

Millennium Hangover

2001 was a lousy start to a millennium. Global recession, a capital spending meltdown, the September 11th tragedy and terrible markets around the world. Extreme volatility too. Peak to trough, the Dow, NASDAQ 100, S&P 500 and TSE were down -27.4%, -58.7%, -29.7% and -30.3% respectively and then from the trough of September 21 to their subsequent peaks gained 23.1%, 52.7%, 21.2% and 18.0% respectively. A veritable roller coaster ride. And for all of 2001 these markets were down -5.4%, -30.7, -11.9% and -12.6% respectively. Frankly, we can't take many more millenniums like this.

We, however, began 2001 bearish on the economy and stock markets. We avoided (and even sold short) overvalued tech stocks, invested in defensive stocks, overweighted golds (one of last year's best performing groups) and, as value investors, found opportunities for profit in some solid but beaten up stocks. We're happy to say, not only did we weather the storm, we had good performance in 2001. To be sure, we had our fair share of losers (AES, Merck, Schering-Plough), but our winners, including standouts Hurricane Hydrocarbons, Abercrombie & Fitch, Symantec, Cryptologic and others, more than compensated. Though our accounts, growth and income, had positive returns in 2001, our hedged accounts where we made money both on our longs and on our shorts, performed especially well, losing substantially less, as one might expect, during the down periods such as that awful September.

We remained bearish for most of 2001 until the meltdown in September. Then, in our last quarterly letter, entitled "Looking Through The Valley", written in the aftermath of September 11, we proclaimed that the bottom had been reached on September 21, 2001, that the market, as a discounting mechanism, was discounting everything foreseeably bad, but not giving credit for what was inevitably (though not necessarily foreseeable) good. The bear market was over. Time to load up on stocks.

Since that bold proclamation, the markets have indeed risen smartly from the lows. And our clients participated too, enjoying a positive last quarter despite a dreadful September.

But though we're still long-term bullish and still believe, for the moment anyway, that the bottom is in, we think that the market went up too far too fast and now, the market, discounting addict that it is, is ahead of itself in discounting an economic recovery and the return to normalized profitability. In its relief that the end of the world is not yet nigh, the market has celebrated with some unjustifiably high valuations. According to Merrill Lynch's U.S. strategist, Richard Bernstein, based on price-to-earnings over growth estimates, at least for tech stocks, these valuations are now at historical highs. Clearly, the market has gotten ahead of itself. Economic recovery and normalized profitability may be inevitable, but in our business, time is money, and you don't want to pay too much for what's too far out - that's overpaying, or for what's unpredictable - that's gambling.

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To be sure, in the case of the economy, as in broken personal relationships, time heals all. Slowly, but surely, excess inventories are being worked off—witness the huge auto sales in October as a result of zero interest financing. Companies are shrinking themselves, their inventories and productive capacity, to meet shrinking demand; lowering their break evens, increasing their productivity, focusing on profitability and sometimes on their survivability. Many, however, won't survive, but their demise will help the survivors to gain market share, and ultimately, pricing power. The consumer, debt laden as he is, won't give up his spending habits encouraged as he is, by low mortgage rates, low energy costs and terror on the run. Monetary liquidity, at record levels, stimulates spending, if not on real assets, then on financial ones. Fiscal stimulus has been high too. Balance sheets where they can are being repaired by nervous chief financial officers. Consumer and purchasing managers' confidence are improving and in time so will investment spending. Tech now accounts for half of all business capital spending in the US and there is some evidence that tech spending has bottomed. And some bottom that was. Tom Siebel (of Siebel Systems) believes IT spending started improving in November, and his company's results seem to bear it out.

More good news. Inflation is contained. Bush's popularity remains exceedingly high. If he were a stock, we'd sell him. This popularity allows him to push worthwhile, but less than popular measures. Lots of wealth has been recreated in the stock market recovery from the September lows. We're all feeling a little better.

So far, so good. And to boot, economists tell us we're already 11 months into this recession so it should be ending soon. Likely not later than the second or third quarter of this year.

Why? Most post-war recessions have been followed by strong growth and strong markets. We, on the other hand, tend to think this recovery will be different. Maybe we'll get a double-dip like Byron Wien, market strategist at Morgan Stanley, forecasts. Maybe not. But we think, very likely, the recovery will be gradual and shallow. And stock market returns will be lackluster too.

Why? First, massive monetary stimulation has still not produced an economic recovery, and after 11 rate cuts from 6.5% to 1.75%, how much lower can the Fed go?

But there are two bigger problems. One is the huge debt burdens on consumers, businesses and governments. The consumer, whose confidence has been rising, keeps taking on even more debt encouraged by the current low interest rates, to buy cars and houses, ignoring the fact that the next major move in rates is up, that the principal ultimately has to be repaid, and that incomes to do so may not be guaranteed. Debt to income ratios are at record highs. Homeowners' equity is near record lows. The second problem is, it would appear that the U.S. consumer is already saturated with goods. With an inability to handle more debt and a lack of desire for more goods, consumer demand could wane. But it's the consumer that drives the economy. And heaven help if house prices decline.

Corporations also have too much debt and poor profitability is constraining their ability to service and retire it, let alone to invest in capital. Similar to the consumer, corporations have too much stuff too. Capacity utilization is low. Consolidation and downsizing are in. With its awful start maybe this millennium should be downsized too, like to 998 years. Corporate defaults are at record highs.

The equity markets aren't allowing for much needed equity financing, and banks, reeling from loan losses, are wary of helping needy companies despite enormous monetary liquidity. The rapid failure of Enron and Kmart are sure to restrain already nervous bankers. They'd rather buy government bonds.

And government bonds for banks to buy should be plentiful as fiscal surpluses of the past give rise to deficits from the declining tax revenues during recession and the burgeoning spending to fend off recession. Remember when we were supposed to run surpluses. Well, the U.S. deficits for each of 2002 and 2003 are now estimated to exceed \$100 billion. Also, apart from the domestic fiscal stimulus, the war against terrorism is a costly affair. When the U.S. invests in a new highway there's a payback from the improved capital stock. But what's the economic payback from using up a million dollar missile? Today the U.S. has combat operations in Afghanistan and Iraq, enforces the peace in Bosnia and Kosovo and keeps peace with troop commitments for the Sinai, Japan, Korea, Taiwan, the Philippines and Europe as well as having significantly enhanced homeland defense. Now Mr. Bush is asking for a 12% increase in defense spending, another \$48 billion. Clearly government debt is going up. For all our sakes, interest rates had better not.

No doubt the effects of the \$132 billion dollar Argentine default are not yet over. Argentina is Latin America's third largest economy, after Mexico and Brazil. It now has massive employee layoffs, production shutdowns, currency devaluation, bankruptcies and political unrest. Its recession could also affect Brazil, one of its largest trading partners and others in the region. Other highly indebted countries might now also be encouraged to default on debt. JP Morgan Chase just wrote off over \$2 billion for Enron and Argentina. Small wonder banks are cautious.

Deteriorating balance sheets don't make bankers confident. Record losses by JDS Uniphase and Nortel don't make bankers confident. The Enron, Kmart and Global Crossing debacles don't make bankers confident. And Japan is a banker's nightmare. But if the economy, indeed the world economy is to grow, all this money we're told is plentiful needs to be made available by banks to borrowers for investment, not just allowed to slosh around in financial assets.

A highly leveraged economy and nervous lenders are not a prescription for capital formation and for quick recovery. Whether it's Japan, JDS Uniphase, Nortel, Enron, Kmart and all the other countries, corporations and consumers who are struggling with too much debt and not enough income to service it, sufficient debt liquidation will need to occur in order to purge the system of the leverage that came from the excesses of the past decade. The U.S. in the 1990s was an investment-led capital expansion like the U.S. in the 1920s and like Japan in the 1980s and therein lies the distinction with other cycles – it takes a long time for economies to recover from the bust of an investment-led expansion.

The U.S. dollar is also too strong to permit a quick recovery. It constrains U.S. ability to compete. Profits of multinationals suffer. Half of the steel formerly produced in the U.S. is now produced abroad. Globalization or no, the world is dependent on the U.S. economy for recovery. But the U.S. continues to run huge trade deficits and more and more U.S. dollars are held by foreigners. There are limits to this dynamic. Ultimately, the U.S. dollar will need to weaken. In the meantime, Ford struggles, closes plants and lays off employees while Japanese car makers get the benefit of a declining Yen with which to hurt Ford even more. The other Asian countries, including China, are unhappy

that the Yen is going down, and threaten to devalue too. We suspect the U.S. won't be happy that its dollar is so strong it can't compete and as a result, its recovery is stalled. It might not be so happy with our depressed loonie either.

Apart from any other kind of recession, we're sure in a profits recession. Yes, the auto companies got rid of inventories with zero rate financing, and that's good for future production. But in doing so they're cannibalizing next year's sales and profits. Profitability is what it's all about, for the economy and especially for the stock market. In fact, for the stock market it's about growing profitability, or these days, about lowered losses. Beating expectations, albeit lowered ones. Beating whispered numbers. We actually do think earnings disappointments may be lessening. Primarily because expectations have been lowered. Wall street analysts are more cautious. They are finally cleaning up their act, are less conflicted and more inclined to say "sell" rather than "neutral" or "hold".

The Enron scandal will clearly put pressure on auditors and regulators too. Look for higher quality earnings, which means lower reported earnings. Look for forensic whistle blowers. And improved accounting standards. Good riddance to "pro forma earnings". All this means is that, in the short run, earnings comparisons may suffer. Not a good thing for an overvalued market.

Leading economic indicators are showing some significant improvement presaging an early end to the recession. Growth in jobless claims seems to have abated. But we think, somehow, unemployment isn't through going up. Lucent has already laid off 44,000 but still has 7,000 to go. Nortel has laid off 41,900 but still has 4,600 to go. And so on.

Enron with 20,000 employees and Kmart with 300,000 employees won't help. We suspect more bankruptcies loom. Remember that the economy (2/3 of it) is being carried by an overconfident, over-indebted consumer who might get a tad less confident if his brother-in-law or neighbour loses his job or, heaven forbid, if he himself does. Savings levels are at record lows and those who do save aren't getting very much return at these crummy interest rates to generate much spending from this group.

We're not economists. But this seems like simple arithmetic. We defy anyone to explain how the economic recovery can be more than tepid if demand is impaired because every spending group has too much debt and too much stuff; if unemployment is still rising making incomes precarious and the consumer cautious; if corporate failures deleteriously impact employees, creditors, suppliers and customers; if lenders, reeling from losses, are reluctant to make new loans; and if the lofty U.S. dollar makes its manufacturers uncompetitive and creates mountainous balance of payments deficits.

Don't misunderstand, even as the news is bleak - bankruptcies, layoffs, accounting fraud, currency devaluations, write-offs etc. - progress in restoring the economy is underway. As we said, time heals all. It sometimes takes longer though. Is the worst over? We think yes. Is it straight up from here? We think not. It's never straight up. Corrections in the economy and in the stock market should be seen as a process. Markets fluctuate. Get ready for another fluctuation. We think it will be quick and dirty, a couple of weeks of scary downdraft. The markets should stay above their September 21st lows, but the especially overvalued tech stocks should correct enough to pressure all markets.

We think we're prepared, even though we'll probably take a little pain too. Our long/short accounts should do better than the long only accounts because they're less correlated to the market. But overall, we think our portfolios continue to be defensive. They comprise five different low risk groups of stocks. Very, very cheap stocks that don't correlate with the overall market, such as Goldfarb, Speedy, Hurricane Hydrocarbons, Pan-Ocean and Newalta; an overweighting in gold stocks (Franco Nevada, soon to be Newmont, GoldFields, Dundee Precious Metals), which tend to correlate negatively i.e., more often than not they go up when the market goes down; washed out stocks like the now deregulated U.S. electric utilities, Mirant (we own the convertible preferred shares which give us a 11% yield in the meantime), Dynegy and some AES, and beaten up and very cheap, Mosaic and Cryptologic (the latter weathering a temporary storm from some credit card companies refusing to process payments for Internet gambling); some safe high yielding fixed income ideas like 12% Hurricane bonds, Pan-Ocean preferred shares with a current yield of 11%, Acclaim Energy royalty trust with a 17% payout; and some blue chip, safe-dependable companies, like Kimberly-Clark, that tend to resist market declines better and sometimes even attract investment from the higher beta decliners. Generally speaking, all our companies have strong balance sheets, growing earnings and cash generation.

The short sales in our long/short accounts should give us some downside protection. We are currently short predominantly overvalued tech stocks: Electronic Arts, Research in Motion, Ariba, Nortel and Xilinx; and also Goldman Sachs and Dupont. These are companies whose earnings are likely to disappoint. We are also shorting Bell International against shares we will be receiving from a rights issue as part of a restructuring of this over-indebted company. We hope to double our money in Bell International over the next two weeks as long as we are able to maintain our short positions and the shares don't rise materially in price.

We continue to be highly selective. Although, truthfully, there's not a lot out there to buy right now. We're probably in for a "trader's market" so we'll probably be trading more than we normally would to take account of what we think will be an abnormally volatile and generally weak market.

We intend to continue to look for value stocks, including some smaller capitalization names, which should outperform the broad market. And we intend to be cautious. What we did last year certainly worked, even in an ugly bear market. We think we can do it again in 2002, in what we expect should be a less difficult, though still volatile year.

Maybe this millennium won't be so bad after all. Not for value investors anyway.

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