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### SUMMARY

- Stock market finishes down for second year in a row.
- Economy in business-led recession. Consumer spending holding up.
- Recovery and higher stock prices expected in 2002.
- September 11th provides turning point for market and nation.

### YEAR 2001 REVIEW AND OUTLOOK FOR 2002

As much as we would like to, we can never forget the year that just ended. The events of September 11<sup>th</sup> have affected us all in ways that we are only just beginning to fathom. We have had a painful reminder amidst all of our comfort and prosperity that the American way of liberty and democracy has not been secured without times of great suffering and sacrifice.

As the immediacy of September 11<sup>th</sup> faded and attention returned to the financial markets and economy, the market found reason to rally strongly in the fourth quarter. The rebound from the crisis lows of September 21<sup>st</sup> was impressive but failed to bring the market anywhere near where it began the year. For the second year in a row, all the major market indices finished well in the red. The bright spot was the bond market that fared well as a result of falling interest rates and investors' flight to safer havens.

Reasons for the poor market showing in 2001 are varied and subject to debate, but the continued deflation of the great speculative

#### Year 2001 Stock Market Performance

	Fourth Quarter	Year 2001
S & P 500	10.3%	-13.0%
Dow Jones Industrial Average	13.3%	-7.1%
NASDAQ Composite	30.1%	-21.1%
Morgan Stanley EAFE	6.8%	-22.6%

bubble of the late 90's is often cited. The mania over investing in anything related to the internet and technology was one of the greatest on record and not likely to be unwound in a few months' time. A peaking of economic growth with the ensuing fear of recession and its impact on corporate earnings is another well-worn excuse for the second off year. The decade-long economic expansion that ended in 2001 was the longest ever during peacetime and climaxed with a frenzy of unsustainable spending on Y2K preparedness  
*(Continued on page 2)*

**Year 2001 Review and Outlook for 2002 (continued)**

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and ramping up of corporate internet capabilities.

Perhaps the simplest explanation lies in the market returning to its long-term trend. The chart below shows the progress of the Standard & Poor's 500 Index from 1930 to the present. The S & P 500 has a well established uptrend dating back to the low of 1942. A steeper uptrend was established by the great bull market that began in 1982. The bear market that began in March of 2000 has brought the market back to the latter trend line, a critical point. Whether the market will stay with the 1982 trend or return to the 1942 trend is a question that will be answered only in hindsight.

Of more immediate concern is what to expect from the economy and the stock market in 2002. Our economy is in recession now, and we

join most of the globe in that same unhappy situation. The nature of this recession has been more of a collapse in business spending as opposed to consumer spending. In fact, consumer spending has held up remarkably well to this point.

We can expect the economy to begin growing again in 2002 as businesses work off inventory and find the need to resume capital spending. Some signs of recovery are already in place. The Federal Reserve will probably keep interest rates low and continue to be more concerned about renewed economic weakness than rising inflation. Low energy prices help businesses and consumers and should have a greater impact on spending than any tax cuts. Refinancing of corporate and consumer debt at lower rates should also aid in recovery. The corporate retrenchment of the past year should

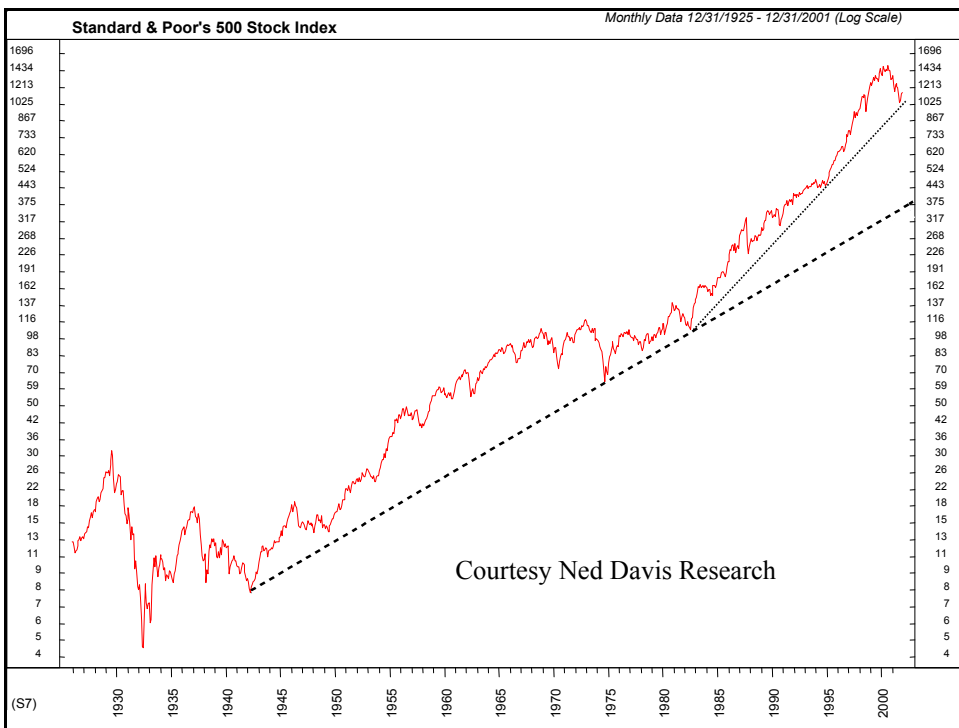
allow corporate earnings to recover sharply, even with only modest economic recovery.

The eventual recovery is likely to be subdued. The expansion of the 1990's and the boom in the stock market rode largely on the back of debt. Corporate and consumer debt levels remain very high, though lower interest rates may keep debt service manageable. We are not likely to see a great surge in consumer spending since the consumer has been spending all along, and there is not much pent up demand. The automakers' 0% financing deals proved to be a big hit. Energy prices remain a wild card. If OPEC and friends get their act together, or there is another crisis in the mid-East, we could see much higher oil prices.

The stock market will lead the economy out of the recession. The post-attack market plunge in September may very well have provided the climax ending to the eighteen-month bear market. Although stocks on average are still at high valuations as judged by price-to-earnings ratios, the market may not be too concerned if there is a significant rebound in expectations and confidence. Just as stocks remained drastically undervalued for much of the 1970's and early 1980's, they may remain overvalued for an extended period as well.

The market advances when there is plenty of money to go into the market and a reason to put it there. Although the bear market chewed up a tremendous amount of wealth, a lot of money came out of the market and now languishes in very low-yielding

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## The Federal Reserve System and Financial Markets

On December 23, 1913, the Federal Reserve System, which serves as the nation's bank, was created by an Act of Congress. The system consists of a seven member Board of Governors with headquarters in Washington, D.C. and twelve reserve banks located in major cities throughout the United States. Its chairman is appointed by the U. S. President. The current chairman, Alan Greenspan, was first appointed in 1987 by Ronald Reagan and reappointed by Presidents Bush and Clinton. Today the Federal Reserve's duties fall into four general areas: 1) conducting the nation's monetary policy; 2) supervising and regulating banking institutions and protecting the credit risks of consumers; 3) maintaining the stability of the finance system; and 4) providing certain financial services to the U.S. government, public financial institutions, and foreign official institutions.

The Federal Reserve System is comprised of four operating arms: the Board of Governors of the Federal Reserve System, the Federal Open Market Committee (FOMC), the Reserve Banks, and the Board of Directors. Each arm plays a unique role in carrying out the four previously mentioned duties of the Federal Reserve System.

The actions of the FOMC have been of particular interest this past year. In 2001, the FOMC lowered the federal funds rate eleven times, two of which were

unscheduled announcements. The FOMC is the Fed's monetary policymaking body. It is responsible for formulation of policy designed to promote stable prices and growth. Simply put, the FOMC manages the nation's money supply.

To stimulate a sluggish economy or thwart a recession, as has been its focus over the past year, the Fed seeks to add money to the economy in one of two ways. First, it can buy U.S. Government securities from banks

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and brokerage houses. Second, the Fed can lower the discount rate, which is the interest rate Fed banks charge commercial banks to borrow funds. When easing monetary policy, the objective is to have more money available for banks to lend to businesses and consumers and thus encourage the economy to grow.

As a new economic cycle begins, and economic growth accelerates, the Fed may choose to shift to a tightening monetary policy. If strong economic growth is left unchecked, high inflation can occur, because businesses will tend to raise prices as demand increases.

**How does Fed policy affect investments?** Fed policy most directly impacts bond markets. Bond prices move in the opposite

direction of interest rates. When rates are falling, bond prices are increasing. This is because coupon rates on newly issued bonds will reflect current interest rates. If investors can earn a 6% return on a new issue selling at a face value of \$1,000, they won't pay \$1,000 for a previously issued bond of similar maturity, paying only 5%. The 5% bonds must be discounted to a lower price to compete with the 6% bond. A previously issued bond of similar maturity returning 7% when 6% rates prevail, would sell at a higher price.

The stock market is also affected by interest rate changes, primarily by swaying investors' confidence one way or the other. When rates are rising, it tends to be more expensive for consumers and businesses to borrow money, and corporate profits may be hurt. Investors anticipating reduced corporate profits will sell stock and move into bonds. Conversely, when rates decrease, stocks become relatively more attractive. There is usually a delayed effect of monetary stimulus on the economy of 6 to 12 months.

Economists and stock analysts agree that trying to time equity selections on interest rate moves is a risky game. Predicting interest rate moves and what effect they will have on investments can lead to excessive turnover and mediocre investment performance. Proper diversification among asset classes is imperative for long-term growth of an investment portfolio.

—Watt Dixon

## INVESTMENT OUTLOOK

### 2001 Review and Outlook for 2002 Continued

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money market funds and bonds. If corporate earnings can recover, the opportunity for higher returns in the market will outweigh the risks. Money will flow in and drive the market up.

Looking back, the most tragic event of 2001 may prove to have established a significant turning point—both for the stock market and the American people. On one level the outrageous attack of September 11<sup>th</sup> hastened the end of the grinding bear market. On a much higher level, it helped us clarify our priorities as a people and a nation. Our country and the world will be wiser and safer in the aftermath of the attack. Our new president emerged as a strong and effective leader, and we found sympathy and support around the world. The American people were united through the common bond of patriotism unlike at any time in the past 60 years.

Best wishes for a happy, healthy and prosperous 2002.

-Whitney Brown

### C. Whitney Brown, Jr. earns CFA Designation

C. Whitney Brown, Jr., vice-president, equity analyst and portfolio manager at Dixon, Hubard & Feinour, Inc., has earned the Chartered Financial Analyst (CFA) designation.

CFA's have successfully completed a graduate-level, self-study curriculum and series of examinations that test candidates around the world in ethical and professional standards, accounting and financial statement analysis, economics, portfolio management and analysis and valuation of debt, equity and alternative investments. Each of the three examinations typically requires candidates to spend 250 to 300 hours in study preparation. Worldwide, the overall pass rate for all three exams this year was 54 percent.

Brown, who joined Dixon, Hubard & Feinour in 1998, is a graduate of the University of Virginia and received his MBA from the University of Chicago.

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