

## **A CASE FOR CAUTIOUS OPTIMISM**

### **“Should I just pack it in and sell everything?”**

That’s an increasingly common question among nervous stock market investors. After two and a half years of bear market frustration, many are ready to give up. Anyone prone to anxiety can easily find reasons to worry: the seemingly endless stream of earnings disappointments, questions about whether there will be more corporate scandals and concerns about the impact of writing off the cost of stock options against earnings. Add ongoing distress among once proud technology stocks, with Canadian firms like Nortel and JDS Uniphase among the big losers. Mix in fallout from the write-down of billions of dollars in bank loans to the telecommunications sector.

There’s more: talk of war in Iraq and fears about global terrorism, Japan’s ongoing economic woes and the implosion of Argentina’s economy. And still more: worries about a double dip recession, talk of a mini-bubble in real estate prices and concerns about the rising debt loads of US consumers. No wonder investors are nervous. Every “down” market must climb a wall of worry to recover. This time the wall seems awfully high. But is it?

### **Historic perspective**

Think back exactly 13 years, when the other George Bush was president of the United States. Iraq had invaded Kuwait, and the U.S. and its allies were preparing to respond. Oil had just topped US\$39 per barrel. Inflation was in the 5% to 6% range and the chartered banks were charging 13.75% on prime rate business loans. The U.S. financial system was under stress from junk bonds and the “S&L crisis caused by the collapse of savings and loan companies. The U.S. and Canadian economies were in recession, unemployment was rising and consumer confidence was plummeting. Residential and commercial real estate values were down substantially from their peaks in the late ‘80s. And, governments were continuing to run severe deficits.

It was indeed a dire time to think about investing. So how did investors who held their ground end up doing? -- The answer: a Canadian who invested \$10,000 in the U.S. Standard and Poor’s 500 Index at the start of 1991 would have more than \$42,000 at October 1, 2002 – even after giving back 29% since the start of that year. Proof once again that the best time to invest is often when things seem the darkest.

## **Positive Outlook**

Start with the U.S. and Canadian economies, which are on track to grow by 2% to 3%. Canada alone looks to add 400,000 new jobs this year. Add low inflation and low interest rates – something which has historically created an attractive environment for stocks. Then layer on stock market valuations that are well within the historical norm for low inflation periods such as this one – especially when the technology sector is excluded from the calculation. Want more? Government finances are in much better shape than a decade ago. There is growth in worldwide trade, which will ultimately fuel consumer spending in developing markets. Companies are experiencing significant productivity gains from the massive technology investments that addressed Y2K concerns.

Perhaps most importantly, there is a renewed focus on reporting real earnings that can stand up to scrutiny. At the core of any market rebound will be renewed investor confidence in the earnings that companies report. There are indeed lots of reasons to be optimistic. Four years ago as the stock market approached its peak, investors focused only on the good news and ignored the bad. Today, many are doing exactly the opposite – concentrating on the bad news to the exclusion of the offsetting positives.

History has shown that when investors fixate on the good news and ignore the bad as they did four years ago, we are close to a market top. It has also shown that when investors only see the bad news and ignore the positives – arguably where we are currently – we are close to a market bottom. Is this as good a time to invest as early 1991, with a similar turn in the offing over the next 12 years? Unfortunately, the likely answer is no; performance that strong is well beyond what history suggests what anyone should expect. But a compelling case can be made that stock market investors with a reasonably long timeframe – five years or more – and the stomach to withstand ups and downs will be amply rewarded for their patience and conviction.