

January 12, 2001

## Temporary Slowdown, Rebound Coming

*The following are excerpts from an Investment Policy meeting at Donaldson Capital Management. The discussions are far-ranging and may answer many of the questions you have regarding the stock and bond markets and our strategies for the coming year.*

**Mike:** Greg, there are many analysts who are saying that the big sell-off in stocks during the latter part of 2000 is signaling the arrival of a recession. What is your view of that argument?

**Greg:** I don't buy it for two reasons: (1) The Federal Reserve has started to cut interest rates, which will stimulate demand, and (2) The unemployment rate is still low. The recessions of the past thirty years have occurred when demand for goods and services fell off the table as a result of high and rising unemployment that produced a kind of self-fulfilling prophecy. Consumers pulled in their spending for fear of losing their jobs; businesses curtailed hiring and building inventory because of the slump in demand for their products. Taken together, these changes in individual and corporate behavior created temporary imbalances between supply and demand. When supply overwhelms demand, prices fall until supply and demand are back in equilibrium. A recession occurs when this imbalance between supply and demand produces a contraction in the economy that lasts for six months or more.

**Mike:** With the unemployment rates still near 30-year lows, it is hard to believe that consumption patterns will change dramatically. Consumers are not going to radically change their spending patterns as long as they have jobs. It is also difficult to believe that employment is going to fall precipitously when corporations have had such a difficult time finding employees over the past two years. In my mind, they will think long and hard before they resort to big layoffs.

**Greg:** But, as you mentioned earlier, the stock market is swooning and the Christmas shopping season appears to have been disappointing. Can we conclude then, that corporate profits will be soft throughout 2001? I'm saying that because it would seem to follow, if demand for goods and services is softening and corporations are reluctant to reduce their workforces, that something has to give, and that something would have to be profits.

## Temporary Slowdown

**Mike:** It certainly looks like profits will slow for the fourth quarter of 2000, but I'm not so sure we should project the fourth quarter of 2000 very far into the future. In my mind, there were at least three major impediments to the normal shopping season that contributed to the weak Holiday sales, which are so important to fourth quarter economic growth. (1) The Presidential race that was supposed to end on November 7 was not settled until 37 days later on December 14. Watching that spectacle couldn't have put very many people in the Holiday spirit. (2) The big snowstorm that swept through the Midwest and East the week before Christmas practically shut down many cities. And, (3) the unrelenting sell off in tech stocks throughout the Holiday season was a constant reminder that we should shorten our Christmas lists.

**Greg:** So you are saying that the current economic slow down is just temporary?

**Mike:** That's right. But let me add, that I don't think it will just, presto, snap back in the new year. The weak stock market will see to that.

**Greg:** Are you speaking of the wealth effect?

**Mike:** You and I believe that the primary wealth effect is full employment, but in this case the sharp and extensive fall in technology stocks during 2000, particularly near the end of the year, had to have had a negative effect psychologically and economically on most consumers. It was the tech stocks that got people's blood boiling in 1998 and 1999. Their demise in late 2000 had to have negatively impacted Christmas sales, as well as all other consumer products sales in the fourth quarter.

### The Effects of the Tech Sell Off

**Greg:** Isn't it just wishful thinking to believe that consumers will shake off their losses so easily in 2001 and pick up their spending right away? Actual money was lost, wasn't it?

**Mike:** Money was, indeed, lost, but I don't think most people have abandoned their tech stocks completely. It is obvious that many people made tax-related tech stock sales at the end of the year, but they undoubtedly kept some stocks and bought others that appeared to be undervalued. Net, net I would say individual investors have about the same percentage of tech stocks now as they did before they initiated their tax selling.

**Greg:** Well, if we assume that most people still have a fair number of tech stocks and if tech stocks stage a comeback, the negative effects on consumer psychology of the big sell off in the fourth quarter would be tempered. Is that what you are suggesting?

**Mike:** Yes, I am. We have been calling for an unwinding of the tech mania of 1999 for the last twelve months. That has now come to pass, but technology is not dead. The industry will continue to grow at a very rapid rate, and the strong companies will get stronger. The big tech leaders will continue to grow approximately twice as fast as the average company in the S&P 500. That kind of earnings growth will attract investment dollars as soon as it appears the unwinding of the mania has completed.

**Greg:** Speaking of big tech leaders, if you have so much faith in them, why do you think they were hit so hard? They have been unwound right along with the concept stocks and the dotcoms.

**Mike:** We did not think the big Techs would be immune from the unwinding, but we thought their high earnings growth would bail them out of any serious price erosion. The odd thing is that the majority of our tech holdings, by

any definition, had great business years, but without exception, they came under intense selling pressure in the last quarter of the year. That tells me that most of them were just swept up in the emotion of the time.

**Greg:** That sounds like you are using the wonderful cliché—"They threw the baby out with the bath water."

**Mike:** I believe when we look back in a year or so, we will clearly see that the massacre of the leading companies was probably as much as anything a result of tax loss selling by the mutual funds. Let me give you one example. Cisco is down 57% from its high in 2000, yet Cisco had earnings growth of 52% last year. They exceeded earnings expectations all four quarters, and Wall Street earnings growth projections for the next few years actually rose during the year. The market was obviously not looking at the fundamentals of the company. So what was it looking at? The only thing one can determine is that Cisco is a technology stock, and all tech stocks were falling, so Cisco had to fall.

**Greg:** In some ways, looking back at the severe correction in the tech stocks and its affect on investors' net worth, it appears that some of the catastrophic effects that some feared from Y2K at the beginning of 2000 actually occurred at the end of the year. Hundreds of dotcom companies have ceased operations and untold billions in market capitalization have been lost in tech related stocks. I have even wondered, if perhaps, Al Gore's defeat may have been related to the tech wreck. It is just odd that in the early part of his campaign he claimed to have originated the concept of the Internet, but that was when Internet stocks were flying high. If you were to chart his fall in the polls, I bet it closely mirrors the fall in the tech stocks. I know this is not a case of "It's the Internet, stupid," but I'll always wonder if it did not have some marginal effect.

**Mike:** Well if it had an effect on 500 odd voters in Florida, it made the deal.

**Greg:** So you are saying that many of the major tech stocks are bargains and will rebound in 2001?

**Mike:** Yes, I am, but their road back to higher prices will be much more gradual than their fall in the final months of the year.

### **If the Hat Fits**

**Greg:** Obviously, the tech stocks will play a big role in our growth portfolios in 2001. What other industries look good to you.

**Mike:** As it becomes more clear that the US economy will not be falling into a recession, the financial services, housing related, and consumer cyclical sectors should move to the front.

**Greg:** I agree that many of the conservatively managed regional banks such as Mellon Bank, Wells Fargo, and Fleet Boston should be big winners. They have lagged the market for the past three years and are due for a move. The environment we envision would also favor companies in the asset management and specialty finance businesses. But banks and the other industries do very poorly during a recession. Is there anything else that we can hang our hat on other than falling interest rates and continued high employment that would argue against the economy sliding into recession?

**Mike:** Yes and the head under that hat is named Alan.

**Greg:** As in Greenspan?

**Mike:** Yes, because Mr. Greenspan has jawboning power as well as monetary policy power. As long as the economy does not suffer some unexpected credit crisis, the odds of a recession forming seem remote. He has both the power to stimulate the economy by lowering interest rates, and just as importantly, he has the influence to convince the American people of the soundness of the economy.

**Greg:** Mr. Greenspan holds a remarkable position in the US economy. No matter what the smart guys on Wall Street think, he has earned the trust of the American people. People believe in him. Thus, indeed, through his actions and speeches he has the power to keep consumer confidence from collapsing, which is usually the catalyst for a recession. The only problem is, he has to correctly judge the forces at work in the economy. Jawboning only works to a point. Interest rates still run the economy. He must walk an incredibly narrow path between moving too fast and rekindling inflationary pressures and moving too slowly and inviting a recession to take hold.

**Mike:** I think you and I are both happy that he is making those decisions and we aren't.

### **Selected Industries and Stocks**

**Greg:** Let's get back to the areas you mentioned earlier that appear to have good profit potential in the coming year. I agree that the regional banks should have a good year. They are direct beneficiaries of the rate cuts by the Federal Reserve. I'm assuming that you are bullish on the asset managers because you expect the overall stock market to rise in the coming year, which would be good for the mutual funds and other investment firms. Finally, you mentioned the consumer cyclicals. That is a big sector of the economy. Could you be more specific?

**Mike:** I'm really thinking here specifically of two companies -- Home Depot and Walmart. They were both sold off in 2000 as worries surfaced about the slowing economies, but they are both very dominant in their industries and are adding new stores domestically and internationally, as well as taking market share from their competitors. We think the stocks have bottomed and are ready to move higher.

**Greg:** Two other industry sectors we like are the consumer staples and the health-care stocks. These groups had a reasonably good year in 2000, particularly in the second half of the year as the economy started to slow. These are steady growers and are not greatly affected by the ups and the downs of the economy or interest rates. Many analysts are downgrading these sectors for 2001 in favor of the more economically sensitive cyclical stocks. We see things unfolding a little differently. The falling interest rates in the coming year will likely lift the cyclical stocks in the early part of the year, but we believe earnings worries will surface from time to time during the year and the steady growing companies will add valuable capital growth and stability to our portfolios. We particularly like Sysco, the food distributing company, CVS, the retail drug store, and Pfizer, the pharmaceutical company. All of these companies should have earnings growth of over 15% in the coming year

## **Our Overall View of the Economy and the Markets**

### **Economy and Interest Rates**

We do not believe the economy will fall into a recession in the coming year. On the contrary, we believe the economy will surprise Wall Street to the upside. We expect the Federal Reserve to cut short-term interest rates by at least another 1% in the coming months, which will ensure continued growth in the economy of near 3% for the full year. We see intermediate and long-term interest rates, including mortgage rates, gradually falling over the next several quarters.

### **Stocks**

It has been almost 30 years since the stock market was down two years in a row, and we do not believe that will be changing. Stocks should have a good year in 2001, producing a return between 10% and 15%, which is slightly higher than their long-term average return of 11%.

We believe big technology stocks will lead the way, along with financials, consumer cyclicals, consumer staples, and health-care stocks. We also plan to continue to hold energy stocks in most portfolios. They provide good

insurance against the increasing OPEC supply machinations. These stocks are again not highly rated on Wall Street, but we think in view of current uncertainties it is prudent to hold them.

## **General Comments**

The preceding discussion reveals a bullish scenario for the economy and the stock and bond markets. It is reasonable to ask what events or situations could change our bullish outlook.

We believe there are four:

Risk 1: Sharp stock market recovery -- If investors become too bullish and push Techs and the overall market dramatically higher in the very near future, the Fed may decide that the "wealth effect" is alive, and well and no further decreases in interest rates are necessary.

Risk 2: Political Stalemate -- The House and Senate are very evenly divided between Democrats and Republicans, and many pundits are predicting a stalemate. We disagree. The current elected officials in Washington will be under enough pressures from their constituencies that they will find a common ground. We predict, indeed, that a coalition of moderates from both sides of the aisle will form and begin to govern like grown-ups. Look closely because it may not last long, but we believe it will come to life for long enough to deal with the tough issues of social security and tax relief.

Risk 3: Disruption in the supply of oil -- OPEC has been decidedly more aggressive in the past year. If the more radical members of the group attempt to push oil prices above \$35 p/bbl, we believe that the same cast of characters that solved the last Persian Gulf crisis will again make their voices heard loud and clear. And the good news is many are members of President Bush's new cabinet. We believe the actions of General Colin Powell and Vice-President Dick Cheney in the previous conflict may still be remembered in the area.

Risk 4: Sharp reduction in the value of the dollar -- Foreign investors have pumped hundreds of billions into stocks and bonds denominated in US dollars. They have been rewarded in two ways. US stocks have appreciated over the past few years. In addition, the value of the US dollar has appreciated against almost all other major world currencies. Because of this, if the US stock markets were to continue to languish, foreign investors may decide to repatriate some of their holdings. Evidence of this action would show up as weakening in the US dollar and corresponding strengthening in the Japanese yen and the Euro. For this reason, we will be keeping a very close eye on the currency markets in the year ahead.

We thank you for your continuing trust. It is our prayer that the coming year brings you peace and health in your prosperity.

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