# Investment Watch

1st Quarter, 2002


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## *"SPRING HAS SPRUNG"*

An old poem has been whirling around in my mind over the last few days. Of course, I had to put my own twist on it…

***Spring has sprung,***
***The economy's riz;***
***I wonder where***
***The market is?***

Well, Shakespeare probably had a difficult period too! But before we dismiss my ill advised rhyme as nonsense, there may be some value in the verse. Give me a chance to explain.

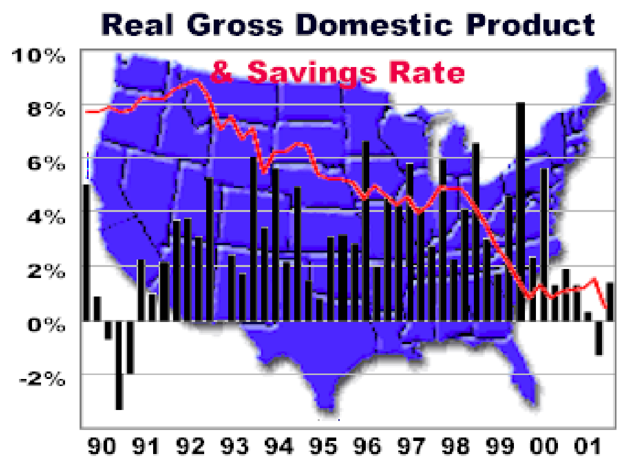
Everyone is asking, "When are *things* going to turn around?" My reply is "What *things* - the economy or the markets?" Because just as sure as spring is melting winter's snow, the groundwork has been laid to guarantee that our resilient economy will spring from the recent mild recession into full bloom - ***the economy's riz!***

You don't have to be a psychic and predict the future. Just analyze the recent past -

- Housing starts were at a 25 year high for January and February
- Jobless rate hit its peak of 5.8% in December and now is declining
- Inventories have been depleted which will require companies to increase production
- Inflation remains in check
- The consumers "keep America rolling"

So is the bottom line that America's longest growth period in our history is followed by the shortest and mildest winter on record? Yes! Believe it or not - ***Spring has sprung!***

Is spring here to stay or are we in store for six more weeks of winter? Don't ask Punxsutawney Phil, he's afraid of his shadow. Rather, analyze what drives the economy.




The Gross Domestic Product (GDP) is one of the best indicators of economic strength, the total amount of goods and services produced in America.

**GDP = C + I + G +NX**

| | |
|---|---|
| **C** | Consumer spending (70%) |
| **I** | Investment spending (16%) |
| **G** | Government spending (18%) |
| **NX** | Net exports (-4%) |

As you can see, consumer spending, comprising 70% of the total GDP, drives our economy. And the consumer has been spending more and more. Unfortunately, because of this spending spree, our savings rate has steadily dropped in the last 12 years from over 7% of our income to almost zero!

Does the consumer have any money left to keep spending? Yes. Lower mortgage rates along with the federal tax cuts phased in over the next six years will put more money in our pockets. However, because we've burnt

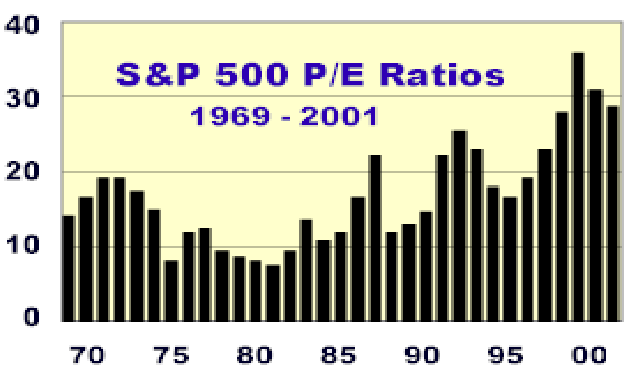
## *"SPRING HAS SPRUNG"*
## *(cont'd)*

holes in the bottoms of our pockets, our money will continue to be the fertilizer which, along with low inflation, increased employment and productivity gains, will make the grass greener on ***this*** side of the fence.

The experts say that nearly every barometer from unemployment to consumer confidence points to recovery. They're right! However, this time the recovery in the economy will not bring about a bull market, at least not right away. As the economy flourishes over the next few quarters the market will not follow and the Dazed and Confused pundits will ask ***"I wonder where the market is?"***

The answer will be simple. (*Someone please stop me*. I can't predict anything. Last quarter I said, "predicting the stock market in the short-term is impossible".) Maybe, this is a medium-term prediction. Well here goes - **Stocks are too expensive now to be carried higher even by a growing economy.**

The Price/Earnings (P/E) ratio tells us whether a stock is expensive or cheap. Generally,




growth stocks have higher P/E's than value stocks. For example, if a stock is selling for \$50 per share and its annual earnings are \$2 per share, the stock has a P/E ratio of 25 (i.e. \$50/\$2). If the price goes to \$60 and earnings don't increase, the P/E increases to 30 - the stock is more expensive.

This is what happened during the tech "bubble" of the late '90's. Just like the seeds that landed in stony places grew rapidly, but then withered and died because they had no depth; so too, the stock prices soared, but then plunged because of the lack of earnings.

Earnings are the good soil that nourish the market. The economy has not yet sufficiently enriched the soil. Corporate earnings were down nearly 22% in the 4th quarter and are forecasted to be negative again this quarter.

Historically, at a trough in the market the average S&P 500 P/E is about 16. In the graph you can see the P/E ratios during the prior market lows ('75, '80, '89 , '95) were all in the 8-18 range. **Today the average P/E is 28.6.** Therefore stocks are expensive compared to the previous market troughs. It's going to take a while for corporate earnings to catch up with their stock prices.

Are there any reasons to believe higher P/E ratios can be supported? *Maybe*. If we view a company's earnings like income on a bond, for every dollar you invest in the S&P 500, the earnings would be 3.4 cents or 3.4%. Because interest rates are low, 3.4% may be a relatively good comparative return, especially given the fact that stock earnings can increase through growth and productivity gains.

If inflation and interest rates remain low, the market could have bottomed out at these high P/E ratios. There's no more room for Greenspan to lower interest rates and he'll think twice when he has to increase them again, which should keep stock prices up and give us some time to wait for increased corporate earnings to be able to drive the market and drive down these high P/E's.

This year Arbor Day is April 26th and as the old adage goes, "From that little acorn a mighty oak tree grew" - but it takes time. We are not speculators but rather long-term investors. Be patient. While we wait, let's go out and plant some trees, because ***- Spring has sprung!***

*Keith Kowalczyk*