

U.S. Strategy

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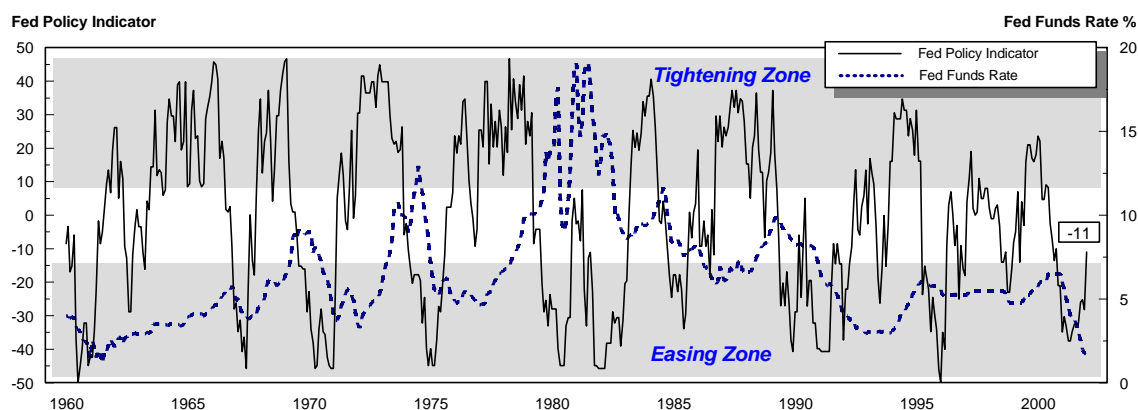
What to Own as the Fed Raises Rates

The relative performance history during Fed tightenings that successfully slow GDP growth is pretty intuitive: you should overweight non-cyclical stocks and underweight cyclical ones in a U.S. equity portfolio. Our current portfolio strategy is precisely the reverse of this, because we think that it is too early to reposition the portfolio for the next round of central bank tightening. But as the Fed starts moving to that regime later this year, we will look to change our strategy to a more defensive one. As the adage goes, "forewarned is forearmed."

At the Federal Open Market Committee meeting on Tuesday, March 19, the markets expect the Fed to move to a neutral interest-rate bias. Expectations will likely be met. Beyond that, the Fed Funds futures market is priced for 150 basis points of tightening between now and year-end. We believe that those expectations are too much too soon.

For instance, our fairly reliable Fed Policy Indicator (FPI) has a February value of -11 and a mid-March reading of -12, signaling that the central bank is on hold.

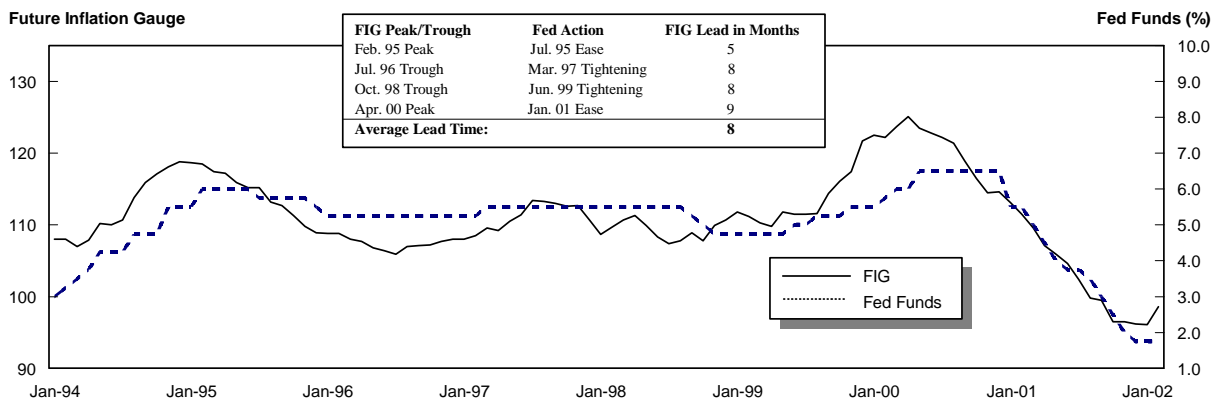
Our Fed Policy Indicator Signals a Fed on Hold; It is Far Away From Indicating Fed Tightening...



Source: Lehman Brothers

Note: Zone of Fed tightening is from +10 to +50; average lead three months. Zone of Fed easing is from -14 to -50; average lead two months.

...And the Future Inflation Gauge Troughed in January, Signaling Fed Tightening in September



Source: Lehman Brothers, Bloomberg, and ECRI.

A version of this U.S. Strategy Weekly is Webcast and can be accessed through *LehmanLive* <http://live.lehman.com/> after 9:30 a.m. EST on the date of publication.

**Fed Tightenings in 1961, 1983 and 1994
Were Alongside Rising Inflation and Bond Yields, Negative EPS Growth and P/E Compression**

	Period Ending; % Returns Except P/E					
	Aug-61	Aug-62	Jun-83	Jun-84	Feb-94	Feb-95
Inflation*	1.0	1.3	2.9	5.1	2.8	3.0
10-Yr. Tsy Yield	4.04	3.98	10.85	13.56	5.97	7.47
YOY S&P 500 EPS	21.0	-8.8	47.8	-3.4	-6.6	-11.2
FWD. P/E Ratio	19.2	14.7	9.8	7.7	13.8	13.0
YOY Stock Return	24.4	-11.6	9.8	2.0	10.4	5.3
YOY Bond Return	9.8	2.0	0.4	-6.6	5.0	-1.3

Source: Lehman Brothers and Ibbotson Associates.

Note:*CPI was used in the 1961 example; core CPI in the others. Stock returns are for the S&P 500. Bond returns are for long-term Treasuries.

The FPI has been a good leading indicator of Fed tightening only after it has reached a value of +10 or higher for three months. To get there for that long would take much stronger final demand and inflation than we think likely over the next few months. The Future Inflation Gauge also points to less and later Fed tightening than the market expects. Cyclical troughs in the FIG have led central bank tightening by an average of eight months. In the current cycle, the FIG bottomed out in January, pointing to a September tightening.

With inflation falling and productivity growth rising over the next few quarters, the Fed is unlikely to get agitated about an inflation problem in the pipeline. Moreover, the central bank, post-recessions, has never tightened before the unemployment rate stabilizes. Our Economics team expects the jobless rate to peak at 6% in the summer; we think that the Fed will start raising the Fed Funds rate in 25-basis-point increments starting in September, to 2.00%, 2.50% at year-end and 4.25% at the end of 2003.

Accordingly, we would argue that now is not the time to rework one's portfolio for Fed tightening (see "Cyclical Outperformance Should Persist for a Few More Quarters", March 4, 2002). Later this year, however, that will be the right move. This week we analyzed the relative performance of S&P 500 sectors and industry groups when the economy was moving from recovery to expansion and the Fed began to raise interest rates.

Methodologically, we limited our study to those cycles in which the central bank succeeded in slowing but not arresting GDP growth. That's what we believe the Fed will attempt to engineer later this year and next, so comparable periods should be the most analogous. Thus, by definition, this study includes only the initial Fed tightening episodes during the three longest business cycles in U.S. history: the 1960s, the 1980s, and the 1990s. Interestingly enough, these were also cycles during which the Fed helmsman was a talented policymaker capable of fostering that often elusive "soft landing": Chairmen Martin, Volcker, and Greenspan.

Of those three business cycles, the three initial monetary tightening campaigns started in August 1961, June 1983, and February 1994. Changes in the fundamentals during these three tightening campaigns were generally the same: rising inflation and bond yields, negative earnings growth, and price/earnings multiple compression. These deteriorating fundamentals aren't as nasty as they've been heading into recessions, but directionally they're the same. On average, the S&P 500 total return was only -1% during the first year of central bank tightening; bonds returned -2%. So these periods are also good times to be overweight cash and underweight both stocks and bonds.

Before discussing relative S&P 500 industry group returns during these three episodes, one needs to be aware of the data limitations of this study, which are twofold. First, historical sector and industry group returns are price-only. In our discussion of relative returns below, we are mindful that yield was a larger component of market return historically than at present; that was especially true in some sectors like Financials and Utilities. The second data limitation is that most of the current S&P sector and industry constituents existed in 1994, but not before. So of the 111 S&P sector and industry group relative returns on pages 3-5, there are 73 observations for 1983 and only 43 that also include 1961.

With those limitations in mind, the history broadly suggests that cyclical underperform while non-cyclical outperform. In the Consumer Discretionary sector, most industry group relative returns are negative for the three time periods. The same is true in the Financials, Industrials and Materials sectors. Even if you adjust the returns of most Financials industry groups for an above-market dividend yield in each time period, most groups still underperform.

By contrast, industries in the Consumer Staples and Health Care sectors show among the best relative returns in the market. The only exception to that was in 1961, when market multiple compression was very sharp. In the Energy sector, several industry group returns are poor. But for the integrated oil and gas industry, which is most of the sector market capitalization, the outperformance has generally been robust.

Relative Price Returns of S&P 500 Sectors and Industry Groups During Year One of Fed Tightenings in 1961, 1983, and 1994

	Q1 (%)			Q2 (%)			Q3 (%)			Q4 (%)			Y1 (%)			Average 1-Yr. Relative Return (%)
	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	
Consumer Discretionary	-	-	-2.61	-	-	-4.83	-	-	-3.17	-	-	-5.09	-	-	-13.19	-13.19
Advertising	-	-	-1.78	-	-	-0.21	-	-	0.42	-	-	-3.04	-	-	0.68	0.68
Apparel & Accessories	10.86	-7.80	6.99	-2.84	-14.76	0.92	-4.29	-8.59	1.85	4.31	-5.78	-10.69	6.17	-21.96	-3.30	-6.36
Auto Parts & Equipments	-	0.20	-8.33	-	-2.64	-5.68	-	-4.90	-0.23	-	2.27	4.10	-	1.42	-9.82	-4.20
Automobile Manufacturers	8.33	3.70	-8.32	-0.13	-6.17	-12.26	1.80	-5.69	-12.15	7.37	-1.42	-6.60	22.48	-1.00	-29.60	-2.71
Broadcasting & Cable T.V.	-0.37	-6.07	-4.69	6.96	-0.26	1.05	4.08	4.54	0.23	3.44	15.54	-1.94	20.55	8.30	-1.16	9.23
Casinos & Gaming	-	-	-18.17	-	-	1.27	-	-	-7.42	-	-	23.58	-	-	-10.76	-10.76
Cons. Jewellery, Gifts	-	-	0.56	-	-	-4.10	-	-	-5.72	-	-	2.96	-	-	0.39	0.39
Consumer Electronics	-	-	-3.37	-	-	13.14	-	-	21.18	-	-	12.96	-	-	32.02	32.02
Department Stores	9.33	-8.74	4.08	-9.07	-11.74	-3.15	2.53	-5.65	-0.72	-2.63	5.34	-10.75	0.57	-9.25	-13.25	-7.31
Footwear	-3.32	-13.42	5.74	-1.21	-5.53	2.46	2.69	1.62	-0.64	-1.37	3.51	-1.05	-1.82	-13.79	15.05	-0.19
General Merchandise Stores	-	-2.79	-5.09	-	-15.14	-7.08	-	-6.60	-1.89	-	1.68	-5.94	-	-6.84	-13.97	-10.40
Home Furnishing	-	-4.61	-5.26	-	-10.66	-9.32	-	-12.82	-5.53	-	-10.00	-0.58	-	-18.00	-18.50	-18.25
Home Improvement Retail	-	-1.84	3.78	-	-16.93	2.63	-	-2.99	6.45	-	0.37	-8.90	-	-12.68	0.02	-6.33
Homebuilding	-	-15.14	-27.16	-	-8.66	-11.64	-	-4.81	-15.22	-	-19.87	10.67	-	-36.47	-41.14	-38.80
Household Appliances	-	-3.86	-7.53	-	-3.03	1.68	-	-1.90	-1.57	-	-4.78	0.19	-	4.49	-4.81	-0.16
Housewares & Specialties	-	-	-4.22	-	-	-3.71	-	-	0.36	-	12.48	1.50	-	-	2.60	2.60
Hotels	-	-0.86	-15.19	-	-11.19	-1.22	-	-7.79	-1.79	-	3.25	6.80	-	-7.18	-15.67	-11.43
Leisure Products	-	-22.82	4.05	-	-4.60	-2.48	-	-6.70	1.58	-	33.61	-4.12	-	-30.02	0.67	-14.68
Movies & Entertainment	-9.61	-15.65	-1.03	-14.02	6.45	-7.76	-13.72	7.84	-3.91	-4.29	1.59	15.05	-21.47	-6.61	4.46	-7.87
Newspapers	-	1.65	0.44	-	-15.44	-4.80	-	-9.46	-2.78	-	18.24	-1.00	-	1.14	-12.89	-5.87
Photographic Products	-	-	9.86	-	-	-0.09	-	-	-3.06	-	-	1.22	-	-	12.17	12.17
Publishing & Printing	1.66	-3.31	-2.36	-5.45	-11.58	-0.01	-8.64	-8.87	-1.11	-10.74	5.17	-11.43	-19.85	-10.70	-15.66	-15.40
Restaurants	-	-4.21	2.16	-	-7.63	-6.61	-	-2.66	7.65	-	8.49	8.27	-	16.07	3.91	9.99
Apparel Retail	-	-	5.66	-	-	-12.19	-	-	-5.39	-	-	-16.05	-	-	-21.24	-21.24
Computers & Electronics Retail	-	-	-6.15	-	-	17.42	-	-	10.53	-	-	-5.07	-	-	9.58	9.58
Specialty Stores	-	-1.33	-5.63	-	-8.62	0.40	-	-9.07	-3.30	-	7.28	-3.78	-	-1.87	-11.78	-6.83
Textiles	-	-	-13.30	-	-	9.61	-	-	7.20	-	-	-5.39	-	-	-1.12	-1.12
Consumer Staples	-	-	0.07	-	-	7.13	-	-	8.12	-	-	1.10	-	-	9.94	9.94
Distillers & Vinters	-1.01	14.91	10.16	-0.71	-11.13	-2.57	-1.65	-9.16	-5.05	4.55	8.09	2.80	-2.41	-2.42	6.62	0.60
Drug Retail	-	1.47	6.80	-	-9.85	5.95	-	-5.42	11.62	-	-3.28	6.95	-	0.03	17.42	8.72
Food Distributors	-	3.95	1.48	-	-12.95	-2.49	-	-3.48	-2.39	-	-1.39	-1.02	-	-6.32	2.09	-2.11
Food Retail	7.81	0.53	2.92	-4.72	-8.96	6.28	-2.77	-2.94	8.09	-8.86	3.70	-4.24	-13.12	-2.72	5.90	-3.31
Household Products	-0.96	0.96	-1.90	-1.63	-9.02	9.42	-0.44	-5.00	9.37	-2.35	7.42	-0.01	-14.02	6.72	6.39	-0.30
Packaged Foods	6.16	2.71	1.75	0.12	0.65	4.84	0.98	1.00	6.41	-2.49	6.88	-0.75	-4.04	20.83	11.77	9.52
Personal Products	-10.19	-13.34	10.01	-0.92	-2.24	2.93	-7.80	-2.63	4.86	-8.38	6.32	0.77	-27.08	-9.69	21.76	-5.00
Soft Drinks	7.82	-2.84	0.58	-0.61	-3.53	12.81	2.79	2.79	13.50	2.06	12.02	0.11	6.03	24.50	15.41	15.31
Tobacco	9.86	11.83	-6.49	-11.71	2.49	8.85	-14.34	-2.27	6.54	-9.36	4.90	-3.13	-19.08	22.90	1.94	1.92

Source: Lehman Brothers, S&P and DRI.

Note: There are six current S&P 500 industry groups that are omitted in this study as they were created after 1994.

Relative Price Returns of S&P 500 Sectors and Industry Groups During Year One of Fed Tightenings in 1961, 1983, and 1994 (Continued)

	Q1 (%)			Q2 (%)			Q3 (%)			Q4 (%)			Y1 (%)			Average 1-Yr. Relative Return (%)
	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	08/01/61	06/01/83	02/01/94	
Energy	-	-	2.42	-	-	-3.27	-	-	1.46	-	-	-3.30	-	-	-2.14	-2.14
Integrated Oil & Gas	-2.28	8.36	2.51	7.27	8.36	-2.32	6.28	14.56	1.94	5.10	3.26	-1.61	22.49	23.80	-0.45	15.28
Oil & Gas Exploration & Production	-	-	-3.22	-	-	-8.31	-	-	-3.89	-	-	-11.40	-	-	-26.59	-26.59
Oil & Gas Refining & Marketing	-	-	-0.26	-	-	8.17	-	-	5.28	-	-	-10.25	-	-	-13.29	-13.29
Oil & Gas Drilling	-10.93	4.82	3.04	-0.01	19.09	-2.92	0.35	23.16	0.68	-0.56	3.35	-7.29	-4.48	24.40	-3.31	5.54
Oil and Gas Equipment & Services	1.40	11.61	2.43	7.09	-5.07	-10.24	-1.38	8.27	0.46	2.04	-3.78	-6.45	9.63	3.18	-5.30	2.50
Financials	-	-6.62	3.96	-	-2.86	-7.01	-	-1.46	-7.09	-	-8.88	3.66	-	-16.89	-0.16	-8.52
Banks	7.77	-3.31	10.22	-6.41	2.28	-9.01	-3.80	-2.82	-11.07	2.21	-17.84	2.99	-3.16	-24.41	0.27	-9.10
Banks (Money Center)	7.18	-6.95	2.47	-3.81	9.32	-5.09	-7.00	4.84	-5.63	7.16	-13.91	0.14	4.44	-16.46	-1.65	-4.55
Consumer Finance	4.15	11.43	-1.96	2.59	-13.11	0.21	1.32	-14.43	-3.40	-5.11	1.17	7.59	-2.04	0.04	12.14	3.38
Diversified Financials	-	-	1.63	-	-	6.18	-	-	-6.18	-	-	4.06	-	-	-0.87	-0.87
Insurance Brokers	-	-	5.24	-	-	-12.40	-	-	-11.03	-	-4.87	5.58	-	-	-2.23	-2.23
Life & Health Insurance	15.71	5.67	-4.52	6.90	-3.43	-3.78	-3.48	-1.26	-6.04	1.57	3.32	4.70	9.48	19.33	-8.22	6.86
Multi-Line Insurance	-	-4.78	1.20	-	-6.37	-7.58	-	0.51	-1.24	-	-6.76	7.27	-	-9.47	6.54	-1.46
Property & Casualty Insurance	5.30	-0.29	5.07	5.42	0.50	-7.12	-0.01	7.01	-1.26	-0.26	-8.27	8.37	0.41	-1.50	5.19	1.37
Savings & Loans	33.97	3.30	0.42	-10.08	-10.26	-4.95	-2.16	-12.73	-15.12	-14.21	-14.06	0.45	-16.18	-30.95	-5.26	-17.46
Health Care	-	-	2.51	-	-	11.88	-	-	8.06	-	-	2.82	-	-	18.64	18.64
Biotechnology	-	-	10.35	-	-	15.00	-	-	6.89	-	-	13.13	-	-	53.83	53.83
Health Care Distributors & Services	-	11.87	4.26	-	-4.93	12.08	-	3.10	8.47	-	-2.91	2.13	-	17.98	22.08	20.03
Health Care Equipment	-	-1.57	0.37	-	-12.43	7.79	-	-9.64	4.40	-	-1.74	6.32	-	-19.47	17.76	-0.85
Health Care Facilities	-	-12.83	3.41	-	4.04	0.77	-	6.25	-7.20	-	11.45	-0.33	-	-13.44	-3.21	-8.33
Health Care Supplies	-	-	3.19	-	-	9.04	-	-	10.10	-	-	-2.66	-	-	5.00	5.00
Managed Health Care	-	-	6.28	-	-	18.47	-	-	7.71	-	-	-9.76	-	-	4.55	4.55
Pharmaceuticals	1.73	0.93	2.53	0.44	-3.81	14.38	-1.42	7.45	12.06	-9.90	1.95	4.39	-11.01	8.51	23.25	6.92
Industrials	-2.35	2.35	0.26	-4.04	-6.17	3.16	-4.62	1.12	1.34	-1.95	-2.51	-0.73	-9.84	0.46	2.05	-2.45
Aerospace & Defense	-13.76	-6.09	0.76	-4.93	-6.05	-3.28	-4.10	-12.84	0.79	10.26	9.05	3.41	1.76	-4.70	3.61	0.22
Air Freight & Couriers	-	-	-2.07	-	-	-10.02	-	-	-12.76	-	-	-1.79	-	-	-18.28	-18.28
Airlines	-13.92	-15.78	-12.60	-6.69	-9.29	-18.57	-3.90	-9.35	-10.05	-0.82	-1.43	-1.62	-9.63	-8.64	-24.29	-14.19
Building Products	-8.17	-3.66	-15.68	-6.82	-3.18	-7.50	-3.85	-0.63	-9.22	-8.14	-6.53	4.37	-18.07	-5.68	-24.43	-16.06
Commercial Printing	-	-	-9.02	-	-	6.06	-	-	0.89	-	-	1.06	-	-	-6.60	-6.60
Construction & Engineering	-	-4.55	7.73	-	4.18	-12.85	-	7.84	-12.53	-	-7.71	-5.73	-	-7.99	-13.04	-10.51
Electrical Components & Equipment	-	-	7.06	-	-	-18.28	-	-	-16.20	-	-	8.47	-	-	-3.86	-3.86
Electronics (Defense)	-	1.56	-7.86	-	-19.77	6.85	-	-17.77	1.25	-	11.45	-0.24	-	-12.21	-4.95	-8.58
Environmental Services	-	-12.84	3.82	-	-15.01	-0.95	-	-16.61	-5.50	-	-9.29	-3.48	-	-30.79	1.89	-14.45
Industrial Conglomerates	3.37	-9.36	-4.61	0.63	-3.07	-1.36	1.31	-6.33	-1.10	-4.45	1.97	4.78	-2.61	-4.10	-1.74	-2.82
Industrial Machinery	-10.31	-2.16	-0.23	-6.57	-5.02	0.20	-4.07	-5.68	-1.16	-5.41	-4.88	-4.25	-15.84	-8.18	-8.41	-10.81
Construction & Farm Machinery	-	1.75	-2.04	-	1.03	-0.08	-	-0.08	-1.16	-	-1.75	2.29	-	8.26	0.08	4.17
Heavy Electrical Equipment	-	-	4.45	-	-	2.51	-	-	0.24	-	-	2.87	-	-	7.43	7.43
Office Services & Supplies	-	-11.57	0.61	-	-10.31	0.08	-	-12.17	-5.76	-	0.80	2.25	-	-12.89	-2.78	-7.84
Railroads	-0.15	9.41	-6.98	-3.11	-12.68	-7.31	0.01	-6.79	-4.61	-1.44	-6.01	4.14	-0.58	-6.95	-12.18	-6.57
Trucking	16.78	14.42	-4.09	1.15	-15.36	-9.57	-9.28	-18.70	-11.19	-0.90	-9.66	-4.21	18.22	-10.69	-27.83	-6.77
Trucks & Parts	-17.23	14.22	-8.75	-0.60	-6.69	-10.54	1.05	-7.58	-4.88	3.98	-11.81	-3.82	-9.82	4.33	-24.92	-10.14

Source: Lehman Brothers, S&P and DRI.

Note: There are six current S&P 500 industry groups that are omitted in this study as they were created after 1994.

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Information Technology	-	-	-0.11	-	-	8.05	-	-	8.31	-	-	1.78	-	-	12.81	12.81
Application Software	-	-2.62	-1.62	-	-17.14	9.61	-	-12.10	13.02	-	23.73	-1.22	-	1.87	14.49	8.18
Computer Hardware	12.27	1.91	7.97	-6.48	-7.68	21.74	-9.35	-3.56	14.08	-3.98	-2.76	-2.47	-8.99	-5.51	26.00	3.83
Electronics Equipment & Instruments	-	-2.90	-4.41	-	-3.38	18.31	-	-7.65	15.77	-	-1.59	4.90	-	-15.62	19.61	2.00
Networking Equipment	-	-	-22.32	-	-	26.86	-	-	41.78	-	-	3.27	-	-	-7.35	-7.35
Semiconductors	-	8.70	-2.90	-	-11.22	0.78	-	-7.81	4.39	-	-5.23	6.99	-	-1.44	15.33	6.94
Telecommunications Equipment	-	11.24	-6.05	-	-22.08	20.37	-	-16.03	16.77	-	-0.46	2.31	-	-18.50	8.89	-4.81
Materials	-	-	-0.24	-	-	3.53	-	-	-2.92	-	-	-2.59	-	-	-3.20	-3.20
Aluminum	-24.77	16.47	-5.44	-1.32	-9.78	7.37	-1.07	-5.68	2.37	12.49	-15.72	-4.34	-11.74	-7.76	1.77	-5.91
Commodity Chemicals	-5.27	8.53	9.00	-1.92	-12.38	0.23	-2.59	-5.30	-6.17	2.33	-2.88	-3.86	-6.11	-4.62	0.07	-3.56
Diversified Chemicals	-	9.26	1.15	-	-10.56	1.96	-	-4.13	-2.97	-	1.90	-0.39	-	2.34	1.39	1.87
Diversified Metals & Mining	-9.09	6.00	3.02	-2.75	-2.22	1.13	1.52	2.01	-5.28	-4.17	-19.65	-5.27	-9.75	-21.11	-2.55	-11.14
Fertilizers & Agricultural Chemicals	-	-	-3.16	-	-	-6.39	-	-	7.78	-	-	5.87	-	-	-6.83	-6.83
Gold	-	-10.48	-4.82	-	18.78	6.79	-	19.65	0.50	-	-12.85	-13.83	-	-12.11	-23.67	-17.89
Metals & Glass Containers	-0.80	-0.35	0.71	0.57	3.58	3.28	3.33	2.50	7.96	6.00	11.56	5.92	7.47	27.82	9.65	14.98
Paper Packaging	-7.45	14.93	0.04	-0.14	-7.96	5.76	-2.44	-0.83	-8.67	-4.08	-6.70	10.94	-9.19	21.99	8.31	7.03
Paper Products	0.47	0.12	-6.51	1.21	-4.87	5.42	-2.50	0.58	-4.61	-8.01	-8.22	4.41	-10.29	4.35	-1.28	-2.41
Specialty Chemicals	-	-	-14.25	-	-	-0.74	-	-	-2.18	-	4.82	2.53	-	-	-16.45	-16.45
Steel	-11.49	9.66	-2.75	-7.61	2.57	-4.21	-7.87	2.27	-12.07	-8.50	-14.28	-10.66	-24.04	0.37	-15.34	-13.00
Telecommunications Services	-	-	2.99	-	-	-5.39	-	-	-5.37	-	-	-0.18	-	-	-2.48	-2.48
Alternative Carriers	-	-	3.08	-	-	-7.75	-	4.82	-6.39	-	0.68	1.46	-	-	-0.76	-0.76
Integrated Telecommunication Servi	-	-	2.25	-	-	-3.26	-	-	-4.59	-	0.05	-7.84	-	-	-12.31	-12.31
Utilities	4.95	2.44	-2.10	3.08	-2.24	-5.65	2.67	1.67	-4.68	3.90	0.82	2.33	6.76	7.75	-4.78	3.25
Electric Utilities	7.00	1.45	-8.03	5.61	-9.79	-2.75	3.56	-4.73	-2.08	4.84	2.02	4.31	9.62	0.01	-8.66	0.32
Multi-Utilities	-	11.20	-3.58	-	7.43	-5.55	-	12.92	-5.56	-	-0.18	-1.36	-	22.04	-9.12	6.46
S&P 500 Absolute	4.85	0.46	-4.39	-1.21	-1.67	2.96	-10.30	-4.21	-0.70	-7.10	-2.74	4.54	-13.67	-7.97	2.19	-6.48

Source: Lehman Brothers, S&P and DRI.

Note: There are six current S&P 500 industry groups that are omitted in this study as they were created after 1994.

The Information Technology sector presents a mixed picture: the average robust outperformance of most of these industry groups is really a function of good returns in only one period, 1994. Given that most technology businesses are cyclical, we would expect this sector to underperform as the Fed raises interest rates.

The Telecommunications Services sector return is slightly negative but covers only one period, 1994. Given the low degree of cyclicity in these businesses compared to Consumer Discretionary or Industrials, we would argue that this sector could outperform as the Fed starts tightening.

Finally, the Utilities sector returns were better, on average, than the market, but the sector significantly underperformed on a price-only basis in 1994. Even if you adjust that with a near doubling of the market yield, which was 3% at the time, the sector wasn't much better than a market performer. This leaves us somewhat perplexed about how to weight this sector as the Fed moves to tighten.

On balance, history suggests that overweighting Consumer Staples, Energy, and Health Care—plus maybe the Telecom and Utilities sectors—is the appropriate portfolio strategy as the Federal Reserve starts a tightening campaign. So that's what we'll be looking to do. But for now we are underweight, in some cases zero weight, these same sectors.

Changes to the U.S. Strategy Portfolio

On March 12, 2002, we added St. Jude Medical (STJ – \$79.06; not rated) to the U.S. Strategy portfolio. St. Jude's cardio device franchise showed momentum in 2001, with ICD and pacemaker sales growing 47% and 15%, respectively, and its Cardiac Surgery business reversing a two-year downtrend. The company has a strong product pipeline, and its solid CRM positioning should reinforce its value in the consolidating medical technology industry. St. Jude replaced HCA (HCA – \$43.37; 1 Strong Buy) in our portfolio, leaving our Health Care sector weight unchanged.

On March 13, 2002, we added Maytag (MYG – \$44.75; 1 Strong Buy) and Furniture Brands (FBN – \$40.77; not rated) to the U.S. Strategy portfolio. On the heels of strong new home sales, the retail sales report showed particular strength in furniture and appliances. Both companies recently raised earnings guidance, continue to generate strong cash flow from operations, and have delivered upside surprises in recent quarters. Strong housing turnover and refinancing activity tends to lead furniture and appliance sales, and we believe both companies stand to benefit from the recent strength in the housing sector.

To make room for these purchases, we removed America Online (AOL – \$25.74; 3 Market Perform) and Genentech (DNA – \$50.30; 2 Buy) from the portfolio. With these changes, our Health Care weight fell from underweight 5% to 4% versus the S&P 500 at 11%, while our Consumer Discretionary weight increased slightly, to 36% from 35% versus the S&P 500 at 13%.

Lehman Brothers U.S. Strategy Portfolio

Sector Ticker	Name	S&P 500 %	Lehman Brothers %	Price As of 03/14/02	Consensus EPS			P/E 02	P/E 03	5 Yr EPS Growth %	Div Yield %	Market Cap (\$ bil)	Portfolio Weight %	% of S&P	
					2001E	2002E	2003E								
Overweight															
CONSUMER DISCRETIONARY		(13)	37												
BBBY	Bed, Bath & Beyond		*	# 32.37	0.70	0.86	1.06	36	30	24	0.0	9.40	2.7	0.1	
BBY	Best Buy			76.61	2.52	3.06	3.60	24	21	20	0.0	16.22	2.5	0.2	
BWA	BorgWarner			64.18	3.23	4.60	5.93	14	11	12	0.9	1.69	3.5	-	
CAKE	Cheesecake Factory		*	# 34.24	0.83	0.99	1.23	35	28	27	0.0	1.63	2.1	-	
DHI	Horton (D.R.)			41.69	3.52	4.09	3.65	11	9	15	0.6	3.21	2.9	-	
FBN	Furniture Brands Intl.			40.77	1.36	2.36	2.87	17	14	15	0.0	2.06	3.0	-	
JNY	Jones Apparel			35.95	2.31	2.52	2.87	14	13	15	0.0	4.51	1.9	0.0	
LOW	Lowe's Companies			43.77	1.31	1.55	1.86	28	23	21	0.2	33.95	2.9	0.3	
MYG	Maytag		* @	44.75	2.34	2.45	2.81	18	16	16	1.6	3.44	3.0	-	
MHK	Mohawk			64.69	3.60	4.10	4.69	16	14	18	0.0	3.40	4.4	-	
S	Sears Roebuck			52.09	4.23	4.80	5.46	11	10	10	1.8	16.78	1.9	0.2	
SWK	Stanley Works			48.96	2.36	2.73	3.07	18	16	13	2.0	4.14	2.0	0.0	
TIF	Tiffany & Co.			37.18	1.21	1.25	1.44	30	25	19	0.4	5.39	3.9	0.1	
FINANCIALS		(18)	26												
CF	Charter One Financial			31.18	2.25	2.54	2.85	12	11	12	2.6	6.99	2.8	0.1	
C	Citigroup Inc		*	48.81	3.00	3.31	3.75	15	13	14	1.3	251.31	3.3	2.4	
BEN	Franklin Resources			42.40	1.89	1.99	2.15	22	19	13	0.7	11.08	3.1	0.1	
GS	Goldman Sachs Group		*	88.40	4.53	4.60	5.85	20	16	13	0.5	42.10	3.3	-	
HI	Household International			57.48	4.13	4.65	5.26	12	11	14	1.5	26.37	3.0	0.3	
MWD	Morgan Stanley			54.68	3.35	3.40	4.15	16	14	13	1.7	59.77	3.3	0.6	
NTRS	Northern Trust		#	59.21	2.16	2.41	2.72	25	22	14	1.1	13.12	3.4	0.1	
STT	State Street Corp			55.35	2.04	2.27	2.56	24	22	14	0.8	17.92	3.4	0.2	
INDUSTRIALS		(11)	17												
CEFT	Concord EFS		*	# 32.10	0.62	0.76	0.96	42	33	29	0.0	16.31	3.2	0.2	
GE	General Electric		*	40.41	1.42	1.66	1.84	24	22	16	1.8	401.11	5.3	3.8	
UPS	United Parcel Services			59.92	2.12	2.22	2.60	27	23	14	1.3	66.99	3.2	-	
UTX	United Technologies		*	74.65	4.54	4.32	4.80	17	16	14	1.3	35.25	2.6	0.3	
WMI	Waste Management			27.56	1.20	1.42	1.74	19	16	13	0.0	17.31	3.0	0.2	
MATERIALS		(3)	5												
AA	Alcoa		*	38.49	1.47	1.64	2.54	23	15	15	1.6	32.62	2.9	0.3	
TIN	Temple-Inland		*	58.88	2.08	1.98	3.89	30	15	11	2.2	2.91	2.0	0.0	
Market Weight															
Underweight															
CONSUMER STAPLES		(9)	0												
ENERGY		(7)	0												
HEALTH CARE		(15)	4												
BAX	Baxter International			55.85	1.69	2.02	2.34	28	24	14	1.0	32.96	1.8	0.3	
MRK	Merck & Co.			63.44	3.18	3.14	3.45	20	18	11	2.2	144.32	1.1	1.4	
STJ	St Jude Medical			79.06	2.36	2.71	3.14	29	25	16	0.0	6.86	1.2	0.1	
INFORMATION TECHNOLOGY		(16)	10												
ADVS	Advent Software			# 58.90	0.98	1.36	1.78	43	33	32	0.0	1.99	1.7	-	
IBM	IBM Corp			# 106.60	4.45	4.77	5.52	22	19	12	0.5	183.69	2.2	1.7	
INTC	Intel		*	# 30.97	0.35	0.68	1.01	46	31	17	0.3	207.19	2.7	2.0	
KLAC	KLA Tencor			# 63.09	1.51	1.16	1.44	62	48	23	0.0	11.80	1.8	0.1	
MSFT	Microsoft			# 61.22	1.66	1.95	2.10	33	30	16	0.0	330.77	2.0	3.1	
TELECOMMUNICATION		(5)	1												
AWE	AT&T Wireless Services		*	8.96	0.05	-0.06	0.01	NM	NM	27	0.0	19.03	0.6	0.2	
Q	Qwest Communications		*	8.25	0.05	0.14	0.28	59	29	17	0.6	13.74	0.6	0.1	
UTILITIES		(3)	0												
					Price As		Consensus EPS			P/E		5 Yr EPS		Div	
					of 03/14/02		2001E 2002E 2003E			02 03		Growth		Yield	
														Performance	
														1998 1999 2000 2001 YTD	
Strategy Portfolio					NA		NA NA NA			20 17		15 0.8		42.9 50.6 -24.4 -37.7 3.2	
Russell 1000 Growth					502.21		NA NA NA			NA NA		NA 1.3		37.4 32.3 -22.8 -20.9 -1.8	
S&P 500					1153.04		45.36 52.82 64.39			22 18		17 1.3		28.6 21.0 -9.1 -11.9 0.4	

SECTOR	WEIGHT	COMMENTS
Consumer Discretionary	OVER	Outperforms after tax cuts, during periods of disinflation and following recessions
Financials	OVER	Inflationary pressures falling; Strong consumer; Tightening credit spreads
Industrials	OVER	Inventory reduction underway; Restocking expected soon
Materials	OVER	Economic recovery is stronger than expected; Rising commodity prices
Consumer Staples	UNDER	Valuation and declining relative revisions
Energy	UNDER	\$18 and \$16 expected mean WTI price in '02 and '03, respectively
Health Care	UNDER	Valuation and declining relative revisions
Information Technology	UNDER	Valuation
Telecommunication Services	UNDER	Underperforms coming out of recessions; Profits nonexistent
Utilities	UNDER	Underperforms coming out of recessions; Low capacity use ratio

* Lehman Brothers Inc. managed or co-managed within the past three years a public offering of securities for this company

@ An employee of Lehman Brothers Inc. is a director of this company

Lehman Brothers Inc. makes a market in the securities of this company

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Lehman Brothers S&P 500 EPS Estimates

	Reported EPS (\$)	YoY % Change	Non- Recurring Write-Offs	Operating EPS (\$)	YoY % Change	P/E Ratio (Operating EPS)
2001E	NA	NA	NA	45.36	-19	25.5
2002E	NA	NA	NA	53.00	17	21.8
2003E	NA	NA	NA	58.00	9	19.5

Consensus S&P 500 EPS Estimates

	IB/E/S Bottom Up			First Call Top Down		
	Operating EPS (\$)	YoY % Change	P/E Ratio (Operating EPS)	Operating EPS (\$)	YoY % Change	P/E Ratio (Operating EPS)
2001E	45.36	-19	25.3	43.30	-21	26.5
2002E	52.82	16	22.0	49.39	14	23.6
2003E	64.39	22	18.1	54.68	11	21.3

Lehman Brothers Total Return Estimates

	S&P 500 Target Price	S&P 500	10 - Year Treasury	LB Long Gov/Corp Index	Cash
2001	1175	-11%	17%	13%	3%
2002	1350	15%	5%	7%	2%

Source: Lehman Brothers, Thomson Financial/First Call, Thomson Financial, and S&P. Thomson Financial estimates, Thomson Financial/First Call estimates and prices as of 03/15/02. LB Gov't./Corp Index and 30 year bond expected return based on Lehman Brothers projection of the following yield curve forward twelve months: Fed Funds 3.00%, 10 Year 5.40%, 30 Year 5.85%.

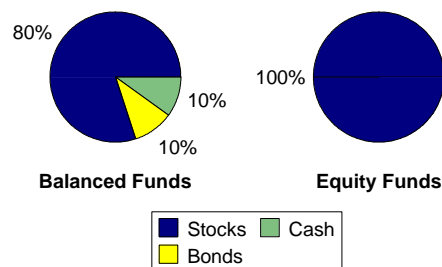
Real Bonds Yields and Forward One-Year Asset Class Returns

Real Yield (%)	Stock Return (%)	Bond Return (%)	Cash Return (%)
Under 3	20.8	-0.5	2.0
3 to 4	14.9	2.0	3.4
4 to 5	10.1	6.0	4.9
5 to 6	12.4	6.6	5.2
Over 6	13.3	10.6	8.5

Source: Ibbotson Associates and Lehman Brothers.

Note: Stock returns are for the S&P 500 index. Bond returns are for long-term Treasuries. Cash returns assume that a 1-year Treasury was purchased and held for one year full year's time. The over 10-year Treasury composite was used to derive the real yield prior to April 1953, as the FRB 10-year series did not exist before that time. Prior to 1957, headline CPI was used in lieu of core CPI, which did not exist, to calculate the real yield.

Asset Allocation



Source: Lehman Brothers.

Lehman Brothers Virtual Economy Portfolio

Sector Ticker	Name	DJ Internet Lehman		Price As of 03/14/02	Consensus EPS			P/E 02	P/E 03	5 Yr EPS Portfolio	
		Index %	Brothers %		2001E	2002E	2003E			Growth %	Weight %
Overweight											
INFRASTRUCTURE		(3)	52								
AMAT	Applied Materials		#	49.29	1.00	0.45	1.45	183	37	21	5.5
AMCC	Applied Micro Circuits		#	9.03	-0.43	-0.15	0.01	NM	NM	37	2.2
BRCD	Brocade Commun.		#	27.02	0.22	0.32	0.58	97	51	41	3.9
CIEN	Ciena		#	8.82	-1.78	-0.71	-0.45	NM	NM	26	1.9
CSCO	Cisco		#	16.74	0.16	0.38	0.53	52	36	25	3.2
EMC	E M C		#	11.71	0.08	-0.01	0.23	NM	51	23	2.8
EMLX	Emulex Corp		#	29.25	0.18	0.58	1.05	60	44	32	4.8
FLEX	Flextronics International		# *	16.61	0.57	0.68	0.95	24	16	28	4.1
INTC	Intel		# *	30.97	0.35	0.68	1.01	46	31	17	6.1
JDSU	JDS Uniphase		#	6.01	-10.57	-0.04	0.05	NM	NM	25	1.2
JNPR	Juniper Networks		#	11.50	0.07	0.17	0.32	68	36	30	1.8
LU	Lucent Technologies		#	4.83	-1.59	-0.45	-0.05	NM	NM	13	3.2
MUSE	Micromuse		#	8.89	0.27	0.25	0.52	44	23	32	3.0
NTAP	Network Appliance		# *	21.46	0.19	0.20	0.31	89	63	30	5.1
PWER	Power One		#	8.36	-0.14	-0.18	0.08	NM	104	21	2.8
Underweight											
APPLICATION & SERVICES		(50)	42								
ADVS	Advent Software		# *	58.90	0.98	1.36	1.78	43	33	32	5.1
DOX	Amdocs		#	26.35	0.60	1.57	1.80	18	15	23	2.3
BEAS	BEA Systems		#	14.94	0.10	0.30	0.42	47	35	33	3.8
CHKP	Check Point Software		#	33.28	1.34	1.27	1.51	26	22	28	4.8
CMVT	Comverse Technology		#	14.13	0.93	-0.04	0.21	NM	59	21	2.4
CEFT	Concord EFS		#	32.10	0.62	0.76	0.96	42	33	29	8.2
LBRT	Liberate Technologies		#	6.44	-1.33	-0.12	0.05	NM	129	54	3.5
SEBL	Siebel Sys		#	33.91	0.56	0.60	0.77	57	44	30	6.5
VRSN	Verisign		#	30.48	-33.80	1.01	1.38	30	22	42	5.0
INTERMEDIARY		(13)	2								
ITWO	I2 Technologies		# *	6.23	-11.05	-0.15	0.08	NM	78	32	2.3
E-COMMERCE		(34)	4								
AOL	AOL Time Warner		*	25.74	-0.73	0.95	1.19	27	22	20	4.5

	Price As of 03/14/02	Consensus EPS			P/E 02	P/E 03	5 Yr EPS Growth %	Performance			
		2001E	2002E	2003E				1999*	2000	2001	YTD
Virtual Economy Portfolio	NA	NA	NA	NA	53	37	29	26.3	-49.0	-66.6	-16.1
Dow Jones Internet Index	57.09	NA	NA	NA	NA	NA	NA	23.5	-66.0	-54.4	-10.1
Nasdaq Composite	1854.14	NA	NA	NA	NA	NA	NA	19.0	-39.2	-20.8	-4.9
S&P 500	1153.04	45.36	52.82	64.39	22	18	17	4.5	-9.1	-11.9	0.4

~ - Float is defined as market cap excluding closely held shares identified by FirstCall.

- Portfolio Inception date is 11/29/99. 1999 Return is unannualized return for the period 11/29/99 - 12/31/99, for Virtual Economy Portfolio and benchmarks.

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852.2869.3000

Key to Investment Rankings: This is a guide to expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months. **1 = Strong Buy** (expected to outperform the market by 15 or more percentage points); **2 = Buy** (expected to outperform the market by 5-15 percentage points); **3 = Market Perform** (expected to perform in line with the market, plus or minus 5 percentage points); **4 = Market Underperform** (expected to underperform the market by 5-15 percentage points); **5 = Sell** (expected to underperform the market by 15 or more percentage points).

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