Things Fall Apart

Things fall apart; the center cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned;
The best lack all conviction, while the worst
Are full of passionate intensity.

The Second Coming, William Butler Yeats, 1919

Yeats' *The Second Coming* – perhaps one of the most oft quoted poems of the 20th century – was written several years after the start of the Bolshevik revolution in Russia. The poem expressed his sense of the dissolution of the civilization of his time, the end of one cycle of history, and the approach of another. There were, of course, many revolutions during the 20th century – political, economic, sexual, scientific, etc. - which is surely one of the reasons that Yeats' poem is so well known. In the midst of some of these revolutions, it was not at all clear that the forces which hold civilization together would prevail over the forces threatening its demise. One example of this was Winston Churchill, leading a weakened and isolated Great Britain against Hitler and his Nazi horde who had conquered Europe, North Africa and a large part of Russia. A second was the United States leading a broad coalition of nations in the Cold War against the rising and implacable tide of Communism, led by Stalin and Mao, who had conquered much of Europe and Asia, and threatened to "bury" the West.

Now again the U.S. and indeed all of Western civilization is faced with an evil and implacable foe – radical, militant Islam. The attacks on the World Trade Center and the Pentagon on September 11th, as well as the more recent use of anthrax as a weapon of bio-terrorism, brings us back from our decade long slumber to the realization that there is evil in the world and people who wish for nothing more than to do the U.S. and its allies great harm. Eric Ormsby, professor of Islamic Studies at McGill University, in a recent article in the *Wall Street Journal,* wrote about General Khalid ibn al-Walid, a Muslim convert who led the assault on the Persian Empire. In 633 A.D., a year after the Prophet's death, General al-Walid wrote a letter to the Persian Emperor, which contained the following: "Submit to our authority and we shall leave you and your land and go against others. If not, you will be conquered against your will by men who love death as you love life". Twenty years later, the Emperor, who had probably laughed at the letter from the upstart general, was driven from his throne, hunted down and butchered.

Earlier this month, one of bin Laden's spokesmen made a similar threat to the West and Americans in particular. He claimed that there are "thousands of young men" eager to become martyrs, who "love death as you love life." If nothing, these words, and the events of September 11th, remind us that the world has always been a dangerous place – something which, for a season, we seemed to have forgotten. Around the world, there are many who are working passionately for our humiliation and ultimately our downfall. Much ink has been spilled about how the world was changed forever on September 11th, but perhaps the attacks were rather a tragic reminder of the need for us to uphold the forces of composition which sustain America and Western civilization and work together against those forces of decomposition – whether they be anarchy, communism, or militant Islam –

which seek to destroy it. Certainly the nation is more unified and purposeful than it has been in many decades, and our actions seem to contradict Yeats' words, for *the Center* will hold once again. Indeed the actions of passengers on one flight and hundreds of firemen, policemen, and security workers at the World Trade Center, who gave their lives to save others, demonstrate that Americans "who love life" still have the courage, resolution and stamina to prevail in this war.

2000-2001: The Second Worst Bear Market Since World War II

The events of September 11th caused the Dow Jones to fall 14.3% during the week when the market re-opened - its worst week since 1933. The stock market's sell off pushed it into the second worst bear market since World War II. If one looks at the cumulative market decline from the peak in March, 2000 to the intra-day lows at the recent bottom on September 21, 2001, the financial damage is extensive:

Index	Peak	Date	Low	Date	Percentage Decline
NASDAQ	5,132	3/2000	1,387	9/21/01	-73.0%
S&P 500	1,553	3/2000	945	9/21/01	-39.1%
Dow Jones	11,750	1/2000	8,062	9/21/01	-31.4%

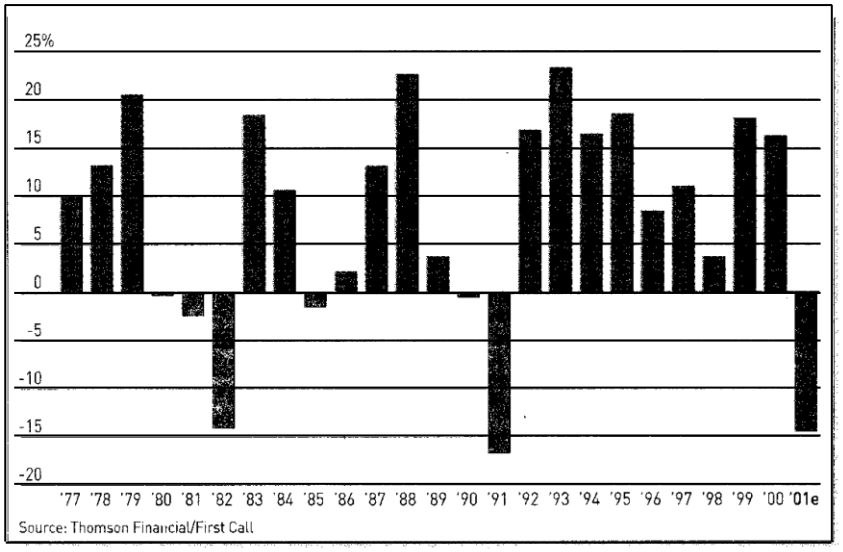
To illustrate the severity of loss on the NASDAQ, $4.5 trillion in market value of stocks traded on the NASDAQ has been erased during the last 18 months. Currently one out of every eight stocks on the NASDAQ trades at less than $1, and nearly two out of every three trade below $10 per share. This kind of pain normally produces emotional scars, which affect the manner in which investors trade for the rest of their lives.

Fortunately, the broader indices, the S&P 500 Index and the Dow Jones, experienced declines which, while severe, were significantly less than the NASDAQ. Moreover, the 13-14% rebound in the stock market indices since September 21st has lessened, for the moment, the extent of the damage. Still, as of October 20, 2001, the S&P 500 Index is down about 30% from its peak in March, 2000.

September 11th's Effect on the Economy

While economists have not officially declared that the U.S. is currently in a recession, it is clear to us at Bradley, Foster & Sargent, Inc. that we are. The manufacturing sector of the economy has been in a recession for almost a year, while the consumer and the service sector of the economy entered a recession with the attacks of September 11th. Weakness is spread across most sectors of the economy with technology, telecommunications, transportation and the leisure industries hit the worst. Consumer spending, which had held up well until the attacks, stopped cold after September 11th. Excluding vehicles, retail sales fell 1.6%, the largest decline in 25 years. This was due in part to the fact that most people were glued to their TVs for several weeks following the attacks. The chart on the following page shows the record of earnings growth over the past several decades with negative earnings appearing usually only once a decade. This is the first recession since 1991. Earnings for the S&P 500 are forecast to shrink 14.5% this year.

S & P 500 Earnings Fall into the Abyss



Is the Bear Market Finally Over?

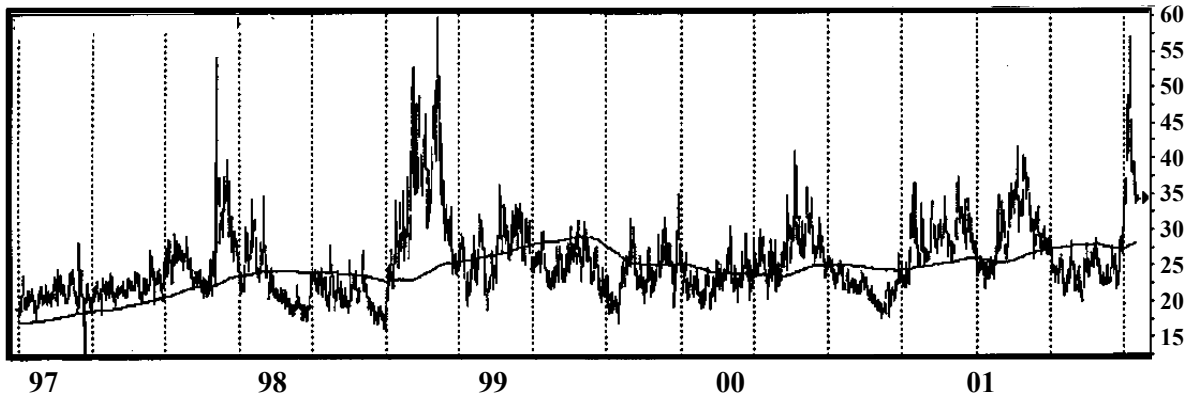
With corporate earnings in the tank, unemployment claims on the rise, daily anthrax reports, and consumer and investor confidence weak, it seems premature to write about the start of a new bull market. Yet the stock market tends to look six to nine months ahead, and new bull markets often start in the midst of recessions. Investors hate uncertainty and often sell stocks in the face of the unknown. However, once a given situation is known and the bad news is recognized and understood, the stock market usually rises – as long as the news at the margin improves. As an example, the stock market sold off 14% or more during the week following the events of September 11th as investors adjusted to the fact that the economy would experience a recession of at least six months and have to fight a war against terrorism. However, once investors' expectations had become acclimated to new circumstances and expectations, the stock market recovered almost all the ground lost since September 11th. In similar fashion, investors know that since World War II, it has been just a matter of time until the economy and the stock market have responded to monetary and fiscal stimulus. The following positive steps have been taken over the past year to turn the economy around:

- Nine interest rate cuts bringing the Fed Funds rate to 2.5%. Most commentators forecast one or two more ¼% rate cuts before year-end. These are the lowest short-term interest rates in 30 years.
- Strong monetary growth and liquidity injected into the monetary system by the Federal Reserve System over the last year and especially since 9/11.
- Fiscal stimulus in the form of a tax cut enacted in 2001 and the likelihood of an additional tax cut, including a modest capital gains tax cut, before year-end.
- Increased government spending in the form of additional outlays on defense, relief for New York, and assistance to the airline and insurance industries. It is likely that the Federal budget surplus will disappear or that a deficit will occur next year. A recession is the right time for deficit spending.

The Wall of Worry

When investors are too complacent, the stock market often languishes. When investors panic and fear is rampant, the stock market usually bottoms. The chart below demonstrates how investor pessimism and pure panic often coincide with a market bottom. The VIX indicator is a measure of the volatility tracked on the Chicago options exchange. In 1997, 1998 and hopefully 2001, a VIX reading of over 50 (which signifies a high degree of investor fear) has signified a stock market bottom:

VIX Indicator



The chances are good, we believe, that the VIX indicator signified the market bottom and the stock market is sensing that the recession will end in early or mid 2002, which will cause corporate earnings to rebound significantly next year. It will not be quick or easy, we suspect. There will be some churning and some setbacks, especially if there are other significant terrorist events in this country. But now everyone knows that America is at war. Even the anthrax mailings this week didn't cause a big market sell-off. An old market adage is that the stock market needs to climb "a wall of worry", and there will be plenty of things for the market to worry about as it climbs this wall of worry. Some market observers fret that that the stock market's valuation is still too high at its current level. They argue that the stock market's P/E of 22 on 2002 earnings is about one third higher than the historical average. This is true, but it ignores the fact that valuations deserve to be higher with inflation and interest rates at such low levels. While certain sectors of the market are fully valued, we do not see broad overvaluation, and there are for the first time in many years some real bargains. While it is entirely possible that the stock market re-tests its September 21st lows, the chances are good, we believe, that a new bull market will commence in the months to come. Established, quality growth stocks will lead the market higher– the type of stocks that our firm favors.

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