1999: The Year of Living Dangerously

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>
> Laszlo Birinyi, Jr. January 2000

At the end of September, 1999, it didn't appear as if 1999 would be a very good year for the stock market. A late summer sell-off of 13% had shaken investors' confidence, and the S&P 500 was only up 5.3% for the nine months ending September 30. The Y2K Millennium scare was fast approaching, and many observers predicted that funds would be withdrawn from the stock market until early 2000. But the stock market correctly discerned that the Y2K scare was greatly exaggerated, and the S&P 500 climbed 14.9% during the last quarter of the year. For the fifth straight year, the Standard & Poor 500 Index chalked up a 20%+ year, showing a total return of 21% for 1999. This is the first time in the history of the U.S. stock market that the S&P 500 has chalked up five consecutive years (1995-1999) of 20%+ returns.

Yet, the S&P 500 Index's gain was modest by comparison to the NASDAQ Composite, which rocketed to an 85.6% gain for the year. Dominated by such large capitalization technology stocks as Microsoft, Cisco and Sun Microsystems, the NASDAQ Composite set a record in 1999 for the largest advance for a major index in the history of the U.S. stock market. The previous record was set in 1915 when the Dow Jones climbed 81.7%. In 1914, upon the outbreak of World War I, the New York Stock Exchange was closed with trading in stocks suspended. When the stock market re-opened six months later in 1915, investors realized that the U.S. was going to stay out of the war for the foreseeable future and that the U.S. would be the industrial producer for Britain, France and the other Allies in Europe. Pent up demand for stocks fueled the great 1915 bull market. In a similar fashion, investors' appetite for NASDAQ stocks, which promised investors a link to the information technology revolution (the Internet), was insatiable. Price often didn't seem to matter – as long as the company was in the right technology sector.

But that wasn't the whole story in 1999. The rest of the story was the volatility and narrowness of the stock market. The Value Line Index actually lost 1.4% for the year, as more than 50% of all stocks listed on the New York Stock Exchange declined. Looking at the market in another way, large capitalization stocks continued to outperform small capitalization stocks, and high P/E stocks outperformed low P/E stocks by an incredible 132%, as speculation became the name of the game. Four growth sectors have led the stock market since the end of 1994 – consumer growth, health care, financials and technology; three sectors were flat or down for the year. Only technology was up and up in a major way.

With the Federal Reserve raising interest rates three times in 1999, the bond market suffered its worst year since 1994 and its second worst year since 1973. The total return for the 30-year U.S. Treasury (which includes price changes plus interest earned) fell

14.78% for the year. A basket of U.S. Treasuries of shorter maturities fell 6.21% during 1999. Interest rates climbed all year as bond bears became convinced that evidence of global economic recovery meant higher inflation and higher interest rates both here and abroad.

The Year of Living Dangerously

During the course of 1999, investors began to think in terms of "Old Economy" companies vs. "New Economy" companies. Old Economy companies sell traditional products and services usually through conventional means, and the relevance of the Internet is not readily apparent. Food, beverage, health care and other traditional growth companies fit this description as do the great preponderance of cyclical companies. In these days of low inflation, most well managed, large capitalization growth companies of the Old Economy variety evidence sales growth in the high single digits and earnings growth in the low teens. New Economy companies can be defined as those offering some connection to the "information technology revolution". It might be online shopping such as Amazon, business-to-business Internet sales (or "B2B" in the jargon), new computer operating systems or software, connectivity to the Internet such as America Online, or cellular phones. Companies which provide the infrastructure for the Internet became the stock market favorites during 1999 as these companies demonstrated something that most of the Internet companies didn't have: strong revenue and <u>earnings</u> growth. The fly in the ointment, however, is the valuations that investors have placed on these companies. The table below gives a number of outstanding companies, which provide products and services which are the backbone of the Internet. As can be seen, the P/E ratios are much higher than the P/E ratios accorded large capitalization companies in normal times. The only period when such high P/E ratios were in evidence since World War II was the "Nifty 50" era in the early 1970's, before the great bear market of 1973-1974 brought the values back to earth.

Company	Price 12/31/99	Estimated 2000 Earnings per Share	P/E Ratio	Market Capitalization/ Annual Revenues
America Online	$ 76.00	$ .39	195	36.5
Cisco	$107.12	$1.13	95	26.5
Dell	$ 51.00	$1.03	49	5.8
EMC	$109.25	$1.42	77	22.9
Lycos	$ 80.00	$ .25	318	40.8
Microsoft	$116.75	$1.76	66	30.0
Oracle	$112.00	$1.25	90	16.4
Sun Micro	$ 77.40	$1.01	77	9.7
Yahoo	$433.00	$ .69	627	281.0

Some of the price/sales ratios shown above equal price/earnings ratios in more normal times.

Old Economy or New Economy Stocks?

What are investors to make of the valuations of these New Economy market darlings? And, perhaps more importantly, how should investors view the hundreds of technology/Internet companies which, unlike the list of leading companies on the previous page, have modest revenues and no earnings at all? Generally there are two approaches which investors take: the first is to dismiss the entire phenomenon as yet another episode of extreme valuations, which have characterized other manias or bubbles such as the South Sea Bubble or Tulip Mania in Holland, about which we have written before. Recently, Federal Reserve Chairman, Alan Greenspan, pondered whether this period would be remembered as "just one of the many euphoric speculative bubbles that have dotted human history". And it is easy to manipulate data to make this point. As an example, the market value of the Internet sector of the stock market is approximately $1 trillion, yet the entire Internet sector in 1999 had only $30 billion in sales and *losses* of $3.4 billion. In other words, the imagination of investors has been captured by the Internet revolution to such an extent that they are willing to pay 33.3 times revenues for these stocks, which are producing $3.4 billion in losses.

It is easy indeed to dismiss the whole phenomenon as a giant speculative craze – one supported by one of the longest economic expansions in U.S. history, low inflation, strong liquidity, technological advance and the expansion of democratic capitalism around the world. But astute market strategists such as Laszlo Birinyi, Jr. have a different point of view. Birinyi, who had an excellent record of predicting where the market would go during the last decade, made the following observation: "The market is telling you that there is a very dramatic event [Internet revolution] taking place here. And dramatic changes of this nature suspend the old rules until new ones are found". One of the reasons for Birinyi's positive outlook on the technology and Internet sector is that many of the old-line growth sectors are no longer growing very fast, and many technology firms continue to show dramatic sales and earnings growth. Thus, institutional investors who seek "growth stocks" have a smaller number of stocks in which to invest, which drives up their prices. Most money managers are willing to pay significantly higher multiples for earnings growth of 20%+ in a world of 2-3% inflation.

It is worth re-emphasizing what we have written before: sometimes the rules do change. Once in a long while, a paradigm does shift. The best example of a "New Era" is the correlation between bond yields and dividend yields of stocks. From the earliest period of the U.S. stock market in the 19th century, dividend yields on stocks were higher than bond yields. Always. It was completely rational. Stocks were riskier than bonds, so investors demanded a greater yield from stocks than bonds. This rule of thumb held throughout the first half of the 20th century until mid 1950's. At that time, investors in the stock market bid up prices to the point that dividend yields were lower than bond yields. As the decades have passed, the margin between dividend and bond yields has steadily widened. Investors have accepted lower dividend yields for 40 years, because they realized that stocks, while more volatile, produce greater long-term returns than bonds. With capital gains taxes lower than taxes on dividend income, many investors prefer to receive their investment returns in the form of stock appreciation. After this change occurred, if investors had sold their stocks as overvalued and withdrawn their money from the market, they would have missed a stock market that has gone up 40 times in the last 45 years.

Old Economy *and* New Economy Stocks

There isn't any question that many companies in the technology and Internet sectors sell at valuations which are extreme. As fund manager Erik Voss said recently, "A lot of investing, at least the technology investing, has turned from fundamental analysis into mainly game theory: you make money by being able to sell to somebody at a higher price, and that's all". However, the fact that this is a common attitude does not mean that there are not some New Economy companies which have marvelous prospects and are appropriate for inclusion in Bradley, Foster & Sargent, Inc. client portfolios. Some of these companies with both rapid sales and earnings growth will be the leaders of tomorrow. It pays to maintain a good dose of humility about what the stock market is going to do next, and sometimes it is a new thing. On the other hand, we do not intend to abandon our investment approach of investing in Old Economy high quality, growth companies at reasonable prices – for the great majority of stocks, which we utilize. In short, we think a portfolio needs both Old Economy and New Economy stocks with an asset allocation mix which will differ, depending on the goals and risk profiles of our individual clients.

2000 Forecast

As we enter 2000, there is a very positive macro-economic situation underpinning the U.S. stock market: continuing strong economic expansion, low inflation, high consumer confidence, global economic recovery in place, strong capital spending, and high levels of liquidity. Earnings for the companies in the S&P 500 Index are forecast to increase 13% to $56.50. The bad news is that the Federal Reserve will probably raise interest rates when they meet on February 1, and they may well raise rates later in the year. If the bond bears are right and inflation does increase as the year progresses due to the global recovery, higher commodity prices and the wealth effect of the stock market, interest rates will continue to rise during the course of 2000. This will make it difficult for the stock market to show much progress – in spite of double-digit earnings increases, and it will damage the bond market for a second straight year. However, we are of the opinion that excess industrial capacity around the globe, productivity gains and the growth of the Internet here and abroad will keep prices in most industries under control. Thus we expect that interest rates will level out later this year and that the stock market, in spite of its high valuation, will turn in another positive year. We intend to focus on many of those quality, growth companies which investors have neglected and whose valuations are attractive – with an appropriate mix of "New Economy" stocks.