MARKET TRUTH Written by Puru Saxena

BRIDGEWATER

27 June 2003

WELL DONE FED – GRIZZLY DEAD?

RECENT ACTION – Over the past 3 months, the stock market has been behaving like an obsessed mountaineer, it just wants to go higher and higher…Now, the majority of advisers and investors are convinced that this is the "real deal". The investing public's appetite for stocks has started to build up again and everyone seems to be worried about missing the next rally.

Sir Alan Greenspan (respect, he's been knighted), so far has managed to hold off the ravages of this nasty bear by flooding the system with a sea of liquidity. Greenie is definitely on an inflationary path as he desperately tries to reignite the US economy. Thanks to his efforts the money supply is growing at an annualised rate of 7.3%. To put it simply, every week the Fed miraculously creates billions and billions of new dollars "out of thin air". This, when you and I have to work very hard for our own dollars! But c'mon who said life was fair!

The FED has pulled interest rates to a record-low so that savings are discouraged. Clearly, the Fed and the government wants you to spend your money - earn, borrow, steal but just keep spending because the economy's revival depends on you my dear. Moreover, 40-year low interest rates have encouraged people to borrow and borrow some more. Initially, this borrowing was mainly being channelled into real-estate – Net Result – Housing in the US, UK and Australia has become the new bubble. However, after the public had finally bought one house for every night of the week, they (once again) turned to the stock market with these easily available dollars! This is the reason why stocks have been advancing over the past 3 months. Too much paper money chasing too few stocks - basic economics at its best!

What does this all mean? Will stocks continue to advance as the Great Bear is mercilessly choked by the blanket of Fed-produced dollars? Carry on reading…

INVESTMENT & VALUATIONS– Over the short-term, depending on sentiment the market can do absolutely anything. However, ultimately the basis of investment comes down to one thing and one thing only – Values. If you look at the most successful investors/speculators of our time (Warren Buffet, George Soros, Li Ka Shing) you'll see they have much in common. All of them take big positions when they recognise great values and then they SIT with these positions. They are patient and offload their positions only when the public finally becomes interested in their holdings. The point I am trying to make is this – You will only make money in this business, if you are dead certain that the stock you are buying represents great value when you dish out your money and buy the stock. Now the billion dollar question -

How do you know that your stock represents great value? You don't have to guess, just take a look at its Price to Earning (P/E) ratio.

For the benefit of those who are as familiar with P/E ratios as they are with Saddam's weapons of mass destruction, let us explain. Every asset comes at a price and every real asset should throw off annual income. This income could take the form of rent, interest or dividends. For example if a house is priced at $ 1 million and the income it puts in your pocket in the way of annual rent is $ 50, 000, the Price/Earning ratio is 20. If the annual rental income was $ 100,000, the Price/Earning ratio would be 10. Every asset whether stock or property, has a defined P/E ratio at any given point in time.

History tells us that when you buy stocks with average P/E ratios under **10**, then over the coming ten years you'll receive an annual average return of **16.9%.** Impressive indeed!

When you buy stocks when P/E ratios are **22**, then over the coming 10 years your annual average return will be a modest **5.0%.**

Today, the P/E ratio on the S&P is just over **33.** What sort of returns can you expect if you buy stocks here? Our answer is that if you were to buy stocks at such ridiculously expensive levels, over the coming ten years you'll probably show a loss.

We're regularly asked what valuations look like at a true bear market bottom. Well, here's what they've looked like in the past -

1949 -- Dow was at **161.** Price/Earning ratio was **5.4**, Dividend yield was **7.4%.**

1974 -- Dow was at **577**. Price/Earning ratio was **7.5**, Dividend yield was **5.1%.**

1980 -- Dow was at **796**. Price/Earning ratio was **6.8**, Dividend yield was **5.7%.**

That's what real bear market bottom valuations look like. Will this happen again? Over 100 years of history suggests it will. In our opinion, it's only a question of WHEN this will happen this time around.

US ECONOMY- The reason why we blabber on so much about the US economy is simply because it's the world's biggest economy and the whole world depends on the US consumer who accounts for nearly 40% of world consumption. At the end of the day, if the US was to head into a severe recession ALL major economies would be affected. The world's second and third largest economies – Japan and Germany are already in recession and with the US on the brink of deflation, the weather forecast isn't very pretty.

The US is running sky-high current account and budget deficits and its reliance on its foreign friends is ever increasing. America imports "truck-loads" more than it manages to export to the rest of the world. Its annual imports exceed exports by over US$ 500 billion and for this pleasure America makes payments to the rest of the world in USD dollars which happens to be the world's reserve currency. Remember, the Fed produces these dollars "at will" and the rest of the world accepts payments in this "monopoly" money. How does the Fed manage to produce dollars "at will"? The Fed churns its printing press and purchases bonds from the US Treasury department thereby flooding the banking system with an ocean of dollars. The US Treasury and banks then use these dollars to pay their foreign friends. What will happen if one day the whole world wakes up and realises this scam? When this happens, it will be like a Great White Shark turning up at your local beach – not a welcome guest! When this happens the entire viability of the US dollar as the world's reserve currency will come into question. In our opinion, it is only a question of time before the world stops accepting US dollars in exchange for goods and services. After all why should the whole world accept money which is "produced at will" in exchange for goods and services which are produced with millions of hours of sweat and labour!!! Euro, Chinese Yuan or gold anyone?

US DOLLAR & GOLD – Our faithful readers remember we've been extremely negative about the US dollar over the past 2 years. The US dollar (due to US debts and deficits) has been declining gradually against major world currencies and gold. If the US wants to reduce or wipe out these imbalances, it will need a weaker dollar. A weaker dollar will force Americans to import less and buy more from local businesses. Over time this will improve the American economy.

So the question isn't whether the US dollar will weaken further, its how much and how quickly it will weaken. So far the dollar's decline has been gradual and orderly. However, somewhere ahead we believe we'll see a real stampede out of US denominated assets and this will seriously hurt the US dollar. So if you're a HK resident and your future is "pegged" to the US dollar, you should seriously consider holding at least 50% of your assets in currencies such as Euro, AUD and gold.

As the US dollar continues to decline, all tangible assets measured in dollars will automatically rise in dollar terms. This includes gold - the only form of intrinsic value which is free from debt. Like it or not, there is only one genuine bull-market and that bull-market is in gold. Over the past 2 years, sophisticated, large interests who understand gold have been accumulating the yellow metal at what we consider "dirt-cheap" levels. It is only a question of time before the gold bull raises its head and makes an impressive charge. We advise each investor to allocate at least 15% of their portfolio to gold.

STRATEGY – With stocks being ridiculously expensive, with bonds "looking" overbought, with cash paying hardly any interest at all, what should investors do? Frankly, we doubt if there is a correct answer to this question. We can only tell you what we feel investors should or shouldn't do. We've been staying well clear of equities for a long time now and this has worked very well for our clients. Now and again we get an investor who criticises us for missing a sharp rally. If you want to participate in such rallies by buying stocks at such expensive levels then be our guest. But, always keep in mind you're not really investing, you're speculating on the hope that some other punter will buy your stock from you at even higher prices. Honestly, we stay away from such speculative gambles and only believe in long-term investing based on values.

Since October 2000, we've been allocating the majority of our clients' money to cautious market-neutral strategies which have produced consistent positive growth in this volatile market. In addition to the above, we've been allocating part of our managed portfolios to Euro denominated corporate/government bonds which (once again) has turned out to be a profitable strategy both in terms of asset performance and choice of currency. We've also allocated 15-20% of our clients' money to gold funds which have produced significant growth over the past 2 years. Finally, we've allocated a small portion of some of our clients' assets to a fund which makes money by shorting the US market. Due to the recent stock market rally, this fund has dropped in value but we continue to believe this will turn out to be a great investment as stocks decline to historically undervalued levels over the coming years.

We are proud to announce that working in conjunction with the BPHR department of the Asian Development Bank, Bridgewater is employed as an external consultant to provide training and guidance to professional staff preparing for retirement. More recently, we have also introduced a mid-life financial planning course.

Bridgewater will not be responsible for any investment decisions made based on this letter alone. We strongly advise that you arrange a meeting to understand the risk/reward profile before investing. You may contact us on contact@bridge-water.com or please phone us in order to arrange a meeting. Until next month, Goodbye and Good Luck!

We are pleased to announce that both Stephen Gollop and myself appear regularly on CNBC and Bloomberg television as guests and comment on various topics of interest. Please visit our website in order to obtain further information about our schedule.

www.bridge-water.com