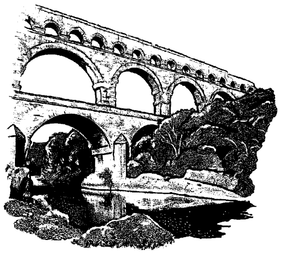

Stanley E. Rulapaugh, CFA **January 1, 2001**

Aaaaaah! You cursed brat. Look what you've done.
I'm melting! I'm melting! Oh, my world. My world.

From the Movie *The Wizard of OZ* based on a book by L. Frank Baum. Spoken in the film by the Wicked Witch of the West played by Margaret Hamilton.

This is the 100th anniversary of the publication of L. Frank Baum's masterpiece *The Wizard of Oz.* Two weeks ago we saw President-elect George W. Bush make his own trip to OZ after a whirlwind of an election. His first meeting was with the Wizard himself, Alan Greenspan. The six interest rate hikes Mr. Greenspan engineered are working and the economy is definitely slowing. How interesting, and coincidental, that just days after the conclusion of the election, many economists are talking about a recession, a "hard" landing. If we are in a recession, it won't be long before the new administration is blamed for it even though the interest rate hikes took place during the Clinton years. That's politics. Many of the same forecasters are encouraging the Wizard to lower interest rates immediately because the economy is falling faster than anyone expected. The markets seemed to expect a rate cut at the Fed's December 19 meeting but when it didn't happen, stocks slumped resuming a downtrend that started back in September. My first forecast of the new year is that Chairman Greenspan will be replaced if he doesn't do something about rates soon. President-elect Bush doesn't need a recession to start his administration.

All this gloomy talk is having an impact on stock prices and on consumer confidence. Retail sales during the Christmas selling season were weak and the after-Christmas sales were no great shakes. Cars aren't selling and Chrysler is expecting a huge loss. Travel is slowing and Las Vegas is expecting a downturn. What few hot toys there were this Christmas weren't available. And computers sure aren't selling.

A year ago we were worried about Y2K and the possibility that all our electrical devices with microchips would stop working on January 1. Of course that didn't happen. In fact, nothing happened so the stock market staged an unbelievable relief rally. Center stage was the Nasdaq composite which went up 22% in less than ten weeks, helped along by new issues pushed on a gullible public by investment bankers as heartless as the Tin Woodman. Panic set in and the Nasdaq fell 37% in the next three months. Suddenly, we were back on the Yellow Brick Road as the Nasdaq rose 33% in less than two months. Since July 17, however, the Nasdaq is down almost 50%, melting like the Wicked Witch of the West.

To get a better appreciation of all these ups and downs, we really need to convert the percentage changes into dollars. If the Nasdaq index was a stock, it would have sold for $4,069 on January 3. It soared to $5,049 on March 1 and then fell to $3,205 on May 26. It rallied back to $4,275 on July 17 only to fall to $2,245 on November 30. Much of the enthusiasm in the early months was caused by day traders who never let the sun set on a trade. In retrospect, they were as brainless as the Scarecrow. Their methods were quite simple. Buy stocks that are going up and sell stocks short that are going down. All of the players were heading in the same direction at the same time, like Flying Monkeys. This generated amazing volatility. Trends that once lasted weeks were over in just a few days. Because of the unpredictability, many of the day traders ran out of money and had to find another less expensive hobby. Their favorite "investments" were the overpriced "dot coms," small technology stocks, and new issues. Most if the hot internet stocks now are going out of business and the new issue market has dried up. The small techs were really poker chips, not businesses. The game is over.

The big technology issues also fell to levels that now make them compelling values when compared to the alternatives. The cost of an investment is how much you have to pay for $1 of earnings. Most investors believe that the 5-year U.S. Treasury note is as close as one can get to a risk-free longer term investment.

Today you have to pay $20 to earn $1. If the note was a stock, we would say that it is selling for twenty times earnings. Hewlett Packard's earnings estimate for 2001 was cut to $1.85 by one prominent Wall Street analyst, driving its price down to $32. That means you have to pay less than $17 for $1 of HP's earnings. This stock is cheaper than a Treasury note. Granted, there is no safety with HP but there is no growth potential in a Treasury note. The note guarantees semiannual interest payments with the return of your principal at maturity. The five year return on a Treasury purchased today is a little more than 30%. To match that, HP has to move from $32 to $40 in <u>five</u> years. And that doesn't include dividends. Unless the economy goes into a tailspin and consumers stop buying computers entirely, HP will survive and growth will resume. But when?

A year ago I wrote that the Y2K problem would be blamed for business problems for at least two years. I have not heard much from Wall Street about Y2K for some time but it must be having an impact. You may recall that many businesses and consumers were frightened into believing their computers would not work after January 1, 2000 so they upgraded their machinery in 1999. This created a bulge in demand, shifting purchases from 2000 into 1999. The higher sales resulted in higher earnings in 1999 for most PC makers but poor earnings comparisons this year. Wall Street analysts have been reducing their earnings estimates and downgrading the stocks for weeks so we are probably at the bottom. Since personal computers were a proxy for the technology boom, do lower sales this Christmas mean the boom is over? I don't' thinks so. Here's how the current slump could end. Computer stores are reducing inventories which means they are ordering fewer "boxes" from manufacturers like Compaq and Hewlett-Packard. Compaq and HP in turn are ordering fewer chips from Intel. Intel has frozen its capital expenditures and is selling its existing inventory of chips as it cuts back on production of new ones. While all of this is going on, the existing stock of computers is getting older and will need to be replaced. At some point in the next several months, someone will want to buy a computer and their particular model won't be available. It will have to be ordered and HP won't have the chips. HP will call Intel and Intel's inventories will be so low that they will have to make some chips. A sudden chip shortage will mean that whatever chips are available will be sold at high prices, bringing back margins and sponsorship to the chip stocks. It wouldn't surprise me to see Intel's stock price double in a matter of weeks as Wall Street wakes up to the surging orders. Remember, the same Wall Street analysts who loved Intel in August, urging purchase at $70, are now cautious at $30. I'm not sure there is much to be learned from any analyst's opinion of a stock's value but they always seem to be the most pessimistic at the bottom. The Lion in OZ finally realized he had courage which is what it takes to buy when the chips are down (pun intended).

The Y2K fears last year also may have caused a time shift in demand of other products like batteries, canned food and household supplies. Retail store sales, whether fashion or grocery, aren't as good as analysts would like even though this could be one of the best Christmas selling seasons ever. Sales "comparisons" are just not up to "expectations." I do believe analysts are paid to take the "Happy" out of the "Holidays." Other investment ideas include some of the consumer products companies that crashed because of high raw materials prices. If oil comes down in 2001 the lower cost of production will be a strong positive. And don't forget the chemicals and transportation issues that will benefit from lower oil.

Will the Nasdaq bounce back to the 5000 high established in March? Not any time soon. There's been too much damage. The Dow Jones Industrial Average and the S&P 500 are more broadly diversified than Nasdaq and we could see a surprising rebound in the coming year. Retailers, computer box makers, chip makers, and consumer products companies may be the bargains to own. The idea that the world is melting is as fictitious as the Wizard and the world of OZ.

Happy New Year!

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