INTERMARKET FORECASTING

TOP-DOWN INSIGHTS…BOTTOM-LINE RESULTS

TRACK RECORD 2000

IFI delivered a favorable forecasting record in its inaugural year:[1]

- We predicted the deceleration in U.S. economic growth and corporate earnings that took hold near the end of the year.

- Our models also correctly forecast the Fed's interest rate policy moves, from its final rate hikes in the first half of the year to its late-year policy shift toward cutting rates.

- IFI foresaw that the U.S. inflation rate would accelerate in the first half of 2000 and then decelerate.

- Our analysis suggested that U.S. bond yields wouldn't stop rising until the Fed stopped raising rates (and begin cutting them) and that credit spreads would continue to widen even after the Fed stopped raising rates.

- We predicted that U.S. equity markets would perform badly (especially tech stocks) and warned specifically about the damage that would be done by Fed rate hikes, trust-busting and the undermining of biotech patents.

- IFI anticipated the peak (and then the drop) in the oil price - although the oil price didn't fall by as much as we expected.

- We correctly predicted that there would be no "Y2K" disaster - in contrast to the claims of such popular Wall Street economists as Ed Yardeni.[2]

- Finally, we correctly forecast the outcome of the U.S. election in November - a sweep by the GOP.

The year 2000 was one in which the U.S. government's "policy mix" became punitive - a reversal of the favorable mix of 1995-99. Markets didn't decline last year, as some claim, because they went up by "too much" in prior years. That's the false view of "bubblists" - and one we reject. Markets prosper when interest rates and tax rates are low and stable, the currency is sound and regulations (or their enforcement) are minimal. This free-market approach made it possible for us to correctly forecast most of last year's results.

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U.S. economy. In early February, after the U.S. reached a record nine-year expansion, we reminded investors that "economic expansions don't die of natural causes. They're murdered by identifiable, anti-market policies. And no component of a nation's policy mix matters more for future fluctuations in business activity than monetary policy."[3]

By February the Fed had raised the Fed funds rate by 100 basis points. We said that was "not enough, yet, to bring a recession" but that the Fed clearly had "adopted a policy that, in time, could halt" the expansion. We predicted that if the Fed kept raising rates, "say another 100 basis points, the U.S. will suffer a noticeable and unavoidable slowdown." Indeed, the Fed raised rates 25 basis points in March and 50 basis points in May - and the result was that the economy slowed down in the second half of the year.[4]

Having grown in excess of 4% per annum from 1997 to 1999, real GDP in the U.S. decelerated sharply from 5.6% in 2Q00 to 2.2% in 3Q00 (and lower still in 4Q00). As they have for most of the past few years, most economists underestimated the U.S. economic growth rate in the first half of 2000; but then they underestimated the year-end slow down. Many of them had prodded the Fed to raise interest rates, allegedly to "fight inflation;" but few seemed aware of the lagged, negative impact of rate hikes on the economy.

Corporate earnings. In early May we warned investors against being bullish on stocks just because first quarter earnings reports were robust. Nearly three-quarters of S&P 500 firms had beaten analysts' estimates. But we showed that the stock market prices *future* earnings (starting at least a year ahead), not current earnings - and that despite current good news, future earnings were likely to decelerate sharply.[5] In May we said that "over the coming year S&P 500 companies are not likely to repeat their current, year-over-year earnings rise of 20%+." Recent profit reports are showing a sharp deceleration.

Federal Reserve policy. In February we expected the Fed to raise rates another 100 basis points, to 6.75%; rates were raised another 75 basis points, to 6.5% in mid-May. Throughout the year we identified the premises that were embedded in the thinking of Fed officials that made them inclined to sabotage the stock market.[6] Through most of the summer economists debated by how much more the Fed would *raise* rates. But starting in late August our market-based models suggested a clear end to Fed rate hikes - and a likely shift toward *cutting* rates.[7] The Fed made no policy change at its meetings of August 22nd, October 3rd and November 15th.

In mid-October our models shifted to predict a pending *cut* in the Fed funds rate.[8] We predicted that the Fed funds rate would be *below 6%* by the end of March 2001.[9] The Fed cut the rate by 50 basis points, to 6%, on January 3rd of this year. Most economists were surprised by this rate cut.

Inflation. Contrary to most forecasters, who believe the Fed "pre-empts" higher inflation with rate hikes, we predicted a rise in the official U.S. inflation rate last year, in large part *because of the Fed's hikes.*[10] The other key factor was the prior rise in the dollar-gold price. Indeed, the year-over-year change in the CPI accelerated from 2% when the Fed *began* its latest series of rate hikes (June 1999) to 3.7% in July 2000, two months after its final rate hike. The CPI rate didn't start decelerating until last August. The gold price had risen by 15% from July 1999 to February 2000, another indicator that the CPI rate would accelerate; then the gold price fell by 7% from February to May, signaling the subsequent CPI deceleration.

The oil price. In late March we predicted a drop in the oil price - but not because OPEC was about to announce a 7% increase in daily output. The price had tripled from \$11/bbl in October 1998 to \$34/bbl in early March 2000. Many oil analysts - citing low inventories - predicted a price above \$40/bbl by year-end. In contrast, we expected the oil price to drop to \$20/bbl by year-end, due in large part to its price being out of line (historically) with the gold price.[11] Although OPEC did announce its 7% increase in daily output last March, we predicted that by year-end it would be *lowering* output, due to a flagging oil price.

Indeed, the oil price declined - albeit by a bit less than we expected - by 26%, to $25/bbl at the end of December. And, as we predicted last March, OPEC is now *cutting* its daily output by 5%.

Bonds. In February we predicted that U.S. bond prices would stay down (yields would stay up) as long as the Fed kept raising rates. It kept raising rates through May and the 10-year U.S. bond yield, having risen already by 180 basis points since January 1999, rose still further, from an average of average of 6.3% in March to 6.5% in May.

In July we explained how past Fed rate hikes, by weakening the future economic growth rate and profits, also would widen credit spreads between corporate bonds and government bonds.[12] Indeed, the spread between the yield on 10-year corporate bonds rated Baa and the yield on the 10-year Treasury bond widened from an average of 230 basis points in July to 278 basis points last month. The yield spread between Aaa corporate bonds and Treasuries also widened, by 37 basis points.

As expected, once the Fed stopped raising rates in May, U.S. bond yields fell. The prior drop in the gold price (from a peak in February) also anticipated this decline in bond yields. Although we correctly predicted the drop in bond yields last year,[13] we underestimated (by half) the full magnitude of the decline (120 basis points from May to December). But we were right to recommend that bond investors be bullish. Many economists had assumed that the above-average economic growth which they predicted for 2000 - and an accelerating CPI rate - would cause poor bond performance in 2000. It didn't. The market prices we use offered far better signals of actual bond performance.

In 2000 we advised investors to look at the disinflationary signal be given by the dollar-gold price, and to ignore fears that bond yields might rise if the U.S. Treasury's plans for long-term debt buybacks were to be curtailed. We argued that it's the fundamental value of the dollar (in terms of gold), not the quantity of government debt outstanding, that ultimately determines bond yields.[14] Indeed, reports of a lesser debt-buyback program after Bush's victory did not deter bond yields from falling in late 2000.

Equities. In early May we showed that current equity pricing is most sensitive to 1) *future* (not current) earnings growth and 2) current shifts in *short-term* (not long-term) interest rates.[15] Thus, despite robust growth in current earnings last spring, equities wouldn't do well because we expected a deceleration in future earnings growth; and despite a decline in bond U.S. yields, equities would suffer by the rise in short-term rates.[16] The three month T-bill rate rose from 5.2% in December 1999 to 6.2% in November 2000. And the S&P 500 fell 9% from its peak in April to its low in December.

The plunge of the NASDAQ by 50% from its peak in March to the end of December was anticipated, in part, by 1) rising short-term interest rates, 2) a new anti-patent policy in biotech and 3) punitive antitrust policy.

In mid-April we showed why high-growth tech stocks, especially those without current earnings, would be hurt most by Fed rate hikes.[17] We argued that "equity valuation metrics have not changed," neither when the market was rising or falling. Like bonds, every stock has a *duration*, a distinct pattern of future cash flows that make their current price more or less sensitive to shifts in interest rates. We argued that *high duration* stocks (the newer tech stocks) were most prone to plunging due to higher short-term interest rates. Lower duration stocks - like higher-yielding, "old economy" stocks in the DJIA, would suffer less by rate hikes. Indeed, the DJIA in December was only 2.6% lower than it was in January.

It was clear to us - as early as November 1999 - that Fed Chairman Alan Greenspan would go out of his way to raise the risks associated with equity investing in 2000.[18] Fed rate hikes of 175 basis points from June 1999 to May 2000 materially raised the risk associated with equity investing (and lowered risk-adjusted returns).

In June last year we defended the higher price-earnings ratios that had held in 1995-99, but showed how higher short-term interest rates would cause a contraction in multiples.[19] The U.S. stock market was no "bubble" in 1997-99[20] and 2000 represented no "pop." Just as lower short-term interest rates generate higher multiples in 1995-99, higher rates brought lower multiples in 2000.

We also identified punitive regulatory policies in 2000 that further depressed risk-adjusted equity returns. In mid-March we argued that biotech stocks were being undermined by the week-earlier announcement by Clinton-Blair that undermined property rights (patents) in human genome research.[21] The biotech index (AMEX: BTK) had plummeted by 35% since March 6th; the Clinton-Blair announcement was March 14th. Most biotech analysts dismissed this policy shift as unimportant and already anticipated by the market. But we expected more trouble and identified established profitable firms that weathered the "policy mix" storm.

IFI also projected market-wide damage due to Judge Jackson's ruling on April 3rd that Microsoft had violated the Sherman Act.[22] Many analysts at the time dismissed the ruling as fully anticipated, kept their "buy" ratings in tact and suggested that the firm's competitors would benefit by its troubles. But over the following two months Microsoft stock fell by 26%, while the NASDAQ fell by 10%.

On June 7th Jackson ruled that Microsoft should be broken up.[23] From this point to the end of the year Microsoft and the NASDAQ fell still further by 35%. One third of the drop in the NASDAQ and S&P 500 in 2000 was due solely to the decline in Microsoft's shares. In the meantime, the Justice Department took an entire year to approve the merger of AOL and Time-Warner, and even then, approved it only with profit-diminishing restrictions. As the approval process dragged on, the stock prices of both firms fell by nearly 45%.

In late May, after the NASDAQ had *already* plunged by 31% from its peak of 5048 on March 10th, we warned investors against buying on the dips and suggested that its level of 3460 was not likely to be its "final" trough.[24] In the next five months - to mid-October - the NASDAQ fell further by 11%.

We stressed the importance of Fed policy shifts for detecting a real bottom in the NASDAQ. Examining the history since 1971, we showed that "final troughs that have taken hold after NASDAQ plunges only when there were signs of a definitive, positive shift in Fed policy - that is, when the Fed *stops raising rates* or, better still, reverses policy and *cuts* rates."[25] We also noted that a distinct pick-up in NASDAQ trading volume should be taken as bullish, contemporaneous indicator. Volume started picking up last December.

We were a bit premature in expecting a "final" bottom in the markets in mid-October.[26] We couldn't have anticipated the uncertainty associated with the drawn-out election results - which no doubt undermined the markets. But in mid-November we correctly identified the improving fundamentals that would emerge once the election was finalized.[27] And at that time we advised clients to treat any nearer-term weakness as a buying opportunity. As we put it, "New bottoms are possible. But after the election is certified, we suspect there'll be a re-focus on improving fundamentals and the market will likely achieve a firm trough. So we re-iterate our recent advice: 'Portfolio managers who've seen a temporary drop in the value of stocks they hold should refrain from panic selling; and those seeking a rare opportunity to buy sound companies at attractive prices should start doing so.' In short, it's bargain-hunting time in U.S. markets."[28]

Politics. Last summer, when George Bush was leading Al Gore in the polls, we warned that Bush might lose that lead, by failing to give credit to the GOP led Congress for the sustained U.S. prosperity.[29] Indeed, his lead narrowed. We used signals from the betting odds offered by the Iowa Electronic Market to anticipate the likely outcome of the election. By early September Bush was still running a campaign that would make the race closer than it needed to be.[30] But after that he began to emphasize tax cuts and other pro-market policies that resonated with voters. Prior to the election we correctly predicted that he would win the White House, while the GOP retained control of Congress.[31] For the next month these results remained in question, but we didn't waiver in our view of the outcome - and that it would be bullish for U.S. markets.

In early December, five days before Gore conceded defeat, we were advising investors about the likely impact on markets of the coming Bush Cabinet.[32]

Footnotes

[1] IFI's President and Chief Market Strategist, Richard M. Salsman, founded the firm in February 2000. For seven years prior to that he was senior vice president and senior economist at H.C. Wainwright & Co. Economics, Inc. His track record in forecasting the markets from 1993 to 1999 is available upon request.
[2] See Richard M. Salsman, "Y-2K is A-OK," *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., September 15, 1999.
[3] "How Long Can This Keep Going On?" *Investor Alert*, InterMarket Forecasting, Inc., February 4, 2000, p. 2. See also Richard M. Salsman, "What Kills Expansions? Interest Rate Hikes" *Financial Post (Canada),* February 19, 2000.
[4] As is typical in history, the U.S. economy actually *accelerated* during the Fed's rate hikes from June 1999 to May 2000. This was due, in part, to the lagged effect of past rate cuts (1998) but also to the incentive to get more business done *before* the expected rise in the cost of capital.
[5] "When Earnings Season Becomes Open Season," *Investor Alert*, InterMarket Forecasting, Inc., May 1, 2000.
[6] See "Why Greenspan Trashes the Markets," *The Capitalist Advisor*, InterMarket Forecasting, Inc., February 22, 2000 and "Fed Wrecking Crew Takes a Coffee Break," *Investor Alert*, InterMarket Forecasting, Inc., June 30, 2000.
[7] "What Will the Fed Do *After* Tomorrow?" *Investor Alert*, InterMarket Forecasting, Inc., August 21, 2000.
[8] *The InterMarket Forecaster*, InterMarket Forecasting, Inc., October 20, 2000, p. 7. We said "markets will start to respond best to this policy shift when the Fed drops its 'bias' toward inflation in its post-meeting announcements." The Fed dropped its bias a bit earlier than we expected - after its December 19th meeting; U.S. equity markets - especially the NASDAQ - responded positively. Today the NASDAQ (at 2747) is 9.5% higher than it was before the Fed's December 19th meeting.
[9] *The InterMarket Forecaster*, InterMarket Forecasting, Inc., October 20, 2000, p. 10.
[10] "Fed Rate Hikes Would Only *Further* Boost Inflation," *The Capitalist Advisor*, InterMarket Forecasting, Inc., May 10, 2000.
[11] "Oil Headed for $20/bbl *Regardless* of OPEC," *Investor Alert*, InterMarket Forecasting, Inc., March 29, 2000.
[12] "Fed Policy, Yield Spreads and Bond Returns," *Investor Alert*, InterMarket Forecasting, Inc., July 10, 2000.
[13] "How Long Can This Keep Going On?" *Investor Alert*, InterMarket Forecasting, Inc., February 4, 2000, p. 2 and *The InterMarket Forecaster*, InterMarket Forecasting, Inc., September 25, 2000, p. 17.
[14] "Gold - Not Debt - Forecasts Bond Yields," *Investor Alert*, InterMarket Forecasting, Inc., October 10, 2000.
[15] "When Earnings Season Becomes Open Season," *Investor Alert*, InterMarket Forecasting, Inc., May 1, 2000.
[16] The U.S. 10-year bond yield fell by 125 basis points during the year, while the Fed funds rate was raised by 100 basis points.
[17] See "The Anti-Wealth Effect," *The Capitalist Advisor*, InterMarket Forecasting, Inc., April 17, 2000, especially page 3.
[18] See Richard M. Salsman, "Greenspan Raises the Equity Risk Premium," *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., November 15, 1999. "In raising interest rates the Fed raises both inflation and the equity risk premium, not by boosting absolute returns on stocks and bonds, but by hurting both markets. . . Higher inflation and interest rates hurt bonds more severely and far earlier than they do stocks." The total return on long-term bonds in the U.S. in the second half of 1999 was -5.3%; as expected, this negative return on bonds *preceded* the negative returns on equities (S&P 500: -.4%) in the first nine months of 2000.
[19] "The Rational Basis of Price-Earnings Multiples," *The Capitalist Advisor*, InterMarket Forecasting, Inc., June 15, 2000. See especially Figure One (p. 7), "Lower Interest Rates, Higher Multiples, 1960-1999."
[20] See Richard M. Salsman, "Why the U.S. Stock Market is No 'Bubble,'" *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., May 14, 1999 and Richard M. Salsman, "Bubble, Bubble, Toil and Trouble?" *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., January 22, 1997.
[21] "The Cancer Threatening Biotech Stocks," *Investor Alert*, InterMarket Forecasting, Inc., March 21, 2000.
[22] See "Antitrust: Landmarks and Landmines," *Investor Alert*, InterMarket Forecasting, Inc., April 4, 2000 and "Microsoft's Anti-Trust Lynching Undermines the Market," *Financial Post (Canada),* April 5, 2000. In late 1998, after the Microsoft trial began, our president Richard Salsman predicted there would be market-wide harm if and when the firm were to be found guilty. See his report, "Investment Implications of the Government's Assault on Microsoft – and on Markets," *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., November 18, 1998.
[23] At this point, some Microsoft analysts actually projected that the firm's break-up value would be *greater* than its current value.
[24] "When Will the NASDAQ Hit a *Real* Bottom?" *Investor Alert*, InterMarket Forecasting, Inc., May 29, 2000.
[25] *Ibid*., p. 4. See also "The NASDAQ Plunge in Historical Context," *Investor Alert*, InterMarket Forecasting, Inc., December 15, 2000.
[26] See "It's a Bloody Good Time to Be Bullish," *Investor Alert*, InterMarket Forecasting, Inc., October 16, 2000. At this point the S&P 500 index was 1374, while the DJIA and NASDAQ were 10239 and 3290, respectively. Each index declined further, to lows on December 20th; but since then S&P 500 has risen by 5%, while the DJIA and NASDAQ have risen by 3.2% and 18%, respectively.
[27] "Portfolios are Being Gored - But Market Resilience Reflects Improving Fundamentals," *Investor Alert*, InterMarket Forecasting, Inc., November 13, 2000.
[28] *The InterMarket Forecaster*, InterMarket Forecasting, Inc., November 22, 2000, p. 4.

[29] "How Gore Might Bushwhack the GOP," *The Capitalist Advisor – Special Series: Campaign 2000*, InterMarket Forecasting, Inc., August 7, 2000.
[30] "Bush's Risky Campaign Scheme," *The Capitalist Advisor – Special Series: Campaign 2000*, InterMarket Forecasting, Inc., September 8, 2000.
[31] "It Looks Like a GOP Sweep - and That's Bullish," *The Capitalist Advisor – Special Series: Campaign 2000*, InterMarket Forecasting, Inc., November 4, 2000.
[32] "The GOP Mandate and the Bush Cabinet," *The Capitalist Advisor – Special Series: Transition 2000*, InterMarket Forecasting, Inc., December 8, 2000.

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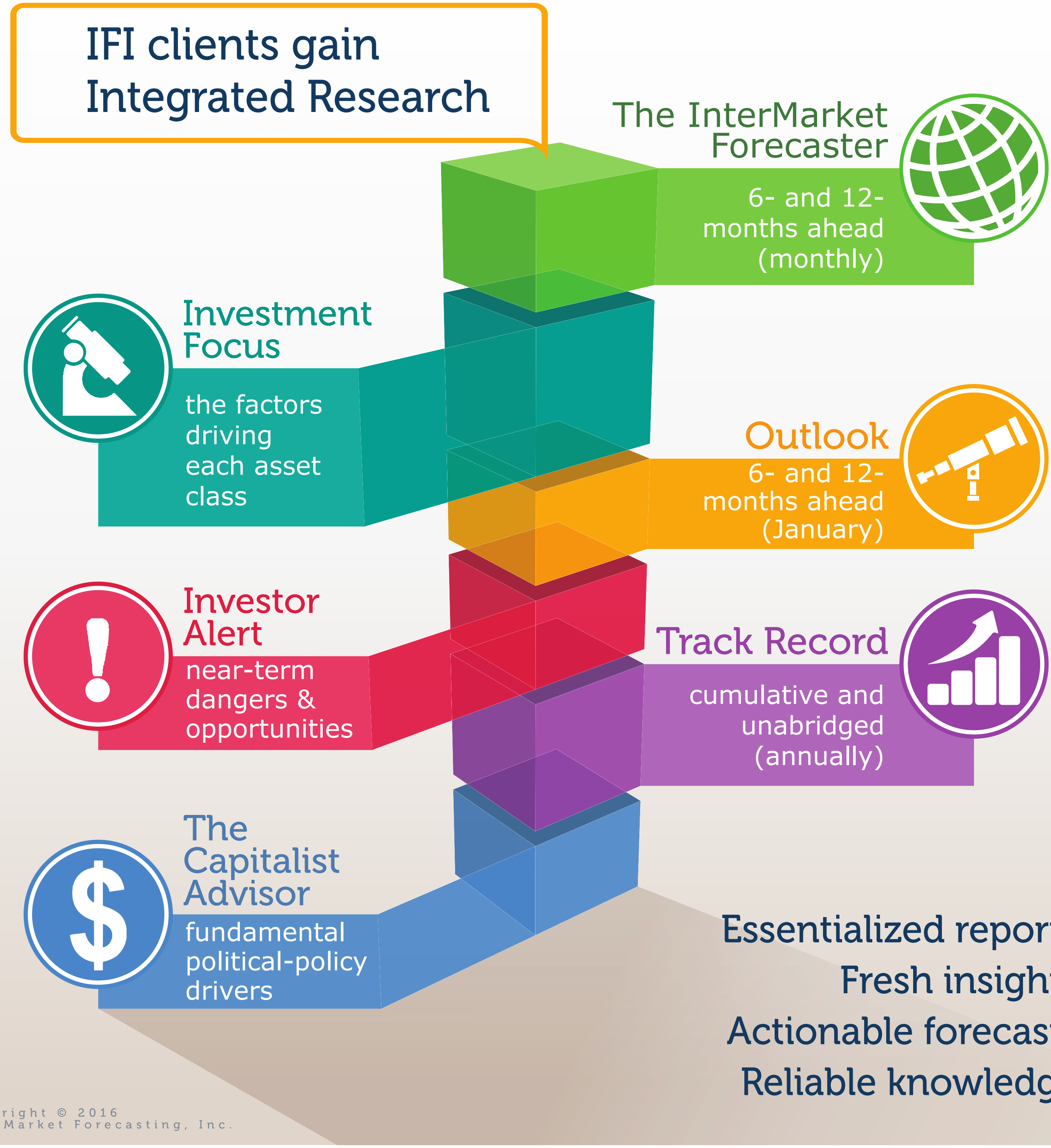

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Richard M. Salsman, Ph.D., CFA®

Richard Salsman is founder, president and chief market strategist. Prior to IFI he was senior economist at H.C. Wainwright Economics, Inc. (1993-1999) and from 1981 to 1992 a banker and capital markets specialist at the Bank of New York and Citibank. Mr. Salsman has authored numerous articles and is an expert in market history, economics, forecasting, and investment strategy. His work has appeared in the Wall Street Journal, Investor's Business Daily, Barron's, Forbes, National Post (Canada) and the Economist. In addition, he has authored three books—Gold and Liberty (1995), Breaking the Banks: Central Banking Problems and Free Banking Solutions (1990), The Political Economy of Public Debt: Three Centuries of Theory and Evidence (2017) —plus many chapters in edited books. Salsman speaks regularly at conferences, investment gatherings and universities. He earned his B.A. in Law and Economics from Bowdoin College (1981), his M.B.A. in Economics from the Stern School of Business at NYU (1988), and his Ph.D. from Duke University in Political Economy (2012). In 1993 he earned the designation of Chartered Financial Analyst (CFA) from the Association for Investment Management and Research.

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