too much, as a slowing economy has brought about a slew of high-profile profit warnings. The good news is that inflation is no longer the Fed's primary concern, and the Fed unexpectedly cut interest rates aggressively only three days into the new year. Declining interest rates are usually helpful to the

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Year 2000 Review and Outlook for 2001 (continued)

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equity markets. Most experts still expect slower growth, but not a recession, and the general consensus is that the Fed remains vigilant and will act swiftly to alleviate any major financial crisis.

Oil prices appear to be stabilizing, although at a higher level than in recent years; and the surge in natural gas prices will bring about more production. Politically, the seemingly unending presidential election rankled the markets but effectively maintained the status quo of gridlock on Capitol Hill. The balance of power all but ensures that no sweeping legislation, such as massive tax cuts or spending of the budget surplus, can be enacted to upset our economic apple cart.

Conditions for equity investing have been so good for so long that many investors have come to expect stocks to always go up. The price-to-earnings ratios on equities became grossly inflated during the 1990's and out of sync with the traditional measurements of equity value. While the 90's brought an

economic expansion of historic duration, the phenomenal stock market returns of that period had more to do with inflation of stock prices than with superlative corporate earnings growth. There have been times when earnings growth was more robust but for shorter periods of time. The effect of the market decline of 2000 has been to inject a harsh, but necessary, dose of reality into the investment scenario. The high returns of the late 90's were simply unsustainable without some reversion to more normal rates of return. The chart below illustrates the Price-to-Earnings ratio of the S & P 500 at market peaks and troughs over the past seventy years. The PE of 30 at the peak in 2000 is obviously far in excess of anything the market had sustained at prior peaks.

While 2000 was a trying year for investors, the same secular trends that fueled the great bull market of the past decade, and especially the past five years, remain largely intact. Low inflation, low interest rates, moderate

taxes and growth of productivity through innovations in communications, computer and healthcare technologies all contribute to an environment where equities are attractive investments. A virtuous cycle of consumer demand, capital spending and growth of corporate profits creates rising stock prices. In recent years the markets have emphasized the positive aspects of these conditions but overlooked the potential pitfalls, such as unsustainably high rates of economic growth and increased levels of corporate and consumer debt. The more we learn about what makes our economy and markets tick, the more important it becomes for the Fed to manage monetary policy very carefully.

As we begin the first year of the new millennium, there will no doubt be a few surprises ahead of us. The markets have an uncanny way of doing whatever it takes to prove the majority wrong. Our best strategy will be the same one we have used all along:



- *Buy quality* -- invest in companies that are financially strong, show predictability of earnings and have market liquidity.
- *Buy growth* -- invest in companies that are growing their sales and earnings faster than most other companies.
- *Diversify* -- invest in enough different companies and market sectors to achieve steady growth and avoid excessive risk.
- *Follow the long-term trends* -- invest where the big institutions and mutual funds are and take advantage of their market moving capability.

Best wishes for a healthy, happy and prosperous 2001.

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THE FUTURE. While our website provides access to a wealth of useful tools and information, at some point in the future we plan to offer our clients secure online access to their account information. Initially, we plan to offer our clients access to current and historical quarterly Portfolio Appraisals. In addition, we are taking a hard look at providing some level of transaction reporting.

-John E. Grace

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INVESTMENT OUTLOOK

I-Bonds

With inflation worries on the minds of many investors, Series I-Bonds may be an appealing investment. I-Bonds are a new type of U.S. Savings bond designed for investors seeking to protect the purchasing power of their investment while earning a guaranteed rate of return.

The earnings rate of an I-Bond is a combination of two separate rates: a fixed rate of return and a variable semiannual rate. The fixed rate remains the same throughout the life of the bond, while the variable rate can change every six months. The fixed rate of return is announced each May and October 1st by the Treasury Department, and it remains constant over the entire life of the I-Bond purchased during the six month period. The variable rate is based on changes in the Consumer Price Index for all urban consumers (CPI-U) and is adjusted every six months. The variable rate is combined with the fixed rate to determine the I-Bond's earnings rate for the next six months. I-Bonds are an accrual-type security, meaning interest is added to the bond monthly and paid after the bond is cashed.

I-Bonds have some compelling tax advantages. The earnings on I-Bonds are exempt from state and local income taxes, and federal income taxes on them can be deferred until redemption up to thirty years. Investors in I-Bonds

may be able to avoid some or all the taxes on I-Bond earnings by applying the proceeds to a child's college tuition. However, the tax break phases out depending on the taxpayer's adjusted gross income.

I-Bonds are sold at face value in denominations from \$50, \$75, \$100, \$200, \$500, \$1,000, \$5,000 and \$10,000. Individuals are limited to purchases up to \$30,000 in each calendar year. I-Bonds are redeemable after they are held for six months. However, you will forfeit three months' earnings if the I-Bond is redeemed within the first five years. After 30 years they stop accruing interest. I-Bonds can be registered with a single owner, co-owners, or beneficiary; and the registration can be changed.

I-Bonds are a safe, conservative investment with U.S. Government backing. I-Bonds are a convenient way to save for college tuition, as well as to periodically make gifts to children or grandchildren. They also can provide stability and inflation protection in IRAs.

Current Savings Bond Rates

I-Bonds	=	6.49%
EE-Bonds	=	5.54%
HH-Bonds	=	4.00%

-Watt Dixon

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