Waiting for Godot

> What are we doing here, *that* is the question. And we are blessed in this, that we happen to know the answer. Yes, in this immense confusion one thing alone is clear. We are waiting for Godot to come.
>
> *Waiting for Godot*, Samuel Beckett, 1953

This year, patience has been the most important character trait for investors in the U.S. stock market. Few investors have made any money since the stock market peaked in the first quarter of 2000 – sixteen months ago. In fact, the losses during this bear market have largely wiped out stock market gains going back as far as late 1998. Thus, it has been almost three years of flat or negative returns for most long-term investors in U.S. stocks. For the first six months of 2001, the S&P 500 Index dropped 6.71%, and the tech-laden NASDAQ Composite fell 12.55%. From its peak in the first quarter, 2000 to the bottom in March, 2001, the S&P 500 Index declined 31%, while the NASDAQ Composite tumbled an incredible 68.4% during the same period.

Investors became hopeful that the stock market would turn around soon after the Federal Reserve announced the first in a series of interest rate cuts on January 3, 2001. The stock market rallied 7%+ within several weeks. Since then, however, despite six interest rate cuts by the Federal Reserve Bank and a tax cut, the stock market is lower than it was when the Federal Reserve started its rate cuts in January. As the year has progressed, the market has become more and more frustrating to investors who have become conditioned over the past decades to expect a rally within three to six months of the Federal Reserve's first rate cut. The question, then, on most investors' minds is: When is the stock market going to turn around? Or, perhaps this time, is the rally not going to come at all?

This endless waiting reminded us of the existential play, *Waiting for Godot*. During the late 1940's and the decade of the 1950's, the philosophy which prevailed in most Western universities and colleges was existentialism. Existentialism was a logical consequence of Nietzche's thought, and it was all the more appealing to many in light of the enormous carnage in World War II and the advent of militant Communism on nearly every continent in the post World War II era. Existentialism's central tenet is that life, which is the result of an accident (perhaps the Big Bang) and subsequent evolution, is absurd and has no meaning. The existentialist's dilemma is best defined by the French philosopher Albert Camus, who wrote that the major decision in life is whether to commit suicide immediately or wait for one's inevitable meaningless death.

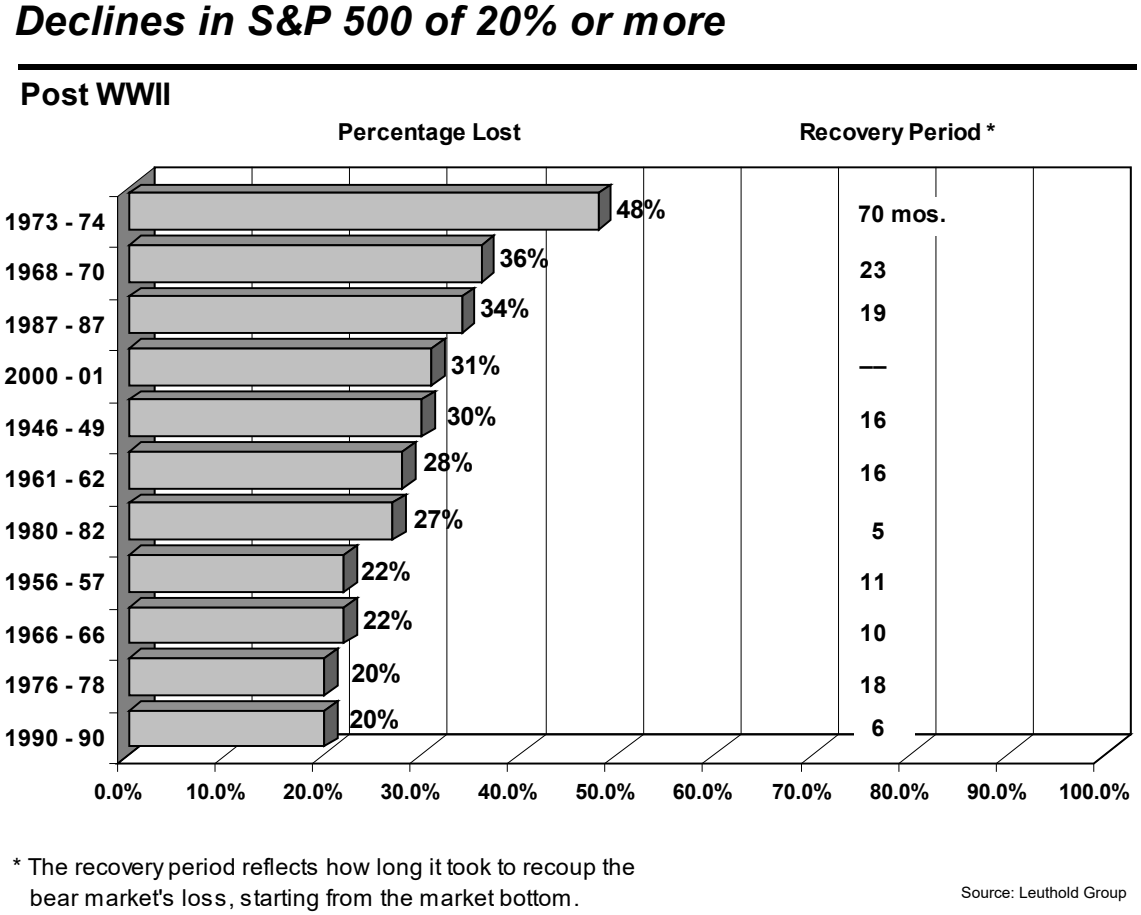
In 1953, Samuel Beckett, the Irish expatriate writer and playwright, wrote *Waiting for Godot*, which brilliantly illustrated existentialism and its philosophy of despair. In the play, the protagonists, Vladimir and Estragon, meet in a bleak country setting and talk. It

soon becomes clear that their lives have no purpose or meaning – except for the meeting which they are soon to have with Godot. They talk and talk and wait for Godot, who will finally provide their lives with some meaning. Godot, of course, never comes. The play ends with Vladimir and Estragon trying to find some rope strong enough with which to hang themselves from the nearest tree.

Are we, like the characters in *Waiting for Godot*, waiting for a stock market rally that will never come? If not, where is the rally? Why is it taking so long, and when will it come? At Bradley, Foster & Sargent, Inc., we believe that the rally will come and that it would be a bad (and unfortunate) decision for investors to lose patience and pull out of the stock market (or to start looking for the rope and the tree).

Bear Market

Over the past year and a half, investors in the U.S. stock market have lived through the fourth worst bear market since World War II. Some analysts believe that the bottom of this bear market was in early April, while others believe that it may be necessary for the stock market to retest these lows during the next six months. In either case, the chart below shows the eleven declines of 20% or more in the S&P 500 Index since the end of World War II:



* The recovery period reflects how long it took to recoup the bear market's loss, starting from the market bottom.

Source: Leuthold Group

Thus far, the worst bear market since WW II was the 48% drop in the S&P 500 between January 1, 1973 and December, 1974. In that period, the stock market had to deal with the first OPEC shock, near double digit inflation, recession, the aftermath of Vietnam, Watergate, and the resignation of President Nixon. It took almost six years to recoup the bear market losses. Over the past eighteen months, the stock market has had to cope with the following:

- Spectacular overvaluation of some sectors in the U.S. stock market;
- Speculative excesses, day trading and other kinds of gambling;
- Excess manufacturing capacity in various technology sectors caused by the Y2K phenomenon and the belief that rapid growth rates had become perpetual;
- The Internet and "New Era" thinking, which caused hundreds of dot coms with unproven business plans to become funded, spend their millions or billions and then fail;
- Excess manufacturing capacity in the telecommunications sector caused by the vast overestimation of demand for bandwidth;
- A U.S. economic contraction which may become a recession as capital expenditures slow and exports decline;
- Simultaneous economic downturns in the U.S., Europe, and Asia.

The Next Bull Market

The above list is a litany of economic woes, but democratic capitalism does an amazing job of shutting down excess capacity, allocating resources, concentrating capital on those areas with the best returns, and allowing the underlying strength of the economy to re-emerge in a growth scenario. Furthermore, both the Federal Reserve and the Administration in Washington have been taking the vital steps necessary to curtail the economic downturn and resume growth. Since the turn of the year, the Federal Reserve has cut short-term interest rates six times, bringing the Fed Funds rate from 6.5% to 3.75% currently. The Fed stands ready to cut rates further this summer and autumn if necessary. Given the economic weakness that is now appearing in Europe and Japan as well as in emerging countries such as Argentina, it is possible that the Fed will cut rates several times more before this cycle is over. On the fiscal side, Congress passed a tax cut which achieved much of what President Bush sought, and the bill provided for tax rebates of up to $300 per person to be sent out in August and September. These funds should be

helpful in boosting consumer and investor confidence and may even give the economy a shot in the arm. However, the consumer actually seems to be in pretty good shape, evidenced by the robust housing and automobile markets and the modest level of non-performing loans in regional and small banks across the country. It is rather an industrial and capital expenditure recession, concentrated especially in technology, telecommunications and other types of manufacturing. Problems in these areas have caused estimated corporate earnings in the 2nd quarter of 2001 to drop 17-18% from the same quarter last year. The third quarter is also forecast to be a difficult one with earnings now estimated to fall 5-6%. By the fourth quarter, many analysts see positive corporate earnings on a year over year basis. With a decent recovery, corporate earnings for the S&P 500 Index in 2002 could reach $60 – an all time high.

Time in the Market, Not "Timing the Market"

As we have written before, we do not know when the market will turn around. We do not believe that anyone can "time the market" with any degree of consistency. By "timing the market", we mean determining in advance a market's top, selling stocks and waiting in cash until the market bottoms, recognizing the market's bottom, and then re-entering the stock market by purchasing stocks. On the other hand, we believe that purchasing quality, growth stocks at reasonable prices, monitoring them continuously to ensure that their fundamentals are intact, selling the ones that falter, and holding the good ones for the long term, will result in the accumulation of real wealth through the compounding of superior rates of return. Quality stocks in the U.S. stock market have produced an average annual rate of return of approximately 11% for the past 75 years. At this rate of return, an investor's principal doubles every 6.5 years.

While no one knows when another bull market will start, we do believe that the cumulative effect of six or more interest rate cuts, lower marginal tax rates, low inflation and ample liquidity will work their magic. If we had to guess when this might occur, we would guess sometime this fall after the majority of institutional and retail tax selling has concluded. Additionally we believe that the leaders in the new bull market may not initially be the same high technology winners that the market knows so well, but rather a new set of companies which evidence strong growth, high returns on equity and consistency of earnings.

In summary, we believe that patient investors, who resist the urge to throw in the towel and wait out the difficult market in cash reserves, will be rewarded when the market suddenly turns positive. Often stocks advance 15-20% from a bottom before there is evidence that the recession has ended. What that catalyst will be, we do not know. We do know, however, that unlike the existential characters who wait in vain for Godot, the bull market will come.

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July, 2001