

Searching for a Market Bottom

What has been will be again; what has been done will be done again. There is nothing new under the sun.

Ecclesiastes 1:9

It was just three short years ago when the buzz in stock market publications was all about the “new era” and the “new economy”. The internet was changing the world, and it would usher in a new way of valuing investments. With the internet, the cell phone, and the personal computer, our world would never be the same. However, investors in the stock market have once again learned the hard way that while technologies change frequently, market behavior never changes. There are bull markets, some short and some long, but ultimately these are followed by bear markets. Some are moderate and barely noticeable like the last bear market in 1998 when the S&P 500 declined 22% between July and October. Others are long and fearsome. For some investors, these bear markets are so destructive and emotionally scarring that they never venture back into the stock market. For others these bear markets eradicate the profits of the previous half-dozen years or more. However, one thing is certain. Bear markets are part of investing in the stock market, and every investor needs to learn how to cope with them. This is the fourteenth bear market with a decline of 33% or more since 1925. Indeed, as King Solomon wrote in the book of Ecclesiastes some 3,000 years ago, “There is nothing new under the sun”.

In the U.S. the great bear markets have followed the “new era” phenomenon, which seems to occur every thirty or forty years. In the late 19th century, it was the railroads. In the 1920’s, it was the automobile and the radio. In the 1960’s, it was transistors, which evolved into the semiconductor chip. And most recently, it was the internet and the wireless communications. In each case, the inventions changed our world and how we function. And in every case, there was a stock market bubble. The most recent bubble – the collapse of which we have been suffering through – came on the heels of a seventeen-year bull market – the greatest in American history. It started in 1982 with the Dow Jones below 800 and ended with a fifteen-fold increase in the Dow, peaking at 11,750 in March, 2000. During the same period, the NASDAQ Composite increased over 31 times, peaking at 5,132.

When the market rolled over in March, 2000 after its final wild climax run, the second worst bear market in the last one hundred years began. Only the 1929-1932 bear market was worse. The damage from the peak of the bull market in March, 2000 through October 10, 2002 looks like this:

Index	Peak	Date	Low	Date	Percentage Decline
NASDAQ	5,132	3/2000	1,108	10/10/02	-78.4%
S&P 500	1,553	3/2000	769	10/10/02	-50.5%
Dow Jones	11,750	3/2000	7,197	10/10/02	-38.7%

At first this bear market didn’t feel too bad – especially if one had avoided stocks in the internet bubble and the perilous valuations in the “New Economy” technology space. Yet during 2000, most investors’ hopes for early retirement and even great wealth were dashed. As the 2001

market continued to bring low one sector of the market after another, emotions turned to anxiety and later to worry as September 11 exploded in America's consciousness and the stock market was closed for a week. Yet the market rebounded 20% or more off last September's apparent bottom, and it seemed as if the worst was over. But in 2002, the bear market resumed with a vengeance. Optimism and hope were crushed, and emotions turned from fear to panic, as the blue chip stocks, the Generals, were humbled one-by-one. Many of the blue chip stocks declined 50% or more, and even traditional safe havens such as utilities were decimated. Over the past year, investors lost confidence in investment banks, corporate management, and even the accounting profession. By July, 2002 this bear market had reached historic proportions. In July alone, investors pulled over \$50 billion from stock mutual funds – the largest monthly withdrawal in stock market history. This represented 1.7% of stock fund assets, which, while huge, was less in percentage terms than the 3.2% of stock funds pulled out in October, 1987. In total, investors redeemed over \$70 billion from stock funds during the third quarter of 2002.

Some savvy investors were early in diversifying some of their assets from stocks into bonds and cash reserves. Others have sold stocks “down to the sleeping level”. Regardless of tactics, fear is rampant. And what most investors, with cash on the sidelines, want to know is: Is the bear market over? Is it OK for me to get back into the stock market? Has the stock market bottomed?

Is the Stock Market Still Overvalued?

Depending upon which market sage you read or listen to, you get markedly different answers to the question about whether the stock market is overvalued or undervalued. Before attempting an answer to this question, it is useful to provide some context to this question. In order to come up with valuation, the first step is to try to estimate what the stock market's earnings will be for the next 12 months or for 2003. The stock market looks to the future so it is less useful to gauge valuations based upon trailing earnings. However, for purposes of comparison, we will use earnings for companies in the Dow Jones Industrial Average for both 2002 and 2003. The most recent First Call estimate is as follows:

	10/20/22	Est. 2002 Earnings	Est. 2003 Earnings	2002 P/E	2003 P/E
Dow Jones	8,322	\$485	\$551	17.2	15.1

The historical average P/E ratio for the Dow Jones over the past one hundred years is approximately 14.5. Accordingly, some market observers maintain that the Dow Jones is modestly overvalued as the current and future P/E ratio is 4 - 18% higher than the historic average market P/E ratio. However, most market analysts believe that valuations are affected by inflation and level of interest rates (i.e.; alternative rates of investment available in bonds and cash reserves). An old and trusted market rule of thumb, about which we have written in years past, is the Rule of 20. In order to determine the proper P/E ratio for the market, one subtracts the inflation rate from 20. This suggests a plausible market P/E. During the past year the CPI (consumer price index) – a useful proxy for the rate of inflation – was recently determined for Social Security purposes to be 1.6%. Thus, the Rule of 20 would indicate that the proper P/E ratio should be 18.4. On this basis, the Dow Jones is currently somewhere between 6% and 18% undervalued, depending on whether you take current earnings or next year's earnings projections. Finally, there is the valuation model which the Federal Reserve has used for fifteen years. As we have described before, the Federal Reserve compares the stock market's P/E ratio to the effective

P/E ratio of the 10-year U.S. Treasury bond. Currently the yield of the 10-year U.S. Treasury bond is approximately 4%. At 4%, the effective P/E ratio is 25, which, when compared to the Dow Jones P/E ratio of 15.1 for 2003, indicates that the blue chips are undervalued by almost 40%. If the yield on the 10-year U.S. Treasury increased to 5% (which translates to a 20 P/E), the Dow Jones would still be as much as 25% undervalued, according to this measurement.

So an investor comes up with three different answers, depending upon which valuation technique is utilized. Moreover, we have not yet explored the toughest problem of all, which is determining accurate corporate earnings estimates. It is almost impossible to come up with an accurate estimate of earnings for the NASDAQ. The great majority of the 100 largest firms in the NASDAQ composite are losing money. Without the earnings of Microsoft, Intel, Cisco, Dell, Amgen, Qualcomm, and Costco, the remaining aggregate of companies in the NASDAQ has no earnings at all. It is also difficult to estimate earnings for the S&P 500 Index, as there are now three measures to follow: reported earnings, core earnings, and operating earnings. And the question of the proper accounting treatment of options is not yet resolved. Thus, in the examples above, we have focused on the blue chips of the Dow Jones Industrial Average where there is greater clarity about estimates for 2002 and 2003 operating earnings.

Large Capitalization Growth Stocks are Undervalued

While it would be easy to hedge our bets on the question of stock valuations given the problems delineated above, we have always tried to call it as we see it. In January, 2002 with the S&P 500 Index at 1135, we wrote that it was “time to go fishing”, as the market’s high valuation assumed a strong economic recovery in 2002 – a prospect that did not seem all that certain. At this point, we believe that there are numerous quality growth stocks at good, if not bargain, prices. However stock market investors are currently transfixed by fear and trepidation. There are four fears that are causing investors to shun stocks or at least demand a higher risk premium for equities: deflation, a double dip recession, war with Iraq, and the Congressional elections.

Deflation

Annual Rates of Return under Deflation*

Years	CPI	Stocks	Bonds	T-Bills
1871-1896	-1.5%	5.5%	6.4%	5.4%
1892-1895	-3.3%	-2.5%	5.1%	4.1%
1919-1922	-2.0%	5.0%	4.2%	6.7%
1929-1932	-6.4%	-21.2%	5.0%	3.0%
Average	-3.3%	-3.3%	5.2%	4.8%

* Source: Morgan Stanley Research, April, 1985

There is a whiff of deflation in the air. Interest rates are at 40 to 50 year lows. The Producer Price Index has declined for the past two years. The CPI is probably overstated at 1.6%. Very few U.S. manufacturing companies can raise prices. Global trade has provided almost unlimited manufacturing and servicing capacity in China and India, which allow multi-nationals to outsource more expensive production abroad. Japan has struggled with deflation for several years now, and stocks there are at a 17-year low. Historical returns from stocks during deflationary periods in the U.S. have been negative as the table above shows. While deflation

cannot be ruled out, the U.S. has not suffered deflation since the Great Depression, and we believe that there are monetary and fiscal measures that would be used to combat true deflation, the most important of which would be rapid and sustained expansion of the money supply by the Fed.

Double Dip Recession Several good quarters of economic growth followed the decline of GDP in 2002 and the attacks on 9/11, but economic data shows the recovery appears to be stalling. Europe is in worse economic shape than the U.S., and Japan is an economic corpse. Who will lead the U.S. out of a recession? With eleven interest rate cuts, the Federal Reserve has done all it can. The consumer appears tapped out, and companies are not ready to increase capital spending. Thus, corporate earnings will fall with stock prices in their wake. So goes the double dip recession argument. However, all the economic indicators point to modest but positive GDP growth in the 3rd and 4th quarter of 2002 – driven by the low interest rates and the consumer, and most analysts believe that the corporate economy will finally get going in 2003. Merrill Lynch recently pointed out that U.S. GDP has grown at an average of 3.4% a year since World War II, including all nine recessions. This is a remarkably steady pattern over many decades and points to the inherent strength of the U.S. economy.

Congressional Elections An economic recovery requires beneficial monetary and fiscal policies. While the Fed has done its job, some argue that Washington politics are too partisan for agreement on a real fiscal program to jump-start the economy. The Congressional elections in early November are likely to result in further political gridlock where no constructive fiscal policies are enacted. Or worse, tax policies which discourage corporate capital spending and job creation may be passed. While this is a potential problem, we will soon know the make-up of Congress and be able to assess whether Congress is likely to produce constructive legislation.

War in Iraq Many fear that the impending conflict in Iraq will go badly with Saddam Hussein retaliating with weapons of mass destruction in the Middle East or even in the United States. The war could be much more costly in lives and financial terms than experts currently estimate, dragging the U.S. into a Vietnam-like quagmire. A war with Iraq could cause a broader Mid-East conflict involving Israel, which could threaten energy supplies to Europe and the U.S. These fears are well founded, but, historically all (but one) of the wars that the U.S. fought in the 20th century ultimately resulted in a stronger U.S. (and global) economy and robust stock market. It is well to remember the motto of the Rothschilds, who made much of their money in the Napoleonic Wars, “Buy on the cannons and sell on the trumpets”.

These four negative scenarios are plausible and have resulted in a high degree of investor concern and fear. Many would rather wait on the sidelines until some of these issues are cleared up. This is not an unreasonable approach. Yet in the meantime, there are quality companies selling at very reasonable prices.

Every investor has a different risk profile and different financial objectives. While caution should be the watchword for some, investors who commit cash reserves to equities, or shift some funds from bonds to stocks, could be handsomely rewarded. As for us, we will wager that the recent October lows were the market bottom.