MEMO

From Robert Zevin

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Since the spring of 1998 it has been a substantial challenge (at which I have failed) to make each quarterly investment policy letter sound different from the others.

For the eighth quarter in a row it remains true that I have avoided most large, U.S. multi-national growth stocks because they are too expensive, and for the eighth quarter in a row these stocks have been disappointing investments. In their stead I continue to hold foreign stocks and small U.S. growth stocks, each of which did especially well at the end of 1999, as well as neglected, inexpensive companies and bonds, each of which continued to do poorly. This is now the fourth year in a row that I have been concerned about slowing growth, falling profits and a recession, all of which continue not to happen.

With respect to the last point, it remains true that the global economy is sustained to a large extent by an inflated stock market, while stocks, in turn, are sustained by the global economy, low inflation and the very rational perception of Alan Greenspan as a prop against falling stock prices. But Greenspan's ability to take credit for both falling inflation and rising stock prices may not last into his fourth full term that begins in late June. Inflation is already rising in many areas and the Fed has already responded with three increases in interest rates. Rising inflation and rising interest rates have hitherto been infallible predictors of a falling stock market. And rising interest rates have been a pretty good predictor of recessions as well.

Of course we live in a New Era in which all the old rules are to be broken. Nevertheless low inflation and interest rates have been the immutable core of the argument for owning lots of stocks. It is hard to see why stocks should now be impervious to the deadly effects that increases in these traditional enemies have had on all previous stock market booms. One New Era possibility has already appeared in print: Investors should and will perceive that any increases in inflation and interest rates, even a possible recession, are all only temporary deviations from an environment of low inflation and interest rates and steady growth. Accordingly they will not devalue stocks that reflect values over the long term because of these brief detours.

This far-sighted steadiness sounds a lot like the unusually smooth path that stocks have followed for the last five years even as they ascended sharply. And it could be quite rational behavior regarding blips in inflation or dips in GNP (although there is always some uncertainty before the fact whether a given move will turn out to be benignly short and shallow). However, it is less convincing in relation to interest rates. When short-term rates rise long term rates rise as well. In the last fifteen months the rate on thirty-year U.S. government bonds has increased from 4.7% to 6.7%, an unusually large move.

If investors believed that interest rates were going to retrace about half of that move and settle at 5.5% a year from now, the implied total return on the thirty-year bond would be well over twenty percent and hence also over the extraordinary recent average return for stocks. In that case they would sell stocks and buy bonds to bring the two returns into a more satisfactory alignment. And if investors believed that bond yields for the next thirty years were going to average 6.7% instead of the lower numbers of the past three years then a major explanation for the doubling of stock prices since early 1997 would be nullified. Either way, from the perspective of high and rising bond yields, the stock market looks more like a bubble than a juggernaut. The last three stock market declines (1987, 1991, 1994) were all associated with interest rate increases comparable to the one we have already experienced since October, 1998.

For now I think it is wise to take some profits in stocks that have gone up the most and add to cash reserves. I continue to favor the healthcare, technology and telecommunications industries. They have done quite well; but I have been right for the wrong reasons since I favored them as recession resistant industries and we have had no recession. Of the three healthcare has been the laggard, especially the biggest multinational pharmaceutical companies. As a result they now appear more reasonably valued than at any point in the past few years. In addition to these companies I expect to be adding more European companies over the next few months. The stunning success of the conversion to the Euro will have positive implications for many years to come and many European stocks are more reasonably priced than their Asian, South American or North American counterparts.