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False Bear

Although history will record the painful sell-off in stocks we have just experienced as an official bear market, we believe it was a false bear. There is a time-honored bit of wisdom that says, "The market is always right." This implies that if the Dow Jones has sold off 20% from its high, it is defined as a bear market and there is nothing else that need be said. In the vast majority of the cases we would agree, but not in the case of the bear market of 2000-2001. There has certainly been a bona fide bear market in Tech stocks, but we believe at least half of the 20% sell-off in the DJIA has been caused by a panicky jump to a faulty conclusion by unseasoned money managers and novice investors, who have never been through a prolonged down market.

This jump to a faulty conclusion has cost all of us in the short run because, as we write this letter, stocks indeed, are much lower than they were a year ago. However, the fundamentals of the economy do not support the selling storm that we have just witnessed, and we believe the damage will be repaired in the coming months. Furthermore, we predict in the not too distant future many investors who recently have been big sellers of stocks will be buying back the same stocks they sold — at higher prices. In the 25 years we have been studying the stock markets, the recent sell-off, in our opinion, ranks as one of the worst misfires in terms of investment judgement we have seen.

Faulty Logic

Let us explain the faulty logic that has caused the markets to come apart in recent weeks. The dotcom companies represented about 10-15% of the sales of most of the major Technology companies, such as Cisco, Sun Microsystems, and Oracle. We remember reading quotes by the CEOs of Cisco and Sun Microsystems in mid-summer saying that the demise of the dotcoms would not severely damage their earnings. First, the dotcoms were a minor part of their business and second, if these major Techs lost some of their business, they could simply fill the orders from their "old economy" customers more expeditiously.

Most of the major Tech firms had big backlogs as late as the beginning of the fourth quarter, so the notion that the fall of the dotcoms would devastate the major Tech companies' earnings did not make much sense. Indeed, at the beginning of January, Oracle CEO Larry Ellison was quoted as saying orders were still strong and he looked for the firm's business in 2001 to improve as the year progressed. At the end of January, he pulled back his positive, forward view and announced that many of the orders had been canceled. By January 2001, the dotcoms had long been among the walking dead and certainly did not represent many of the orders in Mr. Ellison's backlog, so the canceled orders must have come from the old economy companies. But why would they cancel orders en masse? The first of two reasons is obvious; the second falls into the category of unintended consequences:

1. As a result of the economic slow down engineered by the Federal Reserve, most old economy businesses were facing some slowing in sales and profit margins, so expense control became a priority.

2. Many corporations suddenly realized that they need not be so aggressive in their rush to enter the new economy because their dotcom competitors, with whom they had been engaged in a game of economic "chicken," had been reduced to a pile of feathers on the road.

This second revelation must have made the otherwise troubling slow down in the old economy firms' business seem almost tolerable. A real life example of this is the case of Toys R Us and eToys. The week that eToys shut down, Toys R Us stock soared 35%.

The Multiplier Effect

Suddenly, the heretofore "full speed ahead" Technology capital budgets were now seen by many CEOs as a place to cut expenses. In this way, a multiplier effect was created by the fall of the dotcom companies. They represented 10-15% of the major Tech companies' business, but when they went down, they took as much as 20-30% of the business with them because old economy companies canceled orders for new Technology projects.

As the rapidly slowing Tech sales and the emerging new competitive landscape came into sharper focus, almost all Tech stocks collapsed. It was now obvious to everyone that the demise of the dotcoms had impacted the whole Technology industry much more than the amount of their direct business. But, an even bigger problem for the big Tech companies was becoming apparent: their future earnings growth had become murky, at best.

A Leap into the Darkness

As more and more big Tech companies warned of earnings shortfalls, many investors jumped to a series of false conclusions. <u>The first was that big Tech companies would be permanently injured by the collapse of the dotcoms and the pullback in capital spending by the old economy companies.</u> Most of the dominant big Tech companies had enjoyed solid sales and earnings growth for at least a decade prior to the advent of the dotcom mania. Now, incredulously, Cisco, Sun Microsystems, Oracle, Intel, Microsoft and other companies were seen as nothing more than mega-dotcoms who were doomed along with eToys.

<u>At this point many investors made a second, and even more dangerous, leap into the darkness. If the collapse of the dotcoms, which represented 10-15% of big Tech's business, could imperil the entire Technology industry, then the fall of the Technology industry, which represented about 10-15% of the overall economy, could imperil the whole US economy.</u> It appears many investors arrived at this conclusion in mid to late March with the result being the unrelenting pounding that stocks took during that time.

The dynamics we have described here brought 2001's first quarter to an ugly end. But, to fully understand where we go from here, we must look back to why business for the old economy companies slowed, which ultimately resulted in the slashing of their expenditures for Technology. It is our belief that if the old economy businesses had remained strong, we would be writing an entirely different letter today. It is clear that Technology is a very important part of the US economy. Without it, our economy would not be nearly so vibrant. But, with Technology representing only 10% to 15% of the entire economy, the real story of this false bear market lies in the forces operating on the old economy.

Greenspan Dims the Lights

During 1998 and 1999, the US economy grew at an average of over 4.5% per year, and unemployment fell to 25-year lows. These statistics, by themselves, were wonderful news for the American people. This very rapid growth, however, combined with the diminishing labor pool, created fears that wage inflation was just around the corner. Indeed, it was during this time that energy and other commodity prices also started to move higher. And, most importantly, long-term bond interest rates, where the really smart money bets on inflation, started to move higher, as well. All of these data taken together were a clear sign that the seeds of inflation were beginning to sprout, even though reported inflation remained low. Thus, in June of 1999, Alan Greenspan and the Federal Reserve began a series of rate increases that would total 1.75% over the next eleven months.

Many people do not understand how the Federal Reserve can slow an economy as large as that of the United States by merely raising interest rates. It is simply a matter of supply and demand. When the Fed raises rates, they essentially raise the price of any product or service that is financed by loans. An increase of 1.75% does not sound like a lot, however, it represented a 25% increase in the cost of borrowing because it pushed the Prime Rate of interest from 7.5% to 9.5%. This meant for a family with a $100,000 variable rate mortgage, their monthly payment would have jumped from $750 to $950. This $200 increase has the effect of diminishing the disposable income of the family, much like an increase in taxes. Therefore, they will not have that money available for other purchases. In like manner, the companies who would have received this $200 in purchases from our hypothetical family would have seen their business slow by that amount. This explanation very much simplifies the whole process of how raising interest rates diminishes disposable income for businesses and consumers alike throughout the economy. But, the Federal Reserve possesses an even greater power in their arsenal to slow or stimulate the economy.

<u>Imbedded in its ability to raise and lower interest rates, the Fed also holds the power to illuminate and darken our view of the future.</u> This is because no one knows, perhaps including the Fed, how much they will increase rates or how long they will take to do it. In the adjustable rate mortgage example, we saw the direct, out-of–pocket cost of the Fed's rate hikes. As long as they are known, however, direct costs can be managed. On the other hand, everyone knows it is the unknown that can devastate business and family budgets, or even an entire economy. <u>So perhaps, when it comes to evaluating the worth of an investment, the Fed's ability to illuminate or dim the market's view of the future is even more significant than their ability to raise or lower interest rates.</u>

The Safe Bet

Let us give an example that we often share in classes we teach. It is a demonstration of what we call the "Safe Bet" phenomenon. We tell the class we have two bills, a fifty-dollar bill and a twenty. With the classroom fully illuminated, we then display the fifty-dollar bill. Then, we ask the class what they would pay for it. Because the bill is clearly visible, most of the class will offer just under $50. At that price they are assured of a quick profit. We then do the same thing with the twenty. Again, the class wisely offers something just under twenty dollars.

We then turn the lights almost entirely out so that no one can tell whether the bill being held up is a twenty or a fifty. This illustrates how the Fed dims the lights on the prospect of all investments. Because the bill is barely visible, and a 5 looks somewhat like a 2, the students must make a determination based upon either a gut feel or probability. The "economic probability" says this guess is worth $35 (a 50% chance it is $20 plus a 50% chance it is $50). Invariably, the students offer around $20. Why? Because $20 represents the price at which, surrounded by unknowns, the students can eliminate virtually all of the risk. Psychologists have conducted this kind of experiment for years, where they have determined that human beings, in situations where uncertainty is high, are moved to making a safe bet instead of a rational economic valuation. In resorting to gut feel, history shows us, as it relates to common stocks, investors attempt to eliminate risk by reducing the amount they are willing to pay for a company to some historical low point, either in price or in P/E ratios.

This Safe Bet tendency is very apparent when comparing price-to-earnings ratios of the Dow Jones Industrials to interest rates. When the Federal Reserve is dimming the lights (raising interest rates) the average P/E of the Dow Jones Industrial companies falls. And, likewise, when the Fed is turning up the lights (lowering rates), providing greater clarity, P/Es tend to rise.

In summary, as we said earlier, the real story behind the demise of the Tech stocks lies in what has been happening to the old economy companies.

1. In the face of an overly hot economy, the Fed began raising interest rates to slow the economy to a more sustainable rate of growth.

2. Increased interest rates directly lowered disposable income and corporate earnings.

3. As the Fed "dimmed the lights," the future prospects for personal and corporate earnings became uncertain and increased the risks, causing consumers and businesses to limit purchases to more basic needs and look for ways to cut costs.

4. Even though it is arguably the way of the future, Technology could not escape the Safe Bet phenomenon. Consumers and, more importantly, old economy corporate managers became even more conservative than conditions justified and drastically reduced their purchases of new technology products.

We are reasonably confident this chain of events is what precipitated the slow-down in the economy and the Tech collapse, and ultimately the sharp sell-off in all stocks. However, in the aftermath of these events, the real task in front of us is to determine where do we go from here?
The answer: Up

The Fed has stepped in to stabilize the situation by lowering rates 1.5% in three months, reversing nearly all of the increases from 1999 and 2000. Lowering rates will put more money in the hands of consumers and businesses. The lights will come up, and many of the uncertainties about the future will diminish. Capital projects put on hold will be reinstated by both corporations and individuals. Corporate America will realize they acted more conservatively than was justified and once again feel the competitive pressure to spend on new Technology. Investors will realize that growth prospects are still excellent, and they will put money back into stocks with a level of confidence that this economy justifies.

As a result of the Fed's aggressive cut in interest rates, and apparent willingness to cut even further, we believe the major stock market indices will all be higher, and significantly, over the next twelve months. Our analysis reveals six bright spots where we expect lights to shine the brightest.

The Bright Spots

Technology. At the very least the Techs will have a solid rebound during the next twelve months, although it will be several years before the Techs challenge the stratospheric highs they hit in early 2000.

Biotechs. The profit outlook and new drug development outlook are both very promising. The human genome mapping success increases the body of knowledge the biotechs can tap. Major pharmaceutical companies need to work collaboratively with biotechs, even to the extent of company mergers to keep their own revenues growing. Most biotechs are financially very sound and contain a wealth of intellectual capital.

Home Construction and Remodeling. It all comes down to jobs. Home ownership is highly coveted in our country. If Americans are employed, they will build new homes and upgrade the ones they already own. Unemployment has crept to 4.3% at last report, but by historical standards, America is still fully employed.

Energy. OPEC production cuts will keep oil prices high, probably not over $30 per barrel like we saw this winter, but in the high twenties. Gas prices will also remain high, as more than 150 new gas-fired electric generating plants begin production in the US over the next eighteen months. These energy prices will keep worldwide exploration and production growing at 20% or better through 2001.

Retail. The investment opportunity in retail stocks typically comes just before the stores have their worst quarter. We may be there. As this is written, Walmart just warned they will miss their first quarter 2001 earnings estimate, and the stock price barely flinched.

Financials. Most financial institutions benefit when short-term interest rates fall and the economy rebounds. Their interest margins spread and earnings begin to expand. The market typically recognizes that lower interest rates will ultimately improve the Financials' earnings and pushes the stocks higher.

An Expensive Lesson

It is for every generation to learn that the Federal Reserve has the power to stimulate or slow the economy and that no person or company is completely immune from its actions. Unfortunately, coming to a knowledge of the Fed's power is often learned the hard way. Many investors doubted the Fed could slow the runaway economy of 1999 and 2000. That doubt resulted in skyrocketing stock prices and Tech mania. Many of the companies that flew so high are now the pile of dotcom feathers in the road we mentioned earlier. Obviously, those investors were wrong. <u>Now that the economy has indeed slowed to a crawl and stock prices have plummeted, the markets appear to once again be betting against the Fed. We think it's a bad bet.</u> There is no doubt in our minds that the Fed will again spur the economy back to its target of 3 to 3.5% growth, and those who remain invested in the stock market will be rewarded when the true bull returns.

Blessings,

Greg Donaldson — Director of Investment Strategy

Mike Hull — President and CEO