September 23, 2001

A QUESTION OF TIME HORIZON

We were shocked and deeply saddened by the tragic events of September 11. We had all known of the growing threat of terrorism, but who could have imagined the scope of the attack and the depths of our vulnerability. Our prayers are with the friends and families of those who were lost.

Two weeks have passed since that fateful day, and for most of us life is returning to a semblance of normalcy. But much of what had previously been accepted as normal, may never be normal again. For our society and way of life, the September 11 loss goes well beyond lives and structures.

That much will change seems certain. However, from a long-term economic and financial standpoint we expect little will actually change. Our financial markets have experienced unexpected events in the past and the initial shocks were inevitably transitory, whether resulting from single-point events such as assassinations or bombings, or those that took longer to play out such as war or the 1973 oil embargo. The record shows that the stock market is typically higher within a few months following a crisis event sell off. According to a table of 28 such events recently constructed by Ned Davis Research, the stock market rose 12.1 % on average, over the subsequent 126 days.

Before - Where Were We?

The financial markets were on a roller coaster ride even before the September 11 attack. In fact, it had been a rather amazing last three years in the stock market. Not only were we witness to one of the largest speculative bubbles of all time, but we also experienced its demise. As of August 31, 2001, the Nasdaq and Standard & Poor's 500 stock indices were both lower than at year-end 1998, prior to the mania actually taking flight. In other words, the stock market had provided investors with near zero returns for the last three years. And, for those investors/speculators who got caught up in the bubble after its onset, the net investment returns were probably well into negative territory. Gone were the comments of “It's a new era” and “This time is different.” Gone, too, were the phone calls to value managers stating, “You guys just don't get it.” In their place, questions had arisen: “When am I going to make some money?” “Why isn't the economy responding to Federal Reserve Board stimulation?” “Should I be in stocks at all?”

To the last question, our answer was and still remains an unqualified "yes." The stock market has provided investors with very favorable returns over time, and will continue to do so in the future, both relative to inflation and as compared to most other asset classes. Prior to the attack, we believed the stock market was in a bottoming process, but we also thought that it would take some time to complete.

Insofar as the economy was concerned, the U.S. was teetering on the edge of recession prior to September 11. The Federal Reserve Board had been priming the pump, but there were few indications of any improvement. The weakness to that point had been concentrated in the manufacturing and capital spending sectors, and it wasn't clear that lower interest rates would speed the recovery. The technology stock mania had carried over into the real economy as well. With the promise of exceptional returns, huge amounts of capital were attracted to fund new technology and telecommunications ventures. The more seasoned technology and telecommunications companies got caught up in the hype, too. The end result was substantial overcapacity, much of which had yet to be closed, obsoleted, or otherwise worked off. The painful process of reducing that capacity was substantially affecting the whole manufacturing and services supply chain, including what inevitably was becoming an excess supply of workers. Layoffs were rising.

What was keeping the economy out of recession was the American consumer, and we couldn't help but wonder if, given the increasing number of layoffs, consumer spending would cave in, too. Furthermore, the increasingly interdependant global economy had been weakening as well. Global recession seemed a distinct possibility.

After - Where Are We Now?

As a result of recent events, the economic outlook has actually become somewhat more certain than it was before. There is now very little doubt that there will be a meaningful reduction in global economic growth. Typically, stocks bottom several months prior to a bottom in the economy as increasing numbers of investors become willing to look beyond the current weakness to better times ahead. The reason investors were not yet focusing on the eventual recovery was the uncertainty of whether we would have an actual recession and, if so, how deep it might be. Now we know: more cautious consumers are spending less. So, we are in recession. And while it may well be sharp, we believe it will be relatively short.

In what seems a rather perverse turn, the tragedy itself has sewn the seeds of the stimulative economic activities that will help take us out the other side -- perhaps, even more strongly than we had previously thought. The Federal Reserve Board is pouring liquidity into the U.S. economy, as are central banks around the world into their own economies. As a result of the disaster, huge sums of money will be spent to build up our military, defense, and intelligence capabilities, and to beef up security at airlines, airports, utilities, border crossings, commercial buildings, and other public venues. Additional funds will be spent in rebuilding. Miles of fiber optic cable will be laid, and thousands of computers and accompanying software will be replaced, as will the myriad of other equipment that was lost in the disaster. Furthermore, in a reverse effect to the capacity reduction process mentioned earlier, the replacement of facilities and equipment will reverberate far beyond the workers and companies most directly involved in such efforts, resulting in positive stimulation to the entire economy.

So where are we now? The initial stock market downturn has been severe. Our belief is that a reflex rally may soon develop, as most investors are well aware that the stock market has usually recovered quickly following previous unexpected shocks. But following that rally we would not be surprised if there is still some further weakness ahead, given the uncertainty of the U.S. military response and the fact that the degree of economic weakness is still unclear. However, we believe that within a few months investors will have a handle on the downside and begin to look beyond the recession to expected improvement on the other side.

Going forward, we anticipate favorable investment returns as the long-term outlook for stocks remains positive. Inflation is low, interest rates are low, the volatility of economic and inflationary swings have lessened, the technological improvements in productivity are real, and despite the current setback, world trade is in a secular expansion. It is true that some sectors of the stock market are not cheap, but others, particularly those that did not fully participate in the technology bubble, seem reasonably valued. We believe the current weakness provides an opportunity to invest.

Perhaps the key determinant in one's decision process should be time horizon. It is entirely possible that the economic weakness and continuing psychological trauma associated with recent events will carry stock prices still lower. But for many stocks, we are highly confident that we will be able to look back, two or three years from now, and know that these were attractive levels at which to have owned them.

We can only hope that our heightened awareness following the nightmare of September 11 will help to thwart future terrorist attacks. We also hope that those responsible are found and punished, without unjustly condemning an inherently peaceful religion.

Can the nations of the world unite in their effort to isolate those that foster or allow terrorist activities within their borders? Can we cause that isolation to be so painful, that the men and women in power will recognize it in their self-interest to deny terrorism? We hope and pray that reason prevails.
