Montgomery Brothers Wealth Management

Fourth Quarter 2002 Investment Outlook

No Laughing Matter

At Montgomery Brothers, we take what we do seriously but try hard not to take ourselves too seriously. We present our economic and investment forecasts in what we hope is a humorous fashion. Unfortunately, we don't find much of what we see in the immediate future very promising, not to mention very funny. I recently took a golfing trip to Ireland, partly to play golf (Ireland was beautiful, but my golf was ugly), and partly to get away (not very successfully) from the constant barrage of negative global, political, and economic news.

There were two events that occurred during the trip that frame my thinking regarding the outlook. The first was a BBC interview with Warren Buffet in which he claimed to be extremely positive on the long-term economic and investment outlook but completely uncertain as to what the next several months or quarters held in store. He cited the low inflation, low interest rate, high productivity nature of the U.S. economy, the strength of the financial sector, and the stability of our political system. Buffett feels that stock prices will go up only when corporate profits improve. The second event was an article I read in the *Herald Tribune* about the closing of the German Neuer Market. The Deutsche Bourse AG announced that it would shut the Neuer Market following its Nimax index's 96% decline from its March 2000 peak. The Neuer Market had been the leading European exchange for innovative technology company shares and was once considered to be a potential rival to NASDAQ.

The long-term outlook does look acceptably positive to us. The latest recession was relatively brief and mild, and the subsequent recovery is pretty subdued. The third quarter of 2002 was the fourth consecutive quarter with expanding GDP. Consumer confidence, employment, and disposable income (thanks to last year's tax cut) have held up fairly well. While we expect that inflation and interest rates will drift upward, such increases are likely to be tame, not that they won't be painful to some. Similarly, we will likely experience additional corporate bankruptcies and financial crises, but these will be easily and well contained, although it won't seem like it as they occur. Fortunately, in spite of the unbelievably aggravating propensity of politicians to engage in petty extramural squabbling, our political system will continue to lurch toward progress often in

spite of itself. But, like Buffett, we are uncertain as to the shorter-term outlook. The continuing problems in tech-land will be with us for some time. While we doubt that NASDAQ will close, additional pain seems likely in the share prices and in the technology sectors. Mercifully, tech plays a much smaller role in the economy than it does in the stock market.

The stock market indicates that a double dip recession, or worse, lies directly ahead. But MBI believes that this ongoing Bear market is more about correcting the valuation excesses of the 1995–1999 bubble and the collapse of corporate profits than it is about economic fundamentals.

When I returned from Ireland, I ran smack into the anti–World Bank/IMF, anti-war, anti-capitalism, anti-anything-and-everything demonstrations that seem to be held quarterly in Washington, DC. The crowd was reportedly smaller than recent demonstrations, which was surprising, given how much the free market star has dimmed over the past two years, and ironic, given the anti-capitalism rhetoric currently prevalent in Washington.

The real political risk for investors is the to-be-expected overreaction to the economic downturn and to the bear market that resulted from the "irrational exuberance" of the late 1990s. While Montgomery Brothers hesitates to predict how politicians will overreact, we are confident that overreact and re-regulate they will. Our fear is that in their never-ending pursuit of appearing to be doing something, one of the results will be lower rates of innovation and productivity in corporate America.

In Ireland, just as in the United States, the possibility of war with Iraq is front page news. One would think that with the War on Terrorism and the current economic situation, the Bush administration's plate would be full and that Iraq could be moved to the back burner. But, so be it. Just another uncertainty to deal with.

With so many real issues, politicians should address them rather than politicize them. But that would be too much to hope for, ever. The November elections are unlikely to change much, but that's ok. The economic system seems to work fairly well when there is relative stability. Years ago when the economy was doing well and the stock market was roaring ahead, everybody liked political gridlock, but now voters want *action*. Montgomery Brothers is always amazed at how seldom citizens "throw the bum out!" We will be interested to see how Jim Trafficant does when running for the House from "the big house." And what's the story with Torricelli? Mercifully, the elections will be over in early November and the politicians can return to the issues, at least until the next election cycle starts. Unfortunately, that'll be in mid-November.

Economic Outlook

Classic economic theory teaches that in the early stages of an economic recovery consumer spending leads. Lower interest rates, resulting partially from monetary policy and partially from the decrease in economic activity, spur increased home building and

auto sales. The baton is then passed to the corporate sector which rebuilds inventories and initiates capital spending. Or so the theory goes.

Whether theory or fact, let's hope that the corporate sector kicks in soon. The consumer is up to his/her keister in debt. Fortunately, consumer confidence has remained remarkably strong, given the nonstop negativism of the War on Terrorism, Iraq, the sluggish economy, and the apparently never-ending bear market. Corporate executives, on the other hand, have little motivation to take risks. Following the Enron, Worldcom, and Tyco scandals, they're all considered greedy scum. Having been led to believe that growth-at-any-cost was what investors really wanted, they now have to deal with investors', not to mention regulators' and politicians', demands for clean accounting. The economic drag of inventory liquidation is largely over but a rapid rebuilding is unlikely. Additionally, with capacity utilization below 80%, further capital spending seems superfluous. Paying down debt and increasing dividends appear more immediate corporate goals. What corporate executives really need is more corporate profits, but the near-term outlook isn't great.

Congressional gridlock prevents much in the way of additional fiscal stimulus over the near term. Even though the shareholder class has risen in number and the effects of fiscal stimulus are well understood on both sides, the political parties are too locked into their ideologies to find much middle ground. Foreign economies, which make the U.S. economy look great by comparison, continue to look to the United States for economic leadership. In spite of our burgeoning trade deficit, everybody wants to export here even if they are now less keen on investing here. Not promising for the economic outlook.

Montgomery Brothers feels it is of secondary importance whether or not the United States experiences the dreaded "double dip." What is important is that economic growth is likely to remain anemic. But sooner or later surprises will start to be on the upside. After all, the surprises have been on the downside for so long that nobody expects anything except bad news. But, that's what Bear markets are all about! Chances are good that by the time we get consistently good economic news, a Bull market will be well underway.

Interest Rate Outlook

Montgomery Brothers would like to get really negative on the outlook for bonds. Rising interest rates would, hopefully, signal a pick up in economic activity. With interest rates, at least on U.S. Treasury securities, at 40+ year lows, only a true economic bear could be positive on bonds. Our economic model calls for interest rates to start rising soon, but it's been a long time since the economy followed our (or anyone else's) model.

Meanwhile, the newly knighted (can you believe it?) Sir Alan Greenspan is again warning about *budget* deficits. In spite of virtually no correlation between the size or direction of budget deficits and interest rates, Sir Alan is calling for budget discipline. We would have thought the Fed would have tired of rowing the economic boat with one oar by now, or maybe even have come to the realization that monetary policy doesn't have the

clout that it used to have. The Fed, in general, and Greenspan, in particular, seem to relish everyone looking to monetary policy for salvation. The Fed has done a good job of reestablishing price stability and has performed its role as the "lender of last resort" well. But the expectations that the Fed can also deliver full employment, an expanding economy, a strong dollar, and higher stock prices with only one tool is a bit much to ask for. A good tax cut would help!

Stock Market Outlook

A Bull market sucks investors in. A Bear market spits investors out. When the economy was doing great and stock prices were endlessly pushing higher, investors in ever-increasing numbers flocked to stocks. Annual gains of 20% year after year crushed caution and eradicated skepticism. The guy using the locker next to yours was getting rich on dotcom IPOs and tech and telecom shares—why not you? Toward the end, bearishness became passé; everyone jumped on the bullish bandwagon. It was the "new paradigm."

Just the opposite happens in a bear market. People continue to "buy every dip," but each subsequent high is a little lower than the previous one, and each "dip" goes down a little further and lasts a little longer than the dip before. Soon the economy looks suspect and former investment heroes look more and more like pied pipers. Slowly people start selling into rallies and eventually and increasingly into the declines which no longer qualify as dips. Bulls become an endangered species. Bears appear on the covers of leading magazines. What made perfect sense at the top now sounds like mindless drivel. Having previously felt dumb for having sold anything on the way up, you now chide yourself for not having sold everything earlier. In a bear market, the endless erosion of your net worth finally becomes too much to bear. (Get it?) *You* sell—probably at or near the bottom.

Everyone keeps asking us, "Where's the bottom?" The best answer we've heard is that we'll see the bottom when everyone stops looking for it. Besides, the bottom isn't a number or a date; it's a process—a process of squeezing out previous excesses. A process that is, hopefully, nearing completion. But so many concerns remain. These include:

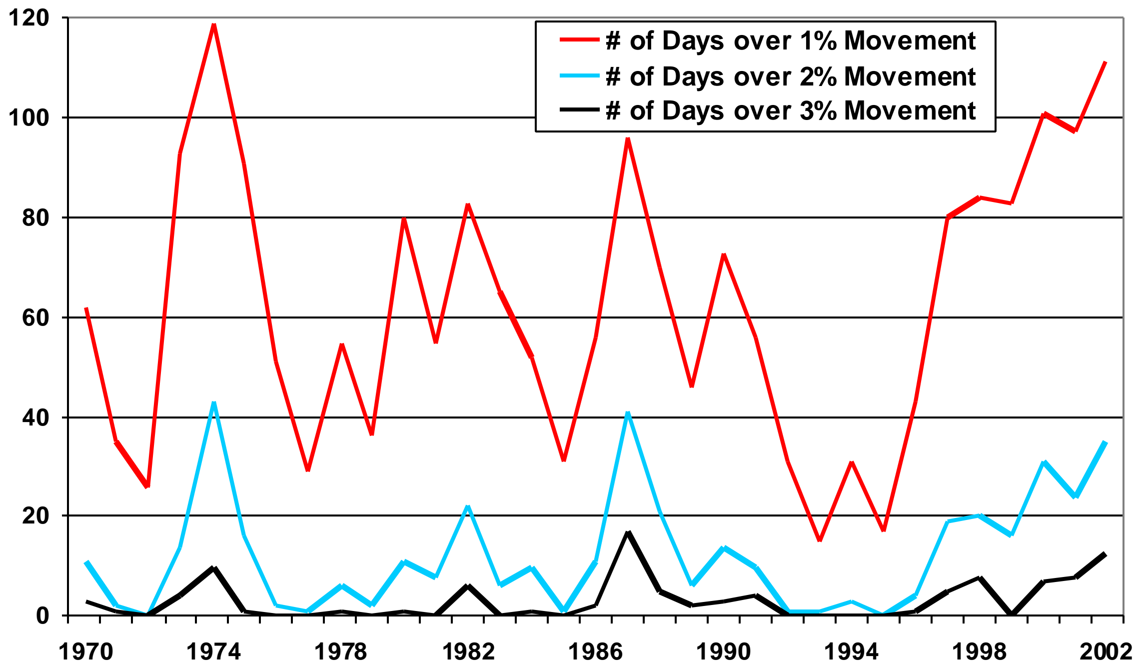
1. ***War.*** Wars aren't necessarily bad for the economy or the stock market, but we believe peace *is* better. The last time that the stock market went down three years in a row was 1939, 1940, and 1941. This was followed by double-digit gains in 1942, 1943, 1944, and 1945, also known as World War II. (This was the longest streak of 20%+ annual gains prior to 1995–1999.) Additionally, the last time that the United States went to war, which also happened to be with Iraq, in case you forgot, the stock market went up 30% during the following 12 months. Still, we don't like war.

2. ***Valuations.*** "P/Es are too high and dividends are too low," is the battle cry of the bears. We are told that at the market bottom in 1982 P/Es were 8.5, and yields were 5.7%. But 10-year Treasuries yielded 13% at that time. Using the "Fed model" for P/Es being the inverse of the 10-year yield, P/Es should have been 7.7 then, and

should be 27 now. Similarly, dividend yields were 44% of 10-year Treasury yields in 1982, and are 54% of 10-year Treasury yields now. Stocks still aren't cheap.

3. ***Earnings.*** We keep hearing that an improvement in corporate earnings is just around the corner, but it sure is a long corner. Virtually every company from A (Agilent) to Z (Footlocker) has "warned" about the earnings outlook. Even more discouraging is when gold companies like Barrick Gold, "steady Eddie" earners like GE, and consumer nondurable companies like Philip Morris warn about potential earnings shortfalls. On the same day! For the Bear to go into hibernation, we'll need better earnings. We still don't see "earnings visibility."

4. ***Volatility.*** Yes! The volatility is incredible and incredibly disconcerting. Feast your eyes on the chart below. It shows the trends of trading days when the Dow Jones Industrials exceeded 1%, 2%, or 3% moves (either up or down) over the past 30 years. Prior to the 1994–1999 period all of the spikes in volatility occurred around market bottoms of late 1974, mid-1982, and mid- to late-1987. Not shown was the period of the 1930s when volatility was at what is still record levels. The 1930s were certainly not a bull market, but there were some great bull market moves during that time. Volatility grew during the late 1990s bull market and has accelerated in the current bear market. We sure don't like the volatility.



Montgomery Brothers believes we're in a period similar to the second half of the 1970s and early 1980s, when the market, in general, went nowhere. We know that there is a Bull market similar to that of 1975 out there somewhere, but we don't know when it starts or from what price level. Markets, however, often bottom in October and we're

moving toward the seasonally strong November to May period. Additionally, the third year of the presidential cycle is usually a fairly decent time for stocks. So let's keep the proverbial stiff upper lip.

When I spoke to Mark from Ireland, he assured me that experiencing down days was easier when you are out of the office. Having been back from vacation for one whole day, I know that he was right.

October 1, 2002 John E. Montgomery

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Some charts courtesy of Baseline.