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December 27, 1999

Is a Bear Lurking Behind the "Goldilocks" Stock Market

- **Surmising the future is fraught with risk. However, blindly assuming the trends of the recent past will continue ad infinitum is fraught with greater risk. The stock market from 1995 to the present has built in a valuation level that is probably not sustainable.**

- **The unique confluence of strong U.S. economic growth accompanied by global economic softness and the dollar's position as the world's reserve currency created a "Goldilocks" environment.**

- **The current account deficit position of the U.S. will be a tension point once foreign economies experience a faster growth rate and require more capital. This could lead to exchange rate weakness for the dollar.**

- **The consequence of these events could be a much less favorable investment environment in the U.S. financial markets. A very different investment strategy will be required to navigate in this new environment.**

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Introduction

A new cultural attitude has enveloped the U.S. It is an attitude that Americans are "entitled" to be wealthy through stock market gains. This new attitude encompasses unrealistic expectations regarding annual rates of return, the inevitability of gains, an ignorance about risk, and an expectation that the government will bail out any future bear market should that unlikely event occur. This new cultural phenomenon also involves an intra-class jealousy by those who haven't made as much as some in the newly minted wealth class. In summary there is an ever-increasing pressure to participate in the stock market's "appreciation entitlement".

This new attitude or crowd psychology about the stock market is a reflection of the ideal confluence of economic and financial factors that have prevailed in the U.S. in the 1990's. However blindly assuming the trends of the recent past will continue ad infinitum is fraught with risk. The stock market from 1995 to the present has built in a valuation level that is probably not sustainable. The unique confluence of strong U.S. economic growth accompanied by global economic softness and the dollar's position as the world's reserve currency created a "Goldilocks" environment. This paper will attempt to highlight factors that could bring about a major change in the U.S. investment environment.

Some interesting gaps between expectations and reality are illustrated by a recently released study of the period from mid-1993 to mid-1999. During this period which was clearly one of the most favorable for U.S. financial markets, the average baby boomer achieved a 6.5% compound return on his stock portfolio. The average individual, classified as wealthy in the study, achieved a return of 9% per year. During that period the S&P 500 compounded by 21.3%. The study further states that the average boomer expects the current bull market to last more than another two years and that he will achieve a compound annual return of 12% in the next decade. What have stocks really returned and why has the typical investor earned returns that are less than those suggested by the popular averages?

If one measures the long-term appreciation of the U.S. stock market from trough to trough or peak to peak, the average appreciation has been approximately 6%. (See Chart-Next Page) In addition dividend yields have averaged 4% to 5% for a total return of 10% to 11% per year. The long-term appreciation rate has approximated the very long-term, secular trend growth in profits. With dividend yields currently around 1.2%, for the stock market to even achieve historically average returns will require that more of the total return come from appreciation. Either faster than historical rates of profit growth or even higher price earnings ratios will be required. For one of these to occur is not impossible but at this late stage in the current business cycle the likelihood of either occurring is questionable.

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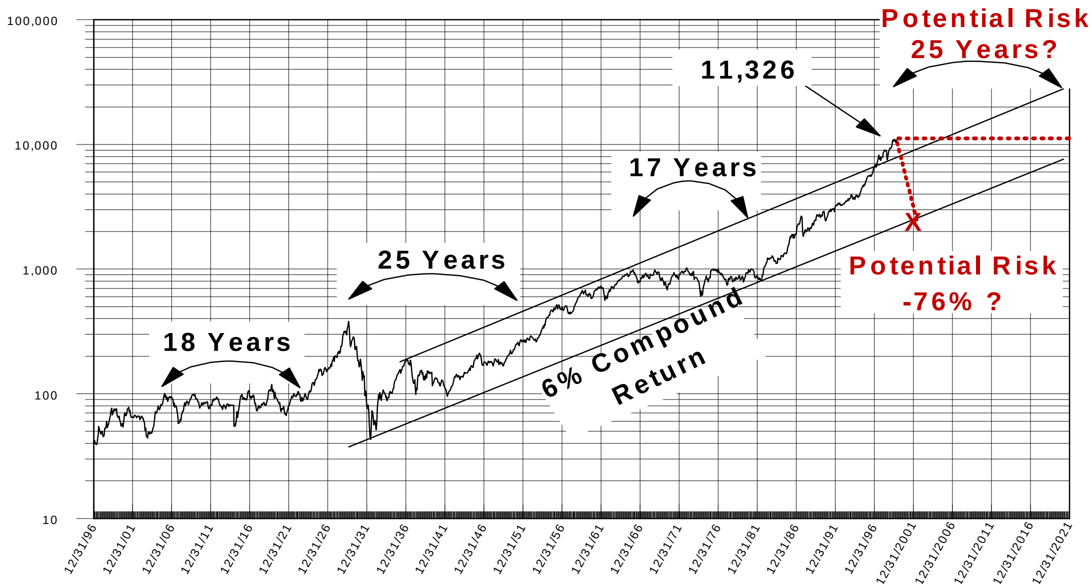
Dow Jones Industrial Average

Monthly Data (1896 - December 16, 1999)



Failing faster profit growth or a further increase in the price earnings ratio, stocks in a positive environment of stable interest rates and normal profit growth could be expected to return something in the area of a maximum of 7.2% (6% appreciation plus 1.2% yield). This is just slightly higher than the current yield of 6.40% on the 30-year U.S. Treasury bond. On the negative side, if the economic environment appeared less optimistic and stocks had to find support from their dividend yield they would have to decline by roughly two thirds just to return to historically average yields. This of course assumes that dividends would not be cut in a recession. A third and also unappealing possibility would be approximately 25 years of no appreciation while earnings and dividend growth restored valuations to historically average levels. Most readers with a decade or less of investment experience are by now probably experiencing a glazing over of the eyes and are quickly tuning out as they relegate this to “old paradigm” thinking.

New Era or Speculative Bubble

A debate rages about whether the U.S. economy has entered a new era of technology driven productivity gains that justify the current valuations. Skeptics call it a speculative bubble while some optimists argue that even higher valuations can be justified. Clearly it has been a spectacular economic environment since the last recession. By February 2000, a new U.S. record will be established for the longest business expansion. Furthermore it has benefited from the cessation of the Cold War, the expansion of free markets globally, and the integration of some spectacular technologies into our lives.

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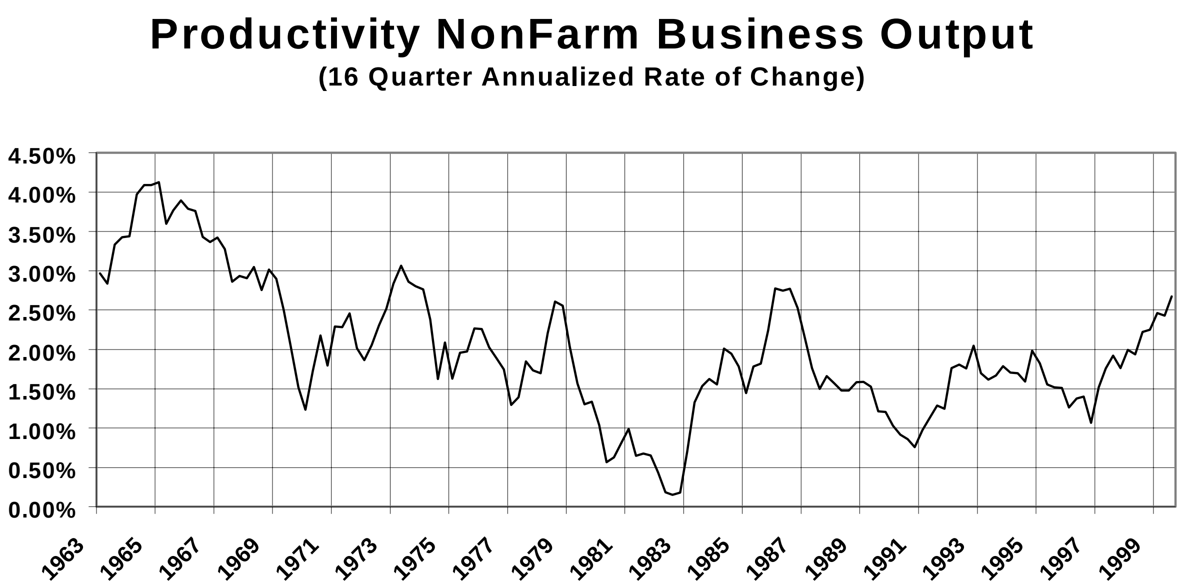
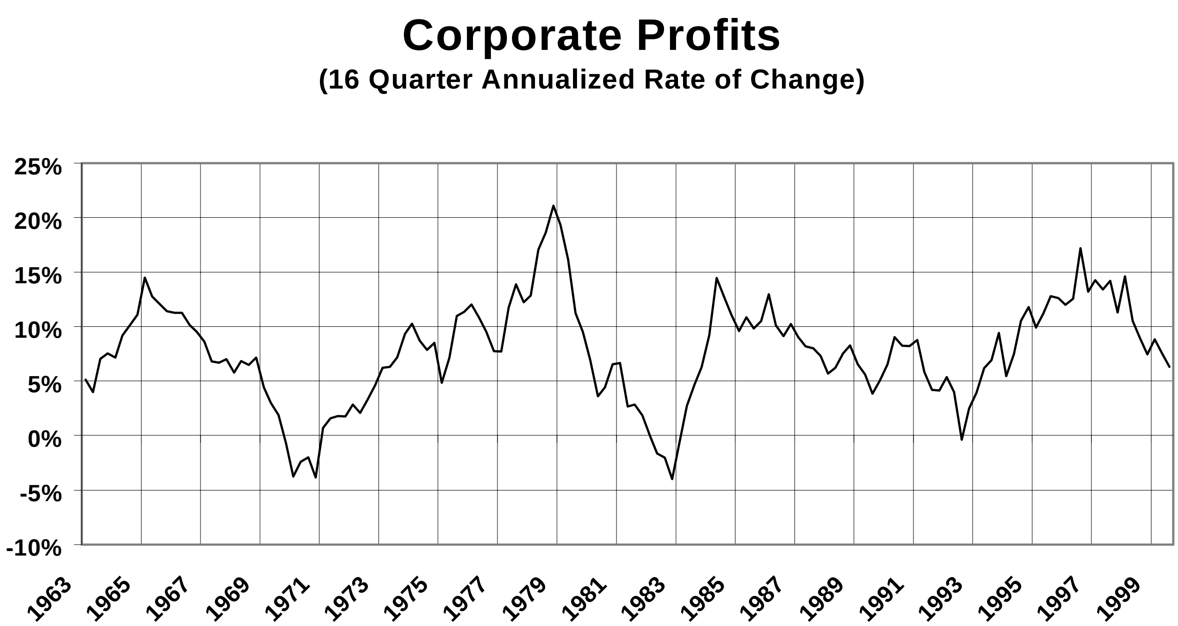
However in spite of all these great developments over the last decade, cyclical productivity increases and profit growth (See Charts) during this record setting business expansion have still fallen short of the increases in earlier expansions. This economic machine, for all its great attributes, has not broken out of the growth range that has contained all U.S. business cycles for many decades.





Although the economic facts don't support a new era view, investor perception is that a new era has overtaken us. Based on an examination of valuation measures this new era mentality began to develop in 1995. Valuation levels by 1994 (dividend yields, price/earnings ratios etc) matched previous peak levels such as 1929 and 1968-72. However beginning in 1995 and continuing to the present, valuations have entered previously uncharted territory.

The following table illustrates the extreme level that valuations have now reached as compared to historical ranges:

	Historical Range	Current Level
Price/Earnings Ratio	8 to 21	31
Price to Cash Flow	5 to 11	19
Price to Sales	.6 to1.2	2
Price to Book Value	1 to 2.4	5.9
Dividend Yield	6.0% to 2.8%	1.2%

Circumstances unique to each business cycle could distort a particular valuation measure. However taken as a group it is hard for an observer not to accept the fact that valuations, if not productivity or earnings growth, have entered a new era. The debate is more over the issue of whether valuations have entered a "permanent" new era or will they return to levels within the historical ranges. So it appears that a discrepancy has developed between new era valuation levels and good but not new paradigm economic growth rates.

Speculative bubbles usually last far longer than the skeptics expect and are extremely profitable while they last. There are usually unique circumstances that will lead people to believe that this time is different. Therefore the challenge is to participate in the very profitable environment while maintaining a strategy to avoid excess risk. In addition one needs to identify the areas where value may still exist and that will benefit from the inevitable economic change that brings about the demise of the bubble. Finally the investor needs to manage his emotions so that greed does not take over and demand more than the markets are capable of delivering on a long-term basis.

Parallels From the Past

Speculative bull markets are usually a reflection of the confluence of virtuous economic conditions that dominate for an extended period. Three previous speculative periods, two in the U.S. (1920's and 1965-72) and one in Japan (1980's), are worth briefly reviewing for comparisons with today. As with most readers, the author must rely on historical accounts in trying to understand the earliest period. The author has the greatest knowledge of the 1965-72 period since he arrived on the financial scene in 1967 with a freshly minted degree after spending most of his spare college time hanging out in brokerage offices as a small time speculator. Similar to many of today's young speculators, he viewed the Wall Street of that era as a great money machine simply waiting to be tapped by his ingenious intellect. While never participating in the Japanese market personally, the author did closely observe it with keen interest and skepticism in his role as a portfolio manager in the U.S. financial markets.

The 1920's bull market has several parallels with the current period. Similar to today, the U.S. stood out globally as an economic powerhouse. European powers struggled to recover from the damage WW I inflicted on them. Gold flowed from European financial capitals to the U.S. In an attempt to reverse this financial strain on European economies, the U.S. Federal Reserve maintained an accommodative monetary policy. The excess liquidity, in a manner similar to the current period, found its way into both the economy and the stock market. As a result the U.S. emerged as an unbridled growth machine whose business was business (and later speculation). A sense of destiny enveloped the country. It was a great decade for the practical application of technology. Older technologies such as electricity and the telephone achieved high levels of usage and provided significant productivity gains. Newer technological developments such as the automobile and then radio also changed the lives of people and provided the speculative froth for the 1920's bull market. If you read the historical accounts of that earlier era, you can easily substitute the words "personal computers" for "automobiles" and "internet" for "radio" and you will think that that you were reading about the late 1990's.

Shortly after Professor Irving Fisher, a leading economist of the period, declared in the autumn of 1929 that stocks had reached a permanent plateau, the stock market proceeded to lose 87% of its value over the next three years.

The automobile and radio, the two newest growth industries of that earlier period, were clearly major economic events that continue to play a major role in our lives seven decades later. However, from among a host of speculative favorites of that era only three automobile companies finally emerged from that period. Radio Corp of America, later RCA, was not only a major success in radio but went on to duplicate this success in television. However, the price peak that it reached in 1929 was not equaled again until 1964, a mere thirty-five year wait for patient long term investors. Thus the challenge for investors is not only correctly identifying the economic significance of a technology but also identifying the companies that will dominate, and finally, identifying the proper valuation to pay for that dominate company. Unfortunately that is no easy task.

Today's optimist would argue that the crash of 1929 and the subsequent depression was a special case that timely and intelligent government intervention could ameliorate. The government is clearly more interventionist today; however, intervention can have secondary or tertiary consequences that may negate the intended outcome.

In 1964 towards the end of the 1950s-60s U.S. bull market a best seller appeared in France entitled the American Challenge. This book argued that American multinational corporations had unfair competitive advantages and that they would shortly own all of

Europe. The author argued that only European legislation could negate this unstoppable behemoth.

The U.S. stock market reflecting this powerful global position advanced ten fold from 1949 to its initial peak in 1966. However, by the late 1960's to early 1970's a run on the dollar's convertibility into gold, higher inflation, and Federal Reserve monetary tightening took their toll on the U.S. stock market. Interestingly, a decade after American industry was considered invincible by the Europeans, it was in a life or death struggle from the Japanese. Imports of steel, autos, and electronics were making huge inroads into the U.S. as overpriced and often technologically inferior U.S. made products could not compete. Reflecting the deteriorating economic environment characterized as stagflation (slow growth with high inflation), the U.S. stock market experienced two severe bear markets, the first in 1969-70 and the second in 1973-74. During the later decline the popular market averages dropped by approximately 50% and many former speculative favorites were down by as much as 80% to 90%. Furthermore many of the previous bull market favorites, dubbed the "Nifty-Fifty", did not reach their ultimate low prices until 1977-78.

A third example of a speculative bubble that came to a painful end was the Japanese experience in the late 1980's. In the 1980's, the Japanese economic system was revered throughout the world. The cooperative relationships between government and industry and the interlocking ownership among companies were pointed to as unique cultural strengths of the Japanese juggernaut. The Japanese stock market reflected this unique position with record speculative excesses. In its last upward phase the Nikkei Index went from approximately 7,000 in 1982 to 39,000 at its peak in late 1989.

However, at the beginning of 1990 after several months of Japanese central bank tightening aimed primarily at deflating the accompanying speculation in Tokyo real estate, the Japanese market commenced a two and a half-year decline. The decline took the Nikkei from 39,000 to approximately 14,500 at its initial low in 1992. It did not hit its final low point of approximately 13,500 until 1998. Ten years after the peak, prices are still less than half of the former top. The primary reasons previously given for Japanese strength are now given as reasons for Japanese weakness.

Three factors appear to be essential for a euphoric financial environment that will cause investors to buy into the concept of higher valuations. One is an underlying economic strength that generates growing profits. A second factor is the availability of credit in order to continue to finance the purchase of financial assets. The third factor is a growing confidence in a continuation of favorable conditions. This tends to be a lagging factor that feeds on itself. The longer a condition remains, the more solid is the underlying belief that it will continue.

Just because equity markets have a high valuation is not a sufficient reason to expect a major price collapse. The high valuations exist because conditions are very favorable.

High valuations existed at the end of 1994 at what was the start of a five-year period that has taken valuations to the current unprecedented levels. While high valuations did not cause the subsequent declines in our three historical examples, high valuations do increase the potential extent of a decline if other conditions set off the decline.

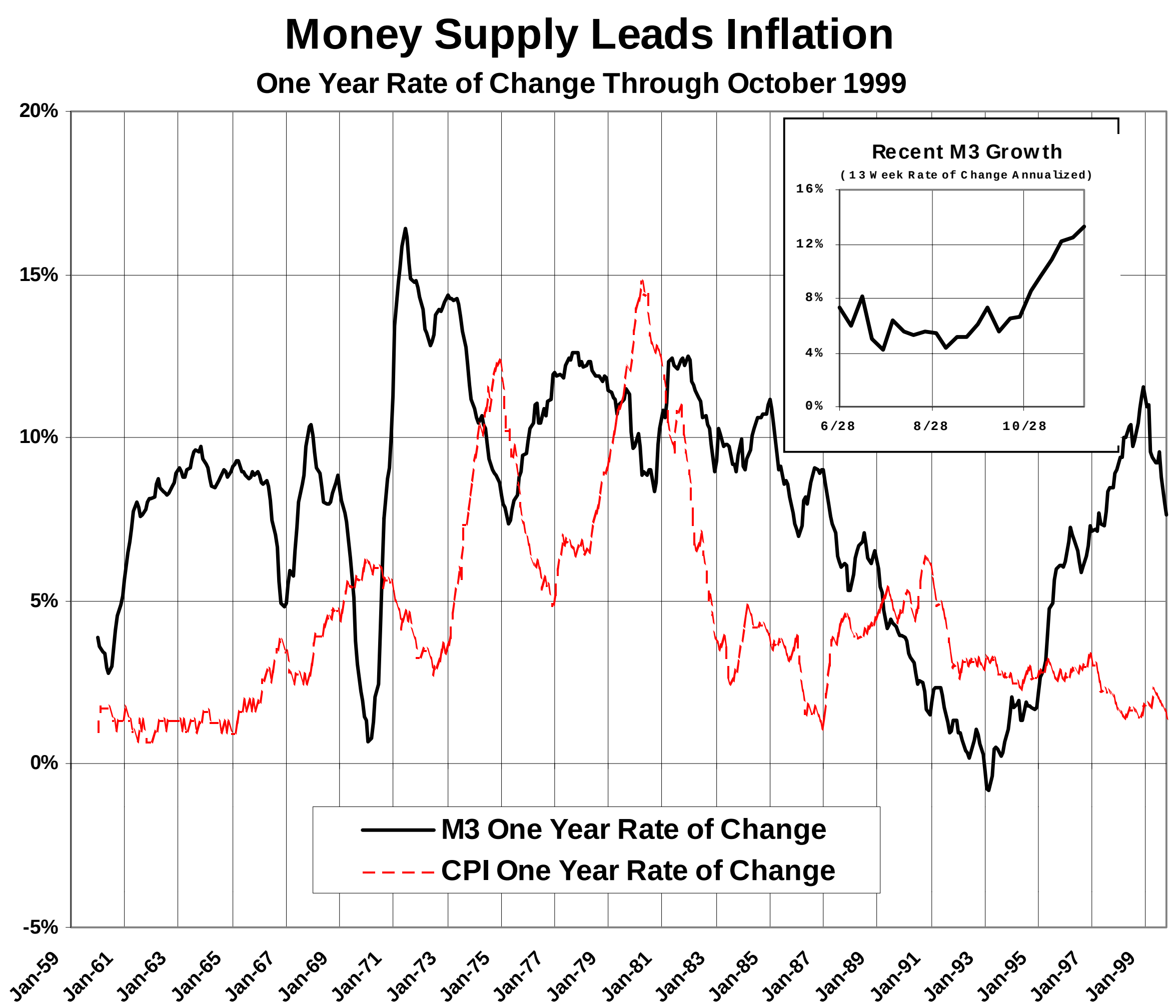
In each of the three historical examples cited, the single most important factor that eventually set off a major decline in stock prices was a shift in central bank policy to a more restrictive stance. The change in central bank policy was not necessarily geared toward ending stock market profits. Usually it was aimed at some other unwelcome economic condition (e.g. inflation). However the ultimate impact was a restriction of credit to the stock market. Since successful stock market participants don't easily or willingly give up practices that were profitable strategies, it has usually taken several restrictive moves over several months or longer to finally break the back of a major bull market.

Another factor that appears to be evident at the end of a bull market is a gradual reduction in the number of stocks participating in the advance. Money in the late stages of an advance tends to concentrate in fewer and fewer issues. The speculation is focused in a narrow group of stocks centered around themes that have dominated the particular economic cycle. Whether it was RCA in 1929, the "Nifty-Fifty" consumer growth stocks of 1972, or technology and internet issues in the current market, these issues become cult favorites that must be owned at any price. Reasons are created to justify unusual valuations. The speculative euphoria surrounding these names creates an artificial view of what is really going on in the overall market.

The Current Period

In 1999 although all of the popular market averages are up for the year, a majority of stocks are actually down for the full year. The number of stocks making new highs peaked in December 1997, a full two years ago. For most of this year more stocks are on the new low list everyday than on the new high list. The daily advance decline line (the cumulative difference each day of stocks rising minus stock declining) reached its peak in April, 1998. Thus under the façade of a strong market suggested by the popular averages is a significant amount of rot as more and more stocks are falling off the bull market train. This helps explain why most investors are under performing the averages. The average stock simply isn't performing as the averages suggest. The other explanation is the tendency of investors to chase a previously strong area rather than look for areas that could outperform in the future. As an example, most money invested in hot mutual funds, venture capital etc. is invested after the best performance has already occurred.

If central bank tightening is the primary factor that ends a bull market, is that occurring presently? At the present time the Federal Reserve is giving mixed signals. It has raised interest rates three times in 1999, which would imply a tightening bias. However, there are two ways of measuring central bank policy. One is through interest rate changes for federal funds and the discount rate. The second way is measuring money supply growth. While interest rates have been raised, the broad money supply M3 (See Chart) has been increasing at very rapid rates. This is true both for the past several years as well as since October. The very rapid growth of this aggregate since October is providing fuel for the strong stock market gains. Some of the current rapid money growth may be Y2K related as the Fed provides liquidity for yearend contingencies. If they begin to restrict money supply growth in January it will add evidence to the tightening bias suggested by the recent interest rate increases. Nonetheless the rapid money supply growth is fueling the current speculative fires. Rapid money supply growth, with a lag, usually leads to higher inflation rates as well.



However, money has been growing rapidly for several years, the economy is at full employment but inflation just isn't a problem as of yet. What are the unique factors that have extended the low inflation environment for so long?

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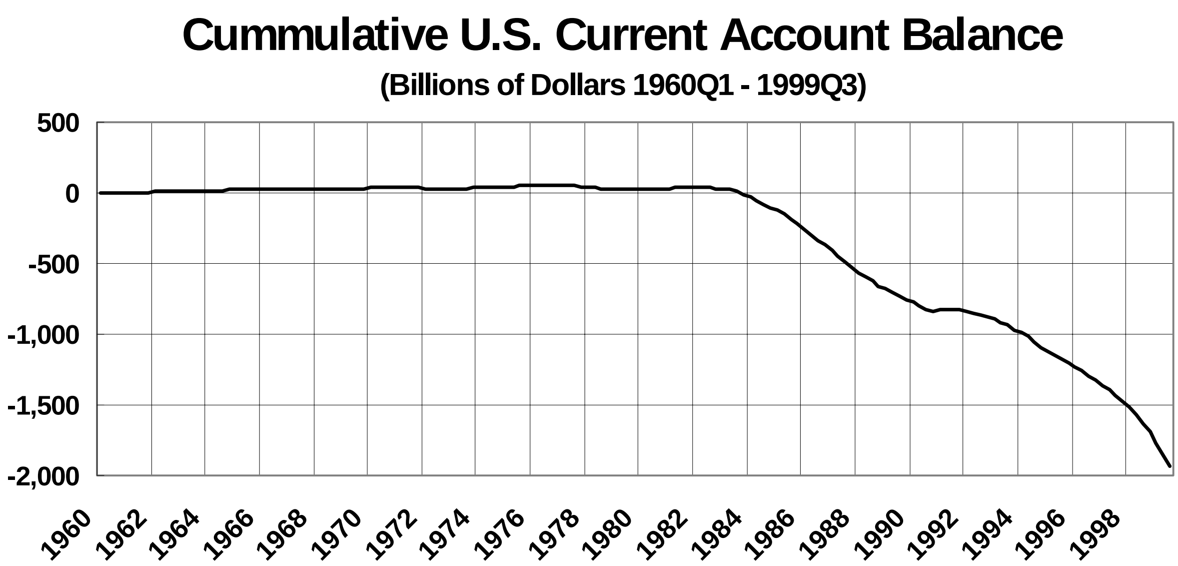
First the fall of communism unleashed a wave of free market thinking globally even within the last remaining major communist country, China. This has flooded the world with cheap consumer goods from low wage countries.

Second, Japan has been mired in a decade long recession. With low capital demands within Japan and very low interest rates, its current account surplus has sought higher returns in other capital markets, primarily the U.S.

Third, Europe spent much of the decade pursuing low growth anti-inflation policies as it sought to create a unified currency block with the Euro. This led to low capital demands within the Common Market. Similar to Japan it had to seek investment returns elsewhere for its current account surplus. Once again the U.S. capital markets benefited.

Finally, the Asian currency crisis beginning in 1997, resulting from the developing countries unbalanced growth policies, led to reduced capital demands leaving the U.S. as the investment choice by default.

The practical effect of all these events has been a U.S. dollar that has appreciated at a 6% compound rate since the end of 1994. The U.S. with the only major growing economy was the place to sell foreign goods and the place to invest surplus capital. It is only because of the dollar's status as a reserve currency that the U.S. has been able to run a persistent current account deficit (See Chart). Any other country running this level of current account deficit would have seen a run on its currency years ago.



Thus the U.S. has been allowed to be a special case both because the rest of the world needed its markets in which to sell their goods and because many of these foreign economies have not needed the capital internally. As U.S. consumers went on a spending binge, foreigners provided the savings that were necessary for investment. These factors have contributed both to the low inflation rate and a rising stock market.

Will this environment continue or are new global trends emerging that will create major problems for the U.S. economy and cause valuation levels in the stock market to decline. The renewed growth now occurring in Europe and Japan combined with the Asian recoveries may be the primary factor that destroys the “Goldilocks” environment in the U.S. As these other economic areas recover, returns on capital and demand for capital will increase in their respective economies. This could put downward pressure on the U.S. dollar as previously invested excess capital is repatriated. If the dollar weakens, import prices will strengthen potentially setting off price increases by domestic manufacturers previously unable to increase prices due to import competition. Since the labor market is extremely tight, any further consumer price pressures are likely to set off labor demands for higher wages. The Federal Reserve can be expected to tighten credit to rein in the inflation rate. Bond prices will come under pressure and of course stock prices will have to decline.

The above scenario sounds pessimistic and painful. However it is still only of a cyclical nature. The real long-term concern for U.S. capital markets is whether the dollar can retain its special status as “the” reserve currency. The aggregate world financial portfolios hold a disproportionately high percentage of their assets in dollar denominated issues. The percentage is disproportionately high relative to the size of the U.S. economy as a percent of the global economy. In a world in which Europeans no longer fear being overrun by the Soviet military machine the possibility exists that the Euro or the Japanese yen could become coinhabitors of the reserve status now exclusively held by the dollar. If this should ever happen the U.S. could be plagued by a decade long period of dollar disinvestment similar to that experienced by the British when the pound lost its reserve status. This would likely create an economic malaise in the U.S. similar to what the Japanese have been living through for the past decade due to other circumstances.

In the bull market environment that prevails today such a discussion seems farfetched. However, conditions similar to those described above developed to a small degree from 1968 through the late 1970’s. Prior to August 1971, foreign holders of dollars could redeem them for gold. While most foreigners never went to the gold window, the French began to do so. Their actions created a crisis that led to higher gold prices and a closing of the gold convertibility feature. Later in the decade as inflation accelerated and oil prices skyrocketed foreigners again began to convert dollars into stronger currencies. Once again a mini run on the dollar occurred and it weakened considerably. However, in that earlier period, the cold war was still raging, the U.S. was the only political refuge from that fear, and there were no major currency alternatives to replace the dollar. Conditions are very different today, especially if the Common Market countries can establish the Euro as an acceptable alternative. The Euro zone represents a population and economic area comparable to the U.S. It conducts more world trade than the U.S., has a far better balance between imports and exports, and has exchange reserves that are superior to the U.S. This is a very different set of comparisons than at the end of WW II when the present dollar exchange standard was established. If the world moves toward a dual or multi-currency reserve standard, the U.S. will be forced to live by a very different set of rules than those that have prevailed since the end of WW II. More importantly it will have profound repercussions for investors.

Investment Strategy for the Future

Bull Markets create a sloppy, careless attitude the longer they continue. Therefore the first thing an investor must do is to recognize the potential for this tendency. Second it is important to remind oneself as to what a realistic return expectation should be. Third decide how much risk one can assume. Fourth have a strategy to minimize risk. Fifth look for sectors of the economy that are undervalued and that could benefit from a significant change in the economic landscape.

The current investment trend is old and extended; however, one could have made that case a year ago as well. Therefore timing an exact top in the market is a precarious task. However, we know from the examples of the past that the favorable economic conditions that supported euphoric valuations eventually changed and stock prices eventually went through painful declines. The present bull market has benefited from weak economic conditions in Europe and Japan. Their weakness has enabled excess capital to flow into the U.S. financial markets. Therefore economic strength in these regions may contribute to the termination of this ideal investment climate.

What signs should one look for to anticipate a major trend change. One would be indications of dollar weakness. The accompanying chart of the trade weighted dollar illustrates the strength of the dollar since early 1995. Although a nominal new high was made in mid-1999 it has made little upside progress since mid-1998. This labored action may be a topping process. Should a trend to the downside commence it could have ominous implications for the U.S. financial markets. Past periods of dollar weakness have been accompanied by rising prices in basic commodities and precious metals. In addition one would expect higher general inflation in the U.S.

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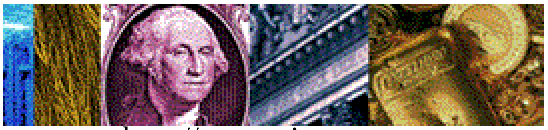

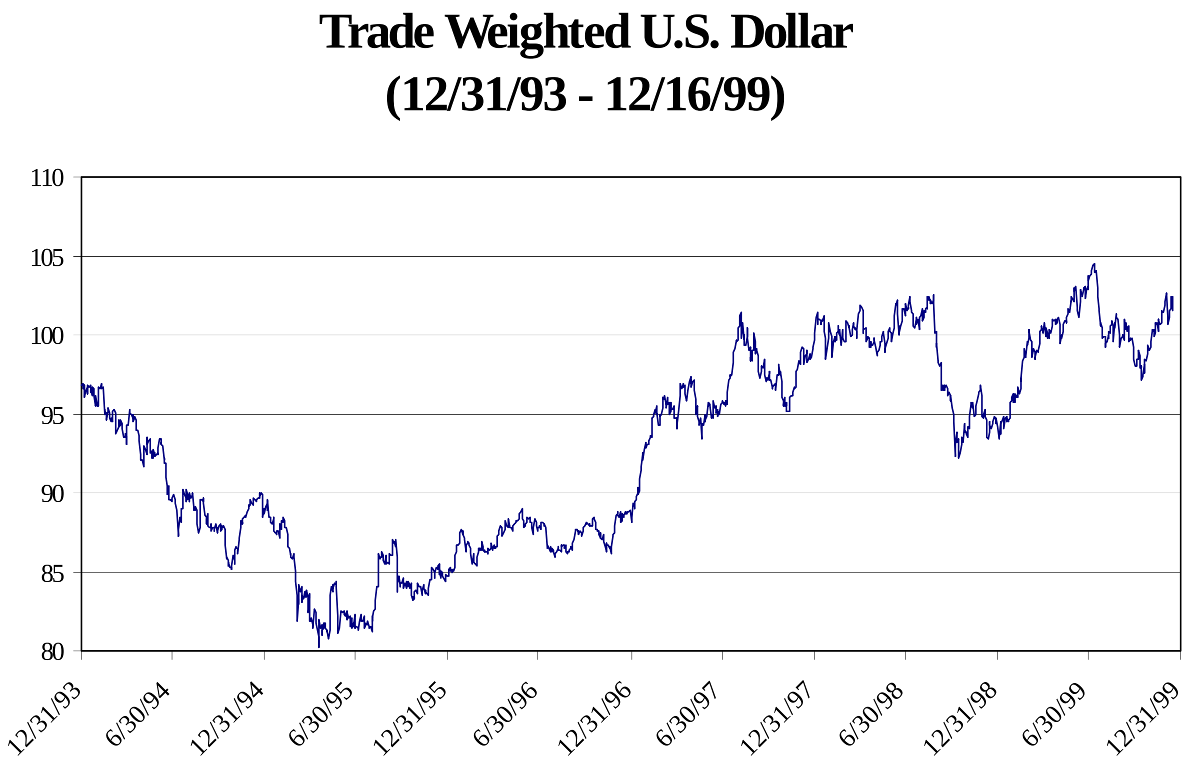

A second indicator to monitor is the ratio of bond prices to gold prices (See Chart). This represents a good long-term barometer of financial market health. Our organization has used this as integral part of our investment process. Our reading of this indicator is that it is beginning to show signs of breaking down after a 19-year advance. Significant further weakness in this ratio would imply an end to the secular disinflation. Bonds under this scenario may be entering a secular bear market. Gold, which is now laughed at as an investment vehicle, could once again become an attractive investment in a weak dollar environment (See Chart). The total supply of new gold is only increasing at about 2.2% per year. This is a very minimal growth rate when compared with the growth rate of the money supply, total debt or the aggregate value of financial assets. Furthermore the current price is below the cost of mining for many companies.

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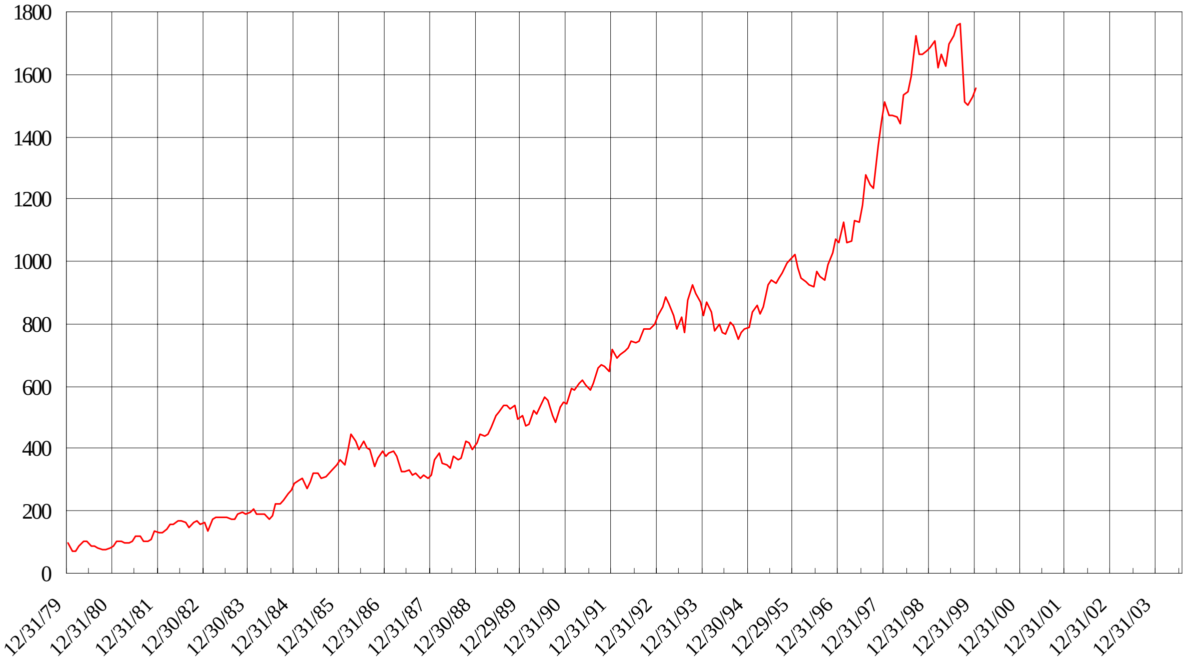
Bond/Gold Ratio

12/31/79 thru 12/16/99



Spot Gold
(1/2/75 - 12/16/99)

Since the financial bull market has been built on declining inflation and declining interest rates, a change in this environment is not likely to be kind to a buy and hold strategy for stock portfolios. The concept of strategic asset allocation has dominated during this financial asset bull market. Strategic allocation recommends a static allocation among assets and then emphasizes the concept of buy and hold forever. This is typical of bull market thinking but it will come apart at the seams in a serious market decline. Once a serious market decline occurs, market timing and tactical asset allocation will once again become sought after investment styles. Tactical asset allocation is built on the concept that different asset classes should be over or under weighted as valuations and the investment climate change. It under weights stocks and emphasizes cash, bonds, and/or gold during stock market declines.

In addition strategies that involve short selling or hedging of long portfolios through the use of stock index futures should standout with higher investment returns than the currently popular buy and hold approach. Outright short strategies could also come back into favor.

Managed futures with a significant exposure to the physical commodity markets such as energy, metals, and grains could be major beneficiaries in a declining dollar and stronger global growth environment. Several fundamental factors could create a very profitable environment for these assets. First, in many cases they are extremely undervalued relative to the cost of bringing on new capacity. This has discouraged the development of new supplies. Second, the low prices that have prevailed for many years encourage higher consumption. Third, stronger global growth will increase consumption across all types of basic raw materials. Fourth, a declining dollar will lower the price of these items in other countries whose currencies are appreciating. This will further encourage consumption. Finally if a recession develops in the U.S., it will most likely lead to Federal Reserve monetary easing. If the dollar is under pressure at that point, additional bank credit may be more likely to flow to physical assets such as commodities, as it did in the 1973-80 period (See Chart), in the same way that it has flowed to equities in this cycle.

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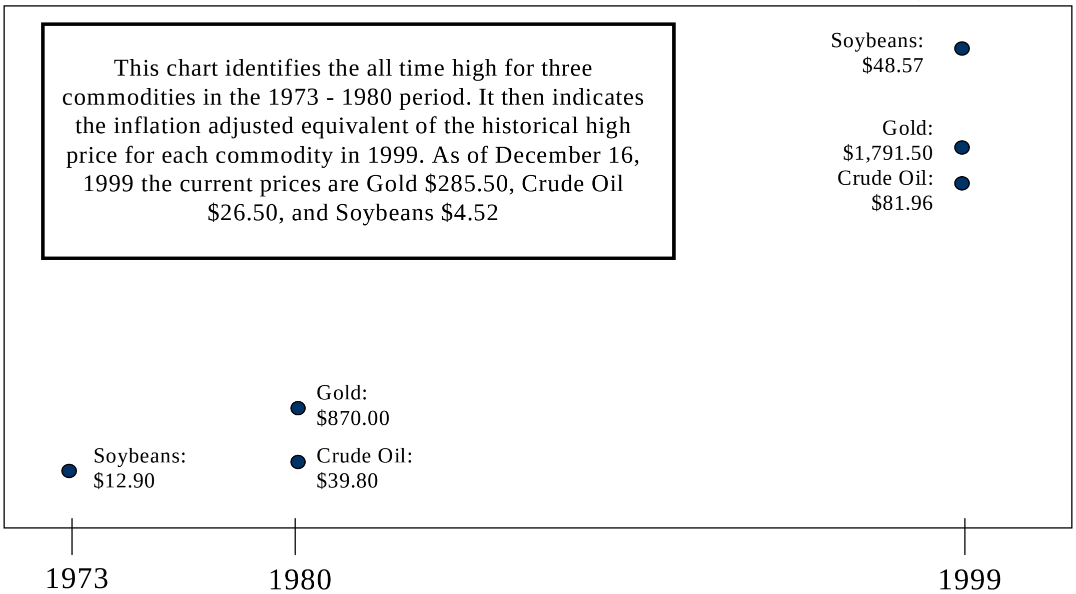
1999 Inflation Adjusted Equivalent of Previous High



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Summary

Surmising the future is fraught with risk. However, blindly assuming the trends of the recent past will continue ad infinitum is fraught with greater risk. The stock market from 1995 to the present has built in a valuation level that is probably not sustainable. The unique confluence of strong U.S. economic growth accompanied by global economic softness and the dollar's position as the world's reserve currency created a "Goldilocks" environment. The current account deficit position of the U.S. will be a tension point once foreign economies experience a faster growth rate and require more capital. This could lead to exchange rate weakness for the dollar. The consequence of these events could be a much less favorable investment environment in the U.S. financial markets. A very different investment strategy will be required to navigate in this new environment.

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About the AIS Group of Companies:

AIS is an acronym for "Applied Intelligence Strategies", computer programs, that combine the best aspects of sound investment principals with the strict disciplines of mathematics.

The AIS Group consists of two companies that offer four different investment styles:

AIS Capital Management is a registered investment advisor that offers a conservative, tactical asset allocation, program referred to as TAAP. TAAP actively rebalances the portfolio weights among four assets: equities, bonds, gold bullion, and cash equivalents.

A second program, Capital Growth, is an aggressive equity growth process that also periodically shorts stock index futures as a portfolio hedge.

AIS Futures Management is a registered C.T.A. that offers two growth oriented diversified, managed futures investment programs. The most diversified program, MAAP, maintains long, short, or neutral positions in 15 markets within six asset groups, equities, bonds, currencies, energy, grains, and metals.

A second program, AIS Financial & Metals, allocates portfolio assets to long, short, or neutral positions in equities, bonds, yen/dollar, and gold.

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