

INSIGHT & OUTLOOK

SEPTEMBER 30, 2003
VOLUME No. 1
ISSUE No. 2

Seeing the Forest for the Trees

The financial media bombard us daily with splatterings of investment “factoids”: “housing starts up x%”, “new claims for unemployment y thousand over expectations”, “revised real GDP z billions” and so on. Rarely do the media attempt to place any of this

news in context. Imagine if you went to the Art Institute of Chicago to see Georges Seurat’s masterpiece of Pointillism, *Sunday Afternoon on the Island of La Grande Jatte*, and you stood just a foot away from the canvas. You would see just a myriad of colorful dots

without having any sense of what the painting was about. To understand the work, you would need to step back several paces and observe the canvas as a whole. Similarly we think investors need some perspective to evaluate the stream of financial news.

Principals:

James B. Patton, CEO
J. Marc Albertson, CFP
William P. Miller, CFA

Macon:
478 Poplar Street
Macon, GA 31201
(478) 742-5554

Atlanta:
3500 Lenox Road
Suite 1500
Atlanta, GA 30326
(404) 419-2471

(866) 606-5554 Toll-Free

- Family Office Services
- Investment Management
- Estate Tax Planning
- Income Tax Planning
- Charitable Gift Planning
- Business Advisory Services
- Trust Advisory Services

www.pattonalbertsonmiller.com



The Great Asset Bubble

Beginning in the mid-1990’s, the United States underwent the greatest asset bubble in its financial history,

encompassing stocks, bonds, the dollar, and real estate. That is the 800 pound gorilla that still glowers over us. In

our opinion all economic and investment news must be interpreted with the asset bubble in mind.

The Recovery – Not Normal

For example, the economy cannot be expected to follow a “normal” recovery path. The recession was not caused by the usual factors-- inventory imbalances or oil supply disruptions. Due to wildly excessive credit expansion and artificially low interest rates, businessmen misdirected hundreds of billions of dollars into such sectors as the internet, telecom, independent energy generation, and retail. Unlike an inventory problem or a supply disruption which can be worked through in 6 to 9 months, the serious mal-investments during the boom years will take a long time to overcome.

We can only hope our government does not repeat the mistakes of Japan after its bubble burst in 1990.

The recession officially ended 22 months ago in November 2001. If it had been a “normal” recession, industrial production would have increased at least 10% by now. Instead it is up just less than 2%. That is despite record reductions in short term interest rates by the Federal Reserve and a massive swing towards so-called fiscal stimulus by the Federal Government.

In all previous recessions since the end of World War II, employment had increased by the second year of a recovery. Yet to date

payroll employment has declined by about one million jobs. So this is not a normal recovery, but Federal statisticians blithely continue to generate reports as if it were. They add about 40,000 (assumed) workers to the widely reported monthly payroll estimate because in past (normal) recoveries new entrepreneurs added jobs to the economy that the government’s sampling techniques didn’t capture explicitly. Because of this and other arbitrary adjustments, we think most Washington employment statistics are of dubious quality and should not be taken at face value.

On the investment side, we are all aware of how excessive valuations became at the peak of the stock market mania in 2000. The S&P 500 hit 1527 and the NASDAQ exceeded 5049. Financial history indicates that the aftermath of bubbles has been a prolonged period of erratic stock market performance. We've seen this in the S&P 500 which has experienced the following price swings since peaking in the spring of 2000: (30%), 22%, (28%), 25%, (35%), 22%, (16%), and since March 2003, 26%.

The net change since 2000 has been about a 35% decline. The NASDAQ has been much worse. Clearly this has not been a "buy and hold" investment environment.

In recent years, whenever the S&P 500 rallied by 20-25%, a major decline soon developed. The most recent S&P 500 rally exceeded 25% at 986 in early June 2003. Weighing the risk versus the reward, we turned cautious at that time. But how do we know this is not the early stages of a new bull market, like

many Wall Street pundits are proclaiming? Well, we don't know for sure. We can only draw on our knowledge of stock market history and try to assess the probabilities.

At its most recent post-bubble low of 769 in October 2002, the S&P 500 traded at a price to earnings multiple of 28 to 50 depending on which definition of "earnings" you used. Look how that compares to past major bottoms in the stock market:

Patton Albertson & Miller, LLC

Macon Office:

478 Poplar Street
Macon, GA 31204
(478) 742-5554
(866) 606-5554 Toll-Free

Atlanta Office:

3500 Lenox Road, Suite 1500
Atlanta, GA 30326
(404) 419-2472
(866) 606-5554 Toll-Free

www.pattonalbertsonmiller.com

<u>Date of Bottom</u>	<u>P/E Ratio</u>	<u>Treasury Bond Yield</u>
6/26/1962	14.9	3.9%
1/3/1967	14.9	4.4
5/26/1970	12.9	6.9
12/6/1974	7.5	6.8
8/12/1982	7.9	12.2
10/19/1987	12.7	9.6
10/11/1990	13.9	8.9

On September 30, 2003 the S&P 500 closed at 996 with a P/E ratio of 28.7. Except for the Great Depression low of 1932, the market has never ended a major bear market with a price to earnings ratio over 20. We think the odds are the rally since October 2002 is a bear market rally. Significant further upside, although possible, is unlikely. So portfolios should be positioned accordingly.

Source: ISI Group

Looking for Value

Finding value in a post-bubble market can be a challenge. We believe one consequence of the Federal Reserve's extraordinarily permissive monetary policy will be a much weaker dollar. Although we cannot be precise about the timing, the dollar's trend over the next few years should be down. Therefore un-hedged exposure to foreign stocks and bonds should do relatively well. Gold stocks should be another beneficiary of the dollar's

decline. They also serve as a bit of insurance in case a financial "accident" similar to Long Term Capital Management or the Asian currency crisis of 1997 roils the world's markets. Certain other sectors such as health care and consumer non-durables should also fare reasonably well in a slow growth economy. We think the long term outlook for energy, especially natural gas, is good and intriguing

values exist in that sector. On the other hand, we would continue to avoid new purchases of capital goods producers, technology, and most financials. Technology in particular has returned to bubble-like valuations with Juniper Network (180 P/E, 11 times sales), Applied Materials (7.4 times sales), and KLA Tencor (81 P/E, 8.1 times sales) typical of the absurd overvaluations that have

cropped up again. A sustained bull market has never started with the former high flyers leading the way. It has always taken new leadership. Perhaps this time will be different, but we doubt it. Significantly, corporate insiders have been selling this rally all the way up, with sales-to-buys running over 30 to 1. We think there is more wisdom on Main Street than Wall Street, so we will continue to handle your investments accordingly.