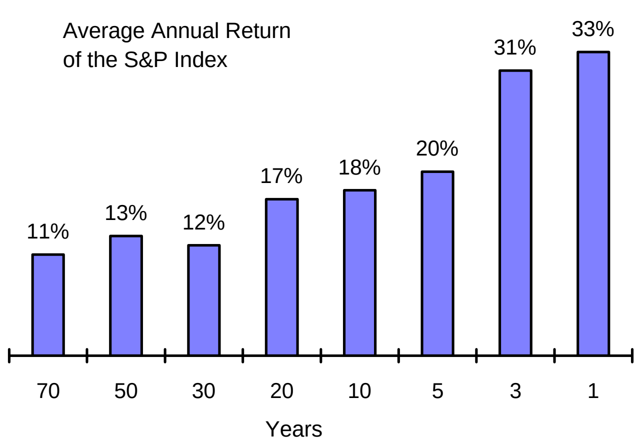
Stock Market Prognosis:
Cautiously Optimistic or Just Plain Cautious?

> So if you are going to value the overall market, the question becomes; “Do you crank in the present 20% returns on equity for American business in aggregate, and say that’s a realistic figure to stick on for this future that runs out until eternity?” I would say that is a fairly reckless assumption and doesn’t leave much margin of safety. And I would say that the present market levels discount a lot of that, and so that makes me quite cautious.
>
> Warren Buffett, Fortune Magazine, July 20, 1998

After a period of minor corrections and stock market consolidation which lasted for most of the recent quarter, the bull market resumed its inexorable advance during the latter half of June and early July. Both the Standard & Poor 500 Index and the NASDAQ Composite have hit new highs during the past weeks. During the first half of 1998, the stock market, as measured by the Dow Jones Industrial Average and the S&P 500 Index, turned in stellar performances yet again, advancing 13.2% and 16.8% respectively. On the other hand, the Russell 2000 Index, which measures the performance of two thousand small capitalization issues was up only 4.7%, highlighting the premium that investors are willing to pay for global, large capitalization, growth stocks. Since January 1, 1995, the Dow Jones has advanced almost 150%. Never before in the history of the U.S. stock market have there been four years in a row with returns such as these.

This brings us to the question which we have asked before: Is there really a “New Era” in the stock market? Are we in the midst of a new paradigm where the old rules no longer apply? The answer depends on whether one is a bull or a bear. If one is a bullish subscriber to the “New Era theory,” the chart below is proof positive that the past several years reflect new political, economic and demographic conditions for the U.S. These have transformed the stock market and the financial returns which are now possible. During the three year period ending in 1997, the average annual return of the S&P 500 Index was greater than 30%.

Changes in Historical Equity Returns 1928-1997



Source: Fidelity Investments

But there are those who hold that the 30%+ average annual returns are not sustainable no matter how good the current conditions. They hold that a return to the mean stock market returns will come in due course. As the chart on the previous page demonstrates, the mean for most of this century has been between 11% and 13%, depending on whether the Great Depression is factored in or not. By simple arithmetic, there will have to be some major bear markets to bring the recent extraordinary returns down to a 13% mean.

Market Valuation Tools Point to Overvaluation

At this point in the bull market, every fundamental market valuation tool is indicating that the stock market is overvalued. For most of this century and part of the last, dividend yield has been a reliable approach to valuing the stock market. The average dividend yield on the stock market over the past 125 years has been about 4.5%. In a chapter on the Great Depression in his recent book, *The History of the American People,* Paul Johnson discusses the well known valuation tool which states that if the dividend yield on the stock market declines below 2%, a bear market will soon be on its way. The dividend yield on the Standard & Poor 500 Index dropped below 2% many months ago when the S&P 500 Index was at 750, and since then the stock market has appreciated over 50%.

Another market valuation tool is price to book value. For the past seventy years, the highest price to book value ratio at a market peak was 2.5 in 1987. Between 1937 and 1987, the price to book value never exceeded 2.1 at a market peak. At the moment, the price to book value ratio is nearing 5.9.

A rule of thumb which has worked well for most of this century is the "Rule of Twenty", about which we have written before. This rule states that the market P/E should equal the rate of inflation subtracted from the number twenty. At the moment with the CPI forecasted at 1.5% for 1998, the P/E ratio for the stock market should be 18.5. Taking into account the Boskin Commission report, which estimated that the CPI was overstated by at least 1%, the P/E ratio for the market should be 19.5. Instead the P/E ratio for the S&P 500 Index on estimated 1998 earnings of $47.50 was 24.2 in early July. If the P/E ratio were to be calculated on 1998 reported earnings (operating earnings less write-offs), the P/E ratio would be even higher at 25.5. To put this into perspective, if the S&P 500 were to fall from its current level to where the rule-of-twenty suggests that it should be, the S&P 500 would drop to 878 - a decline of 24%. If the lower inflation estimate were to be used, the S&P 500 would nonetheless drop 20% to 926. If the stock market were to return to the average P/E ratio for this century of 15, the market would drop 38%.

Both bulls and bears agree on the reasons why the stock market has had such a phenomenal run since 1991. As we have repeatedly chronicled, this is the first time in almost a century that all of the following benign conditions are in place: low and declining inflation, low interest rates, a sound currency, a budget surplus, improving margins and strong corporate earnings, absence of global conflict, strong and growing world trade, a technological revolution, the spread of democratic capitalism, and a favorable balance of supply and demand for equities. Could anything be better?

Crowd Behavior

In spite of these near perfect conditions, a time is approaching, we believe, where greater caution is called for. It may even be now. Not because conditions may turn bad in the short run, but because the stock market is beginning to value some stocks as if these conditions will go on forever. Buying stocks at more than 50 or 60 times earnings - even great companies like Microsoft and Pfizer - leaves little margin for safety. Valuing fashionable Internet companies with no earnings at $5 billion or more is asking for trouble. These sorts of valuations are predicated largely on the "Greater-Fool-Theory." This theory assumes that the buyer of an asset at greatly overvalued prices will be able to find an even greater fool to purchase the asset at a still higher price. Two of the most famous examples when the Greater-Fool-Theory reigned were the Tulip Bulb Mania in Holland in the 17th century and the Souk Al-Manak in Kuwait in the early 1980's. In both cases, huge prices were paid for assets which had no real value at all - in one case tulip bulbs fetching prices of $10,000 and more, and in Kuwait, when newly chartered companies with neither sales nor earnings were valued at tens of millions of dollars. Such crowd behavior is well described in David Mackay's classic published in 1841, *Extraordinary Popular Delusions and the Madness of Crowds.*

The Dow Jones at 10,000

There is a good chance that the Dow Jones Industrial Average will hit 10,000 at some point in the next 18 months, as long as the positive fundamental conditions persist and assuming that $20 billion a month continues to flow into the stock market as it has over the past three years. A great tide of retirement assets has gone into the stock market over the past decade. 90.4% of all money in U.S. mutual funds has flowed in during the past seven years. There is no reason, given the baby boomer demographics in the U.S., that this shouldn't continue. However, if there should be a shift in allocation of funds away from equities for any reason, a major support for high valuations will have been removed. These funds have provided the liquidity and the powerful demand for stocks witnessed this decade.

There are also very good reasons why strong, global growth companies which can produce consistent top and bottom line growth should be valued at high price/earnings ratios. As Edwin Kerschner, the brilliant market strategist at Paine Webber has convincingly written, a company which can produce consistent 15% or 20% growth in a 1-2% inflationary environment is worth 30 or more times earnings. Companies such as General Electric, Gillette, Coke, Microsoft, Pfizer and Wal-Mart, which reliably produce double-digit growth in earnings, deserve high P/E ratios. The real question for these companies is what happens to the price of their stock if either the company stumbles or if the environment changes.

If the Dow were to hit 10,000 in the next eighteen months, what kind of a return is that? A move in the Dow Jones from its current level of 9,175 to 10,000 is a return of only 9%. An investor can earn the same return with a 5-year corporate bond over this period. This suggests that the risk-reward ratio between stocks and bonds may be about equal and that most of the easy money in this bull market has been made.

There is nothing which says that the stock market will halt at 10,000. It could move much higher - especially if those who believe in the "New Era" are correct. Moreover, there continue to be excellent opportunities to purchase well established, large capitalization growth companies when they stumble and a margin of safety is present at the time of purchase. But on the whole, the number of companies able to show double-digit revenue and earnings growth is narrowing. They are increasingly concentrated in the technology, financial (banks and insurance), drug, consumer brand and service industries. While pricing power is limited in the current environment, companies in the above sectors have been able to show growth through selling more units of product and/or through acquisitions. In the raw material, basic industry and energy sectors, it has been difficult in this near deflationary environment, compounded by the problems in Asia, to increase revenues and to maintain operating margins.

Conclusion

In our January investment outlook, we wrote: "In the absence of serious overvaluation and with the powerful trends in place in the U.S., we are cautiously optimistic. Accordingly, we will continue to purchase, at good prices, high quality growth companies." Since we wrote that, the major market indices have risen 20% or more, and signs of overvaluation, while not yet serious, are beginning to crop up. Nevertheless we still remain cautiously optimistic. However, the emphasis has shifted from optimism towards caution. Many of our clients wish to keep their portfolios fully invested in equities, as they are interested in the maximum long term returns and are willing to live with the greater volatility of equities and the possibility of a serious market decline in the short run. For clients who are more risk adverse and have less tolerance for downward volatility, it is a good time, we believe, to take some of the past years' gains off the table and allocate these assets to more defensive, higher yielding equities such as REITs, or to fixed income instruments, which have less volatility and produce income.

In summary, this is not a prediction that the bull market is over. As discussed above, we believe that there is an excellent chance that the market will move higher over the next year. However, prudence calls for increasing caution. Like Warren Buffet, quoted at the beginning of this commentary, we are taking a more cautious stance. However like Buffet who, shortly before he made this statement, announced Berkshire Hathaway's purchase of General Re-insurance at 23 times earnings, we believe that the stock market still presents many good opportunities to make money by buying great companies at good prices. We also want to choose the appropriate risk/reward ratio between stocks and bonds for clients who look to us to do so.

July 1998