

October 8, 2003

Briefing Note

Richard D. Shaffer, CFA
Director of Research

Equity Markets – One Year After the Bear

As dates go on Wall Street, October 9, 2003 will be a pretty big one. Exactly one year ago marked the end of the longest (30.5 months) and deepest (the S&P 500 declined 49.1%) bear market since the 1930's. No one rang a bell one year ago, of course, because we only knew the bear had ended after we confirmed a new bull market had emerged. *(During June 2003, the S&P 500 index crossed "the 20+% trough-to-peak valuation gain" commonly used to define a new bull market. The trough date was 10/9/02, which becomes the date ending the last bear and beginning the new bull market).*

In July 2002, we wrote, *"now, we think the broad U.S. equity market is likely to be up over 30% cumulatively within the next 2 years (i.e., by 6/30/04). In effect, we envision the S&P 500 index reaches 1100 by then, compared to today's closing level of 820."* In November 2002, we modified the S&P up 30+% time frame to the end of October 2004. When the market tested its October 2002 lows earlier this year (hitting 800.73 on March 11th), due to fears surrounding the impending war with Iraq, we pushed the time frame out to December 2004, but re-affirmed the 1100 target.

With the new bull marking a first birthday, it seems a good time to review how the little fellow is progressing compared to other young bulls, and consider the shape he's in for further growth.

The Leuthold Group recently published a thorough examination of stock market recoveries during the past 103 years since 1900. We recommend it to you. It notes –

The median bear market since 1900 produced a (34)% cumulative slide in peak-to-trough stock market performance, over a 20-month period. Accordingly, the recent bear market fits into a "special" category of Nasty Bear Markets (particularly deep and long).

Year One of a recovery has generally been the strongest (by far), providing a median gain of 38% (in a range of +13% to +172%). By comparison, yesterday's close at 1039 by the S&P is 34% above the trough figure (776.76).

The median year one recovery from a Nasty Bear has been 56%, in a range of +38% to +172%. *Has the current recovery proceeded too far ... to fast? Not compared to the past.*

Year Two of a stock market recovery has generally produced further gains, but at lower levels. The median cumulative gain after two years of a market recovery has been 59%. This represents a median advance of 15% during year two. In only 3 cases, all of which occurred over 70 years ago, was second year performance negative. Year two recoveries from Nasty Bears have followed a generally similar pattern.

According to Leuthold, the third year of a market recovery has generally been not so good. The market has declined more than half the time during the third year of a bull market, with a median return of (3)%.

Employing data for the *average* historical recovery (which was much better than the *median* one), Leuthold constructed a series of



hypothetical price targets for the S&P 500 index, going out 24 months from the bear market low on 10/9/02. Based on their analysis of 21 prior bear market recoveries, the current performance target for the S&P would peak at 1250 toward the end of the second year of a recovery (i.e., 1250 by December '04), if the past is prologue.

Compared to the standard of the last century's average market recovery, Chartwell's "call" for the S&P to reach 1100 by the end of 2004, looks pretty darn conservative. Still, we think the resulting 8% total return (including dividends) would make stocks the clear short-term winner versus Treasury bonds.

FED MODEL UPDATE

The Fed Model tracks the implicit earnings yield of stocks (Earnings ÷ Price), with the explicit yield-to-maturity of bonds. Using this model as a guide (see our brief, at http://www.chartwellusa.com/Fed_Model.pdf), what do the broad stock market's current prospects look like, compared to the primary investment alternative - bonds?

Before we can adequately address *that* question, some further points to consider –

New announcements of poor or corrupt corporate governance practices continue to assault us. The latest involve spurious management practices at a number of mutual fund families and weak oversight at the NYSE itself. The market *should* stay conservatively valued;

Early in 2002, we stated institutional investors would be prudent to expect long-term annualized domestic equity returns only in the 6% to 9% range when setting contribution and spending policies. We still believe this. Our more optimistic two-year view should be seen as a subset of this conservative longer-term perspective;

The past year's market action has helped to rebuild investors' underweighted strategic

equity allocations. However, many plans are still left with less equity exposure than their policy targets. That position is tantamount to forecasting a long-term increase in the attractiveness of fixed income assets, despite falling bond yields. If that's *not* your viewpoint, then staying underweight stocks is simply short-term market timing;

We still expect the economic recovery will be tepid, although many economists have recently revised their forecasts upward. If we're right, a leisurely expansion phase will help keep 10-year Treasury bond yields from rising more than 1% above today's level during the next two years, to 5%. The Fed will also have something to say about long-term rates, if only because they've virtually promised to keep the short end of the yield curve anchored at 1%. For perspective, there have been no instances we can find during the past century when the Treasury yield curve sloped +400 basis points;

Analysts' consensus forecasts call for the S&P 500's operating earnings and "as reported" GAAP earnings to continue a robust recovery through 2005. That pattern is consistent with the corporate earnings growth we saw coming out of the 1990-91 recession. But, if this economic recovery is slower than previous ones, than corporate operating earnings ought to rise less than expected over the next two years.

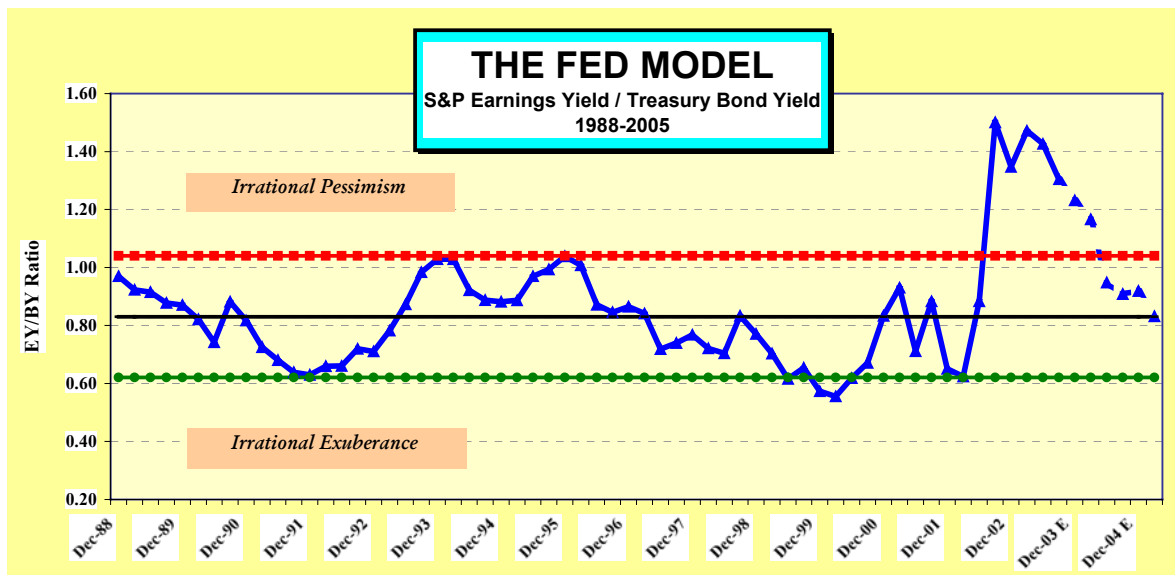
We also know from previous research that analysts' estimates are often quite optimistic early, only becoming more realistic (and lower) as one moves closer to the measurement date. This was the case in 2001, 2002, and 2003.

So, we're now beginning to worry about earnings disappointments and/or earnings revisions during late 2004 and 2005. To conservatively account for future disappointments in future earnings, we think it is prudent to apply a 15% haircut to analysts' estimates of trailing 1-year earnings for the S&P, starting with the year ending June 2004.

Assuming all of this, would the S&P become “too expensive” if it gradually rises to 1125 by year-end 2004? Would it become too expensive if then rose to 1200 by the end of 2005?

We believe the answer to both questions is no. As the following graph reflects, despite our

conservative assumption of rising interest rates, and even more conservative earnings growth estimates than the Street, the S&P at 1125 next year and 1200 the following year would only represent a move down to average valuation levels based on then-trailing earnings, whereas today it remains cheaply valued.



SUMMARY

How could the equity market possibly have returned more than 28% since last summer, and still remain “cheap” compared to bonds? Simply put, there was an extreme valuation disconnect in place last summer, with the domestic equity markets becoming undervalued on waves of selling by “irrationally pessimistic” individual and institutional investors. As Byron Wein of Morgan Stanley suggested last July, the stock market hadn’t been that cheap since the early 1980’s.

More specifically, actual realized earnings growth has been quite robust during the past year (GAAP earnings are up 23%), and expected earnings growth is solidly positive for the upcoming year. It seems that the market’s recovery has simply been keeping pace with the earnings recovery.

Looking at historical precedent, Leuthold’s research indicates the current market recovery is not outpacing previous recovery patterns. If anything, the year-old bull has not been raging as much as most prior advances during the last century.

Although the new bull market is one-year old and the S&P is at 1039, we still think it is a good strategic move to re-build your plan’s overall equity exposure back to its long-term allocation target, or even slightly higher. While the move isn’t likely to prove as worthwhile as last year’s recommendation did, we see the inevitable trade-off between bonds and stocks still favoring equity exposure at this time, if, and this is very important, you have a two-year investment horizon. The key driver will be realized earnings versus forecasts and expectations. Keep your attention there.