

# How Much Can the Market Bear?

*By Ralph Weil*

**C**an we have a third year of declines for the current bear market? We can, but is it likely to happen? We think not. There are many signs that suggest the economy is bottoming and that sometime this year corporate earnings and cash flows will improve. As in the year 2001, our major concern for the overall market is valuation. But before we address the future specifically, let's take a look at the past year.

It is now official; the longest running economic expansion ended in March 2001. And again, the equity markets led the turn. The Standard & Poor's 500 and the NASDAQ indexes topped out during the January/February time period, while the Dow Jones Average, due to its higher energy weighting, topped out in May. As we know, the equity market is used as one of the leading indicators in forecasting the direction of the economy. The market's lead time for downturns is generally shorter than for upswings in the economy.

This recession is being felt most significantly in manufacturing. It is now quite apparent that in the boom times of 1999 and 2000, excess in-

ventories were built pretty much throughout the entire economic structure. Stockpiles were built at all levels from raw materials, manufacturing and transportation, all the way to the end-user level. So it can be safely said that the current downturn is a classic inventory correction. The consumer has continued to do his part by spending on housing, housing related items, automobiles and to a lesser extent, other durable goods. The inventory excess is a self-correcting problem and should be worked off by mid year.

As previously stated, consumers have been doing more than their share in supporting the nation's economy. This has been the case even in the face of rising unemployment and the events of September 11. As tragic as September 11 is, it should be remembered that the recession predated those cowardly acts. After the eleventh, most forecasters feared that the consumer would put his hands in his pockets and not spend. Fortunately, after a brief lull in activity, people started spending again. The housing segment was helped by low interest rates and the automobile segment was pushed

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ahead by big incentives. While this spending activity certainly kept us from falling off the cliff in economic terms, its downside could be less activity in the first and second quarters of this year.


Looking at current economic signals, we are seeing signs that are encouraging and give us some reason to believe this part of the cycle is bottoming. Among others, those signals include:

- Improvement in the Purchasing Managers' Index
- Slowing in the rate of unemployment growth
- Improvement in the leading indicators
- Improvement in consumer confidence
- Better orders for durable goods except for the volatile transportation segment

It is clear that these are positive signs, but there are also signs the recession will continue at least for a couple more quarters. Inventories in certain areas are still a problem, while in other segments, such as semiconductor memory chips, prices are starting to rise. Another concern is how long consumers can continue their spending spree in the face of rising unemployment (at a slower rate) and the advanced spending done at the end of 2001.

Total returns for all of 2001 are shown in the table below. As can be seen in the table, fourth quarter returns rebounded sharply. This will impact recovery returns for 2002.

When we examine the outlook for 2002, we have a hard time seeing revenue and profit growth before the second quarter and most likely not until the second half of the year. Slow revenue growth presents problems for management in offsetting rising costs. We know for instance that insurance costs, including health, are rising significantly this year. Given the recession, industry will have a hard time passing those higher costs on to the consumer. Overall, we agree with the general forecast of a recovery most likely starting in the second half of the year. While the Federal Reserve has put in place eleven interest rate cuts since the beginning of 2001, it takes time for the cuts to be felt in the economy. This time around, the impact is effected by the size of the inventory overhang and other factors.

Our conclusion is that, given the uncertainty of the timing of the recovery in earnings and cash flow, and the substantial rise in the equity markets since the bottom, the gain in the market for 2002 will be modest. This year will clearly *not* be one of those years when the old adage "A rising tide lifts all boats" will apply. Stock selection will be paramount, as it was in 2001. We will commit our energy to a careful monitoring of each company and a critical assessment of its outlook in an unsettled economic environment. 

	<b>2001</b>	<b>4Q01</b>
<b>Dow Industrials</b>	-5.3%	+27.0%
<b>Standard &amp; Poor's 500</b>	-11.9%	+22.0%
<b>NASDAQ</b>	-20.8%	+42.0%

# What's Next?

By Jim Fox

We frequently are asked this question. It is particularly common at year end as investors look forward to a New Year and make financial plans. We analyze available information and make our forecast in spite of long odds. (See this issue's accompanying article.) The reality is, no one knows where the market is going—it is fickle.

In our industry there is an adage that addresses this challenge. "If you must forecast, forecast often!" One of our sage, retired partners used to respond to the question about market outlook by quoting Jay Pierpont (J.P.) Morgan, "Stocks will fluctuate!"

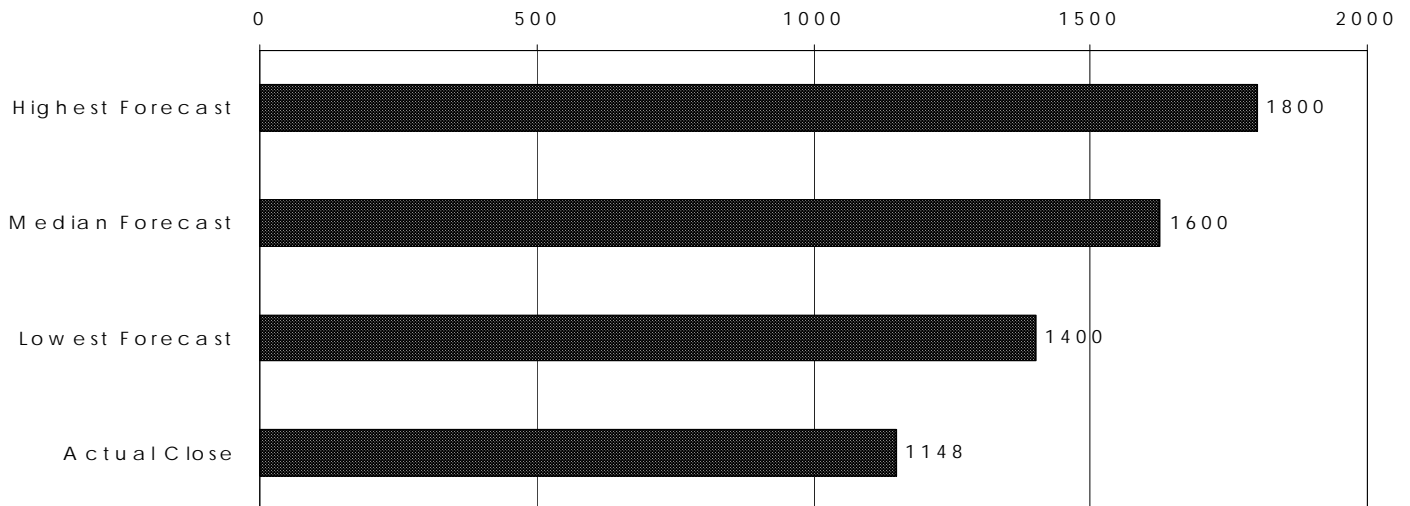
Nevertheless, we must always look forward and attempt to anticipate risk and opportunity. Part of this effort includes evaluation of input from each of the professional sources we access. One of these resources is the strategist employed by each of several major Wall Street firms. While we recognize they inherently have biases as well as conflicts of interest, they do take influential positions.

Their record for 2001 is not good—even adjusting for post September 11. Ten of the most respected brokerage firms posted forecasts in a *Wall Street Journal* survey published at the beginning of the year. The forecast for last year's closing Standard and Poor's 500 Index (S&P 500) ranged from 1400-1800 and the median estimate was 1600. The actual closing of the S&P 500 for last year was 1148, a forecasting error, on average, of 30% by strategists who are well paid to analyze market action.

In our letter of one year ago, we projected a return to economic growth by year end. Our expectation was that the markets would show a modest positive return for 2001. We clearly missed the timing of the turnaround. Our cautious forecast, while closer to the mark, was also overly optimistic. Nevertheless, our caution produced strong relative returns for the period. Not only did our clients avoid serious damage, we found ourselves making gains during the sharp year-end rally. Like most of our clients, we are glad last year is behind us.



Analysts Forecasts vs. Actual S & P 500  
2001 Closing Value



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## The 5th in 87 Years

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**W**e are pleased to announce that our Board of Directors, in concert with the firm's principals, has elected Peter Boyle, CFA, President of Clifford Associates. Peter is only the fifth President in Clifford's 87-year history.

This event marks the culmination of a succession plan put in place a number of years ago to allow our former President, Jim Fox, relief from the day-to-day management responsibilities of the firm.

Jim, who joined Clifford Associates nearly 20 years ago, will retain his position on the Board of Directors as well as his primary responsibility of managing client portfolios. Under Jim's leadership the organization has grown and prospered. Today, the firm manages over \$760 million in assets for individuals and non-profit institutions. Besides our core investment counseling business, the firm is also now recognized as a leading provider of services to the planned giving community.

Peter, for those of you who have not met him, joined Clifford Associates 10 years ago. Since that time he has served in a number of management roles, in addition to having responsibility for both individual and institutional clients. Having grown with the company and possessing significant investment knowledge, he is well suited to lead the firm for many years into the new century.

We are pleased that this considered, planned transition will ensure continuity of our core investment philosophy, which has been in place since the firm's founding. Peter will continue to work with his existing clients and looks forward to meeting those served by other partners in the firm.

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**W**e have completed the initial development of the Clifford Associates website. Please visit us at [www.clifford1915.com](http://www.clifford1915.com). Our plan is to continue the development of the website. Over the next year or so, we will offer access to our newsletters among other information. This facility will not only speed information on investment issues to our clients, it will allow us to add more frequent, periodic updates.

Finally, after we are satisfied our security and confidentiality standards are met, we will provide on-line access to clients for their portfolio status. These reports will be updated daily for those clients whose custodian provides linkage to Clifford's systems. Others will be current except for the delay in reconciling cash balances from monthly custodian statements. We would like to add your e-mail address to our database, please contact us at [info@clifford1915.com](mailto:info@clifford1915.com)