Continuity of Thought Toward Higher Prices is Broken

> These crowd madnesses (1929) recur so frequently in human history that they must reflect some deeply rooted trait of human nature. Perhaps it is the same kind of force that motivates the migrations of birds or the mass performances of whole species of ocean eels. There seems to be a cyclical rhythm in these movements. A bull market, for example, will be sweeping along and then something will happen - trivial or important - and first one man will sell and then others will sell and the continuity of thought toward higher prices is broken.
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> Bernard Baruch, *My Own Story,* 1957

It is an old maxim that there is not one stock market but rather a market of stocks. Never was this more applicable than during the first quarter of 2000. If someone inquired recently at Bradley, Foster & Sargent, Inc., “How’s the stock market?”, the answer was invariably, “Which one?” Through the second week of March, the Dow Jones Industrial Average had declined 14.8% for the year, while the NASDAQ Composite was up 24.1%. This enormous market disconnect of 38% in relative performance between the Dow and the NASDAQ reached its climax on March 10, 2000 when the NASDAQ reached 5048. Then the NASDAQ pulled back a bit, and the Dow Jones began to recoup some of its losses. The sector rotation out the more speculative technology and biotechnology issues into the financial stocks and other “Old Economy” stocks accelerated a bit, and by the end of the first quarter, the NASDAQ was only up 12.4%, while the Dow Jones was down 4.6%. The Standard & Poor 500 Index with its mix of technology and “Old Economy” stocks finished the quarter up 2.3%.

However, “the continuity of thought toward higher prices” had been broken, as the great speculator Bernard Baruch put it when writing about the start of the 1929 crash. In a similar vein, the NASDAQ continued its decline over the past three weeks. Relatively minor events such as the breakdown of settlement talks between the Justice Department and Microsoft occurred, which normally would not have affected the market, but now helped accelerate the decline. Then market guru Abby Cohen from Goldman Sachs made a small change in her asset allocation, taking 5% out of equities and putting it in cash reserves. By this time the NASDAQ was in minus territory for the year, while the Dow Jones was attempting a comeback. Then came the sickening slide during the week of April 10-14, which culminated in Friday’s sell-off. When the carnage was over on Friday, April 14, the NASDAQ had dropped 25.3% during the week and 34.2% since its high on March 10, 2000. Until April 14th, the Dow Jones and S&P 500 Index had been holding up pretty well, but the March CPI report hammered these indices, too, sending them both into negative territory for the year (10.4% and 7.7% respectively).

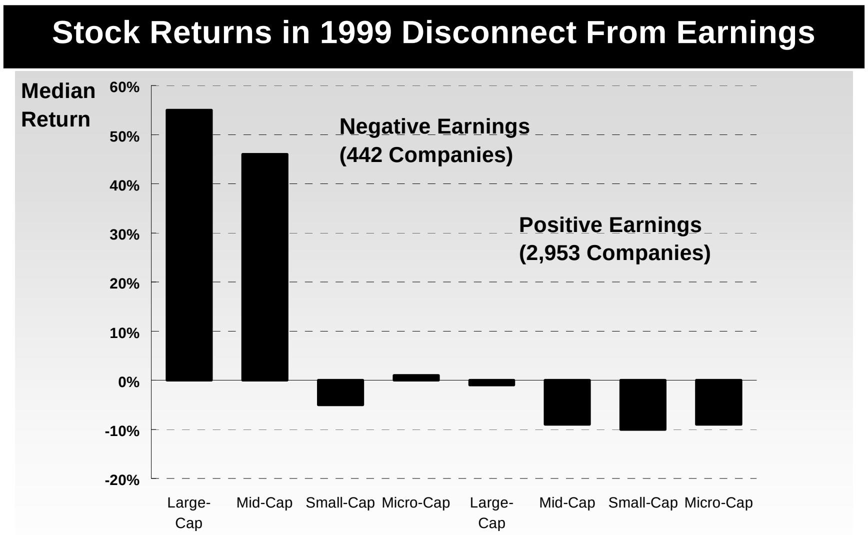
During the last week of March and first two weeks of April, investors lost $2.6 trillion on paper across all U.S. stocks. While this is a huge sell-off, it is important to put it in perspective. The NASDAQ Composite increased 40.1% in 1998, 85.6% in 1999, and was up 24.1% by March 10, 2000. During this period of less than 27 months, the NASDAQ Composite more than tripled. Even after its recent plunge ending on April 14th, the NASDAQ was still up 32% over the past year. On the other hand, the Dow Jones showed only a 30.3% increase since the end of 1997, and the majority of stocks on the New York Stock Exchange have been in a bear market for more than a year. To put the recent sell-off in perspective, the Wilshire 5000 – the index of all publicly traded U.S. based stocks – is still up approximately 3% from one year ago.

Stock Market Valuations Tend to Go to Extremes

In an effort to describe what has been going on in the stock market, the well-known investment strategist from Paine Webber, Ed Kerschner, has divided stocks into three categories: the Old Economy stocks such as Coca Cola, Merck, GE and Proctor & Gamble; and two categories of New Economy stocks: the "old new industrials" representing established large capitalization stocks such as Microsoft, Intel, Cisco, Dell, and Sun Microsystems, and "new new industrials" representing large capitalization but recently public stocks such as Amazon, Yahoo, Lycos, CMGI, etc. The average P/E of Old Economy stocks is 11, while the "new old industrials" recently had an average price/earnings ratio of 54. The "new new industrials" (largely Internet related) had an infinite price/earnings ratio as they had no earnings as a group. In terms of sales, the market capitalization of Old Economy stocks recently sold at .6 times sales, the established large capitalization technology companies sold at 7.3 times sales, and the new new industrials sold at 85.7 times sales.

The above metrics demonstrate the tendency of the stock market valuations to go to extremes. This tendency has been amplified recently as many investors - institutions and individuals - have adopted the momentum style of investing, which emphasizes buying a stock, almost regardless of fundamentals, as long as its price is rising and selling it as soon as it drops. Many observers believe that the enormous growth of day-trading and online investing has only exaggerated this style of momentum investing, which some call "The Greater Fool Theory." The Greater Fool Theory is making money by buying a stock at a high price in the hopes of being able to sell to an even greater fool who will buy it at a higher price. Momentum investing also means selling stocks as the price drops, and this has tended to result in stocks, which fail to meet investor expectations, dropping 50% - 75% in a very short period – sometimes in a day. At the apogee of the stock market's dichotomy during the first quarter of 2000, the investment performance of a number of great professional investors in Old Economy established growth stocks and value stocks was so poor that they were forced to retire or close up shop. Great investors such as Julian Robertson of Tiger Management and George Vanderheiden of Fidelity, retired from professional money management, and even the legendary Warren Buffet, often regarded as the greatest investor of the 20th century, turned in a dismal year in 1999. In the Berkshire Hathaway 1999 Annual Report, Buffet wrote, "We had the worst absolute performance of my tenure {Berkshire Hathaway Class A stock was down 19.9% in 1999}, and compared to the S&P, the worst relative performance (-41%) as well. Even Inspector Clouseau could find last year's guilty party: your Chairman."

The last several years have been a period when earnings seemed not to matter. Stock prices often de-coupled from a company's fundamentals, as investors thought in terms of "concept" stocks and cared more about their hopes for a company rather than its earnings and P/E ratios. The table below is a marvelous illustration of how investors abandoned the long-observed principles of investment management and tended toward speculation:



Source: FACTSET, T. Rowe Price Associates, Inc. 2000

Where is Inflation Headed?

The release of the unexpectedly high March CPI numbers of .4% (excluding food and energy) turned a valuation correction in the NASDAQ into an across-the-board route for the entire market. All sectors dropped, as inflationary fears were rekindled. In the last analysis, stock prices are determined over the long run by two factors: earnings and price/earnings ratios (i.e.; valuation of those earnings). When inflation increases, interest rates increase too. Higher interest rates mean lower price/earnings ratio, which translate into lower stock prices. There is currently a huge debate among economists and investors about whether inflation is dead (or at least subdued) or not. The bulls maintain that there is much excess industrial capacity around the world, that globalization is on the increase, and that companies consequently have very little power to increase prices. When commodity prices and labor costs do increase, productivity increases have been and will be so large due to the technological revolution that inflation will remain under control at 2-3% for the foreseeable future. They maintain that the .4% increase in March retail prices followed modest increases of only .2% in January and February; they believe that March's numbers were an aberration caused by the spike in fuel prices. In other words, inflation is dead, and interest rates will flatten out this summer and decline thereafter.

The bears hold that the economy is growing too fast to keep inflation under control. They believe that U.S. GDP growth of 5-6% combined with a strong global economy will inevitably lead to higher inflation. They point to the increased cost of raw materials including energy prices and health care as evidence. They also maintain that the tight labor market in the U.S. will push up labor costs. They believe that the March CPI numbers reflected a spillover from higher fuel prices into other sectors of the economy. The next major inflection point will come on May 16 when the April CPI numbers will be released in the morning *and* in the afternoon the Federal Reserve will announce whether it will raise rates a sixth time. One of the reason's for the market's precipitous decline on Friday, April 14, was the fear that the Fed will raise interest rates a half percent this time. We predict an increase of ¼%, which is more in line with the Fed's gradual approach.

If the bulls are right and inflation increases only grudgingly from annualized rate of 2.75% last year to 3-3.5% this year, it is unlikely that the S&P 500 and Dow Jones are vulnerable to a further correction of more than 10%. In fact, it is more likely that the market will recover and trend upwards this year. If the bears are right and inflation increases to 4-5%, there is a real danger that p/e rations will ratchet down, affecting all sectors of the market – except perhaps gold and real estate. If a p/e ratio of 15 were applied to the Dow Jones earnings estimates for 2001 of $575, the result is a Dow Jones of 8625 – a 16% decline from its current level. If a p/e ratio of 16 were applied to the S&P 500 operating earnings estimate for 2001 of $65, the S&P 500 Index would be at 1040 – a 25% decline. Not a pretty picture, but it is important to note that many stocks in our client portfolios already sell at P/E multiples of 16 or below.

Our Near Term Game Plan

We are at an inflection point when there are several important unknowns. The most important of these is whether inflation is accelerating and will cause interest rates to continue to rise. Another key variable which will increase investor uncertainty over the next six months is the presidential and congressional elections. It is important to remember that the stock market languished in 1993-1994 until a Republican majority controlled Congress. Other variables include the tension between China and Taiwan. On the other hand there are a number of important things that we do know which are very positive: there is a technological revolution underway which a market correction will not end. Strong corporate earnings growth in the U.S. is on track for the foreseeable future; there is a big federal budget surplus, and strong supply/demand fundamentals for equities caused by a demographically driven allocation of funds into equities. While many large capitalization technology stocks are fully valued, many quality Old Economy growth stocks appear to have bottomed and are at historically inexpensive levels.

Warren Buffet wrote last year, "The key to investing is not how much an industry will affect society or grow, but rather its competitive advantage and the durability of that advantage." We intend to keep some powder dry over the next several months in light of the unknowns and in light of the relatively expensive valuations that still exist in certain sectors. But we also intend to commit funds to those high quality growth companies – including leaders in technology - with a strong and durable competitive advantage as sector rotation occurs, and where we can purchase them at reasonable prices.

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