

April 16, 2002

INVESTMENT POLICY MEMO

As is often the case early in an economic and stock market recovery there is an abundance of alarming news on all fronts. The war on terrorism has spawned a war of terror against the Palestinians. America's continuing shoot first response to 9/11 is breeding new terrorists by the country throughout Islam while it apprehends or kills existing terrorists a few at a time.

The spotlight has been turned on numerous corporate accounting frauds and follies in the wake of the Enron collapse although relatively little attention has been paid to the feckless complicity of every Wall Street firm in the Enron deception motivated solely by their greed to continue earning money from the sale of that company's worthless securities. Information technology firms continue to reel from the unwinding of an over-investment bubble that paralleled the stock market bubble. There is a general perception that the recovery will be weak. That capital investment will not recover for a long time. That profit margins will continue their decline of recent years from their unusual peak in the late 1990's. And that, as a result, corporate earnings will not grow significantly for the next few years or longer.

As noted above, it is normal early in a recovery for pessimism about the economy to persist. Unemployment typically does not begin to decline until six to nine months after a recovery begins. Just as the recession surprises most people every time, so does the strength of the following recovery. It will take awhile for economic recovery to flow through to corporate earnings; but profits are likely to be at new highs by the end of next year. Accounting scandals are the detritus left behind whenever a stock market bubble bursts. They tell us something about the bubble in the past but signify little or nothing for the future.

The economy is growing again because of government spending on the war and on domestic security. Investment will recover from its recent collapse because, as noted in earlier investment memos, there are many areas that were neglected during the period of excessive investment in computers, telecommunications and the Internet. These include schools, roads, railroads, air traffic control, airport security, power generation and power conservation. Investment in housing and motor vehicles has been strong; but there are good reasons for expecting these categories of investment to remain near or above their recent levels. We are still in the early stages of a revolution in biotechnology that will generate large investments in the mass production of new pharmaceuticals. In addition there remains a massive need and opportunity for investment in developing countries.

Government spending and the simultaneous reduction of taxes, implies some truly bad news for the economy and the stock market. In its first eight months the Bush administration destroyed the government surplus that had taken over eight years to build. And since September 11, Democrats in Congress have joined Republicans to form an unruly lynch mob using the torch of patriotism to incinerate every vestige of fiscal responsibility which no longer receives even the lip service that was once its due. Of course a growing deficit is good news for the economic recovery. And this good news seems to be reflected in the superior performance of the stocks of cyclical companies as opposed to steady growth or stable companies.

But a growing deficit, driven by war spending also means higher inflation and higher interest rates. Each has declined significantly over the past twenty years and each appeared ready to rebound even before the September attacks. Developments since September have increased the probability that inflation and interest rates will rise and have increased the amount by which they are likely to rise. Interest rates in the bond market have already reflected this to a limited extent. The monthly average yield on a ten-year U.S. government bond has risen from about 4.75% last fall to about 5.25% now. When interest rates began their decline twenty years ago, the ten-year bond had average monthly yields well over 15%. Only five years ago their yield was 7%. So far the bond market is not taking the prospect of higher interest rates very seriously.

Higher interest rates and higher inflation are the two ingredients guaranteed to produce lower stock market valuations for any given level of earnings and dividends. The heightened risks of war, terrorism and global instability that are now endemic also suggest a lower level of optimism in stock prices. So far, the stock market has reflected these realities by refusing to keep going up after its initial ten percent bounce at the end of last year. At this point the stock market recovery is exceptionally weak for the first six months of an economic recovery rally. Current valuations for most stocks are much more reasonable than prevailing prices two years ago. This fact alone does not demonstrate that stocks are cheap or expensive or fairly priced, only that they are not as overpriced as they were two years ago.

What is a fair price for the stock market? This simple-sounding question is impossible to answer with any precision. Now is an especially difficult time to make such a judgment because the parameters that determine a fair price are shifting. If inflation moves up over the next five years into a range of 2% to 3% from the 1% to 2% range of the past five years, interest rates on the ten-year bond might increase modestly to 6% by 2006. If earnings grow at 7% a year and are expected to continue growing at that rate, stocks five years from now (as measured by the S&P 500) might sell at 16 times earnings compared to 20 times at present. This assumes that investors will want to earn about 3% more on stocks than they do on bonds.

The implication of all these assumptions combined is that for the next five years both stock investors and bond investors would earn something in between 4% and 5% a year. However, if stock market investors wanted to earn 3% a year more than bond market investors for the next five years as well, because of the prospects for higher inflation, continued terrorism and political instability, then stock prices would have to fall an additional 15% from current levels. So, if all of these assumptions were certain truths, the stock market would still be overvalued. To the extent that earnings growth is higher, inflation and interest rates are lower and terrorism and political instability are vanquished, stocks will be worth more and *vice versa*.

My tentative conclusion is that stocks, as measured by the S&P 500, are someplace between fair value and overvalued. Owners of the S&P 500 will probably earn something between 2% and 8% a year for the next five years or so. In this environment it makes sense to own stocks that are insulated from a decline in earnings multiples because they already sell at low multiples. It also makes sense to own stocks that offer dividend yields better than bonds and comparable to the total returns anticipated from stocks even though the dividends will also grow. Finally, it makes sense to own stocks that will benefit from inflation and renewed economic growth. These are generally smaller, more cyclical companies. They have already done three times better than the S&P 500 since the September stock market bottom. Nevertheless, Value Line forecasts that they will continue to do two or three times better than the large company dominated S&P for the next five years as well.

Among the companies that are attractive are real estate investment trusts, construction contractors and the manufacturers of their supplies and equipment, publishers, suppliers of consumer durables, makers of semiconductors, software firms and companies which supply services to businesses such as payroll accounting and computer outsourcing. The three major sectors of large growth companies in the S&P 500 are technology, health care and consumer staples. Technology is still suffering from an over-investment bubble. Health care firms are being successfully challenged about drug pricing which is the heart of their exceptional profitability. Consumer staples companies are in many cases still very generously priced compared to their growth prospects. Consequently I continue to focus on smaller, cheaper companies that have been doing well rather than the major growth giants.