

Will It Be Different This Time?

A year ago, in our January investment outlook, we asked the question: "Where do you go from here?". Our answer was cautiously optimistic, as we forecast that 1996 would be another good year, following the exceptional stock market performance in 1995. Well, we turned out to be right this time. The broad, high quality stock index, Standard & Poor 500 Index, increased 23.0% as the confluence of positive factors affecting the U.S. economy and stock market continued. According to Lipper Analytical Services, Inc., the average U.S. equity mutual fund (there are 2,490 diversified domestic stock funds) rose 19.47% in 1996. On the other hand, the bond market turned in a disappointing year with a total return of minus 1.21% from the 30 year U.S. Treasury Bond, while the Lehman Government Corporate Bond Index was only up 2.90% for the same period.

So, as we look forward to 1997, what can we expect? Will this great bull, now entering its seventh year, continue this year or will it all end badly with the "irrational exuberance" in the stock market (to quote Alan Greenspan) leading to an overvalued stock market, which will burst like a giant bubble?

Some historical perspective on this bull market is useful. The market took off in late 1990, and 1991 was a very good year for the market with the S&P 500 Index up more than 30%. Then the stock market turned in three sub-par years between 1992 and 1994, taking a breather while earnings caught up with prices. 1994 was the most difficult of these three years, for rising interest rates caught the stock market off balance. With the bond market having one of its worst years in decades, the total return of the S&P 500 Index nonetheless managed to eke out a positive year at 1.25%. Then the great bull market took off again with the S&P 500 Index showing a 69.15% cumulative gain over the past two years. A portfolio invested solely in S&P 500 stocks (the type of stocks which Bradley, Foster and Sargent, Inc. primarily focus on) over the past six years would have shown this kind of gain:

<u>YEAR</u>	<u>S&P 500 INDEX % GAIN (TOTAL RETURN)</u>	<u>CUMULATIVE GAIN</u>
1991	30.3%	30.3%
1992	7.6%	40.2%
1993	10.1%	54.4%
1994	1.3%	56.4%
1995	37.5%	115.0%
1996	23.0%	164.5%

What happened in the U.S. to cause a 17.6% average annual return over the past 6 years - more than 60% higher than the historic return of the S&P 500 since 1926? And, will these kinds of returns continue this year or not?

In addressing the first question, Abby Cohen, well known Chief Investment Strategist for Goldman Sachs, makes a lot of sense. She writes that the economic expansion that has driven stock prices higher has been one of the most durable expansions on record because it has been accompanied by low inflation, job creation and high quality profit growth. Secondly, there have been many structural changes - both in the U.S. economy and in corporate America. On a macro-economic level, the budget deficit (as a percentage of GDP) has dropped from 6% in 1991 to less than 2% in 1996, and the Fed has exercised good monetary discipline. Furthermore, the shift in the economy to a more knowledge-based, technology-driven private sector has increased productivity dramatically. Moreover, she writes that there has been a major shift in thinking in regard not only to inflation but also to inflationary expectations. While in the 1970's and 1980's, consumers often rushed to buy because prices were bound to be higher soon, in the 1990's there has been great resistance to price increases. Additionally, in an increasingly global economy, companies have been able to out-source production to countries where costs are lower in order to compete on price; and if they didn't, their competitors did. All this has led to the likelihood that inflation has probably been overstated for the past several decades. The Boskin Commission's report released in December 1996 indicated that inflation has been overstated by more than 1%, which means that the current inflation rate is closer to 1.5% than 3%.

Another very positive factor was that the bull market began with stock prices significantly undervalued relative to the improving economy and to the performance of many top notch companies. Finally, the baby boomers have come of age, and rather than consuming, they are saving in a big way. Their savings have flowed into the stock market largely through stock mutual funds - especially via the 401(k) and 403 (b) plans - and have been growing dramatically. In 1996, funds invested in U.S. equity mutual funds totaled over \$225 billion dollars - far above the record breaking \$130 billion in 1993.

In addition to these factors, democratic capitalism has broken out all over the world. Markets which were not open to U.S. companies a decade ago have enormous potential now. These include Eastern Europe, the former Soviet Union, China and India. Who would have believed that Proctor & Gamble would be selling over \$1 billion of products in China, or two of McDonalds largest restaurants would be in Moscow and Beijing? U.S. companies are often the world leaders in marketing, and they have been able to utilize their global marketing skills to promote their strong brand names to produce significant corporate cash flow. Absent a major war or the ascendancy of trade protectionism in the U.S. Congress and abroad, this increasing globalization of the economy should continue to help drive stock prices.

The second major factor is technology. It is hard to overemphasize the revolution taking place in technology. The changes in the new Information Age are as momentous as those which occurred at the dawn of the Industrial Age. Some have compared the advent of the Internet to the creation of the printing press. The huge productivity increases have been made possible by the processing of information by powerful PC's (at ever lower prices), guided by sophisticated software and then distributed rapidly through Internet and Intranet, telefaxes,

paggers, cellular phones and satellite networks. This is a global phenomenon too. Intel sells more than 50% of its chips abroad, and by 1999, 100 million PCs will be sold globally each year. The revenue growth of many companies in the technology sector is likely to be 30%+ for years to come.

These are some of the reasons for this great bull market. However, the fact that the stock market has gone from a position of under valuation to what we believe is fair valuation must also be recognized. Using the old rule of thumb, the S&P 500 index at 765 is 17.7 times 1997 operating earnings. With true inflation at roughly 2% (3%+ less the 1.1% overstatement explained in the Boskin report), there doesn't seem much room for P/E expansion - even if inflation remains benign and the economy turns in another year of 2.5 - 3% growth. We agree with most economic forecasters that the earnings growth in 1997 by S&P 500 companies will not exceed 10% - perhaps 8-10%. Thus with little likelihood of multiple expansion and modest earnings growth, we believe that the stock market's potential appreciation is under 10%.

There is some risk that one or more of the many factors that influence the stock market could turn negative. One possibility is that the economy will grow faster than expected, bringing the dangers of higher inflation. This would cause the Fed to increase interest rates, creating a P/E multiple contraction leading to a market correction. The Fed might even raise interest rates modestly just to quell stock market speculation and dampen "irrational exuberance". Another possibility is the U.S. economy will slow down, causing corporate profits to flatten or even decline. Of the two scenarios, we believe that higher inflation and/or higher interest rates is the more likely one. The data presented below provides some historical perspective on the stock market performance in the year following and the two years following two exceptional years such as 1995 and 1996:

Law of Averages

After two great years, the Dow usually suffers during the next two

<u>Year</u>	<u>2 Year Cumulative Gain</u>	<u>Next Year</u>	<u>2nd Year (Cumulative)</u>
1928	90.8%	-17.2%	-45.1%
1934	72.7%	38.5%	72.9%
1936	72.9%	-32.8%	-14.2%
1955	74.2%	1.6%	-11.6%
1976	63.0%	-17.3%	-19.9%
1996	68.2%	-	-

Source: Logical Information Machines, Inc.

With the exception of the period during the Great Depression, the cumulative two year record of the Dow after two great years is uniformly negative (-11.6% to -45.1%). This is clearly a warning signal that the easy money in this cycle most likely has been made, and it is unlikely that we will see such remarkable returns soon.

Summary

A trend tends to continue until something derails it. There are powerful characteristics of the current "virtuous" trend which re-inforce its momentum, and it is not easy to see, at this point, what will change the powerful forces at work in the U.S. economy and stock market. Higher inflation would certainly be a serious problem, and we trust the Fed will do what is necessary to combat it. But we do not currently see higher inflation on the horizon. So we are guardedly optimistic that this will be another good year for the U.S. economy and perhaps a moderately good year for the stock market. We believe that both the strong projected growth of the technology sector of the U.S. economy and the enormous opportunities for U.S. multinationals abroad will continue to propel the stocks of selected companies. We also believe that the consolidation underway in the financial industries - banks and insurance companies - will not end soon, giving investors good investment opportunities. Finally we believe that REIT story is only in the 4th or 5th inning, and that there is still much money to be made in this sector. We see other values as well. On the other hand, we are well aware of the historical evidence which points toward caution in the seventh year of a bull market, and after two remarkable years. However, we don't think it makes much sense to sell the stocks of excellent companies which have appreciated significantly if their prospects remain good - especially in taxable accounts where significant capital gains taxes might have to be paid - except where appropriate for diversification. Circumstances are different with each investor, but generally we would rather ride out a decline, maintaining our position in a first class company, than selling stocks of good companies, paying the tax, and risking being wrong on the direction of the market.

Thus, without trying to time the market, our strategy continues to be to seek to buy high quality growth stocks at reasonable prices. This usually occurs when their stock price has adequately discounted temporary problems that we understand. We also look for good defensive sectors such as the REITS where the likelihood of price volatility is somewhat reduced.

In conclusion, we will hazard a guess that things actually will be somewhat different this time around. We think that the U.S. economy will have a longer, slower economic expansion that continues through 1997 which, together with the increased flow of funds into the stock market, will prove the law of averages wrong this year and lead to a positive year. However, over the next two years, we think that the law of averages will catch up, leading to a significant correction (perhaps 20% or more) - just as in the previous markets. However, a correction which comes from a level in the Dow of 7,000 or more will mitigate the pain. Whatever may come, it is time for lower expectations.

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