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Driving the Market

By Bruce White

During the last quarter investors have been pre-occupied with a host of economic concerns including:

- possible renewed inflation
- rising interest rates
- volatile currency valuations
- a growing trade deficit
- political uncertainties
- Y2K fears

While these general uncertainties have made the news, very little attention is being paid to specific fundamentals, such as cash flow and earnings growth, which create wealth for shareholders.

Interest Rates and Inflation

There is no consensus on Wall Street about whether or not the Federal Reserve will raise interest rates on November 16th. Much of the recent volatile trading in stocks has come from the uncertainty about the direction of interest rates. Without a convincing argument that we are experiencing inflation, proponents of higher interest rates look to the unrelenting strength in the U.S. economy to justify a Fed tightening. Real interest rates (nominal rates

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Y2K Ready

By Peter Boyle

After nearly a decade of work and an estimated \$50 billion in private sector capital, it appears as the century turns, the ball will drop on time in Times Square, floats will roll down the streets of Pasadena and technology-related disruptions will be minimal.

Despite the possibility of disruption, history has shown that U.S. companies can and do adjust, and react. In 1999 alone, the Chicago Board of Trade shut down trading because of a power failure, and AT&T's frame relay network crashed. On any given day, one to two percent of ATM's are out of service. In this technology dependent era, failures both mechanical and electronic have become a normal part of our economy.

Some concern remains about the psychological impact of Y2K on the economy. While precautions such as printing additional currency have been addressed, others may have repercussions. For example, supply bottlenecks could occur if businesses seek additional inventory levels as insurance against possible shortages. On this subject, Alan Greenspan commented

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"While it is easy to obsess about a few institutions in our society that may not be ready, let us not lose sight of the fact that the overwhelming majority of us are not only prepared, but have contingency plans to deal with breakdowns....The evidence is becoming more persuasive that our electronic infrastructure will be ready for the century date change."

Federal Reserve
Chairman
Alan Greenspan
September 17, 1999
On the subject of Y2K

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minus inflation) are historically high, so without an increase in inflation, we do *not* see any likelihood of a significant increase in interest rates, beyond a potential small Fed tightening.

International Outlook

As Japan's economy recovers, the Japanese stock market has shown significant gains so far this year (see Chart 1). Foreign capital has flowed into the yen, which has caused the yen to strengthen against the dollar. This is an important distinction, because the dollar has not weakened against other currencies, including the euro.

Japan is a large part of the world's economy with 13% of global GDP, compared to Germany at 7% and the UK at 4%. Many observers fear that a stronger yen will increase inflationary pressure

in the U.S. because higher-priced imports from Japan will allow U.S. manufacturers to raise their prices. The Japanese government wants a weaker yen to help exporters speed the economic recovery in Japan that has been so long in coming. However, governments have a difficult time moving currency valuations for extended periods in the face of market forces.

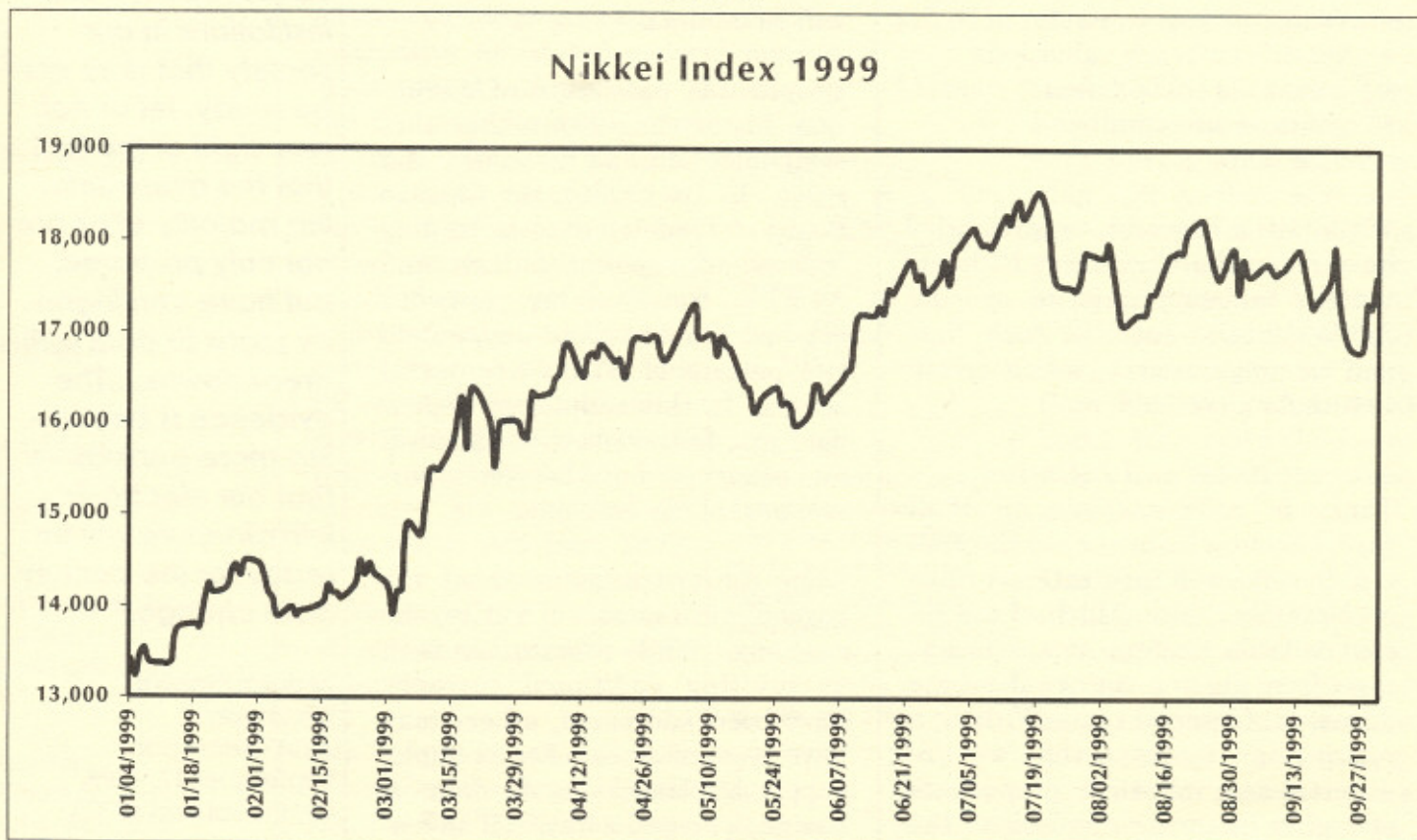
We believe that the recovery in Japan will continue. Japan will stay on the path of restructuring its banking system, reducing government regulation and reducing taxation. Any inflation pressures on the U.S. markets should be minor and not result in higher interest rates.

Political Uncertainty

At the time of this writing, there is no federal budget in place. Being a year away from a presi-

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Chart 1

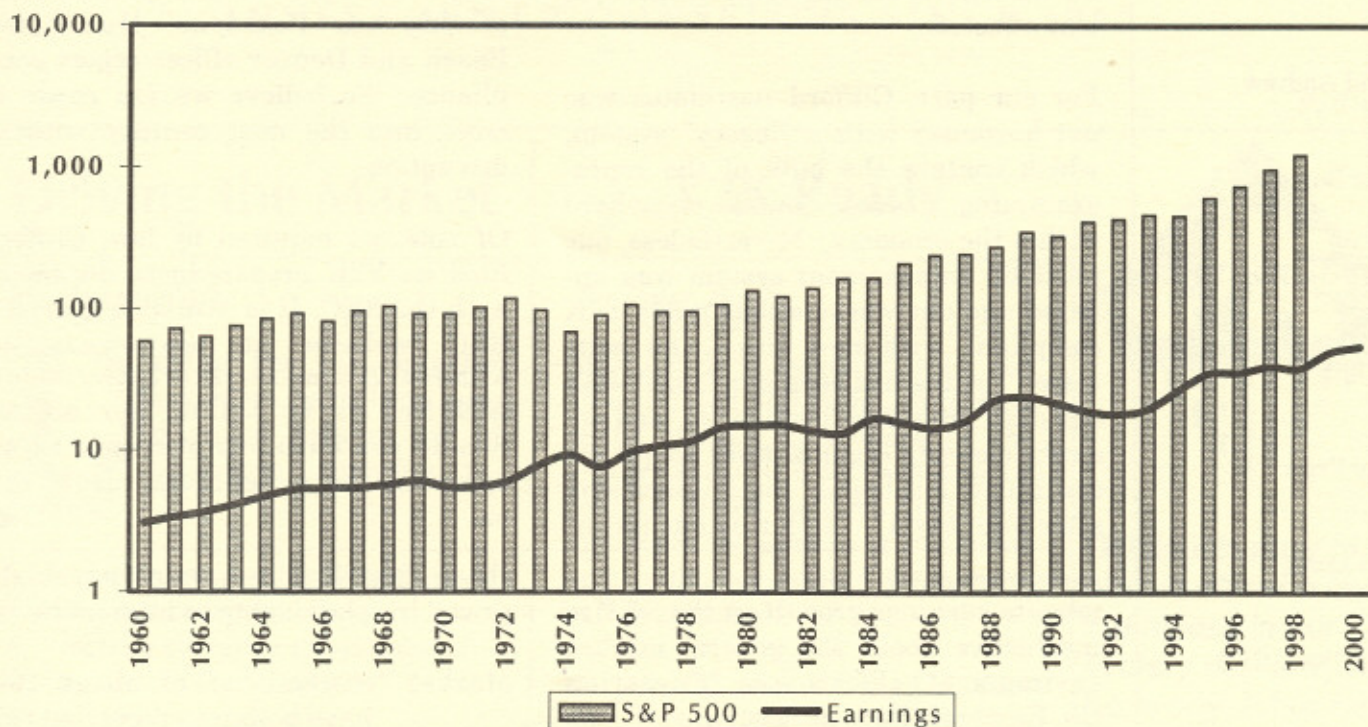


The Nikkei 225 stock average is a price-weighted index of 225 top-rated Japanese companies listed on the Tokyo Stock Exchange. This chart shows the index for 1999 in terms of yen. The line shows that the index has risen 31% year-to-date, from 13,416 on January 4th to 17,605 on September 30th. In dollar terms, the year-to-date percentage increase was even greater, at 38%.

Data source: Bloomberg

Chart 2

Earnings Drive the Market



This chart shows the growth in the Standard & Poor's 500 earnings compared with the year-end Index values from 1960 through 1998, on a logarithmic scale. Earnings growth and value of the index have been closely related over time. We believe the relationship will continue in the future.

Data source: Index values are from Bloomberg. Earnings are from three sources. For 1960 through 1981, earnings are from a study made by the New York University Leonard N. Stern School of Business. 1982 through 1998 earnings are from Baseline, and the 1999 and 2000 earnings estimates are from Zack's Investment Research.

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dential election, politics will dominate the federal budget process even more than usual. In spite of the usual "smoke and mirrors," the federal government has become more responsible than in the past, and the days of huge deficit spending will not return soon.

Y2K

Some investors are trying to time the market by raising cash in their portfolios, in preparation for the possibility of a Y2K problem. Such efforts are seldom successful. No one can say that there won't be any problems, but the U.S. financial system is as prepared as possible. The worst case scenario is a Y2K-caused market decline in the fourth quarter. Even if this unlikely event oc-

curs, there will probably be a millennium rally to follow. After January 1, 2000 many who sold will want to get right back into the market. Because the market is forward looking, we suggest this whip effect might happen even sooner than January 2000, particularly if money is transferred from international bond and stock markets to the relative safe harbor of U.S. securities.

Earnings Driven

Missing from much of the current discussion about stock prices is the continued successful creation of wealth by U. S. companies. Although we use cash flow as a more accurate measurement of an *individual* company's value, the ag-

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that as the level of uncertainty diminishes, businesses should feel less need for insurance, leaving their inventories less affected.

For our part, Clifford Associates was not burdened with a "legacy" system, which contain the bulk of the reprogramming issues found elsewhere within the economy. Nevertheless, our portfolio management system was updated and our workstations made Y2K compliant with new chips and software. Testing has been performed with our data providers, custodians, and security clearing organizations to ensure continued electronic communications after January 1st. As far as our physi-

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gregate earnings growth on the S&P is instructive about the general market environment. (Please see "Capturing the Economic Rate of Return in our Winter 1998 issue for a discussion of cash flow.) Earnings gains over the last three years have largely resulted from productivity improvements and financial restructuring; but the next gains will be from unit sales growth, as global economic health improves. S&P 500 earnings are projected to grow about 10% from 1999 to 2000. In the long run, stock prices are a function of earnings growth (see Chart 2).

Are stocks overvalued?

Excluding the volatile technology sector, the S&P 500 is trading at 21 times 1999 estimated operating earnings per share, compared to the ten-year government bond trading to yield 6%. Certainly that doesn't make the index

cal plant is concerned, our telecommunication providers as well as the municipal and private utility companies serving our Pasadena, Huntington Beach and Denver offices report compliance. We believe we are ready to cross into the next century without disruption.

Of note, as required by law, Clifford filed its Y2K preparedness document with the SEC. It is available from the SEC website at http://www.sec.gov/Archives/y2kforms/advy2k1/r2_adv2k1801-09797.html or by calling our offices. Should you have any questions as we approach the millennium, please call us.

cheap, but it is not extremely high-priced in relationship to interest rates.

Market "corrections" of about 10% have become a recurring feature during this long-running bull market. However, the indices are hiding the greater weakness in the majority of stocks: 61% of NYSE and 83% of NASDAQ stocks are down by more than 20% from their 1999 highs. Now more than ever it is a market of stocks, not a stock market.

Looking Ahead

Although we are cautious and vigilant about changes in the economic environment, we remain positive about the individual companies we own. Over the next few years it will be important to own those companies that can execute a strategy of creating internal wealth in a dynamic world.



Among the less-than-serious market indicators, Donaldson, Lufkin & Jenrette gives us the following: In the 24 years that followed American golf team Ryder Cup victories, the market was up 83% of the time with an average gain of 13%.