

Overview

In case you hadn't noticed, our previous economic forecast proved mostly accurate. We are now facing this question: after two years, is the recession finally over? To provide an answer to this question I will analyze the following economic trend: the housing start index plunged 11% in September and increased 6.1 percent in October as record low interest rates fueled home buying. The National Association of Realtors said that sales of previously owned homes climbed to a seasonally adjusted annual rate of 5.77 million units from an upwardly revised 5.44 million unit pace in September. The homebuilders' monthly market index rose to a two-year high in November, due to strong sales, brisk traffic of buyers and optimistic expectations about sales. Economists figure new construction will remain relatively healthy in coming months, since low mortgage and real estate investment potential are keeping home sales near record levels. As discussed in my previous newsletters real estate is one of my favored leading indicators. In reference to unemployment the number of Americans unemployed for six months or more are increasing as the economic recovery crawls ahead, a trend not seen since the early 1990s when the job market stagnated even as the economy grew. The U.S. job market, while stalled, has not suffered as much as in previous economic downturns. Unemployment in October was 5.7%, down from a peak of 6.0% seen earlier in the year, and has remained in a fairly tight range this year. In comparison to Europe, the U.S. is still a country with low unemployment

EUROPE

Europe's problems are piling up fast. Its economies are struggling to regain momentum, and their biggest economy, Germany, is moving toward another recession. Several countries are now set to breach the

budgetary guidelines known as stability and growth pact. Some economists criticized this agreement. But in the past year or so, the impact of the downturn on government finances has become clear. Yet Europe's response is to engage in another of the bureaucratic and theological arguments, which so often pass for action in the European Union. To the fury of some EU finance ministers, the president of the European Commission, Romano Prodi, recently described the stability pact rules as "stupid." The Germans, who are about to breach the rules they were so keen to put in place in the late 1990s, are particularly angry at what they see as the commission's attempts to wreck the pact. Mr Prodi, aided by the French government, seems motivated by a desire to acquire more power for the Commission in operating the pact's rules. Territorial bickering has largely usurped serious debate about the substance of the pact. The British are neutral and staying out of the fray. A wise position.

In the U.S. several members of the Federal Reserve have made it clear they think the ECB should cut rates sooner rather than later. Europe is failing to help stimulate a global recovery. In addition, there is a feeling in America that Europe, with a population bigger than America's, should be doing more. Instead, the perception in Washington is that European political leaders are too inwardly focused, too preoccupied with their own problems. Europe does have many longer-term challenges to preoccupy it, though some are of its own making. In the spring of 2000, the so-called Lisbon agenda was launched at a summit in the Portuguese capital, aimed at making the EU the most competitive global region by 2010. That now seems hopelessly optimistic, mainly because European governments themselves are not able to reduce the red tape

in launching an economic program to boost competitiveness. Too many companies are still under the umbrella of government heavy Regulations. As if these problems weren't enough, the EU now finds itself with a new problem. Ten new countries, mostly from Central and Eastern Europe, are set to join in May 2004—and applications for others to join later are pending. As usual European leaders have found it easier to postpone difficult decisions. As a consequence, they will have to make many of them, all at once. If they fail, Europe will pay a very high price.

JAPAN

Japan has long been written off as an engine of global growth. Political bickering dating from the Dark Ages has kept this country in an economic slump that now is over 10 years old. I suggest that the Japanese government fold up and retire its economic minister and advisors. They should hire a group of U.S. economists and let them prepare a plan to revamp the economy. They also should take a hit on the bad loans that plague most Japanese banks and move on. I do not see a solution to the economic slump because the main underlying problem is cultural. When a culture is mired in 19th Century business philosophy, it cannot compete in the 21st Century's global business philosophy.

ARGENTINA

Argentina took a big step towards joining the club of financial deadbeats that includes Zimbabwe, Iraq, Liberia and others countries that are in default on their official debts to the World Bank. Argentina's government paid only \$79.2m out of an \$805m repayment that had become more than 30 days overdue. Since the country has over \$9 billion of reserves—a figure that has been rising recently—its motive was largely political. This situation in turn will impede the country from going forward with IMF negotiation. It means that there is probably more economic hardship in the cards for Argentineans.

The Stock Market

In the past 90 days, the Dow Jones Industrial index went from about 9,000 to about 7,400 and is now up again to about 8800. The NASDAQ went from about 1400 to around 1100 and now is around 1450. If you compare the two indexes, you'll see that in the recent 30-day rally, the NASDAQ ended up above the DJI. This it means that technology is alive and it is in a slow recovery environment. Facing one of the toughest investment climates in recent memory, biotech companies are fighting for survival. A recent Merrill Lynch survey indicated that up to 35 percent of the nation's biotech companies have less than a year's worth of cash left at current spending levels. This dictates that we should be more selective in investing in life sciences. Using our hedging strategy, we should have better returns in reducing investment risk.

What to do

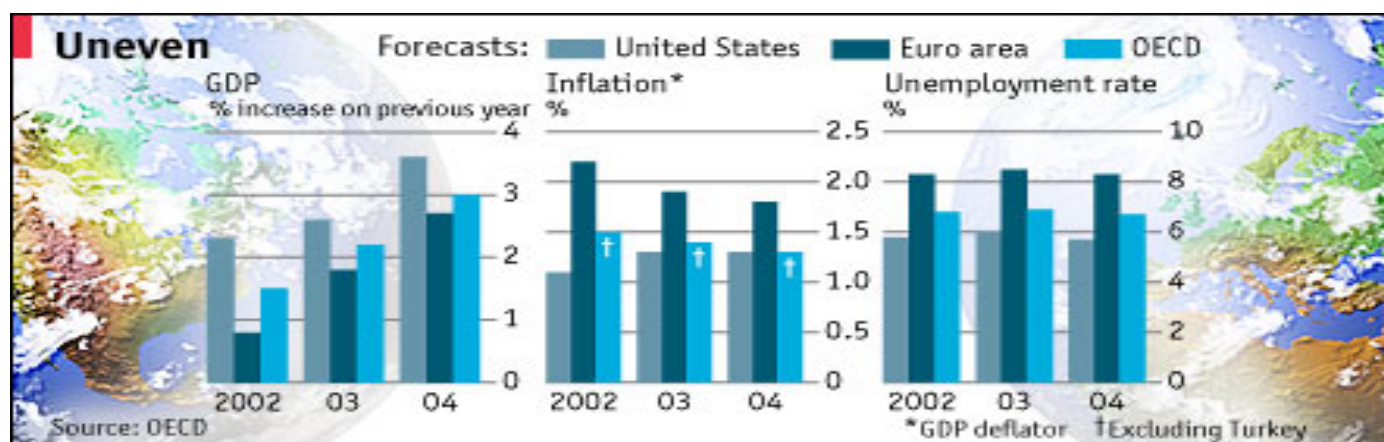
An answer to my first question at the beginning of this newsletter is the following: we are not out of the wood. In this moment the patient is barely walking after having been in bed with an economic flu for two years. I maintain my previous forecast of a slow recovery in the U.S. by the first quarter of 2003. I do not predict economic recovery in the Euro area before the second and third quarter of 2003. Of course if the recovery will not materialize in the United States in the first quarter of 2003, I shall revise my European forecast after the first quarter of 2003. Slow recovery means that stock market volatility will be our companion for the next four months. After the recent rally we should have a correction of the NASDAQ index to between 1300 to 1350. Between now and the end of 2002 we should have the NASDAQ index trading between 1300 to 1450 range. At the end of the year I forecast the index between 1300 to 1350. We have kept a large amount of cash—about 65% to 70% average—since January 1. We now are keeping the cash positions of our portfolios at around 55% to 60%. We are selling puts in companies that present decent growth opportunities in keeping the cash position to cover the puts.

In addition, we buy selectively, starting to accumulate some stocks which we think are under valued or in a position of fast growth in this economic environment. As contrarians, we also buy some micro caps with high-risk high-reward opportunities. For global portfolio holders we suggest diversifying with about 65% of their portfolios in U.S. dollars and about 35% in Euro, British Pounds, and Australian Dollars. In the last three years we also kept our global portfolios diversified with REIT's preferred shares. From 1999, the average total return on the Reit's shares has being about 18% per year.

Preferred stocks list:

Life Sciences: ASTM, AVE, BRL, CEGE, CELG, CYTC, DNA, DVSA, CEPH, CHIR, GSK, ITMN, IVX, KG, MATK, MEDI, NicOX (Nuveau Marche' France), MLNM, NTEC, NBIX, PPD, PTI.TO, RGEN, SCLN, SRA, and WPI. REIT's: GLB preferred shares, HCP preferred shares and SHU preferred.

**Indexes: DJI 8,676 – NASDAQ 1,444 - S&P500 913 - Russell2000 398 - Amex BTK 359
 10-Year Treasury Bond 40.79 – U.K. FTSE 100 4,071**



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