A Bull Market Climbs a Wall of Worry

The number one rule of making money is not to lose money. The second rule is to remember the first rule.

Warren Buffett

After the three dreadful years of 2000-2002, the stock market came roaring back in 2003. Both the S&P 500 Index and the Dow Jones Industrial Average climbed 28%+ (including dividends), while the NASDAQ rebounded 50%. The new bull market, which started several weeks before the commencement of hostilities in Iraq in March 2003, recouped all the stock market's losses in 2002. It left the NASDAQ Composite about 60% below its peak of 5048 reached in March 2000. The S&P 500 Index remains roughly 28% below its peak achieved in the same month of 2000. Generally speaking, whatever investors made in the final year of the last bull market in 1999 was snatched away by the 2000-2002 bear market, and the commencement of the new bull market in 2003 has now brought investors back to breakeven. This assumes, of course, that investors stayed the course and did not bail out at the bottom of the market in 2002, an assumption that can not always be counted on. All too often, we encounter investors who sold their stocks at the bottom and are only now returning to the stock market, having missed the powerful rebound last year. This unfortunate scenario demonstrates one of Bradley, Foster & Sargent's fundamental principles of investing: Don't try to time the stock market. Sell individual stocks and even sectors, but stay invested in the appropriate level of equities that meets the asset allocation guidelines that have been chosen to achieve one's long-term investment objectives.

Will the Bull Market Continue?

As discussed before, we do not claim to be able to predict the future, nor do we believe that we can accurately foretell where the stock market is headed over the short term. We agree with Warren Buffet in this regard, who wrote years ago: "Let me again suggest that the future has never been clear to me (give us a call when the next few months are obvious to you – or, for that matter, the next few hours)." Nonetheless, we do analyze continuously a great deal of economic data, political trends, international events, and market valuations and draw some tentative conclusions, realizing fully that our conclusions may change often. With this caveat in mind, we remind our readers that last year at this time, we did forecast (correctly, as it turned out) that the stock market in 2003 would not undercut the bottom that was reached in July and October of 2002 and would end the year higher. On the other hand, we were not alone among investment managers and economists in predicting a 10-15% increase instead of the 28% rise that occurred.

We believe that the basic premises of this bull market are still intact. In 2003, the positive future prospects of the economy and corporate earnings caused price/earnings ratios to expand, but we think that this will not be the case in 2004. It will rather be an increase in corporate earnings which will cause the market to rise, allowing the earnings to "catch up" to the valuations the market has placed on companies. Before venturing a forecast about the current bull market scenario, let us lay out the basic building blocks of this bull market:

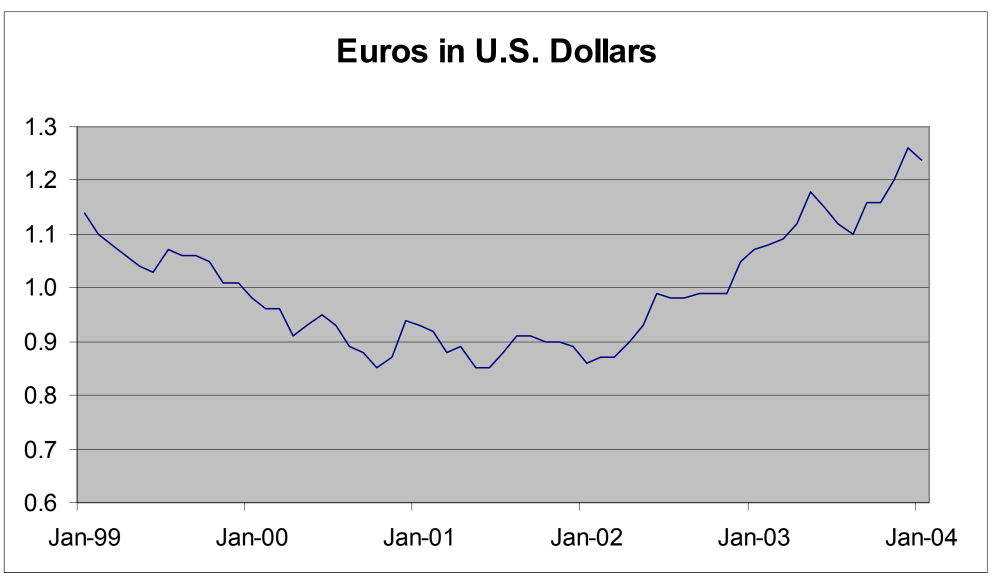
- Low inflation and the lowest interest rates in decades (allowing for relatively high P/E ratios, i.e.; a market P/E of 18-20);

- Lower taxes on income, dividends and capital gains, helping both consumers and businesses increase spending with confidence;
- Large government deficits for fiscal 2004 and 2005, which will help the economy show sustained growth (a recent example being the 8% GDP growth in the third quarter of 2003);
- Strong monetary growth, providing good levels of liquidity for the economy;
- Strong economic growth in China and India with indications that Japan's economy has finally turned around;
- The risk of major terrorist attacks on U.S. soil has been mitigated by our troops on the offensive in Iraq and Afghanistan (Libya's recent action is a good example of this).

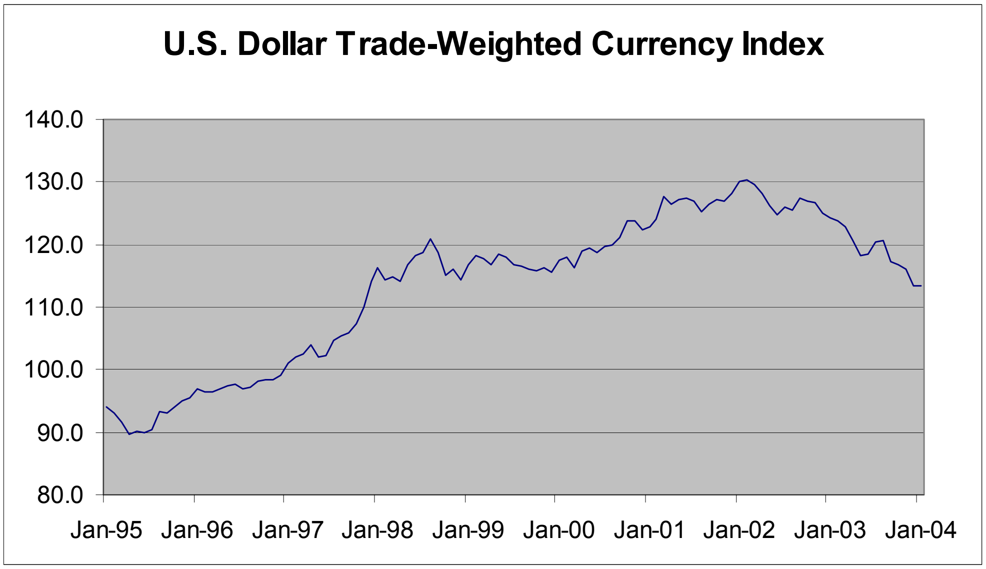
The Wall of Worry

If an investor were to focus solely on the mainstream media's reports about the economy over the past half year, one would think that the stock market was still heading south. The media has focused largely on various problems facing the U.S., many of which could negatively impact the U.S. and the stock market: the falling dollar, the budget deficit, the jobless recovery, and the war in Iraq. Let's look at these problems which are causing such worry for the media and investors alike.

The Falling Dollar: The U.S. dollar has fallen against the Euro almost 50% since early 2002. Each day the U.S. dollar seems to hit a new all-time low against the Euro, having recently touched $1.30 for each Euro. The value of a country's currency generally represents the confidence level that foreigners have in that country's economic and political prospects. If foreigners continue to lose confidence in the value of the U.S. dollar, they could sell their stocks and bonds, causing the value of the dollar to fall further and causing U.S. interest rates to rise to attract monies to fund the deficit. However the following charts show a somewhat different picture:



The chart shows the value of the Euro in U.S. dollar terms since the inception of the Euro in 1999. The Euro started out at $1.13 to the U.S. dollar and fell steadily to around $.85 in early 2002. At that time, the most worrisome threat to the global economy was a global recession caused, in part, by global deflation. The Federal Reserve was determined to do whatever was necessary to combat deflation and to get the U.S. economy going again. A strong U.S. economy, which would cause the U.S. balance of trade to deteriorate, would help re-ignite the global economy. Accordingly, the Federal Reserve continued to cut the Fed funds rate to 1% (significantly lower than the European Central Bank's rate of 2.5%), causing the U.S. dollar to weaken to help U.S. exporters. The end result has been a weaker dollar, but as of January 19, 2004, the U.S. dollar was only about 9% lower than it was in 1999 at the Euro's creation. Moreover the U.S. economy is booming with unemployment at 5.7% and dropping, while Germany and France show little or no GDP growth with unemployment at 10% or more. The unemployment rate in the former East Germany is 17% almost 15 years after the wall was torn down.

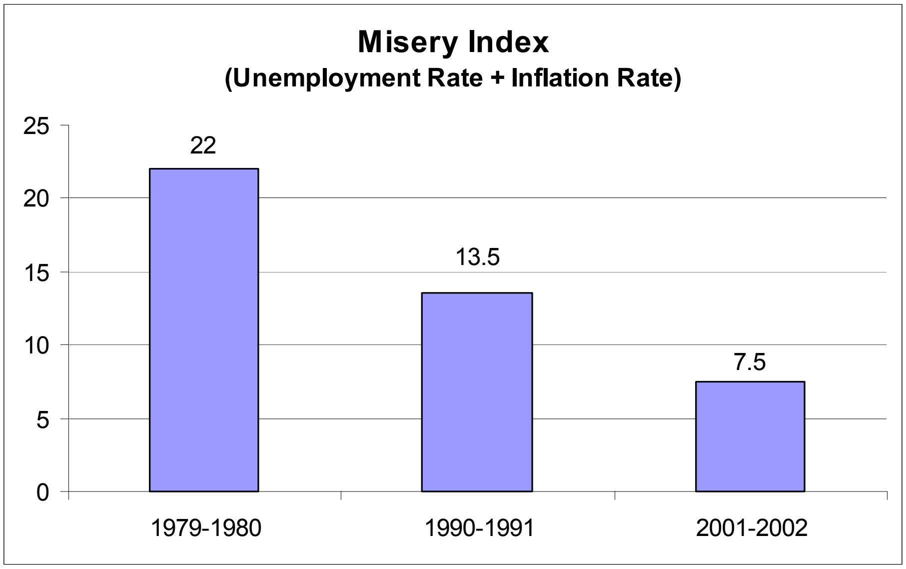


The index above shows the value of the U.S. dollar vs. a basket of currencies of a large group of major U.S. trading partners. Although the U.S. dollar has declined 12% against the index since early 2002, it has nonetheless appreciated roughly 20% against the trade weighted index since 1995. While a continuation of the short-term trend of a falling dollar could indeed be negative for the U.S., we believe there are good grounds to expect a stabilization of the dollar or a resumption of the longer-term positive trend.

U.S. Budget Deficit: For the fiscal year ending in September 2003, the U.S. had a budget deficit of $374 billion. This was significantly more than the previous year's budget deficit of $158 billion. For the year ending in September 2001, there was a surplus of $127 billion. The projections for the next two years show things worsening: an estimated deficit of $425 billion in the year ending September 30, 2004 and $475 billion for 2005. Won't this cause interest rates to rise? How can the country afford this kind of fiscal irresponsibility?

While we are generally not positive about large budget deficits, it is important to put deficits into perspective. Just as a family or a well-run business may run a deficit some years and need to borrow for some expenses (education, housing, autos, etc.), so most countries need to borrow sometimes – especially in times of war. The U.S. had very little debt for most of its history until World War II and the Korean War. During those two wars, the budget deficits were so large that the national debt reached $330 billion – 130% of the country's GDP at that time. This was the highest level of national debt to GDP in the country's history. Currently, because of the U.S.'s strong real economic growth over the past 20 years, U.S. GDP is nearing $11 trillion. The national debt is $6+ trillion. This 60% ratio of national debt to GDP – which measures a country's fiscal soundness – is significantly lower than that of most industrialized nations, where the average ratio is over 100%. Facing the twin challenges of the War on Terror and a recession, a budget deficit of 3-4% of GDP for several years is a reasonable price to pay for national security and the resumption of strong economic growth. Clearly there is a need in the longer term to reduce the U.S. budget deficit significantly.

Unemployment and the Jobless Recovery: Several decades ago, U.S. economists created the misery index to help measure the health of an economy. To calculate the misery index, one simply adds the national rate of unemployment and the rate of inflation. The chart below shows the misery index during the last three recessions:



While every recession is painful for many, it is clear to see that the 2001-2002 recession was the mildest of the three by far. The policies of the Federal Reserve and the administration appear to have worked remarkably well in limiting the economic damage during the past few years.

The War in Iraq: This continues to be a tough slog. It is proving to be expensive both in lives and treasure. But the capture of Saddam Hussein, the participation of more than 30 U.S. allies in rebuilding Iraq, and the acceleration of the timetable to create a democratic Iraqi government, leads one to hope for real progress in 2004.

2004 Game Plan

With a strong economic recovery underway and inflation still well under control, the stock market should continue to climb this wall of worry – helped out by the continued flow of funds out of low-yielding CDs and money market instruments and into the stock market. We believe that it is not in the interest of the European Union or Japan to allow their currencies to appreciate much more, as it hurts their exports upon which so many of the EU companies depend (67% of the Germany GDP is tied to exports). The two major risks confronting the market are rising interest rates and the elections in November. If inflation were to accelerate and interest rates were to rise too fast (perhaps to 5.5% or 6% on the ten-year U.S. Treasury bond), stock market valuations could contract. On the political front, a major premise of this bull market is lower taxes, and if this premise were to be thrown into doubt as the November elections approach, the market could stagnate or decline, as investors await the election results. Yet a down market in a presidential election year seems improbable to us. Over the past 52 years, there have only been three down markets during presidential election years, the most recent being in 2000. In brief, we throw our lot with those who foresee a positive year in the stock market, albeit with lower returns than in 2003. We close as we opened this piece by pointing to Warren Buffet whose investment strategy is to seek to lose as little money as possible in the bear markets so there is ample capital to make a lot of money in the good years. In the end, 2004 could well be one of those good years that Warren Buffett talks about.