Time to Go Fishing?

> I cruised off the coast of Florida. The fishing was good
> My mind was easy. I was having a fine time.
> *Reminiscences of a Stock Operator,* Edwin Lefevre, 1923

Why do many of the famous speculators and stock market operators spend so much time fishing? Is there a correlation between fishing and making money in the stock market? In famous autobiographies such as Bernard Baruch's *My Own Story* or *Reminiscences of a Stock Operator,* which is the story of the legendary speculator Jesse Livermore, the protagonists appear to spend at least a third of their time away from the stock market, trying to catch fish. Is it that fishing teaches patience and tenacity, a requirement in building wealth in the stock market? Perhaps. But it is more likely that successful investors come to realize that there are periods – sometimes-lengthy ones – when it is hard to make money in the stock market. Sometimes these periods are outright bear markets such as we have had over the past two years. Often they occur after the stock market has made a great upward move, and a period of lengthy consolidation is needed before the market resumes its upward trend. Faced with these circumstances, some investors just go fishing. It is not necessarily the fishing itself. It is rather doing something enjoyable and constructive, something that prevents one from making stupid investments, leading to the loss of capital.

The first half of 2002 may well be another one of those periods when it makes sense to go fishing. Now to be clear: none of the Portfolio Managers at Bradley, Foster & Sargent, Inc. will be taking an extended fishing vacation. We will be very involved in the stock market. Our expectations, however, for the stock market over the next few months are rather low, due to the uncertainty about the duration of the current recession, the shape of U.S. economic recovery, and how the stock market will react. It may take some time until there is better visibility on the economy. A prolonged period of waiting would naturally be disappointing, as stock market investors have already experienced the second worst bear market since World War II. From the peak of the bull market in March 2000 to the trough on September 21, 2001 (or at least what we believe is the trough), the S&P 500 Index was down 39.1%, while the technology-laden NASDAQ dropped a gut-wrenching 73%. Fortunately the stock market turned on September 21, rallying strongly through year-end. Nonetheless, for the full calendar years 2000-2001, the S&P 500 Index was down 21.9%, while the NASDAQ showed a decline of 52.1%. After two consecutive years with the major indices in negative territory, market commentators take comfort in the fact that the stock market has not had three straight years of negative returns since the 1930's. However, rules of thumb are made to be broken, and a case can be made for a third straight year of market losses.

At Bradley, Foster & Sargent, Inc., we do not subscribe to this bear market scenario, believing instead that the market will be higher at the close of the year than now. But the market may face some challenging months before the bull market resumes in the latter half of the year.

The Bear Case

The case for a resumption of the bear market throughout 2002 is best summarized by Morgan Stanley's strategist Byron Wien in his annual year-end "Ten Surprises" for the coming year: "Strength in the U.S. economy early in the year is a result of inventory rebuilding and proves to be short-lived. The economy does a double dip and slips back into recession. The squeeze on corporate profits continues because of rising costs and a lack of pricing power. Because of the market's high valuation going into the year, the S&P 500 closes lower in 2002 for the third straight year." There has been much talk about whether the U.S. economy will experience a V-shaped recovery or a U-shaped recovery. Byron Wien's forecast is instead a W-shaped economy. This negative scenario depends on several major premises. The first is that the U.S. economy, which, according to the National Bureau of Economic Research, entered a recession in March, 2001, stays in recession throughout 2002. This would cause the stock market, whose current generous market valuation is predicated on an economic recovery in the latter part of 2002, to decline. A second major premise is that neither the extremely low interest rates nor the Federal Reserve's expansive monetary policy gets the economy moving. Nor does the drop in fuel prices. Finally, this scenario assumes that fiscal policy for 2002 – a combination of tax reduction and increased government spending – will be ineffective in bringing the U.S. economy out of recession. If the economy were to stay mired in recession throughout 2002, the S&P 500 Index could well retest its September 21st low of 945 – a decline of 17% or more. This scenario is certainly possible – especially if there were to be another serious terrorist attack, but we believe that it is the minority case – as does Byron Wien, who assigns a one-in-three probability of this forecast occurring.

The Bull Case

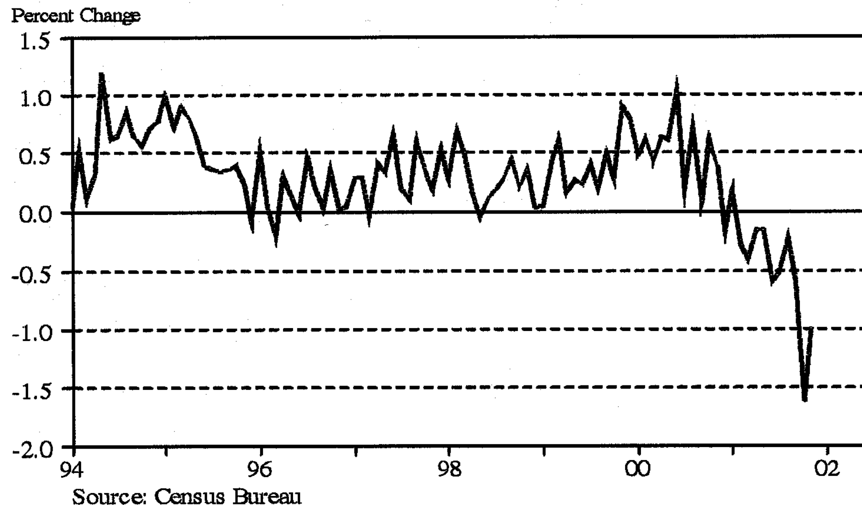
Since World War II, there have been thirteen recessions and thirteen recoveries, given the dynamic and sustained economic growth inherent in democratic capitalism in the U.S., we believe that this fourteenth recession will be followed by an economic recovery – this year. According to the National Bureau of Economic Research (NEBR), the average duration of a recession since WW II is eleven months. If the current recession started in March 2001, we are currently close to the end of that average duration. According to the NEBR, short recessions last only six months, while the longest recession since WW II lasted 16 months. It, therefore, seems probable that the current recession will end sometime during the first half of 2002. What are the major reasons why the U.S. economy should recover and achieve GDP growth of at least 3% by the second half of this year? The following list is incomplete but highlights the major factors which underlie our positive analysis:

- Eleven interest rate cuts have brought the Federal Funds rate to 1.75%. The chances are 50-50 that the Federal Reserve will cut short-term rates once more at their upcoming meeting at the end of January, bringing short-term rates to their lowest level in more than 30 years.

- The Federal Reserve has grown the monetary base at 7%+ over recent months, and this expansive monetary policy has created ample liquidity for the U.S. economy and the U.S. stock market. Growth in money normally impacts economic activity with a lag of a year or more.

- The federal tax cut that was passed in 2001 delivers over $35 billion in tax reductions in 2002. On the other hand, increased Federal spending due to the September 11th attacks on America will amount to at least $70 billion in 2002. This does not include automatic spending increases of $40 billion +, triggered by the recession, which include unemployment insurance, welfare, etc. Together this will mean that the Federal budget surplus will turn into a deficit for the next several years. In a recession, this is a necessary thing. Cries for rolling back the tax cuts, in order to produce a surplus, will not be heeded by most politicians as they focus on the fall 2002 elections.

- Inventories have fallen dramatically as the chart below indicates. As the economy bottoms and inventories begin to be re-stocked to more normal levels, this will give the economy a big boost, as factory utilization begins to rise again.



- The price of gasoline at the pump, as well as heating oil and gas, is dramatically lower than it was a year ago. In effect, this is an additional tax cut for most American consumers.

Due to the above factors, we see an economic recovery by the second half of 2002 – if not before. Unlike some market commentators, we do not see a V-shaped economic recovery. Unlike other recessions over the past 20 years, this is the first time that there is a synchronized global recession underway. Japan has been mired in recession for years and is dealing with outright deflation and huge national debt. Europe, while holding up better, is entering a mild recession, and the U.S. has been in recession for almost a year. No other country or continent will help pull the U.S. out of recession. It is the U.S. that needs to act as the economic locomotive for the rest of the world. Another reason for our view of a slow U-shaped recovery is the likelihood of only modest growth in capital equipment spending (technology) during the next few quarters in the U.S. So much excess manufacturing capacity was built in the late phases of the technology/internet bubble that it will take more time to right-size manufacturing capacity. It is much more likely that the consumer, who

remained in relatively good shape in 2001, will lead the economy to recovery. This includes housing and auto activity as well as broader retail sales. With autos and gasoline taken out of the numbers, retail sales in December 2001 were actually up 4% over December 2000.

Does Economic Recovery Mean a Higher Stock Market in 2002?

By year-end, we think yes! But there may be some rough sledding before we see positive returns in the U.S. stock market. This rough sledding comes in the form of a stock market valuation which already assumes a second half recovery in 2002. The S&P 500 Index is currently at 1135, which is a Price/Earnings ratio of 22.5 on estimated 2002 operating earnings of $50. This puts the stock market's valuation at the high end of historical valuations. When utilizing the Federal Reserve's model, which compares the market's P/E ratio (earnings yield) with the yield of the ten-year U.S. Treasury bond, the stock market is currently about 8% overvalued. It is also important to note that while the overall S&P 500 Index may be fairly valued, there are various sectors of the stock market which sell at 10-15 times 2002 earnings. So there are real bargains for the first time in years.

Since September 21st, the market has come back approximately 18%. Interest rates have dropped, and the liquidity that was pumped into the market encouraged investors to see across the valley in the hope that economic recovery was just a matter of time. Now that the market has bounced back some, investors want to see proof of a recovering economy in the form of better corporate earnings before they commit more money to the market. This will take time.

This brings us back to fishing. We don't suggest investors liquidate stocks and hold cash reserves as the famous speculator Jesse Livermore often did, waiting for better markets. This is not our investment approach, and we do not believe that timing the market in this way can be done consistently. We are in good company in our investment methodology as this is how investors such as Warren Buffet, John Templeton, and Peter Lynch see it, too. Ibbotson Associates has demonstrated that stocks outperformed Treasury bills cumulatively between 1952-1992 by a factor of ten times. However, the total return for stocks would have been lower than T-bills during this period if an investor had not been invested in stocks for just 5% of these months. In other words, the major market moves took place in just 5% of the months. If you were out of stocks during those periods, you missed most of the performance.

We wish there were some easy way to avoid the market volatility until economic recovery is well underway, but by then, stocks will be a good bit higher. What is required is time, patience and the wisdom to avoid making silly mistakes, leading to the loss of capital. It is also vital to hold onto the conviction that the stocks of well-managed, quality growth companies will provide excellent returns on capital over long periods of time.

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January, 2002