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## Overview

Information in our newsletter of February 2002 reflects the actual state of market trends. After the Enron scandal, others emerged. From Tyco to Quest, from Merck to Xerox, about a dozen companies either cooked their books or implemented "creative accounting practices." The latest revelation is regarding the executive stock options widely used in publicly traded companies. It has created a nightmare for investors. If many companies were to reinstate their accounting practices regarding stock options, their profits would vanish. The greedy actions of some executives of large corporations have tainted the credibility of corporate America. In addition, this situation is increasing a stock market downfall, as well as the dollar downfall. Salaries of executives of large and medium-sized publicly traded corporations should be tied to stock performance and not to whatever the board of directors' members decides. Salaries, bonuses, and stock options of U.S. companies are two to seven times higher than that of publicly traded European company executives. Perhaps executives should be sentenced to at least 10 years in prison when there is an incidence of fraud. A publicly traded company is NOT the executive's private company -- its shareholders own it. Most of us are fed up with these folks and Congress is being asked to pass a law establishing conflict of interest thereby separating companies which provide accounting and consulting, without creating another bureaucracy. They should definitely consider increasing prison terms for fraud.

Now, let's analyze the decline of the dollar against major currencies. In the U.S. we have a current annualized trade deficit of between

\$380 billion to \$410 billion, which is around 4.3% of the GDP. We also have an increase in government spending and a decrease in revenue. This year the U.S. will run a budget deficit of around \$160 billion. Next year, the deficit should be around \$150 billion. In addition, tax revenues are much lower than last year. We now have an increase in unemployment due to an increase in layoffs by major corporations. We reiterate what we have published the past five years: history has proven that large corporations and large mergers are not the solution on how to increase employment or efficiency. The contrary is true. Disappointment and anxiety have prompted investors, particularly foreign investors, to re-examine America's economic model. One of the long-ignored issues now emerging is U.S. reliance on foreign savings. With a current account-deficit of around 4% of the GDP and rising, America now faces tough choices. On the monetary front we have a telecom debt burden that is still running high and a consumer sector that is at an all-time high, while savings is almost zero. For instance, houses are purchased with average mortgages of about 93% of the purchase price. On the bright side, there have been increases in real estate and related activities that keep the economy running. We do not know how long this real estate boom will last, but it seems that we are at the top of the real estate market cycle now.

### Europe.

This year Europeans got their first experience with the Euro. Consumer prices have increased over 6% in the past six months. This increase has been a consequence of "rounding up" consumers' prices at the start of the year and keeping them higher. By the end of this year a

liquidity drainage from the pockets of consumers will be made in Europe. At that point, prices will stabilize. Competition will do what politicians have not been able to do, and therefore, inflation next year will be around 3%. In any event, real inflation in Europe in 2002 is between 6% and 7%. Since EU governments need more cash than ever to run their inefficient governments and welfare states, politicians try to convince people that inflation is under control. This is what they want people to believe. In any event, due to the stock market's poor performance, the Europeans will buy more government bonds. Due to inflation for EU bond investors this year the return of capital will be negative. Suffocating taxes and spending policies of bureaucrats and special interest groups persist. Red tape is king! If and when real competition and low taxation appears in Europe, the dollar will go up to \$1.50 per Euro. We predict that it will not happen in the next three years.

## **The Stock Market**

A stock market downturn this year has erased \$2.4 trillion in market value, representing almost one-quarter of the U.S. gross domestic product. The dollar was overvalued at around 83 cents against the Euro and is now around 99 cents. It seems that the dollar could go as low as \$1.10 per Euro in the next few months. If this trend persists into the next year, two major things will happen: in 2003 we will have lower inflation or even deflation. Then we will have higher inflation and rising interest rates in the U.S. to restart the economy and to lower government debt. Investors are looking more closely at companies, and mutual fund managers are under pressure to be proactive with the management of companies in which they invest. Many investors are abandoning the stock market and building a large position in money markets. This liquidity will return to the stock market sooner or later. I believe that even in today's market, opportunities abound. One must be careful and invest in single stocks, after spending considerable time analyzing

companies that are undervalued. One should also use hedging instruments to protect one's investments. We suggest keeping at least 50% of one's portfolio in money market accounts or U.S. treasury bonds and invest the rest in a well-diversified portfolio. Since we invest most of our money in the life science sector, we would like to share a few words about this important sector of the economy. We are going through constant transformations in the life science sector. In 2002, health care expenditures will be larger in absolute terms, and lower in specific terms. This means that governments all over the world will push for more prescription drugs that cost less, thereby favoring drug companies that manufacture generics. In addition, the nutraceutical segment will go through a major transformation in research, development, marketing and clinical trials. We forecast a bright future for such market segments as the medical diagnostic, generic drugs, CNS area, and drug delivery systems.

## **What to Do?**

In our previous newsletter we predicted that economic recovery would not happen before the end of this year or the first quarter of 2003. Thus far, this prediction appears to be on target.

Now let's fine-tune a new forecast. Since the stock market is purging from all the existing bubbles, scandals, liquidity crunch, and economic downturns, we now are in uncharted territory. The NASDAQ composite is around 1370, which is near the 1997 lows. The DJ Industrial is around 8,800 and about 9% above the 1997 lows. What happens over the next four months will determine the fate and trend of the U.S. and world economy for the next two to three years. If the stock market holds at recent levels or with a slight improvement, then we shall have an economic recovery in the first quarter of 2003. If by the end of October, the NASDAQ composite is around or under 1250, we shall then re-examine our economic forecast at that time.

As of now, we expect that at the end of August the NASDAQ composite index will be between 1250 to 1450. We keep our global portfolio model with about 65% in U.S. dollar and the rest in Euro.

Due to the fact that the life sciences sector has been purged of excessive valuation, we think that some of the following stocks are undervalued in relative and absolute terms.

The following is our companies' preferred list.

**Symbol: ABGX, ASTM, ARDM, AVE, CEGE, CYTC, DNA, GENZ, GSK, HGSI, DVSA, CEPH, CHIR, ITMN, IVX, KG, MEDI, NicOX (Niveau Marche' France), MLNM, NBIX, PPD, QSC, RGEN, SCLN, SRA, and WPI.**

To invest in single stocks you must use a disciplined approach and a specific hedging strategy to take advantage of the market volatility. If you are not a sophisticated investor we suggest a mutual fund approach. Keep in mind our recommendation to keep at least 50% in a money market or short-term AAA government bonds.

*Dario A. Bianchi*

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Post Office Box 27736 • Fresno, CA 93729 - USA • Tel: (559) 291-6479 • Fax: (559) 438-7016