

# MONTGOMERY BROTHERS WEALTH MANAGEMENT

## 2003 Investment Outlook

### **Don't Just Stand There, Do Something!**

Everyone knows that the first priority of a newly elected president is to get himself reelected. This is the rationale behind the “presidential cycle” as it applies to the economy and stock market. Each president does everything in his power to make sure that the economy is doing well in presidential election years. In anticipation of the economy doing well during the fourth year of the presidential term, the stock market usually does well during the third year.

Additionally, (virtually) everyone knows that George *W.* Bush is committed to *not* being an instant replay of his father by *not* getting reelected. George *H. W.* Bush was an immensely popular “war-time” president who, in retrospect, missed the boat on the election-year cycle by not stimulating the economy prior to his reelection bid. *W.* is hell-bent on not repeating the same mistake. To this end, he recently forced Treasury Secretary Paul O’Neill and Economic Advisor Larry Lindsay to walk the plank. O’Neill had consistently said that the economy was doing okay and, regardless, that there was little that could or should be done to stimulate it. Additionally, he suggested that the cornerstone of Bush economic policy would be tax simplification. For an administration anxious to look like it is on the economic ball, O’Neill’s “Don’t-just-do-something,-stand-there!”-message just didn’t do it. And, since tax policy is the preferred economic stimulus for this administration, tax simplification wouldn’t cut it either. Adios, Paul!

Whether or not O’Neill was right or wrong about the economy and the need for additional fiscal stimulus, get ready for more. Therefore, we weren’t surprised when we received our invitation to the National Association of Business Economists’ (NABE) upcoming policy conference called “The Revival of Activist Policy: What Will it Mean for the Economy?” Now, most people think that most government policies are fairly ineffective, but Montgomery Brothers disagrees. Government policies, in general, and tax policies, in particular, work very effectively but often with long lags and, even more often, in unexpected ways.

For example, MBI believes that the supply-side incentives put in place during the first term of the Reagan administration set the table for the productivity boom of the 1990s. Unfortunately, supply-side economics can also be used to explain (at least partially) the excessive capital spending of the “bubble” economy of the late 1990s that left the economy with a great deal of excess capacity. More recently the 1997 tax act reduced capital gains tax

rates across the board and can be blamed for helping to cause an even larger stock market “bubble” than otherwise might have occurred. Additionally, in the 1997 act, homeowner couples were given a \$500,000 capital gains tax break on the sale of their primary residence every two years. MBI believes this was the beginning of the rapid increase in housing prices which was further exacerbated by the collapse of the stock market and the decline in mortgage rates to 40+ year lows. Having missed predicting the stock market “bubble,” many are now anxious to forecast that real estate prices will be the next “bubble.” Certainly prices have risen rapidly but housing prices run on different dynamics than stock prices. While some home buyers will get burned, a general collapse in home prices appears unlikely to MBI. Nevertheless, we would not be trading up on our personal residences right now, either.

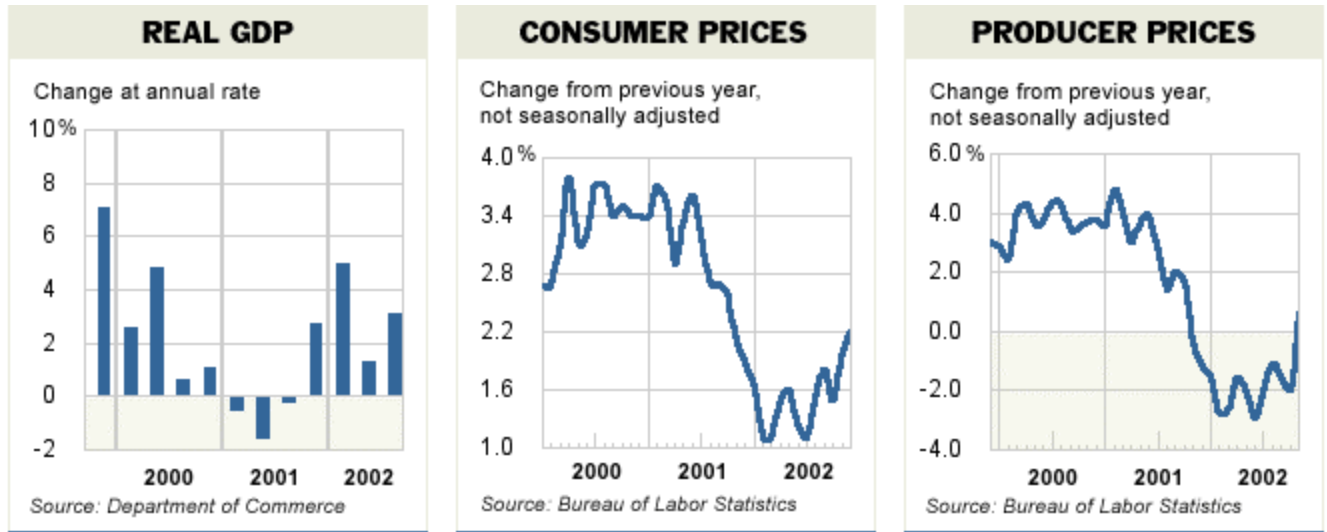
Economic activity is likely to be deferred while the shape and scope of Bush’s tax and economic stimulation package takes form. Ironically, recent departee Larry Lindsay’s economic nostrums will play a large part in George W. Bush’s proposals, but horsetrading with the Democrats will be necessary regardless of the Republicans’ recent election successes. Most policy proposals will more likely be driven by political rather than economic considerations.

Space and common sense preclude us from a full discussion of possible Bush proposals, but allow us to touch on one currently popular proposal—the elimination of the double taxation of dividends. Economic efficiency would dictate that dividends be treated like interest on debt and be tax deductible at the corporate level. This won’t fly for a number of reasons, not the least of which is that corporations don’t vote. But millions of Americans who own stocks do vote. MBI expects that some level of dividend income will escape taxes, or be taxed at a capital gains rate. Montgomery Brothers likes dividends and believes that the stock market will react favorably to a package including such tax legislation. But dividends shouldn’t be the be-all and end-all of investment decision making.

MBI has always been leery of activist government. While the recent, post-”bubble” events show that some regulation is needed, the free market, capitalist system has excellent self-correcting propensities. Politicians (and regulators) tend to go overboard and often end up putting sand rather than grease into the economic gears. One need look no further than Europe and Japan to see examples of more activist governments than we have in the United States.

## **Economic Outlook**

In early fall, shortly before the Commerce Department announced GDP for the third quarter, we had the pleasure of meeting the newly arrived economic minister of the German embassy. He was perplexed at the economic angst that he was witnessing here in the United States and remarked that the U.S. economy was the envy of the developed world. As can be seen from the chart below, real GDP has risen four consecutive quarters after the mild recession of the first three quarters of 2001, while inflation has remained subdued.



Third quarter 2002 real GDP advanced at a 4% annual rate and was up by more than 3.2% from the third quarter 2001. (It's no wonder that the Democrats couldn't hang the recession horns on the Republicans in the November elections.) Fourth quarter 2002 growth will probably slow from the third quarter pace, but it will be positive for the fifth quarter in a row. And, while MBI's inflation antenna has started to twitch, there's as much chatter now about deflation as inflation.

But like the old Cheech and Chong skit where they played Mexican border guards insisting that the U.S. tourists "must have the silver horse bookends" to reenter the States, President Bush believes that we must have economic stimulus now! MBI wonders how much of this stimulus is needed to get the economy going and how much is needed to get W. reelected? Or are we being redundant?

For some clues, let's take a look at the economic formula for the economy, where

$$\mathbf{GDP = C + B + G + NE}$$

**C** is, of course, **C**onsumer spending, which by now virtually everyone knows represents (a) about two thirds of the U.S. economy, (b) has been virtually single-handedly carrying the day, and (c) is expected to collapse at any moment under the combined weight of debt, bear markets, and uncertainty. MBI believes that consumer spending is based on the number of people employed and their disposable income. While the number of employed people is unlikely to grow much over the foreseeable future, more than 134 million people currently have jobs and their incomes are growing. The 2001 tax cut, with more likely to come, has had a salutary effect on disposable incomes and wages, and salaries also continue to grow. Consumer confidence keeps getting buffeted by the ongoing bear market, vague but continual terrorist threats, and the possibility of war with Iraq and, now, maybe North Korea. It's a good thing there is virtually NO correlation between consumer confidence and consumer spending. In MBI's opinion the biggest damper on the economy, in general, and

consumer attitudes, in particular, was that the beautiful “bubble” of the late 1990s burst, leaving us face to face with the reality of having to spend, save, and invest more wisely. Bummer! Consumers will continue to spend but probably less than they earn. This will cause economic growth to remain slow.

**B**usiness spending, along with the stock market and corporate profits, boomed in the 1990s. This led to excess capacity being built, which will take a long time to be absorbed into the economy. Corporate profits and corporate pension plans benefited from the stock market’s salutary effects. With profits off and the stock market down, corporations must now fund deficient pension plans and face up to the more ridiculous excesses of the late 1990s by writing down goodwill fantasies. Lastly, since corporate executives are now assumed guilty until they prove themselves innocent, risk-taking is out of fashion. Expect little economic help from business spending in 2003.

**G**overnment spending actually refers to the net surplus or deficit position of the Federal as well as State and Local governments. When governments run surpluses, fiscal policy is restrictive, but when budgets are in deficit, fiscal policy is expansive. During recessions and economic slowdowns, federal fiscal policy automatically turns expansionary as taxes contract and counter-cyclical spending increases. The clearest signal yet that the economy is already on the mend is that more fiscal stimulus is on the way. The federal government will certainly increase spending and probably further reduce taxes by mid-year 2003. This obviously will enlarge the federal budget deficit even further. There was a time when Democrats championed counter-cyclical Keynesian policies and the Republicans lectured about deficits. But no more! Now Democrats sound like Herbert Hoover and Republicans extol the virtues of running budget deficits.

Unfortunately (?) at least some of the fiscal stimulus from the federal government will be offset by the efforts of state and local governments to close their deficits by raising taxes and/or cutting spending. State governments, once considered paragons of fiscal virtue and breeding grounds for creative government policies, are now bellying up to the federal spending bar just like every other special interest group. Hopefully, state and local governments will earn some of the kudos given to them during the fat times of these increasingly lean times. Regardless, there will be the usual lag of six to twelve months before any fiscal stimulus takes hold. That puts us into late 2003 or early 2004.

Lastly, **Net Exports (NE)** is a misnomer since our large trade deficits mean that our net *imports* subtract from GDP. Most of our major trading partners, primarily in Europe and Japan, are in far worse economic shape than the United States, so we continue to import more than we export. Additionally, keep in mind that the U.S. economy is larger than the next five largest economies combined, and that the countries that are growing faster than the United States tend to be smaller, developing countries that are export oriented. Not much help there!

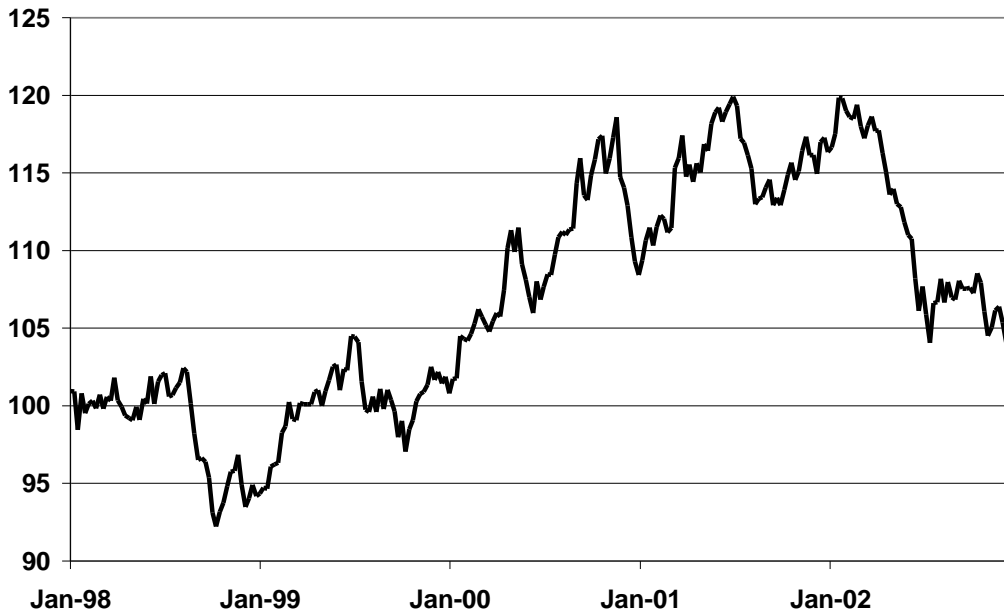
Net, net? The economy will probably continue to stumble along with 2–3% growth and with still low but rising inflation rates. W. once made an analogy (which we hated at the time) in which he compared the U.S. economy to having a hangover. As we recall, the

bigger the binge, the greater the hangover and the longer the recovery time. In retrospect, the 1990s were one helluva party.

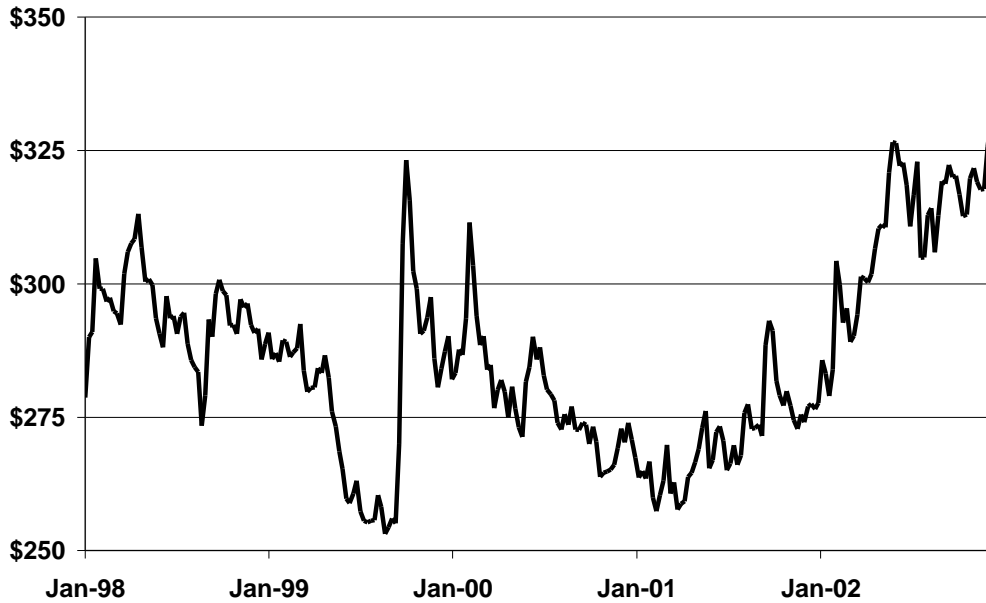
## Interest Rate Outlook

All of our professional lives we've been told to beware of *inflation*, and NOW we're told we need to be on the lookout for *deflation*? We'll have none of it! While nearly \$6 trillion of market capitalization disappeared during this bear market and hundreds of billions more in corporate bond defaults and bankruptcies must be considered deflationary, we worry less about deflation than we should and for two reasons. The first is that U.S. politicians will do everything in their power to reflate rather than tolerate deflation. Having watched Japan and having read about the Great Depression, monetary authorities will continue to do everything in their power to reflate. Second, if you look at the three charts below, you'll see inflationary not deflationary pressures emanating from the dollar, gold, and commodities markets.

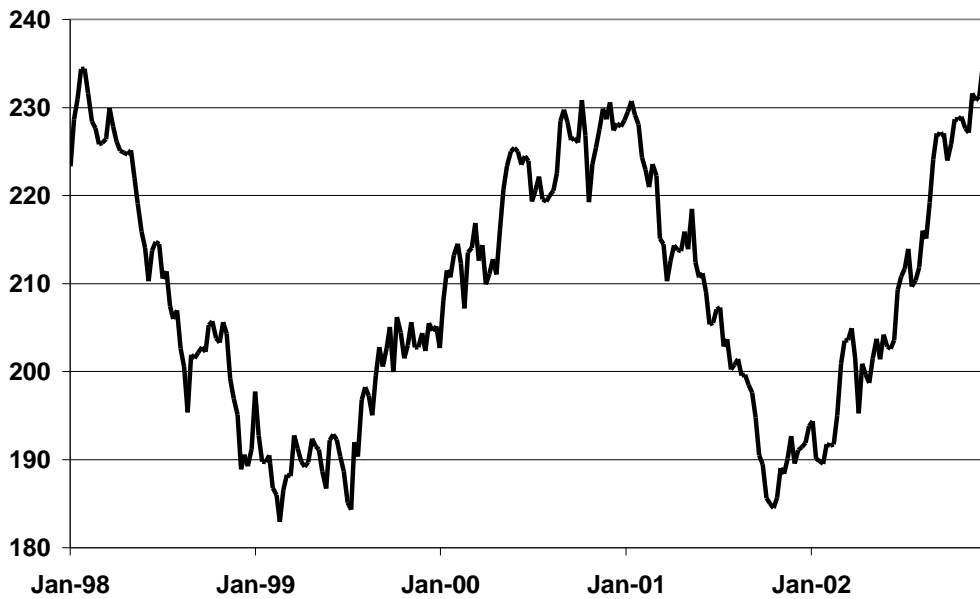
**U.S. Dollar Index, 1998-2002**



### Gold Price, per Troy Ounce, 1998 - 2002



### Commodity Research Bureau Index, 1998-2002

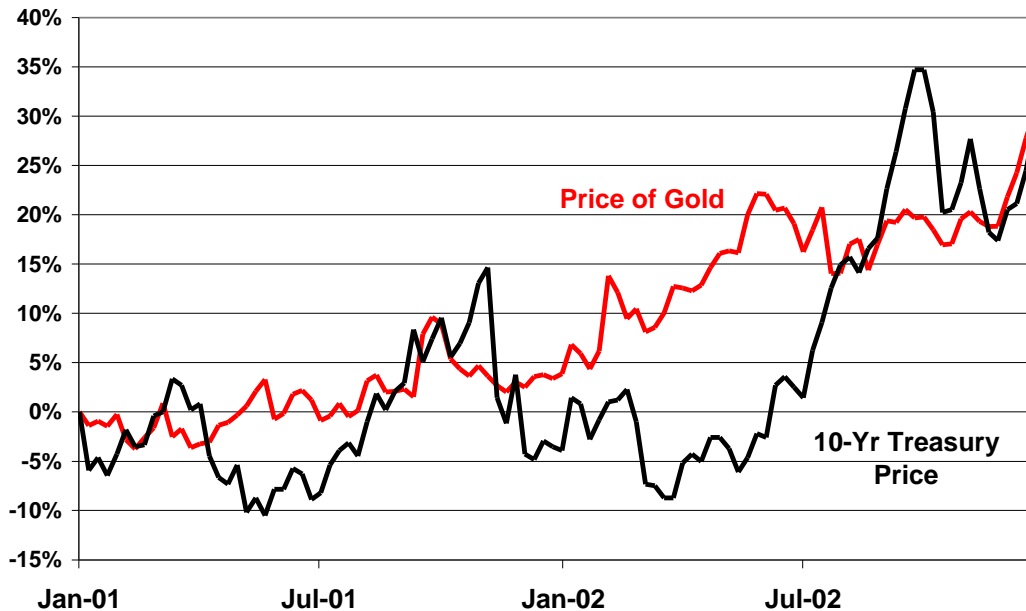


As you can see, the broadly based dollar index is well off its highs, gold is at a five-year high, and the CRB (Commodities Research Bureau) index is attempting to break above multiyear highs. The only thing that makes us nervous is that Alan Greenspan and so many other Federal Open Markets Committee (FOMC) members keep telling us that we shouldn't worry about deflation. GULP!

Contrary to popular belief, Montgomery Brothers is of the opinion that Greenspan does want to be reappointed as Fed Chairman in 2004. If the Rolling Stones, several of whom are grandfathers, can continue to tour, why not another term for Greenspan? Most public figures are cognizant of their place in history; few, if any, more than Alan Greenspan. Having achieved near universal acclaim when things were going well, Greenspan's star has dimmed as things have gotten worse. Now accused of having sat by idly while the "bubble" grew and grew, Greenspan is throwing up his hands and asking, "How could I have known and even if I had known, what could I have done, and even if I had done something, it might have made things worse. So don't blame me!" George W. Bush at least partially holds Alan Greenspan accountable for his father's defeat in 1992. If Greenspan does want to get reappointed by W. you can bet your bottom dollar that monetary policy won't be tightened going into the 2004 election.

At any rate, we believe that monetary policy will be unchanged for the foreseeable future, so we don't have much reason to deviate from the consensus forecast for interest rates which, unfortunately, is usually wrong. Through mid-year the consensus is that U.S. Treasury interest rates are likely to remain low at the shorter end of the yield curve, while edging up slightly for longer maturities. After mid-year 2003, interest rates across the board are expected to rise as the effects of the fiscal stimulus become clearer. Montgomery Brothers is a big believer in diversification, but also a big contrarian. With money market returns drifting below 1%, the safety inherent in such investments becomes expensive. If anything, interest rates are likely to stay lower for longer than the consensus is expecting, but then rise faster later. In what is one of the bigger ironies of the investment world, the appreciation of gold and 10-year U.S. Treasuries has been virtually the same over the past two years, as you can see from the chart below.

**Change in Price of 10-Yr Treasury Bond vs. Gold  
January, 2001 through 2002**



This just shouldn't be!

Far too many now see Treasuries and real estate as “sure things.” While Uncle Sam will not default on interest or principal, investors can experience a beating over the shorter term. According to Ibbotson Associates, longer-term government bonds have had negative total returns in nine of the past thirty years. The time to back up the truck and buy bonds was two or three years ago but diversification still makes sense. Current bond holdings should be focused on investment quality corporates, in mid-term maturities. But, in general, Montgomery Brothers feels that it's now time to increase stock allocations while reducing bond exposure.

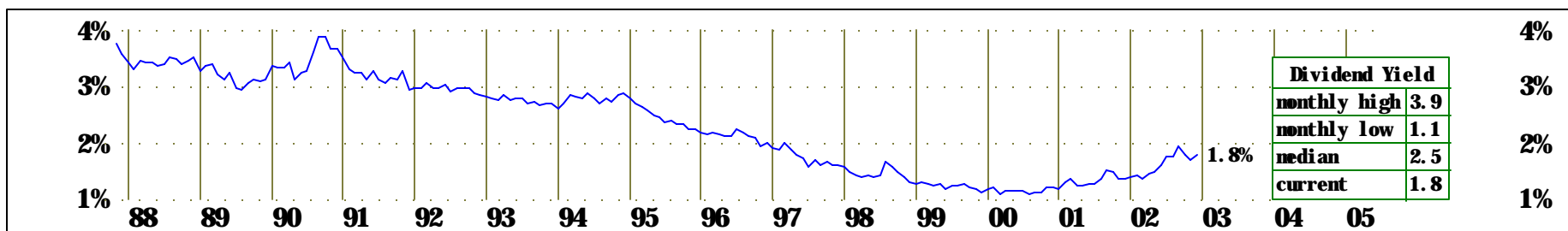
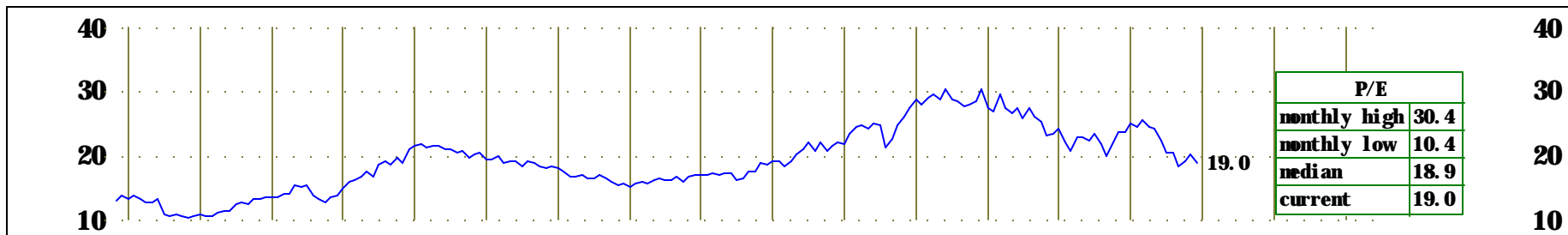
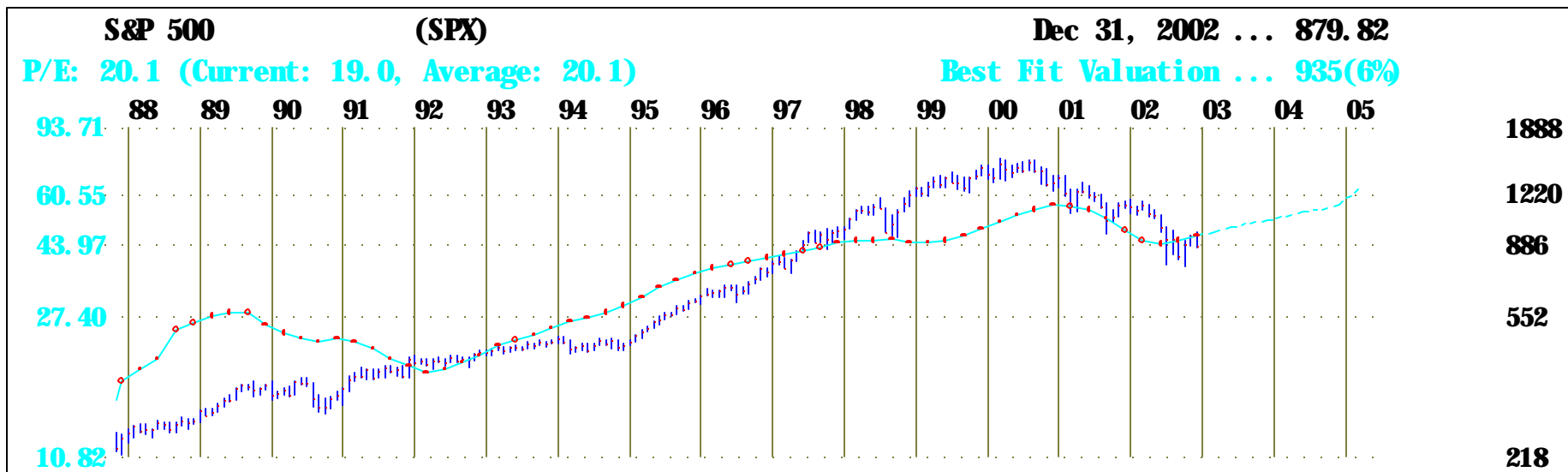
## Stock Market Outlook

Back in late 1999 and early 2000, Montgomery Brother kept a body count of value investors who lost their jobs, closed their shops, or had their reputations besmirched by the new paradigmgers. MBI has now initiated a death watch for Wall Street investment strategists who lose their jobs because they stayed bullish through what is now the longest bear market in over half a century. So far, three major investment houses have canned their mouthpieces. But in spite of toning down their rhetoric and reducing their “pie-in-the-sky” forecasts, too many bullish strategists remain employed.

Even though stocks are not cheap, they are certainly more reasonably priced now than they were three years ago. The charts on the next page show the S&P 500 along with its trailing 12-month earnings for the past 15 years. (Also shown are the forecasted 2003 earnings.) The 935 (+6%) “best fit” is a least squares regression analysis projecting the current value of the S&P based on earnings and interest rates. Shown below that are two indicators of value, the price to earnings (P/E) ratio and the dividend yield for the S&P 500 for the same 15 years (which include the “bubble” valuations from 1995 to early 2000). As you can see, P/Es are currently close to their median level of 18.9 while dividend yields at 1.8% remain below their median of 2.5% (but interest rates are at 40+ year lows, so take the dividend yields with a grain of salt).

Montgomery Brothers believes that over the long run stock prices generally track earnings. The current bear market has been all about (over) valuation compression and declining earnings. P/Es on the S&P 500 went from around 30 in late 1999/early 2000 to 19 today while S&P 500 earnings declined from a reported high of \$56.34 in 2000 to an expected \$47.34 for 2002. (As is usually the case, the stock markets started down well before the economy and corporate profits.) This contraction in P/Es came in spite of the yield on the 10-year U.S. Treasury bond declining from 6.0% in March of 2000 to 3.8% today, and the Fed cutting short-term interest rates 11 times.

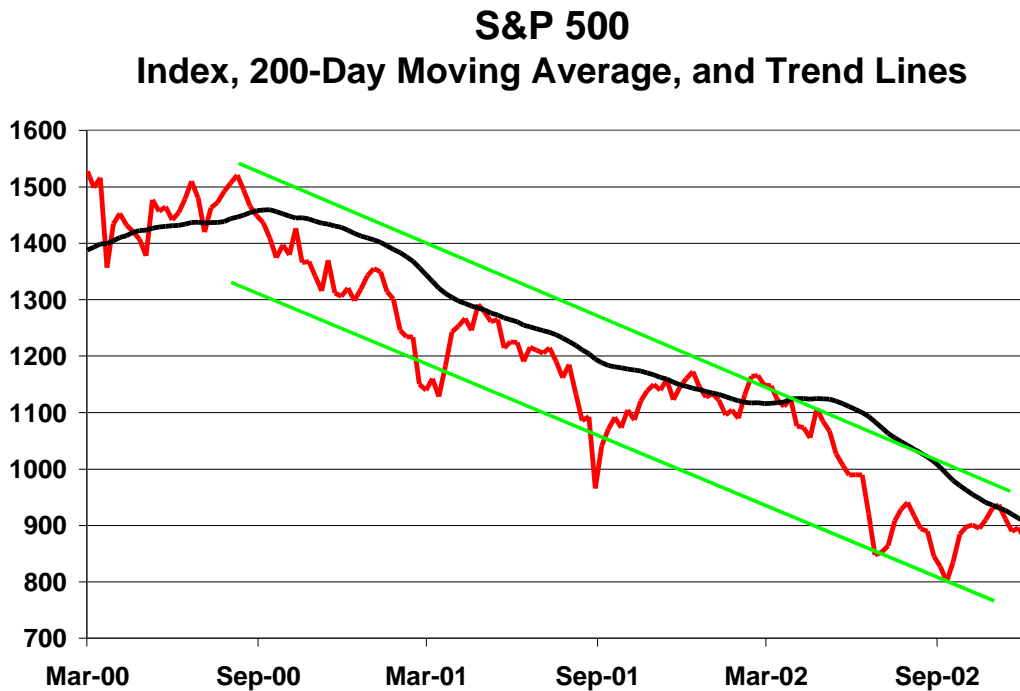
Wall Street analysts, fat lot of good they've done us, continue to be bullish on the earnings outlook. But having been caught with their hands in the cookie jar, these analysts have toned down their optimism and have now issued more SELL recommendations than we can *ever* remember. (We don't remember *any* sell recommendations in 1999 or 2000.)



Besides, investors by and large, have lost faith in corporate profits as stated by most companies. As the “bubble” grew so did the rationale for overstating and misrepresenting corporate profits. When I taught financial statement analysis at Georgetown University’s Business School, I stressed the quaint notion of “quality of earnings.” Companies that clearly and conservatively stated their financial results would be rewarded with higher stock market valuations. During the “bubble,” companies with high-quality earnings were actually penalized in the marketplace while low-quality earnings companies were rewarded. This will revert as investors return to fundamentals.

Low dividend yields while disconcerting are explainable on several levels. First, when you compare stock yields to bond and money market yields, stock yields aren’t that bad. Additionally, payout ratios are at historically low levels. Should, as we suspect, dividends get better tax treatment, dividends could be increased. Back before corporations were forced to publish financial statements, dividends were the only thing for investors to analyze. Like “quality of earnings,” it’s back to the future for dividends!

MBI can only imagine that you are sick to death of hearing that 2002 was the third down year in a row for major stock market averages and that there’s only been once, during the Great Depression, when the major averages were down four years in a row. Similarly, we’ve all heard that 2003 is the third year of the presidential cycle and that that’s the best year of the four-year cycle. None of this guarantees that 2003 will be a great year but implies that it might not be as bad a year as 2002. Shown below is a chart of the S&P 500 since its March 24, 2000 top through year-end 2002, with trend lines and its 200-day moving average.



The trend lines and moving averages have been heading south for the past 2-3/4 years but MBI expects that in 2003 the trading range will flatten and that the S&P 500 will trade in a

range of around 750 on the low side to about 950 on the high side. Volatility should remain high since investor conviction is so low. Too many professionals are trying to scalp a couple of points here and there, index arbitrage is increasing as a percentage of overall volume, and more hedge funds mean more short positions. Volatility begets volatility.

Washington, in its never-ending desire to look like it's doing something, will further overregulate Wall Street and corporate America. But both are resilient and strong. The free market, capitalistic "system" is largely self-correcting and there are plenty of laws on the books to prosecute the "bad guys." But greed is, and always will be, part of human nature so learn to deal with it. Besides, this recent round of corporate skullduggery is yesterday's news. If you're going to worry about something, war and terrorism seem good places to start. But if you wait until uncertainty passes, economic stability is re-established and corporate profits are back, you'll be investing in late 1999/early 2000, again. At that time almost everyone was long on greed and optimism. As we enter 2003, most are long on fear and safety. It would have been better to be long on fear and safety in early 2000. Only time will tell, but we've got a hunch that a little greed and optimism might pay off in 2003.

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