Sitting Tight in a Bull Market

> Our portfolio shows little change: We continue to make more money when snoring than when active.
>
> Warren Buffet – 1996 Berkshire Hathaway Annual Report

What a difference a week makes! On March 25 the Tuesday before Easter, the day the Federal Reserve Bank raised interest rates $^{1}/_{4}$%, the Dow Jones closed at 6876 – up 7.1% since the beginning of the year. While several percent below the Dow's high of 7,112 reached on March 11, a complacent optimism seemed to reign among investors. Most thought that the market had already discounted the 25 basis point increase in interest rates and that the market would not be too shaken. A week later, as this commentary goes to press, an entirely different psychology – one of doubt or even fear – has gripped the market.

The first seeds of doubt were sown two days after the rate hike when market observers began to talk about the possibility, even the likelihood, that the $^{1}/_{4}$% interest rate hike would not be strong enough medicine to slow the economy enough to satisfy the Fed. The stock market promptly sold off one hundred fifty points. Rather than seeing the Fed's rate hike as a one time event, investors began to anticipate the worst – the emergence of inflationary pressures and a series of rate hikes. On the Monday after Easter, another two hundred points were chopped off the Dow. The specter of 1994 was haunting the market, as investors remembered the havoc which a series of interest rate hikes had caused in the bond market and some sectors of the stock market. Fears of weak first quarter earnings soon to be announced caused even more anxiety. Today the Dow Jones Industrial Average went through 6441, which is where it started the year, having given up all its first quarter gains.

The question, of course, is: Is the party over? Are we still in a bull market with new highs to come later in 1997 or in 1998? Or, have we already seen the market top and entered a major correction (if not a bear market)? And what happens if all those who came late to the party (buyers of equity mutual funds since 1994) panic at the thought of losses and pull the plug, causing mutual fund managers to dump stocks to meet redemptions?

While we hasten to reiterate our belief that neither we, nor other money managers whom we know, can accurately predict the stock market with regularity, we do believe that very little has changed fundamentally concerning the U.S. economy. What has changed is how the stock market is valuing future earnings. What has not changed are the positive underlying fundamentals including low inflation, a growing economy and healthy corporate earnings. This change in valuation was the aim of Fed Chairman Alan

Greenspan, who twice in testimony before Congress signaled his intentions to raise interest rates. He maintained that his primary motive was to pre-empt inflationary pressures before they became visible. He also spoke about the stock market's "irrational exuberance" and the danger that a burst stock market bubble would pose to the U.S. and global economy. In other words, Greenspan wanted to lower stock market valuations and alter investor complacency, re-introducing the discipline of downside risk to cavalier investors, many of whom were beginning to believe in the inevitability of ever higher stock prices. Warren Buffet probably would have concurred in this objective, having written in the 1996 Berkshire Hathaway Annual Report, "You can, of course, pay too much for even the best of businesses. The overpayment risk surfaces periodically and, in our opinion, may now be quite high for the purchasers of virtually all stocks." What better way to restore valuations than by raising interest rates? In fact, there has been a 10% reduction of values in less than a month in the broad stock market indices, while a hot sector, such as technology, has dropped by 25% or more.

On the other hand, the economic fundamentals in the U.S. have rarely been better. The economy is in good shape with GDP forecast to grow in 1997 at 2.5% to 3%, while the earnings growth of companies in the S&P 500 are projected to grow 6-10%. Inflation continues to be begin at 3% or less. Prices of commodities such as gold and oil are down, and even wage increases remain moderate. The U.S. dollar continues to be strong, keeping a lid on inflationary pressures and forcing the export industry to become even more competitive. While some pockets in the important technology sector have faltered over the past quarter, the driving forces of ever larger PC sales and the spread of the Internet and Intranet show no signs of letting up. Economic growth in newly capitalist countries continues apace, which presents enormous opportunities for U.S. brand name companies with a strong multinational presence. The global political scene, while never entirely without turmoil, is free of major hot spots. Even in Washington, where damaging fiscal, regulatory and political potions can be quickly brewed and served, both the executive and legislative branches seem impotent. The Clinton Administration is reeling from the daily revelations of fundraising scandals and the Republican controlled Congress seems exhausted from their near death experience in the 1996 elections. Nonetheless, continued focus by both branches of government on deficit reduction does seem likely, and capital gains and income tax cuts are still possible.

If we believe that the U.S. economic fundamentals are strong and will translate into higher corporate earnings, the question, then, is: How do we judge the stock market's current valuation? As this is written, the Dow Jones Average is at 6470 – marginally above its starting point for 1997. The Price/Earnings ratio on the current 1997 earnings projections is 15.1. While above the average P/E of 14.4 for the Dow in this century, the valuation appears reasonable – with inflation forecast at 3% for this year. If we focus on the Standard & Poor 500 stock index, we see that analysts estimate earnings of $45 for 1997. With the S&P 500 at 748, this translates into a P/E ratio of 16.6. Over the past 40 years, when inflation has been below 3.5%, the average P/E ratio for the S&P 500 has been 16.5. Once again the current valuation seems to be reasonable – although a move of 10% up or down would be easy depending on market psychology. Byron Wien of

Morgan Stanley has constructed an interesting chart which suggests an equilibrium level between stocks and bonds – assuming various levels of S&P 500 earnings and interest rates for yields on long U.S. Treasury bonds. With the long Treasury bond currently yielding 7% and consensus S&P 500 earnings of $45, this chart forecasts fair value for the S&P 500 of 718 – 4% below its current level. A swing of 1% in interest rates in either direction could mean a 15 – 18% change in the stock market's valuation according to this chart. We find these estimates to be helpful, but they are, of course, only a computer model.

Interest Rate and Earnings Sensitivity Analysis for the S&P 500

S&P 500 Equilibrium Point* with Long Treasury Yields at:

Earnings ($)	5.0%	5.5%	6.0%	6.5%	**7.0%**	7.5%	8.0%
40.00	939	852	778	713	656	605	561
41.00	958	870	793	726	668	617	571
42.00	977	887	808	740	681	628	581
43.00	997	904	824	754	693	639	592
44.00	1016	921	839	768	706	651	602
45.00	1035	938	855	782	**718**	662	612
46.00	1054	955	870	796	731	673	623
47.00	1073	973	885	810	743	685	633
48.00	1093	990	901	824	756	696	643

*Stocks and bonds equally attractive.
Source: Morgan Stanley

In summary, we believe that we are still in a bull market. We do not see at this point enough excesses in the U.S. economy or political situation to throw a monkey wrench in the works and cause a recession or an inflationary boom. Chairman Greenspan got exactly what he sought: a strong correction of some of the stock market's overvaluation. Once earnings catch up with prices, we would venture a guess that later in the year or in 1998, the stock market will test its high of 7,112. In the meantime, we will continue to focus our purchases mainly on high quality companies within sectors of the stock market which have already corrected significantly as well as such basic investment themes as U.S. companies profiting from globalization, technology and the ongoing consolidation in the financial industries.

As we wrote in January, this is a time for lower expectations. Stock market returns in 1995 and 1996 were exceptional, and it is unlikely that we will see similar returns any time soon. It is a time for intelligent patience and letting the earnings growth of high quality companies in our portfolios eventually lead to higher portfolio values. In that vein, the following quote in the investment classic Reminiscences of a Stock Operator written in 1923 by Jesse Livermore is perhaps a good way to close:

> "And right here let me say one thing: After spending many years in Wall Street and after making and losing millions of dollars, I want to tell you this: It never was my thinking that made the big money for me. It was always my sitting. It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets . . . who make no real money in the market. The reason is that a man may see straight and clearly and become impatient and doubtful when the market takes its time about doing as he figured it must do. That is why so many in Wall Street . . . lose money. The market does not beat them. They beat themselves, because though they have the brains, they cannot sit tight. You must have not only the courage of your convictions but the intelligent patience to sit tight."

April 1997

Hartford, CT 06103