CHAPTER ELEVEN

2000 AND BEYOND:
CONDITIONS FOR THE NEXT GREAT BULL MARKET

1. Introduction

Historic events distract the strategist. The charts tell what is really happening. A proper classification and interpretation of the indicators allows us to recognize what is happening and what will happen.

Beginning in 2000 the financial markets entered a new era. These were unique times. It resembled the periods going from 1926-1945 or 1968-1982 when stock market averages showed little or no progress and moved between broad ranges. These statistics are saying that from 1926 to 2000 the stock market has shown no improvement 50% of the time.

The historical return of the stock market has been close to 9%. This is an average of long periods when stocks made little or no progress – such as 1926-1945 and 1968-1982 -- and periods when the market appreciated close to 20% per year as from 1995 to 2000.

It is a fallacy to believe the market will provide a 9% return if stocks are held for the long term. If a ready-to-retire person plans for a 9% return in a period like 1968-1982 or more recently from 2000 to 20xx, he will be disappointed by the lack of appreciation of the nest egg at the time of retirement.

Periods when the market trades in a broad range (up 30%, down 30%) require active portfolio management to overcome the unfavorable investment climate. During such times, only active portfolio management based on the selection of asset classes and stock sectors can provide superior returns from a simple buy-and-hold strategy. One of the main objectives of this book is to propose an investment approach based on the selection of stock sectors to overcome the negative tendencies of the overall market.

The purpose of this chapter is to review the conditions that have accompanied the bust of the financial markets in 2000 and the events that have to take place before the next great bull market can materialize.

2. 2000: The financial markets implode

In 2000, the most important event was the sharp rise of the yields on lower grade corporate bonds relative to the yields of the 10-year Treasury bonds. The ratio of the two yields can be interpreted as a measure of credit risk. Since 1955, the spread has ranged between 1.20 and 1.45. In 2000, the spread soared above 1.45 suggesting that credit conditions were becoming historically unusual. The view of the author has been, as regularly documented in *The Peter Dag Portfolio Strategy and Management*, that a sound financial system cannot be restored until risk spreads fall within their historical range.

As reviewed in detail in previous chapters, the most negative phase of the business cycle for the broad market averages is characterized by a strong economy, rising commodities, higher inflation, and higher short-term interest rates. 2000 was a textbook case of this situation, which was repeated in 2002, and at the end of 2003.

The economy began to slow down in 2000, followed, as it has always happened in the past, by a peak in commodities, inflation, and interest rates.

The collapse of the broad market averages did not reflect what was really happening. The advance-decline line began to rise toward the end of 2000, suggesting that in spite of the carnage, amplified by the colossal decline in technology stocks, the majority of issues listed on the NYSE were rising. Although the rise of the advance-decline line was due mostly to the strength of financial issues including non-operating companies, investors were given a powerful sign that profit opportunities were available.

Investors need to be flexible and recognize that economic and financial times change. As they evolve from one phase to the next, new stock sectors become attractive while others lose their profit potential (see chapter 6). A strong economy is favorable for growth and commodity based stocks, while a weaker economy, such as the one that began to materialize in 2000, makes financial assets and stocks particularly attractive. In spite of the market debacle, 2000 was no exception.

3. <u>2001: The economy slows down</u>

The growth of the money supply, the strength of the dollar, and the sharp steepening of the yield curve suggested that there were strong forces at work. They will ultimately succeed in reviving the economy again following the typical lead/lag of at least 12 months.

The economy kept weakening in response to the lagged effect of lower liquidity, a weaker dollar, and flattening yield curve from 1999 to 2000. But in the second half of 2002 business conditions began to improve in response to the stronger growth in monetary aggregates, a rising dollar, and a steepening yield curve that took place since mid 2000.

Bond yields and short-term interest rates declined following the beginning of the economic slowdown. Lower commodity prices and sharply lower inflation accompanied the weakness of the lagging indicators.

In 2001, the broad market averages continued to sag while the advance-decline line kept rising.

Credit spreads soared, reflecting deteriorating balance sheets and lower credit ratings. The Fed recognized the risk to the system and aggressively cut short-term interest rates well below the inflation rate. Such low real interest rates were a strong statement by our policy makers that the US economy had serious problems. These problems were allowed to materialize when the Fed let the growth of the money supply soar from a 7% growth rate to a 20% torrid year on year pace.

There was no doubt the markets needed to heel themselves following the financial orgy of the late 1990s. The Fed could help. President Bush helped with the tax cut. However, the market needed time to solve the problems and the huge distortions originated by excessive money creation, a phenomenon totally ignored by the Fed.

Credit spreads needed to decline within the 1.20-1.45 historical range to reflect that the excesses created in the previous cycle were purged. Only then could short-term interest rates rise safely to their market level of 4-5%. This is the historical norm during sound economic times in the US or any other country with an inflation rate of close to 3%.

From the investor's viewpoint, the new economic and financial environment had several implications for the years that followed.

- The high credit risk reflected by the high credit spreads was going to cause below average growth in monetary aggregates and overall stock market appreciation.
- Only a carefully implemented stock sector strategy would provide attractive returns.
- Because of low real interest rates, commodity volatility would be above average, as discussed also in *Profiting in Bull or Bear Markets* (see Chapter 6).
- Low real interest rates below 1.4 were inflationary, as they were in the 1970s.
- The Fed's policy geared to protect the banking system from the overhanging credit risk will continue to keep interest rates at below the inflation rate until credit spreads declined to within historical range.
- The Fed strategy gave the incentive to invest in high yielding instruments and stocks. In fact, this was exactly the purpose of the Fed – to divert funds to high-risk instruments and sectors to facilitate their financial healing.

In 2001, the financial and economic environment turned favorable for stocks and financial assets. The collapse of the technology sectors obscured this important development.

Once again, weak economic conditions accompanied by lower commodities, lower inflation, and lower interest rates were setting the stage for another investment opportunity in equities. The relationship between business cycle and stock prices was repeating itself again with impressive regularity in spite of the implosion of the technology bubble.

4. 2002: The recession bottoms and commodities respond to low real interest rates

Not surprisingly, the economy was strong in 2002. The strength was anticipated by rapid growth in the money supply and a rising dollar in 2001. The yield curve also steepened sharply in 2001. This development caused additional economic stimulus in 2002.

The inventory cycle kicked in and the manufacturing sector began to increase production to raise inventories in line with sales.

The increased demand for raw materials, due to the increase in output, placed upward pressure on commodities, which began to soar also stimulated by an unusually aggressive monetary policy. In fact, in spite of accelerating inflation at the producer and consumer levels, the Fed lowered interest rates with the rate on 13-week Treasury bills falling to 1.2%.

The policy of the Fed remained unusual, especially at a time when the economy was strong and commodities and inflation were rising. Under normal circumstances, they should have let interest rates rise to their market levels of close to 1.5-2.0 times inflation, bringing the rate on Treasury bills close to 2.5% instead of 1.2%.

The reason for this policy, in the view of the author, had been the sharp increase in credit spreads, which soared to an all time high toward the end of 2002.

The high spreads were caused by the sharply deteriorating financial position of business mostly caused by the bursting of the technology bubble. The high spreads eventually discouraged borrowing and created the conditions for the next economic slowdown. The Fed, fully aware of what was happening, cushioned the banking system from a rapidly deteriorating credit environment by lowering aggressively the inter-bank rate to 1%. This policy was also driven by their fear of deflation as producer prices showed negative growth on a year-on-year basis in 2002.

The broad stock market averages continued the relentless decline, which started in 2000. Not all issues listed on the NYSE, however, were being punished. The advance-decline line in fact kept rising, signaling to the astute investor that the majority of the issues were moving higher.

Interest rate sensitive issues like bank stocks, high yielding stock partnerships with a commodity driven business, and bonds did very well in this environment. Precious metal stocks began to respond favorably due to the low real interest rate policy pursued by the Fed.

The scenario that characterized the financial markets, and the stock market in particular, required the kind of disciplined strategies discussed in this book. This was clearly not an environment favorable to naïve strategies such as buy-and-hold, indexation, and averaging down.

5. Conclusions: After 2002 -- the unwinding of the excesses of the late 1990s

As of late 2004, the economy and the financial markets were still healing. Credit spreads were declining but still historically high. Declining inflation and historically low real interest rates reflected a vulnerable economic climate. The outlook for major capital gains in stocks was not likely.

The implosion of the financial bubble caused an enormous destruction of wealth. The Wilshire 5000 index, which measures the value of all stocks, peaked in 2000 at 14,000, meaning that the value of all stocks was $14 trillion. The size of the US economy in 2000 was $10 trillion.

By 2003, the Wilshire 5000 index collapsed to 8,000, a loss of $6 trillion in the value of US equities, or 43%. The loss in wealth of $6 trillion in market value was about 60% of the US economy in 2000. Technology stocks suffered an even bigger loss. The Nasdaq declined from about 4700 to 1210 in late 2002 for a loss of 74%.

Not surprisingly, credit spreads remained unusually high to reflect the unsound financial foundation of US business.

This kind of wealth destruction was accompanied by a 23% decline of the dollar, an indication of the loss of purchasing power of the US consumer.

As the dollar collapsed, not coincidentally, a typical basket of commodities soared more then 50%, with gold going from $260 to $420, crude oil jumping from $25 to $55, and copper leaping from $0.65 to $1.45.

This environment impacted business costs and expectations. The need to control costs in an environment of soaring commodities led to emphasize even further the need for low wages, benefits, and overall production costs.

The consumer experienced low growth in wages below the inflation rate, resulting in a persistent loss of real income.

Corporations responded to the market collapse by cutting benefits. Several companies had pension funds at risk, a serious concern of the Fed. Failing corporations (e.g. Enron) caused the destruction of lifetime savings.

Business responded to new ideas and embraced globalization as a need to survive. Schools in China and Asia started to produce high-level engineers who competed with US engineers in terms of skills and wages. The US responded to 9/11 by restricting the influx of foreign students, thus reducing needed skills.

The Wilshire index was still 20% below the 2000 peak, suggesting that the country had yet to recover $4 trillion to match the level of wealth it had in 2000.

As of 2004, the Fed was still pursuing an overly lose monetary policy as it was in the late 1990s when the money supply was growing at 15-20% y/y.

The difference this time was that, although rates were kept at 1% to cushion the banking system from the crisis, monetary aggregates were failing to respond as the dollar kept sinking.

The crisis caused by the market collapse was still not over in 2004. The sagging dollar, the historically low level of nominal and real interest rates and the high credit spreads were sending a strong signal that the US economy was still very sick.

What is going to happen next? Fig. 11.1 below is going to help us finding some answers.

The main objective of the graphs is to show that the stock market, as represented by the S&P 500, has moved between a 15-20% channel from 1987 to 2004. During these 18 years, it has risen an 8.8% compounded pace per year.

The striking trend is the above average growth rate from 1996 to 2000. This exceptional appreciation of stock prices was ignited by the aggressive monetary expansion engineered by the Fed. This aspect of the market was extensively discussed in the financial report *The Peter Dag Portfolio Strategy and Management,* published twice per month by the author and available on www.peterdag.com.

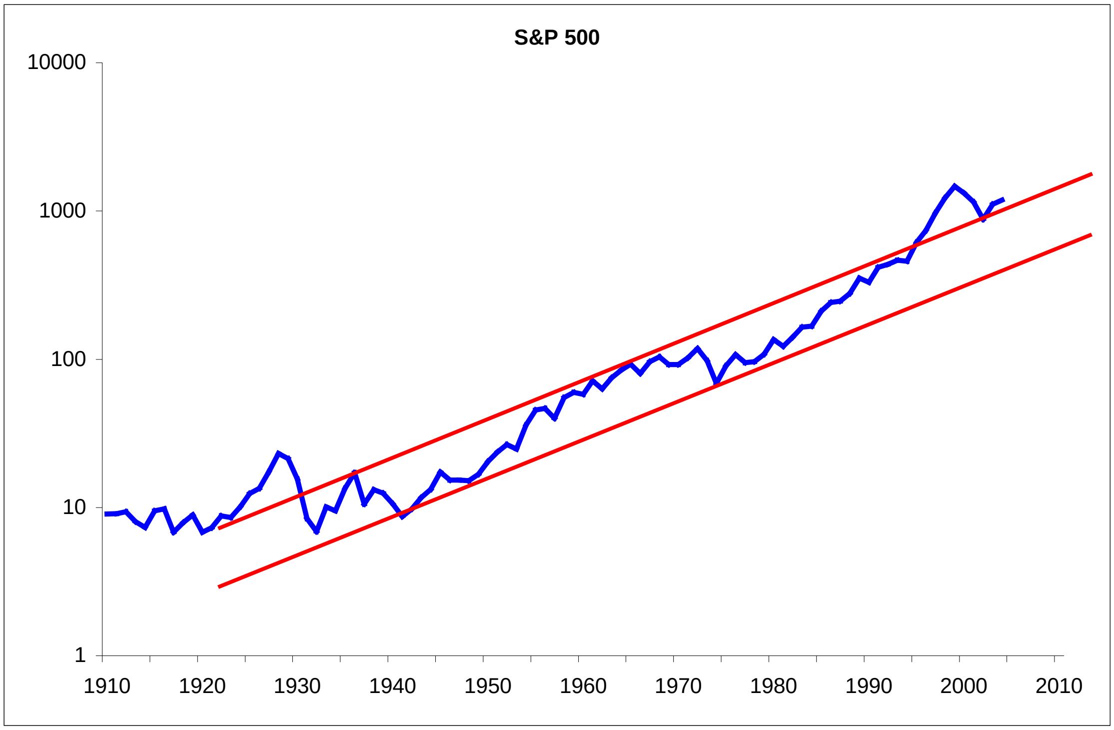
The second remarkable trend is that the S&P 500, after its peak in 2000 caused by overvaluation and rising short-term interest rates, stopped declining when it fell to the historical channel rising at an 8.8% pace.

Now that the excesses of the late 1990s are being brought under control, it is fair to assume that the market will continue to rise within the 30-40% band at an 7% pace. This is the historical capital appreciation of the broad stock market, excluding dividends. At the current pace, the S&P 500 will reach the 1500 level it enjoyed in 2000, by approximately 2008.

Forecasts are fraught with risk. One can safely say, however, what trends investors will have to see to decide that the US economy and the financial markets are back to normal conditions.

- **Credit spreads** between BAA bonds and 10-year Treasury bond yields will start moving again within 1.4 and 1.2. This is the time when the growth in monetary aggregates will start responding again to changes in interest rates as they have historically done.
- **Real short-term interest rates** will rise again to their historical level relative to inflation, which is the level accompanied by low inflation and rising productivity growth. They will have to move above inflation, possibly close to 1.5 times the inflation rate.
- **The nominal level of short-term interest rates** will reach 4-5%. This level has always been a strong signal of a healthy economy in any country in any part of the globe since the times of Babylonia.

- **Commodities** will stabilize and go through mild cyclical fluctuations because of high real short-term interest rates.
- **Inflation** will have to be close to 2-3%, as **10-year Treasury bond yields** fluctuate close to 5-6%.
- **The steepness of the yield curve**, as measured by the ratio between 10-year Treasury bond yields and the rate on 13-week Treasury bills, will have to fall within the historical range of approximately 1 and 1.6.
- **The dollar** will be strong on the premise of stable economic conditions, low inflation, and reflecting a healed economy and financial system.



<u>Fig. 11-1</u>. The stock market, as represented by the S&P 500, has moved between a 30-40% channel from 1930 to 2004. During these 18 years, it has risen an 7.4% compounded rate per year.

The above conditions will create an environment, which has historically been accompanied by the following events.

- **The growth of the money supply** will respond again to changes in interest rates.
- **The dollar** will bottom, as investors recognize that the financial environment in the US has finally stabilized.
- **The stock market** will begin to rise at a rate above the historical 7.4% pace (see next for more details).

As the economy and financial markets transition toward normalcy, they will continue to follow the cause and effect patterns that accompany changes in the business cycle. They always did and always will as discussed in this and the previous book by the same author. Readers are also invited to visit www.peterdag.com for up to date commentaries on business cycle developments and their implications on the selection of stock sectors.
