SIGMA
INVESTMENT COUNSELORS

Sigma Summaries

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Anatomy of a Recovery

Two barometers suggest that investor sentiment remains decidedly skittish: our clients, who generally express skepticism that the recent improvement in stock prices is sustainable, and the record levels of short selling activity in the equity markets. This bearish investment sentiment is not surprising. After what seems like an unprecedented series of unpredictable global and domestic calamities that have produced an extended period of market disappointments, many investors have either developed a clear distaste for equities or, at a minimum, are nervous owners. Further, there seem to be enumerable reasons for current worries: the economy is still sluggish, unemployment continues to rise, terrorism remains a threat, the Federal deficit is rising, the dollar is weakening, and cases of corporate malfeasance continue to surface. Yet, the stock market has continued to forge ahead.

While we cannot predict with certainty that we are in a sustained new bull market, we can say with certainty that **there has never been a bull market that has not climbed a wall of worry.**

The 1930s bull market was well under way long before many investors climbed on board and realized that the economy was beginning to rise from the depths of the Great Depression. How could this be? Understanding the economic landscape at the time may provide some enlightenment.

The markets experienced extraordinarily speculative activity in the 1920s with the Dow Jones Industrial Average peaking at 381 on September 3, 1929. When the carnage was finally over on July 8, 1932, the Dow stood at 41. The Dow's decline of almost 90% was nothing short of devastating, wiping out the savings of millions of investors and fortunes accumulated by many others.

The economic environment also plagued investors. In 1932, a quarter of the 40 million members of the civilian work force were unemployed; industrial production was half what it had been in 1929; and Americans were hoarding gold, currencies and coin.

In addition, the country's financial institutions were in a state of disarray. The American banking system was so crippled that President Roosevelt ordered a 10-day bank holiday to determine which banks were capable of reopening their doors and which could survive with an infusion of capital. Wall Street was harshly reprimanded and disgraced and self-regulation was replaced by the creation of the Securities and Exchange Commission. Further, the Glass-Steagull act of 1933 forced all banking firms to separate investment-banking operations from commercial bank activities.

In the midst of all this disruption and confusion, the stock market started to recover. Why? Because the fear that the disastrous economic environment would never cease was already discounted in stock prices. **The market is an anticipatory mechanism.** When Roosevelt was able to demonstrate some leadership and instill a sense of confidence in the prospects for the country and when fiscal and monetary stimulus began to be reflected in an improved economic outlook, the market had already begun to reflect these positive events.

Uncertainty again created opportunity in the 1950s. There was pervasive fear that World War II would be followed by another depression. Despite such fears, a new bull market phase began in the early 1950s. Other fears also spooked investors during this time. Aggressive monetary and fiscal policy to finance economic growth and the war had resulted in high inflation. Inventory profits caused by inflation were distorting corporate profits making them appear unrealistically high. High inflation also made real assets such as commodities and real estate seem more appealing than common stocks. Then there was fear that the war-induced guns and butter inflationary financing would continue to be the order of the day due to the cold war and the outbreak of the Korean War late in the early 1950s. Finally, investor psychology was still traumatized by the great stock market debacle during the Great Depression. So once again, one might ask why did the market soar during the 1950s and early 1960s with all these fears and uncertainties in the background?

As it turned out, to paraphrase a quote by Franklin Delano Roosevelt, the greatest fear investors had was fear itself. The Treasury, the Federal Reserve Board and the Eisenhower administration all established policies that were sensitive to avoiding recessions on the one hand and the dangers of inflation on the other. The three recessions of 1949, 1953, and 1958 might suggest that economic policies were too cautious. However, slow GDP growth of 1-2% was accompanied by stable prices and little to no inflation. Low inflation helped stock prices move upward and the rebuilding of America symbolized by the building of our interstate highway system also led to rising stock prices.

Once again the bull market that started in the early 1980s also started in an environment where investors were grim and timid. At a cocktail party in 1982 an acquaintenance, who was a real estate investor, looked at me condescendingly when I suggested stocks might be an attractive asset category. Of course, the only assets that had performed well during the vicious years of rampant inflation during the 1970s were cash among financial assets and hard assets such as real estate, commodities and art.

At the beginning of the 1980s, investors were traumatized by a mammoth Federal budget deficit, high real interest rates, an overvalued dollar, excess consumer credit, and many business loans potentially in default. These concerns were the reasons that equity valuations became unusually low with the S&P 500 selling at 8 times earnings vs. an historical average of 15 times. **Investors were frightened, but so were politicians who were encouraged to pursue more stimulative fiscal and monetary policies.** It took awhile, however, for investors to realize that the Fed had broken the back of inflation and interest rates were in a two-decade slide. Similarly, investors were slow to perceive that pro-business tax reforms had stimulated corporate profit growth, and OPEC, which had caused two oil shortages in 1973-74 and 1979-80 and record high gas prices, was no longer effective. **Little did investors know that the stock market had begun its greatest bull market in 1982.**

Is history currently repeating itself? While valuations may not be nearly as attractive as they were in 1980, is there too much concern about reinflation or deflation, the size of the Federal budget deficit and the amount of consumer credit? Could the recent improvement in corporate profits be more than a flash in the pan? While much of the improvement to date has come from rigorous cost cutting, will the fiscal stimulus that Congress finally has enacted combined with monetary stimulus lead to better sales growth and more sustainable improvements in corporate profits? While terrorism, corporate scandal, and obscene corporate compensation policies for many senior executives have not abated, are investors now overly pessimistic about these factors?

Only over time will this series of questions be answered and will we know whether the market just might be in the process of climbing a wall of worry once again. **All markets, however, have leaders and laggards or stocks that perform better or worse than others.** Most of the better performers are likely to be companies in industries or sectors that reflect the economic environment of the times or demonstrate new innovations or business models.

For instance, steels, industrials, and railroads were among the better performing industries in the bull market of the 1930s spurred by FDR's New Deal initiatives. In the1950s, stocks of consumer durable companies benefited from the pent-up demand created by government constraints on consumer spending during World War II. During the war many factories traditionally used for the production of autos, for example, were converted to the production of goods needed for the war. Obviously, this limited the supply of autos available for purchase, thereby creating the pent-up demand. After the war, the hotel industry also fared quite well as the interstate highway was built.

In the 1980s, healthcare stocks provided leadership as the drug companies offered a plethora of new products as a culmination of years of productive research efforts. Of course, the telecommunications and technology revolution in the 1990s led to these types of securities enjoying their greatest ever decade of stock performance.

As indicated in many previous Sigma publications, **Sigma focuses its efforts on identifying those industries and companies that have strong fundamentals.** Examples today might include those participating in the following investment themes: the aging of our population, the growth in demand for post-secondary education, and the continued outsourcing of non-core activities by businesses, to mention a few.

We also recognize that ultimately we are investing not just in the stock market, but also in individual stocks. Moreover, we are looking to purchase such securities at attractive valuations. After all, at the end of the day, the stock market itself is just a market of stocks.

Written by: Ann Conrad, CFA

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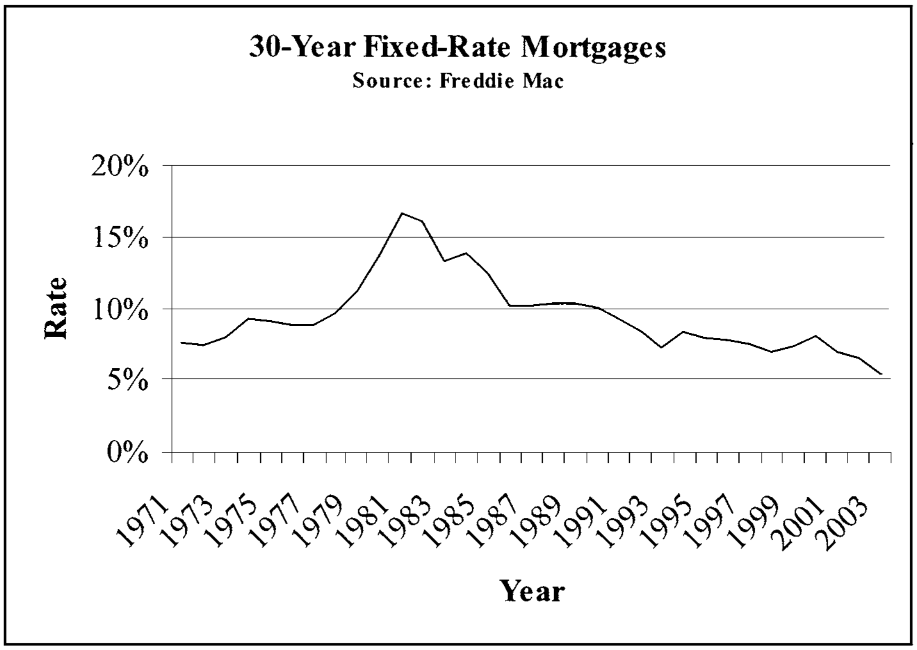

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