Bradley, Foster & Sargent, Inc.
Investment Management

Where Do We Go From Here?

In July, 1995, in our regular quarterly outlook for the U.S. stock market, we forecast that the Dow Jones Industrial Average could increase another 10% from the 4,600 level, continuing its powerful bull market advance and piercing the 5,000 mark by the end of 1995. Well, we were right this time. The confluence of positive factors, which had been in place for the first half of 1995, continued without interruption, and the Dow Jones closed the year at 5,117. It was an outstanding year for the stock market. The broad high quality stock index, the Standard & Poor 500 Index, increased 37.5% - the best year since 1958, and according to one market historian, it was the twelfth best year for the stock market since the start of the Civil War, when publicly owned securities began to trade.

The big winners this year were large capitalization U.S. growth stocks. Leading the way were technology and financial services as well as consumer growth and health care stocks. While the average U.S. equity mutual fund's return of 31.1% was well below the S&P 500 Index, it nonetheless was still an excellent year for stock mutual funds. The average stock as measured by the Value Line Index only appreciated 19%, while intermediate term government bonds (5 years average maturity) returned approximately 14%. International funds, as well as most regional or country funds, did poorly compared with the U.S. markets as did a number of sector funds such as gold (1.7%). We were pleased to be in the right place most of the time in 1995, but the question, of course, is where do we go from here?

The legendary investor, Warren Buffet, once said that his basic strategy was to make a lot of money in the good years and just try to hold on to it in the bad ones. In planning our investment strategy for 1996, this is naturally the first question that we have to answer. Is 1996 going to be one of the good years, or will it be one of the bad ones? In other words, has this bull market pretty much run its course, or should we have our sights set on 6,000 over the next 18 months? Should we batten down the hatches for stormy seas, or will there be a period of turbulence followed by more smooth sailing?

In trying to answer these questions, it is useful to go back to our fundamental premises as to what is driving this bull market and check to see they are still intact. Readers of our previous quarterly outlook pieces will recall our thesis that this great bull market is built upon seven critical supporting pillars:

- Low inflation trending downward
- Corresponding low and declining interest rates

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- Moderate overall U.S. economic growth
- Robust corporate earnings with impressive year over year comparisons
- Sound fiscal policies in Washington leading to both spending and tax cuts
- Strong and expanding global trade
- Reasonable stock market valuations

In trying to assess 1996, it makes sense to re-examine each of these key pillars to see whether they are still strong or whether cracks are appearing in the edifice.

Premise	**Status**	**Explanation**
Low Inflation	Intact	The CPI Index was up only 2.6% in 1995. Few economists predict inflation above 3% in 1996. Low wage increases and global outsourcing should keep U.S. inflation low.
Low and Declining Interest Rates	Intact	With economic growth slowing and the consumer carrying high levels of debt, we look to the Fed to cut short term interest rates at least 1% in 1996. Long rates already reflect this expectation and should not drop much more than 1/2%.
Moderate U.S. Economic Growth	In question	While the majority of economists forecast weak to moderate growth, some foresee the economy turning down into a recession due to excessively high real interest rates and high consumer debt.
Robust Corporate Earnings	In question	We have just completed the best three years of U.S. corporate earnings growth since 1947-1949. Earnings growth cannot keep up this pace, and we will probably see numerous earnings disappointments in 1996. The first three shortfalls in our universe - Motorola, Intel and Wal-Mart - have already occurred.

Sound U.S. Fiscal Policies	Unlikely	It looks increasingly likely that there will be no tax cuts until the November elections have taken place. Spending cuts will also be postponed until a national referendum occurs. However, it is also likely that large spending increases will not occur.
Strong and Expanding Global Trade	Intact	A continuation of growing global trade is likely with two caveats: a resurgent Russian nationalism combined with a Stalinist-type government could damage trade in Eastern Europe; also an ascendancy of the Perot/ Buchanan or Gephardt voters would empower the first trade protectionists in America since the Great Depression.
Reasonable Stock Market Valuations	Intact	While certain sectors of the stock market became frothy in the 4th quarter of 1995 (Internet and other technology stocks), most stocks are not overvalued in terms of most historical comparisons (P/E ratios, earnings yield comparison with long term bonds, etc.). Yet many stocks are full valued, and earnings disappointments would cause serious damage to stock prices.

Assessment

Two of the most important pillars are still intact - low inflation and correspondingly low and declining interest rates. As long as these two remain in place, we believe that possible weakness in the stock market will be confined to periodic sawtooth corrections with a downside of possibly 4,500 (12%) on the Dow Jones Industrial Average. If higher inflation were to kick in (3.75-4% or more), the market could see a much more severe downturn, but we estimate the probability of this occurring as low.

Slowing corporate profitability combined with an increasing number of earnings disappointments will make stock selection much more important in 1996 than in 1995. If the Fed does not act swiftly enough, these earnings disappointments could turn into a genuine recession. However the damage to the market should not be too extreme as long as the Federal Reserve cuts interest rates in a timely fashion and provides strong liquidity to the market. The political stalemate in Washington will give little help to the stock market this year, and election uncertainty may lead to more stock market volatility.

Finally, it seems unwise to forecast a down stock market in a presidential election year. This has only occurred twice in the last forty years. It also appears as if four of our seven key pillars of the market are still intact, while several others may firm up during the course of the year. Furthermore, history shows that over the past 130 years the stock market usually follows an excellent year, such as we have just had, with another up year - usually more modest. Nevertheless the risk- reward ratio for many stocks has shifted considerably, and Bradley, Foster & Sargent's investment strategy in 1996 is to be invested in sound defensive sectors. We also hope to take advantage of opportunities where our confidence in earnings growth is high or where the stock price has adequately discounted temporary problems that we understand. We are also positive on the bond market, forecasting that the total return for bonds in 1996 will at least equal their coupon. In the end, 1996 may turn out to be one of those good years that Warren Buffett talked about. We hope so!

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