# Is the Bear Market Finally Over?

> During a period of persistently declining prices, a novice asked Russell Sage whether he thought stocks would rally. "They also have," was his laconic response.
>
> *The Art of Speculation*. Philip L. Carret

There is no doubt about it: We have been enduring the first real bear market in two decades. While the major stock market indices were down 35-40% during the famous October crash in 1987, the S&P 500 Index actually showed a modest gain that year. There was also a six-month bear market (down 20%) during late 1990 and early 1991, but the market was up over 30% in 1991 so that bear market was relatively painless. The "Long Term Capital Market panic" caused a significant market decline in 1998. At that time, the S&P 500 Index fell 22% in three months. However, the market roared backed in late October 1998 with the NASDAQ tripling in less than 18 months. But, this is the real McCoy.

The NASDAQ has lost two-thirds of its market value worth trillions of dollars since its March 2000 high. The S&P 500 Index was down 30.4% from its peak last year. And the Dow Jones, which topped out at 11,750 in January 2000, last month hit 9106. No one knows if we have reached bottom or not, but thus far the carnage looks like this:

| **Index** | **Peak** | **Date** | **Low** | **Date** | **Percentage Decline** |
|---|---|---|---|---|---|
| NASDAQ | 5,132 | 3/00 | 1,619 | 4/01 | -68.4% |
| S&P 500 | 1,553 | 3/00 | 1,081 | 3/01 | -30.4% |
| Dow Jones | 11,750 | 1/00 | 9,106 | 3/01 | -22.5% |

While the NASDAQ has hemorrhaged over a period of a year or more, the S&P 500 Index lost only 9% last year with most of the pain confined to the technology, telecommunications and media sectors. However during the first quarter of 2001, the carnage spread to most sectors including the financials, health care, media, retail and consumer companies. Many well diversified growth portfolios were down 10-15% percent during the first quarter of 2001. The only place to hide was in cash reserves and bonds.

## Causes of the 2000-2001 Bear Market

There were two main underlying causes for this bear market: the overvaluation of the stock market and the underlying economic conditions in 2000-2001. A confluence of positive fiscal, monetary and corporate conditions produced the best five-year stock market performance of the 20$^{th}$ Century during the years between 1995-1999. As this five-year streak neared its end, the stock market was significantly overvalued with the S&P 500 Index trading at over 27 times forward earnings. Furthermore, the stock market was rife with day trading (gambling), speculation, and excesses of every sort. At the end of every great bull market, there are many who believe that "this time, it's different." This market was no exception; the great technology boom and the advent of the Internet encouraged this kind of "New Era" thinking.

Warren Buffet, who has always had a good way with words, explained the situation in Berkshire Hathaway's 2000 Annual Report in the following terms: "The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on the pumpkin and the mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."

The "New Era" thinking was reinforced by enormous Y2K technology spending. Additionally, many leading companies feared the advent of the Internet and didn't want to see their companies "amazoned." This caused still more capital spending on Internet business models. The flood of venture capital money and an easy IPO environment in the dot com arena made it possible for all sorts of untried Internet business models to get funded.

Meanwhile, the Federal Reserve was determined to cool the supercharged economy and to ensure that the asset bubble which was building in the U.S. was deflated before it did irreparable damage to the broader economy, as it has in Japan over the past ten years. The Fed began to raise interest rates and tighten the money supply as soon as Y2K passed without incident. These monetary steps, combined with overbuilding of manufacturing capacity in some technology sectors, caused the economy to hit the wall late last year. Inventory channels became clogged, and the economy turned down. Thus 2001 operating earnings for the S&P 500, which were forecasted to be up 10% at $62.00, were suddenly ratcheted down to $54.50 – a decrease of 5%. The stock market was thus facing a double whammy: both overvaluation and an economic downturn (perhaps a recession) in 2001.

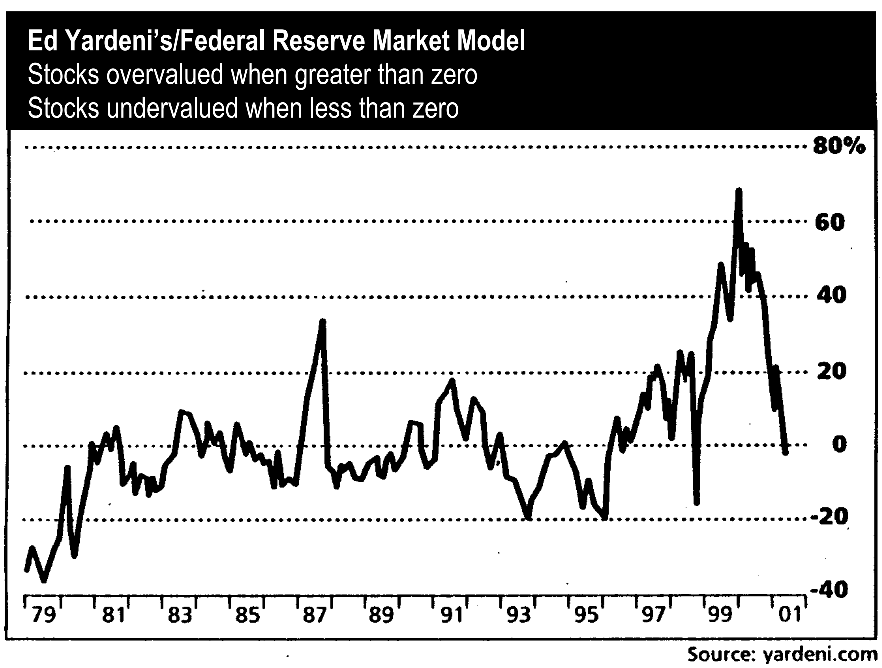
Thus, over the past year the stock market reacted first to overvaluation and then to the economic contraction. First the stocks of the Internet and technology companies with unworkable business models were taken to the wood shed; then the stocks of the good companies with unsustainable market valuations, i.e.; P/E ratios of 100 or more, were taken down. Once the capital spending slowdown and inventory corrections began in earnest, it became clear that many top-notch companies were going to have down earnings (or even losses in 2001). This caused the selling to accelerate. Finally the short sellers, having had to wait for a long time for the right conditions, have compounded the pain by taking many market leaders further down.

# When Will the Stock Market Turn?

What every investor wants to know is: Where is the bottom? When will I see the market value of my stocks stop going down and begin to climb again? At Bradley, Foster & Sargent, we don't pretend to be able to call market bottoms and tops. Perhaps the market has already seen the bottom. Or, maybe the market will need to retest the lows reached in the last four weeks. Or, perhaps the economy is in for a much worse recession than now appears the case, in which case the stock market will likely hit new lows.

What is clear, however, is that old tried and true rules are back in force! What do these rules say about the current valuation of the stock market? Some observers currently use a very simplistic approach to seek to demonstrate that the stock market is still significantly overvalued. Their thinking goes as follows: The stock market over the past century has had an average P/E ratio of approximately 14.5. If one values the 2001 earnings of the Dow Jones or S&P 500 Index at this P/E ratio, the result is a Dow at 7600 or a S&P 500 Index at 800. With the Dow Jones at roughly 10,000 and the S&P 500 Index at 1225, the market remains 30-45% overvalued.

However this approach neglects to take into account the modest level of inflation and the corresponding low level of interest rates. In fact, short term T-bills are nearly down to 4%, while the 10-year U.S. Treasury bond is approximately 5%. We have previously written about a valuation model used by the Federal Reserve. This model essentially compares the stock market's valuation with the earnings yield of the 10-year U.S. Treasury Bond. Here is what this model is currently showing:




As can be seen from this chart, it appears as if the stock market is currently slightly undervalued. Yet this does not necessarily mean that the market will now recover to higher levels. The chart is helpful in showing not only what "fair value" might theoretically be but also how far the stock market has deviated from "fair value" from time to time. For example, the stock market according to this model was 20%

undervalued in 1994, 1996 and in 1998. On the other hand, the market was almost 70% overvalued in early 2000.

## Positive Signs for a Market Turn

The U.S. economy may be in a recession right now. We estimate that there is a 50% chance that GDP will be modestly negative in the second and third quarter of 2000, as inventory corrections and capital spending slowdowns work their way through the economy. Unemployment may rise from its current level of 4.3% to around 5%. However there are also some very positive signs in the economy which make recessionary comparisons with 1973-1974 or 1981-1982 inappropriate. For example, core inflation will probably decline to 2% this year vs. 8-10% during the aforementioned recessions. The service economy is also in good shape, and the housing and automobile markets are holding up well, too. The Federal Reserve is cutting interest rates rapidly. Last week the Fed Funds rate was cut by one half percent for the fourth time this year. Moreover, the Federal Reserve has loosened the strings on monetary growth, providing significant liquidity. This should work its way into the stock market by year-end. Finally, it is clear that a major tax bill will be passed in 2001. While the current bill is hopelessly back-loaded so that tax relief will take place only in several years, it is likely that the current economic slowdown and rising unemployment will pressure the politicians to increase the size of the tax cut and accelerate its implementation.

One of the most important stock market rules over the past eighty years has been "Don't fight the Fed!" In the past, when the Federal Reserve cut interest rates three times within a few months, a powerful rally has usually ensued. There have been thirteen three-step easings since the 1920's, according to Michael Strauss, senior economist for Commonfund. Twelve times, the market was up a year later. The average rise was slightly more than 20%. The one time it didn't work was in 1930, when the economy was in such dire straits that rate cuts didn't work.

## The Next Bull Market

In summary, we believe that the Fed's actions combined with fiscal relief will cause the stock market to turn up before year-end. If corporate earnings increase by 10% or more in 2002, which is the usual pattern after a short recession, and inflation remains low, there is no reason why the Dow couldn't hit 12,000 or more. Yet a word of caution is in order: investment returns will probably be closer to the historical mean of average annual returns of 11%, rather than hefty gains of the 1995-1999 bull market. In addition, market leaders in the next bull market may be very different from the supercharged technology companies of recent years. It may take years for the excesses of the past several years to be washed out of the system. The NASDAQ sells at a P/E ratio of 121, according to Birinyi Associates. Even if money-losing stocks are taken out of the calculation, the price-earning ratio is 35. The market leaders the next time around will likely be the types of companies which Bradley, Foster & Sargent, Inc. favors: established, quality growth companies selling at reasonable prices – not growth companies at any price.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