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Bulls, Bears, and Spiders

Of the nine Select Sector SPDR Funds, the so-called spiders, eight are now off peaks attained last year, some by magnitudes much greater than implied by the term "correction." The Technology Select Sector SPDR Fund, however, has continued its bullish ascent into the stratosphere — so far.

Just as no absolute rules govern the dating of business-cycle recessions or determining when a recession becomes a depression, there are no firm guidelines for distinguishing a stock-market "correction" from a "bear market." Often, it would seem, individual experience has figured largely in such judgments — as the wags have long observed. To wit, a recession is when your neighbor loses his job and a depression is when *you lose yours*; a stock market correction is when the other guy gets hammered in the market and a bear market is when *you do*.

Usually, it is only when most major stock indexes have deteriorated markedly for some time that the market's ursine behavior becomes inescapable — even to those on Wall Street whose prosperity depends on pumping up expectations and prices as long as possible.

Barring such circumstance, distinguishing even very broad weakness in the equities markets also is sometimes confounded by the behavior of constituent stocks comprising the benchmark indexes cited by the market gurus. If a few stocks that are heavily weighted in an index do well even though most others languish, that index may not mirror the performance of most firms' shares. Currently, for example, it is widely observed that the stellar performance of a relatively small proportion of high flyers has propelled the NASDAQ Composite Index to repeated new highs even though most constituent stocks are not doing well.

As we discuss below, even the performance of the widely cited S&P 500 Index, the inflation-adjusted moving average of which constitutes one of AIER's leading business-cycle indicators (and which we reported as clearly expanding in last month's business-cycle analysis) has been so affected. For despite the apparent recent positive trend of that indicator (see chart below), the performance of its constituent stocks by sector — as shown by the separate records of the nine Select Sector SPDR Funds — reveals widespread deterioration in most stocks and nearly all sectors that comprise the S&P 500.

What Are the Spiders?

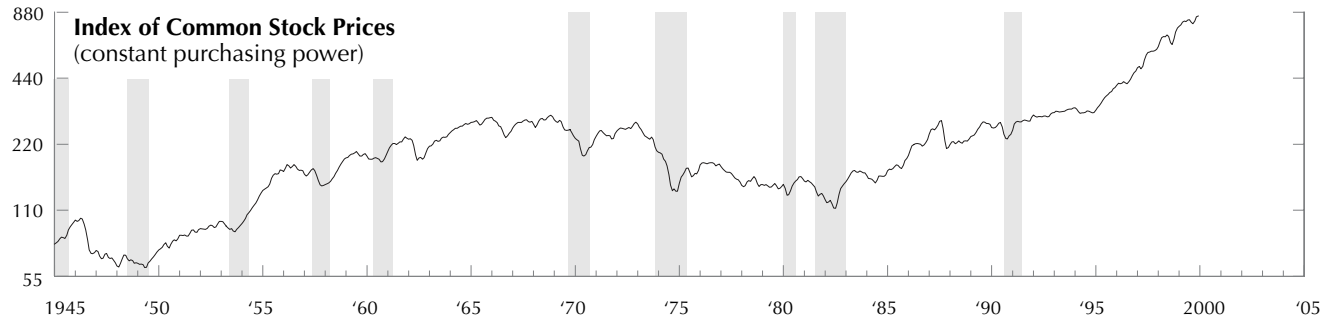
The Select Sector SPDR Funds, or "spiders," which began trading on the American Stock Exchange in December 1998, are nine sectoral investment portfolios that are comprised of the stocks in the S&P 500 Index (the "SPDR" refers to Standard & Poor's Depositary Receipts and the nine portfolios are held in the Select Sector SPDR Trust).[1] We briefly describe each fund below, but taken together the nine SPDR funds, which separately invest in the shares of between 31 and 90 constituent S&P stocks, hold all 500 stocks in the S&P Index.

Each of the nine funds is designed to track the price and dividend performance of its underlying "Select Sector Index." Unlike most mutual funds, pricing of SPDR Fund shares is continuous and shares are traded throughout the trading day. Fund shares may be bought in both round lots (100 shares) and odd lots (less than 100 shares), can be purchased on margin, and in most other respects trade as ordinary common stocks. An exception is that, unlike common stocks, SPDR fund shares are exempt from the rule that shares may be sold short only an uptick — *i.e.*, they can be sold short anytime during the trading day. The Funds are not "actively managed" but generally sell securities only to meet changes in the composition of a given Select Sector Index (unlike aggressively managed funds that may see great turnover in holdings that yield capital gains tax liabilities regardless of the overall performance of the fund).

From the perspective of this discussion, they provide a convenient and timely performance record that may not be revealed in the broader (but more widely followed) stock indexes. As described in the funds' promotional literature, currently the Select Sector SPDR portfolios are based on the following nine indexes:[2]

[1] The terms "Standard and Poor's Depositary Receipts," "SPDRs," and "Select Sector SPDR" are trademarks of The McGraw-Hill Companies, Inc., and have been licensed for use in connection with the listing and trading of Select Sector SPDRs on the Amex.

[2] "Select Sector SPDRs: Benchmark Sector-Based Equity Portfolios of Companies in the S&P 500."



"The Basic Industries Select Sector Index. This Index is composed of more than 50 companies involved in such basic industries as integrated steel products, chemicals, fibers, paper and gold. Among its largest components are E.I. DuPont de Nemours & Company, Monsanto Company and Dow Chemical Company.

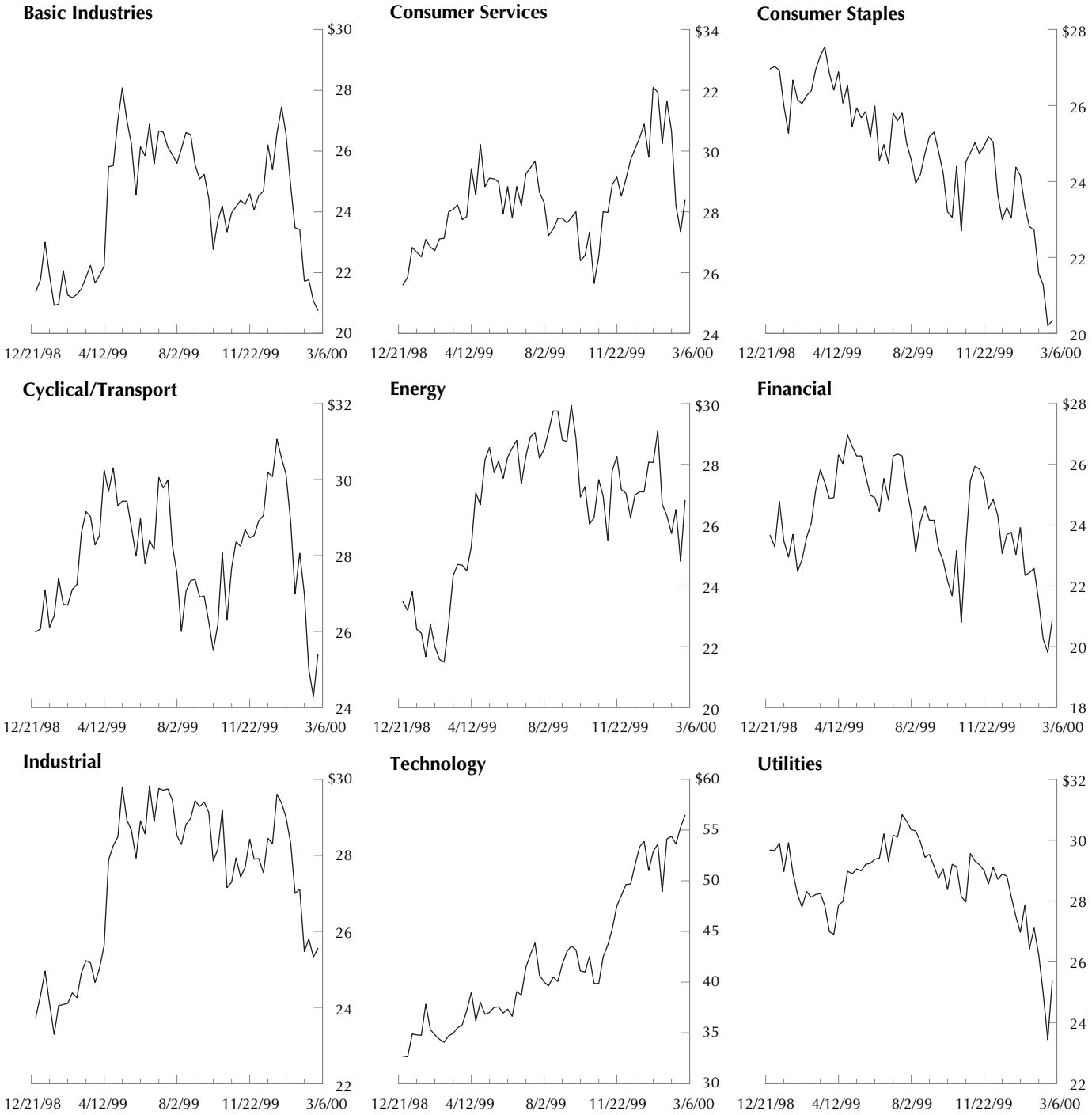
The Consumer Services Select Sector Index. Companies in this sector of more than 40 stocks include entertainment, publishing, prepared foods, medical services, lodging and gaming. The Walt Disney Co., Time Warner, Inc. and McDonald's Corp. are included in this sector's mix.

The Consumer Staples Select Sector Index. The companies in this sector are all involved in the development and production of consumer products that cover cosmetic and personal care, pharmaceuticals, soft drinks, tobacco and food products. Its more than 60 component stocks include the Coca-Cola Company, Merck & Company, Inc. and Pfizer Inc.

The Cyclical/Transportation Select

Additional information may be obtained by writing to ALPS Mutual Funds Services, Inc., 370 17th Street, Suite 3100, Denver, CO 80202, or from the web site at www.spdrindex.com.

Share Prices Per Unit of the Select Sector SPDR Index Portfolios
(Since Inception)



Source: Yahoo!*Finance*, http://finance.yahoo.com.

CONSUMER PRICE CHANGES IN 1999

The general price level increased more rapidly last year, owing in part to soaring fuel prices.

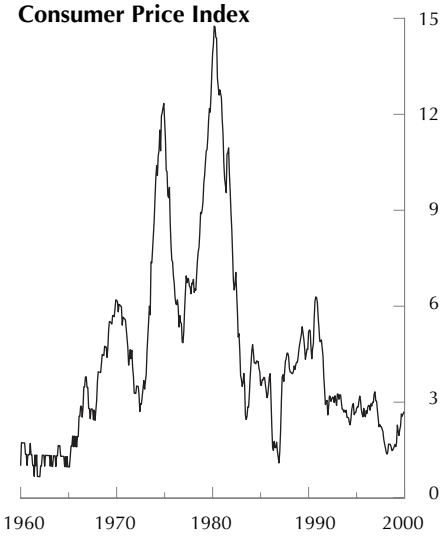
The rate of price inflation, as measured by the Consumer Price Index, accelerated to 2.7 percent in 1999, compared to 1.6 percent in 1998. The increase mainly reflects rapidly rising energy prices; excluding energy, the CPI increased only 2 percent.

The price of motor oil increased 30 percent, which helped push transportation costs up 5.4 percent. In 1998, in contrast, motor fuel prices fell 15 percent and overall transportation prices decreased 1.7 percent. These price reversals had a large impact on the CPI, because expenditures for transportation account for nearly a fifth of the CPI basket of goods and services.

The price of home fuel oil followed a similarly volatile path over the past two years, but housing costs increased at about the same rate in both years, 2.2 percent, because of offsetting price changes for other housing expenditures.

The prices of high-tech items continue to plummet: personal computers (down 26.5 percent), cellular telephone services (-11.6 percent), televisions (-7.3 percent). Their impact on the CPI is limited, however, because such items are given a relatively small weight in the index. If your own spending habits differ from those of the average consumer, your cost of living may have increased more or less than the CPI.

Annual Percent Change in the Consumer Price Index



Percent Changes in Selected Consumer Price Indexes
December 1998 – December 1999

Expenditure Category	*Percent Change*
All Items	2.7
Food and Beverages (16% of expenditures)	2.0
Food	1.9
Food at Home	1.7
Breakfast Cereal	2.1
Bread	2.0
Cookies	4.0
Meats	3.6
Beef and Veal	4.4
Pork	3.1
Bacon, breakfast sausage, and related products	3.6
Pork Chops	4.9
Poultry	-1.1
Fish and Seafood	1.7
Eggs	-13.2
Milk	3.4
Cheese and related products	4.0
Ice cream and related products	0.8
Fresh fruits and vegetables	2.0
Apples	5.5
Bananas	-2.5
Potatoes	7.1
Citrus fruits	7.1
Lettuce	6.7
Tomatoes	-17.2
Canned fruits and vegetables	0.6
Frozen vegetables	2.7
Candy and chewing gum	1.9
Butter	-22.4
Salad dressing	0.7
Peanut butter	3.5
Nonalcoholic beverages	2.3
Juices and carbonated drinks	3.0
Coffee	-1.7
Soup	0.0
Food away from home	2.3
Full service meals and snacks	2.2
Limited service meals and snacks	2.6
Alcoholic beverages at home	2.7
Beer and ale	2.9
Wine	1.8
Distilled spirits	3.7
Housing (40% of expenditures)	2.2
Shelter	2.5
Rent of primary residence	3.1
Owners' equivalent rent of primary residence	2.4
Hotels and motels	1.7
Fuels and utilities	2.4
Fuel oil	30.9
Electricity	0.7
Utility (piped) gas	2.1
Water and sewerage maintenance	1.8
Garbage and trash collection	2.5
Household furnishings and operations	-0.2
Floor coverings	-2.0
Window coverings	-0.6
Bedroom furniture	-0.8
Living room, kitchen, and dining room furniture	-0.7
Major appliances	-0.1
Clocks, lamps, and decor items	-4.9
Dishes and flatware	-3.3
Tools, hardware and supplies	-0.1
Outdoor equipment and supplies	-1.8
Housekeeping supplies	1.9
Household operations	2.9
Gardening and lawncare services	2.4
Repair of household items	2.6
Apparel (5% of expenditures)	-0.5
Men's apparel	1.0
Suits, coats, and jackets	2.0
Shirts and sweaters	-1.1
Pants and shorts	0.0
Boys' apparel	0.8
Women's apparel	-0.6
Outerwear	-2.9
Dresses	-2.6
Suits and separates	-0.1
Girls' apparel	-0.2
Infants' and toddlers' apparel	2.6
Watches	-2.1
Jewelry	-1.8
Footwear	-3.0
Transportation (17% of expenditures)	5.4
New cars	-0.8
New trucks	0.7
New motorcycles	2.3
Used cars and trucks	1.2
Car and truck rental	6.6
Motor fuel	30.2
Motor vehicle maintenance and repair	2.5
Tires	-1.1
Motor vehicle insurance	0.5
Motor vehicle fees	1.4
Public transportation	6.8
Airline fares	10.9
Ship fare	-5.7
Public transportation within city	0.8
Medical care (6% of expenditures)	3.7
Medical care commodities	3.8
Prescription drugs and medical supplies	6.1
Over-the-counter drugs	-1.1
Medical care services	3.6
Physicians' services	2.6
Dental services	4.6
Eye glasses and eye care	3.1
Hospital and related services	5.1
Hospital services	5.1
Nursing homes and adult daycare	4.6
Recreation (6% of expenditures)	0.8
Video and audio	-0.6
Televisions	-7.3
Cable television	2.8
Video cassettes, discs, and other media incl. rental	-3.2
Audio equipment	-3.9
Pet food	0.8
Veterinarian services	3.5
Sporting goods	-3.0
Photography	-0.2
Toys	-8.0
Sewing machines, fabric and supplies	-3.0
Music instruments and accessories	-0.9
Recreation services	5.2
Club membership dues and fees	1.5
Admissions	8.6
Fees for lessons or instructions	4.6
Newpapers and magazines	1.9
Recreational books	-1.9
Education and communication (5% of expenditures)	1.6
Education	4.4
Educational books and supplies	0.0
College tuition and fees	4.0
Elementary and high school tuition and fees	6.7
Child care and nursery school	5.1
Communication	-1.2
Postage and delivery services	3.0
Telephone services, local charges	2.8
Telephone services, long distance charges	-0.4
Cellular telephone services	-11.6
Personal computers and peripheral equipment	-26.5
Computer software and accessories	-2.0
Other goods and services (5% of expenditures)	5.1
Tobacco and smoking products	11.4
Personal care	2.9
Cosmetics and related products	4.4
Haircuts and other personal care services	3.5
Legal services	5.1
Financial services	4.4
Funeral expenses	3.4

Sector Index. Building materials, retailing, apparel, housewares, air transportation, automotive manufacturing, shipping and trucking are all represented in this group. The more than 70-stock Index includes Wal-Mart Stores, Inc., Ford Motor Company and Home Depot, Inc.

The Energy Select Sector Index. Energy companies in this more than 30-stock Index develop and produce crude oil and natural gas, and provide drilling and other energy-related services. Leaders in the group include Exxon Mobil, Royal Dutch Petroleum Company and Chevron Corp.

The Financial Select Sector Index. A wide array of diversified financial service firms are featured in this sector with business lines ranging from investment management to commercial and investment banking. Among the more than 70 companies included in the Index are American International Group Inc., Citigroup, Inc. and BankAmerica Corporation.

The Industrial Select Sector Index. General Electric Co., Minnesota Mining & Manufacturing Co. and Tyco International, LTD are among the largest components by market capitalization in this more than 30-stock sector. Industries in the Index include electrical equipment, construction equipment, waste management services and industrial machinery products.

The Technology Select Sector Index. More than 80 stocks covering products developed by defense manufacturers, telecommunications equipment, microcomputer components, integrated computer circuits and process monitoring systems are included in this Index. Components include Microsoft Corporation, Intel Corporation and International Business Machines Corporation.

The Utilities Select Sector Index. Utilities provide communication services, electrical power and natural gas distribution. The more than 40 component companies include Bell Atlantic Corporation, SBC Communications, Inc. and BellSouth Corporation."

Eight Bears and a Bull

It doesn't take a rocket scientist to see from the charts on page 26 and the table on this page that there is now widespread deterioration in the price performance of stocks in virtually all sectors of the economy *excepting the technology sector*, which continues to soar. All the other SPDR portfolios have undergone "corrections" and, semantic difficulties aside, five would seem to qualify as "bear market" portfolios. The Consumer Staples Select Sector SPDR has been in a bearish trend almost since its inception. With the technology stocks so out-of-sync with the rest of the market, the question is "What Lies Ahead?"

Performance of the Select Sector SPDRs
(From Inception)

Index Fund (ticker symbol)	*Peak Date*	*Percent Change from Peak to Present*
Basic Industrial (xlb)	May 3, 1999	-26.06
Consumer Services (xlv)	January 10, 2000	-11.59
Consumer Staples (xlp)	March 15, 1999	-26.20
Cyclical/Transport (xly)	December 27, 1999	-18.26
Energy (xle)	September 6, 1999	-10.45
Financial (xlf)	April 19, 1999	-22.58
Industrial (xli)	June 14, 1999	-14.34
Technology (xlk)	N/A	N/A
Utilities (xlu)	July 12, 1999	-17.83

Latest data February 28, 2000.

What to Make of the Techs

Although the term "mania" is increasingly invoked to describe it, the investor behavior reflected by the current prices of technology stocks is not entirely devoid of reason. Even from the perspective of conventional securities analysis it is plausible that these high-priced stocks *could* yield positive returns over the next quarter century. Some "new economy" high flyers that actually have earnings and are in the right markets with the right products would seem to have a bright future. If their projected growth trends are realized and the "old economy" value stocks continue to languish, they *might* yield total returns over the next 25 years or so only somewhat below those obtained historically by, say, the high-yielding Dow stocks.

But for that to happen a great deal must go right and nothing wrong. For example, with an astonishing P/E ratio of 130, the current price of the quintessentially "new economy" stock of Cisco Systems would seem to imply very high expected growth rates. Such a stratospheric multiple of current earnings means that even to come close to matching the Dow or other "bricks and mortar" stocks' performance, Cisco would have to be expected to grow roughly 40 percent a year over the next five years, more than 25 percent for the next five years, and over 15 percent in the following five years — and be about 36 times its current size 15 years hence. Cisco is indeed a very good company, but this is asking a great deal. At the same time, "old economy" stocks with far lower P/E ratios (and their own bright prospects) would have to stumble along at below average performance levels for over two decades. This possibility seems unlikely.

Rather, prior experience suggests that, eventually, even the most promising sectoral stocks whose performance is greatly out-of-sync with the rest of the market eventually come to ground. For example, Kenneth L. Fisher has noted "eerie" parallels between the behavior of tech stocks today and energy stocks in 1980. He observes that at that time, energy stocks — especially energy IPOs — appeared unstoppable. As a result of OPEC's success as a cartel, soaring inflation and commodities prices, and the Iran-Iraq war, the consensus forecast had oil prices trebling four years out, and "no one envisioned oil's falling." He believes that "Right now technology stocks are just where oil stocks were in early 1981."[1]

Or consider the fate of investors who placed their faith in an investment trust during the stock market boom of 1927-29. Like today's technology stocks, the shares of investment trusts continued to soar even when broad market imbalances had become apparent. At that time, such trusts were said to be immune to major and sustained reverses, and that even if a wide range of individual stocks went in the tank, the shareholder of an investment trust "lands on a cushion." The title of Edward Angly's 1931 commentary on such views might resonate as well today: *Oh, Yeah!*[2] ❑

[1] See "1980 Revisited," *Forbes*, March 6, 2000, p. 186.

[2] For a discussion of attitudes toward investment trusts in the 1920s, see John Kenneth Galbraith, *The Great Crash, 1929* (Boston: Houghton Mifflin, 1961).

PRICE OF GOLD

	1998	*1999*	*—— 2000 ——*	
	Mar. 12	*Mar. 11*	*Mar. 2*	*Mar. 9*
Final fixing in London	$293.85	$294.00	$289.90	$290.50

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