INVESTMENT STRATEGY UPDATE

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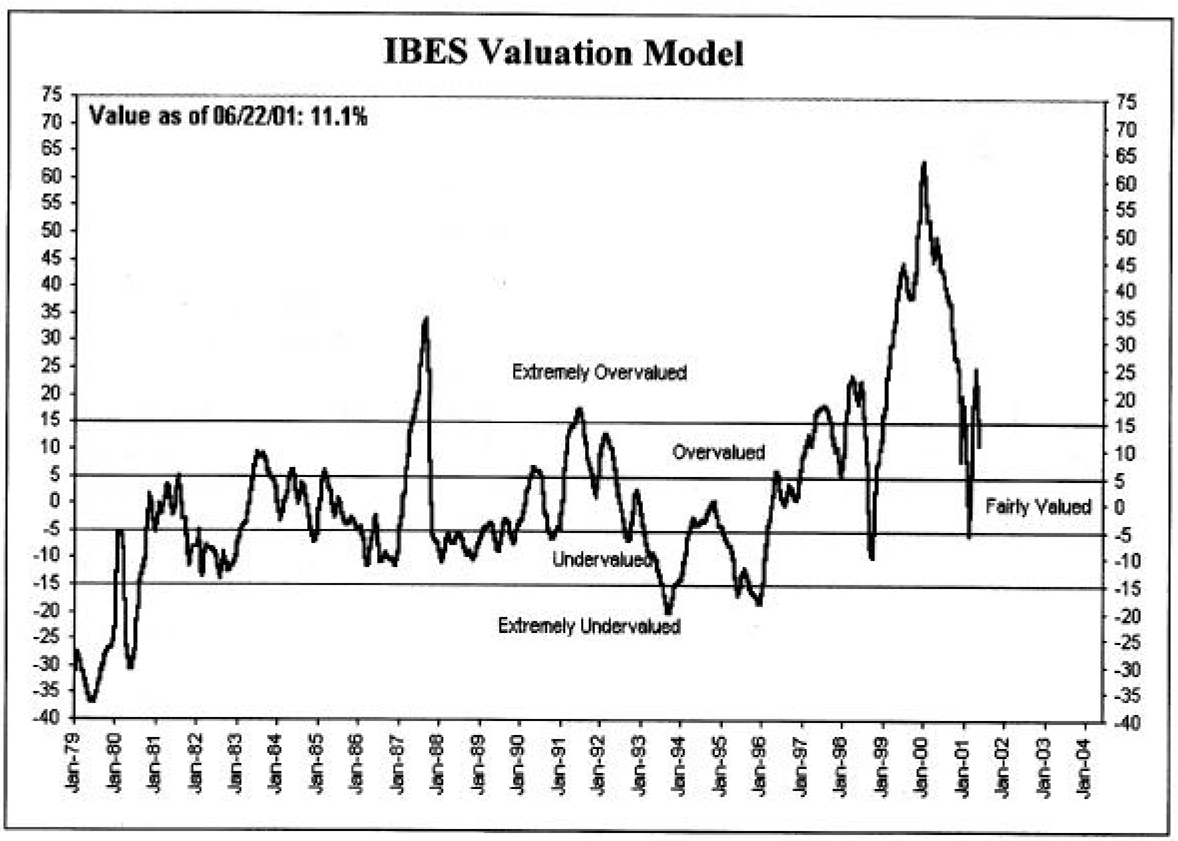
June 27, 2001

TOO FAR, TOO FAST?

The last three months have been a roller coaster ride for many stocks. The quarter started with stocks moving sharply higher. At one point, the S&P 500 Stock Average was up by 18% from its low in early April, while the Nasdaq was more than 40% ahead of previous levels. That stocks rose was no surprise. The Federal Reserve Board had responded to a weakening economy by aggressively lowering short-term interest rates and rapidly expanding the money supply. With abundant liquidity and the prospects of a rebounding economy, investors were willing to look over the valley of weak corporate profits. Now, however, the rally seems to have ended and stocks are once again moving lower. What happened?



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Several methods of valuing stocks are based upon the relationship between forward corporate earnings estimates and bond yields. The IBES valuation model, shown above, is one such valuation gauge. It compares the earnings yield (twelve months forward earnings/price) to the yield of the ten-year Treasury note. In theory, the value of stocks is a function of the sum of its stocks and their future earnings discounted back to the present. So, valuations are affected by a larger or smaller forecasted earnings stream and by the interest rate used to discount those earnings.

As shown above, by the peak of the rally in late May, valuations had once again risen to historically high levels. Not only had stock prices rallied, but bond yields rose as well. It seems that bond market investors, too, had responded to the prospects of a rebounding economy, as well as to an increased possibility of higher inflation, by driving bond prices lower. So, based upon twelve-month forward earnings estimates and the then current U.S. Treasury ten-year bond yield, the Standard and Poor's 500 Stock Index was some 25% overvalued. While stocks have since retrenched, they still calculate to be moderately overvalued.

This apparent overvaluation leaves us with several possible conclusions: First, higher valuations are justified as the U.S. economy is stronger than is currently realized and, therefore, analyst earnings estimates are too low. Second, and currently gaining in popularity, the economic rebound will be slower than bond market investors anticipate; therefore, the inflation risk is lower and bond yields should be lower as well. Or third, stock market valuations were, and are still, too high, considering the fundamentals.

Let's start with the economy. By their actions a few weeks ago, investors seemed to be anticipating a swift, strong economic rebound. We have differed from that outlook, believing instead that the recovery will be much more sluggish than expected. The current slowdown (for it is not yet a recession) is different from most of those past, in that consumer spending has remained quite healthy. This time, the weakness is in corporate America. Capital spending has been anemic and corporate profits are in a recession.

Because weakness in the economy has been relatively confined to the corporate sector, an accommodative monetary policy and lower short-term interest rates might not work so quickly this time to restimulate the economy. Lower interest rates might not be sufficient to offset higher energy costs. A recovery in capital spending will depend upon many factors other than interest rates. Furthermore, the technology and telecommunications sectors are in a strong cyclical downturn, and weakness in those sectors seems likely to continue for a while longer, given that both were severely overbuilt during the boom -what with Y2K and the buildup of the Internet infrastructure. Additionally, there is still a significant inventory overhang, exacerbated by the fact that technology and telecommunications equipment previously sold to the dot-coms and others has been coming back onto the market. Eventually, technological enhancements and the associated potential increases in productivity will demand that technology spending pick up, but probably not for at least two more quarters.

The technological revolution is real, and is very bullish for the economy long-term. The evolution of the Internet will continue bringing major change to our daily lives -- only differently than was originally envisioned by stock market bubble investors, the dot-com entrepreneurs, and the venture capitalists who backed them.

Regarding valuations, we are well aware that the stock market almost always rises when the Federal Reserve Board lowers interest rates. That cause-and-effect relationship was the focus of our March 27, 2001 *Investment Strategy Update* titled "Tug of War." In fact, according to market letter writer and money manager Marty Zweig, there have been ten occasions since World War II when the Fed lowered interest rates five times or more in succession. One year after the fifth cut, the stock market was up one hundred percent of the time, with an average one-year return of 28.1 %.

However, this may be the first time that the Federal Reserve Board has taken major steps to rescue the economy when stock market valuations were not already at severely depressed levels. This time, in an attempt to keep the economy from falling into recession, the Fed acted at the first signs of weakness. While stock prices came down, as investors reacted negatively to pending economic weakness, overall valuations remained quite high. So as the Fed eased, plentiful liquidity and a seeming belief by stock market investors that the game was on again, resulted in stock prices rising too far, too fast, in our opinion -- particularly relative to our sluggish fundamental outlook.

Investment Outlook

There is an old saying which goes "Don't fight the Fed." We agree, believing that the long-term outlook for equities is quite favorable and that most stocks have, indeed, entered new bull markets. Furthermore, if there's one thing we have learned in recent years, it is that valuations can rise much further than expected and, sometimes, remain high for quite a while. Yet, we are of the opinion that the stock market is unlikely to make much upside progress over the next few months. Rather, we envision a trading range, or perhaps some additional stock market pullback, thereby providing time for the fundamentals to catch up with valuations.

It is not our practice to repeat ourselves from one *Investment Strategy Update* to another. But in expressing our current feelings toward the stock market environment, we cannot improve upon the sentiments expressed in "Tug of War."

> *So, we do not believe that economic disaster is at hand. Nonetheless, investors may require some additional time to adjust to the deteriorating corporate earnings outlook. Also, speculative stock market bubbles do not typically end in V-type bottom formations. We suspect the stock market will spend much of this year bouncing along the bottom. In all likelihood, there will be periods when it seems as though stocks are of to the races again, only to have the market turn down once more. In like manner, future periods of weakness are likely to be accompanied by predictions of still further downside -- particularly in the technology sector.*

Since the technology bubble peaked in early 2000, we have been able to benefit from what has been much more a market-of-stocks than a stock market. As many stocks did not participate in the bubble, their valuations remained far more reasonable.

And, for the most part, they participate in sectors of the economy which were not subject to over-investment and, therefore, over-capacity. Thus far, we have been able to successfully navigate a difficult stock market environment. We remain optimistic that we will continue doing so until more favorable tail winds return.

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