INVESTMENT STRATEGY UPDATE

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January 1, 2001

2001- THE YEAR AHEAD

Tempus fugit (Latin: time flies). We live in a time of rapid change. Technology and the events affecting our financial markets seem to be evolving at an ever-faster pace. As the new year commences, we look forward to the challenges and opportunities before us. Yet, we can't help but also wonder at the year just past. And, quite a year it was.

From an investment standpoint, the year 2000 began as 1999 had ended. New-economy technology stocks continued to soar while the old-economy value stocks were being totally rejected. It didn't seem logical to us, at the time, that technology stocks could deliver sufficient earnings growth to justify their stratospheric valuations. Yet in the public's eye it was a new era, and the stocks just kept rising. But in April, perceptions began to change and technology, telecommunications, and media stocks entered what has since become a serious bear market. Reluctantly, investors began to look toward the old economy and, to their surprise, found a large number of companies with growing earnings selling at attractive valuations.

So where are we now? In hindsight, the Internet stock mania turned out to be more hype than substance. Too much money was thrown at companies that had little hope of ever producing a profit. But in the resulting carnage, the stock prices of real technology companies have plummeted toward more reasonable valuations. Should we not now be looking to the technology sector for future growth? And what about the old-economy stocks? Those with predictable earnings, such as the foods, financials, and health care companies, have already moved higher and are no longer undervalued. It's the cyclical companies that seem most attractive from a valuation standpoint, but with the economy slowing, isn't it still too early to buy anything with earnings risk?

The Economy and Inflation

Rising interest rates, higher energy costs, and declining stock prices have combined to take their toll. The economy is slowing. Now the questions are: How much will it slow? How soon and to what extent will the Federal Reserve Board ease? And, once the Fed takes remedial action, how long will it take to restore a normalized rate of growth?

In setting investment strategy, it is always worth knowing how one's expectations differ from those most commonly expected. Then we must ask ourselves, what are the investment implications of an eventual shift in majority expectations? The economy is slowing quite rapidly and the consensus economic forecast has been coming down. But, it is still believed that the Fed will act soon enough to engineer a soft landing. Our outlook differs from the consensus in that we believe there will be less growth than is generally expected. In fact, we think there is as much as a 40% chance the economy will experience a mild recession -- two consecutive quarters of negative real growth.

BTR CAPITAL MANAGEMENT, INC.
BALANCED TOTAL RETURN INVESTMENT MANAGEMENT
550 Kearny Street, Suite 510, San Francisco CA 94108 - (415) 989-0100 - FAX (415) 989-0123

Adjusting monetary policy to steer the economy is certainly more art than science, and Fed chairman Allen Greenspan has been skillful indeed. But even for the Fed, it is somewhat of a guessing game. Since changes in monetary policy affect the economy with a nine- to twelve-month lag, the Fed cannot even be sure of how its previous actions will affect the economy, let alone those actions yet to be implemented.

Here's our sense of the current situation: It is a global economy, and the U.S. has a growing dependence on the economic health of our trading partners. Since oil is priced in dollars and the dollar has been strong, very high oil prices are placing a great strain on most foreign economies, particularly those with no domestic energy production. In addition, following the last Federal Reserve Board interest rate increase in May, global central bankers continued raising their rates in response to rising inflationary pressures. Those restrictive measures have yet to fully work their way through these foreign economies which, as a result, are likely to weaken further.

Domestically, our non-technology manufacturing clients and contacts tell us that orders are very weak. Also, we think that sliding stock prices and fears of possible job losses in a weakening economy will have a deleterious effect on consumer spending. Until recently, the wealth effect has provided a strong prop to consumer spending. Now, the wealth effect may be working in reverse. The bottom line is that we expect the economy to weaken further, but it is important to understand that we do not anticipate a dire outcome. From a long-term point of view, the underlying economy is still quite healthy.

In our September 28, 2000 *Investment Strategy Update,* "Inflation Matter", we reviewed the inflation outlook in depth. We concluded that, "Cyclical inflationary pre pressures will come and go, but...for now, we see little in the way of longer-term inflationary risks.... It is a tough competitive world." With the economy now slowing, cyclical inflationary pressure is waning as well. Inflation is not a current concern.

Interest Rates and the Bond Market

Recently the Federal Reserve Board indicated a shift in its primary emphasis. In the Board's opinion, recession is now a greater risk to the economy than is inflation. We believe the Fed will act soon to restimulate the economy -- perhaps as early as this month. Its primary thrust will be to encourage more borrowing by lowering short-term interest rates. How much it lowers rates will depend upon the degree of economic weakness and the Board members' collective perception of how hard it must push. Before the Fed is through, we would expect at least a 1 decrease in the Federal Funds Rate.

With Federal Reserve Board stimulation, interest rates on longer-maturity bonds and notes will decline as well, but probably not very far. The 10-year U.S. Treasury Note yield has already fallen to 5.1 % from 5.8%, just a few weeks ago. So to some extent, future economic weakness and probable Fed action are already priced into the bond market. Here again, the degree of economic weakness is the key. If the consensus expectation of 2½% to 3% real growth is correct, bond yields may actually rise from current levels. In fact, even if the economy weakens to the lower end of our expectations, we would not expect to see long-term yields decline very far below 5%. The point is that, from here, the upside potential in quality fixed-income investments seems rather limited.

We also wonder about the record-high current account deficit. Foreign owners now hold 37% of U.S. Treasury debt. And according to International Monetary Fund figures, during the past year 67% of all the capital from current account surplus countries was used to buy U.S. dollar assets. What will happen to the inflow of foreign funds if we go into a period of dollar decline? Won't the Fed have to keep U.S. interest rates relatively high in order to continue attracting an adequate flow of funds?

The Stock Market

Stock market fundamentals remain generally positive. Interest rates are low, inflation is contained, and our government is in budget surplus. In addition, led by the new technologies, we are squarely in the positive phase of the long economic cycle. This should result in lengthy, robust economic expansions and short, shallow contractions. While it is true that the global economy is slowing, we believe the setback is temporary.

So the environment for stocks is favorable. Nonetheless, going forward we expect more modest stock market returns than those of recent years. The primary reason relates more to where we have been, rather than to where we are going. Over the long run, the stock market cannot outpace the underlying earnings growth of the companies that constitute that market. Yet, with the enormous investment returns realized during the 1990s, that is exactly what has happened. History tells us that investment returns will regress to the mean. In other words, for the stock market as a whole, the above-trend returns of recent years are likely to be followed by a period of sub-par returns. With the year 2000 now behind us, that process is well underway.

We expect the major capitalization-weighted stock market indices to average 7 to 8% investment returns for the first half of the decade, including the year just past. Those are not unattractive returns in an inflation environment of 3% or less. But it is important to remember that not all stocks are the same. While some of the largest components of the popular indices are still very highly valued, large numbers of other stocks are priced quite reasonably. As a result, we expect a period during which many stocks and most value managers will produce superior returns to those of the market averages.

Sector Selection

Regarding technology, we offer the following thoughts: Most tech stocks have retrenched to levels that seem to represent fair value. While from a longer-term perspective this appears to be a rather attractive entry point, we think the group will, at the least, test the recent lows during the first half of the new year.

Historically, manias such as that just seen in technology stocks do not end gently. The sentiment phases of a post-mania bear market are often described as complacency, concern, and finally, capitulation -- a near total give-up by technology investors. We do not believe the capitulation phase is yet complete.

Also, we would point out that excessive capital investment in the technology group during the last several years has probably led to meaningful overcapacity. During a weakening economic environment, the result may well be technology-related pricing pressure, leading to further earnings disappointments. Nonetheless, we believe the major damage has already occurred, and

we have added a few basic technology positions to our holdings. We plan to add more in coming months, during what we anticipate will be a very favorable entry point.
Insofar as stocks that should be bought now, quality companies with predictable fundamentals typically hold up well during a weakening economy. While many of those companies, including the foods, finance, and healthcare companies are no longer cheap, they should continue to perform well in an environment of economic uncertainty.
In addition, cyclical and cyclical-growth companies currently sell at very reasonable valuations. Typically one should wait to buy cyclical stocks until after the Fed has actually begun to ease and the full extent of an economic downturn is understood. But those events may not be that far off and, as we said, valuations are attractive.

Investment Strategy

So, how should we be currently structured? From an asset allocation standpoint, stocks provide better returns than bonds, over the long term. And, as we have indicated, the upside potential in bonds appears limited from current levels. Yet in uncertain times, fixed income investments are also worthwhile as a temporary store of value. For now, we are comfortable holding a portion of assets in relatively short-maturity bonds and notes. In addition, we are temporarily maintaining higher-than-average cash reserves, awaiting future stock purchase opportunities.

Regarding stock selection, we are pursuing three primary strategies. First, we are long-term investors in the stocks of quality growth companies selling at attractive valuations. While some of these holdings may see lower valuations in coming months, we are confident that, two or three years from now, we will look back and be glad that we have owned them. Second, we continue to hold defensive positions which, while no longer cheap, should perform relatively well in coming months. And third, we are invested in a few special-situation stocks where the outcome should bear little relationship to overall stock market conditions.

As indicated, we expect a favorable buying opportunity during coming months, particularly in the technology sector, and we plan to be more aggressive as the year progresses. Our current expectation is that 2001 will finish strongly, resulting in attractive investment returns for the year as a whole.

The investment future is bright with promise and new opportunities. The great technological revolution is in full force, and we expect its impact to broaden. Until recently, the technology companies themselves have been the primary beneficiaries of the new economy. Going forward, we expect the benefits will also accrue to the users of those technologies -- the former old economy. In addition, we are very enthusiastic about the future of healthcare. The baby boom generation is aging rapidly, and there will be major new advances in health care technology. We plan to increase our exposure to the sector.

In this, the second year of the new millennium, we wish all of our clients and friends health, happiness and, of course, prosperity.
