The Stock Market at 9,000: Uncharted Territory

> Ptolmey's famous map (AD 150) designated those areas outside the known world as "Terra Incognita". The Greeks and Romans - and later, Christians - believed these areas contained "Insulae Fortunatae" (or the like) - paradise on earth. On the other hand, some cartographers warned that "in these places there be monsters". Perhaps the most levelheaded approach to these unknown areas was exemplified by Pierre Desceliers, who in 1546, described an unknown land as "Terre a descouvrire".

How many money managers were bullish enough at the start of the year to forecast that the Dow Jones Industrial Average would soar over 1,000 points during the first 100 days of 1998? Perhaps only a handful throughout the country! Certainly no one that we know. In the Bradley, Foster & Sargent, Inc. quarterly investment commentary written in mid-January, 1998, we thought that we were going out on a limb by forecasting that the stock market would turn in yet another positive year with the averages up by 6-9%. After all, the U.S. stock market has never before turned in average annual returns of more than 30% for three straight years. What market strategist would dare forecast that the S&P 500 Index would be up 13.95% during the first three months after its remarkable 125% advance during the previous three years? Especially in light of the "Asian contagion" and the chilling winds of deflation that were blowing at the turn of the year.

During the first few weeks of the year, it actually looked as though the market was going to take a rest or even decline. Inflows into equity mutual funds were down in January, and inflows into bond funds were up. The stock market dropped several percent as gold declined from $300 to nearly $270 an ounce. The yield on the 30 year U.S. Treasury Bond dropped to 5.65%. But that was the extent of the stock market's decline. By the end of January, it returned to above break-even, and then February saw the resumption of the great bull market. By early April, the NASDAQ Composite and S&P 500 Index were up over 16% and 15% respectively, while the Dow Jones "lagged" at 14%+. The more broadly based Value Line Index was up 10% for the first quarter. Consistent with the market's recent pattern, the stocks which have benefited most from this year's bull market's advance have been large capitalization, global growth companies as well as financial service firms, while most smaller capitalization and emerging growth stocks continued to underperform the market.

Uncharted Waters

The bull market's continuing advance has led us now into virtually uncharted waters. Most investors are aware that the stock market has never been more expensive than it is today. Not in 1929, not in 1968, and not in 1987. Every measure of valuation on the S&P 500 Index - whether it is the current price/earnings ratio on trailing 12 months earnings of 28.3 or on 1998 estimated earnings of 24, the price/cash flow ratio of 14, the price/book value of 5 times, or the dividend yield of 1.5% - produces the same results: an historic high in the valuation of the U.S. stock market. All market observers are agreed on the data. The only question is: are these prices justified by current political and economic conditions, or not?

The Bull Case

Over the past several years, our quarterly investment commentary has laid out the case for the bull market. The case rests on a rare confluence of political, economic, demographic, and technological factors which have led to the most remarkably positive conditions for democratic capitalism, both here and abroad, in a century. It is perhaps useful to reiterate the key pillars of this bull market and review them to see if they remain a sound foundation for future market advances:

Premise	Status	Explanation
Low Inflation	Intact	The CPI Index for the past 12 months was 1.4%, which, after taking into account the findings of the Boskin Commission, means that inflation was effectively zero in 1997. Economic troubles in Asia and the low price of oil should keep inflation very low for 1998. Bears worry that the U.S. economy will overheat later this year, causing inflation to rise.
Low and Declining Interest Rates	Intact	Long U.S. Treasury yields in early 1997 were 6.85%. Now they are 100 basis points lower at 5.85%. There is a reasonable chance that interest rates will continue to decline if inflation remains below 2%. Earlier this year, we forecast that the Federal Reserve would cut short-term rates due to financial conditions in Asia, but this seems less likely now.
Strong Corporate Earnings	Intact	Weaker earnings growth during the first half of this year will probably limit growth in corporate profits to single digits in 1998. However, operating margins and the return on equity for U.S. companies have been remarkably good. Corporate restructuring and government de-regulation should help maintain these trends.
Sound U.S. Fiscal Policies	Intact	The uneasy alliance of a Republican Congress, a Democratic White House, and Alan Greenspan at the Fed has produced remarkably sound U.S. monetary and fiscal policies, including both a cut in the capital gains tax rate and a budget surplus.
Strong and Expanding Global Trade	Intact	The emergence of the U.S. as the sole remaining superpower, the spread of democratic capitalism, and the absence of war on a major scale has enhanced the prospects of strong and expanding global trade.
Technological Revolution	Intact	A genuine technological revolution is underway - in every way as dramatic as the industrial revolution during the period of 1871-1914. Personal computers, Internet, faxes, wireless communication, bio-

		technology, and fiber optics are just a few features of the information revolution which will impact the economy for many years.
Demand for and Supply of U.S. Equities	Intact	Baby boomers continue to pour retirement savings into U.S. equities. $37.5 billion flowed into U.S. equity mutual funds in March, 1998 - the most ever in a single month. This is probably the single biggest factor in the inexorable climb of the stock market. Corporate stock buybacks and mergers reduce the available supply of equities. These positive trends should continue.

The Bear Case

Bears agree with most or all of the premises above for the bull market. However, they part company with the bulls on the question of the stock market's valuation. They point out that these extremely positive conditions have caused a profound enthusiasm for equities, which have brought valuations to levels never seen before in the U.S. stock market. Investors everywhere have excessive expectations. The S&P 500 Index has produced average annual returns of more than 30% over the past three years, which makes the 11% average annual return of the S&P 500 since 1926 look puny indeed. Irrational enthusiasm and floods of liquidity have driven up stock prices - especially for the large capitalization growth stocks such as Microsoft, Coca-Cola, Gillette, GE, Pfizer and Warner Lambert whose P/E ratios range between 31 and 47 times 1998 estimated earnings. Bears believe that this can only mean disaster for investors who buy at this level. They compare the asset inflation now underway in the U.S. with the one experienced by Japan in the latter half of the 1980's. There, the Japanese stock market fell over 60% and has still not begun to recover. Bears believe that a decline in the U.S. stock market is long overdue and point to the following chart as evidence that there has been no meaningful corrections in the S&P 500 Index since 1990:

Important Declines in the S&P 500 Index (1957 - 1997)

1957	20%	1980	22%
1961-1962	29%	1981-82	22%
1966	22%	1987	34%
1968-1970	37%	1990	20%
1973-74	48%		

Conclusion

In his message in the 1997 Berkshire Hathaway Annual Report, Warren Buffet said: "If returns on equities remain exceptionally high - and if interest rates hold near recent levels, there is no reason to think of stocks as generally overvalued. On the other hand, returns on equity are not a sure thing to remain at, or even near, their present levels." In the press, these comments were widely reported as "Buffet Says Stocks Are Not Overvalued". However, that was an optimistic spin on his statement. A better summary would be: If either interest rates rise or corporate earnings decline, then stocks will be overvalued.

Although we do not try to predict the movements of the stock market or "time the market", we do try to gauge roughly the valuation of the stock market. And we do believe that many stocks are indeed overvalued. Once a stock sells at 35 or 40 times earnings and begins to lose its underlying connection with its fundamental value, what is to prevent the valuation to rise to 50 or 60 times earnings? At these price levels, there is no underlying measure of valuation that can justify the price of the stock. It is then that the momentum buyers take over. They are investors who purchase a stock in large part because its price trend is up, and their approach is to sell the stock once the price declines - regardless of underlying fundamentals. Today there are many well-known companies of excellent reputation, the price of whose shares are being driven by momentum-type buyers. In brief, we believe that many of these current darlings of the stock market are overvalued at current levels. On the other hand, there continue to be excellent growth companies whose stocks are reasonably priced, although bargains are getting harder to find.

On balance, we believe that the overall stock market valuation is somewhat ahead of itself. However, the overvaluation is not more than 10-15%, assuming that the key pillars of the bull market, which were enumerated above, remain intact. Generally, bull markets do not end due to modest levels of overvaluation. They end because interest rates climb or earnings deteriorate. As these fundamentals look strong for 1998, we remain cautiously optimistic about the stock market. However, this would not preclude the possibility of a market correction of up to 20% this year due to unforeseen events. Based upon this market outlook, we continue to commit funds to the stock market, buying well-established growth companies with good prospects at reasonable valuations and avoiding some of the current darlings of the stock markets at inflated prices. We also remain positive about intermediate and long-term bonds which offer reasonable real returns with modest downside risk.

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