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Observations on a Lousy Year

It would be natural to express feelings of relief as we close 2002. However, since this is the third down year in a row for the U. S. equities markets, such expressions have proven quite premature in the past. Therefore, it is hard to feel anything other than ambivalence about the year just ended. The fact is that it was a lousy year. Equity investors would certainly agree. But more generally it was a lousy year as the country has been forced to resign itself to deal with some unpleasant realities.

Of course the most important and difficult of these has been our return to the brink of war. The celebration of the peace dividend when the cold war ended has given way to the realization that the world remains quite dangerous. In some respects, it is even more dangerous than when we had a single visible, more predictable adversary in the Soviet Union. When our old adversary collapsed, many academics were discussing "The End of History." It was suggested that it was the end of Totalitarian states. Democracy and individual freedom had triumphed. But we now know that history has certainly not ended.

Conflicts based on religion are as old as man. The conflicts between the Muslim world and secular Western societies have been the basis of history for a thousand years. The rise and fall of totalitarianism in the twentieth century appears as a brief departure from the basic conflict.

So we are resigned to deal with it. We are fighting a war with the ghost like terrorist of Al Queda and we must take a stand against the secular power of Saddam Hussein who uses religion to generate support for his own ambitions.

The collapse of the Soviet Union also freed us temporarily from the daily fears of the use of weapons of mass destruction. The nuclear threat went out of our daily mindset. Biological and chemical weapons were never really in it. Now they are certainly part of our consciousness. The North Korean nuclear threat seems crazy, but it is real, and must be dealt with. The government is serious about setting up emergency measures to deal with anthrax and small pox.

We are resigned to this more dangerous world. The mood seems similar to the 1970's when the outcome of the cold war was still very much in doubt. The effect is to lower our collective expectations.

The second reality is that the business cycle has not been repealed. Except for a brief, shallow episode in 1990, the U. S. had not experienced an economic recession in close to twenty years. Alan Greenspan was knighted for his adept handling of the economic reins at the Federal Reserve. The new economy brought unprecedented productivity gains that would power the economy ever upward.

Wishful thinking!

We are resigned to the fact that cycles are always with us. Our free society embraces the returns that come from opportunity and cannot avoid the risks that also come with it. This return to reality has the effect of lowering our collective expectations.

The third reality that we have faced is that corporate America is just as fallible as the rest of the country. After close to twenty years of no serious economic slowdown, excesses (say greed) got into the system. Investment bankers, accountants, CEO's, CFO's, shareholders, etc. didn't want the merry-go-round to stop. The rules were stretched. Shareholders, regulators, auditors all winked. We have become resigned to be skeptical again. The effect is to lower our collective expectations.

The U. S. equity market has been adjusting to the lowering of expectations for the last three years. In the year 2000, the expected growth rate of earnings for the companies in the S&P 500 was over 19%. Now it is about 12%. Historically, expected earnings growth of 10-12% has been the "norm." In the year 2000, the price/earnings ratio of the S&P 500 was about 35X expected earnings. Now it is close to 16X. Historically, 16X is reasonably close to the "norm." Excessive expectations have been dashed. The market is priced more consistently with longer term reality.

Meanwhile, we are dealing with reality. The risk of war is near and great. But we are resigned to it and have prepared. The economy is recovering from the recession. Fiscal policy and certainly monetary policy are stimulative and will remain so. Companies are lean. Profits should recover nicely over the next two years. The antibodies are working on the culture of corporate greed. Enron, Worldcom, etc. will be mentioned in the back pages of the paper, if at all, this time next year.

Expectations are more consistent with history and reality. I think returns on equities will be positive in 2003. I believe stocks will outperform bonds for the first time in a long time.

All of us at Davis Hamilton Jackson & Associates wish you and yours a healthy and peaceful New Year.

*-Robert C. Davis, CFA
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A copy of our Form ADV, Part II is available upon request.

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