The Main Thing

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

Several weeks ago, the senior pastor of Park Street Church on the Boston Common gave a sermon in which he quoted with approval this famous dictum of Lee Iacocca, former CEO of Chrysler. Iacocca is remembered as the executive who, having been summarily fired as the number two at Ford by Henry Ford, went on to save Chrysler from bankruptcy and help it become one of Ford's most formidable competitors. Iacocca's modern day proverb can be applied to many spheres of life, which go beyond car manufacturing or one's approach to life. It is especially relevant to the stock market at the moment. The difficulty of applying this proverb is twofold: first, one has to determine what the "main thing" is, and secondly, one has to stick to it. When the world seems to be falling apart with currency devaluations in Asia, the possibility of the collapse of the Japanese banking system, Russia's default on government bonds, the threat of worldwide deflation and now Congressional hearings about the possible impeachment of the President of the United States, it is not easy to figure out what the main thing is.

From Bradley, Foster & Sargent, Inc.'s inception on July 1, 1994 until our July, 1998 investment commentary, the main thing was the relentless advance of the most powerful bull market this country has ever seen. The bull market started during the summer of 1982 with the Dow Jones at approximately 850. The Dow rose more than eleven-fold to reach 9,412 on July 21, 1998. During this period there were three corrections and/or short term bear markets in 1984, 1987 and 1990-1991, but the basic theme continued to be the inexorable advance of the bull market. During this sixteen year bull market, corporate earnings as measured by the S&P 500 Index nearly quadrupled, while the stock market's valuation of stocks (as measured by the P/E ratio) tripled from a low of 8 in 1982 to a P/E on forward earnings of 25 in July of this year. As we have chronicled on numerous occasions, this bull market was built on a firm foundation of strong and growing corporate earnings, declining inflation, declining interest rates, expanding global trade and an absence of global conflict. Over the past four years, several new and positive factors have contributed to the market's advance: sound U.S. fiscal policies with lower capital gains taxes and a budget surplus, a technological revolution, the outbreak of democratic capitalism around the world, and strong demand for U.S. equities based upon demographics and savings for retirement. With all of these positive factors in play, it seemed relatively easy to figure out what the main thing was. However, in our July investment commentary, we indicated that it was time for caution, as the world had changed. Now investors are trying to figure out whether the U.S. stock market's decline is signaling a major bear market brought on by global deflationary forces or whether the sell-off is merely another correction in the bull market which started in 1982 and will break 10,000 on the Dow Jones in due course.

Stock Market's Decline since July, 1998

Most stock market indices peaked in mid-July, although the Russell 2000 (an index which measures small capitalization stocks) hit its high in April 1998. The following table shows the extent of the stock market's decline this summer through October 8th:

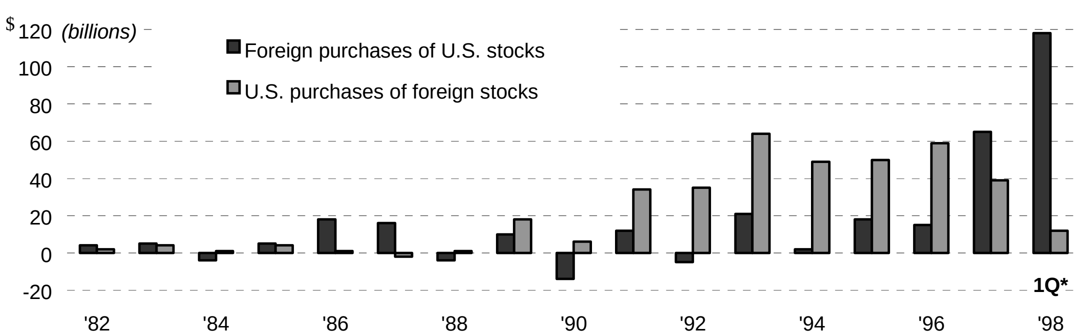
Index	Date of High	Closing High	Closing Low	Correction (%)	Performance 12/31/97-10/08/98
Dow Jones	July 17	9334	7539	(19.2%)	(2.2%)
S&P 500 Index	July 17	1187	959	(19.2%)	(1.2%)
NASDAQ Composite	July 20	2014	1419	(29.5%)	(9.9%)
Russell 2000	April 21	491	310	(39.9%)	(28.9%)

As can be seen from this table, the established, large capitalization stocks fared considerably better than both smaller capitalization stocks, represented by the Russell 2000, which has been savaged in a 40% drop, and the technology-heavy NASDAQ Composite which is down nearly 30%. Looking at individual stocks rather than indices, figures provided by Salomon Smith Barney show the average stock's decline from its 52 week high through September 30th at 35.1% for mid capitalization issues, and 53.5% for issues with capitalization of less than $250 million. Stocks with capitalization over $20 billion were down significantly – 21.8% on average from the 52 week high. Even some high yielding defensive stocks like REITs are down 20-25% this year. As the table above shows, despite the gut-wrenching market of the past months, the stock market (as represented by the large capitalization indices) is off only marginally since January 1, 1998.

A Valuation Correction Turns into Panic

The stock market's decline started in the latter part of July as a valuation correction. At the top in July, P/E ratios exceeded 25 on forward earnings. Overseas investors, who usually come late to a bull market in U.S. equities, were once again a contrary indicator. The market's top coincided with record purchases of U.S. equities by foreigners as shown by the chart below:

In Love with America



*First-quarter 1998 figures are annualized.

Source: Barron's Market Week

In August, the market continued its sell-off as economic and political problems in Russia reached crisis proportions, culminating with Russia devaluing the ruble and defaulting on its government bonds. Simultaneously the acceleration of President Clinton's problems began to shake investor confidence. Japan's apparent inability to jumpstart its economy and address its banking crisis led investors to conclude that Asia's problems might worsen and spread to Latin America. Then in September, the near failure of a hedge fund called Long Term Capital Partners (run by John Meriwether of *Liar's Poker* fame), which had leveraged its balance sheet through debt and derivatives to over $100 billion, caused sheer panic among investors in financial stocks. Like a chain reaction, the volatility and losses in global markets brought down Meriwether and caused many of the highest quality, large capitalization banks and brokerage firms, which were major investors in and lenders to the hedge fund, to put up $100-$300 million each to bail it out. Impeachment hearings remind foreigners of Watergate and the terrible U.S. bear market of 1973-1974. This, as well as the cumulative impact of other news, has probably caused many foreigners to exit the U.S. stock market during the last quarter.

Bearish Factors Impacting the Stock Market

These are some of the factors which have caused a high degree of investor anxiety and enormous volatility in the stock market. It is not infrequent for stocks of well-established companies, which issue warnings of a slowdown in revenues or earnings, to drop up to 25% before the stocks begin trading again. Most of the stocks of the money center and regional banks as well as the large brokerage firms have fallen 50% or more since August, due to investors' worries about potential problems in emerging markets and hedge funds. Another sector which has been savaged has been computer software and information technology firms, due to investor fears of a slowdown of capital spending and lower corporate cash flow brought on by global deflationary forces. Some observers believe that too much capital in certain countries and industries has caused an overcapacity problem which is ushering in deflation, lower margins, lower profits and restricted cash flows. This would cause a real slowdown in capital spending, which has been a key engine of the economic boom in the U.S. over the past five years. Another negative factor preying on investors' nerves is the year 2000 problem in computer software, which could cause some companies or even industries to operate at sub-par levels, if these problems aren't fixed. The result might be a recession in the U.S. with 1999 corporate earnings lower than in 1998. Some bearish forecasters predict that earnings for companies in the S&P 500 Index will be only $42.00 next year - well below the $46.00 foreseen for 1998.

Another negative influence is the high level of real interest rates in the U.S. With the Consumer Price Index up less than 2%, the real rate of inflation level is effectively zero, as shown by the Boskin Commission last year. The chilly winds of deflation are blowing in Japan and other countries around the world. Real U.S. interest rates are over 4.5% - well above the norm of 2.5 - 3%. This has had the effect, some observers believe, of weakening other currencies against the dollar and magnifying the global deflationary impact. Meanwhile there has been an inverted yield curve in the U.S. capital markets with the Fed Funds rate higher than the yield of 10 year U.S. Treasury bonds. Historically, the stock market does not like an inverted yield curve, as it can presage a recession.

What is the Main Thing?

For the first time in several years, there is contradictory evidence about the future of the U.S. economy and stock market. Here are some of the key patterns and fragments of evidence that we are currently analyzing in order to make the best judgments about 1999 and beyond:

Negative Factors	**Positive Factors**
High real interest rates and inverted yield curve signals coming recession.	Federal Reserve has cut interest rates twice and will ease more if necessary. Don't fight the Fed.
Stock market is a forward looking mechanism and is now forecasting a U.S. recession.	The U.S. stock market has successfully forecast most recessions but has also predicted many which never occurred.
Global deflationary forces will cause a U.S. slowdown or recession.	U.S. and European economies are resilient and strong and make up 65% of global GDP.
The capital spending boom is coming to an end and will cause lower profits and fewer jobs.	The technological revolution has a long ways to run and will continue to drive capital spending.
Impeachment hearings will negatively affect the U.S. economy.	President Clinton may have had less to do with the economic boom than Congress and Fed Chairman Greenspan.

What other factors need to be added to make a complete picture? Several important ones: The U.S. is still the beneficiary of nearly zero inflation, declining interest rates, a budget surplus, strong demand for equities by the baby boomer generation, strong global trade, the rise of democratic capitalism globally, and strong, well managed companies. Moreover the stock market is no longer significantly overvalued. The stock market's P/E, while historically high, is more reasonable in light of interest rates at 30 year lows. If earnings grow 5% or more next year, the stock market could show reasonable appreciation.

Macro-economic trends are never easy to forecast successfully. In the absence of compelling arguments which cause us to tip strongly to the bearish or bullish side, the main thing is not to succumb to fear or greed and to avoid hasty or premature judgements about macro-economic trends. Indeed it is critical precisely at times like this to stick to the discipline of buying high quality, well-established companies at reasonable prices with the knowledge that over the long run, these stocks will do very well. This is also the time to weed out companies which have disappointed, shifting proceeds into some of those great companies which have been too expensive to buy over the past two or three years. For some investors who have been shaken by the recent risk and volatility of the stock market, this may be the time to change the asset allocation in their portfolios to include more bonds and less stocks. In summary, the main thing for investors is to think through their investment objectives carefully, to ensure that their asset allocation matches these objectives and to remain patient and calm, maintaining realistic expectations of investment returns for each asset class.