March 26, 2003

WHAT A DIFFERENCE THREE YEARS MAKE

There is an old stock market saying that, "history repeats itself, only differently." The stock market surged with the onset of war, amid a frenzy of short covering by the rapidly growing contingent of hedge fund managers. Yet, only a small portion of the enormous sidelined cash reserves has been recommitted to stocks. A majority of the investors we talk with are still pessimistic.

The shift in investor sentiment over the last three years is nothing short of amazing. Unbridled confidence has given way to extreme pessimism about America's future, and not just concerning the short-term consequences of uncertainty, war, and high energy prices. Many of the comments we hear engender a much more deeply seated fear: "The world has changed. America's days in the sun have passed." "What makes you so sure the economy will grow over the long term? It doesn't have to." "Forget history, bonds will outperform stocks for the next ten years, so why should I put any money into stocks?"

Consider that the underlying worth of an equities market is a function of the expected stream of future earnings of the companies in that market. If we know that corporate earnings grow at roughly six percent per year, over time, why is it that the stock market undergoes such wide swings? Much of the answer lies in the waves of crowd psychology – the cycles of fear and greed.

It Was a New Era

5,048 – that's where the Nasdaq closed on March 10, 2000. We were flying high back then. It was a *new era*, and all one needed to do to get rich was to buy a bunch of technology stocks – the riskier the better. The pace of technological advancement was so rapid that the earnings of technologically advantaged companies were expected to soar. As a result, the companies of the future sold at enormous valuations. Cisco, for example, traded at 137 times highly inflated earnings expectations. Nortel was 122 times forecasted earnings. And many of the new era companies, such as Priceline.com, Webvan, and Amazon.com, had no earnings at all. But what did that matter? It was all about growth. We were kings of the world, and technology was our scepter. The first quarter of 2000 saw the largest ever quarterly net inflow to equity mutual funds. By contrast, fixed-income mutual funds were under heavy liquidation.

An interesting trait of investor psychology is the natural tendency to extrapolate current trends into the future. It didn't matter, those three years ago, that the long-term total return from stocks had approximated ten percent per year. The stock market had been rising at nearly twice that rate, and the most commonly stated expectations of future investment returns were huge. Some observers, including we at BTR, preached caution. But the most typical response we heard was that we simply didn't understand. It was a new era, and historical comparisons were thought to be of little relevance – *this time was different*.

Or So They Thought

Consider the change, from then till now. Contrary to expectations, bonds have performed quite well since early 2000, while the trailing three-year stock market return is among the worst in history. But now, despite significantly lower valuations, the most commonly-stated expectations of future stock market returns are quite low, if not negative, over the next several years. Once again, it seems investors are extrapolating their most recent experience into the future.

Indeed, there are reasons to be pessimistic. This is a time of war and terrorism. The consumer is strapped, companies have no pricing power, and many investors are worried about the prospect of deflation. In addition, there is the budget deficit, the trade deficit, the current account deficit, and the dollar which, taken together, lead other investors to be concerned about the risk of inflation. And, oh yes, let's not forget the competitive threat from China. In fact, there seems no end of things to worry about. Under ordinary circumstances, current valuations might seem reasonable, but once again we have been hearing those words – *this time is different*.

Hope and Optimism

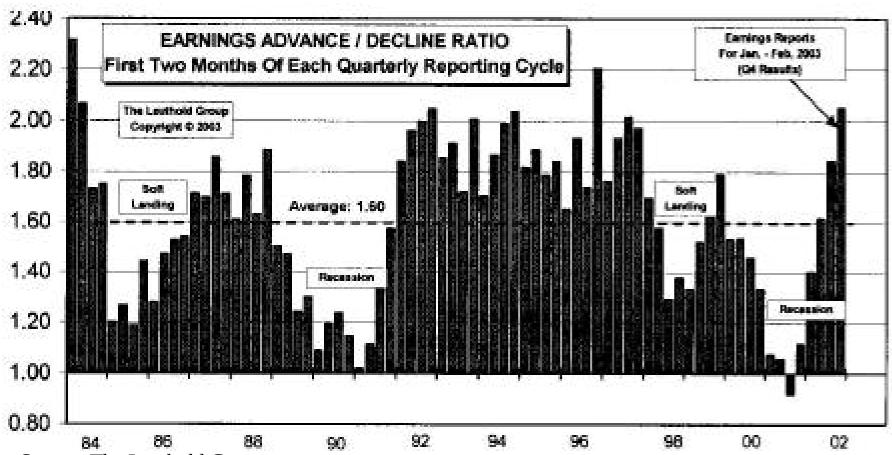
The majority of what we hear and read seems focused on the negative aspects of the current environment. But the positive factors should be considered in the mix as well, and there are many reasons to be hopeful – perhaps even optimistic – about the future.

First, the economy. There is no question that the uncertainty and very high energy prices experienced prior to the war did considerable damage to the economy. Even so, we still consider it likely that the recession is behind us. Economic recoveries tend not to be straight line, and one need only look back to the last recession as an example. While that recession officially ended during the first quarter of 1991, the economy remained sluggish for more than a year following the bottom. Consumer confidence fell to new lows, and polls taken among economists and corporate leaders in early 1992 showed that many continued to believe the recession had not yet ended. Of course, we all know how strong the economy was during the remainder of the 1990s.

So why do we think the current economy is okay? For one thing, the economy has been growing – 2.4% in 2002, according to the latest data. Furthermore, monetary policy has been expansive. The resulting decline in interest rates has created a strong fundamental demand for housing, as well as added major support to the consumer through the very high level of mortgage refinancings. On the corporate side, the inventory-to-sales ratio is extraordinarily low, and there is a growing backlog of delayed capital spending projects that will eventually have to be undertaken. Weakness in the dollar is a competitive positive for U.S. companies. And, at this stage of the game, U.S. deficit spending is a source of stability. If that's not enough, additional fiscal stimulus seems likely.

Lower energy prices benefit the economy as well. And the price of oil has already come down sharply in anticipation that the war will soon be behind us. Furthermore, spring and warmer temperatures are around the corner, and it won't be that long before Venezuelan oil production comes back online. Longer term, the economy should continue to prosper as a function of growth in the labor force, productivity improvement, and some modest price inflation.

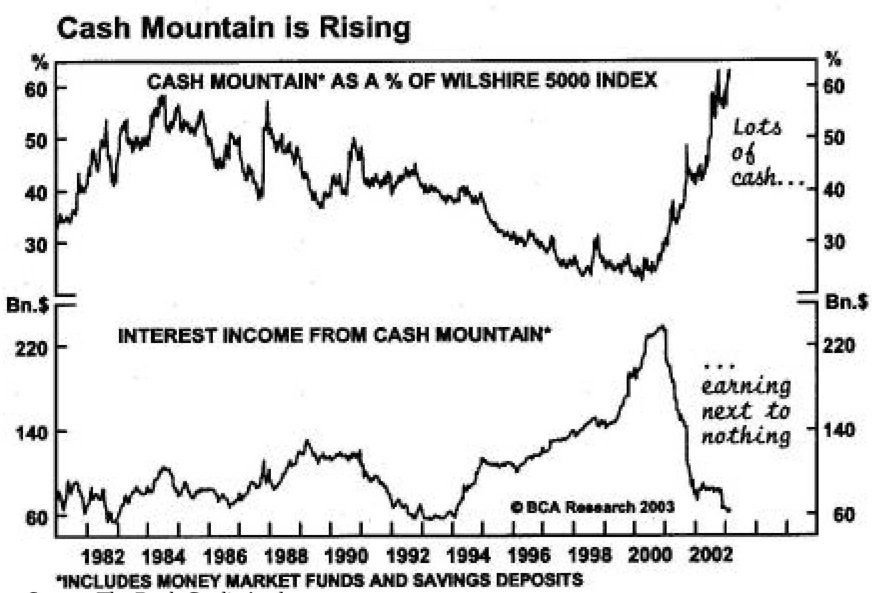
Other things being equal, an improving economy should benefit the stock market. But the economic outlook is just one of the stock market positives. U.S. companies have learned to prosper in the current slow-growth environment by restructuring and downsizing. Corporate America is on the mend, and earnings momentum has been improving. As shown in the following chart, a growing number of companies have been reporting positive year-on-year earnings growth. Narrowing corporate bond spreads provide corroborating evidence of reduced financial strain. And the inevitable rebound in capital spending will further bolster earnings.



Source: The Leuthold Group

The stock market, selling at close to the median valuation level of the last fifty years, is now reasonably valued in our opinion. We are well aware that previous periods of post-bubble secular weakness brought stock prices down to very low valuations, but those were either associated with significant monetary and fiscal policy mistakes, such as occurred during the 1930s, or with rapidly rising inflation, as in the 1970s. This time we have not made the policy mistakes of the 1930s, nor do we see much possibility of a significant rise in inflation. With a continuing low-inflation low-interest-rate environment, we do not believe there is a significant downside risk to current valuations.

The present state of investor psychology is also a meaningful positive. We know from past experience that bear market bottoms take place amidst extreme and sometimes climatic pessimism. At the bottom, the last bulls capitulate, finally throwing in the towel – lamenting that hope is gone, the future is bleak, and there is no reason to ever own stocks again. Three years ago, when everything seemed so positive, there was a dearth of buying power available to fuel a continuing stock market advance. Investors were already invested. Now by contrast, with significantly more pessimism, there are huge cash reserves on the sidelines, earning minimal returns. Note our second exhibit. The economic recovery will continue, and at some point following the war, investor confidence will rise anew. When it does, there is a huge amount of potential buying power available to fuel the next advance.



Source: The Bank Credit Analyst

Don't misunderstand our message. There does seem to be a lot to worry about. And while current valuations are not expensive, neither are they particularly cheap. The point is that stocks have come down a long way. Bear markets provide the opportunity to enhance returns by being able to buy a wider variety of stocks, including those of the highest quality companies, at attractive levels of valuation. We don't know if the final stock market bottom has yet occurred, but our opinion is that the process of ending this bear market is well advanced. From current levels we expect to earn reasonable inflation-adjusted returns from our stock market holdings, and that is more than we currently expect from the most traditional alternatives of cash, bonds, and real estate.

So don't get bearish now.
