

# The Blue Sheets

A quarterly review of the markets and the economy  
January 2002

## What Were We Thinking?

*Eventually we will be looking back on this New Year*

### The Consensus is Bullish, Naturally

As surely as December 21<sup>st</sup> marks the low point of the sun's arc in the winter sky, every January we can look forward to Wall Street's optimistic predictions for the stock market in the wonderful New Year ahead. As a matter of tradition, these predictions take one of two forms. Either the new year will be a continuation of the prosperity of the year just finished, or we will put behind us all that temporary nastiness of the preceding year and get on with the financial rewards which have become our inalienable rights. In January 2002, of course, Wall Street's forecasts are of the second type, 2001 having been so unpleasant.

The cheeriness of these annual forecasts should come as no surprise. After all, the folks who write them sell stocks for a living, so what are they going to say, "Stocks stink; you shouldn't buy any stocks"? This year, 7 out of eight of the best-known strategists are predicting 10-15% gains for the major stock market indexes in 2002. But that is also what they predicted last year, and the year before. (Actual results: in 2000 the S&P 500 *lost* 10% and in 2001 it was *down* 12%.)

These Wall Street forecasts always read well, and they always make sense. After all, the men and women who write them are highly educated, richly compensated and have access to all the data in the world. Furthermore, all of us who read them want to make money in the new year, so we are looking for reasons to be optimistic. We are predisposed to agree with their happy projections.

### Can we rely on past patterns?

This year's crop of prognostications share a few arguments in common with each other. First, they all point out that there has not been an incidence of three consecutive years of down markets since 1942. Hence, they argue, since the indexes fell in both 2000 and 2001, we should be confident that one way or another stocks will rise in 2002, preserving this remarkable 59-year track record of no more than two consecutive annual losses.

Not to put too fine a point on things, but if Aristotle were to examine this syllogism, he just might be inclined to challenge the conclusion. As you probably recall from Philosophy 101, a Syllogism is a deductive argument consisting of a major premise, a minor premise and a conclusion. It is a fact that the only two-year decline since 1942 was in 1973-74, and it was followed by an *up* year. What is less clear is why longer declines have been so rare; or, put another way, whether the conclusion (stocks will

rise this year) logically follows from the major premise (a 59-year absence of three consecutive declines) and the minor premise (that we just experienced a two-year decline).

I am reminded of an exercise that I experienced in a summer program for financial professionals at Stanford University. The group was presented with a series of numbers and asked to tag onto the series a figure that was consistent with it. For example, if the series was 1,3,5, then you could sustain the series by adding on the number 7, right? What was amazing to me was to see how many different numbers could be consistent with a given series. For example, can you see how the number 2 could be a correct answer? Consider this series, for example: 1,3,5, 2,4,6, 7,9,11, 8,10,12.

This year's market forecasters are suggesting that we will not experience three consecutive down years because it is inconsistent with the pattern of the past. Would I be too skeptical if I were to suggest that the conclusion is not supported by the major premise? *If* patterns of up and down years were a valid way to forecast market direction (itself a *highly tentative* premise) then one series of three consecutive down years every six decades could certainly be consistent with the recent patterns. You might conclude, as I have, that the two-down-then-up argument is not all that inspiring.

## **A fundamental approach**

Another issue common to this year's optimistic January forecasts is their expectation that the US economy will begin to grow again this spring, helped by low interest rates and fiscal stimulus. With the recession behind us, the argument goes, stock prices will surely rise. Two possibilities that forecasters apparently consider unthinkable are a) that normal growth will *not* resume right away due to debt excesses or b) that the economy could begin to revive without a commensurate increase in stock prices.

Unthinkable? Really? In 1980 the US suffered a pretty serious recession; true to form, the Dow Jones Industrial Average rose in the second half of that year as it became clear that we were pulling out of the recession. Sure enough, 1981 saw a 1.7% inflation-adjusted gain in GDP; not robust, but at least it was up. However, the DJIA *fell* that year from 1024 to 824 and in 1982 the economy was back in the soup. We had what was then referred to as a "double-dip" recession. Corporate earnings dipped 2% in the 1980 recession. In 1981, despite a modest recovery, earnings were down another 7%. It was the second stage of the recession in 1983 that really got to earnings, which plunged 45%! The Dow bottomed at 777 in the middle of that year and the rest, as they say, is history.

Many economists believe that the inventory correction of 2001 has run its course, removing the main factor that has caused the current recession. With this burden lifted, optimists maintain, our ever-rising consumer income will start having its usual felicitous effect on GDP, and we'll be off to the races again. Every forecaster also assumes that consumer borrowing will remain robust because of the drop in interest rates. Some even count on a rise in *corporate* borrowing to boost economic activity. Few mention the reality that both consumer and corporate debt burdens have *grown* during this recession, and stand at record levels. It is more common for debt levels to decline in a recession. Nor do writers mention that there is little if any "pent-up demand" of the sort that usually exists among consumers after a recession. Nor that companies have enormous excess capacity and do not need to ramp up their capital spending. They are more likely to close un-needed factories, offices and stores.

There is one rule of forecasting that has never been repealed; "Nobody knows the future." The past may provide clues, but that is all. I certainly do not *know* if American consumers can and will continue

to increase their debt burden to maintain their spending. I do not *know* whether some wonderful new development in information technology will come along that promises irresistible productivity gains for businesses. And I do not pretend to know whether the Federal Reserve will cut interest rates next month, or whether the federal government will plunge once more into \$400 billion annual deficits to help stimulate business and employment. Even if we could know these things, their impact on stock prices could easily be misinterpreted.

So what am I saying? Only that this year's Wall Street forecasts ignore the reality that with the S&P 500 selling at 40 times the past 12 months' earnings and 25-30 times estimated 2002 profits (which estimates are almost always too high) stocks seem priced for perfection. Perfection is a lot to ask for.

**If you twist my arm for a forecast, I am going to say that it's hard to imagine how the overall stock market can rise this year.**

**Why? Essentially, for two reasons.**

**First, expectations for corporate earnings are too high.**

**Second, valuations are ridiculous! A year from now, people will look back on January 1, 2002 and say, "What were we thinking?!"**

The following table, from the 12/31/01 Barron's, shows how stocks and bonds were valued at previous bear market lows. It makes clear how amazingly overvalued stocks are today. Something, I don't know what, will disrupt the current wave of enthusiasm for buying shares. The momentum will shift to selling and prices will head south. Eventually we will be able to buy shares of solid businesses at sensible prices again. I am growing very weary of waiting, but not weary enough to risk your retirement nest egg and have to face you next year at this time and hear you say, "What were you thinking?"

### **Bear Bottoms** S&P Industrials

<u>Date</u>	<u>P/E</u>	<u>Divd. Yield</u>	<u>Price to Book</u>	<u>Price to Sales</u>	<u>Bond Yield</u>	<u>Earnings Yield</u>
06/13/49	5.4x	7.6%	0.89x	0.43x	2.4%	18.5%
10/22/57	12.0	4.4	1.43	0.75	3.7	8.3
10/25/60	16.3	3.6	1.64	0.93	3.9	6.1
06/26/62	14.9	3.9	1.54	0.85	3.9	6.7
01/03/67	14.9	3.5	1.84	0.93	4.4	6.7
05/26/70	12.9	4.4	1.45	0.66	6.9	7.8
12/06/74	7.5	5.1	1.07	0.38	6.8	13.3
02/28/78	8.3	5.3	1.14	0.40	7.6	12.0
04/21/80	6.8	5.7	1.08	0.34	10.8	14.7
08/12/82	7.9	6.3	0.97	0.33	12.2	12.7
07/24/84	9.4	4.4	1.36	0.44	12.8	10.6
10/19/87	12.7	3.4	1.92	0.58	9.6	7.9
10/11/90	13.9	3.6	2.24	0.60	8.9	7.2
<b>Average</b>	<b>11.0x</b>	<b>4.7%</b>	<b>1.43x</b>	<b>0.58x</b>	<b>7.2%</b>	<b>10.2%</b>
<b>Current</b>	<b>30.0x</b>	<b>1.3%</b>	<b>6.70x</b>	<b>1.47x</b>	<b>4.6%</b>	<b>3.3%</b>

One of the most obvious things about this data is that the P/E ratio (ie. what we investors are willing to pay for the earnings stream of these businesses) is almost three times the P/E at other bear market bottoms. Even more significant to me is the paucity of the 1.3% dividend yield. The fact that stockholders are willing to accept such a small up-front cash payment from their investments each year means they are far more optimistic than usual about future earnings growth. Earnings did grow rapidly in the 1990s, so it is natural for investors to expect more of the same. However, I think this is the expectation that is most vulnerable to disappointment and most likely to spark another downward spiral in stock prices.

Over the years, corporate profits are constrained by competitive forces as well as by the demands of government (taxes) and labor (wages). Over long periods of history, business profits have averaged the same growth rate as GDP, something like 6% a year. This growth consists of population or workforce growth (1%) plus productivity gains (2%) plus inflation (3%). But from 1990 to 2000 earnings grew at nearly 10% a year! The reason that earnings grew unusually fast in the 1990s is that profit *margins* were near their cyclical low in 1990 and their cyclical high in 2000. The rapid earnings growth was not due to a permanent increase in the rate of productivity or to a new, benign era in capitalism. Unless we can make a case for faster-than-historic growth of the workforce, productivity or inflation, then long-term profits growth is going to be about the same as it has always been. Not only that, but after a cyclical peak in profit margins such as we saw in 2000 (after-tax profits were about 6% of sales), market forces are likely to put pressure on margins, resulting in slow profit growth for a while.

If it should become clear in the next year or so that corporate earnings are not in a new growth era, investor enthusiasm that is keeping the market's P/E so high is likely to wane. That being the case, if we want to make more than a few percent return on our portfolios, we are going to have to find some investments that are better values than the market as a whole. Some undiscovered gems or misunderstood securities. We have some ideas along those lines. But first, I want to introduce you to a friend of mine who has a history of very keen, pragmatic insights into the interaction of the economy and the stock market. (I wrote this for the January 2002 issue of Financial Advisor magazine.)

## **Deja Bear**

### **Murph says it feels a little like January 2000**

#### ***Hope trumps fear and reason***

In the final quarter of 2001, America hosted a remarkable stock market rally in the face of extraordinary economic and political uncertainty. "A public demonstration of the strength of the American way of life", say bullish commentators. "Testimony to the storied resilience of democracy and capitalism."

As citizens we've all experienced a patriotic surge of strength and optimism, an exhilarating antidote to September's fear and destruction. Hoping for a new dawn of capitalism, investors have opened their wallets in response to Wall Street's beatific vision of a V-shaped recovery, international harmony and a resurgence of global prosperity. I don't know about you, but some days I am sorely tempted to throw caution to the winds, raise my financial fist in defiance of

the unseen enemy and ride that promised wave of recovery to unimagined riches. I want to believe.

Actually, I do believe. I believe that good trumps evil. I believe that beneath all the chaos, the world is actually evolving toward democracy and free markets because these work better than any system of social order ever tried. The insurmountable evidence is our “Longest enduring society of free men governing themselves without benefit of kings or dictators.” (WSJ annual Thanksgiving Day editorial.) I believe in America, in freedom and investing in the public securities markets. It’s the price of those securities that gives me pause. And I have learned the hard way that it matters what you pay. It matters a great deal.

I am not just a private investor throwing in my lot with the enthusiastic public. What makes my situation different is that someplace along the way I assumed the mantle of personal financial advisor to hard-working, hard- saving people who look to me for sober judgment in matters that will significantly influence the quality of their lives. Feeling every ounce of this responsibility lately, I have been sifting each morning’s fresh economic data, searching for that nugget of truth that will give me permission to join the stock market rally with a clear conscience. Instead, I find myself feeling the way I did two years ago, before the bubble burst. So I do what I often do when I am searching for market truth. I look up my old friend, Murph.

### **Looking for wisdom at Delmonico’s**

George Murphy dropped out of St. Mary’s Seminary in Cleveland, Ohio early in the first Eisenhower Administration. More accurately, he sneaked out of the dormitory in the middle of the night, bicycled to Union Terminal and caught the 6:02 Sunrise Special to New York City. The rest, as they say, is history.

Murph is not saying, but his friends guess he’s past 70. Been on “the street” for half a century and paid attention every blessed day of it. He’s a living legend at Delmonico’s, an opulent bar and steakhouse just a five minute walk from the NYSE. Younger traders and portfolio managers can’t get enough of his colorful recollections of fortunes won and lost. And Murph never tires of the telling!

It’s a little windy as I turn the corner onto Beaver Street, and a dusting of fine snow swirls across the blacktop. As I push open the heavy, carved door, I am cheered by the glow of holiday lights strung above the mahogany bar, the clink of crystal and china and the buzz of the after work-crowd. Sure enough, I spot George Murphy at a small table in the far corner. He seems to be having a spirited exchange with young Jack Clark.

Jack joined Murphy Advisory about five years ago. Notre Dame undergrad, two-year internship at Morgan Stanley, Chicago B School and a stint with Janus. Aside from their Gaelic surnames and mid-western Catholic roots, Jack is the antithesis of the self-educated Irishman who worked his way up from the back office of Glore Forgan. Murph and Jack come at most issues from very different perspectives. But they enjoy the daily battle and they both know their clients are better off when they are able to hammer out a consensus. So, when they go at it they don’t hold back. Let’s grab a seat at the next table and see what we can learn.

## The market according to Murph

- Jack: Murph, I really think we're missing the boat this time. If we get this wrong, you're not going to have a practice to sell me. It's *that* big! The Dow is up 20% from its low. America's in a new bull market and we're sitting on the sidelines watching the parade go by! You've gotta get with the program, man; we've gotta go with the flow, be in the game, do whatever works. That's what clients pay us for.
- Murph: (Leaning back in his chair, staring at the pilsner glass as he idly turns its base on the linen table cloth.)  
Go on, Jack, I'm listening. For a change!
- Jack: (Sensing the older man's respect, he also settles back and talks more calmly.)  
Number one, as we all know, recessions run two, maybe three quarters, and we're into the third quarter already. Number two, the stock market is a forecasting machine, and it bottoms out three to six months before the economy does. And it *has* bottomed out, Murph. The bottom is behind us! What are we waiting for?
- Murph: C'mon, Kid. You sound like one of those talking heads. Where is it written that recessions are 6-9 months, huh? And are we talkin' GDP recessions, here, or earnings recessions? Let's look at some history; earnings peaked in 1929 and they didn't get back to that level for 20 years, not until 1948. And stocks didn't get back for another 6 years after that. You want to invest a year and a half after the market peaks? Ok, in the middle of 1931 you buy the Dow at 150, down from 381... on its way to 41 the next year!
- Jack: Don't drag out that 1929 ancient history stuff. It'll never be like that again, all those bank failures, restrictive trade tariffs, bread lines, panic in the streets. The Fed has a grip on money supply and reserve policy today. We've had 11 rate cuts and if that's not enough to kick- start the economy, we've got tax cuts on the way. And, oh by the way, consumer sentiment and leading indicators have both started to rise again. I'm telling you, Murph, it's recovery time and we need to raise our stock allocation and stop hunkering down in bonds and value funds.
- Murph: You're right about the Fed, Jack. Greenspan's been great; my hat's off to the guy. But you know what bothers me? Japan. Eleven years of stock market declines, persistent recession, deflation the past three years and still no sign that consumers are coming back. It bothers me that maybe the Fed is pushing on a string this time. One half percent interest rates didn't stimulate anything in Japan. Maybe 2% doesn't work here. Maybe 1% doesn't. I think it all depends on the quality of loans that are out, and they worry me. Consumer installment debt is at an all-time high as a percentage of incomes, and way above where it usually bottoms in recessions. Personal bankruptcies were high and rising *before* the recession.

Now we have the Enron mess, possible K Mart bankruptcy, a \$60 billion write-off at AOL, 16% capacity reduction at Ford, a huge devaluation in Argentina and heaven knows what other surprises are in store.

And I am very skeptical about this promised consumer spending. Because of the consumer's long binge, we have the newest car fleet and the most up-to-date housing stock ever. Build me a case for "pent-up" demand, go ahead I dare you. The US consumer can cut spending, work on his balance sheet for years and hardly notice a change in lifestyle. That's two-thirds of the GDP that can easily stop in its tracks.

The big driver of the last bull market was capital spending, but today's businesses are only using 75% of their capacity, and they are choking on debt. Cap spending can go on a long furlough. That leaves Government spending. I'll give you that one. Post- 9/11 those ol' boys in Washington have all the excuses they'll need for years worth of new programs. But more government slows the wheels of commerce, son, and don't let anybody from those fancy colleges tell you different.

Jack: Murph, interest rates are the lowest they've been since you were counting paper securities in the vault at Manny Hanny. Last week I bought Ruth a new mini van for nothing down and no interest on a five-year loan! Not stimulative? Are you kidding? Give the consumer a chance to spend and voila, you've got a recovery.

Murph: Ever hear of profitless prosperity? Do you think Daimler-Chrysler is making money on the van you bought for 88% of the sticker price with an interest-free loan? Believe me, if that's what it takes to sell cars, they'll cut production until they can sell them at a profit. I see more layoffs ahead.

Keep in mind that companies are in business to earn a profit, and business profits ultimately drive stock prices. Over the long haul, earnings grow about the same as GDP. That's all. In the eighty years from 1920 to 2000, GDP grew at a compound rate of 6.0% a year and the Dow grew 6.0% a year. Coincidence? I don't think so.

Sometimes profits grow faster than average for a while, and sometimes slower. Profit margins swing between 3 % and 6% of sales. When they get low, the weak competitors get weeded out. When margins get high, new competitors come in and eventually drive margins back down. It's always out of balance and always seeking equilibrium. In 1999 and 2000 margins got to 6%, the high side of the range. I think they've entered a multi-year retreat.

Jack: Well, think about the other aspect of low interest rates. Our bond portfolio did great for the first 10 months of last year; I'll give you that. But now the 10-year yield is under 5%. And if I'm right that this economy is back, then rates will start inching up and our bond prices will start to slip.

Murph: Don't think I haven't lost a little sleep over that one, Jack. You know, for years I've been saying that the inflation surprises will be on the downside and that long-term Treasuries will yield 4%. Well, we almost got there last month. I know at some point we need a new game plan. Eventually I want to load up on stocks, too. You bring me a story with good value and I'll buy it. But don't ask me to become a momentum guy. Ultimately, you can't win that game. This isn't Las Vegas, Jack, it's Wall Street, where America raises capital for legitimate businesses. It's our job to know the difference between gambling and investing, and God help us when we forget it.

Jack: There's always been a speculative aspect to the markets, Murph, and you know it. If it weren't for the promise of quick riches, we wouldn't have the liquidity that we all enjoy.

Murph: True. But remember who makes all the money in Vegas. The house, not the wide-eyed visitors.

Jack: So now I'm naive, right? And what about you? You cut back on equities in '98 when the Dow was 8,000 on its way to almost 12,000. You left 50% on the table. Was that smart?

Murph: For the last five years, bonds have earned more than stocks, haven't they? Now who's naïve? Jack, history is a great teacher, if we'll just pay attention. There's valuable information in the historical data. A couple hundred years of free market transactions show a range within which most commercial activity takes place. When current numbers are near the extremes of an historic range, an opportunity is usually smiling at us from the data.

Stock valuations reflect waves of emotion on the part of the players who are in it for the quick buck. And coming off a heady decade like the nineties, there are more speculators than ever. Even a lot of the pros have become players. If you try to go with the momentum, instead of paying attention to legitimate investment values, then you're a speculator, Jack, and you're gonna end up like the dandies at the blackjack table.

Murph notices me as I get up to leave, and lifts his Guinness in a silent toast.

Murph and I are on the same page. Even Alan Greenspan, in a January 11 speech, agreed that some of the data that looks encouraging may prove to be temporary because the consumer and corporate debt burdens are still so heavy. If we don't get the expected sharp recovery, the market could turn south before the winter is over.

So where can we earn a profit if the overall market is not cooperative? Here's one idea...

## Washington Mutual, Inc. (WM-34-NYSE)

Some years back, Robert Schuller wrote a book titled, “Tough Times Never Last, But Tough People Do.” While the book was written to offer spiritual inspiration and motivation to people experiencing pressures in their lives, its title mirrors the essence of one of our favorite investment strategies: in difficult economic times, financially strong companies with a sound business plan typically gain market share from weaker participants in their industry, ones with less staying power. Investing in the best companies is a strategy particularly suited to difficult economic times.

The largest savings bank, largest mortgage lender, and largest mortgage servicing organization in the United States is Washington Mutual, whose history dates back to 1889. It is the lowest-cost provider of these services, and its cost advantage is expected to get even greater as it employs its new “Optis” automated underwriting and loan origination software. The company’s head of mortgage banking believes this leading-edge software will allow it to eliminate 90% of its loan processing centers within a year, even as it literally multiplies the volume of loans it can handle!

Washington Mutual puts great emphasis on personal service to its banking customers, which has facilitated rapid growth of its low-cost deposits, a key part of its competitiveness. The company is committed to using its efficiency to establish a nationally recognized consumer banking franchise, which will deliver steady increases in market share and return on capital.

Analysts at Goldman Sachs and elsewhere place 2002 earnings at \$3.90 a share, up from about \$3.60 for the year just ended. They believe the company can continue to deliver the 15% average annual earnings growth it has achieved over the past 15 years.

Earnings for savings banks have tended to be fairly volatile and sensitive to swings in interest rates, doing better when rates are declining, because falling interest rates allow for a lower cost of funds and an increase in fees for refinancing existing mortgages. Washington’s management has focused on making its earnings less sensitive to interest rate swings by developing a growing stream of stable income from mortgage servicing fees and by expanding into home equity loans, which tend to be less cyclical than purchase money mortgages.

If we should have a double-dip recession, or an extended period of sluggish economic activity, the savings bank industry could see some increase in loan loss provisions. This risk seems well reflected in the stock’s very low P/E ratio (WM sells at less than 9 times estimated 2002 earnings, compared with about 30 times for the S&P 500 and 15 times for the savings bank industry.) What is not reflected in the price is the company’s position as the largest, best-capitalized and lowest-cost provider in its industry. Bill Nygren (manager of Oakmark Fund, a large stockholder) thinks WM is a Wal-Mart story. That is, its competitive advantages should allow it to steadily gain market share from less efficient competitors in a slow-growth, fragmented consumer business. Eventually, if it keeps succeeding, the market will begin to *expect* future growth and assign Washington Mutual a growth stock P/E ratio.

We have added Washington Mutual to our recommended list of industry leaders.

<b>DJIA</b>	9987	<b>IBM</b>	120	<b>WM</b>	35	<b>J. Michael Martin, J.D., CFP</b> <b>January 12, 2002</b>
<b>Nasdaq</b>	2022	<b>WMI</b>	30	<b>XOM</b>	38	
<b>S&amp;P 500</b>	1145					

41