Disciplined Growth Investors

The Way Wealth Is Built

CYCLICAL BEAR MARKET?

October 1998

Since the beginning of the Asian currency crisis nearly one year ago, the U.S. stock market has developed into a bear market. A bear market is one in which over half of the public stocks decline more than 20% from their peaks over the last twelve months. As of August 31, over 80% of all stocks in the U.S. had declined more than 20% from their 52-week high. For the broad stock market the damage is even more severe. For those stocks under $1 billion in market value, 90% have declined more than 20% from recent highs and 75% have declined more than 30%. The recent selloff has included the very large cap stocks as well, shattering their image of invincibility. Increasingly, bonds are emerging as the only area showing positive performance.

Since we are in a bear market, it is now important to define the potential severity of this bear market. Bear markets always bring considerable immediate pain. Nearly all bear markets also bring enormous opportunities for the astute, patient investor with the courage and vision to invest when the outlook is poor but the values are compelling. Rarely a bear market can be a trap, when the secular economic forces overwhelm the cyclical ones and crush corporate earnings over a multi-year period.

Recently, Barton Biggs, a respected strategist at Morgan Stanley wrote an article in which he split bear markets into two types, cyclical and secular. A cyclical bear market lasts 14 months on average and stocks suffer declines of 20% or so. During the course of cyclical bear markets, stock ownership shifts from weak hands into stronger ones. Cyclical bear markets are typically followed by changes in market leadership. Investors in the next generation leaders should enjoy several years of above-average returns. According to Biggs, there have been 30 cyclical bear markets this century. Secular bear markets last over several years with stocks suffering declines in excess of 40%. During secular bear markets a generation of investors lose confidence in stocks. Secular bear markets are also associated with periods of extreme economic calamity, in which corporate earnings evaporate. There have been two secular bear markets this century, 1929-32 and 1968-74.

So are we in a cyclical, or secular bear market?

We believe the evidence strongly suggests we are in a cyclical bear market. Investments in stocks today should yield exceptional results over the next three years.

There are four fundamental reasons why we evaluate this bear market as nasty, but cyclical.

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The economic background. Although the currency problems in Asia are causing economic distress in that region and the Russian default is causing bank credit problems, the U.S. and Europe remain generally healthy. The U.S. is the largest economy in the world. A careful check of the condition of the U.S. indicates a moderate slowdown with little or no inflation. Commodity prices are under pressure from weak foreign currencies. Productivity improvements are high. In fact, the story of the last 10 years' success in the U.S. is the huge improvement in productivity in both manufacturing and services. The commitment to productivity gains has not abated at all and is a major reason why the U.S. economy is likely to weather the Asian crisis. Despite the scandals surrounding President Clinton, the U.S. political movement is clearly in the direction favorable to investments. The federal budget is in surplus. Investor-friendly tax reform (including social security) is likely to happen within the next few years. If the Clinton scandals help Republicans gain a veto-proof Congress in the November elections, then investors could be further reassured of the move towards investor-friendly legislation. Europe is beginning to follow the U.S. example and is also benefiting from monetary unification and early movement away from the welfare state.

Significantly, should the Asian problems begin to depress U.S. economic activity the U.S. has many options to stimulate economic growth. With the federal budget in surplus the U.S. could easily cut taxes to promote consumer activity. With the fed funds rate at 5.5% and virtually no inflation, the Federal Reserve has plenty of room to cut rates. We believe the majority of investors today now believe that the Asian problems will tip the U.S. into recession in 1999; we strongly believe those investors are failing to understand how many policy options are still available to the U.S. government.

The interest rate background. There is little or no inflation. Long-term interest rates recently declined below 5.3%, reflecting the virtual absence of inflation. The decline in long-term rates has inverted the yield curve; i.e. short-term rates are higher than long-term. This is suggestive that the Federal Reserve is following tight monetary policy. The spread between short-term interest rates and inflation is at or near record levels along with gold at twenty-year low prices are also suggestive of a tight Fed policy.

We now estimate the Fed will be forced to ease monetary policy before the end of 1998. This easing should reinforce the low long-term rates and significantly enhance the attractiveness of common stocks.

The valuation background. With the exception of the very largest stocks, the broad U.S. equity market is selling at extreme undervaluations normally only seen once every decade or so. The last two periods of comparable undervaluations occurred in 1990 after the Persian Gulf crisis and in 1982 after interest rates reached over 20% in order to break the inflation spiral of the 1970's. This valuation extreme is occurring in the face of outstanding earnings and productivity progress, much restructuring to improve returns on capital, and many stock buybacks. Small cap stocks are selling at valuation levels relative to big caps not seen in the past 19 years, since accurate comparative data have been compiled. The undervaluation of the broad U.S. equity market is the single strongest argument for this market selloff remaining only cyclical as opposed to a secular bear market.

The technical background. In recent days the number of new stocks hitting twelve-month lows has been averaging over 1000. This is consistent with extreme oversold markets in past cycles. (1982, 1990, and 1994). If history holds true to form, the major stock market averages will correct further over the next few months while the broad market builds major bases by experiencing fewer lows. Upon completion of this base-building, we would expect the investment performance over the next three years will be powerful and will be centered around the mid-cap stocks. We also expect small-cap stocks to fully participate along with the mid-cap stocks.

As always, there are risks to our forecast. The most obvious is the combination of the Asian currency devaluations and Russian defaults overpowering the efforts of the U.S. and Europe to stimulate their respective economies. Given that Japan is beginning to address its serious problems and the U.S economy is the dominant world economy we believe this risk is tolerable. The second risk is that the very large cap stocks simply cannot sustain their current valuation levels and decline sharply in spite of declining interest rates and decent economic news. A further substantial decline in very large cap stocks would undercut consumer wealth and consumer spending. This would pave the way for a recession in 1999. The third risk is untimely response from such policymakers as the Fed and the Japanese central bank.

Given the interest rate environment and the extreme undervaluation of the broad market, we believe the risks are far outweighed by the rewards at this point in this market cycle.

ABOUT DISCIPLINED GROWTH INVESTORS

Disciplined Growth Investors is a registered investment advisor specializing in the management of small and mid cap growth equity portfolios. Our clients are pension funds, foundations, and high net-worth individuals. We are completely independent and 100 % owned by our employees.

Our investment process is designed to exploit the ever-present inefficiencies that exist in the financial markets especially in the assessment of individual securities. Our investment research is fundamental and seeks to discover stocks of well managed companies engaged in attractive businesses. Our investment style of “Growth at a Reasonable Price” employs both growth and valuation criteria in security selection. We then apply proven portfolio management disciplines to achieve success for our clients.

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For more information Please contact:
Cynthia Lennie
At:
Disciplined Growth Investors, Inc.
100 South 5th Street
Suite 2100
Minneapolis, MN 55402

Phone: 612.317.4108
Fax: 612.904.2546
Email: cindyl@dginv.com