Special double FED issue: **November 22, 2002**

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Market Summary:

DJIA	8,845.15	**+222.14**	**+2.58%**
Nasdaq	1,467.56	**+48.21**	**+3.40%**
S&P500	933.76	**+19.61**	**+2.15%**
R2000	397.69	**+9.10**	**+2.34%**
NDX	1,118.14	**+47.61**	**+4.45%**
NYSE	493.12	**+8.69**	**+1.79%**

The Big Picture:

Pay no attention to that man behind the curtain

Our story so far: On October 10th, after tentatively making a new yearly low (intraday), the market reversed itself, closing strongly. We believed that one-day reversal was extremely significant, and on the morning of October 10th, I recommended closing out our short positions.

The reversal was our telltale clue that sellers had –finally– exhausted themselves. Since then, the path of least resistance has been upwards.

In many ways, this market resembles the 2001 Q4 rally: An oversold market, under-invested mutual fund managers, and shorts trapped below. It is a combustible combination. The post 9/11 rally went further faster than most expected. Liquidity was the fuel, as the Fed "stabilized the system" by both cutting interest rate and increasing money supply.

The 2001 liquidity-driven rally was (in hindsight) 1999 redux: The Fed's Y2K fears – as people stocked up on bottled water and batteries – was a run on the banks. If a panic caused too much cash withdrawals, it could collapse the banking system. As a contingency against this, the Fed flooded the economy with liquidity. All that cash found its way into the markets, primarily high beta Nasdaq stocks. The rocket launch from October 1999 ended some 80% higher. Liquidity was also the fuel in 2001, that propelled that NDX launch some 40%.

The Fed's panicky intervention in 1999 and 2001 shows what happens when interventionist central bankers overreact to perceived external threats.

Which brings me to the present: It's not the threat of terrorism, an anemic economic recovery, or an impending War keeping the Fed up at night: Its the terrifying prospect of DEFLATION. Real interest rates are now below zero; China and Japan are exporting price decreases. It isn't too hard to imagine a scenario where deflation lands here. If the insatiable demand of the US consumer ever gets satiated, there could be real trouble.

So the Fed is, once again, flooding the system with liquidity. Their rhetoric makes this imposingly clear: Fed Governor Bernanke's speech before the National Economists Club in Washington, D.C. yesterday was titled "Deflation: Making Sure "It" Doesn't Happen Here." (See below).

This will be the 3rd time in 4 years that the Fed is fueling a Nasdaq launch. We all want to ride this rocket for all its worth. *But I cannot help but recall that the last 2 times this scenario occurred, it ended abruptly – and quite badly . . .*

Nasdaq under increased Fed liquidity:

1999 year end rally: Nasdaq doubles, from Aug trough to March 2000 pre-crash peak.

Post 9/11 rally: Another wild Nasdaq ride: 9/21/01 trough to January 2002 peak up 51.26%.

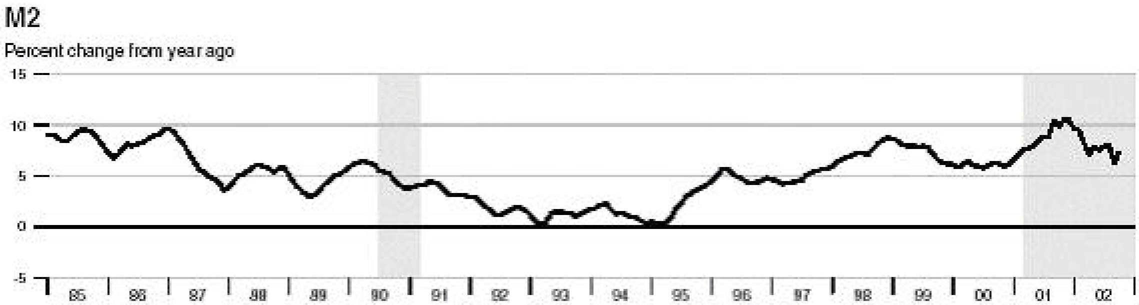
The present rally: From October 10th lows, to yesterdays high: Nasdaq up 32.49 % . . . to ?

Charts courtesy of bigcharts.com

The above charts show how the Fed's response to a perceived threat to the monetary system or economy have resulted in unsustainable Nasdaq rallies launch. When the November / December MZM numbers are revealed, I suspect shall see significant increases in Money Supply (See charts on next page).

Money Supply

Since the Bull market began in 1982, the Fed has been increasing money supply year over year. Note that whenever the growth of MZM falls below 7.5% from over 10% – in 1987, 1993 and 2000, the result was either a recession or a market crash. Real interest rates (3rd chart below) are now below zero.



Source: *Monetary Trends*, The Federal Reserve Bank of St. Louis

Quote of the Week:

Deflation: Making Sure "It" Doesn't Happen Here

“Because central banks conventionally conduct monetary policy by manipulating the short-term nominal interest rate, some observers have concluded that when that key rate stands at or near zero, the central bank has "run out of ammunition"--that is, it no longer has the power to expand aggregate demand and hence economic activity. It is true that once the policy rate has been driven down to zero, a central bank can no longer use its traditional means of stimulating aggregate demand and thus will be operating in less familiar territory . . .”

“However, a principal message of my talk today is that a central bank whose accustomed policy rate has been forced down to zero **has most definitely not run out of ammunition**. A central bank, either alone or in cooperation with other parts of the government, retains considerable power to **expand aggregate demand and economic activity** even when its accustomed policy rate is at zero. [The] policy measures that the Fed and other government authorities can take if prevention efforts fail and deflation appears to be gaining a foothold in the economy. . .

“A healthy, well capitalized banking system and smoothly functioning capital markets are an important line of defense against deflationary shocks. The Fed should and does use its regulatory and supervisory powers to ensure that the financial system will remain resilient if financial conditions change rapidly. And **at times of extreme threat to financial stability, the Federal Reserve stands ready to use the discount window and other tools to protect the financial system**, as it did during the 1987 stock market crash and the September 11, 2001, terrorist attacks.

Third, as suggested by a number of studies, **when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more preemptively and more aggressively than usual in cutting rates** (Orphanides and Wieland, 2000; Reifschneider and Williams, 2000; Ahearne et al., 2002). By moving decisively and early, the Fed may be able to prevent the economy from slipping into deflation, with the special problems that entails.” *(emphasis added)*

-**Remarks by Governor Ben S. Bernanke**, before the National Economists Club, Washington, D.C., November 21, 2002, “Deflation: Making Sure "It" Doesn't Happen Here”

Explanation of Holding Periods
Long Term *– Price movement expected in months to years.*
Intermediate *Term - Price movement expected in weeks to months.*
Short Term *- Price movement expected in days to weeks.*

Explanation of Ratings
Buy *– Expected relative performance of greater than +20% in the intermediate term.*
Trading Buy *– Expected relative performance of greater than +20% in the short term*
Hold *- Expected relative performance of -10% to +10% in the intermediate term.*
Reduce *– Expected relative performance of –10% to +10% in the short term.*
Avoid *– Expected relative performance of –10% to –20% in the short term.*
Sell *- Expected relative performance of less than -20% in the intermediate term.*
Short Sale *– Expected relative performance of less than –20% in the short term.*

Ratings are benchmarked relative to the S&P 500

**In addition to the above listed rating there is a category called Remove that is not considered a rating. The term Remove means that the position is recommended to be eliminated and coverage is suspended.*

Coverage Universe

Rating	*# of Stocks*	*Percent*
Buy	*9*	*28.1%*
Trading Buy	*2*	*6.3%*
Hold	*12*	*37.5%*
Reduce	*6*	*18.8%*
Avoid	*0*	*0%*
Sell	*0*	*0%*
Short Sale	*3*	*9.3%*

Coverage universe as of October 22, 2002.

Valuation Methods
One or more of the following valuation methods are used in making a price projection: Analysis of the supply and demand for a security to ascertain how high or low a stock price may move before either overhead supply or underneath demand develops. Analysis of a companies P/E ratio, price/book ratio, price/cash ratio, earnings expectations or sales growth as they relate within an industry group or to the broader market. Dividend yield of the S&P 500 vs. the dividend yield of the 10-year government bond. Individual sector analysis along with investor sentiment and Federal Monetary policy.
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