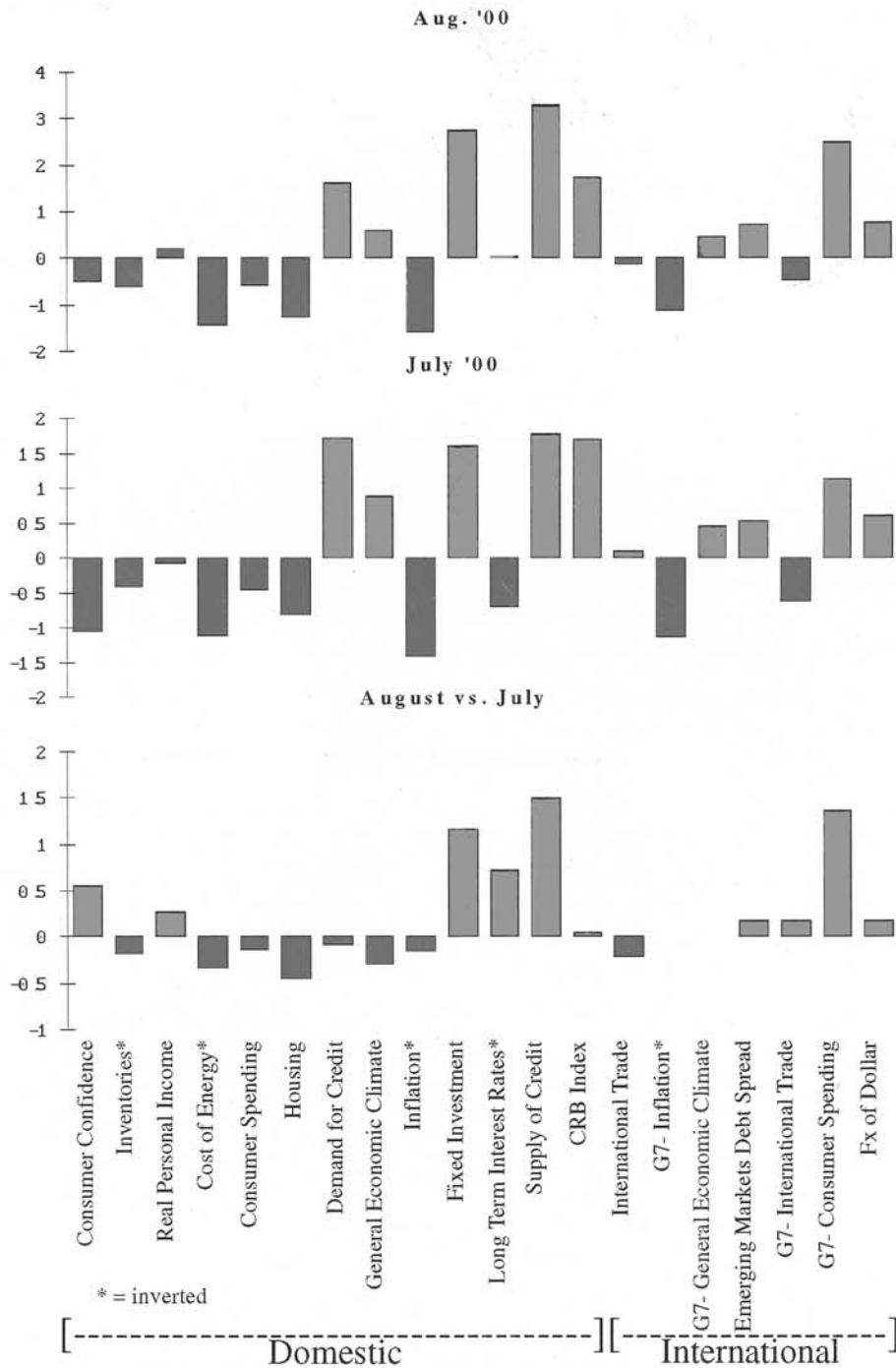


“Recession On The Horizon”

August 16, 2000

The following charts show fact based trends in ASC Economic Factors as of August 2000 as compared to July 2000 and changes expressed in standard deviations around the norm, hereinafter referred to as “units”.



ASC Factor indicators of future activity reflect a US domestic economy that is beginning to show signs of a significant slow down, possibly even a recession. Following are significant changes in trends last month expressed in standard deviations around the norm or "units". Initial employment claims fell by .56 units. Inventories rose by .64 units. Housing fell by .45 units after falling .61 in the previous month. Fixed Investment rose by 1.16 units. Long rates fell by .73 units. Supply of Credit rose by 1.58 units. Exports fell by .48 units. G7 Consumption rose by 1.36 units. It appears that the trend toward slowing picked up momentum last month. The areas that are showing the most weakness are consumer spending and housing. Even though spending picked up somewhat last month, the trend of consumer spending is at 1.1 standard deviations below normal; housing is at 1.4 below normal (this was before today's release in which housing starts were down 3.3% at 1.5 million units). Both factors are nearing the recession zone.

Deciphering the basis for an outlook for a slowing economy is always conjectural. Since this service was first offered in January 1982, it has notified its readers of the risks of every significant slow down that has occurred along with the recession of 1990 that was highlighted in October, 1989. Setting the stage for the current slow down, household's participation in the market was at a record level accompanied by a huge run up in margin debt. Assets on paper were being created at a rapid clip. Meanwhile, credit card debt and installment credit have soared. Consumers went on a buying binge loading up on SUV's, new houses and vacations. With the "new economy", everyone was going to be rich. The sobering up process began with the bursting of the Dot Com bubble. Margin calls and plummeting paper assets were the wake up call. The over-margined consumer had to retrench. Some managed to survive the first down draft and are now buying time, hoping that technology stocks bounce back quickly. Nonetheless, it

appears that the credit cycle has run its course; the sobering up process has begun. The combination that generally spells trouble for credit-created booms are higher interest rates and declining value of collateral. That appears to be the case, currently.

The actual onset of a recession is likely to be delayed until the first or second quarter of 2001 as the current boom slowly rolls over and leads to a bust. First, less than robust auto sales will be met with large incentives to move inventory. This process will pull sales forward and usually leads to very weak auto sales subsequently. Inventory increases will be followed by production cut backs then layoffs. We appear to be in the very early stages of this process. In addition when growth slows, the current "new economy" mind set may be sobered up by the prospect of a weakening economy. Some of the current activity to upgrade to the latest networked technology may be delayed. Apparently, PC sales and wireless devices have already begun to slow.

We stated last month "at the first sign of a recession we'll cash in that position" regarding a trade in electronics and technology. Signs of slowing are enough in evidence to gradually move toward a more defensive portfolio, which precludes exposure to the highly economic sensitive groups of electronics and technology. These industries have economic leverage, growing at approximately 3 times the GDP rate and experiencing high rates of growth during expansions. Conversely, during contractions, they usually suffer severe price erosion and significant declines in profitability. In a recession, they will once again be remembered as cyclical growth industries instead of pure growth plays. Even if a full-blown recession does not set in, gradually moving toward a defensive position seems to be well advised. The last time this newsletter warned of a recession was in June of 1995. At that time, the principal culprit was a slow down in Europe and relatively high US auto

inventories. One may recall that during January of 1996, when the US government shut down briefly, there were several economic services that proclaimed that the recession had arrived. Even though we never had one, based on the way industry groups behaved, it sure felt as if we had a real one.

The one area that we part company with the consensus is that along with a slowing economy will come an immediate reduction in inflationary pressures. It appears that with a slowing economy, productivity will fall, as there is a delayed reaction to lower demand to cut back employment. As we have recently seen, higher than expected demand lead to increases in production without corresponding increases in employment and increased productivity. Now the flip side, lower production on the same level of employment should lead to lower productivity. As a result, stagflation may rear its head once again. As the US economy slows, the US dollar should weaken which will add to inflationary pressures. For this reason, one should not expect interest rates to fall as much as in a typical recession, at least in its early phase. If the recession becomes more drawn out, then inflationary forces should finally give way and interest rates should come down sharply.

Recession proxy groups that increased in rank last month were foods, consumer growth, electric utilities, insurance and health care. Typically these groups perform best when the economy begins to slow in a significant way leading to increased economic risks for groups that benefit from discretionary spending. With stable demand characteristics, these groups are deemed to be defensive in the event of a recession. The commercial banks are still not that highly ranked, currently at 35 out of 46. Credit quality concerns, which usually occur late in the cycle, do not appear to be fully reflected in the current valuation on the money center banks.

Investment Strategy

Equities:

Over the next several months, it appears appropriate to move into more defensive groups. Candidates are health care, insurance, consumer growth, foods and electric utilities. The basic industries are already discounting a recession, so should not see that much down side if a mild recession occurs. Over weights in S&P groups are advised in Consumer Staples, Basics, Utilities and Health Care. Under weights are advised in Consumer Cyclical, Capital Goods, Capital Goods Technology and Communications. A market weight in Energy and Financials (other than insurance) is appropriate.

Fixed Income:

Regarding the issue of quality spreads, on a scale of 1 to 10, with 10 representing a maximum position in lower quality debt and 1 representing a maximum position in Treasuries, we would rate the current environment as a 4, down from a 6 last month. There appears to be a small premium being paid for the tax-free feature of municipals over Treasuries of similar maturity that makes munis comparatively attractive for those with a high tax rate. We would advise continuing to reduce exposure to emerging market debt. Spreads appear to be on the rise.

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