

Brother, Can You Spare a Dime?

After three years of false rallies and failed recoveries, and with the consensus growing that the economy and stock market cannot improve until “geopolitical uncertainties” are resolved, even bullish analysts are warning that stock market gains this year are likely to be modest. What is more, an increasingly-vocal contingent of bears is predicting that stocks will decline for a fourth consecutive year in 2003 – something that has happened only once before, at the start of the Great Depression from 1929 to 1932.

We maintain our view that the market will enjoy one of the best years ever in 2003, with the S&P 500 rising 45% or more. But the pessimists cannot fathom this. Many argue that today’s problems are “different” from any we have faced before, and, for this reason, they believe that in the coming years investors will have to settle for much lower returns in the stock market than those to which they became accustomed during the past couple of decades.

This kind of “New Era” thinking is common around both bull market tops and bear market bottoms. Indeed, there is little difference between the claims made by today’s pessimists and those of the optimists in the late 90’s, who argued vehemently that technological innovations like the Internet were “different” from those of previous generations and therefore rendered passé such “old-economy” concepts as recessions and bear markets.

We talk with investors every day, and we are amazed by how many are convinced that the potential for terrorists to obtain nuclear or biological weapons and set them off within our borders represents a threat so dissimilar from any we have had to face in the past that there is little chance the U.S. will ever see anything to rival the extraordinary economic growth and bull market of the past two decades.

Our rebuttal? In October 1962, the United States and the Soviet Union came to the brink of nuclear war over the placement of Soviet missiles in Cuba, and every American knew that the Soviets had the capability to obliterate every city in the United States in just a matter of hours – a threat immeasurably greater than any posed today by even the most well-funded and dedicated terrorist group. Yet in spite of the potential for a nuclear exchange during the Cold War, stocks performed quite well, with the S&P 500 rising more than 500% from the fall of 1962 (the Cuban Missile Crisis) to the fall of 1989 (the collapse of communist regimes throughout Eastern Europe).



The 1951 Buster-Jangles nuclear weapons test. The Army was assessing the impact of nuclear weapons on soldiers who saw a blast in the distance. The image of the mushroom cloud would come to define the terrifying threat of mutually-assured destruction during the Cold War

Then there is Iraq. When it comes to consensus opinion, it is hard to find any more widely shared than the notion that the uncertainty regarding the showdown with Saddam Hussein is holding our stock market back, and that stock prices simply cannot rise until this situation is resolved.

Some believe that even victory against Saddam will do little to alleviate the market malaise. After all, regime change in Iraq will not solve the North Korean nuclear threat, and it might only add to rising anti-American sentiment in Europe and continued instability in the Middle East – none of which can be good for U.S. businesses. The pessimists argue that this “geopolitical” risk is unlikely to go away any time soon and will thus continue to adversely impact the confidence of investors and keep a heavy weight on the stock market.

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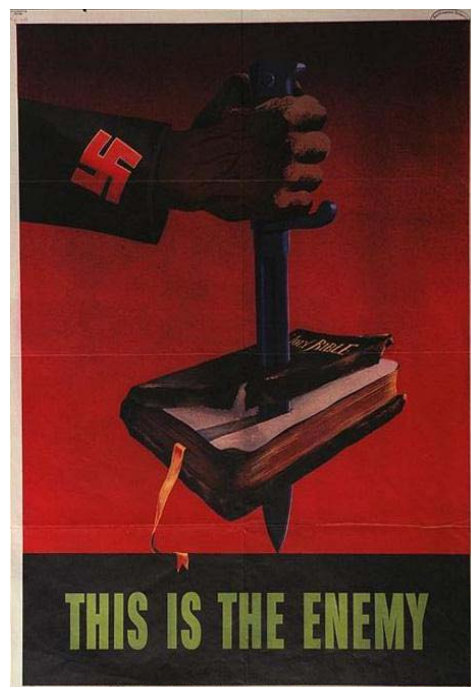
While these are certainly real problems, it is difficult to see in them the same potential for global economic disruption that was facing the U.S. the last time the stock market suffered losses as serious as those experienced during the past three years. In 1933, Adolph Hitler became Chancellor of Germany, transformed the country into a ruthless totalitarian state, pulled out of the League of Nations, and withdrew from disarmament talks – *and the Dow Jones Industrial Average rose more than 63%*. In 1934, the Dow tacked on another 5%, then surged 39% in 1935, even as Germany was forcing compulsory military service and revealing the existence of the Luftwaffe, a violation of The Treaty of Versailles. In 1936, as tensions continued to rise in Europe, the Dow rallied 25%. The Dow gave back 33% in 1937, but recovered much of that loss in 1938, rising nearly 28%. *In spite of the continuing global economic depression and the rise of the Nazi menace in Europe, the Dow gained 156% from the end of 1932 to the start of 1939.*

Fast forward to 1942. German U-Boats began sinking ships off the American coast, Sevastopol fell to the Germans, the Nazi conquest of Crimea was completed, and the German army launched its attack on Stalingrad. No one could have known at the time if or when Germany would be stopped. Yet the S&P 500 rose 20% that year, surged another 26% in 1943, climbed 20% in 1944, and rocketed 36% in 1945. As is always the case, stocks moved much higher long before anyone knew how or when the global military and economic crisis would end – before there was any *fundamental* evidence to support rising stock prices.

Even if war with Iraq were to degenerate into a Vietnam-style quagmire (unlikely, but not impossible, since any outcome not anticipated by consensus opinion has to be considered a possibility, and the consensus is overwhelming that the U.S. will defeat Iraq quickly), it is important to remember that the Vietnam War started out small and took several years to become a serious problem for the U.S. economy; from the time the first U.S. helicopters arrived in December of 1961 until the U.S. launched the first B-52 raids on North Vietnam in April of 1966, the S&P 500 rose more than 28% (not great, but certainly better than a decline). And one can argue that the struggling market of the late '60s and early '70s was a product of the rapid increase in government intervention in the economy rather than the war itself, as taxes, spending, and regulation expanded dramatically during this period.

What about today's lousy economy? The pessimists claim that the stock market simply cannot rise in the face of continuing evidence that economic conditions are not getting much better, and may in fact be worsening – factory orders have declined, consumer confidence has fallen to its lowest level since the terrorist attacks of September 11, 2001, the nation's labor market is experiencing one of the most protracted slumps since World War II (and most economists don't see it getting better in the next few months), last year's fourth quarter GDP expanded by an anemic 0.7% (versus a gain of 4.0% in the third quarter), and corporations are warning that they continue to lack "visibility" when it comes to predicting the strength of future sales. Perhaps most worrisome, there is the growing fear that even a quick victory in Iraq will do little to improve the confidence of consumers. After all, our success against al-Qaeda and the Taliban in Afghanistan did nothing to convince Americans to spend more time in Wal-Mart – retail sales were much better before Operation Enduring Freedom than they are today.

But as we pointed out in the October 2002 issue of *fcNOTES*, "At Hand (But Not In Sight)," in the last nine recessions, the average lead time between the stock market bottom and the beginning of an economic recovery was more than five months. In fact, every recession we have studied saw stocks turn higher while the economy was still heading south. So evidence of continuing economic weakness is not in itself enough to justify the view that stocks will be lower twelve months from now.



*The original "Axis of Evil" ...
Arm with Nazi insignia on uniform sleeve
stabs a dagger through the Bible.
(U.S. Office of War Information, 1943)*

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To believe that stocks will post a fourth consecutive year of declines, one must be able to envision economic risks comparable to those of the early 1930s. While few were seriously worried in 1930, as most business leaders, economists, and politicians expected the recession of 1929-1930 to be "self-limiting," by the time the stock market finished its third consecutive losing year, unemployment was approaching 25% and the banking system was near collapse. It is only natural to think that today's problems are more difficult than those of previous generations, for the simple reason that problems in hindsight never look as serious as they do before they are solved. But if investors were able to learn to live with the profound economic and geopolitical challenges of the 1930s, not to mention the truly unprecedented threat of mutually-assured destruction during the Cold War years, surely we can overcome the difficulties we face today. Our problems may be different on the surface, but our psychological response to them as investors will not be; we will adjust to new threats, price them into the market, then continue to do what we have always done – invest for a better future.

If you find yourself worrying about the possibility of a fourth straight losing year for stocks, we would suggest that the most important lesson to take away from the 1929-1932 bear market is that three years of double-digit declines goes a long way towards wringing the risk out of equities – even an investor who bought stocks at the end of 1931 and had to ride out another down year would nevertheless have realized a gain of more than 25% within two years.

Cyclical bull moves have always been very powerful in the first year following multi-year bear markets, and that is why it is highly likely that the experts who are predicting "moderate" gains for stocks in 2003 are dead wrong. As we explained in our last newsletter ("Gap Analysis"), we see only two possibilities: the S&P 500 either will surge more than 45% or will suffer another double-digit decline. *Let us be very clear on this point: another down year is more likely than the gain of 10 to 20 percent that the majority of forecasters predict.* But it is not the most probable outcome. The market usually moves in ways that surprise the greatest number of people, and right now a sudden and massive move higher will come as a much bigger surprise to just about everyone than will another lousy year. (In the January UBS/Gallup Index of Investor Optimism, one of the many sentiment indicators we follow, expectations for short-term returns on investors' own portfolios hit an all-time low, and only 38% of investors were optimistic about the performance of the stock market in the coming 12 months.)

The S&P 500 is off to an unhappy start so far, rising nearly 6% in the first two weeks of 2003, only to plummet 8.6% to close the month with a loss of 2.7%. But don't give up yet – the Dow declined nearly 15% in the first two months of 1933, but finished the year with a 64% gain. This is why the only thing that matters at this stage of the game is what you own when the big move comes. We continue to urge long-term investors to allocate 60% of investment cash reserves to stocks if they have not already done so. Although we would not dissuade aggressive investors with a higher tolerance for risk from using the recent weakness to become fully invested, we remind our readers that we are still waiting for the major averages to break out above the 200-day moving averages to confirm our bullish view and provide the signal for us to recommend a fully-invested equity position for all investors.

They used to tell me

I was building a dream

With peace and glory ahead.

Why should I be standing in line

Just waiting for bread?

Once I built a railroad

I made it run

Made it race against time.

Once I built a railroad

Now it's done.

Brother, can you spare a dime?

From "Brother, Can You Spare a Dime?"

By E. Y. Harburg & J. Gorney

In 1932, this song went to number one on the charts not once, but twice, in two different recordings by Rudy Vallee and Bing Crosby. Although one out of four Americans who wanted to work could not find employment, the Dow surged more than 60% in 1933.

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