Stock Market Malaise and the Enron Blues?

> There are two powerful arguments in favor of capitalism over its historical alternatives: (1) capitalism better helps the poor to escape from poverty than any other system and (2) capitalism is a necessary condition for the success of democracy.
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> *Business as a Calling*, Michael Novak, 1996

Many barrels of printer's ink have been spilled over the Enron debacle. Not to be outdone, TV newscasters (especially CNBC) have devoted endless broadcasting hours to the Enron saga and Arthur Andersen's complicity in the events. Naturally, politicians felt that they had to appear to be doing something about this, and Congress has already held five separate Enron hearings. With this endless daily market diet, we have decided to resist the temptation and not devote an entire Bradley, Foster & Sargent, Inc. quarterly market commentary to the Enron/Arthur Andersen scandal.

There are, however, two issues involving Enron that are important to address before turning to other reasons for a lackluster stock market this year. First, is the Enron debacle a symptom of a systemic problem? In other words, is capitalism the problem? Secondly, within a democratic and capitalist society, what are the responsibilities of corporations?

Capitalism in the Dock

Some observers have sought to characterize the problems at Enron/Arthur Andersen as mere symptoms of capitalism. In other words, isn't capitalism a system which routinely fosters materialism, greed and dishonesty? Thus, the dishonesty and fraud at Enron and the unethical actions of Arthur Andersen in Houston can be found, according to this view, throughout corporate America. Hollywood and TV have painted this sort of portrait of corporate America for decades. In the book *Hollywood vs America,* Michael Medved quotes an exhaustive analysis of prime time television by the sociologists Richter, Richter and Rothman which concludes: "By 1980 a majority of the CEO's portrayed on prime time committed felonies". In real life, of course, less than one percent of those convicted of felonies in America involving theft, murder, and drugs are businessmen. Moreover, a majority of Americans are involved in business in one way or another (or someone in their family is), and Americans expect people in business, especially those in large corporations with a professional culture, to conduct themselves in an honest and morally upright fashion.

If the problems at Enron and Arthur Andersen are indeed systemic in nature, the only remedy would be a sweeping overhaul of a deficient system. But they are *not* the fault of the system, they are rather the result of human failings. Every company has a unique corporate culture. Some are known for their integrity and high ethical standards. Johnson & Johnson with its exemplary corporate Credo written in 1943 comes easily to mind. Other companies either lack such corporate values or have a credo but neglect to establish adequate safeguards to counter human frailty and venality. Perhaps the corporate culture which can engender the worst ethical behavior is one which combines demanding and sustained pressure for superior financial results with moral laxity or even inattention at the board level or among senior management. This appears to have been the case at Enron as well as at numerous other companies in the 1990's. In fact, this moral laxity seems to have been prevalent in many fields of endeavor in the 1990's. During the past 150 years, there have often been long economic upswings which produced strong bull markets. The latter stages of these booms frequently brought speculative stock market bubbles and with them unethical corporate behavior. One need only recall the railroad wars in the latter part of the 19th century, the Teapot Dome scandal in the 1920's and the excesses of the go-go era of the 1960's. In each instance, the task has been to arrest such behavior, not to dismantle the system. Those who have broken the law must be held accountable in our courts of law and opinion leaders must re-emphasize the importance of ethical behavior within business and demand good corporate citizenship.

The Responsibilities of a Corporation

Far from being an indictment of capitalism, the genuine outrage which Enron has generated throughout American society is a symptom of the high expectations which the American public has for U.S. corporate behavior. Businesses are expected to exhibit the following moral ideals, thereby serving the common good: to satisfy clients with goods and services of real value, to treat employees with dignity and respect, to create new jobs and new wealth, and to provide shareholders with good return on their capital. Moreover, there are a series of external corporate responsibilities which need to be demonstrated. In *The Spirit of Democratic Capitalism* and *Business as a Calling*, Michael Novak lays out the corporate responsibilities which businesses have to the community in which they operate. Several of these are detailed below:

- To exemplify respect for the law: Businesses cannot survive without the rule of law. When a businessman breaks the law, it is not only wrong in itself, but it is also suicidal, as the corporate life is rendered difficult, if not impossible, without the law.

- To protect the political soil of liberty: Free business corporations are only permitted to operate freely in a minority of countries on this planet. People in business have a responsibility to be watchful over their political society – as the survival of business depends upon the survival of free institutions.

- To contribute to making its own habitat, the surrounding society, a better place: A business has a responsibility as a civic leader and should contribute to other mediating institutions in the private sector such as education, the arts, health initiatives, the needs of the poor and homeless, and the environment, etc.

- To practice social justice: Business is a crucial institution of civil society. For its own well-being and survival, business depends on its personnel being active in civil society; in politics, the law, church, the arts, charitable works, and other civic activities. Businesses should encourage their employees to volunteer and be good citizens in the community.

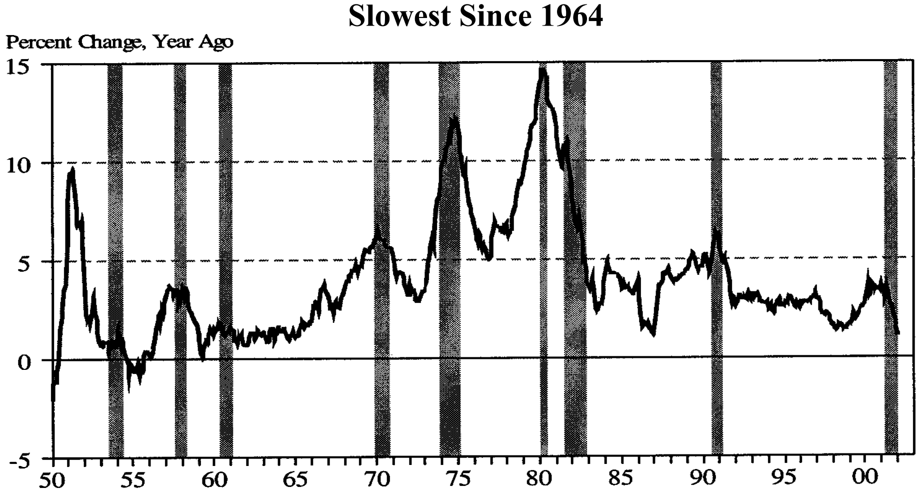
The Gates Test

Capitalism is, of course, far from perfect. Winston Churchill once said that democracy is the worst system of government except when compared to all the others. The same can be said about capitalism: it is the worst economic system except for all of the others. Ultimately, the empirical evidence is what counts. William Bennett often talks about the "gates test". When you open the gates of a country, do people come in or go out? We are familiar with the exodus from socialism and from behind the Berlin Wall. Over the last decades, 30 million people (not including the millions of illegal immigrants) have come to America to participate in this wonderful, if flawed, capitalist system. No, the Enron debacle is a not a systematic failure but rather one that results from human frailty.

Enron and the Stock Market Blues

During the first quarter of 2002, the stock market turned in a lackluster performance. The S&P 500 Index, which in mid-February was down 6.5% for the year, bounced back in March to finish the three month period up .28% (total return). The Dow Jones, which has a heavier weighting in "old economy" cyclical stocks, was up 3.82% for the quarter, while the technology-laden NASDAQ showed a 5.32% decline. During the first few weeks of April, the stock market malaise continued with the S&P 500 Index drifting down 4%. Industry leaders IBM and GE led the decline. Even long-term U.S. Treasury Bonds, a safe haven in 2001, produced negative returns of 1.86% during the first quarter. It would be easy to blame these negative returns on Enron, the aggressive accounting issues and the duplicity of some research analysts at the big investment banks. But, alas, that would be too easy. The problems are much more mundane. Like the protagonist in the movie, *Jerry Maguire*, who would shout, "Show me the money", investors are saying, "Show me the earnings". After the sell-off in September following the terrorist attacks, investors bought stocks because of dramatic interest rate cuts, increased government spending and the hope (even likelihood) of an economic recovery. Now, hope is not enough; they want to see the earnings. The good news is that conditions are good both on the inflation/interest rate front and on the earning front. First inflation:

Consumer Price Index
Slowest Since 1964



Source: Bureau of Labor Statistics

From the table on the preceding page, it is clear that inflation is not a problem. Most corporations have little or no pricing power. In fact, the Federal Reserve may be still more worried about the dangers of deflation rather than inflation. The current, modest level of inflation will allow the Federal Reserve Bank to keep short interest rates low throughout the remainder of 2002. However, there are likely to be several hikes in the Fed Funds rate from 1.75% now to perhaps 2.5% by year-end.

The good news on the earnings front is that U.S. corporate earnings will improve significantly in the second half of the year. The Federal Reserve did an excellent job of cutting interest rates dramatically in a timely fashion, and it also provided ample liquidity for the markets. Increased government spending, lower taxes, and a decline in fuel prices all played a role in moderating the economic decline. Recently it has become clear that the recession in the U.S. was brief and shallow (if there was even one at all). The economy actually grew 1.7% in the 4th quarter of 2001, and it is likely that GDP growth in the first quarter of 2002 will be 4%+. Inventories have stopped declining, and industrial production is increasing. Unemployment appears to have peaked around 5.7%. All this means that year-over-year corporate earnings should show major improvement in the 3rd and 4th quarters of 2002. Estimated 2003 operating earnings for the S&P 500 Index are $50-$55. This will bring earnings back to their 1999-2000 peak. The big question, then, is valuation. What multiple will investors pay for these earnings?

Market Valuation and Investor Sentiment

In our last quarterly market commentary, we suggested that it was time to go fishing. We think that there may still be time for a few last casts. The S&P 500 Index is currently at 1102, which places a Price/Earnings ratio of 22 on estimated 2003 earnings of $50. This puts the stock market's valuation at the high end historically. It means that investors cannot count on an expansion of the market multiple (even with inflation at historic lows). Thus returns will be limited to the growth in corporate earnings which, for the S&P 500, have averaged 7-8% annually. While investors expect earnings to accelerate as the economy recovers, the possibility of an Arab-Israeli war in the Middle East, the chance of renewed terrorist attacks on the U.S., and the impending conflict with Iraq have put a damper on investor enthusiasm for the market. Moreover, investors have awarded rich valuations to the highest quality companies, and the market has slowly been bringing the mighty down to earth – first Microsoft, then IBM, then GE, etc. With a backdrop of the Enron/Arthur Andersen debacle and worries about accounting, investors are seeking safety in small and medium sized companies with modest P/Es, good immediate prospects, and strong balance sheets - sectors such as S&Ls, apparel, restaurants, homebuilders, HMOs, and early cyclical companies. While sector rotation may elevate the stocks of these companies for a season, we do not believe that many of these will ultimately be the leaders in a new bull market. We also think that the technology sector needs more time to heal. As the expression goes, "Time heals all wounds". Or as some wags have put it, "Time wounds all heels". Our philosophy is to counsel patience and the wisdom to avoid stocks which turn out to be "heels". We intend to stick to our game plan – investing in high quality companies with leading market share, consistent revenue and earnings growth, and strong balance sheets. In time, these companies will lead the market higher. They always do.

April, 2002