March 27, 2001

TUG OF WAR

Fed Easing and S&P 500 Returns
(Prior Six Fed Funds Peaks)

Date of first rate cut	3-month return%	6-month return%	9-month return%	12-month return%	18-month return%
Jun-74	-7.78	-20.28	-3.07	10.69	4.87
Mar-80	4.11	22.89	32.98	33.22	13.80
Jun-81	-0.22	-8.80	-14.67	-18.46	7.19
Aug-84	-0.35	8.70	13.72	13.17	36.14
Feb-89	2.08	21.87	19.78	14.90	11.67
Mar-95	2.80	16.72.	23.01	28.92	37.27
Average return	0.11	7.18	11.88	14.07	18.49

Source: Salomon Smith Barney

On January 3, 2001 the Federal Reserve Board surprised the financial markets by lowering short-term interest rates 50 basis points. Over the following three weeks the stock market rallied sharply. And why not, the Fed was easing, and “Don’t fight the Fed” is a well-accepted stock market axiom. On January 31, the Fed lowered interest rates 50 basis points more. So what did the stock market do? It promptly headed lower, giving up all of the Fed-induced gains and more. Now the Fed has lowered rates yet again, and still the markets have not responded. Why?

Picture the stock market as the middle of the rope in a huge game of tug of war. On one end is Alan Greenspan and the Federal Reserve Board, expanding liquidity, lowering interest rates, and generally determined to do whatever it takes to keep the economy from falling into a recession. At the rope’s other end is the rapidly deteriorating economy, a growing stream of downward corporate earnings’ revisions, and investors’ fears of still greater weakness ahead.

Over the years, it has paid to invest with the Fed. The evidence is clear. When the Federal Reserve Board lowered interest rates in the past, the stock market usually rallied nicely over the following three-, six-, twelve-, and eighteen-month periods. Going back fifty years, the only exceptions have been when the depth or duration of the economic downturn was unusually severe.

So what about now? The economy has slowed more rapidly than almost anyone expected and earnings expectations have declined markedly, especially in the technology sector. Will the Fed's magic work once again? And, how long will it take before the economy rebounds? The stock market is telling us that we're in for a difficult time and a number of the pundits agree.

This is the first significant slowdown in the technology-based new economy, and no one is quite sure how it will respond to Fed stimulation. Our technology and telecommunications infrastructures were severely overbuilt in recent years and it could take some time to work off the excess capacity. In addition, there was the huge stock market bubble and subsequent meltdown in the new-economy stocks. With over-leveraged consumers and so large a portion of spending associated with the wealth affect, the economy would have a difficult time if cautious consumers reduce spending in order to rebuild savings. Significantly lower rates may be required to pull us out of the downturn.

Still, we place our bet with the Fed. Predictions of economic doom are not that unusual and on more than one previous occasion it appeared as though we were headed for disaster. There was the stock market crash of 1987, a real estate and banking crisis during the late 1980s and early 1990s, and, lest we forget, a budget deficit that was soaring out of control. In each case, with the Federal Reserve Board's help, catastrophe was averted and prosperity renewed.

We think the Fed may have acted too late to avoid a recession, but we do not believe the retrenchment will be very deep. The Fed has responded aggressively, by lowering interest rates and sharply increasing the money supply. In addition, we expect fiscal policy to be stimulative, as it appears likely that tax cuts will soon be enacted. We think the Fed will continue to lower interest rates and do whatever is necessary to restimulate the economy.

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 off 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.

What should investors be doing? We believe that this is a highly attractive environment in which to invest. While few investors can accurately claim success as market timers, those who make a habit of investing at attractive levels of valuation are well rewarded over the long term. Stock market corrections enhance value and create opportunity. In our opinion, this will be a year with several opportunistic moments at which to invest.

Where's the Value?

There are numerous ways to differentiate value and growth investing. But in recent years, investor definitions were driven by the realities of the marketplace. It was all quite clear. Growth was growth and value was value and there was very little in between. Conventional wisdom held that growth stocks were those that grew earnings rapidly. Value stocks, on the other hand, grew more slowly, often paid a dividend; and always sold inexpensively. By early last year, new-economy growth stocks had risen to valuations that anticipated impossible outcomes while, at the same time, so-called old-economy stocks such as the banks, insurance companies, retailers, and machinery manufacturers were reflecting extreme pessimism. Of course, we all know what happened next.

In the current environment, the definitions of growth and value do not seem all that easy. Many of the high-expectations companies have reported or warned of disappointing results and have seen their stock prices fall sharply. These so-called growth stocks can become value stocks if they sell cheaply enough. Conversely, value stocks have recently moved into favor and many, such as the retailers and machinery stocks, have risen to levels at which they now seem fully valued. Value stocks that become too expensive are no longer value stocks. Does that mean that the new-economy technology stocks are now in the value camp? Not yet, in our opinion. While technology stocks as a group are significantly cheaper than they were, they are still not cheap by historical standards.

From a value investor's standpoint, the dilemma is manageable. For one thing, the price action within stock market sectors is far from uniform. There are almost always individual stocks that, for one reason or another, have risen too high or fallen too low. For instance, while large-capitalization value stocks have risen significantly in recent months, many of their mid- and small-cap brethren have appreciated far less, and still sell at attractive levels of valuation.

Also, the choice to purchase or sell a stock need not be an all-or-nothing proposition. Volatility creates opportunities to buy or sell partial positions, while awaiting further strength or weakness to complete the action. Such a program might be appropriate in a stock that you wish to own as a long-term investment, say in the technology sector, which has reached an attractive level at which to begin accumulation. If the stock subsequently heads higher, at least you will have some. Alternatively, if it later falls to an even more attractive valuation level, you can always complete the position, thereby lowering your overall cost. Bear in mind, however, that such a program requires the fortitude to stick to your plan of buying more on weakness. Currently, we are seeing accumulation opportunities in companies which, several months ago, we doubted we would ever have a value investor's opportunity to own.

The quest for stock market truth is a game of hindsight. However, while we cannot know what the future holds, historical precedence often provides us with valuable forecasting tools. Taken as a whole, the stock market may not make much progress in coming months. But the bottom line is that the Federal Reserve Board is aggressively easing and will continue to do so until it wins the current tug of war. Recession will neither be deep nor long lasting, in our opinion. And, as in the past, "Don't fight the Fed" will prove to be a valid investment stance. By this year's fourth quarter, stock prices are likely to be moving higher. We continue to expect attractive returns, going forward, for the disciplined opportunistic investor.