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Investment Outlook

P I M C O

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What a Fool Believes

"A man hears what he wants to hear and disregards the rest," wrote Paul Simon some 30 years ago. "Sees what he wants to see" as well, I suppose: serial sniper killers in white vans, aliens in flying saucers, and monsters in the Loch Ness. And when hearing or seeing things that go bump in the night doesn't satiate humanity's need to displace rational fears, then they'll move on to beliefs, and believing just about anything they want to believe. Investors are no different. Armageddon in the '30s and early '80s. Nirvana in the '20s and late '90s. Neither was close to the truth but they seemed real enough at the time, and so the "rest" as Paul Simon put it, was disregarded and money crossed hands from the true believer to the legitimate skeptic. This money exchange is most obvious and dramatic at market tops or bottoms. Easy to belittle the fool who bought CISCO at 80 in March of 2000. Easy to criticize the chump who sold Citigroup at its low tick in 1990. But the fact is that the economy, markets, and the tape make winners and losers of us all no matter what the year or season. Doesn't take a market bottom or top to illuminate the dunce, nor does it take a bubble or its popping to shine light on investors' foolishness.

A man or woman hears what they want to hear at pretty much any time of the day.

I introduce the timelessness of credulity, to suggest that now is just about as good a time as any to display a lack of common sense when it comes to value, future returns, and the attractiveness of bonds versus stocks in asset allocation models. For sure, investors have been hearing what they wanted to hear for years now when it comes to sugarplum corporate earnings. First there was the number, then the "whisper" number, then the "proforma" number, then "next year's" number as blessed by a bevy of Wall Street analysts on the semi-take. It got so that you could believe anything you wanted to believe and have the "numbers" and the experts to back you up. Actually you still can. Despite the introduction of a new, commonsensical earnings measure by Standard & Poor's called "Core Earnings," many Street analysts go their merry way in promoting permutations that make a mockery of Graham & Dodd. Nearly unanimous commentary will focus on how the S&P 500 companies are going to earn more than \$50 per share in

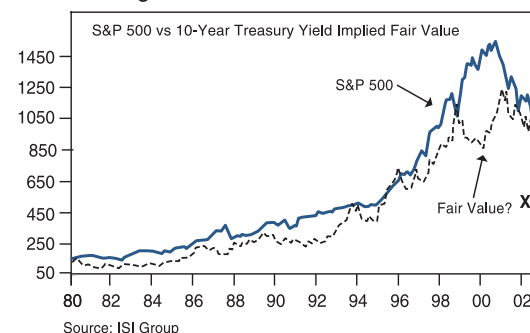
2003. That number makes current market levels of 900 seem reasonable because of the 18x PE ratio that \$50 implies. But you have to dig real hard to learn that these expected earnings are what they call “proforma” earnings, the slimiest of the slime, the standard that Jeff Bezos of Amazon set for his company when skeptics were howling that he was never going to show a profit. He showed ‘em. Proformed those earnings from the red to the black quicker than you could spit, or his stock could split. Didn’t matter that expenses weren’t expensed, that goodwill impairment wasn’t amortized, that “one time” charges happened to occur with more regularity than a constipated owl. It’s still the same way almost everywhere across the (Big) board folks. Amazon was not the outlier. To be brief and concise as opposed to gross and verbose let me stagger you with this one simple revelation. Instead of the nearly \$42 per share of operating earnings that S&P companies reported as of 6/02, Standard & Poor’s estimates that “Core Earnings” – a polite term for “real” earnings, were only \$18.48. Put that 50x PE in your value pipe and smoke it.

Now I don’t want to get on a rant here and make it seem like I don’t like stocks when I really do (stocks that yield 3.5%+, that is), but that’s a pretty big difference folks. Granted Standard &

Poor’s cautions against using their Core Earnings without a historical context (they don’t provide one however) but \$42 or \$18.48? What can we believe? Whatever we want to, I suppose. Whatever makes the most sense to bolster our own position. Being bearish on stocks, I use the \$18.48 to present a shocking alternative. Bulls grab for the \$42 and \$50+ next year because it makes their holdings seem rational. Surely the reality lies somewhere in between, but the rub of course is which number comes closest.

Supposedly astute analysts and commentators have recently hoisted another canard on the investment public in their attempt to pump stocks, citing a model used by none other than Alan Greenspan. This “Fed Model” shown in the chart below seeks to compare valuations for bonds and stocks by using the yield on 10-year Treasuries vs. the “earnings” yield for stocks, which is really the market’s P/E ratio turned upside down into an “E/P.”

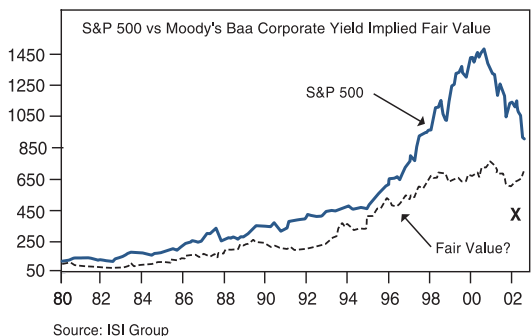
Finding Fair Value: The Fed Model



The visual correlation isn't bad as you can see with the exception of the late '90s bubble, and what's striking is that today's fair value or E/P shows the market undervalued relative to Treasuries and "worth" nearly 30% higher than current levels. (This chart, provided by ISI, however, uses those slimy "operating earnings" of nearly \$50 per share. \$18.48 gets you somewhere near my "x" on the chart – some difference eh?)

But should the Street really be using 10-year Treasuries as the convenient bogey to beat? After all, Treasuries are risk free and stocks anything but. Instead, how about an apples-to-apples comparison for once? To their credit, ISI does just that with the chart below.

Finding Fair Value: Variations on The Fed Model



Instead of 10-year Treasuries, this chart uses Moody's Baa corporate bond yields which is a pretty fair measure of the composite debt of S&P 500 companies. Now this chart tells a different story. Because corporate spreads have widened by 200

basis points or so to 10-year Treasuries over the past four years, instead of a 4% 10-year Treasury target, stocks must now compete against a near 7% Baa corporate yield. And well they should. Chart II, as a matter of fact, shows the same visual historical correlation as the Fed/Treasury model with one glaring difference – the late 1990s bubble valuation has yet to be corrected. Fair value, using pumped up proforma earnings still shows 650 for the S&P 500. (Note, again, my "x" using S&P Core Earnings.)

I am somewhat incredulous at recent commentary suggesting the bond market is mimicking the same bubble produced by stocks several years ago. These warnings, of course, are generally self-serving, meant to wean investors' money back into the stock market, which generates the most commissions and the highest fees. As I've mentioned in recent *Outlooks*, given a near deflationary global economy, while U.S. Treasury yields are fully valued, they are as well, near fairly valued. Granted, Fed funds may not stay in the "1s" forever, but inflation promises to stay low for some time, which supports 10-year Treasury yields at near 4% levels. On the other hand, stocks with their more than suspect proforma earnings remain the bubblish investment to me. And while Greenspan's Fed model may show stocks undervalued to 10-year Trea-

suries, when comparing an apple to an apple and using Baa corporate yields they are by even conservative measures nearly 30% overvalued. Surely, even those who disregard the near deflationary scenario advanced by yours truly in last month's *Outlook*, must recognize the value of corporate bonds when compared to stocks.

In the end analysis, it is fair to ask who is the true fool – the eternal “glass more than half full” stock optimists or the bond guy with a supposed axe to grind. We all hear what we want to hear and disregard at least some of the “rest.” Only time will tell, of course, but I suspect that unless (1) “true” earnings accelerate sharply or (2) Baa corporate yields come down smartly, that in addition to white vans, stock investors are seeing (and buying) a lot of white elephants these days.

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