



# INVESTMENT STRATEGY UPDATE

June 30, 2003

## TIME TO SELL BONDS

Most often, stocks and bonds foretell a similar economic future. But such is not the case currently, as the two markets seem to be forecasting vastly different outcomes. Rising stock prices suggest that the reflationary thrust of fiscal and monetary policy is succeeding. An improving economy would result in rising corporate profits, thereby justifying higher stock prices. But in an unusual contrast, the continuing decline in interest rates warns of further economic weakness and an increasing risk of deflation.

Which view of the future is correct? We side with the stock market. There has been a massive amount of fiscal and monetary stimulus over the past year, and now there is the added thrust of the new tax package. Our expectation is for an improving economy with moderately rising inflationary pressures.

If we are right in our assumptions, fixed income investments have significantly overshot fair value and long-dated bonds should be sold. As for the stock market, valuations are not expensive, but neither are they cheap. The bear market is over, in our opinion, but we think that it is too early to expect a new secular bull market. We anticipate a volatile, slowly rising, trading range type of market, providing equity investors with multiple periods of opportunity.

### **It's the Economy, Stupid**

With the war in Iraq now over, investors are focused on the economy. So too, is the Bush administration. George W. is well aware of the primary reason behind his father's failed re-election bid. George H. Bush's popularity had soared following the first Iraqi war. But, while a recession had ended in early 1991, the pace of the subsequent economic recovery was agonizingly slow. Unfortunately for the first President Bush, the economy was still sluggish when voters took to the polls in November 1992, and there was little confidence in his administration's economic policy. Today's economy has been setting up much like that of the early 1990s. The Federal Reserve Board has been stimulating aggressively but, at least until now, the economy has remained quite weak. Is it any wonder that George W. pushed so hard for a fiscally stimulative tax package?

Yes Virginia, the presidential economic cycle is alive and well, as is the presidential stock market cycle. On numerous previous occasions, often with obvious help from the Federal Reserve Board, newly-elected heads of state have allowed the economy to soften during the early months of their presidency – typically blaming the weakness on

the previous administration. A weak economy early, allowed for subsequent restimulation, and a decent economic environment by the time of the next presidential election.

In fact, going back to 1948, real GDP growth has averaged 4% during election years versus 3.2% during non-election years. The equities markets have been strongly affected as well, providing their weakest returns during the first and second years of the presidential cycle, and their strongest during the most stimulative third year.

We anticipate that the pace of economic activity will soon begin to pick up, barring unexpected events. Monetary policy has been highly expansionary. The continuing drop in interest rates almost guarantees another round of mortgage refinancing. A weaker dollar places U.S. corporations in a more competitive position worldwide. And, we believe the recently enacted tax package will prove to be quite stimulative. Will the economy respond quickly enough to support the Bush administration's re-election bid? Only time will tell.

### **Inflation/Deflation**

In several previous *Investment Strategy Updates*, we have contrasted the conduct of our post-bubble economy with the policy mistakes that marked both the 1930s deflation/depression and the more recent Japanese deflationary experience. While there is little doubt that a prolonged deflationary period would be highly destructive, the fact that the risks are well known to both the public and the Federal Reserve Board render the possibility of a deflationary outcome as far less likely.

Federal Reserve Board Chairman Alan Greenspan's recent commentary that "the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation," seems to ensure the continuation of a highly reflationary Fed policy. In addition, a falling dollar is anti-deflationary because of the resulting rise in import prices. While recent price trends have shown little movement in either direction, the most probable outcome, in our opinion, is a moderately increasing rate of inflation. In fact, some of the early-cycle indicators of future inflation, such as gold, raw material costs, and selected commodity price indices are already rising.

### **Fixed Income**

We believe the bond markets are substantially at risk, at these levels. While Chairman Greenspan's recent comments indicate that it will likely be a while before the Fed raises short-term interest rates, we are of the opinion that fixed-income investors will respond rather quickly to signs of economic improvement by driving long-term interest rates meaningfully higher.

Investors tend to fight the last war, buying what they know has previously been rewarding. During the late 1990s, on the back of the great bull market, money poured into stock market mutual funds. Bond funds, by contrast, were very unpopular then, and under heavy

redemption. In hindsight, investors should have been doing exactly the opposite – selling their stock funds to buy bond funds. More recently, following the terrible three-year bear market in stocks, many investors have been selling their stock funds in order to seek the greater safety and more predictable returns that have been available in fixed income funds. We believe this preference for bond funds over stock funds will prove to be just as inappropriate as was the overwhelming desire to own stocks a few years ago.

Since 1957, the median yield on the ten-year U.S. Treasury note has been 6.6%. Currently the yield is 3.4%. This bond market has well exceeded fair value, in our opinion, and we think that long-term interest rates are poised to rise – perhaps 100 to 150 basis points over the next year, followed by still higher rates beyond that. If interest rates go up, bond values go down. And today's rates are so low, that current interest payments provide little buffer. Furthermore, the new tax bill makes fixed income investments relatively less attractive to the taxable investor. For at least the next five years, the tax rate for capital gains and stock dividends will be a maximum 15%. Interest payments, on the other hand, will continue to be taxed at an individual's regular income tax rate. So on an after-tax basis, there are now a large number of stocks that pay higher income returns than the ten-year treasury note. And common stock dividends have the potential to grow over time.

So what is a fixed-income investor to do? The answer, we think, is to stay in very short-term maturities and consider equity yield alternatives to fixed income. Yes, we are well aware that short-term fixed income investments provide very little in the way of current return, and that yield stocks and convertible securities have already responded to the new tax package by moving higher. But we think that both strategies will protect investors from the inevitable capital erosion of rising interest rates.

### **The Stock Market**

The stock market has been on a tear recently. And, why not? After three years of highly destructive bear market, pessimism was extreme and substantial cash reserves were being held on the sidelines, available to fuel the next advance. Furthermore, monetary policy was massively stimulative and equity valuations were reasonable. And then came the new tax package.

In the past, lower capital gains tax rates have usually led to higher stock prices. Such was the case following the capital gains tax rate cut in 1982. Later, after subsequently being increased, capital gains rates were again lowered in 1990, which was the start of another bull market. In 1997, the capital gains tax was lowered to 20%, and we all know how stocks fared in the late 1990s. Now, the capital gains tax has been lowered once again – this time to 15%.

Recent *Investment Strategy Updates* have commented on the fact that post-bubble markets do not tend to quickly reignite. Rather, most often, they endure a multi-year give-up stage during which the participants of the previous bubble continue to reduce their holdings. The later half of the 1970s is our most probable model for the next few years. Reasonable earnings growth, plus a very modest dividend yield, is likely to be partially offset by

gradually eroding price/earnings ratios. The net result, we think, will be continuing volatility and a gradually rising stock market.

The S&P 500 rose 73% during the two year period following the 1973/74 bear market. However, we are not expecting the current advance to carry that far. Valuations are not cheap and we don't like the rapidity with which bullishness and general speculation have returned. Nonetheless, the current bullish forces are powerful and substantial buying power remains available. There may be a pause in coming weeks, but we think this market is likely to rise further.

We believe the months and years ahead will provide ample opportunity for equity investors. The 1970s produced above-market returns for many investors, who prospered by utilizing the volatility. While some attempted to time the market, others simply stepped up their willingness to react to the undervaluation or overvaluation of individual equity issues. This remains our approach for the next few years. In other words, we intend to add to positions on weakness and reduce on strength. We are willing to modestly increase turnover in this environment, in order to enhance investor returns.

### **Conclusions**

Now is not an easy time for asset allocation. The possibility of event risk is ever present. Yet, we believe that we are in a period of time during which the stock market will produce modest overall returns. And that should be fine, given the likelihood of a continuing low rate of inflation and the relative unattractiveness of alternative asset classes. Interest rates are at their lowest levels in nearly half a century. With the prospect of an improving economy, it is time to sell bonds. Fixed income and other non-stock market alternatives may have favorable entry points during coming years, but we don't think such is the case currently.

All in all, we are relatively comfortable with the outlook for the next few years. For those of us analyzing companies, industries, and trends, it is a market of stocks more than a stock market. We believe that disciplined equity investors will prosper by periodically adjusting stock and group holdings to reflect the alternating periods of strength and weakness. Overall, we favor dividend-paying, higher-quality stocks. Given our outlook, one will not need to go very far out the risk curve in order to achieve general stock market returns or better. In fact, despite the recent speculative trends, we do not expect the next few years to broadly reward the risk takers. Volatility will no doubt continue, but we look forward to favorable after-tax returns. BTR's total-return approach to investing should fare well in the environment we foresee.

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