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IS IT A BULL OR A BEAR … OR A HYBRID ?

While most people like to see stock market indices rise to record levels (the excitement of it all!), there are a number of downsides to fast-rising markets and/or sustained high price-earnings ratios (PERs), as the world has witnessed over the past few years.

One of the major downsides to fast-rising and/or sustained stock-market bull runs is that people, in general, tend to save less, spend more, and, it follows, gamble more.

The danger of such a situation is apparent: If markets start to collapse, or even suffer a major reversal, it will result in a domino effect, right down the line, from banker to housewife.

The US Federal Reserve has done more than a reasonable job in keeping the lid on the US economy, using, as its weapon of choice, mini, interest-rate increases.

But the US economy has now slowed, considerably, and the fear that exists, today, is that the US economy will have a rather bumpy landing, causing a fast and/or steady erosion of share/stock prices.

That very fear caused widespread selling pressure on The New York Stock Exchange on Tuesday, January 2, and the following Wednesday morning, necessitating the US Federal Reserve to take extreme measures: It cut interest rates by one half of one percent in a shock move that took nearly everybody by surprise (except Dr Alan Greenspan and his gang at the Fed, of course).

For investors, who had purchased stocks and shares on margin, the knock-on effect of a fast erosion of share prices is only too apparent: They will be wiped out, completely, unless they have salted away sufficient previous profits, allowing them to ride out the storm.

For those, who have been greedy and have not taken their profits and put them in banks in order to prepare for the stock markets' rainy days, then they can, unwittingly, precipitate an avalanche of selling as their holdings are liquidated, in part or in whole, either due to financial necessity or, in the worst cases, by banks and brokerage houses, which demand coverage of short positions (which, no doubt, took place on January 2 and January 3).

Aside for this depressing scenario, there is the question as to whether or not the stock markets of the world, and especially the US stock markets, will be able to recover in short order from any major meltdown in equity prices.

In the middle of December, the US Federal Reserve showed a distinct bias to raising interest rates, reversing its previous determinations, clearly due to its concern that the US economy was cooling at such a fast pace that it could get pneumonia instead of just a couple of sneezes, due to clogged economic nasal passages.

It is widely expected that the Fed will continue to take definitive action by lowering interest rates as it deems fitting and proper, but on the order of between 25 basis points and 50 basis points, if not this month, again, then in February.

Such supportive acts by the Fed is likely to cause investors to regain a little – albeit brief -- of their lost confidence, resulting in a burst of buying on major bourses, with indices, rising, perhaps, to one-day gains of record proportions (as happened on the afternoon of Wednesday, January 3).

But that is likely to be that -- and just that: One little prick and the frail bubble bursts.

It will mean little in the long run since the effects of the first (probably, of many more to come) mini, interest-rate reductions will not kick in to the US economy for at least 6 months, if not longer.

The stock markets of the world will look in gleeful anticipation for more interest-rate reductions – and the pattern on stock markets will start to be repeated, many times, as indices gyrate up and down, as does a little boy play with his yo-yo.

To a great extent, what will have been forgotten amid the monotonous chants and investor incantations, all aimed at invoking the gods of the stock markets with entreaties that the US economy get another injection of happiness in the shape of interest-rate cuts, is that the fundamentals of the US economy will not have been altered.

The US economy is slowing, to be sure, but the fundamental differences, between the pre-Internet *'revolution'* and the situation of today, have not changed, appreciably.

One of the major differences between *'yesterday'* and today, however, is that the average consumer has less disposable income at hand.

Motor-car sales are slipping; computer sales have slowed; banks are becoming more and more careful to whom to lend money; and, there are growing fears that many start-up companies and Internet-related entities will end up on the scrap heap, in time.

Bank of England, in early December, issued its second warning with regard to high- leveraged positions of companies that are engaged in Universal Mobile Telecommunication Standard (UMTS) licences (Third Generation Wireless Services) since the costs of country licences, plus the cost of the 3-G infrastructural requirements, are, already, straining financial systems, worldwide.

Bank of England realises that what affects one major bank in one country can affect banking operations in other countries, cascading down the line.

As far as many banks are concerned, it may, already, be a case of slamming shut the barn door after the horses have bolted.

While, in TARGET's last analysis of the world's changing flexible economies, a report that indicated that there is an urgent need for a different set of guidelines in order to allow investors to make an intelligent determination as to the underlying values of *'modern'* companies, especially companies in the midst of transformation, and this applies, especially, to those entities, engaged in acquiring UMTS *'platforms'*, at the end of the day, fundamentals will out.

(Please see TARGET Intelligence Report, Volume II, Numbers 229 and 234, published on December 1 and December 8, 2000 for these reports)

With PERs of many publicly listed companies, standing at 30 times and more, investors may start to apply *'old'* measures of comparison and, by so doing, allow share prices to slip to levels where PERs are closer to 10 times than 30 times.

In spite of there, having been a tickle of a stock-market rally in the last quarter of last year, ended December 31, 2000, one should realise that most indices were, as at the end of last year, at the same levels as they were at the beginning of 2000, or even a touch below those levels.

That would indicate a bear market for the 2000 year, regardless as to what many stockbrokers would have investors believe.

Returns from fixed, income-earning *'paper'* have, for the 2000 year, been equal to, if not ahead of, returns from investments in equities.

Getting back to PERs, TARGET notes that, in the 2000 year, they were standing, on an international basis, taking the world as a notional stock market, at about 30 times.

This compares with PERs of about 22 times for the previous decade.

And investors have, for the most part, been sadly disappointed that their corporate *'darlings'* have not performed as they had hoped.

The generalisations for purchases at high prices, and the justifications for buying at record PERs, fell on fallow soil.

Because, buying equities at relatively high PERs is based on an assessment, which comes down to maintaining that there shall be a much faster growth in earnings than had been possible in the past.

That was fair enough, considering the demands for the corporate transformations of many companies, plus the requirement for new game plans in order to meet the challenges of the 21st Century, however, in many cases, the formulae, applied for purchasing equities, has not paid off as had been anticipated.

The voracious demands of the Internet forced many companies to change corporate strategies, or suffer the obvious consequences of intransigeant management determinations.

Recently, a Canadian stockbrokerage company sent out a letter to investors, a letter which amounted to a recommendation for the purchase of shares of Nortel Networks Corporation, an important worldwide supplier of telecommunications equipment as well as being a major force in research and development, outsourcing its manufacturing requirements when needs be.

Nortel Networks is listed on The New York Stock Exchange as well as The Toronto Stock Exchange and, in November 2000, a sudden decline in the share price of this company brought both markets to its proverbial knees.

At the time of the Caldwell Securities Ltd report, dated November 21, 2000, but mailed out nearly one month later, the price of the shares of Nortel Networks was about $US36 (about $HK280).

An interesting aspect of this report was that it stated, inter alia: *'… At current price levels, Nortel's shares are trading at a multiple of about 40 times its current* (historic) *earnings per share. With earnings growing at 40%, however, the ratio of its share price/earnings multiple to its growth rate (PEG ratio) is a reasonable 1:1.'*

Now, this report was issued, following an alleged management meeting with the President and Chief Executive Officer of Nortel Networks at Boston, Massachusetts, the US.

One may assume, logically, that the following statement was based on the comments of Mr John Roth, Nortel Networks's President and CEO: *'In fiscal 2001, management believes that the overall market will grow in excess of 20%, but expects that Nortel will grow both its revenue and earnings per share by 30-35%. This is largely because the company is focused on two of the fastest growing sectors in telecommunications: Fibre optic communication and wireless Internet.'*

Nortel Networks announced that its Trading Results, for the 3 months to September 30, 2000, were a Loss Attributable to Shareholders of about $US586 million (about $HK3.37 billion).

This compared with the like 1999 period of a Loss Attributable to Shareholders of about $US79 million (about $HK612 million).

For the first 9 months of the 2000 Financial Year, to September 30, 2000, the Company had chalked up a Loss Attributable to Shareholders of about $US2.06 billion (about $HK16 billion).

And, comparing the first 9 months of the 2000 Year with the first 9 months of the 1999 Year, one sees that Nortel Networks suffered a Loss Attributable to Shareholders of about $US523 million (about $HK4.05 billion) in 1999.

So much for PERs.

Is a PER of 40 times expensive for this company?

In view of the US economy's known slowdown, and its expected continued slowdown, which will, without question, impact on other countries, to be sure, may one rely on Mr Roth's assessment of his Company's 2001 forecast profits?

The short answer: Probably not.

That does not mean that Nortel Networks is not a good company in its field, but it does mean that a purchase of its shares at a price which represents a PER of 40 times could be considered costly in the extreme.

The 2000, 12-month high for Nortel Networks was $US89 per share.

At the time that it hit its peak at $US89 per share, stockbrokerage houses in the US and Canada must have been touting the shares at a PER of about 99 times.

Was that too expensive for the shares of this company?

Of course!

It was a price out of this world, at least, for that time.

It was a crazy price since the Company could not deliver profits to justify such a high PER.

And it, still, cannot deliver profits to justify a price of even $US20 per share.

Nortel Networks states that it is concentrating on solutions for UMTS providers, using fibre optic capabilities as its base.

For certain, UMTS is the future, as is clearly evidenced by the vast amounts of money that international companies are willing to pay in order to obtain country licences for the exclusive privilege to operate for 3-G networks.

The costs, in most cases, are running into the tens of billions of dollars.

While, in the purchase of equities, today, one is required to be ready to pay prices, based on somewhat higher PERs than in pre-Internet days, it does not mean that PERs should be at levels of between 40 times and 100 times, although there may be the odd case, here and there, that justifies such a purchase.

According to Mr Brendan Caldwell, of Caldwell Securities: *'Nortel Networks shares should be purchased with a three-year target price of $*(US)*100 per share.'*

On what basis Mr Caldwell can make such a statement would be interesting to learn: Could it on the basis of 100 times earnings, or more?

Or it is a case of post hoc, ergo proctor hoc?

<u>Stretched Valuations</u>

While higher PERs may well be justified in the new (economic) order of things, one must be extremely careful about going overboard.

The factors that caused the US stock market's bull run of the past decade or so remain in place, to be sure.

Those factors include monetary stability, fiscal prudence (thank you, Dr Alan Greenspan), the continued liberalisation and diversification of markets for goods and services, and a more international approach to business, encompassing the concept of the family of nations when it comes to doing business.

But this is all old hat; and, the market has discounted it, to a great extent.

Higher oil prices have made many markets wobbly.

Earnings have slowed down as many companies felt the pinch of the combination of higher interest rates and higher oil prices which, in turn, resulted in bread-and-butter companies, having to tighten their belts in order to guarantee that the ends met.

Oil-price rises added to the pressure on equity prices, which started to buckle under the weight.

Higher oil prices had a knock-on effect in the marketplace, too, as consumer purchases started to wane, dramatically.

But the oil-price rises of 2000 appear to be behind us, at least for the time being, and one may look forward to a reduction in demand for the black *'gold'* – the panic should be over, with the exception of the odd rise, here and there.

Oil reserves are likely to rise to record levels because countries are more than likely to start to raise oil inventories … just in case the Arabs try to hold the world to ransom, again.

But the difficulties encountered in 2000 have, already, taken their toll on many a company, which has had to bite the bullet and to state that which most people knew: Earnings cannot meet expectations.

Downward revisions of many companies's earnings for the next quarter will continue to come in and be felt, no doubt, but, after that, such reports may be relegated to history.

Overvaluations in the hi-tech, telecommunications and Internet-related sectors of equity markets remain a problem because some people still believe in miracles.

It is a very real problem because people, who aim too high, often fall too low.

In the case of an investor, who thinks that such-and-such a company will see its price rise to a level that the PER is 50 times or more, could be very disappointed when crunch-time comes and he is asked to top up his account with his stockbrokerage company.

Miracles are few and far between, he will learn only too late.

PERs of 50 times and more are unrealistic, for the most part.

Equity markets of the world are still in transition, adjusting to changing circumstances as new technology is ever changing the environment of companies.

This is a very dangerous time for investments, in general, as is it a very dangerous time when a company attempts a major expansion move, utilising a large proportion of its surplus cash resources.

Stock markets are likely to be in for a bumpy first half of this year, but a gradual accumulation of good-quality shares in companies of the ilk of Nortel Networks Corporation, Citigroup Incorporated, Lucent Technologies

Incorporated, Cisco Systems Incorporated, HSBC Holdings plc, Deutsche Bank A.G., Microsoft Corporation, British Telecom plc, Siemens A.G., Nippon Telegraph and Telephone Corporation, China Mobile (Hongkong) Ltd, Fujitsu Corporation, Sony Corporation may well pay off within the next few years.

But the price must be right.

Historic PERs of 40 times, or even 25 times, may well turn out to be too expensive, but a point must be reached, somewhere, perhaps, between a PER of 10 times and 20 times, that results in an investor, obtaining a reasonable return on his investment.

But one, always, has to recall the axiom of the Greeks of the 6th Century B.C.: Everything in moderation.

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