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Questioning Market Leaders For Long Term Investors

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MARKET STRATEGY **INTERVIEW**

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General Market Overview

ELAINE GARZARELLI — GARZARELLI CAPITAL, INC.



ELAINE GARZARELLI, President of Garzarelli Capital, Inc., was a partner and managing director at several major brokerage firms prior to starting her own company in 1995. She has been studying the stock market for over 20 years and has been ranked first team in Quantitative Analysis in Institutional Investor magazine's all-star poll for 11 years. She was also ranked in Strategy and Market timing. She initially developed her Sector Analysis methodology for predicting industry earnings and the stock market while working as a corporate profit economist with her staff of econometricians. This methodology

allowed her to predict the major trends in stock prices and the earnings of 80 S&P 500 industry groups. She is credited with predicting the bear market bottom in the S&P 500 price index in 1982, the top in 1984 and the bottom, the crash of 1987, the upturn that followed, and the top and bottom in stock prices in 1990. Her indicators showed an overvaluation in the S&P 500 of 40% in late 1999 and she warned of overvaluation and problems with company cash flow statistics as early as 1996, several months before Alan Greenspan's "irrational exuberance" speech. She currently uses this mathematical approach for stock market timing and industry selection in producing her Sector Analysis Monthly Monitor. She issues this institutional report to clients managing over \$100 million. She was featured as a top Businesswoman in Fortune magazine and in BusinessWeek's "What's In" list. She appears frequently on television, including ABC Good Morning America, CNN's MoneyLine, Fox Business News, and The Nightly Business Report. She spends three weeks each month doing research (working with economists in the industries she covers and analyzing her industry earnings models). During the rest of the month, she presents her forecasts on the economy, the stock market, and specific industries to institutional clients. Her education is in economics and statistics at New York University, and she holds a doctorate from Drexel University.

SECTOR – GENERAL INVESTING

(WAF801) TWST: Please give us a quick overview of what you see going on in the marketplace.

Ms. Garzarelli: Living with cyclical bull and bear markets will probably be the norm for the next five to 10 years. A buy-and-hold strategy, which worked so well from 1982 to 2000, should not be as popular in the future, in our opinion.

Cycle timing is back in vogue because of the recent bear market, and the realization by investors that a 50% decline in stock prices would require a 100% recovery simply to break even. For those who invested in the NASDAQ, a 140% rise from here would still be only breaking even. Our indicators over the years have determined tops and bottoms in cyclical bull and bear markets within a few percent, on average. Our bear market reading

was given in May 2000, and our bullish composite signal in the late summer of 2002.

Our composite remains bullish at 62% and will not become bearish until it falls to 30%. A drop to 42% would suggest a 10% to 15% correction. Our indicators are fundamental, not technical, and comprise four main areas worth about 25% each — economic, monetary, valuation and sentiment. The composite reading ranges from 0% to 100%.

We believe a bull market began on October 9, 2002, and February will be the 16th month of the new bull market. Although the bear market began in March 2000, it should have started in late 1996 or early 1997 based on the downtrend in income-tax corporate profits beginning in 1997. S&P 500 operating profits trended up until late 2000. When Greenspan used the words “irrational exuberance” in his December 1996, speech, he was absolutely right. The stock market should have peaked about then and shifted sideways to down until early 2001, a few quarters before tax earnings bottomed. The recession ended in November 2001, and the stock market generally bottoms about six to nine months before the end of a recession.

My first assignment as an assistant economist was to predict tax-return earnings. That was well over 20 years ago, so this measure is the one we have used primarily in valuing the S&P 500. Even though it covers many more companies, it is a consistent historical series and correlates well with stock prices over time. Recently, this measure as a share of GDP rose to an historical high.

Income tax profits are important because corporations like to show higher profits to shareholders, but they do not have the same incentive

when reporting their profits to the IRS — hence, the more accurate numbers. Tax-return profits are not affected by pension fund values, stock options are expensed, and excluded are expenses such as bad debt, depletion, and capital losses or gains. Other advantages are that inventory withdrawals are valued at current cost and depreciation is on a consistent accounting basis and valued at current replacement cost.

TWST: What happened?

Ms. Garzarelli: The S&P 500 stock price index (highly weighted in tech and telecom) continued to rise until March 2000, because the index followed S&P operating earnings instead of tax earnings (as mentioned, S&P 500 earnings did not peak until 2000). As all know now, S&P earnings were grossly distorted by many

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unusual things, one being non-expensed stock options. Instead of bubbling, had the S&P 500 followed tax earnings and peaked in late 1996 moved sideways, and bottomed in early 2001, we believe stocks likely would you have ultimately fallen much less and the economy would have endured fewer dislocations.

TWST: Are investors coming around to that?

Ms. Garzarelli: I think so. Such earnings come out with a lag, however. A month ago the final figures for the years 2002 and 2003 were revised and were understated by 20%. One of the reasons was less expensing of stock options.

TWST: They revised the numbers. Why such a lag?

Ms. Garzarelli: The tax-accounting measure is published only annually by the IRS in “Statistics of Income” and are the primary source of the

final data. Interim data is interpolated and extrapolated using financial account measures and we receive the numbers quarterly.

TWST: Does that make it a useful series, then, from an investor's point of view?

Ms. Garzarelli: Yes, because the divergence between the two earnings measures beginning in 1997 would have given investors a heads-up that something was terribly wrong. Companies went overboard in making their earnings look attractive to investors during this dot-com period. In the future, such earnings should alert investors to possible phantom profits or fraudulent practices that were finally brought to a head in 2002 — with **Enron**. Thus, the reason for the 20% crack in stocks in July of that year.

So, as it turned out, the stock market was wrong from 1997 to 1999, and Alan Greenspan was right on.

TWST: Things have gotten back on an upward track. What's driving it at this point?

Ms. Garzarelli: Basically it is earnings and low interest rates. There is a significant recovery here which is spreading around the world. Productivity has been booming and labor costs (wages and benefits) have dropped to historic lows relative to earnings. That means that companies are making exorbitant profits without having to raise prices. Labor cost is the largest chunk of a corporation's costs (about 65%) and with interest rates down, interest expense is also low. That's a very good mix for profits while top-line growth is improving. Productivity is a function of modernization, a better trained labor force, the ongoing substitution of capital for labor, and out-

sourcing. Economists in many industries tell us how long it takes their companies to use the new technology available to them most efficiently. So the trend should continue. The high level of "unit price to unit cost markup" is the most unusual aspect of this productivity phenomenon. Like the

industrial revolution in the late 1800s, the economy could enter a period of low inflation as a result of continued productivity enhancements keeping labor costs under control. **Cisco's** Chief called productivity

the "new engine of wealth."

TWST: And that's pretty much controlled at this point.

Ms. Garzarelli: Look at **IBM** moving 3,000 programming jobs to China for \$10 an hour versus \$55-\$60 an hour here, and Levi Strauss moving plants there. There is also outsourcing by services industries such as accounting firms, scientific lab companies and medical billing firms to India.

Also, the US is operating below potential. The potential for our economy's growth is about 3.5% and we do not predict reaching potential for the foreseeable future even with the hefty economic growth we predict. We expect 4.5% real GDP this year followed by 3.4% in 2005 and 2006. Rising commodity prices bear a very small relationship to the Consumer Price Index, according to our models. Also, the direct effects of a falling dollar are rather small as foreign producers tend to absorb most of the costs these days. Thus, we do not see high inflation that would eventually be a cost-push factor for wages.

TWST: Given that, why are people still so skeptical about the market? Nobody's developing a high level of conviction here.

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Ms. Garzarelli: I think many investors are looking at the S&P 500 p/e ratio and seeing that over the last 40 years or so it has averaged around 15, so they might believe that 15 should be fair value. We think the way to look at the p/e is to adjust it for interest rates. Since stock prices reflect the present value of a discounted stream of earnings, when rates are low, bonds do not look as attractive and high earnings yields are not required by investors. According to our model, at a 4.0% 10-year bond, the p/e should be around 19.5. We see 65.60 for S&P operating earnings this year, which is above the consensus of 60.63 to 62.23. Therefore, the S&P 500 is undervalued since the current p/e is 17.2

But as discussed above, we also look at a different valuation measure using tax-return earnings, which is more optimistic.

TWST: So it's not time to run yet.

Ms. Garzarelli: No, not until interest rates rise or earnings peak — or if oil prices jump dramatically, thereby curtailing consumer demand. Also, it might be a policy mistake such as Greenspan tightening at the wrong time or the dollar crashing. But it's not in the interest of any country to allow the latter to happen.

TWST: I thought the dollar had already crashed.

Ms. Garzarelli: Well, it is declining orderly, which is a positive for Bush. A falling dollar stimulates our exports; it may transport a little inflation which is not so bad, and it raises multinational profits.

TWST: As George Bush said in the State of the Union address, the deficit is not an issue!

Ms. Garzarelli: Looking at the numbers that we mentioned above of 4.5% real GDP growth for 2004, 3.4% for 2005 and 2006, that suggests a federal deficit at about 2.2% relative to GDP by 2006. That doesn't look bad to me.

Since the October 2002 bear market bottom, our indicators have not yet fallen to a 42% correction signal (10% to 15%). If they fall to 30%, we would recommend cash, rebalancing, or sector shifting. Our indicators signaling these levels would require a few events such as a peak in industrial production, rising interest rates, an overvalued stock market, and/or a Fed tightening.

We have seen a decline in money supply for several months but it is, for the most part, a shift out of money market funds into stocks and bonds and not a sign of a change in monetary policy. Corrections therefore, should be limited to 4% to 7% at our

current indicator level.

TWST: I didn't think anybody watched money supply anymore.

Ms. Garzarelli: Many people do and it was discussed in the news. Some commentators fear it may slow the economy. But such a shift of funds, which also happened in 1992 and 1993, was correlated with rising stock prices and a robust economy.

TWST: So given all that bright light, where should people be looking?

Ms. Garzarelli: We recommend staying away from consumer staples and pharmaceuticals, which are growing 10%-12%, and staying with those companies that are recovering from deficits or those that will have earnings growth

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of 20% or better, which are also undervalued. Some catch-up candidates that have recently corrected are home-improvement companies, like **Home Depot (HD)**, down 48.7% from its all time high, and homebuilders, like **Centex (CTX)**, down 7.2%.

TWST: The market keeps waiting for them to fall on their face, but they don't.

Ms. Garzarelli: Yes. Housing statistics recently came out upbeat. Rails were good performers, then pulled back for several weeks. **Norfolk Southern (NSC)** is down 38.7% from its all-time high.

Restaurants pulled back a bit because of mad cow disease, so **McDonald's (MCD)** looks good — down 47% from its all-time high.

Materials was the second-best sector since the bottom but then pulled back in the last four or five weeks, so I think the group will have another run. That includes chemicals like **Eastman Chemical (EMN)**, which is down 38.7% from its all-time high. It has a 4.5% dividend yield.

Auto parts should outperform this year such as **Delphi (DPH)**, down 46.8%, and **Dana (DCN)**, down 64%.

TWST: So you're trying to find the cheaper names at this point.

Ms. Garzarelli: Those that are cheap and will have earnings growth better than 20%.

TWST: Given your view, what would you stay away from at this point?

Ms. Garzarelli: I would stay away from those industries that are stable that won't have earnings better than the S&P 500, the food, beverage and tobacco companies. I think steady growth of 8%-12% is just not going to be of interest to portfolio managers at this stage. They want to see stronger growth in earnings. Valuation will come into vogue when the economy peaks. Then the industry shift will be to those industries and companies with the greatest value versus the greatest earnings growth.

TWST: Any political risk in here, domestic political risk?

Ms. Garzarelli: There could always be risk that the Congress or the Fed makes a policy mistake. The tax cuts have worked and the Fed has been intelligent. It is hard to complain about the economic rebound. Let's hope the fiscal and monetary "good sense" continues regardless of what the November election brings to the table.

TWST: Thank you. (TJM)

Note: Opinions and recommendations are as of 1/29/04.

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