

# The Fog of War

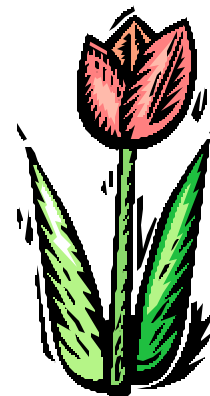
By Randy Zaharia

Throughout the twentieth century, US financial markets have managed to cope with armed conflicts and crises. As one can see from Figure 1, since 1926, our markets dealt with World War II, the Korean War, the Vietnam War, the Iran Crisis, and the first Gulf War.

Despite all these conflicts, the equity markets generally advanced to higher levels. In fact, when one fac-

tors in the more overarching Cold War of the late 1940s to the early 1990s, it is apparent that markets have managed (and will probably continue to manage) through “the fog of war.”

Given all this, what can we expect following the conclusion of the current Gulf War with respect to the US economy and the financial markets? Let us consider the ramifica-



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### Attention Office Visitors

by Jim Fox

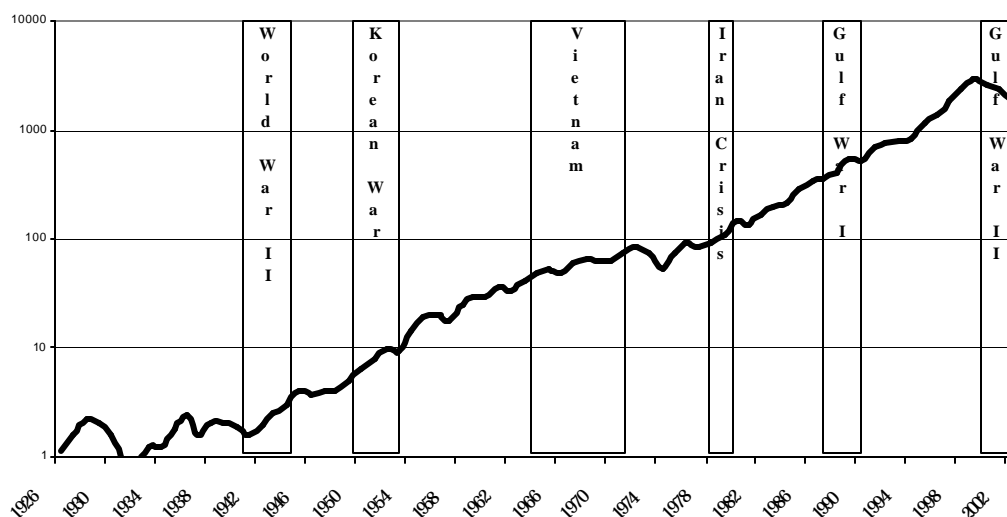
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**FIGURE 1: S&P 500 GROWTH OF A \$ DOLLAR**



The chart above represents the affect of armed conflicts on S&P 500 Index from 1926 - 2002

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tions from both a short-term and a long-term perspective.

#### **SHORT -TERM PERSPECTIVE**

Looking out over the next 18 months, there are several key issues and considerations within the economy. First, the Federal Reserve has provided substantial monetary stimulus. Short-term rates are below current inflation rates of 1.5% to 2.0%, indicating negative real returns on cash. Since mid-2001, the money supply has grown about 7% to 12%, ensuring plenty of cash in the banking system. Next, fiscal policy has become quite stimulative with increased spending on defense and with deficits in the \$300-billion range for fiscal year 2003 and beyond. Tax cuts in the \$300 to \$700-billion range are under consideration, including business incentives and accelerated tax cuts. With the success of the current Gulf War, oil prices have declined and are expected to remain in the \$20 to \$25 per barrel range, providing a significant positive economic stimulus to the US and to the world by increasing real economic buying power. Also, fiscal deficits may contribute to a continued weakening in the US dollar, thereby stimulating demand for US exports.

However, one key drag on these positives will be the large fiscal deficits incurred by state governments, estimated at \$100 billion, which could drain off some of the stimulative federal policy effects as states raise taxes and cut spending to balance budgets. Another drag on the economy may be the possible foreign disinvestment of US financial assets (due to a weakening dollar), especially in the bond markets, resulting in increasing interest rates.

Many of these factors are reflected in consensus US Gross Domestic Product (GDP) growth estimates currently modeled by economists for 2003 and 2004. Due to the war, year-over-year growth estimates for 2003 vary from 1.0% to 3.5% with most around 2.0% to 3.0%. Estimates for 2004 range higher, between 2.5% to 4%, as the economy is expected to more fully recover.

Yet, how are we shaping up so far? Household disposable income has increased over the last

three quarters. Housing and refinancing activities have been strong throughout 2002 and into 2003 (though with some recent weakening). Non-auto retail sales, until March 2003 and the start of the war, were fairly robust, suggesting that the consumer was still fairly active. Corporate profits were up for the third quarter in a row, rising at a 14% to 18% annualized rate in the fourth quarter 2002. However, unemployment has been holding just under 6% and there is little expectation of improvement in the employment situation during 2003. Also, due to high oil costs and fear of traveling by the public, the air transport industry is in dire shape. United Airlines continues under bankruptcy protection and American Airlines (AMR) teeters on the edge. Finally, with inventory levels low and with increasing signs that business may be raising capital spending (up 5+% in fourth quarter 2002), especially in the information technology area, there is hope that businesses might provide some modest upside to the economy in late 2003 and into 2004.

All in all, the consumer has been pulling the economy along over the last few years, especially with respect to auto and housing purchases, which this has resulted in 2% to 3% underlying growth in GDP. However, with consumer demand possibly plateauing in 2003, a pickup in business spending will be critical in keeping GDP growth moving forward in 2003 and 2004. We expect a modest improvement in business spending (continuing the trend we have seen in the last three quarters of 2002), adding to moderate economic growth in 2003, and accelerating into 2004 as business profits and overall spending pick up further.

#### **LONG-TERM PERSPECTIVE**

What about the next two to five years? What might we expect on the longer horizon?

First, there most likely will be fallout from the diplomatic battles involved with Iraq. Strains within the United Nations, the European Union, and within NATO will not disappear immediately once the war is over. Alliances will prob-

ably shift and re-adjust. Within Congress already there have been calls for changes in NATO's structure, as well as calls to shift military bases from Germany to Eastern European countries such as Hungary and Poland. The strong chill over US-French relations may take years to thaw. Will the European Union continue in its present state? Will Britain join the EU monetary system and give up the pound sterling? One ramification could be a possible preference for the Euro over the dollar, at least at the margins, which might aggravate an already expected weak dollar.

Since Europe is in flux, international investing may be more challenging over the next few years as the ebbs and flows of Europe shift with the new uncertainties. However, as we saw in the 1980s with the Reagan defense initiatives and the resulting European crisis, eventually many of the strains did work themselves out.

Second, on the homeland security front, even as this current war is successfully concluded, there will still be an ongoing threat of terrorism. While the most recent military battles have been in Afghanistan and in Iraq, the roots of ultra-Islamic terrorism against Western civilization go back over many years. As such, the costs of security and defense will probably continue and become an ongoing reality of daily life, both locally and nationally. These were costs that the economy was able to avoid during the 1990s ("the peace dividend") which are now becoming "embedded" in the economy.

Finally, from a financial perspective, we may have reached the secular bottom in interest rates. The data shown in Figure 2 indicates that interest rates peaked in 1981 near 15% and then declined to today's current levels near 4%. These levels are comparable to 1970 and earlier. Short-term rates are less than the 1.5% to 2.0% inflation levels, and two to ten-year government bonds yields range from roughly 1.5% to 4.0%. However, given the possibly weaker dollar, growing budget deficits, and increased inflation expectations, inflation may reach the 3%+ level over the next several years as the economy achieves "full potential" status of 3.5% to 4.0% GDP growth. As a result, intermediate to long-term bonds may experience price deterioration, especially those ten years and longer, as interest rates climb.

Given that cash and intermediate/long-term bonds are possibly high risk or negative return options (relative to inflation) over the near to intermediate term, that leaves two likely options: *short/intermediate bonds and*

*stocks*. Short/intermediate bonds are basically a temporary option to "park" money until purchasing longer bonds once interest rates have moved, or to eventually re-allocate into equities.

The attractiveness of equities has both supporters and opponents. Recently, a well-known bond expert forecasted a Dow Jones level of 5,000 based on sluggish earnings and very high valuations, underscoring the unattractiveness of the stock market. On the other hand, another well-known economist and investment research ex-

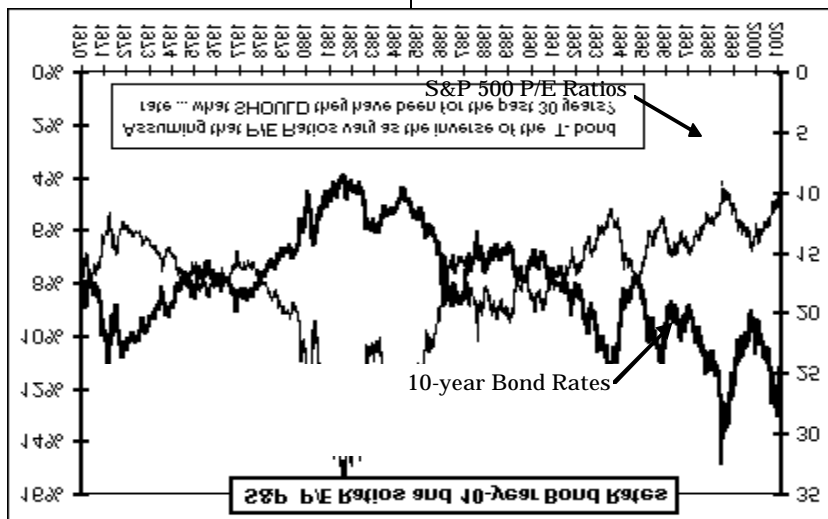


FIGURE 2 - Indicates that 10-year bond rates peaked in 1981 near 15%. Conversely, P/E's have generally increased since 1981.

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pert noted that based on some slightly different income measures, the overall equities market appeared to be the cheapest it had been since 1970, making the stock market highly attractive. And finally, the economist and chief investment officer for a major US bank investment subsidiary recently noted that the current price-to-cash flows for the S&P 500, starting in 1960 forward, was now at the median level. He also noted those same price-to-cash flows were comparable to values seen in 1995, in other words the market appears reasonably priced. (See also Figure 2 - P/E valuation vs. interest rates relationships.)

**Conclusions:**

So, what does this all mean? Our best estimate is that current equity valuations appear reasonable overall, and we do not expect any major change in valuation levels from current levels. As a result, the key factor going forward will be the underlying earnings growth of the companies. If the long-term earnings growth rates are around 7% to 8%, then the markets should advance in the high single digit range as well.

We do not believe that the momentum investing of the late 1990s will re-emerge anytime soon. In fact, the next two to five years may be very much a stock-picking environment similar to the 1970s and 1980s, and identifying attractive companies will be even more critical than it was in the 1990s. In this kind of environment, much like the Marine "grunt," or the front-line soldier, one has to do a lot of "heavy lifting" and a lot of "traveling" to find the good companies that will bring returns in excess of single digits.

So, here at Clifford Associates, we spend a lot of time looking closely at the essence of a company: its management, its products and services, its competition, its cash flows and returns, and its long-term prospects. Once we have done our research, our "heavy lifting," across a number of stocks and industries, we feel we will have assembled a portfolio of attractive stocks appropriate for the times ahead.



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