

## **MDE Market Perspective (3/30/01)**

### **Near-Term Economic Conditions**

The recent sell off in worldwide equity markets has been brought about by both valuation concerns and concerns that both the U.S. and foreign economies, and the corporate profits which drive these economies, are on the brink of a prolonged downturn. This persistent sell off over the past twelve months has created a climate of fear and negative sentiment. As each day's reports on CNBC, the Wall Street Journal and competing financial news sources brings still another piece of bad news, investors are increasingly concerned that a recession is imminent. Like the unrelenting "drip, drip" of the ancient Chinese water torture, the constant and persistent bad news feeds investor anxiety. This fear causes increased selling of equities, thereby further diminishing investors' balance sheets, which in turn further creates the prospect that future spending is likely to be curtailed. At the same time, corporations have put capital expenditures on hold while the over building of capital stock in the late 1990s has resulted in a glut of equipment, especially in the tech and telecom industries. These reactions serve to create a further drag on spending.

We at MDE clearly recognize the validity of these views as causes of a slowing growth rate of economy. However, we strongly caution against overreaction to the near-term trends. For reasons discussed below, we feel that there is nothing structurally wrong with the U.S. economy that the Federal Reserve, along with the new Administration and a cooperative Congress, cannot remedy within a reasonable period of time.

### **It's Different This Time...Or Is It?**

Prompted by fear resulting from the unrelenting stream of negative news with which we are bombarded by today's "24/7" media, individuals are now beginning to think that "... it's different this time". People prominent in the media are beginning to speculate and express concern that this time the market will not rebound and may not make higher highs. In large part, these are the same people who were also repeating the mantra "...it's different this time" as they justified the excessive valuations of Internet companies with no earnings or technology companies whose valuations far exceed their underlying fundamentals.

We actually agree with the view that "...it's different this time", but for different, positive reasons. As we enter this downturn, the fundamentals of the U.S. economy are far stronger than they were during the last recession of some ten years ago. In the late 1980s, the U.S. faced a savings and loan crisis, a defense industry downsizing, a real estate bust, a weakness in corporate quality and efficiency and a huge budget deficit. However, the self-corrective mechanisms inherent in the free enterprise system, with monetary stimulus as a catalyst, took over and, with competition and financial market pressure, a rapid and vigorous adjustment was stimulated. The United States entered a recession in July 1990, but the economy was growing again by April 1991.

Today the U.S. situation is less troubling, in most respects, than that of ten years ago. The stock market excesses created by an unprecedented market run up from 1995 - 1999, followed by the "dot com" and related technology meltdowns, plus higher energy costs have

combined to create today's near-term investment environment. However, U.S. competitiveness remains stronger than ever. Productivity growth, which is the fundamental driver behind prosperity, remains high and should continue to be so for the foreseeable future. The United States continues to be the leader in information technology, healthcare, financial services and knowledge creation which, among other things, will be the driving forces in an expanding U.S. economy for years to come. Although some corporations will undoubtedly take advantage of the current slow down of the economy and do some "bookkeeping" retrenching, they will be cautious in laying off employees after experiencing the tightest employment market in a generation. Consequently, unemployment is not likely to rise substantially as in past downturns.

A slowdown in information technology investments was inevitable after the heady and unsustainable growth of recent years culminating with Y2K. While "dot.com" companies may be disappearing, the Internet is clearly here to stay. "New economy" companies that have staying power are developing a healthy new appreciation for earnings driven business models, while "old economy" companies are learning how to evolve and more effectively leverage the Internet as a productivity enhancing tool.

In spite of all the earlier predictions to the contrary, the recent downturn has confirmed our long held belief that "no one has outlawed the business cycle". As has so often been the case in the past, the U.S. economy is once again undergoing a restructuring which - despite bankruptcies, downsizings, mergers and buyouts - will stabilize and reshape the economic landscape to make it more efficient and provide the solid foundation for the next cycle of growth.

### **The Role Of Monetary Policy As A Key To Recovery**

The Federal Reserve has cut interest rates three times this year in an effort to stimulate economic activity and forestall a recession. Gross Domestic Product, the broadest measure of the economy, slowed from 2.2% in the third quarter to 1% in the fourth quarter. Following the Fed's March 20th 50 basis point reduction of interest rates, the markets voiced their disappointment by reacting violently and negatively. However, we are comfortable with the Fed action. We think it is important for Alan Greenspan to assert the independence of the Fed vis a vis the financial markets.

More importantly, the Fed still has considerable flexibility to manage future rate reductions. In 1993, the Fed lowered the Fed Funds rate to 3% in an environment of 3% inflation. This created 0% real interest rates. By comparison, today real interest rates are at some 2%, thereby giving the Fed substantial room to provide additional stimulus as needed.

The Fed is taking its customary incremental approach to management of the money supply and interest rates. This incrementalistic approach of lowering interest rates by 50 basis points on March 20th was clearly the more prudent course of action as compared to capitulating to the financial communities' demand for a greater cut. The last thing the Fed wishes to do is grow the money supply too rapidly for fear that it would re-ignite and fuel short-term euphoria at the ultimate risk of long-term inflation and economic stagnation like the 1970s.

Using its incremental approach to maintain a stable and more modest growth of money supply, the Fed will help the economy start to recover and secure a longer-term prosperity.

### **Inflation in Decline**

An important positive byproduct from the current economic slowdown is the demise of the inflationary pressures that were threatening to resurface a year ago. There is now some slack in labor markets and manufacturing sectors so that wage pressures are unlikely to create an inflationary push over the near-term. In addition, energy prices have retreated from their recent highs and corporations are unlikely and/or unable to increase prices in a sluggish economic environment. This results in expense control and productivity enhancing technology as a way to increase profit margins.

### **Attractive Market Multiples**

At its current level, the S&P 500 index is currently trading at approximately 20 times estimated 2001 earnings. This P/E multiple is far below the 29 - 30 multiples reached during the market's peak. While a multiple of 20 is still in excess of the historical market average of 15, many commentators believe that, today, S&P companies have much stronger growth characteristics than they did in prior periods. In addition, inflation, interest rates and tax rates on individuals are lower today than they were when the markets sold at 15 times earnings thereby providing a superior economic environment that allows it to sustain a higher multiple.

Additionally, while there still exists many technology stocks that are overvalued on a relative basis, many of the major technology stocks now sell at an average of 25 times earnings. Even if growth estimates on technology companies are revised downward from current estimates of 30% to 20%, these multiples are more reasonable and sustainable as a base for further growth.

### **Negative Earnings Outlooks May Be Exaggerated**

Earning expectations are being reset to very low levels. Corporations are using this period as an opportunity to release any piece of bad news and take any charge-offs they may have been contemplating, as they hope their particular piece of negative information will be lost in a sea of negative information. As has been the case in the past, once this "negative news purge" is behind us, corporations will be better positioned to post better earnings in the future. Over the course of the next year, reported earnings should be helped by a combination of easier currency comparisons, likely elimination of goodwill write-offs, an end to the inventory correction currently in progress and easy fourth-quarter 2001 comparisons.

### **Demand for Equities**

As baby boomers near their retirements, the impact of their low savings rate is likely to increase the demand for equities. Assuming that they will want to continue their relatively high consumption lifestyles, boomers will soon recognize that they will have to play catch up with their savings by investing in higher return instruments - namely stocks. Vehicles, such

as the 401(k) and other tax advantaged plans, will be expanded to encourage such an increase in savings. We believe that the bulk of this savings will flow to the equity markets. In a similar vein, the savings of Generation X and later are likely to increase as their ambitions seem to be to work hard while young, save and invest aggressively in order to retire early and then kick back and relax.

The financial markets also have substantial liquidity waiting on the side lines as reflected by the large holdings in money-market mutual funds. These fund balances reached a total of \$1.825 trillion at the end of 2000-up by 14% from 1.61 trillion at the end of 1999. In addition, cash in mutual funds was 5.8% percent at the end of 2000-up from 4.3% a year ago. This cash will be unleashed once investors perceive that the markets are near or beyond the market bottom. This cash, in addition to all the other factors discussed herein, should create substantial fuel for eventual stock market recovery.

### **Conclusion**

While we will not be so bold as to predict that we are at a market bottom, we are mindful of the time tested maxim that the time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell. In other words, the only way to get a bargain in the market is to buy what is on sale. Opportunistic investors buy when others are despondently selling. Bear markets have always been temporary and, for all the reasons cited above, there is no reason to think that this one should be different. Share prices generally turn upward from between 3 - 12 months before the bottom of the business cycle. The stock market is a great discounting tool and stock prices incorporate all of today's bad news. Markets should begin to respond positively with the first signs of continued economic expansion, before the bottom of the economic cycle is actually reached. Therefore, we strongly discourage selling into weakness. To the contrary, we urge clients to begin re-entering the market over the near-term, albeit on a gradual basis. We believe that those with the courage to do so should be well rewarded some 12 - 24 months from now.