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The Case for Optimism

The images of Saddam Hussein's statue falling in Baghdad and the joyful celebration that erupted among the Iraqi people were very moving sights for freedom-loving people everywhere. Even though skirmishes will continue for a few more weeks, the toppling of the statue and the show of strength by America's military are sure signs that the cruel regime of Saddam Hussein is at an end, and a new chapter in world history is now being written.

We believe the toppling of Saddam will also mark a new day for the US economy and, particularly, the securities markets. US consumers and businesses, living with one eye on the headlines for nearly three years, have been held hostage by a series of shocking events the likes of which our country has seldom seen:

1. The Tech mania collapse began the longest bear market in seventy years
2. The terrorist attacks of September 11, 2001
3. The collapse of Enron and revelations of other corporate corruption
4. Two spikes in oil prices: the first after 9/11 and the second prior to the Iraqi war
5. Stalemates at NATO and the United Nations over Iraq
6. The build-up and beginning of the Iraqi war

In the past, any one of these kinds of events has sent the economy into a recession. Yet, even in the face of all this, the US economy, except for a brief period in 2001, has managed to continue growing, surprising many economists and confounding nearly everyone in the financial media.

While stocks (Chart 1, next page) have declined almost 40% from their highs in 2000, cumulative, real Gross Domestic Product (GDP) (Chart 2) has grown by over 5%. Without adjusting for inflation, the economy has grown by nearly 10 % during the past three years. Chart 2 shows that total US goods and services produced now approaches 10 trillion dollars.

Chart 2 also shows the aforementioned, shallow recession that occurred around the time of the September 11 terrorist attacks, and the subsequent return to growth in 2002.

Chart 1

S&P 500 Index

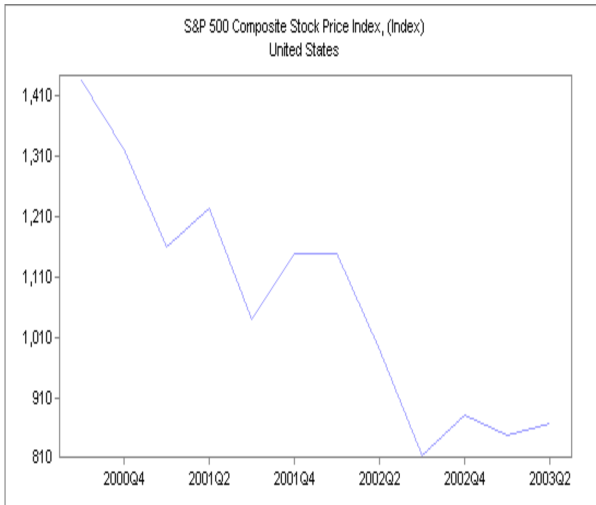
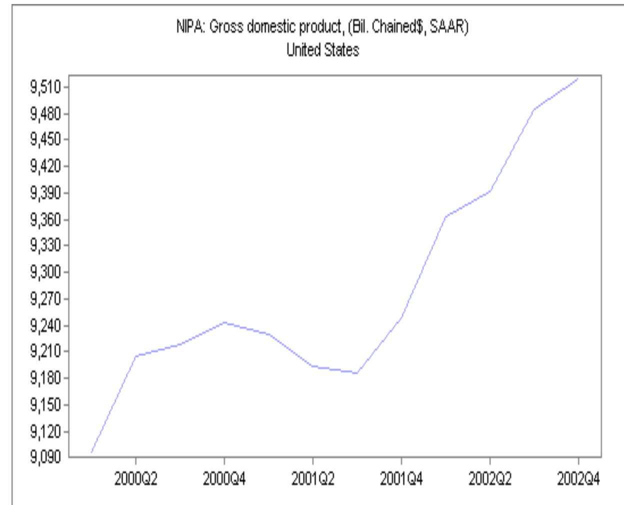


Chart 2

Gross Domestic Product



Last week, Alan Greenspan offered an explanation of how the economy has continued to grow in spite of all that has taken place. He said that over the past 20 years both government and the private sector have greatly improved their operating flexibility and financial strength. While Mr. Greenspan lauds the management of American businesses, we sense a bit of humility from the man who has battled long and hard to drive down inflation and keep it low. The decline in inflation has driven interest rates to 40-year lows, which have had an even greater impact on consumers, who make up two-thirds of the US economy. These low interest rates for consumers have sustained housing, auto, and retail sales at surprisingly high levels and kept the US economy growing.

It's a Stock Market Thing

If the US economy has continued to grow, why are the newspaper headlines so full of bad news about the economy? While, indeed, the economy has turned in a creditable performance over the past three years, its 2% annual growth has been below what is generally accepted as optimum growth (3+%). Employment is always big news, and even though the current level of unemployment at 5.8% remains below historic averages, it has risen from its 30-year low level of 4.0% in 1999. The reality of terrorism on our shores has put everyone on edge waiting for the next shoe to fall, and with it the economy. Many people are interpreting the sharp fall in the stock market as a foreshadowing of bad things to come for the economy. Finally, as we have said so many times, bad news sells more newspapers and advertising than good news. Therefore, because of the media's fixation with the shocks that our country has endured, it has underreported the reasonably good economic news.

If the economy has performed better than almost anyone would have expected under the circumstances, why has the stock market performed so poorly? Many economists would answer that question with an old saying, "The stock market has predicted five of the last three recessions we have had." This, of course, is a way of saying that the stock market has not been a very precise predictor of recessions. It has been very good in a general sense of hinting at the direction of the economy, but at its extremes, the stock market tends to overshoot both high and low. The reason for its over and undershoots is simple;

the stock market is very good at discounting or evaluating the present worth of almost any company if current business trends continue. The problem is things change, and when a lot of things are changing in a short period of time, the markets tend to retreat or advance on pure emotion, abandoning the genius of its discounting capabilities.

Anatomy of a Bear Market

To understand the bear market of the past three years, let's start first with a description of the stock market's "genius of discounting." Investors discount or determine the present value of a business based upon a formula using three variables: (#1) a "starting point" – where earnings or dividends are now, (#2) a "growth rate" – the trend of future earnings and dividends, and (#3) a "discounting rate" – the time value of money. This formula makes it possible to accurately determine what a company is worth, its so-called intrinsic value. As long as two of these variables stay reasonably steady, the market can reevaluate a company very easily to reflect new information. Say for instance, a company's projected earnings growth rate falls from 10% to 8%. Keeping the other two variables steady, we can determine the new intrinsic value of the company based on the slower growth expectation. In this case, a slower earnings growth rate would cause the intrinsic value to fall. Problems arise with confidence in the accuracy of the calculations if any one of the variables becomes extremely volatile, or even worse, if more than one of the variables begins to change at the same time.

That is what happened in the Technology sector both on the way up and on the way down. Tech company earnings growth accelerated throughout 1997 - 1999. Many Tech companies had been growing earnings in the 15-20% range for the last decade. As Y2K fears drove companies and individuals to upgrade their computer systems, Tech earnings began to grow at ever-faster rates quarter after quarter. The rapidly accelerating earnings growth produced wildly optimistic expectations of future earnings growth and drove Tech stock prices to hyper-inflated levels by late 1999. We remember one company whose projected long-term earnings growth was 18% in early 1998 and by the middle of 1999 its long-term projected growth rate had risen to nearly 30%.

As Y2K passed and the sky-high earnings growth expectations were increasingly found to be unsustainable, the market began a sharp pullback in Tech stock prices in early 2000. Because Tech stocks had grown to such a large portion of the Standard and Poors 500 Index, the S&P's projected earnings growth rate also started down, and with it the price of the index.

By the middle of 2001, the overall stock market had corrected significantly to reflect the fall in projected earnings growth. The correction had been sharp and swift, but the damage was largely confined to Tech stocks and a few very large companies that did a lot of business with the Techs. At this point, earnings growth projections for the S&P stabilized, and indeed, earnings growth estimates for small and midsized companies actually began to rise. Furthermore, even though Tech and some big-cap stocks were still correcting, small and mid-cap stocks appeared to have made a bottom and had begun to move higher. We wrote about this in our July 2001 quarterly letter, in which we said we believed the uptick in small and mid-cap stocks was a sign that the economy was strengthening and that a pick-up in the economy would be good news for all stocks. Our optimism was short-lived.

On September 11th, terrorist planes hit the World Trade Center towers and the Pentagon, and the market fell dramatically. However, based on the Federal Reserve's quick action to cut interest rates, President Bush's declaration of war on the terrorists, and the military's entrance into Afghanistan, almost immediately the market began to climb again and did so through the end of 2001. Surprisingly, in the fourth quarter of 2001, the economy re-emerged from recession only months after the terrorist attacks had virtually shut down large portions of our economy.

As 2002 opened, however, we were hit with what would be another devastating shock: the Enron/Arthur Andersen saga began unfolding, the first in a series of revelations of corporate corruption. If the dramatically slowing growth rates for Tech companies' earnings had left the market doubting its vision of the future, Enron, et al, now added to the confusion by raising questions about the "starting point." As we said earlier, when two of the three variables in the valuation model become volatile, or in doubt, confidence in the "genius of discounting" collapses and emotions take over. The market fell almost 25% to the July low of 7702, then another 7% to the October low of 7286.

Combining the uncertainty of future earnings with questions about the quality of current earnings created the worst bear market since 1929. The other shocks we identified earlier, contributed to the bear market by reducing, and in some cases, eliminating investors' tolerance for uncertainty and risk.

The Case for Optimism

We believe there is a lot of truth to the old saying, "What doesn't kill you will only make you stronger." Our nation, economy, and stock markets have taken some very hard knocks in recent years, yet we are still standing. Even though we may not feel it yet, we are stronger. We are also a better country for the trials we have been going through. We have been humbled by the shocks to our nation. We have been shamed by the revelations of corruption in some of our boardrooms. We have been betrayed by old friends. Sometimes, hard times show us our weaknesses. Sometimes, hard times show us our strengths. If we are wise, we will see them both and learn from them.

Our optimism that stocks are ready to begin a new bull market comes from an analysis of the seven shocks identified earlier. As we write this, almost every one of them is being resolved or significantly improved. Four of the seven shocks we have experienced in the last three years have their roots in the Middle East: terrorism, spikes in oil prices, the NATO/UN stalemate, and the Iraqi war.

Terrorism – We don't think anybody knows what will ultimately happen in our attempts to bring democracy to Iraq. However, we believe an unmistakable message has been sent from the US to terrorists in every corner of the globe: "Don't tread on us. We will come after you in the mountains of Afghanistan, the jungles of the Philippines, the cities of Europe, Asia, and the United States, or the deserts of Iraq." Terrorism requires four components: masterminds, soldiers, a place to train and plan, and money to finance the effort. Certainly, all of these components of terrorism are still present in the world today, but the US's war on terrorism has driven the cost of each component sky high. Today the money men who have financed terrorism must count the cost of their actions in a way they have never imagined. Because of this, we believe the threat of terrorism has diminished, and investors will extract less of a terrorism premium on stock prices.

Oil Prices – With the Iraqi oil fields largely in tact, we believe oil prices will likely fall to a range of $22 to $28 /barrel, OPEC's stated target range. This will put more dollars in consumers' pockets, as well as diminishing many of the very real hindrances to planning that oil price spikes always bring.

NATO/UN Stalemate – We hold no illusions that differences with France, Germany, Russia, and China will simply disappear in the afterglow of military success in Iraq. We do believe Russia and China have shown themselves to be very pragmatic nations, and they will soon realize they have nothing to gain from the split with the US and begin a process of mending the rift that has formed. They also need us to help resolve the North Korean nuclear crisis. On the contrary, our relations with Germany, France, and the United Nations are not so clear. Apparently, last week German Chancellor, Gerhard Schroeder, telephoned British Prime Minister Tony Blair and France President Jacque Chirac telephoned President Bush with conciliatory overtures of finding common ground for the future. We are not so hopeful these relationships are going to improve very soon. From a purely economic perspective, we believe continuing strained relations with these important trading partners will hurt world economic growth, but at present, the rhetoric does not sound very optimistic. On the positive side, it is hard to imagine that these relationships can get any worse, so perhaps the cooler heads in these countries and the United States can figure out a way to repair the damage.

The Iraqi War – Fortunately, it was quick. Now, only the reconstruction remains.

As this list of uncertainties begins to clear, one unresolved shock remains on our list – corporate corruption. Last summer Congress enacted the Sarbanes-Oxley Act, designed to protect shareholders by getting tough on corporate fraud and corruption and setting new standards for auditors and research analysts. This Act's impact is already being felt by the public companies with whom we have spoken. Corporations are changing everything from conducting board meetings without company executives present to a complete reevaluation of compensation and perks. We believe Sarbanes-Oxley's insistence that boards of directors be more independent and more directly accountable to shareholders will be a big plus for investors' confidence. We are convinced trust in American companies will be restored, maybe not too quickly with the average person, but certainly with the major institutions who control the US stock and bond markets.

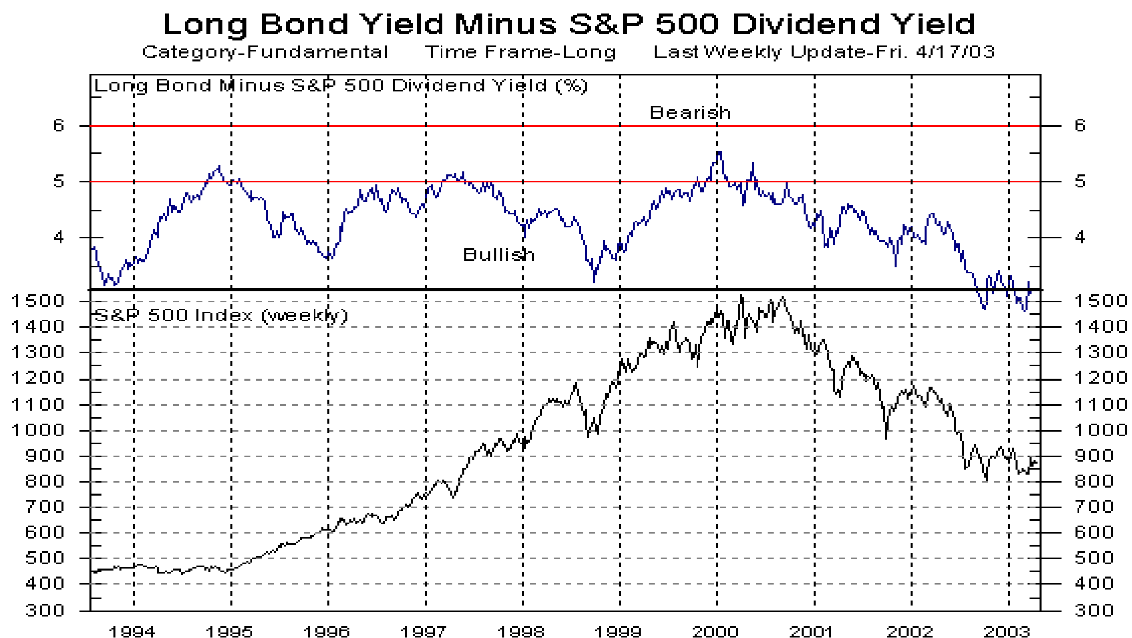
Beyond the Shocks

So, where does that leave the stock market once the excesses of the 1990s unwind and these latest shocks settle down? We believe removing these difficult impediments will allow the stock market to do what it has done best over the last 100 years – grow. What emerges from all of the uncertainty of the last three years is an economy that is smarter and stronger than it was before all this began and interest rates at 40-year lows. Through Sarbanes-Oxley and the efforts of many good people in corporate America, the market will gradually regain its trust in the earnings companies report and the projections they offer for the growth of their businesses. Until the market begins again to trust those two variables, we believe (as we have been writing for the past year) that dividends currently offer the best basis for valuing companies.

Stocks Are Undervalued Relative to Bonds

If you owned the Dow Jones Industrial Index today, you would receive a dividend of $201.05 during the coming year (Variable #1 from our discounting model). Projecting those dividends forward at a growth rate of 6% (Variable #2, the same rate at which dividends have grown over the last 100 years), then discounting that stream of dividends back to a single present value (Variable #3), our model finds **the intrinsic value for the Dow Jones Industrial Average to be roughly 11,000. With the Index currently hovering around 8300, it is about 25% undervalued.** As good as that sounds, we doubt the market will rush back tomorrow to this intrinsic value simply because we have made the calculation. However, once the shocks fade and investors begin regaining trust in US corporations, we are convinced that the undervalued status of the current market will be recognized and stocks will begin a new bull market phase.

Imbedded in this valuation model is an assumption that every investment decision is made relative to alternatives the investor has for his or her money. Comparisons over time of how the expected returns on alternative investments relate to each other can be more than revealing, especially when those relationships get out of line. Historically, the dividend yield on stocks has remained considerably lower than the interest yielded from long-term bonds. The top portion of Chart 4, below, shows the difference in those yields over the last ten years. Until recently, the spread between Long-term US Treasuries and the dividend yield on the S&P 500 has moved between 3 and 5 ½-percentage points. The spread peaked at about 5 ½-percentage points at the beginning of 2000, indicating that the dividend yields offered by stocks were very low compared to yields available from long-term bonds. In short, stocks had become very expensive relative to the alternative of bonds. In the three years that have followed, stock prices have fallen, driving dividend yields higher. At the same time, long bond yields have declined, closing the gap to less than 3 percentage points – the lowest point in the last decade.



This difference in yields now manifests itself daily as investors weigh the decision between investing in 30-year US Treasury Bonds yielding slightly less than 5.0% and common stocks yielding just under 2.0%. This looks like an easy choice for bonds until we take into consideration that if commons stock future dividend growth equals its historic rate of the last 70 years, in 30 years, based on today's purchase price, stocks will be yielding nearly 16%, not including capital gains. We think the decision is weighted even more favorably toward the stocks of those companies who consistently pay out large portions of their earnings and keep those dividends growing year after year. The current yield on our Rising Income Equity model portfolio now approaches 3 ½ %, with projected dividend growth of over 7.0% per annum. Whether to own a company with that kind of dividend yield and a very high probability of solid dividend growth and the potential for price appreciation, or to avoid all risk and buy a US Treasury at under 5.0% is becoming an easier and easier decision. As more investors become comfortable that the economic and earnings coast is clearing and come back into stocks, these yields will be hard to resist, especially, as we have previously stated, they may also receive a tax break on some portion of the dividend.

Blessings,

Greg Donaldson   Mike Hull

p.s. Each year, the Securities and Exchange Commission requires us to update a document called the "Uniform Application for Investment Adviser Registration" (ADV) that is on file with them. The ADV contains detailed information about Donaldson Capital Management, and how we operate. We have just updated it for 2003. If you would like a copy, please call our office; we will gladly send it to you.