WILL THIS RALLY FIZZLE?

July 1999

Since the market lows of October 1998 the stock market has enjoyed a strong recovery. Is this simply a recovery from an oversold low or is it the start of a major broad-based bull market?

We believe last October was the start of a multi-year, broad-based bull market. Our case for the market lies in the action of the market itself plus a reasonable set of economic forecasts.

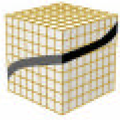
During the past four years and especially since September of 1997, the stock market was seemingly in a bull market. Yet the bullish market action was confined to only a handful of mega-cap stocks which we define as those with greater than $70 billion in market value. For veteran market analysts, this was a dangerous development. True bull markets enjoy broad-based participation with lots of stocks going up.

Small Cap Stocks

It has been our practice to use the performance spread between the S&P 500 and the Russell 2000 as a measure of market breadth. The S&P 500 index is comprised of 500 companies but is dominated by 50 mega-cap companies. The Russell 2000 is comprised of 2000 small-cap companies. In our view, when the S&P 500 is outperforming the Russell 2000, the market is becoming narrower. When the Russell is beating the S&P, the market is broadening, i.e. more stocks are participating in the bull market.

It is our contention that the performance of the S&P 500 in 1998 masked a severe bear market in the broad market. From September 30, 1997, the start of the Asian crisis, until October 15, 1998, the definitive Fed easing, the S&P 500 actually increased in price by 11% while the Russell 2000 declined by 26%. This was the most extreme spread since the creation of the Russell 2000 index 20 years ago and the third most extreme between large caps and small caps in the past 62 years.

On October 15, 1998 the Fed eased unexpectedly for the third time in succession. This easing signaled that the Fed would supply sufficient liquidity so that economic turmoil outside the U.S. would not tip the U.S. into recession. The stock market environment dramatically changed with this easing. From October 15, 1998 until June 30th of this year, the Russell 2000 has outperformed the S&P 500, +37% to +31%.



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Mid Cap Stocks

The experience in mid cap stocks shows an equally dramatic change. The mega-cap stocks, again the market leaders since 1995, have experienced a slowdown in relative performance versus the mid-cap stocks. We analyzed the price performance of two groups of stocks over the last twelve, six, and three months ended June 30, 1999. The first group consisted of those companies greater than $70 billion (56 stocks) and the second group those companies from $1-10 billion in size (1276 stocks). Here is the data:

Price Change for Periods Ending June 30, 1999

	Mega-Cap (> $70 Billion) 56 Stocks	**Mid-Cap ($1 Billion-10 Billion) 1,276 stocks**
12 Months		
Average	+ 38.2%	+ 20.3%
Median	+ 24.3%	- 1.1%
6 Months		
Average	+ 11.9%	+ 24.9%
Median	+ 11.0%	+ 9.9%
3 Months		
Average	+ 7.1%	+ 17.4%
Median	+ 4.7%	+ 12.5%

Source: Baseline

If we just focus on median results, we can see that the median mid-cap stock actually declined over the last twelve months but has sharply improved its performance during the last quarter, increasing by 12.5%. The mega-cap stocks have a great twelve months history (+24.3%) but are experiencing a sharp slowdown in relative and absolute performance.

It is critically important to understand that this change in leadership is immature and not yet widely discussed. After an extreme performance differential like 1998, a change in market leadership usually persists for years.

Economic Environment

This emerging change in stock market leadership is supported by the economic environment. Over the past six months we have gradually begun to appreciate the significance of the Asian currency/financial crisis. The events of the past two years represent more than a simple currency exchange issue. We are coming to believe that the Asian currency crisis foretold an end to the economic system which had been in existence since the U.S. lost its world dominance after the Vietnam War. The ascendant star in that world economic order was Japan. In 1989, Japan had the largest stock market in the world and was regarded as the country with the best business model. The fact that Japan was a set of islands, inhabited by 126 million homogenous people, with a limited natural resource base and relatively closed capital markets did not seem to dampen the enthusiasm of its admirers. We believe that the Japan business model was only narrowly effective and that Japan's consumer and financial markets were too closed to replace the U.S. as the dominant worldwide financial center.

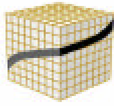
The problems in Japan slowly spread around Asia and ultimately affected some weaker economies such as Russia and Brazil. This threatened the stability of the worldwide economy. What saved the world economy from an extended downturn was the technological boom in the U.S., stimulation from restructuring in Europe, and the initial steps to recovery in Asia.

From an investment perspective, it is our opinion that the Asian crisis was both large and long enough to convince investors that corporate earnings, particularly in small and mid-cap stocks, would be damaged over an extended period of time. The Asian problems seemed too intractable to be resolved quickly. The only sector of the U.S. stock market that escaped this growing fear were the mega-cap stocks which offered strong balance sheets, relatively strong earnings stability and were denominated in the safest currency, U.S. dollars.

The emerging leadership is being driven by the slow but definite improvement in some of the economies most hurt by the Asian crisis. This is helping investors regain confidence in the earnings outlook for the broad stock market. The emerging leadership is likely to be lead by the major victims of the Asian crisis, such as mid-sized and smaller U.S. companies and some of the Asian markets.

Recent Market Data

The behavior of the stock market during the second quarter of 1999 is validating the emerging trends. The improvement in the worldwide economy and the continued strength in the U.S. economy have the Fed worried that tight labor markets will bring about a new round of inflation. On June 30th the Fed raised short-term interest rates slightly after telegraphing the move for weeks. Normally, a move towards a restrictive Fed policy is bad for stocks, particularly the mid-sized and smaller companies. Yet in spite of this Fed rate increase the market clearly broadened in the second quarter. We believe the improving earnings outlook is overpowering fears of a mild Fed tightening.



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The Risks

Every market environment contains a set of risks to be continually assessed. For this cycle, the most obvious risk is the overvaluation of the mega-cap stocks. An abrupt return to more normal valuation levels would significantly harm consumer net worth, slow down economic activity, and hurt corporate earnings. A second risk is the combination of tight labor markets in the U.S. combined with recoveries in foreign economies. This could eat up worldwide capacity and bring about another round of inflation. This would place the Fed in a tough dilemma. The third risk is the unsettled political relationship with China. The fourth risk is an economic downturn caused by distortions from the Y2K cycle.

The Reward

Notwithstanding the risks listed above, we believe the broad U.S. stock market has entered a bull market of considerable duration and potential. The stocks of small and mid sized companies will be leading this bull market.

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