

InvesTech Special Report
JULY 1998

"The New Paradigm"
...Era - or - Bubble?

Is Wall Street in a 'New Paradigm Era'...

... or merely an 'Old Bubble' carried to New Extremes?



Santayana, an early 20th Century philosopher, once said, *"Those who do not learn from the past, are doomed to repeat it."* And Sir Isaac Newton, who lost the equivalent of over \$1,000,000 investing in the South Sea bubble of 1720, remarked, *"I can measure the motions of bodies, but I cannot measure human folly."* However to this day, analysts cannot agree as to what constitutes a bubble... or how to recognize a bubble before the inevitable washout and aftermath.

It is widely perceived that the U.S. economy and stock market have embarked on a *"New Paradigm Era"* in which old rules no longer apply and traditional barriers have been broken. Yet as Federal Reserve Chairman Alan Greenspan warned Congress on February 26th 1997, *"Regrettably, history is strewn with visions of such 'new eras' that, in the end, have proven to be a mirage."* This is an insight into one such likely mirage...

What Constitutes A Bubble?

“That the free enterprise economy is given to recurrent episodes of speculation will be agreed... This process, once it is recognized, is clearly evident, and especially so after the fact. So also, if more subjectively, are the basic attitudes of the participants. These take two forms. There are those who are persuaded that some new price-enhancing circumstance is in control, and they expect the market to stay up and go up, perhaps indefinitely... Then there are those, superficially more astute and generally fewer in number, who perceive or believe themselves to perceive the speculative mood of the moment. They are in to ride the upward wave; their particular genius, they are convinced, will allow them to get out before the speculation runs its course... For built into this situation is the eventual and inevitable fall. Built in also is the circumstance that it cannot come gently or gradually. When it comes it bears the grim face of disaster. That is because both of the groups of participants in the speculative situation are programmed for sudden efforts at escape. Something, it matters little –although it will always be debated– triggers the ultimate reversal.”

A Short History of Financial Euphoria

John Kenneth Galbraith

Historically, bubbles have always been a part of the lessons of investing. There was the Japanese stock market and real estate bubble which popped in 1989. In domestic real estate, there was the not so “recession-proof” California, as well as the price deflation or washouts of condominiums in Hawaii... residences in the Northeast... commercial office space in the oil belt... and numerous other regions in the 1980’s. Many investors may also remember \$850 gold... \$50 silver... \$37 oil... numismatics... baseball cards... and the list goes on.

In the stock market, bubbles are usually limited to individual sectors which ride high on excessively exuberant expectations – only to plunge back to earth later. Yet history has left several notable eras which were recognized as “bubbles” only in the eventual and inevitable devastation. Seasoned investors may remember the “Nifty Fifty” era... the “Go-Go Fund” era... or even the “Investment Trust” era of the 1920’s.

In essence, a bubble is created when objectivity, reasoning, and valuation give way to greed and the desire for profits. In “*A Short History of Financial Euphoria*,” author Galbraith describes the common seeds of past manias that inevitably give way to disastrous consequences:

- 1) The basic premise that investing involves a trade-off between risk/reward is lost as investors are “captured by the wondrous satisfaction from accruing wealth. The very increase in values thus captures the thoughts and minds of those being rewarded.”
- 2) The belief that “some new price-enhancing circumstance is in control” – that there is “something new in the world” that justifies a permanently higher level of valuation.
- 3) The illusion that, except for temporary setbacks, “values are going up permanently and indefinitely.”
- 4) The “condemnation at those who express doubt or dissent. ... because of defective imagination or other mental inadequacy they are unable to grasp the new and rewarding circumstances.”

Yet only in the aftermath, is a “bubble” identified as a bubble. While in progress, it can only be recognized by its symptoms which are common with speculative eras of the past. **At what point does a healthy bull market turn into a bubble ripe for the popping? Here are a few differences:**

HEALTHY BULL MARKET

DANGEROUS BUBBLE

Buying based on intrinsic fundamentals or underlying values	↔	Buying based only on anticipation of rising prices or profits
Expectations based on historic norms	↔	Expectations based on recent gains
Healthy respect for risk	↔	No respect for risk
Major perceived risk: “Losing 1/3 or 1/2 in a bear market”	↔	Major perceived risk: “Not being on board”
“Feared Recession” arguments	↔	“New Era” arguments
Periodic or frequent corrections	↔	Absent or infrequent corrections
“Smart Money” profits	↔	“Foolish Money” profits
Skepticism and logic prevail	↔	Speculation and greed prevail

Time For A Reality Check...

Wall Street consensus is that the U.S. has entered a “new era” of tame inflation, low interest rates, and rising productivity that will carry economic prosperity well into the new millennium. If so, say pundits, then today’s extreme valuation levels in the stock market are justified. Just how extreme is stock overvaluation? The figure below shows the S&P 500 Price-to-Dividend Ratio on the vertical scale, and the S&P Industrials Price-to-Book Value Ratio on the horizontal scale. Simply, the higher on the chart, or the farther to the right a year appears, the more overvalued it is. **Clearly, when compared to overvaluation at some of the most historic market tops such as 1929, 1968, 1972, and 1987... today (1998) is off-the-chart!**

Consensus on Wall Street is also that today’s investor is smarter, better informed, more patient, and longer-term oriented than in the past. Consequently, it is believed that today’s mutual fund holder will never panic in a bear market. However, not all agree with this consensus:

Investors may overreact to a downturn, SEC warns

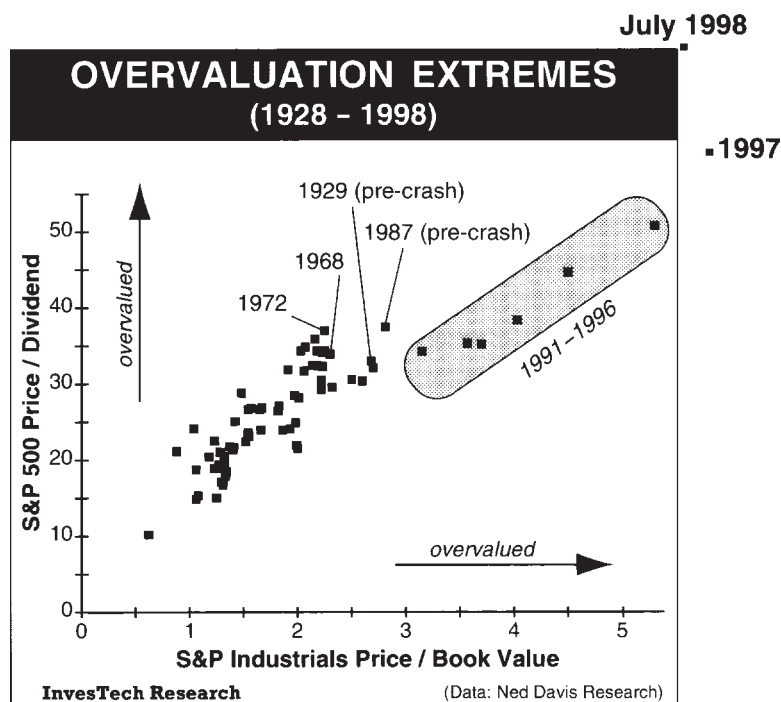
“Inexperienced investors who have known only the bull market of the last decade could react ‘precipitously’ to a downturn and ‘at great cost to themselves and our markets’, Mr. Arthur Levitt, chairman of the Securities and Exchange Commission warned yesterday.”

London Financial Times – Feb 26, 1997

And Federal Reserve officials also appear nervous as evidenced by this Congressional Testimony in early 1997:

“History demonstrates that participants in financial markets are susceptible to waves of optimism... Excessive optimism sows the seeds of its own reversal in the form of imbalances that tend to grow over time. When unwarranted expectations ultimately are not realized, the unwinding of these financial excesses can act to amplify a downturn”

*Federal Reserve Chairman Alan Greenspan
– Feb 26, 1997*



One dot represents each of the past 70 years of stock market valuation. The higher the dot, the more overvalued in terms of Price-to-Dividend ratio; the farther to the right, the more overvalued in Price-to-Book Value Ratio.

Meanwhile, the cold fact remains that the assets in equity mutual funds now total \$3,164 Billion, as compared to \$226 Billion in October 1990 at the start of this bull market. **Quite simply, 93% of the money in stock mutual funds has not experienced a bear market or even a -15% correction in blue chip averages!**

Perhaps more ominously, an overwhelming majority of fund investors believe they never will experience such a decline. This late 1996 Lou Harris poll reveals that 85% expect the next 10 years to be as spectacular or better than the past decade. 78% are not expecting a mild bear market of -20%. And almost half think that minor -10% corrections are a thing of the past:

Survey Of Fund Investors “Expectations”

- 85% Expect market performance to meet or beat past 10yrs
- 78% Expect NO declines over -20%
- 41% Expect NO annual declines of -10% over next decade

Lou Harris poll – 1996

“Actual Risk” Since 1900

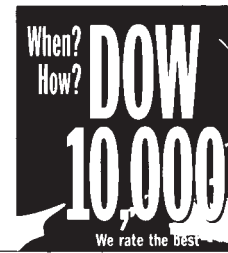
(from one year’s high to the next year’s low)

DJIA LOSS	#YEARS	FREQUENCY	CURRENTLY
-10%	65	every 1.5yrs	> 7 years
-20%	39	every 2.5yrs	> 7 years
-30%	21	every 4.6yrs	> 10 years
-40%	11	every 8.7yrs	> 23 years

Just how far out of touch are these investor expectations with reality? Compare the “actual risk” for all the years of this century (above right). A -10% correction has occurred in 65 years, or once every 1.5yrs on average – yet 7 years have lapsed since the last. A -20% decline has triggered every 2.5yrs – again, over 7 years since the last. A -30% bear hits every 4.6yrs – last seen during the ’87 Crash. And a major bear, with -40% losses, strikes about every 8.7yrs... last felt by investors 23 years ago!

- Is it a contest to see who can forecast the highest level for the stock market? No... more likely it's just a not-so-mild case of "irrational exuberance" feared by the Federal Reserve.

Reality Check: Bull or Bubble?

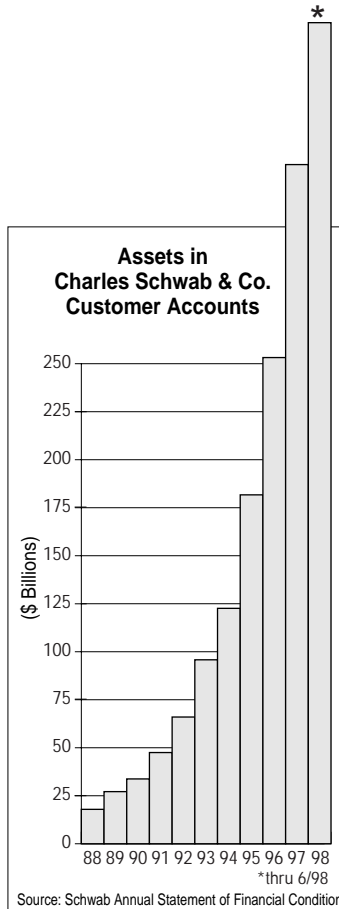


Bonnel's Rosy Outlook: Dow 20,000 By 2007

By Leo Paolucci
Investor's Business Daily
Some investors shiver at the thought of what might be 10 or 15 years ahead. Not Arthur J.

Bonnel conference. "That's where the real money is. Trying to buy if the Dow slips back to 4000 is like trying to buy a stock that's going to 20 at 4%, instead of 4%. There isn't much difference." Bonnel strongly believes that stocks

"A person can make more money with patience than with brilliance," he said. "Almost anyone who's made big money did it long-term in stocks or real estate." "The true genius in investing is recognizing the direction of the long-

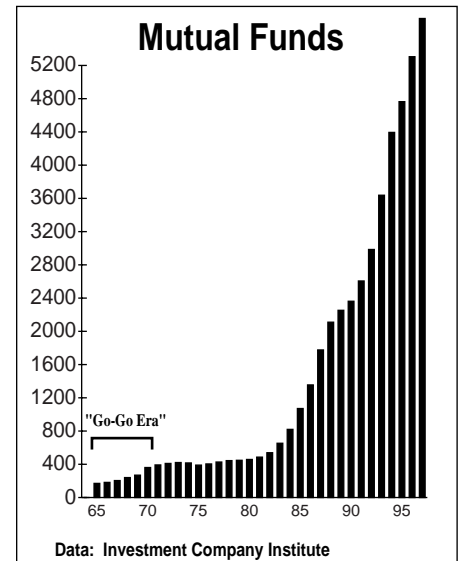


- Public investment funds placed with the nation's largest discount brokerage firm have risen over 19-fold in less than a decade:

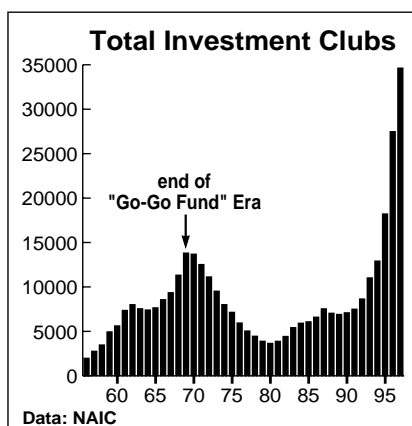
Reality Check: Bull or Bubble?

- Since 1981, the number of mutual funds have multiplied at a rate far above any historical experience... far above the "Go-Go Fund" era of the 1960's... and far above the "Investment Trust" era of the 1920's.

Reality Check: Bull or Bubble?



InvesTech Research



InvesTech Research

- The number of investment clubs has increased over 5-fold in the current bull market. Today, more than 1 in 3 adults own mutual funds – a 66% increase in four years. That easily surpasses the "Go-Go Fund" era in which 1 in 4 adults owned stocks when the washout began in 1969.

Reality Check: Bull or Bubble?

- Market historians note that stock market bubbles have been accompanied by a “bubble” in the price of a seat on the New York Stock Exchange. In March 1998, a seat sold for a cool \$2.0 million – far above the peak prior to the 1987 Crash. Also note the 1929 and 1966-69 peaks... which will become relevant in the next section of this report.

Reality Check: Bull or Bubble?

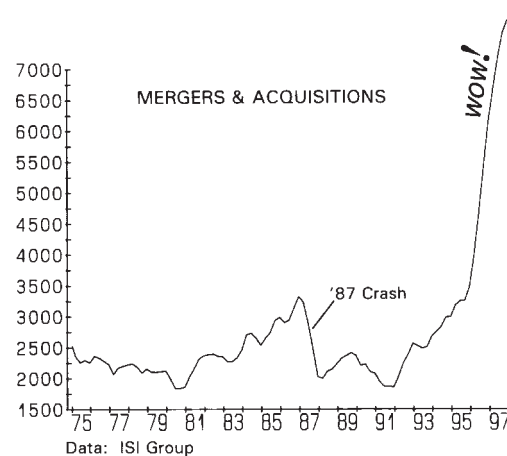
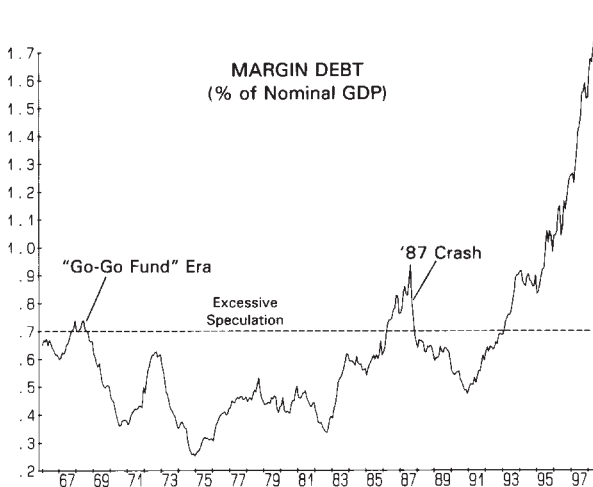


- Safety in diversification? Certainly not in small-caps. The cumulative P/E ratio of all domestic NASDAQ stocks has been hitting unprecedented, frothy levels. It would require a decline of over -75% to take the NASDAQ P/E ratio back to where it started this bull market in October 1990.

Reality Check: Bull or Bubble?

- Mergers and acquisitions? Since 1996, there's been no “deal” too big, too expensive, or too leveraged for Wall Street to piece together.

Reality Check: Bull or Bubble?

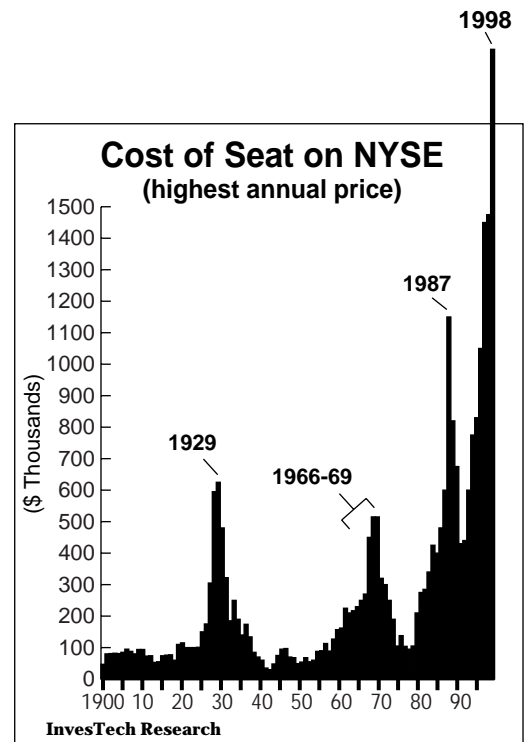


- Margin debt (money borrowed to purchase stocks) has soared to record levels – even relative to the size of the economy. Note how far it is above the dangerous peaks in 1987, 1972, and 1968... just prior to the three biggest bear markets of the past half century. And of course, this doesn't include the second mortgages, refinancings, or record credit card debt that has been used to divert funds into the stock market.

Reality Check: Bull or Bubble?

The Inevitable Questions:

- What has driven stocks to such overvalued extremes?
- Why do the SEC and our Federal Reserve seem so worried?
- Why are investor expectations so out-of-touch with reality?
- What has created so many symptoms of a dangerous “bubble”?



TODAY: The Not So “New Paradigm Bubble”

Many reasons, excuses, and theories have been postulated for Wall Street’s exuberance today. They range from advances in technology, to increases in productivity, to changing demographics (aging baby-boomers). Yet these all miss the mark in explaining how Wall Street arrived at DJIA 9000 from DJIA 800 in 1982. In 1981 when President Reagan took office, interest rates were above 13%, gold had recently hit \$850/oz, the DJIA was at the same level as in 1966, and real estate was considered by all to be the safest, best long-term investment. What happened? What changed public opinion so dramatically?

The answer is “*disinflation*”. As inflation receded over the past 16 years, so did the fear or expectations of inflation. Gold lost its luster. Real estate washouts in the oil belt, California, and the Northeast removed its “safe haven” perception. And as interest rates slipped year after year, thrifty CD and money market fund savers were pushed to seek other alternatives... *the stock market*. A “Disinflation Era” is not new... and neither is the dangerous bubble which it can create. Let’s examine historical precedent:

THE INVESTMENT TRUST ’20s

Start: August 1921 – as the high inflation of World War I receded.

Stocks: DJIA up 6-fold in 8 years.

THE GO-GO FUND ’60s

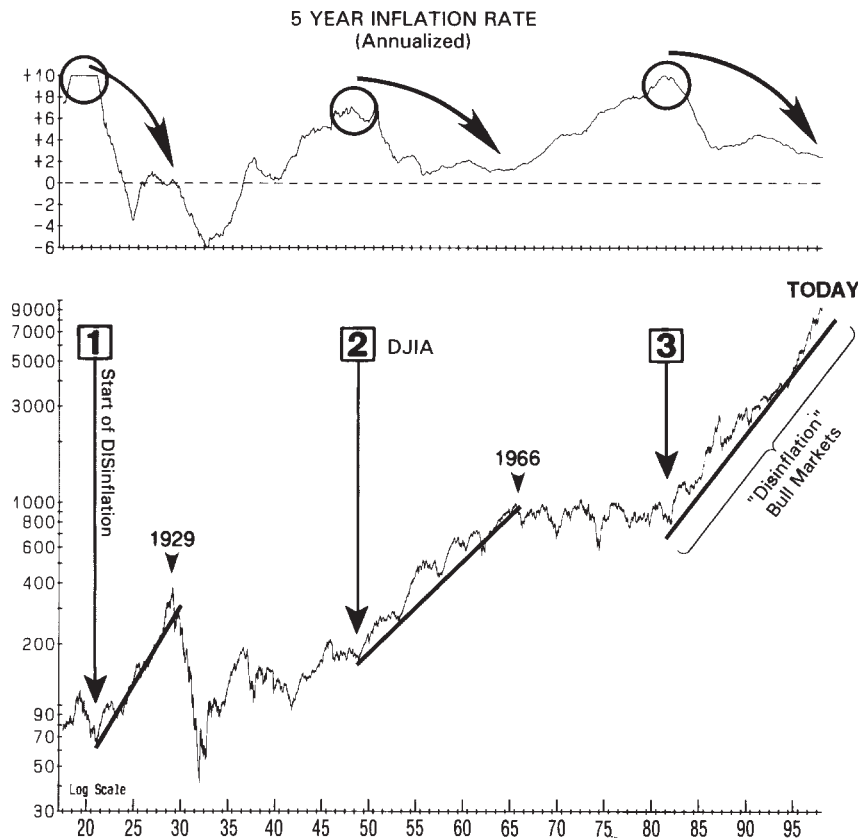
Start: June 1949 – as the high inflation of World War II (and the Korean War) receded.

Stocks: DJIA up 6-fold in 17 years (with subsequent tops in 1968 and 1973).

THE MUTUAL FUND MANIA ’90s

Start: August 1982 – as the high inflation of the Vietnam War and the 1970s receded.

Stocks: DJIA up 11-fold in 16 years.



Here are the ominous parallels and sequence of events in these “Disinflation Eras”:

1

Correctionless Market

Each of these periods was accompanied by a “correctionless” stock market. The length of time without a -15% correction in the DJIA...

In 1929:

Longest in DJIA history (at the time).
3.4yrs (Mar 1926 - Sept 1929)

In 1966:

2nd longest in DJIA history (at the time).
3.6yrs (June 1962 - Feb 1966)

TODAY:

Longest in DJIA history.
7.8yrs (Oct 1990 - July 1998)

2 Mutual Fund Mania

The correctionless market leads to public infatuation with stocks, and fuels a mutual fund mania:

In 1929:

The Investment Trust

"A few years ago it was practically unknown, under that name at least, in this country. But now so-called investment trusts spring into being almost daily; their offerings are avidly absorbed by the public, which begs for more."

"Companies for the purpose of handling other people's money have been springing up so fast of late that it is hardly possible to find enough experienced operators."

The Saturday Evening Post – Apr 28, 1928

"The establishment of Investment Trusts by banks, banking houses, and by independent groups has almost become a fad. The public appetite for them seems to grow even more rapidly than the trusts. They represent a buying power in the market which appears to be without a saturation point... In fact, the number of Investment Companies has grown so rapidly during the last 2 years that their promoters are having some difficulty in finding distinctive names for their organizations."

New Levels in the Stock Market
– Aug, 1929

In 1966-68:

The Mutual Fund Explosion

"Almost as fast as Americans have been buying funds, other Americans have been starting them up... 'We don't have a count on the funds waiting to register,' admits the SEC's Solomon Freedman, 'because we're too busy to poll all our five branches to find out how many more there are.'"

Dun's Review – Jul, 1969

SO YOU WANT TO START A MUTUAL FUND

"All kinds of people who have made some money in the market suddenly decide they are investment managers, and it would be a shame if their talent were confined only to their own securities. So they want to start mutual funds. 'They're coming out of the woodwork—lawyers, doctors, all kinds of people—and very few of them know what they are doing.'"

Forbes – Jun 15, 1968

TODAY:

Funds on Fire

THAT BRILLIANT FLAME STREAKING across the horizon during the first half of the year wasn't the Olympic torch on its 15,000-mile, 42-state trek to Atlanta: It was the mutual fund fireball... Investors' thirst for stock funds seemed unquenchable.

Money – Aug, 1996

To say that investors are wild about mutual funds is like saying Tiger Woods can putt. In 1996, some \$223 billion was handed over to equity-fund managers—\$28 billion more than all the money in equity funds only eight years ago. It's almost as much as the gross domestic product of Sweden.

Business Week – Feb 3, 1997

3 Extreme Overvaluation

The mutual fund mania causes stock prices to "detach" from values, sending valuation gauges to lofty levels seldom or never seen before

(i.e. a 96th percentile means the stock market has previously been more overvalued less than 4% of the time since January 1910):

In 1929:

DJIA Price/Dividend = 96th percentile

DJIA Price/Book Value = 99th percentile

In 1966:

DJIA Price/Dividend = 99th percentile

DJIA Price/Book Value = 90th percentile

TODAY:

DJIA Price/Dividend = 99th percentile

DJIA Price/Book Value = 99th percentile

4 Old Rules No Longer Apply

The obvious excesses and overvaluation are dismissed by many as invalid or obsolete:

In 1929:

Price-Earnings Ratios

"But apparently there has been a fundamental change in the criteria for judging security values. Widespread education of the public in the worth of equity securities has created a new demand. Half of the gain in common stock prices in the past six years has occurred during the last fifteen months which has been the period of greatest growth for the investment trust."

Outlook & Independent – May 15, 1929

"Old standards of judgement have been overthrown... In short, this market, this Coolidge market, like the younger generation, abandoned with sheer disregard, if not with disdain, all the old traditions and conventions and made for itself a new and bigger place."

New Levels in the Stock Market
– Aug, 1929

In 1966-68:

No New Era

The failure of the general market to decline during the past year despite its obvious vulnerability, as well as the emergence of new investment characteristics, has caused investors to believe that the U.S. has entered a new investment era to which the old guidelines no longer apply.

Barron's – Feb 3, 1969

TODAY:

IS THE MARKET JUST PLAIN NUTS?

Month after month, the stock market keeps confounding its critics. Strategists see yearend forecasts eclipsed within weeks. Traditional valuation yardsticks prove useless.

Business Week – Jan 27, 1997

THEY'RE NOT AS LOONY AS THEY LOOK

SQUASHED THUMBS. In considering the p-e question, the biggest trap that investors can fall into is to rely on age-old rules of thumb that once worked but no longer hold up.

Business Week – May 18, 1998

5 Unparalleled Stability

The unprecedented mutual fund mania is [falsely] perceived as a new source of stability on Wall Street:

In 1929:

"These [Investment] Trusts act as great cushions against the market's shocks... Such influence, such terrific resources in constant reserve, have given the market an internal buoyancy it never possessed in the old days."

Outlook & Independent – Sep 18, 1929

In 1966-68:

"It is, of course, the theory that any sharp drop in the market will be cushioned because the mutual funds in particular, attracted by all the bargain-priced stocks, will immediately start buying and thus shore up the entire market."

Dun's Review – Sep, 1968

TODAY:

If Market's a Yo-Yo, They Hold String

Mutual fund investors are the key to stability on Wall Street.

The New York Times – Jul 21, 1996

6 Supply/Demand Imbalance

Disconnected from "values," stocks become a commodity – appearing to move ever higher on rising demand:

In 1929:

"The recondite problems of Federal Reserve policy were not the only questions that were agitating Wall Street intellectuals in the early months of 1929. There was worry that the country might be running out of common stocks. One reason prices of stocks were so high, it was explained, was that there weren't enough to go around, and, accordingly, they had acquired a 'scarcity value.'"

The Great Crash, 1929 – John K. Galbraith

In 1966-68:

THE GO-GO YEARS

But there was a final, crushing argument in favor of the funds in 1965. With almost \$2.5 billion net in new money a year coming into the stock market through the funds, wasn't the market, over the long term, bound by the law of supply and demand to go up and up and up, to everyone's benefit? Weren't the funds, so long as they thrived, a sort of guarantee of a permanent bull market?

– John Brooks

TODAY:

Stock Surge Leaves Experts Wondering

"Buttressing much of the buying is a feeling that the huge baby boom generation of Americans born after World War II is beginning to save in earnest for retirement. This theory holds that they have created a perpetual motion machine or rising markets by pumping so much money into stock mutual funds."

The Washington Post – Feb 10, 1996

7 Riskless Attitude

With no apparent risk, investors view cash as "trash," with the major risk as "being out of the market":

In 1929:

How High is "Up"?

"Probably the question most frequently heard around Wall Street is 'How high can stocks go?' To the unsophisticated observer there appears to be no maximum price."

The New York Times – Aug 21, 1929

In 1966-68:

"Many now have come to believe that market risk is no longer a realistic consideration, while the risk of being underinvested or in cash and missing opportunities exceeds any other."

Barron's – Feb 3, 1969

TODAY:

The risks in cash

"As we have come to reevaluate the concept of risk, it has become clear that the risk of not owning stocks is, in the long run, greater than the risk of owning them."

Forbes – Jun 15, 1998

8 Perpetual Economic Prosperity

Tame inflation and low interest rates are extrapolated to mean a "recession-free" economy – for as far as the eye can see:

In 1929:

"If history repeats itself, and, if the stock market is as good a register of the trend of business as it was in the period 1903 to 1907, we are entering an era in business activity that was beyond the dreams of men a decade ago."

New Levels in the Stock Market
– Aug, 1929

"No Congress of the United States ever assembled, on surveying the state of the Union, has met with a more pleasing prospect than that which appears at the present time. In the domestic field there is tranquility and contentment... and the highest record of years of prosperity."

President Calvin Coolidge
State of the Union address – Dec 4, 1928

In 1966:

NO MORE RECESSIONS?

Official word: Plan just right, be prepared to act at the first sign of trouble, and recessions can be prevented.

U.S. News & World Report – Feb 15, 1965

CAN PROSPERITY GO ON AND ON?

Backers of the "new economics" think Government now can keep the boom going indefinitely.

U.S. News & World Report – Nov 15, 1965

TODAY:

Are recessions necessary?

U.S. News & World Report – Jan 27, 1997

Recessions No Longer Seem as Inevitable

The Washington Post – Dec 2, 1996

Growth Forever

"The U.S. economy likely will not see a recession for years to come. We don't want one, we don't need one, and, as we have the tools to keep the current expansion going, we won't have one."

Wall Street Journal – Jul 30, 1998

9 "New Era" Hype

All of the above are a source of fuel for the "New Era" hype and hopes:

In 1929:

"For the last five years we have been in a new industrial era in this country. We are making progress industrially and economically not even by leaps and bounds, but on a perfectly heroic scale."

Forbes – Jun 15, 1929

The New Era-ationality

"For five years at least, American business has been in the grip of an apocalyptic, holy-rolling exaltation over the unparalleled prosperity of the 'new era' upon which we, or it, or somebody has entered."

Business Week – Sep 7, 1929

In 1966-68:

"A 'new era.' Dips or no, in all of the debate there seems to be a consensus that the present is something of a 'new era'... A number of 'conservative' economists and businessmen now accept the idea that business expansion can go on indefinitely—though they usually qualify such predictions."

U.S. News & World Report – Nov 15, 1965

New Environment

"As the result of all that has been happening in the economy... during the last decade, we are in a different—if not a new—era and traditional thinking, the standard approach to the market, is no longer in synchronization with the real world."

Forbes – Oct 1, 1968

TODAY:

The Triumph Of the New Economy

"Is the market crazy? Hardly. Underlying the equity boom is the emergence of a New Economy, built on the foundation of global markets and the Information Revolution."

Business Week – Dec 30, 1996

New Era For Taking Market's Pulse

The New York Times – Feb 11, 1997

MORE EVIDENCE OF A NEW ECONOMY

Business Week – Feb 23, 1998

10 Federal Reserve Censure

The Federal Reserve unsuccessfully tries to keep investors' feet on the ground:

In 1929:

Scolding by the Federal Reserve

We've tried everything else. Let's give them a good old-fashioned scolding. This is about what the members of the Federal Reserve Board must have said to each other before issuing the famous statement of February 6.

"For the time being, then, probably the best they can do is to sit tight and pray that the market will fall of its own weight."

Outlook & Independent – Feb 20, 1929

In 1966:

A SPEECH THAT JOLTED THE STOCK MARKET

Stock prices skidded when the top man in the Federal Reserve asserted: "We find disquieting similarities between our present prosperity and the fabulous '20s."

U.S. News & World Report – Jun 14, 1965

TODAY:

Greenspan rattles markets

Analysts not sure warning will turn tide

"Federal Reserve Chairman Alan Greenspan took another swipe at the 'excessive optimism' of the financial markets Wednesday, sending both stock and bond prices tumbling."

USA Today – Feb 27, 1997

11 Scolding of the Federal Reserve

The Federal Reserve, in turn, is told to respectfully "shut up":

In 1929:

"He avows his superior obligation to a frantic stock market over the obligation of his oath as a director of the New York Federal Reserve Bank... the Bank should ask for [his] immediate resignation."

– Senator Carter Glass
Chairman, Senate Banking Committee

In 1966:

"Recently when [Federal Reserve Chairman] Martin warned that there are 'disquieting similarities' to the 1920s, [House Banking Committee Chairman] Patman called for his resignation, likened him to Genghis Khan, and said the FRB is 'the root of all financial evil.'"

U.S. News & World Report – Jul 19, 1965

TODAY:

Greenspan's Market Meddling

"With all due respect, would [Federal Reserve Chairman] Alan Greenspan please shut up?"

The Washington Post – Mar 4, 1997

Small Investors' Advice to Greenspan: Butt Out

Wall Street Journal – Mar 7, 1997

* The Inevitable Washout

Each "New Era" ends in devastating consequences for the average investor...

In 1929:

The next decade saw the 2 most severe bear markets of the first half of this century:

1929-32: -86%

1937-38: -55%

Most retirees didn't live the 25 years necessary to see their portfolios recover.

In 1966:

The next decade saw the 2 most severe bear markets of the last half of this century:

1969-70: -36%

1973-74: -48%

Between December 1968 and December 1974, the unweighted Value Line Index of 1700 stocks lost over 74%.

TODAY:

The next decade...



What the Future Holds...

A stock market bubble can be prevented, but it can't be corrected...

Painful recessions and periodic bear markets can usually prevent the valuation extremes and sentiment excesses that create a dangerous bubble. Yet tragically, this simple, historic fact must be relearned every time. For example, after the Japanese stock market and real estate collapse, the former head of the Bank of Japan lamented:

"Looking back, we now feel that we should have applied the brakes on the excessive boom much earlier... However, back in those days, as [consumer] prices were not rising, it was difficult to obtain people's understanding for a policy aimed at achieving sustainable economic growth by monetary tightening."

— **Yasushi Mieno**, Former Governor, Bank of Japan

The historical truth that bubbles can be prevented but not corrected even appears obvious to those involved in creating the current bubble, as evidenced by this 1996 quote from the former Federal Reserve Vice-Chairman:

"It's very hard to surgically prick a balloon. You may let out a lot more air than you bargained for."

— **Alan Blinder**, Former Vice Chairman, Federal Reserve

And in an article from 30 years ago, the current Federal Reserve Chairman wrote this critique of the 1929 Crash:

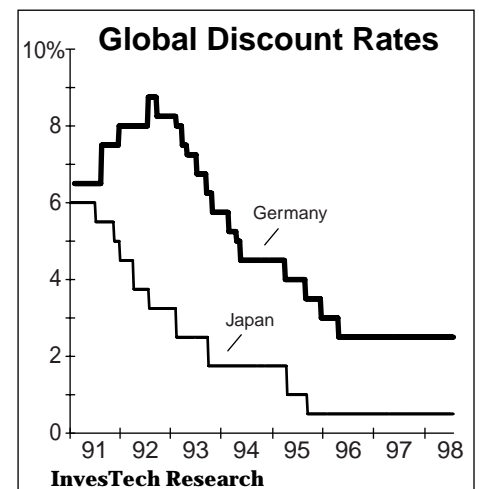
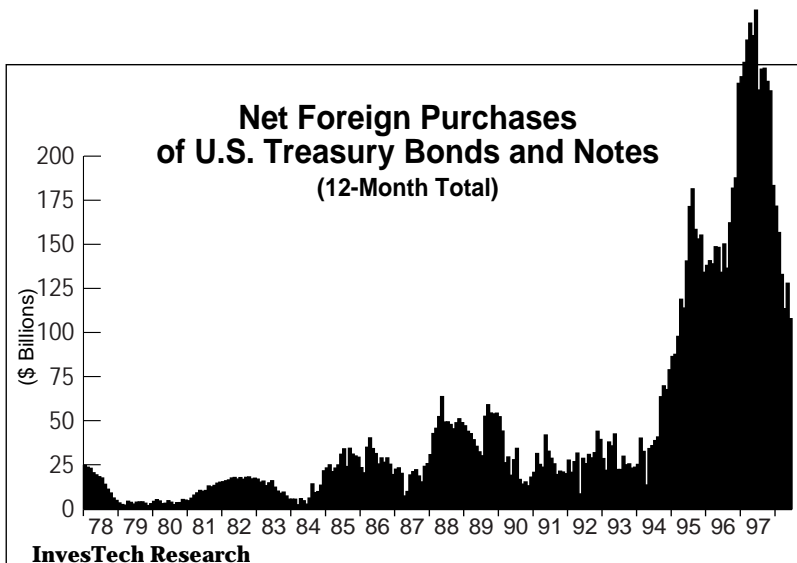
"The excess credit which the Fed pumped into the economy spilled over into the stock market – triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence."

— **Alan Greenspan**, *"Gold and Economic Freedom"*, 1966

Yet the mere presence of a bubble, even with all the overvaluation and extremes, rarely pops itself. It may continue to inflate, transparent to those inside the bubble, until some external event causes the initial pinhole. As John Galbraith noted about past bubbles, *"Something, it matters little –although it will always be debated– triggers the ultimate reversal."*

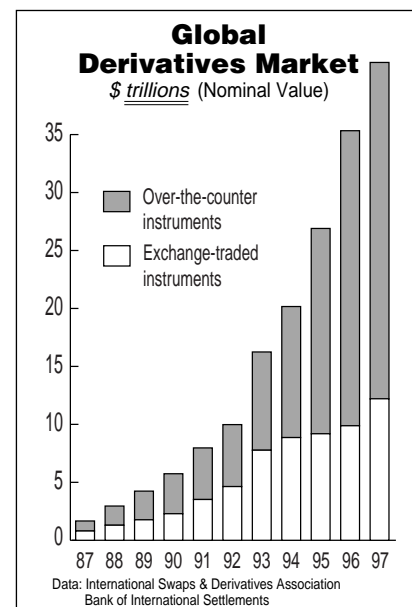
From whence could the pin or trigger come?...

Global economic and financial turmoil offer a number of potential sources. Recessions in Germany and Japan have driven interest rates down to 1/3 of levels in 1991-92 (or 1/12 in the case of Japan). However, the frenzied effort to jumpstart foreign economies has instead pushed excess liquidity into the U.S. financial markets.

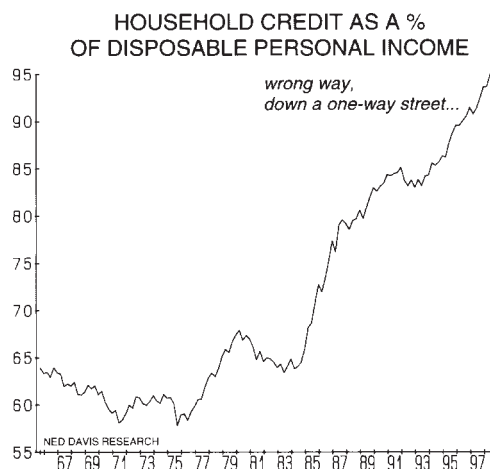


As a result, purchasing of U.S. Treasuries by foreign investors and central banks has soared to unprecedented levels. The short-term benefits have funded our trade deficit, supported the Dollar, and sloshed liquidity into Wall Street. *The obvious danger is what might happen now that this trend shows signs of reversing.*

Another potential trigger resides in the global derivatives market. It's assumed by today's young gun-slinging money managers that such leveraged derivatives are as liquid as cash – even in a falling market or financial crisis. However, note that the face value of these global derivatives now totals over \$41 trillion... 6 times larger than in the last U.S. recession... and 17 times larger than when liquidity disappeared during the 1987 Crash. That \$41 trillion has never experienced a true global recession or liquidity crisis. *What happens if speculators all want out at the same time?*

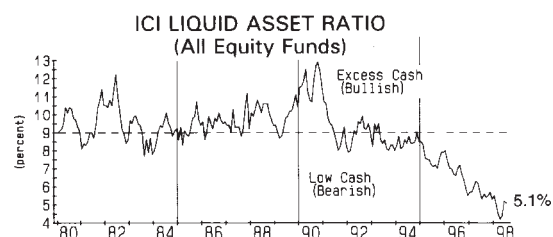


InvesTech Research



Liquidity could also prove a problem for today's consumers. Household debt (even as a percentage of income) continues to rise to record levels. Personal bankruptcies are also at record levels – even in this 8th year of economic expansion. *With consumer spending accounting for 2/3's of GDP growth, how long can households keep heading the wrong way down a one-way street?*

If illiquidity is the trigger, mutual funds are sitting on the target. Cash reserves, tracked by ICI, have been reduced to the lowest levels of this 16-year disinflation bull. Meanwhile, nervous fund families, including Fidelity and Vanguard, have requested permission from the SEC to borrow from money market funds to meet redemptions if necessary. Some are even “investing” cash reserves in stock index futures. *Is it confidence, ignorance, or recklessness that leads mutual funds down the same path as in the Go-Go Fund 1960's, or as the Investment Trusts of the late 1920's?*



Threat of a Crash...

- This 7.8 years without a -15% correction in the DJIA is virtually double the previous record. Among the 5 longest such periods... are the 1929 Crash and 1987 Crash. *Coincidence?*
- This 16th year without the DJIA dropping under the previous year's low is double the previous record of 8 years... which ended in the 1929 Crash. *Coincidence?*
- Intraday volatility (daily high-to-low) is averaging over 2% (~180 DJIA points) for 1997-98. Among the 3 previous records... again, 1929 and 1987. *Coincidence?*

Historical precedent paints a foreboding picture. A “crash” is always a possibility in a correctionless, overvalued stock market. And none have been as correctionless or as overvalued as this one. Wall Street confidence relies heavily on the Federal Reserve and its ability to control or halt a meltdown scenario. Media has publicized the “un” official *Plunge Protection Team*, comprised of the Federal Reserve, Treasury, SEC, and CFTC – all of whom are “*thinking carefully about how they would respond to the unthinkable*” on Wall Street. Only time will tell if such confidence is misplaced...

Plunge Protection Team

White House Group Shapes Plans to Ensure Any Market Free Fall Is Contained

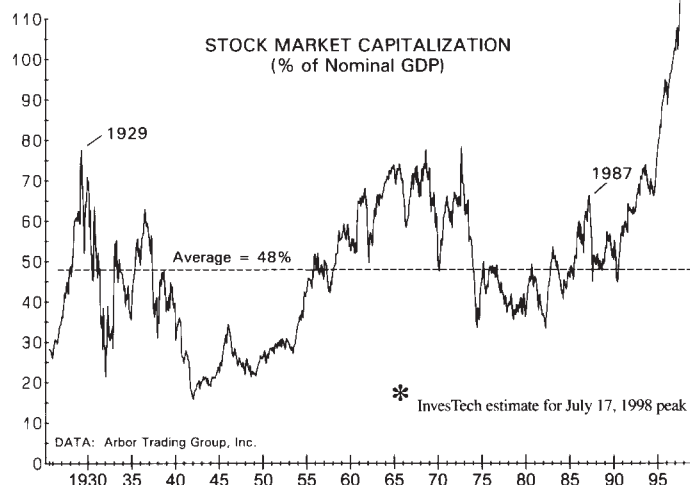
The Washington Post

Weighing the Dangers...

Today's parallels with history, and repeated warnings from the SEC and the Federal Reserve carry ominous overtones. A correctionless bull market, record overvaluation, plus public exuberance all add up to unprecedented risk – for the stock market, as well as the U.S. economy. By July 1998, stock market capitalization (in relation to GDP) has reached over twice the peak before the last recession or prior to the 1987 stock market crash.

Simply stated, even a mild bear market of -25% from today's lofty levels, would wipe out \$2.8 trillion – with more economic impact than any bear market of the past 60 years!

To Alan Greenspan, who wrote so astutely of the lessons of 1929, the threat must weigh heavily. The anecdotal evidence is overwhelming that Wall Street is in some type of bubble – a mania where valuations and expectations have disconnected from reality. If that is indeed the case, then what lies ahead is inevitable. And the downside risk is grossly underestimated by today's investor. With valuations based on the broad S&P 500 Index (but downside risk expressed in more familiar DJIA point terms), the table below shows how far today's stock market could tumble before hitting 70-year average valuations. *NOTE: This is only to average valuation levels since 1928, not the extreme lows that are typical in most bear markets!*



VALUATION RISK 1928-1998

	July '98	70-yr Norm	Downside Risk
Price/Dividend	74.4	25.9	= DJIA 3250
Price/Book Value	5.3	1.9	= DJIA 3348
Price/Earnings	30.5	14.6	= DJIA 4470

InvesTech Research

In one sense, it doesn't matter whether today's bubble unwinds in a deflationary crisis as in 1929, or in a series of protracted bear markets as in the late 60's. The consequences for the average investor were the same. Those who blindly followed a buy-&-hold strategy were devastated, both financially and psychologically. Meanwhile, those investors who recognized the dangers and took evasive action weathered the fallout – or even profited handsomely in the years that followed.

It also matters little, if it is a bubble, what circumstance or event is blamed for “pricking” the overinflated balloon. Inevitably, the fact remains that much of the fault must lie with Wall Street itself. If not for the sirens and aggressive marketing in an overextended, overheated, overvalued bull market, then the excesses and speculation couldn't reach such extremes.

The purpose of this special report is not to frighten or build the case for a crash. Our sole objective is to educate. It is a dangerous, perhaps even financially fatal assumption to think the next 5 years will be a repeat of the recent past. But historical precedent cannot be ignored. The 1980's and 90's are not the first era where investors have been pushed away from inflation hedges, real estate, bonds, and cash. And, as revealed inside, it would not be the first such bubble created by these disinflation forces.

Only time, and 20/20 hindsight, will reveal if today's “new era” is a mirage – merely an old era carried to new levels of excess. Unfortunately, the symptoms are present and warning flags are flying high. **Yet even if Wall Street is in a bubble destined to deflate, one must also remember that the devastation which followed the late 20's and late 60's created tremendous profit opportunities for those astute investors who understood and perceived what was happening. The historical perspective and evidence presented in this report serve as a vital step in that direction.**

FREE REPRINTS of this special report are available by contacting:

InvesTech Research
625 Wisconsin Avenue
Whitefish, MT 59937
406-862-7777

InvesTech Research publishes the widely respected InvesTech Market Analyst and InvesTech Mutual Fund Advisor newsletters. A free sample issue is available by calling (406) 862-7777 or by visiting InvesTech's website at <http://www.investech.com>