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Classy Monitor

A longtime securities analyst and respected mentor cites the importance of geopolitics

An Interview With James Moltz -- James Moltz headed C.J. Lawrence and its successor securities operations for 25 years, in the days when securities analysts were stock pickers, not financiers, and as the research boutique was sold to Morgan Grenfell in 1986 and then to **Deutsche Bank** in 1990. Some of the best in the business cut their teeth under Moltz, who was also the firm's chief investment strategist. Investor Robert Raiff of Centurion Partners was mentored by Moltz, and so was energy specialist Charlie Maxwell. Now, in a corner office at protege Ed Hyman's International Strategy & Investment Group in Manhattan, Moltz continues to monitor the markets and to offer valuable perspective and insight. Known as a steady and calming influence in uncertain times, Moltz met with us recently to share his views.

--Sandra Ward

Barron's: *At what point in the market cycle are we?*

Moltz: We are at a stage where the financial bubble has been washed out and the market's trying to rebuild. That's going to take time. This has been a pretty significant cleansing process, both in terms of size and duration. It's about as long and as big as we've had in the post-World War II period. In the last downturn of this magnitude, 1973-74, it took five years or so before the market got back to prior peak levels. Although earnings rose from the lows in 1975, it took until 1980 for the Standard & Poor's 500 to surpass the previous high it set in 1973. It took until almost 1982 before the Dow Jones Industrial Average hit its prior high. That's quite possible this time, too.

Q: *What about the notion that this bubble was so big and so extraordinary that the downturn will be even more extended?*

A: It will take considerable time -- five years is a long time -- because it was so huge and so all-encompassing. It's hard to get the fundamentals realigned. We had an extraordinary window between, say, 1992 and 2000, where the old economy stuff worked and the new economy stuff went gangbusters, resulting in a huge buildup of capital capacity on both the business side and among consumers. There isn't much likelihood those two will get in gear again. It's been unusual that housing and autos have stayed pretty strong, so it's hard for an encore there. And I don't see how technology could come back, or at least can incrementally drive the economy the way it did in the latter half of the 'Nineties. We've got more saturation in personal computers and cellphones and all those things. We've come through a period where there was an unbelievable rise in demand, and that isn't likely to be replicated.

The reason Greenspan finally put his foot on the brake was because we not only had a financial bubble, we also were stretching fundamental resources. The Federal Reserve was rightly concerned about excess demand coming into the system when capacity and manpower was being stretched. Then we had the Y2K threat superimposed on all that.

Q: *What about corporate profits and the lack of business spending?*

A: One of the problems is the big decline in profitability and also the quality of profits. As we got to the latter part of the 'Nineties, we were clearly substituting capital for people and changing the mix of costs

on the income statement. Fixed costs went up and variable costs went down. That's great when volume is rising. When volume slips, you get the reverse of that. Profits declined 31% in 2001, in contrast to 1975 when profits fell about 10%. There was a much steeper decline in profitability in this setback than in 1975, and one of the things we're having to live with and wrestle with now is what to expect in 2003. The trajectory of earnings coming back hasn't been anywhere as steep as people hoped and that's a problem for the market.



Najlah Feaney

James Moltz doesn't call his view of the market either optimistic or pessimistic, but "realistic."

Q: *What's your outlook on inflation?*

A: Our forecast is for 1% to 2% inflation, modest inflation. We don't see deflation setting in, which people were yakking about a few months ago.

Q: *Why not, if there is isn't any pricing power? What's to prevent deflation?*

A: The only thing that prevents it is if there's some improvement in aggregate business. Inventories are so low there should be some rebuilding, and that should result in profits coming up. They aren't coming up at the rate that had been projected, but they're coming up.

Aggregate capital spending isn't doing much; it was down in 2002, but equipment spending is starting to tick up. So there are pieces that suggest we'll see some improvement in capital outlays, and that should be enough to keep prices from going to deflationary levels. But, conversely, with all the excess capacity around the globe, we don't see prices going up much.

Q: *Well, is it so bad for the stock market if there's a little bit of inflation and inventories are being restocked?*

A: It's an okay environment. It isn't a great environment. What's good about it, the clear pluses, is that government policies are appropriately stimulative on the monetary and fiscal side. We aren't doing the wrong things from a policy point of view and that's encouraging.

Q: *We've had 12 rate cuts, but they don't seem to have been so stimulative.*

A: One could argue they should have started a little sooner. They clearly didn't want the economy or the markets to get away from them on the downside and given what happened with 9/11, we were pretty lucky we got through it. The lower rates and the auto-finance deals really stabilized the economy then. That was important.

Q: *So has the monetary stimulus created a bubble in housing?*

A: We don't have a bubble in housing, but we certainly don't think housing can get much better. There is clear evidence of weakness on the very high end, so if you've got some very fancy place on Nantucket, it might not be selling, but the middle or lower-tier parts of the market are doing fine.

Q: *Is the consumer debt load a worry for the stock market?*

A: Debt generically is a worry for the stock market. A lot of private debt has built up over the last decade or two and depending on how you measure it, you can become concerned about how consumers are going to respond going forward: whether they begin to worry about their jobs and begin to save more.

In looking at the profile of retail sales last year, consumers were being very selective and price-conscious and careful, but they're still spending. Disposable income is okay. Real income is okay. So there's evidence that they will hang in there but they'll be pretty selective and pretty choosy.

Q: *Where do you expect growth to come from?*

A: From areas in which the consumer has clearly identified they want to spend. Money being spent around the house is on the rise. Sales are fine at **Williams-Sonoma** and **Pier 1**. Sales are mixed on the electronic side, you can see longer-term patterns emerging there. Companies such as **Comcast** and **Cox Communications** are reporting rather substantial gains in broadband purchases by customers. Video-on-demand and all the things we've talked about for a long period of time are coming into play and that's an area where consumer spending will be strong. Demographics dictate that education and education-related areas are probably going to fare pretty well. Defense spending is going to rise. There's a significant tail to that in the sense that there's a lot of spending on increasing safety and adjusting to terrorism that's hard to put your finger on. There is still a fair amount being spent on infrastructure, transportation and roads. There are areas that collectively can add up to modest growth economically. We're forecasting 3% real growth for this year.

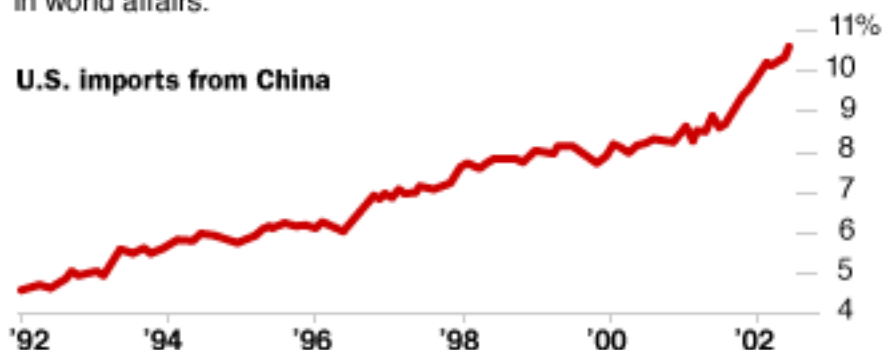
Q: *Given that, why hasn't the stock market responded?*

A: Because profitability has been strained and valuation clearly has been an issue. The market went from being majorly overvalued to an okay valuation. Valuations went down in the 'Seventies because we were on the edge of a major inflationary spiral. We had wage and price controls that Nixon put on in August 1971 and weren't taken off until April 1974, when companies raised their prices very significantly. Energy prices went up dramatically. All of that boosted inflation and killed price/earnings ratios. P/Es went from 18 times all the way down to seven. This time, P/Es went from 27 to around 15 to 16. We were cushioned by the very low level of inflation and the low level of rates.

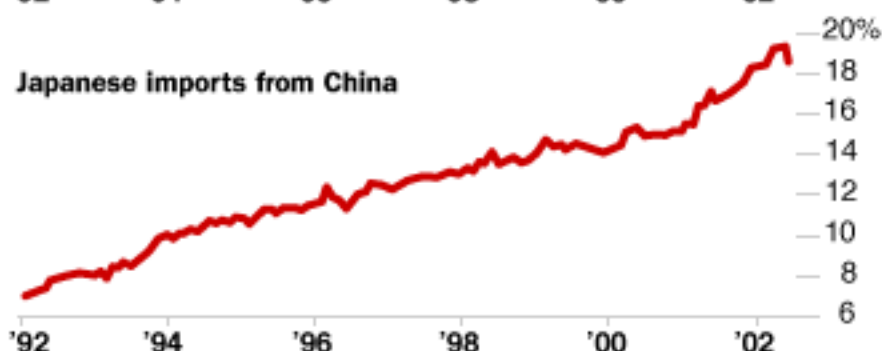
A RISING TIDE

Goods from China are accounting for an increased share of the imports of the major industrialized nations. As its economic power grows, the globe's most populous country will want a greater voice in world affairs.

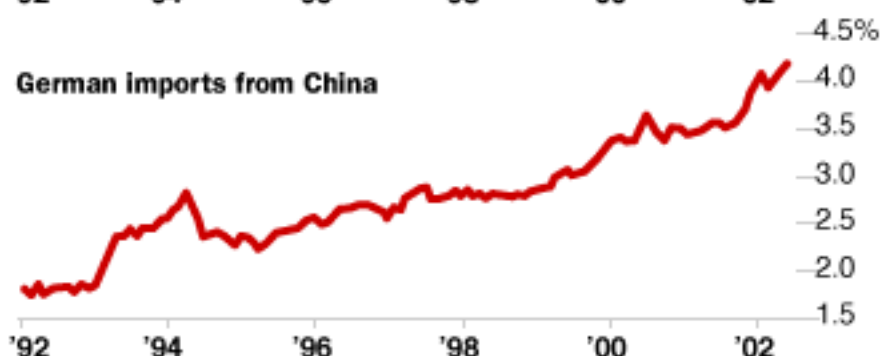
U.S. imports from China



Japanese imports from China



German imports from China



Source: International Strategy & Investment Group

Q: *So is it really different this time?*

A: It is materially different in that sense. It may not end up being any different in how long the digestion period is, but it's different. The only thing worse in 1974 was that, in effect, we didn't have a government - Nixon was holed up in the White House before he eventually resigned.

Q: *Any other way this downturn is different from those of the past?*

A: It is different in the overall geopolitical sense. We've got an issue with terrorism. A good part of the world doesn't like us. It's a very unusual time when candidates in German and Brazilian elections are elected to some degree because they are anti-American. On public television the other night, there was a program about South Korea and the growing anti-Americanism there. There is a lot of unfavorable world opinion toward us that didn't exist to the same extent in the 'Seventies. There was an "ugly American period" in the early 1960s where Europe was particularly antagonistic toward America, but it's different now. There's also a different competitive situation today, because China is growing in leaps and bounds and the whole developed world, including the U.S., is losing share to China. Think about that: people aren't generally interested in investing in businesses that are losing market share to somebody and the same holds true for countries. China is growing like a

house afire. They've blown by Italy to become the world's sixth-largest economy, and in the next two to three years they'll pass France and Britain. They're going to be a force to contend with, and their skills are improving.

Q: *Is there any way we benefit from the strength of China?*

A: The consumer benefits by getting lower-priced goods. But the manufacturing base in this country just isn't growing. The number of people working in manufacturing hasn't changed in a decade or so. We're transferring our manufacturing base to other parts of the world. A laissez-faire economist would say that's terrific. But if you're working in an auto plant or textile plant, you might not think it's so terrific.

Q: *Where does it lead?*

A: On a very long-term basis, we will have a very strong rival that will want to see things done its way, and that's going to create issues. That may be decades down the road, but it seems to me that, somehow or other, it inhibits valuations. It puts a limit on our pricing power as a nation. It puts a limit

on the kinds of things we can readily produce. And it will strain us from a government standpoint.



Q: *Do we become completely vulnerable or will we still have some leverage?*

A: It makes us economically vulnerable, although the advocates for allowing this to happen argue that it also makes us all interdependent, and in the end there is an aggregate good from it. So the suggestion is that China's got to start cooperating. But none of this will be easy. Our government also needs to rethink its policy of proceeding unilaterally. You can't create a new government in Afghanistan and create a new government in Iraq and not call on the neighbors to help out. The history of occupied nations isn't very good. Sure, a war in Iraq can be won. That's not the issue. The issue is: What do we do afterwards?

Q: *Are you optimistic or pessimistic about the stock market now?*

A: Realistic. Valuations are okay and they may just stay okay, which means you make single-digit returns. If you make 6% to 7% to 8% in price and a couple of percent in dividends that is probably okay. I'm not glum about that. But it dictates that people's expectations have to come down. The course the market takes will probably be lumpy, too.

Q: *Where is the greatest risk in the market?*

A: There have been individual areas where there has been concern, particularly on the credit-raising side. But I take some relief in the fact that as the spread between corporate bonds -- junk bonds -- and government bonds has started to narrow, we may have seen the worst in that arena. You are going to continually have to watch the credit markets for signals on equities, because we do have this heavy debt burden and it doesn't get waved away with a wand. But, by and large, those who were really extended and weak have probably been exposed.

Q: *What areas will lead to wealth creation?*

A: Wealth was created in the 'Nineties in financial stocks and health-care stocks and technology and certain segments of consumer discretionary businesses, particularly media. People aren't making great sums anymore investing in automobile companies or copper companies. But financial-service companies -- particularly leaders like **Citigroup** or **American International Group** that are reasonably priced, or ones that provide niche services, such as **Intuit** or **Fiserv**, where saturation levels are low and they can grow nicely -- will provide opportunities for patient investors. So will health-care companies focused on new vistas in medical research and treatment. We've been interested in some segments of the health-care market that are off the beaten path, companies such as **Dentsply International** and **Patterson Dental**, with solid businesses and solid records.

Q: *Some of the traditionally defensive sectors didn't behave very defensively in this downturn. Drug stocks, for instance, were lousy performers. What do you make of that?*

A: The downturn happened to coincide with a period when the political heat was turned up on the drug stocks over their pricing practices and as their new-drug pipelines dried up. The drug companies haven't

had real new blockbuster products coming out and patents have matured. That's a real problem for **Schering-Plough** and **Bristol-Myers Squibb**, and the stocks have come down a lot. Some of them deserved that. But the earnings at **Pfizer** never slowed, and it has met its targets for the past several years, and still the stock is down to 30 from 50.

Q: *What areas of the world offer the best opportunities?*

A: In a broad sense, they are probably still as good here as any place else in the world. There are obviously emerging areas in the Far East and even Eastern Europe, but they're very awkward to invest in because size is an issue and governance is an issue. The markets in emerging areas aren't liquid and transparent and that presents problems and opportunities. But, for average investors, it makes it difficult to capitalize on them. In 1991, when the Berlin Wall came down, there was this notion that everyone had to be invested internationally and especially in Eastern Europe. It turned out to be a waste of time. At some point, it won't be a waste of time, and we're probably closer to that point. But it continues to be frustrating.

Q: *You're famous for your Market Monitor indicator. What's it signaling now?*

A: I'm hoping that's not the only thing I'm famous for because it hasn't been working that well: It went negative early in 1999 and it turned positive early, too. There are six variables, all relatively simple: the earnings yield versus the yield on a 10-year bond, and the earnings yield versus the T-bill, the year-over-year change in short rates, the year-over-year change in long rates, the moving average and the advance-decline line, and that's it. Right now, the monitor is suggesting it's a good time to buy stocks

It seems to me that one of the things that might give the market some support here is the interest differential that exists between stocks and other assets. There are such minuscule returns from money funds that people will begin to seek higher returns and there's no alternative to stocks at the moment. You still have to keep some cash, but not as much as you had before.

Q: *Thanks, Jim.*

E-mail comments to editors@barrons.com¹

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