The Dow Jones at 10,000: Good News/Bad News?

I can calculate the motions of the heavenly bodies but not the madness of people.

Sir Isaac Newton, Master of the Mint, April, 1720 after having sold his shares in the South Sea Company at a 100% profit of £7,000.

The Dow Jones Industrial Average, after flirting with the 10,000 mark for some weeks, recently crossed that threshold and closed over the mark for three consecutive sessions. It is rare that such a major milestone is celebrated with so little hoopla and enthusiasm. Perhaps this was because many investors remember the sixteen-year period between 1966, when the Dow Jones first touched the 1,000 milestone, and 1982, when the Dow Jones finally breached the 1,000 mark for good. It was not an easy period in the stock market, and much money was lost - especially in the terrible 50% down bear market of 1973-1974. The question is: After a twelvefold increase in the Dow Jones during this incredible 17-year bull market, are we in for another difficult period? Or, is the market still in a major secular bull trend?

At Bradley, Foster & Sargent, Inc., we are not embarrassed to admit that we don’t know the direction of the stock market over the short term. We are also prepared to confess that we don’t know where interest rates, the price of oil or the yen/dollar exchange rate are headed in the short term. In this regard, we find ourselves in good company. Such august investors as J.P. Morgan, Gerald Loeb, John Templeton, Peter Lynch and Warren Buffet maintained that it is impossible to predict the direction of the stock market with any degree of regularity. What we do know is how to evaluate a company, its industry and how to buy shares in it at a good price for growth over the long term. Even in a difficult market such as the one between 1975 and 1981 when the broader market averages went nowhere, it was possible to make good money in the stock market by choosing the right companies in the right sectors.

The Stock Market is a Market of Stocks

In the stock market, there is clearly a real dichotomy building. One sector of the stock market comprised of large capitalization, growth stocks continues to perform dramatically better than the majority of stocks. During the first quarter, the S&P 500 Index, which is heavily weighted with large capitalization growth stocks, showed a total return of 4.97%. The total return of the Dow Jones Industrial Average was 6.95% during the same period. The NASDAQ Composite, influenced by Internet stocks, was up 12.25%. On the other hand, the small capitalization Russell 2000 Index was down again - by 5.77% this quarter and 17.33% for the past 12 months. The difference in performance between the S&P 500 Index and the Russell 2000 over the past year is **34.04%**. The S&P mid-capitalization index was down 6.68% this quarter, while the S&P small capitalization index was down 9.19%. Various sectors of the stock market are behaving in very different ways. What does this mean for investors?

Narrow Breadth of the Stock Market

In stock market parlance, the breadth of the market is very narrow. The small select group of stocks which accounts for most of the market's rise is not representative of the market or the economy as a whole. According to Byron Wien of Morgan Stanley Dean Witter, only 53% of stocks on the New York Stock Exchange are above their 200-day moving average - the lowest percentage of any market top in recorded history. Wien believes that the history of the U.S. stock market provides evidence that such narrow markets end badly. As a prominent example, Wien points to the 1973-1974 bear market decline, when the Dow lost 46% of its value. In that case, only 61% of stocks were above their 200-day moving averages. Although the Dow closed over 10,000 for three days in a row during the first half of April, 53% of stocks in the Russell 3000 were 33% off their highs, 70% were off 20%, and 88% were 10% off their highs. Domestic mutual fund performance for the first quarter was barely above breakeven. It is no wonder that there was so little joy among professional investors when the Dow breached the milestone 10,000 this month. Not many investors are participating in the stock market's rise.

Expensive Levels of Valuation

On April 12, 1999 the Standard & Poor's 500 Index closed the day at 1359. The companies which make up the index are forecast to earn $47.50 in 1999, which means that the price/earnings ratio for estimated 1998 earnings is 28.5. The S&P 500 Index's dramatic rise over the past five years owes much more to the increase in the stock market's valuation (Price/Earnings Ratio) than to the earnings growth during this period. The table below demonstrates the rise in valuations:

Year	Operating S&P 500 EPS	P/E Ratio	S&P 500 Index (year-end)
1994	$33.01	13.9	459
1995	$38.81	15.9	616
1996	$40.35	18.4	741
1997	$44.74	21.7	970
1998	$44.79	27.4	1229
1999	$47.50E	28.6	1359

While operating earnings for the S&P 500 Index have risen 43.9% over the past five years, the P/E ratio of the index has gone up 105.8%. With inflation and interest rates having declined significantly during this 5-year period, the stock market's higher valuation is a rational phenomenon. Yet, at the current P/E of 28.6, the valuation of the S&P 500 Index is higher than it has ever been - even in times of low inflation. A far more astonishing level of valuation is the 100 largest stocks on the NASDAQ which now sell for over 100 times their trailing 12-month earnings. Normally these exalted levels of valuation would cause investors to search elsewhere for better bargains, but many of these stocks are in the hands of more than five million investors who trade over the Internet, many of whom are day traders and momentum investors whose strategy is to try to buy high and sell higher - whether it take minutes, hours or days to turn a profit.

Internet Mania

Much of the current market exuberance is being influenced by wild enthusiasm, a mania, for Internet stocks. Manias among "investors" is not a new phenomenon. As long ago as 1720, Sir Isaac Newton, the great scientist who was also Master of the Mint, recognized the mania that surrounded the great South Sea Bubble. While the market was still climbing, he sold his shares at a £7,000 profit. According to Charles P. Kindleberger in his book, *Manias, Panics and Crashes,* Newton later re-entered the market at the top, succumbing to the speculative fever which gripped London that year. He ended up losing £20,000 this time. In the U.S., there have been a number of manias over the past two centuries. In the 1830's, shares in canals and Eastern railroads sold like hot Internet IPOs today. After the Civil War, there was wild speculation in railroad stocks, and the introduction of the telephone and telegraph in the latter part of the 19th century also ignited speculative excesses. During this century, there have been three great manias - radio stocks in the 1920's, electronic stocks in the 1960's, and now the greatest of them all, Internet stocks.

These great speculative booms seem to have several things in common: they take place at times of general prosperity and well-being, there is generally adequate monetary liquidity to fuel purchases of financial assets, and there is a new technology which fires the imagination and creates visions of future riches. It is always more exciting to invest in the hope of great future earnings than the more down to earth stuff of earnings and dividends. For example, the greatest glamour stock of the great 1920's bull market and the radio mania was RCA. Unlike the 500 companies that could be classified "radio companies" in 1929, RCA actually made money. Its guiding genius and CEO was David Sarnoff, the young operator who had become famous taking down the radio transmissions from the sinking Titanic. In spite of several major corrections along the way, RCA's stock had risen from a trading range of $1-$3 in 1921 to a peak of $573 in 1929 before it split 5 for 1. Raymond F. DeVoe, Jr., who now writes a market newsletter, tells a wonderful story about an elderly man who in 1968 walked into Ray's office in Manhattan with a certificate for 100 shares of RCA. He wanted to sell the shares, telling DeVoe that he had bought the shares in 1928 and was just then, forty years later, breaking even.

Will there be an Internet equivalent of RCA? Yes, indeed! There are some excellent Internet companies with rapid revenue growth and even several with earnings. Clearly there will be some survivors. How long will this Internet mania last? That is not as easy to say. The speculation in radio stocks in the 1920's went on for most of the decade. Will it end? Surely! How? Not all manias end the same way, but the pattern is similar. Generally some unexpected event occurs. A few participants break ranks and sell, fearing that they must act before others do. The confidence of others who hold these same positions is challenged, as they are holding the stocks for no other reason than the positive price momentum. When this rationale disappears, more selling occurs. As more investors bail out, panic spreads, and prices plummet. Prices plunge because most investors knew all along that the stocks were overvalued and that they were playing a greater-fool-game. We are now at the point in the Internet mania that the stock of any company which has a product, application or service, vaguely associated with or packaged as an Internet company, i.e.; **.com**, appreciates dramatically - whether bank, brokerage firm, transportation company, retailing or media company. This, too, will pass, and much money will be lost on these issues - when investors return to valuing companies on their present and future earnings potential.

Will Equities Reach a Level of Permanently Higher Valuations?

Jim Glassman and Kevin Hassett of the American Enterprise Institute have argued in several *Wall Street Journal* essays over the past six months that equities deserve a much higher level of valuation than they have received heretofore. Their basic argument is since equities are no riskier than bonds over the long term. They perform better and therefore should have no risk premium over bonds. Therefore, equities are not overvalued but undervalued. P/E ratios of up to 100 are appropriate, according to these authors. These arguments seem to be grounded on the assumption that the economy, corporate earnings and stocks will encounter the same favorable conditions in the next seventeen years as they have since 1982. In other words, the likelihood of good U.S. fiscal and monetary policy, strong corporate earnings growth, an increase of democratic capitalism, global political stability, and the growth of world trade will continue unabated into the distant future. This will lead to strong and growing earnings, which will lead to a permanently higher level of valuation for equities. While nothing can be ruled out, this scenario does not take into account a possible recession in the U.S., geopolitical instability, terrorism, or a war which cannot be managed. Ultimately, it is hard to believe that human nature has changed permanently for the better just because we are approaching the new millennium.

1999 Game Plan

In our January commentary, we opined that the market would probably trend higher during the course of the year - due to positive U.S. corporate earnings forecasts, low inflation, strong demand for equities from retirement plans and baby boomers, the fiscal surplus and strong global trade. The major market indices have, indeed, increased. On balance, however, we believe that the market leaders are richly valued and priced for perfect conditions. It is more than ever a time for caution and lower expectations - because of the narrow breadth of the stock market, the expensive valuations in the leading sectors of the market, the excessive level of speculation in the Internet sector and the potential quagmire in Kosovo. A 15%+ correction in leading market indices could result from any serious, unexpected event. On the other hand, there are sectors of the stock market which are still attractive and even undervalued. Over time, money tends to flow from overvalued financial assets to undervalued assets. Ultimately, stock prices reflect earnings growth, and we will continue to purchase stocks of companies with good earnings prospects at prices where there is a margin of safety. In addition, we believe that this is a time when fixed income instruments can provide competitive returns as well.

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