Fleet Investment Advisors Quarterly Market Outlook

EQUITIES

The stock and bond markets, as represented by the Standard & Poor's (S&P) 500 and the Lehman Brothers Aggregate Bond Index, ended the first quarter almost unchanged, returning 0.28% and 0.10% respectively. During the quarter, the stock market was temporarily buoyed by hope that a strong economic recovery would boost corporate profits. Then it stalled on worries that economic strength would bring inflation and monetary tightening by the Federal Reserve Board. Similar factors influenced the bond market.

The economy is recovering more quickly than expected. Unemployment insurance claims appear to have peaked, retail sales remain healthy and even the long-suffering manufacturing sector is picking up. We expect a modest recovery, with corporate earnings growing roughly 9% in 2002 after declining more than 20% last year. While this level of earnings can't support outsized price gains of the type that investors experienced during the late 1990s, the S&P 500 could deliver returns in the high single digits this year.

Our optimism about the S&P 500 is tempered by our awareness of potential constraints on stock prices. Economic growth must continue for the market to maintain and build on its gains, yet it's possible that consumer spending may ease off before capital spending by businesses picks up the slack toward the end of 2002. Moreover, with price-to-earnings (P/E) ratios at high levels and inflation at low levels, stocks aren't likely to benefit from expanding P/Es. The stock market will probably be volatile, swinging with changes in investor expectations about economic growth, corporate earnings, interest rates and "wild cards" such as violence in the Middle East.

In light of these concerns about large cap stocks, now is a good time for investors to consider diversifying with additional equity styles, such as small and mid cap stocks. Although these stocks are selling at P/Es that are roughly similar to large cap P/Es, small cap earnings are expected to grow at 16% in 2002 and 29% in 2003, while mid cap earnings should grow 13% and 26%. Large cap stock earnings should grow a more modest 9% and 11% over the same periods. In addition, small cap stocks have historically led the stock market coming out of recession and well into recovery. Small cap stocks, as measured by the Russell 2000, returned 3.99%, and mid cap stocks, as measured by the S&P MidCap 400, returned 6.72% for the quarter.

In a time of lower expected returns on stocks and bonds, the income provided by REITs (real estate investment trusts) may appeal to some investors. In addition to a higher dividend yield as compared to large cap stocks, REITs still provide the opportunity for moderate long-term capital appreciation. REITs are at historically attractive valuations relative to stocks and bonds.

International stocks also offer attractive valuations, selling at a significant discount compared to U.S. large cap stocks. This discount is likely to decline over time as corporate restructuring boosts profitability, particularly in Europe. International stocks, as measured by EAFE, returned 0.51% for the quarter.

FIXED INCOME

On the fixed income front, we believe that after two consecutive years of strong returns by bonds, more modest returns are likely this year. The yield on the 10-year Treasury rose from 5.05% at year-end to 5.4% on March 28. Intermediate and long-term interest rates may rise somewhat further this year, though not by as much as short-term rates. As the economy strengthens, the bonds of lower quality issuers may perform better. In this context, it may be worthwhile for some investors to consider allocating a portion of their fixed income assets into high yield bonds that have been subject to careful credit analysis. These bonds offer a substantial increase in yield over Treasuries.