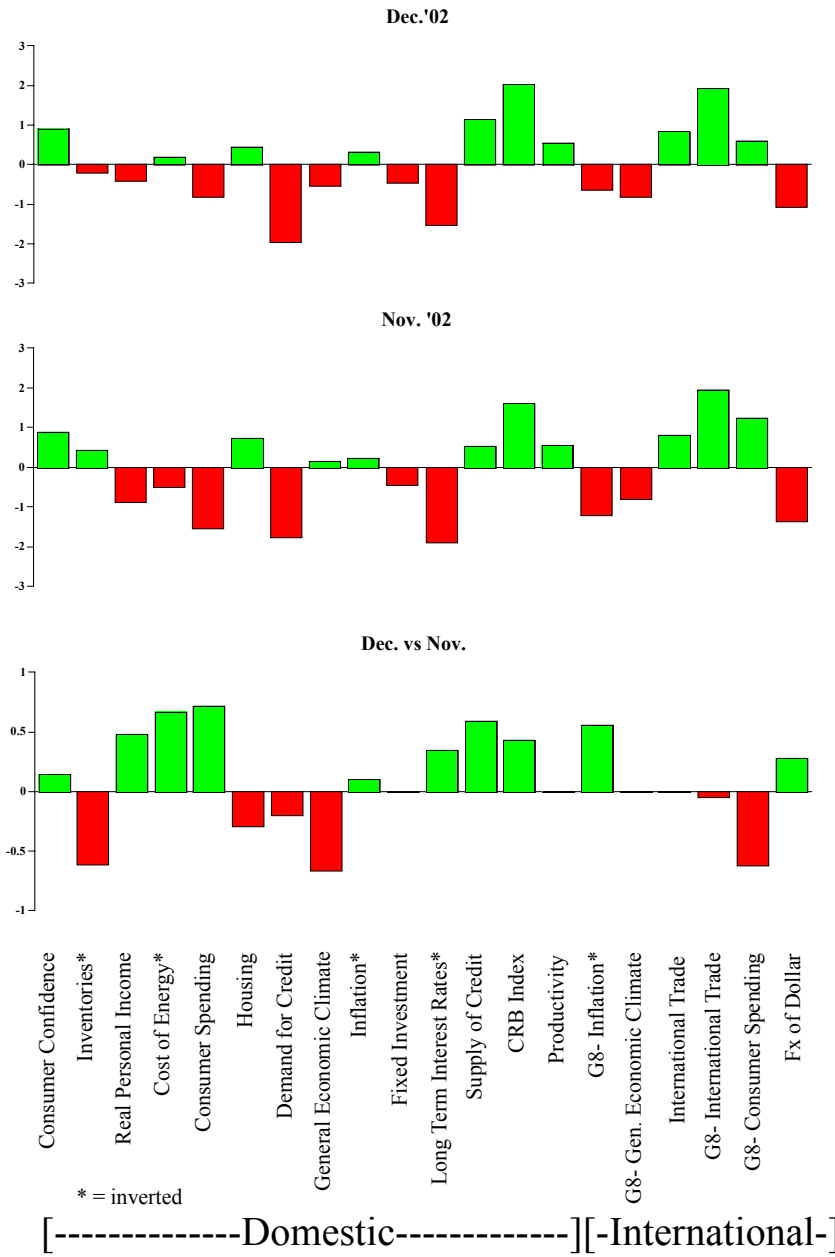


Shift Toward the Defensive Is Indicated

December 18, 2002

The following charts show fact based trends in ASC Economic factors as of December 2002 as compared to November 2002 and changes expressed in standard deviations around the norm, hereinafter referred to as “units”.



ASC Factor indicators of future activity show that the economic recovery has climbed back to normal at least for a while. Following are significant changes in trends last month expressed in standard deviations around the average rate of change or "units." Inventories rose by .61 units. Real Income rose by .48 units. Cost of Energy fell by .67 units. Consumption rose by .72 units. General Economic Climate fell by .66 units and is now .51 units below normal. Long Term Rates fell by .35 units. Supply of credit rose by .59 units. The CRB Index rose by .43 units. G8 Inflation fell by .56 units. G8 Consumption fell by .62 units. The current ASC factor sum is 100.81, as compared to 98.8 last month. The recovery that we have characterized as a "muddle through" has sprung a leak. One should not be surprised by a renewed weakening in the economy. Although a full blown recession is unlikely, growth in early 2003 is likely to be under 2%.

The transition out of the "soft patch" we are now in appears to be a function of whether the causes of the current weakness, the slow down in manufacturing and the over indebted consumer have extensive ripple effects. We appear to have a temporary over supply of autos and an auto-sated consumer that may take a while to get past. It should be a comparatively mild adjustment that should not cause one to abandon the prospect of a recovery but simply to be mindful of risks on the downside until the economy regains its footing. The prospect of cascading has been discussed by other services, namely a scenario in which cutbacks in employment and loss of jobs has an effect on consumer demand and leads to a weakness followed by more weakness scenario. It is doubtful that the adjustment is more than just temporary because everything except for consumption has already been weak. Absent should be the weakness in consump-

tion that leads to an inventory correction, then cut backs in employment and reduced consumption. A mini version of an inventory correction should be sufficient given that inventories over all are not much out of line.

Liquidity has not been provided to companies that have needed it the most. With the lower federal funds rate, banks have been paying depositors 1.5% and buying bonds and earning a smaller but safe spread. Companies with heavy debt loads left over from the heady days of 2000 have been slow to restructure their debt because the IPO window is almost closed and yields on junk bonds have been slow to fall. While we have had an accommodative Fed, there is still somewhat of a credit crunch because of the desire to reduce risk by large lenders. The appetite for risk is still not there.

We have been on the recovery course since September 2001 after having foreseen the recession of 2001 in August 2000. Since that time, the US economy has been growing at around 3%. It appears we have not had a normal response with regard to the consumer in which consumption falls, savings increase sharply, debts are pared back and the consumer's appetitive for goods has a time to return. In this recession, consumption paced by autos and housing stayed strong throughout. As a result, we have a sated consumer that needs a significant rest. After 3-4 quarters of adjustment, the US economy should be poised to resume growing.

As for ASC group ranks, energy slipped from 9 to 21. However, the natural gas sub group rose to 12 from 25 last month and is ranked favorably. Technology and electronics fell sharply. The electric utilities moved up sharply from 17 to 3. A high rank for utilities generally indicates that a significant

slow down in the over all economy is likely. Along with the utilities, other defensive groups such as foods, consumer growth and pharmaceuticals moved up sharply as well. Starting in November 2002, the ASC model began to detect precursor conditions indicating weakness in the US economy. The specific factors leading to the higher ranking of the defensive groups are Inventories, Consumption, Demand for Credit, General Economic Climate, and Long Term Rates. It appears that weakness in goods producing employment (down for 18 months in a row) is starting to have some dampening effect on the recovery.

The outlook for natural gas companies in exploration, production and distribution, is quite favorable. We are holding on to overweights in these key areas. We are also holding onto weak US dollar cyclicals and capital goods companies along with the beaten down telecom companies that have shown signs of life. The areas that would appear to be most exposed to a slow down in the economy are the commodity PC box makers. Since Intel and Microsoft essentially control capacity, the industry is going to have to scramble to compete with Dell.

Making the adjustment from an offensive portfolio to a defensive one can probably be made gradually, if euphoria builds on what should be a successful war in Iraq. Strength in our prior favorites, the economically sensitive, offensive groups should allow one to rebalance gradually. While we do not know how long the current defensive period will last, it may last long enough to represent significant risk if one were to ignore it entirely. It would appear that one needs to be rather defensive at least for the first part of next year. Even if we do not have a recession, the "double-dippers" are likely to raise the specter of one, so the issue will be alive.

## Investment Strategy Equities:

Groups that are well positioned are electric utilities, financials, pharmaceuticals, and other weak dollar cyclicals such as capital goods, papers and chemicals. Over weights in S&P groups are advised in Basics Industries, Financials, Health Care and Utilities. Market weights are advised in Capital Goods, Communications Technology, Consumer Staples and Energy. Underweighted are Capital Goods Technology and Consumer Cyclicals.

## Fixed Income:

With a more defensive outlook on equities, our posture on bonds is more positive. With a weaker US dollar foreign denominated Treasuries or equivalent seem to be appropriate. Over the intermediate term, the yield on the long bond is likely to begin inching higher. Regarding the issue of duration, on a scale of 1 to 10, with 10 representing a maximum position in shorter term debt and 1 representing a maximum position in Long Treasuries, we would rate the current environment as a 4 down from 9 last month, suggesting an average maturity of 6-7 years.

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