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April 17, 2000

Stocks, Bonds, and the Model Now

At Seagate Global Advisors we focus on the fixed income markets. The Lawton Bond Model is used as an investment management tool to forecast interest rates and manage fixed income portfolios. Future equity market prices are one of the many inputs to the Model. The weight assigned to equity prices changes from time to time. Presently, the weighting is very high, making a correct equity market forecast critical to getting the bond market right. Because of the current high inverse correlation between stocks and bonds, and the recent high volatility in stocks, I wanted to review my opinion of the US stock market.

Our premise for a number of years has been that the equity market would not have a meaningful correction or bear market until the market became ridiculously overvalued, and everyone who could invest was fully invested, and perhaps even margined. Why? We have to go back to the 1987 stock market crash to provide an answer.

After the stock market crash of 1987, when the Dow dropped 20% in one day (and 36% from the peak several months prior) the general consensus was that the economy would head into a recession, and that stocks would drop further. Contrary to this expectation, Greenspan eased credit, the stock market bounced smartly, and the economy did not go into recession. Those that bought immediately after the crash subsequently made a lot of money. This was the beginning of the current "buy the dip" mentality.

The next meaningful dip came in 1990. The drop in the Dow was a sobering 21%, but still less than the crash of 1987. Shortly thereafter the market recovered, and went to new highs. Again, those who "bought the dip" made money.

At about the same time, research on the long-term benefit of investing in stocks started to be widely read and accepted. In particular, research by Roger Ibbotson and Rex Sinquefield dramatically outlined the benefit of long-term stock investing. In addition, two highly successful stock investors, Peter Lynch (Fidelity Magellan Fund) and Warren Buffet (Berkshire Hathaway) advocated long-term investing. Consequently, long-term investing was taken to heart by older investors, baby boomers entering prime savings years, and institutional investors.

On the macro-economic front, the backdrop for equities improved when Greenspan took over as the Fed Chairman in early 1987. The heavy lifting to get inflation under control had been done by the Volcker Fed. Inflation was in the process of being tamed and the fiscal situation, while still poor, was improving quickly. Thus, the damage caused by inflation and deficit spending on the equity market was being reversed.

Real estate, the asset class that moved sharply higher during the previous inflationary period, finally went down in the early 1990's. The idea that you "always make money in real estate" was replaced by "you always make money in stocks." "Just buy the dips, and be a long-term investor!" The academic research, stock market gurus, and general wisdom all supported this moneymaking strategy.

This strategy became self-reinforcing for equities. As more investors became involved in the stock market, more people were buying dips, and the dips in the market started to disappear. Every little move down became a buying opportunity. There was no meaningful correction for almost eight years from 1990 to 1998. The correction in 1998 was relatively mild and again reinforced the buy the dip strategy. Academic studies started to appear based on this unusual period. The conclusion often was that stocks were less risky than normally thought. If you always make money in stocks, why not allocate more of your portfolio to equities, take a loan out on your house to invest in equities, and buy on leverage?

As the 1990's progressed, the fiscal situation of the US improved, interest rates moved lower, and inflation had been tamed. Layered on top of this was a bona fide technological revolution touching all aspects of the US economy, which helped push up US corporate profitability, which further supported higher stock prices.

Part of this technological revolution was the advent of the internet. The internet promised to change life, as we knew it. The investment opportunities were numerous, and the internet itself made investing online available to all investors with a PC at low cost.

The situation was explained as a "new paradigm." Technology would help the economy to grow above historical levels without inflation. Stocks were starting to be touted as a riskless asset class that only went up. Long-term historical equity valuations did not apply in this new time and place according to many investors.

These were the primary conditions that caused me to conclude that the US equity market was in little risk of a significant sell-off or bear market during much of the 1990's. This view of the US equity market helped the Lawton Bond Model produce accurate forecasts over the past decade when issues relating to the US equity market were a critical input to determining interest rates. The scenario I saw developing had a bad ending, but sometime in the future.

This process moved to the next phase last October in the NASDAQ when investors naïvely ramped up their internet and high tech investments, with little attention paid to basic investing principles.

The world changed further last February when Fed Chairman Greenspan stated that he did not care if productivity outpaced worker compensation. His notion of the new paradigm had been pushed to the limit, and that inflation would not be allowed to re-emerge on his watch. Essentially, Greenspan said he was going to slow the economy down, despite few tangible signs of inflation. The implications of this for equities were negative, and indeed, we have since had a significant sell-off in the US equity market, mostly concentrated in the NASDAQ.

The question asked to me this morning was, “Does the recent blow-off in the NASDAQ fulfill your scenario for the US stock market, and if it does, what do you expect going forward?

This was a good question, which has caused me think carefully about the US equity market.

I am sure that my many friends in the equity world will find things to dispute, but, overall, the scenario outlined above describes and explains the stock market price action since 1987. However, the situation has evolved to be a bit more complicated than I have been giving allowance for. Now is a good time to consider the complexity and nuances of the current situation, and their implication for the bond market.

To some extent, my overall premise that the stock market would suck in all the possible investors before going down, and then body slam them has been fulfilled in a mini-version with the recent tech blow-off. However, our original vision that what happened in the tech sector would occur in the broader market may not now occur. That is to say, it is no longer possible to contend that there has been no meaningful correction. A 35% correction in the NASDAQ is a significant drop, (though the broader markets are down much less), and a number of stocks have fallen 80% or more. Furthermore, the tech and internet sectors were the sectors that individuals trading and investing for their own accounts seem to have focused on. The damage has been intense for many investors. It is the kind of damage that creates psychological scars, and makes it hard to come back to the table to invest with new money. Some investors are still holding onto the hope that their stocks will come back, but many of the air stocks will not catch much of a bid again. The recent drop has taught a new group of investors that there is actually risk in the stock market, that earnings may matter, and that price/earnings ratios may actually be important.

Therefore, the recent slide has served to educate investors, and make them more sophisticated in selecting equities, whether they invested in tech or not. This will tend to make the market more efficient, and make severe dislocations less likely, as prices move

to more closely reflect economic and financial fundamentals and less the hopes and fears of unsophisticated investors.

That still leaves many stocks expensive on a historical basis, though there are some stocks that appear to represent good value. Also, the recent drop in stock prices takes some of the pressure off the Fed to tighten sharply, as the negative wealth effect and higher interest rates already in the system start to appear in slowing economic numbers.

It is a little early to tell, but my initial read is that the "buy the dip" mentality is still in place, and the mantra "you always make money in stocks" is alive. It is just that those humming the mantra have moved to the next level of understanding, and will be more selective investors in the future.

The bloom is off the rose for internet retailers and other tech and internet related companies that have no way to make money. We have closed the first chapter on the internet boom, and it was quite extraordinary, to say the least. The internet is a society and business changing technology, and there is a tremendous amount of money to be made as the technology develops. However, few companies are going to make much money selling watches or books on the internet. Take a walk down Fifth Avenue in New York. Every one of those electronics stores and gizmo sellers will have a web site. So what? The consumer wins not the internet seller. Despite the recent carnage, I believe the internet provides a multitude of viable and exciting business opportunities, just not some of the ones recently presented to investors. Indeed, we at Seagate are working on new and unique ways to utilize the internet to leverage our expertise and to serve our clients more efficiently.

For the stock market going forward, it will be harder for stocks to go up as quickly as in the past, given more discriminating investment analysis, and a vigilant Fed.

This new market presents us with a much more difficult forecasting environment for interest rates. Until something happens to reduce the inverse correlation between stocks and bonds, the weighting on future equity prices in the Lawton Bond Model will be high. For the immediate future that means a higher risk environment for bond investing.

Counterbalancing this uncertainty is the certainty that Mr. Greenspan will slow the US economy down, which in the intermediate term should be good for bonds.