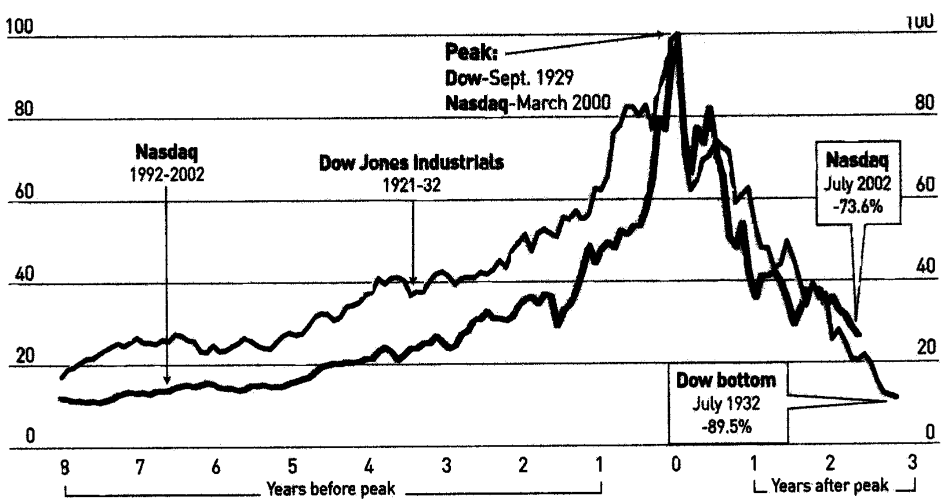
# No Place to Hide

> Walking through the New Orleans French Quarter the morning after Mardi Gras is never pretty: Men sleeping off the night before, lots of bottles and discarded masks, and here and there the police investigating a fresh felony. This is the equivalent of what we're watching now as the U.S. economy and culture recover from the late 1990s boom.
>
> *Wall Street Journal* editorial, June 27, 2002

The great stock market bubble peaked in March 2000. In a final climax run during the first quarter after the Millennium was celebrated, the NASDAQ climbed 25%, hitting 5,132 - up tenfold in ten years. Then the most ferocious bear market since the Great Depression (as the chart below demonstrates) began. The first stage of this bear market lasted about nine months - from March 2000 through the end of the year. Most of the big losses in this period were incurred by the speculative Internet companies with unprofitable business models and no earnings, while the Blue Chips held their own. CMGI, for one, had a market capitalization of $55 billion at its peak. During 2000, its stock price fell from $151 to $4 per share. It is trading now at 40 cents a share.

The next phase of the bear market took place during the first nine months of 2001, bottoming on September 21st. During this period, many leading companies suffered huge losses – especially the top notch technology leaders: Cisco, EMC, Sun, Intel, Lucent, etc. Their stock prices were down 75%+ during 2001, although during the 4th quarter of 2001, the market rebounded so that losses in the Standard & Poor 500 Index were contained at approximately 12% for 2001. In 2002, the bear market has brought down the bluest of blue chips. There has been *no place to hide*. The market has brought the mighty low: Microsoft, IBM, GE, Merck and Home Depot. All are down over 50% from their peak. Since March 31, 2002, the S&P 500 Index cratered another 26%. As of July 19, 2002, the S&P 500 Index was down 44.8% from its peak, while the NASDAQ has declined 74%. The chart below demonstrates the similarities between the NASDAQ in the last decade and the Dow Jones from 1922-1932:

**The Nasdaq has six months to go to equal the duration of the 1929-32 bear market. The two bubbles have traced remarkably similar paths**




Sources: Investor's Business Daily, CSI Inc., Dow Jones

## Major Differences between 2000-2002 and 1929-1932

The chart on the previous page demonstrates the similarity of stock market action during these two major stock market bubbles. However, it does not accurately portray the whole picture of the current bear market. The table below presents the extent of damage for all three major market indices:

| Index | Peak | Date | Low | Date | Percentage Decline |
|---|---|---|---|---|---|
| **NASDAQ** | **5,132** | **3/2000** | **1,310** | **7/19/02** | **-74.5%** |
| **S&P 500** | **1,553** | **3/2000** | **842** | **7/19/02** | **-45.8%** |
| **Dow Jones** | **11,750** | **3/2000** | **7,967** | **7/19/02** | **-32.2%** |

As the stock market currently stands, the broadest stock market index of quality stocks, the Standard & Poor 500 Index, is showing the second worst decline since the Great Depression. The only worst post World War II bear market decline was in 1973-1974 when the S&P 500 Index was down 48%. The current bear market has now been underway for 28 months; only the 1929-1932 bear market was longer, lasting 34 months.

Although the chart on the first page demonstrates that the decline of the NASDAQ over the past two years has been nearly as extreme as the Dow Jones in 1929-1932, *there is a world of difference between the real economic situation then and now.* During the 1929-1933 period, the Federal Reserve Bank and the federal government made several terrible mistakes in monetary and fiscal policy. Rather than expanding the money supply, cutting taxes and lowering trade tariffs, Washington did the opposite. Money supply actually contracted by a third during 1929-1933, leading to deflation. Congress passed the destructive Smoot Hawley tariffs which, together with similar legislation by our trading partners, caused a huge reduction in global trade. Finally the Roosevelt administration passed punitive income tax rates. GDP actually fell nearly a third during the Great Depression, and unemployment reached 25%. The economy here and abroad were in shambles, and there was little improvement throughout the 1930's.

## The Right Stuff: Monetary and Fiscal Policy in 2001-2002

On the other hand, the U.S. economy, after experiencing an economic downturn in 2000-2001 with one or two quarters where GDP fell modestly, has been on a steady recovery since the fourth quarter of 2001. GDP growth in the 1st quarter of 2002 was almost 5%, and moderate economic growth continued in the second quarter. The Federal Reserve, which had injected much liquidity into the monetary system in 1999-2000 to cope with fears of Y2K dislocations, withdrew the excess liquidity later in 2000 and 2001. As the stock market bubble burst and more stress was put on the economy, the Federal Reserve moved decisively, lowering interest rates eleven times to bring short-term interest rates to their lowest levels in 30 years. The Federal Reserve has also moved to expand the monetary base over the past several years. On the fiscal side, the Bush administration passed a tax cut to stimulate the economy, while the war on terrorism has caused the federal government to increase spending. These steps have brought the federal budget into deficit again. Fortuitously, Washington has provided exactly the right medicine to bring the economy out of recession, and it is working. An economic recovery is underway, as Chairman Greenspan recently confirmed. The unemployment rate appears to have peaked at about 5.8%-6.0%, and the various manufacturing indices are all showing increased output. Meanwhile, the consumer, encouraged by low interest rates, mortgage re-financings, and zero down payment automobile sales plans, has kept the economy from tanking. It has been corporate America, and especially the technology and telecommunication sectors, which have struggled. It is all too easy in hindsight to identify the massive overinvestment undertaken by the telecommunication companies, which loaded up on debt to meet the extensive demand that the Internet was meant to have unleashed. Naturally this led to the allocation of huge amounts of capital to equipment manufacturers for the semi-conductor, wireless phone, fiber optic, and countless other technology manufacturers. This overcapacity, so easy to identify now, was not so apparent several years ago. It is clear now that several years of downsizing, consolidation and even bankruptcies were needed to right size these industries. While this process of "creative destruction", as Schumpeter called it, is well underway, more time is required before leading companies in the technology sector can once again earn a satisfactory return on their capital. It is also clear in retrospect that it is possible to invent a marvelous new technology – such as the radio in the 1920's or the Internet in the 1990's– which millions of people can use to good advantage - but very difficult for companies involved in the development to earn an adequate return on capital.

## Why the Savage Market Downturn since April 2002?

It appears to us at Bradley, Foster & Sargent, Inc. that there are four main reasons for the painful sell-off over the past three months: previous overvaluation, loss of investor trust and confidence, doubts about the economic recovery, and terrorism/Middle East conflict.

**Overvaluation:** As the quote from the *Wall Street Journal* editorial on the first page suggested, it was quite a boom in the latter half of the 1990's. And almost everybody had a good time – investors, analysts, fund managers, Internet startups, technology companies, utilities companies, and even accounting companies. At the end of it, there was significant overvaluation in the stock market influenced by "New Era" thinking. By early 2000, the S&P 500 Index was valued at 26-28 times forward estimated operating earnings. The stock market party ended in March 2000, and we have been dealing with the terrible hangover ever since. All this seems so easy to see with 20-20 hindsight.

**Investor Confidence:** The collapse of several major companies, the spectacle of their CEOs and senior management enriching themselves and violating their responsibilities to investors and employees, the collusion of an accounting firm, SEC investigations, lawsuits, regulatory disarray, accounting conundrums, and finally and most importantly declining earnings and stock market prices have severely damaged investor confidence in corporate America and Wall Street. It will take at least three things to restore confidence: the investing public's realization that most companies have not broken the law or acted unethically; accurate accounting and a resumption of growth in earnings and cash flow; and time. We doubt that the media fanning the flames will help the situation nor do we believe that it will be useful for Washington to get more deeply involved in regulating business. Measures to oversee accounting accuracy and sending those who have broken the law to jail should help restore investor trust.

**Doubts about the Economic Recovery:** The continued subdued corporate spending, the time needed to repair the balance sheets of much of corporate America, and the apparent weakness of much of the technology sector has cast doubts about the economic recovery. However there are many positive signs including the continued strength of the consumer, the low unemployment rate, the weakening dollar (which will help U.S. corporate earnings), low inflation, and the trends in the manufacturing sector. Nonetheless, it may take more time before corporate CEOs begin to invest robustly, and investors will probably want to see the evidence of recovery after the many disappointments of the past several years before recommitting capital to stocks.

**Terrorism/Middle East Conflict:** The international situation can cause doubt about investing for the long-term. During the last 10 months, terrorists have attacked the U.S., and the U.S. has responded boldly with a global war on terrorism; the Israeli/Palestine situation has broken into savage warfare, and India and Pakistan (both nuclear powers) have come close to a shooting war. This instability, the falling dollar, as well as some of the above factors, have caused foreign investors to moderate their flow of funds into the U.S. stock market. Is America still a good place to invest in? We believe that it is still the best market in the world for investors (see accompanying article by Paul Johnson).

## What to Do Now?

Many investors have never been through an emotionally wrenching, multi-year bear market. (1987 doesn't count, because the stock market was up 35% for the year going into the October 1987 crash, and the downturn only lasted several months. The S&P 500 Index in 1987 was up 2% for the year.) The last crushing bear market was in 1973-1974. The first thing to realize is that this bear market will finally end, too. Perhaps with a final burst of selling that will exhaust sellers. It could happen this month, or it may take the rest of the year. With the economy improving, *we do not believe that the current disconnect between a bad stock market and an improving economy can last much longer.* However, as the stock market became so overvalued in 1999-2000, the stock market may need to descend to a level of real undervaluation before buyers are tempted to step in and risk new capital. As it is impossible to predict the final bottom, it is important for investors who need to live on the income from their portfolio to protect and preserve their capital. Diversification into bonds and cash reserves is vital for those who have a short-term horizon for their funds or are dependent on income from their portfolio. This is a good time to review your asset allocation with your portfolio manager. This is also the time to upgrade the quality of a portfolio, swapping weaker companies for stronger, as a bear market brings down the good with the bad. Finally this is the time where we hope to be spotting the future market leaders, as the leaders in a new bull market are rarely the same leaders as the last bull market. For those who have invested in stocks for the long haul because of their superior long-term returns, don't get scared out at the bottom. As Louis Rukeyser wrote in his last newsletter, "Scared money is usually dumb money". Take the advice of investor manager Wally Weitz: "Know yourself well enough to know that if the market does get worse before it gets better, you won't sell out at the bottom".