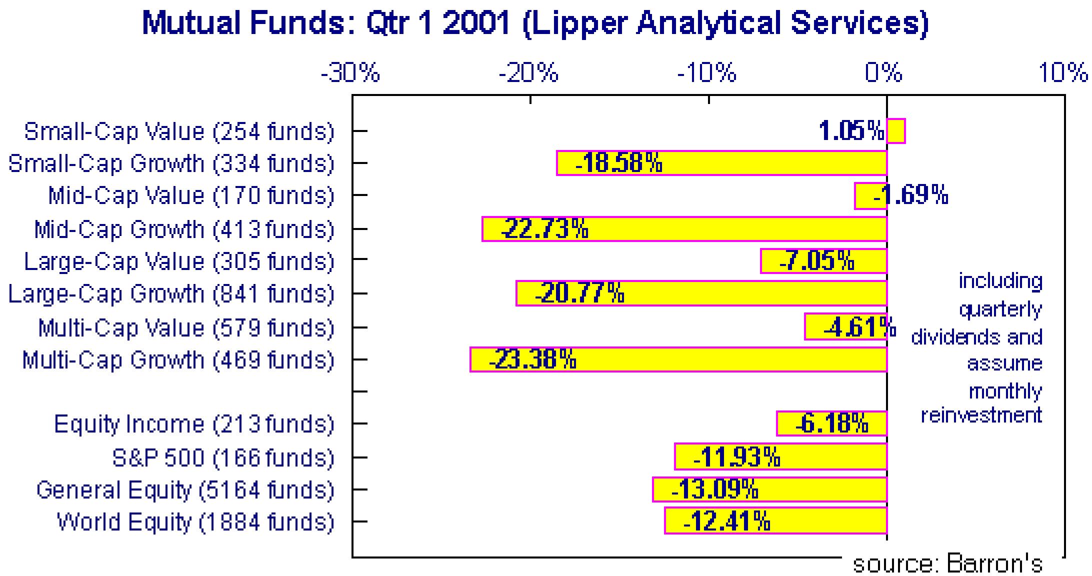
Niemann Capital Management, Inc.

First Quarter 2001 Review

Third time's a Charm.

Finally. Three *50 basis point (1/2%) rate cuts* and one decimated NASDAQ later, the Fed manages to get signs of life out of U.S. stocks. The third cut came towards the end of the first quarter, halting the nasty bear *blitz-krieg* documented by Qtr 1 2001 Mutual Fund benchmark returns (chart below). Back to back declines like those of the past two quarters haven't been seen in U.S. markets for over two decades.



The Fed has piled on two more half point cuts since to ensure business leaders and investors alike get a simple message: *they will do what they can to re-ignite economic growth.* Unfortunately, as those looking for a mortgage over the past few months have discovered, the Fed can only impact short-term yields. Mortgage rates are higher now than when the Fed made its first rate cut in January. Such is the nature of *forward-looking markets*. The good news is, as investors lose patience with their 3+% annual return in money market *before taxes*, some of the $2+ trillion dollars in money funds will find its way back into stocks.

The average growth fund is down almost 40% over the past twelve months, with Science & Technology imploding 62.22%, according to *Lipper*. It is typical, following a scalping like this, for investors to rush back into fallen angels thinking how cheap prices seem relative to where they were. And its true once the market finds an intermediate low, as it did in April, that stocks down the most usually experience the sharpest price advances – this is in fact what we've witnessed over the past six weeks. Well, *Caveat Emptor*! Buying stocks that have fallen from $100+ into single digits is a losing proposition in the long run. Should history repeat, most of these securities won't see a price above $15 for *years,* and many will simply die quietly over the next several months. Sure, stock prices have fallen a lot – but so have earnings, assuming there were any in the first place.

These are reasons why you haven't seen many growth positions in our portfolios in recent months. We choose to remain focused on valuation and earnings in the short run, and are mindful that over the past four quarters *value classes have out-performed their growth counterparts* by a wide margin.

Has the Bear run its course?

Now that the Fed is our friend, lets review a few other classic setups we look for to uncover an impending bull trend. **Does everyone know it's a bear market?** Inexplicably, talking heads don't think a bear market exists until the major averages fall at least 20% from their highs (even when their portfolios are probably down twice that much). All three of the major news "weeklies", as well as countless other publications have recently sported *pictures of bears on their covers.* If it's obvious, it is obviously wrong – this negative press is a good sign the bear may be ready for hibernation. **Is the bear gorged?** Another sign of a satisfied bear is when the stocks leading the downside quit making new 52-week lows. While this is recently the case, the next market decline will be the true test, and in general stocks must hold their April lows.

Testing For a New Bull

	Yes	No
A normalize yield curve (Bullish Bonds)	√	
Downside Leadership stops making new lows	√	
20%+ Price Declines in major Indexes	√	
Recession Headlines in the Press	√	
Plunging Confidence (Consumer & Business)	√	
Investors find a new growth catalyst		?
Coordinated Rate Cuts around the globe		
Japan	√	
England	√	
United States	√	
European Central Bank	√	

Rate cuts spur growth. The ECB (European Central Bank) finally followed the rest of the world, cutting interest rates last week. Coordinated rate cuts in major economies around the globe are a precursor of future growth, probably by 2002. **The U.S. yield curve is normal** for the first time in 2 years. Normal means shorter-term rates are lower than longer rates all the way from Fed funds, the overnight rate, through the 30-year bond. Usually the economy begins to expand approximately nine months after the yield curve "normal-izes". **Favorable tax policy** (for the first time in 12 years) is a very important ingredient to the next bull trend – though rate reduction, the best part for entrepreneurial risk-takers, is being mangled and capital gains taxes have yet to be reduced. **Investors discover a new catalyst.** Technology based "productivity tools" (computers, software, communications) drove the last market cycle. What will be the mantra three years from now? Hint: It's probably not the Internet.

Cautiously Optimistic

Historically stocks return an average 21% over the twelve months following the first Fed cut, so why not dump all of our money into stocks right now? Well, we don't think a new bull trend is baked in the cake - yet. Typically, 6 to 9 months pass before a Fed rate cut begins to get traction, and the U.S. economy is still decelerating. The current "profit recession" (meaning declining corporate profits are the major impact of the slowdown) is a cycle of the vicious type, feeding on itself as businesses throttle back capital expenditures and lay off employees in an effort to stay in the black. So far consumers have done the heavy lifting - sales of housing and cars are still close to record levels. The key question: Do consumers run out of buying power before companies begin investing capital for future growth?

And of course there are always the random risks that emerge. Consider the outbreak of foot in mouth disease in California. Historically found in the leaders of third world countries, those infected develop the overpowering urge to "seize utility and energy assets" and install "windfall profits" taxes. Who would accept the risk to build a power plant when the governing authority says they may confiscate the profits, or simply steal the assets for "the public good"? What effect will random, rolling blackouts (as Thomas Donlan of Barron's kindly puts it, "a remarkably stupid thing to do in an energy crisis") have on California, the engine of the U.S. economy?

"Event risks" are harder to overcome in a weak economy. Hopefully, we're not in for a long hot summer.

Bottom Line

A new bull trend may be afoot, but it is indeed rare that an emerging bull is led by the same industries as its predecessor. Who would argue that technology is key to our future, yet this fact doesn't guarantee a repeat of the last "tech bull trend". More likely there will be a new catalyst for growth – the recently announced "National Energy Policy" for example. Energy companies account for only about 6% of market capitalization *after* solid gains over the past several months. Technology as related to energy and transportation (fuel cells, etc.) are interesting. Of course there will be winners among the old standbys, but probably not as many, nor as easy to find.