A Fourth Consecutive Down Year for Stocks?

The main thing is to keep the main thing the main thing.

Lee Iacocca

Not since the "mother of all bear markets" during the Great Depression has the Dow Jones Industrial Average declined four years in a row. But a number of well known market pundits, hedge fund managers and investors believe that it may happen again – in 2003. What are the chances of it happening again? And what is the main thing that investors need to hold onto as they deal with this unpleasant possibility?

To make judgements about the market's course, we need to take a quick backward glance at the year that has just ended. It was a truly horrible year for the stock market. Not since 1974 have stocks done so badly, and not since the Great Depression has a bear market wreaked such destruction. The average U.S. stock fund was down 22.4% in 2002, while the Lipper Growth Fund Index dropped 24.2%. The Value Line Index declined 28.6% during the year, and the NASDAQ composite was off 31.5%. The only sectors of the stock market which managed gains were sector funds such as gold and real estate. Bonds, on the other hand, turned in another terrific year with long U.S. Treasuries gaining a total return of 15%+. Finally, three-month Treasury bills returned 1.78%.

Next, we need to review the three periods in the last century when the Dow Jones declined three consecutive years or more. The first was 1901-1903 when the stock market suffered a major hangover after the run up to the *fin de siecle.* The market went through a period of "irrational exuberance" at the turn of the 19th century, and it took three years to wash out the excesses of the big celebration. Another period, 1939-1941, was when much of the world became engulfed in World War II. It was only the U.S. victory at Midway in June, 1942 that finally caused the market to change course and launched what was ultimately a 22 year bull market. Then, of course, there is the three-year period we have just experienced which, in certain respects, resembled the market at the turn of the last century except for the terrorist attacks on September 11, 2001. The only period during the last century when the Dow Jones Industrial Average declined for four consecutive years was 1929-1932. This bear market lasted from October, 1929 through July, 1932. From peak to trough, the Dow Jones was down a crushing 89%. It took the Dow Jones 23 years to climb back to its 1929 high.

The current bear market started during March, 2000 and saw the NASDAQ composite decline 78% from its peak of 5,132 to its most recent low of 1,108 on October 10, 2002. With the NASDAQ currently at 1,376, the composite could take 15 or 20 years to regain its March, 2000 high. The S&P 500 Index and the Dow Jones declined 50.5% and 38.7% respectively during the same period. But is the bear market over?

The bears who forecast another year of declines for stocks have three major arguments: valuation, the economy, and the geo-political situation.

Overvaluation

Bearish investors maintain that bear markets end when the stock market's P/E ratio is much lower than its current level of 18+. They point out that the average P/E for the stock market over the last century is about 14.5 and that bear markets often end with the P/E ratio at 7 or 8. They also point out that bear markets usually end when the dividend yield on stocks is 5-6% – not the modest 1.8-2% currently. Both of these arguments are true. P/E ratios are usually low at the end of most bear markets, because inflation and interest rates are high. As the stock market is a discounting mechanism, high interest rates mean low P/E ratios. However, inflation is currently low at 1.5-2.2%, and interest rates are consequently at 40 year lows, which means that a P/E level of roughly 18 is reasonable. Dividend yields, while much lower than in the 1950's when the dividend yield was higher than bonds, do not look so paltry when compared with money market interest rates of 1% or less. In fact, there are 100 stocks in the S&P 500 which pay dividends of more than 3%. So these bear arguments are not entirely persuasive.

According to the Federal Reserve model, which compares the stock market's P/E ratio to the effective P/E ratio of the 10-year U.S. Treasury bond, the Dow Jones is undervalued by over 30%. Even if the 10-year U.S. Treasury were to rise to 5%, if inflation were to increase, the Dow Jones would still be approximately 16% undervalued – according to the Fed model. When measured with the tried and true Rule of 20, the Dow Jones (at 8,587) is approximately 10% undervalued (a P/E ratio of 18 times estimated 2003 operating earnings of $524 = 9,432). Thus, assuming an economic scenario of modest growth of perhaps 2-3% for the coming year, our conclusion is that the Dow Jones and S&P 500 are currently somewhat undervalued rather than overvalued.

U.S. Economy

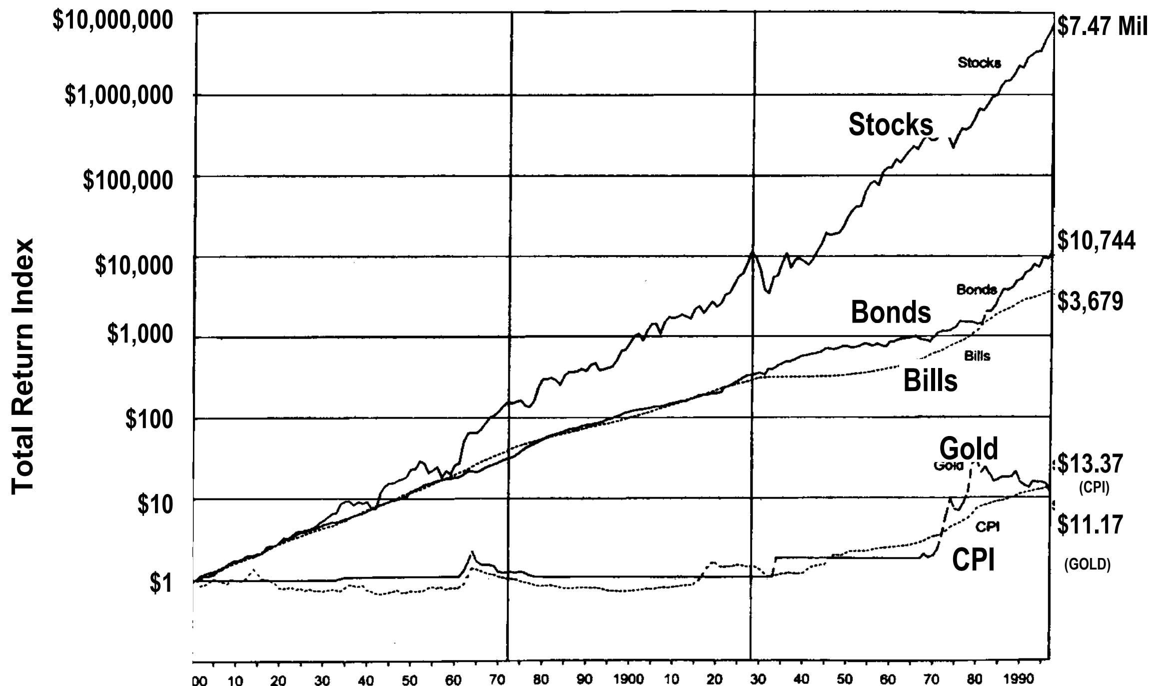
Here the bears fear deflation or a double dip recession. Japan has been losing the battle of deflation for some years, and most of the rest of the world is either struggling with recession or has little growth (except for China). Yet the U.S. economy in 2002 performed reasonably well. Real GDP growth appears to have been nearly 3% for the full year. Corporate profits rose in 2002 after falling each quarter in 2001. Industrial production rose modestly in 2002, and most commodity prices moved higher throughout 2002. Prices for manufactured goods declined 1.2% due to the deflationary impact of almost unlimited manufacturing and servicing capacity in China and India. However, service prices were up 3.7%, which caused overall inflation in the U.S. to rise approximately 2%. The Federal Reserve has said that they are prepared to do whatever is necessary to combat true deflation – if it were to be a problem as in Japan. The November election gains of the Bush administration make it likely that fiscal policies favoring economic stimulus will be enacted including legislation abolishing all or part of the double taxation on dividends. We believe that this will be positive for stocks and will induce healthier balance sheets in corporate America. While the budget deficit will certainly increase due to the War on Terror, the proper time to run a deficit, from a macro-economic perspective, is now as the economy struggles to recover. At this point, there is little evidence to suggest that the economy will revert to recession.

Iraq, North Korea and Terrorism

Investors fear uncertainty more than almost anything else, and in the geo-political realm, there is plenty of uncertainty. At this point with more than 100,000 U.S. troops deployed in the Middle East and a coalition building of the U.S., the U.K., Australia, Turkey and various other countries in the Middle East (Kuwait, Qatar, etc.), there appears to be more than a 50-50 chance of war with Saddam Hussein. Given his history of using chemical weapons against Iranian soldiers in the 1980's and the Kurdish people in the 1990's, many fear his use of weapons of mass destruction in this war or another terrorist act – elsewhere in the Middle East or on U.S. soil. The situation in North Korea is also worrisome with the likelihood of North Korea having two or more nuclear weapons. This is a serious problem for the U.S., but it is also a problem for China, Russia, Japan and South Korea. Diplomatic steps by the U.S., in conjunction with these other countries, could defuse this hot spot. Finally Al Qaeda continues to seek to terrorize the West, and only a sustained and coordinated effort by many countries will defuse this threat. These situations are worrisome and give ample reason for the stock market to sell at a discount and for U.S. Treasury bonds to be in strong demand. However it is important to remember what happened during the Gulf War in 1990-1991. Once the war was joined, the Dow Jones rose 5% in one day and gained 31% for the full year 1991.

The Main Thing

These very real problems can easily cause an investor to lose sight of the main thing. And the main thing is not to forget the amazing long-term record of U.S. equities. The chart below, which we displayed several years ago, bears reproducing. The chart, taken from Jeremy J. Siegel's excellent book, *Stocks for the Long Run*, chronicles the astonishing record of the stock market over a 195-year period.



Annual U.S. Stock Market Returns 1802-1997*

Periods	Average Annual Return % (Nominal)	Average Annual Return % (Inflation-adjusted)	CPI
	1802-1997		
1802-1997	8.4%	7.0%	1.3%
1871-1997	9.1%	7.0%	2.0%
1926-1997	10.6%	7.2%	3.1%
	Post World War II		
1946-1997	12.2%	7.5%	4.3%
1966-1997	11.5%	6.0%	5.2%
1966-1981	6.6%	-0.4%	7.0%
1982-1997	16.7%	12.8%	3.4%

* *Stocks for the Long Haul*, Jeremy J. Spiegel, 1994

The most significant point in this table is that the real after-inflation, compound annual return of stocks has averaged 7% per year over the entire 195-year period. At this rate of return, purchasing power has, on average, doubled in the stock market every decade. This rate of return has been achieved in spite of foreign and civil wars, bouts of inflation and deflation, impeachments and assassinations, and the Great Depression. Siegel calculates the real return for U.S. government bonds during the same period to be only 3.5%. *For investors with reasonably long term horizons, stocks have demonstrably been a vastly superior investment than fixed income securities or any other kind of securities.*

2003 Forecast

In our investment commentary last October, we wrote that we would "wager that the recent lows of October 10, 2002 were the market bottom". We are on the mark thus far. The S&P 500 Index hit an intra-day low then of 769 and closed today at 901. The Dow Jones touched 7,197 and currently trades at 8,587. We continue to wager that the October 10, 2002 bottom was the bear market low. Although the stock market may well pull back – especially due to a war in Iraq, we believe that the stock market will not penetrate these lows. Moreover, we will press our wager by forecasting that the total return of the S&P 500 Index and Dow Jones will be at least 10% this year. But hold fast to the main thing: maintain the long view and own quality growth stocks for the long haul.

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