

The NASDAQ Bubble is Punctured

Many explanations for the business cycle have been advanced. As simple and perhaps as good an explanation as any is the inability of the majority of mankind to maintain a regimen of hard work in the face of easy living conditions.

Philip L. Carret, *The Art of Speculation* (1930)

Much ink has already been spilled on the great NASDAQ bust of 2000 by market pundits of every sort. However, relatively few market observers have come right out and told the unvarnished truth about the great asset bubble which took place between the fall of 1998 and the end of 2000. The truth is that most of us have just lived through the greatest stock mania of our lifetime. This is especially true of Internet stocks in the dot.com bubble. It is unlikely that we will ever see again such extremes in day trading (gambling), speculation, margin debt, and momentum investing.

For a season, all the old investing rules were suspended - first by individual investors and then by major institutional investors, whose aggressive equity mutual funds poured billions and billions of dollars into companies with untested ideas and no earnings.

Investors, who were pleased in the past to see a great company's stock double or perhaps triple in a year or two, saw dot.com stocks rise ten or twenty fold in six months. The mere mention of the word, *internet*, in a prospectus almost guaranteed a successful IPO, which would double or triple the offering price in the first day. The subsequent collapse of the dot.com market has taught some investors a painful lesson about risk, volatility and diversification. The collapse of the NASDAQ caused the loss of \$3 trillion in market capitalization in 2000. The best pure internet plays such as Yahoo, Amazon, Doubleclick and Ebay lost over 75-90% of their value in 2000. The ones with tenuous business models have generally lost 95% of their market value or are close to bankruptcy.

Fortunately the madness was largely confined to "new economy stocks" (i.e.; the technology sector of the market) so that the damage to the broader stock market was relatively limited. The chart below shows the performance of the S&P 500 Index in 1999 and 2000 with and without the technology sector:

S & P 500 Index With and Without Technology Sector
1999 - 2000

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Causes for the NASDAQ Bubble

Why did this great speculative mania occur? And has the final chapter been written on this remarkable episode in U.S. stock market history? Speculative excesses invariably appear at the latter stages of a bull market, and in the U.S., there has been a long bull market, commencing in 1982. Investors are typically confident, having made much money in the earlier stages of the bull market, and they are often willing to risk some of their gains on more speculative stocks. Robert Schiller in his book, *Irrational Exuberance*, lists a dozen reasons for the great bubble. Here are some of the key ones that he notes:

- Large numbers of investors began to use the Internet in 1997. Many became enamored with it and ascribed to it major economic importance;
- The Internet ushered in a "New Era" and with it, new rules. Earlier "New Era" thinking was triggered by the advent of the railroad and the radio;
- The perception by many investors that there is little risk in stocks;

- The expansion of defined contribution pension plans 401(k) and 403(b) and much broader stock ownership;
- The large increase in money supply in 1999 due to the Federal Reserve's fears of Y2K problems on 12/31/99;
- The advent of discount brokers, day traders, and 24 hour trading;
- The rise of gambling in all forms in the U.S.;
- The large influx of foreign money into U.S. stock market during last years of decade.

There were clearly other economic, political, and cultural influences that contributed to this great asset bubble. But somehow the sense that a "New Era" had arrived - that all you needed was a good idea, a creative business atmosphere, the Internet and two guys with pigtailed to create a money-making machine - was the major impetus. With the Internet apparently changing everything in the economic sphere, there seemed to be ample reason to suspend the normal rules for valuing a stock. Who cared if a company had positive cash flow? There was an endless supply of venture capital money and gullible investors who would snap up all shares offered. And so it went, inevitably spiraling out of control.

The NASDAQ Composite more than tripled from its October 1998 low of 1,492 to its intraday high of 5,132 on March 19, 2000 - an increase of 244% in 18 months. The party stopped in March, and by year-end, 2000 the Composite was down 51.9% from its high. The chart on the following page shows the rise and fall of the NASDAQ Composite during this period:

NASDAQ Composite

October 1998 - December 31, 2000

Where Do We Go from Here?

A number of economic and political factors inflicted serious damage on the stock market during the last two months of 2000. The first was the general uncertainty in the political climate due to the prolonged contest for the White House. The second was the combination of tight money and high real rates of interest, which the Federal Reserve Bank had imposed in its fight against the threat of inflation and an overheated economy. The third was the sudden arrival of a slowdown in the economy, which was heralded by many companies' pre-announcing revenue and earnings shortfalls. It began to look as if the slowdown might escalate from an inventory correction to a full - fledged recession. Finally there was a wave of damaging year-end tax selling, which investors had postponed from the usual late November/first week in December period in the hope of selling into a stronger market. No such luck! The market ended weakly and appeared poised to continue south in January. Fortunately the Federal Reserve, which had been fighting the last war (inflation), realized that the real enemy was a possible recession and acted between meetings on January 3rd to cut interest rates by 50 basis points.

Investors are now confronted with two likely, parallel economic series of events - declining earnings and lower interest rates. Corporate earnings in 2001, which were originally forecast to be robust, will be either flat or down for the year. 2001 operating earnings for the S&P 500 Index, which were forecast at approximately \$62.50, are now predicted to be flat with 2000's earnings at roughly \$58.00. Corporate earnings growth has just been postponed for a year. (Normally this would occasion a 10-20% sell-off of the Dow and S&P 500 Index). We do expect the Federal Reserve to cut interest rates as much as needed in order to avoid a recession, not that it is apparent that they

administered a dose of excessively tight money supply in 2000. This is what the Fed did in 1991-1993, and we see the pattern repeating itself. Furthermore it is likely that some tax relief will be enacted this year which should produce additional macro-economic stimulus to the U.S. economy.

What should investors do, when confronted with an economic slowdown/recession that is just beginning and the Fed in a cycle of interest rate cuts? In the past, investors have generally chosen to go with the Fed, looking out beyond the economic downturn to the higher earnings which monetary stimulus usually brings. In other words, commit reserves to the stock market now - despite the likelihood of lower earnings over most of 2001. The primary problem with this approach is that major stock market indices are still richly valued, although there are sectors where stocks are reasonably priced.

Valuation Parameters
 In 1995 when the Federal Reserve began to cut interest rates, the P/E Ratio on the S & P 500 Index's operating earnings was 14. Today, with the S&P 500 Index at 1340, and estimated operating earnings for 2001 are \$58, the P/E is 23.1. The P/E Ratio for the Dow Jones on estimated 2001 operating earnings is lower at 19, but from an historical perspective, this is still quite high. Then there is the NASDAQ 100 (made up of the largest 100 companies by market capitalization on the NASDAQ), which, despite the crushing bear market last year, still carries a P/E of over 50. The NASDAQ bubble has been punctured, but it has certainly not burst. The chart below shows the P/E ratios of the selected leading technology companies, most of which are quoted on the NASDAQ:

Market Valuation of Leading Technology Stocks

	<u>Price*</u>	<u>2001 EPS</u>	<u>P/E</u>
Broadcom	\$125	\$1.4	87
Ciena	\$95	\$.76	125
EMC	\$75	\$1.02	74
i2 Technologies	\$50	\$.34	147
JDSU	\$57	\$.96	59
Network Appliance	\$67	\$.53	126
Qualcomm	\$71	\$1.37	52
Siebel Systems	\$75	\$.67	111
Veritas	\$96	\$.84	 114
Verisign	\$87	\$.54	161
Yahoo!	\$32	\$.36	88

* January 18, 2001

2001 Game Plan

The proven market adage is "Don't fight the Fed." With the Federal Reserve committed to provide liquidity to the economy at reasonable real rates of interest, we believe that the economy will manage to avoid a recession. Inflation is trending down and should not be a problem. Employment and productivity are high. There are relatively few real problems in the economy - whether in the banking or real estate sectors or in overstocking of inventories. Thus, further serious corrections of the major market averages seem unlikely. On the other hand, we do not see much room for further P/E expansion on the major averages. It is possible that the price appreciation of the Dow Jones and S&P 500 Index might be limited to single digits for the foreseeable future. In order to maximize our investment performance, we are focusing on quality growth companies which will be the beneficiaries of the Federal Reserve's interest rate cuts. Additionally, with double-digit gains in the broader market indices less likely over the

foreseeable future, a strategy of closing out positions more rapidly - to take advantage of sector rotation and pricing inefficiencies - may well be called for. In summary, the strategy over the past year or two has been to preserve capital in a risky and volatile market. With the Federal Reserve on our side, we believe that the wind is at our back, and there will be ample opportunities for patient investors to make money - albeit with lower returns than the halcyon years of 1995-1999.

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