

MID-YEAR MARKET COMMENTS

July 24, 2003

A “POST-BUBBLE” RECOVERY

We believe that the bear market is over and the recovery is under way. The question is: what kind of recovery? In the aftermath of one of the worst speculative bubbles in market history, we think investors will be facing something more challenging and difficult than a classic “V-shaped” recovery. Instead, we expect a “post-bubble” recovery – one that is volatile and drawn out over many years because a lot of time is required to digest the excesses built up during the bubble itself.

The current rally is typical of the first major move in a “post-bubble” recovery. When the first rally finally takes hold the stocks that are down the most tend to enjoy the biggest bounce, regardless of their fundamentals. **You can see in the Chart below how the lowest quality stocks --companies with no earnings-- have outperformed the stocks with earnings by 43% since the rally started last October.** If history is any guide, these more speculative stocks should be less of a factor as the “post-bubble” recovery plays out.

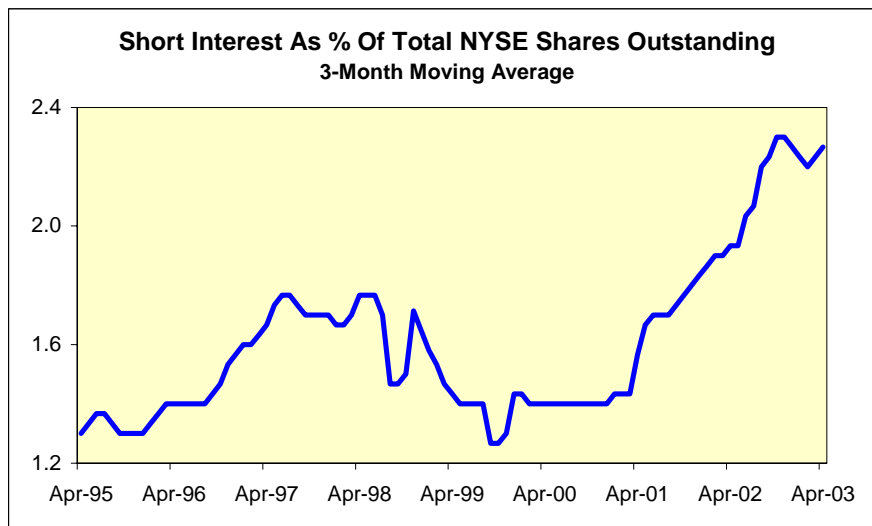


Source: FactSet. Published in 7/14/03 International Strategy & Investment *Portfolio Strategy Report*.

HEDGE FUNDS FUEL THE RALLY

The huge build-up of short selling by hedge funds has helped fuel the rally. Hedge funds have had explosive growth over the last five years because they have the ability to go short as well as long. Those funds that have shorted the most have performed the best and, as you might expect, have received the most new money. Accordingly, short selling, as seen in the Chart below, has been steadily rising in the rally and now is at its highest level in history. As a result, short covering should continue to be a market factor.

Short covering probably explains some of the performance of the S&P 500 (SPDR) and especially the NASDAQ 100 (QQQ) Indices, two of the most expensive areas of the market; because the hedge funds have been using these two indices as a convenient way to short the market.

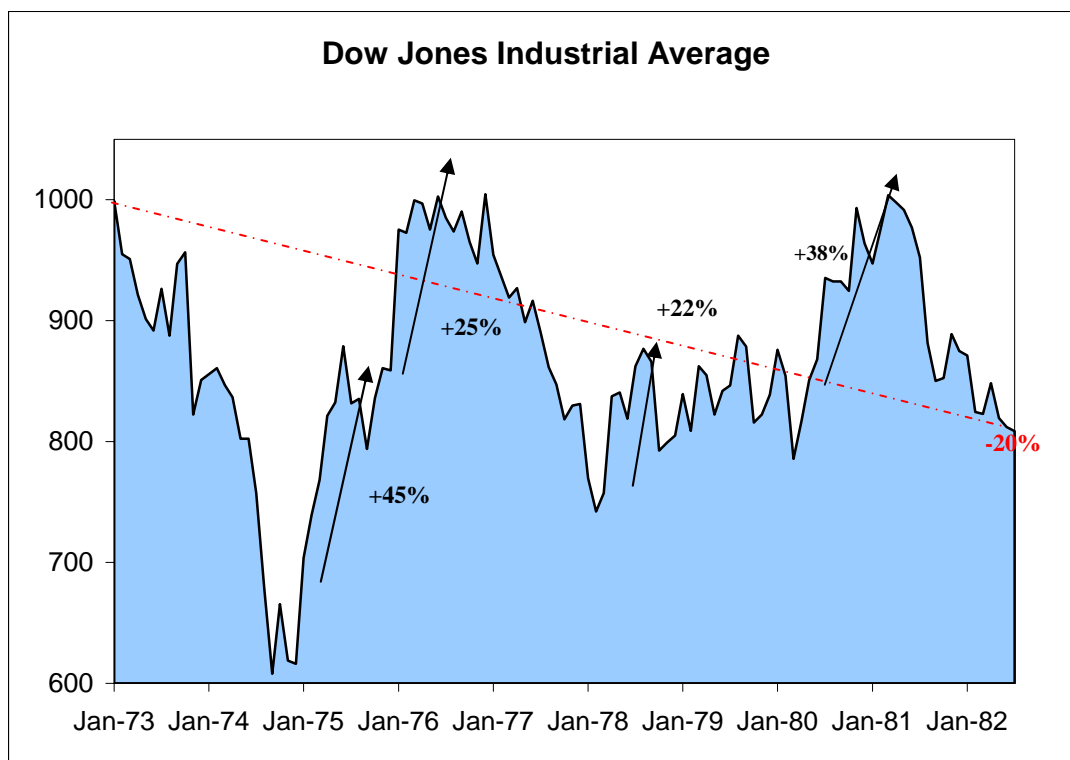


TWO KINDS OF MARKET RECOVERIES

We think it is important to be aware of how a “post-bubble” recovery differs from a “V-shaped” recovery. The “V-shaped” recovery is prone to only a minimal number of corrections and could last ten years or longer. The bull market recoveries after 1982 and 1990 are recent examples. On the other hand, the “post-bubble” recovery has a trajectory that is not at all v-shaped, but instead traces a pattern like the ups and downs of a roller coaster ride with wider than normal rallies and pullbacks.

In the last 100 years, there have been only two major U.S. stock market bubbles before the recent “high-tech” bubble. The first was the well-known bubble of the late 1920s and the second, the less well-known “Nifty-Fifty” bubble of the late 1960s and early 1970s. In both cases, the “post-bubble” recovery from the market lows was dramatic, but very erratic; also in both, it took a long time until earnings became reasonable relative to stock prices. There was a third equity bubble in Japan during the 1980s, with the Japanese still struggling with “post-bubble” consequences - more about Japan later.

How the “Nifty-Fifty” post-bubble period played out is the most compelling historical parallel to what we are seeing today. The Chart below covers the time from the peak of the bubble in January 1973 through July 1982.



You can see in the Chart that the Dow Jones Industrial Average (DJIA), a proxy for the “Nifty-Fifty,” had four rallies of more than 20 percent during this period. You can also see that the strongest of them was the first major rally off the bottom: a 40% move followed by a six-month period of consolidation and then another 20% advance. **Note that despite the four major rallies, the DJIA was still lower by 20% after nine and one-half years. Meanwhile, the low P/E value stocks [i.e., the bottom 20% of S&P 500 stocks on a P/E basis] went up 635% over the same period of time.**

IBM -- A POST-BUBBLE EXAMPLE

IBM was the leading technology stock of the “Nifty-Fifty” era. Its share price dropped 58% during the 1973-1974 recession. Then over the next two years, it rallied 50% from its lows. During the next six years, however, the stock gradually slipped back to a price just above its 1974 low. Over this time, IBM’s earnings climbed steadily, as the stock’s P/E multiple dropped from 35 times earnings in 1972 to 10 times earnings in 1981. Only then, after IBM became attractively priced on a valuation basis, did it finally experience a sustained upward move, some 400 % over the next five years.

RCA, the tech leader of the 1920s bubble, showed a similar price pattern -- a big initial bounce off its low, and then its price lagged for years even though its earnings were going up. A sustained move finally started when RCA’s price got down to 5 times earnings in 1941 some 12 years after its peak.

WHY JAPAN WILL NOT HAPPEN HERE

The “post-bubble” period in Japan has lasted 14 years so far, even though there have been four major rallies of 25-50% in the Japanese equities market. The question is could our country follow Japan into a deflationary spiral? We do not think so for one major reason: Unlike Japan, the United States encourages immigration even after 9/11. The flow of new immigrants has been a powerful, yet unacknowledged, factor driving American economic growth.

Immigrants want to come here for good reason. A recent study shows that legal immigrants into the United States have a 400% better chance of becoming millionaires than the native born.

Another reason the immigrants come is the way the American wealth ladder works. There is a common misperception among some politicians and media people that the rich are getting richer and the poor are getting poorer. But, in fact, something else is going on: individual Americans and families are moving both up and down the wealth ladder like no other place in the world.

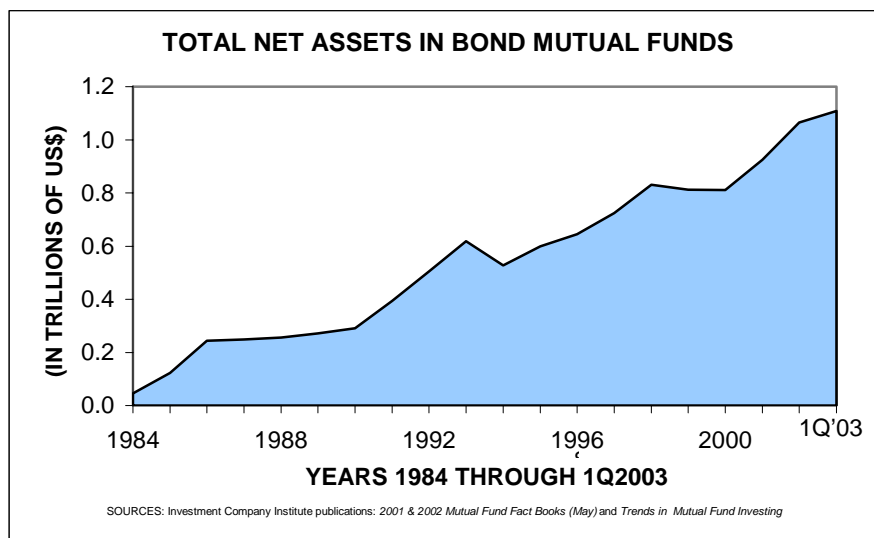
While some of the rich are getting richer, some are also getting poorer, even as some of the poor are growing richer. In short, as time passes, the rich are not always the same people and neither are the poor. A look at the *Forbes Magazine* list of the 400 richest people in the United States shows that most were born to families in the middle and lower rungs of the wealth ladder.

FOUR FACTORS DRIVING THE RECOVERY

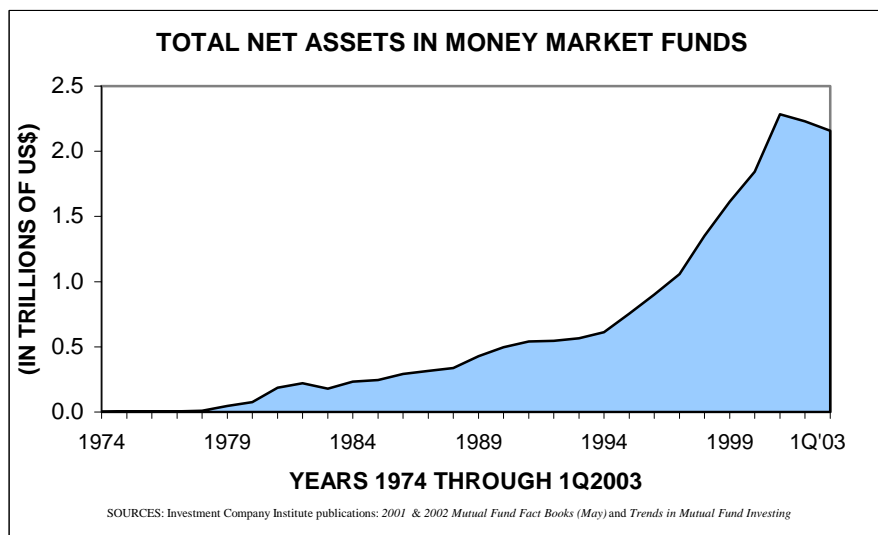
1.) MONEY ON THE SIDELINES

One of the main reasons for a recovery is the potential buying from the huge amount of money that has been built up in bond mutual funds and money market funds. A large accumulation of money on the sidelines has almost always coincided with a major stock market bottom, especially when yields on those funds were so low.

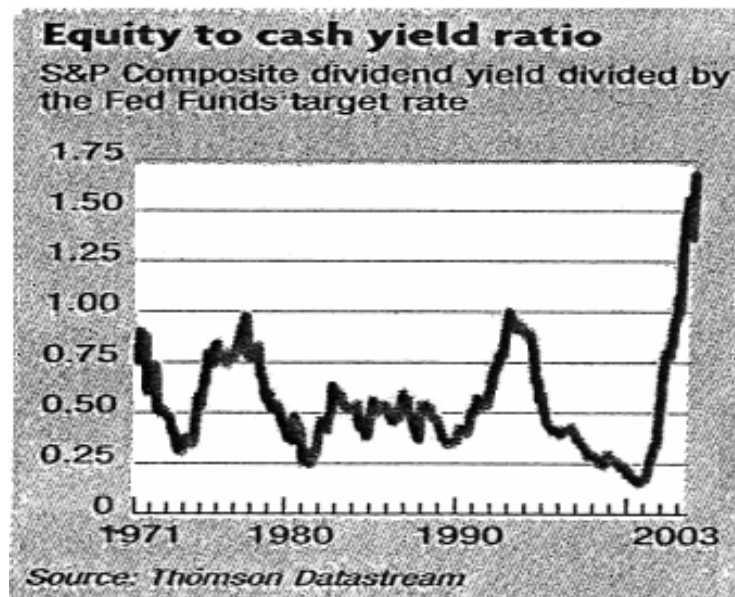
- a.) **Bond Mutual Funds.** The 1Q of 2003 may have marked a classic contrarian turning point in the market cycle, as investors witnessed one of the largest flows of money ever from equity mutual funds into bond mutual funds, even while yields dropped to one of the lowest levels in 40 years. The Chart below shows the build-up in bond funds.



- b.) **Money Market Funds.** The Chart below shows an equally dramatic build-up in money market funds.



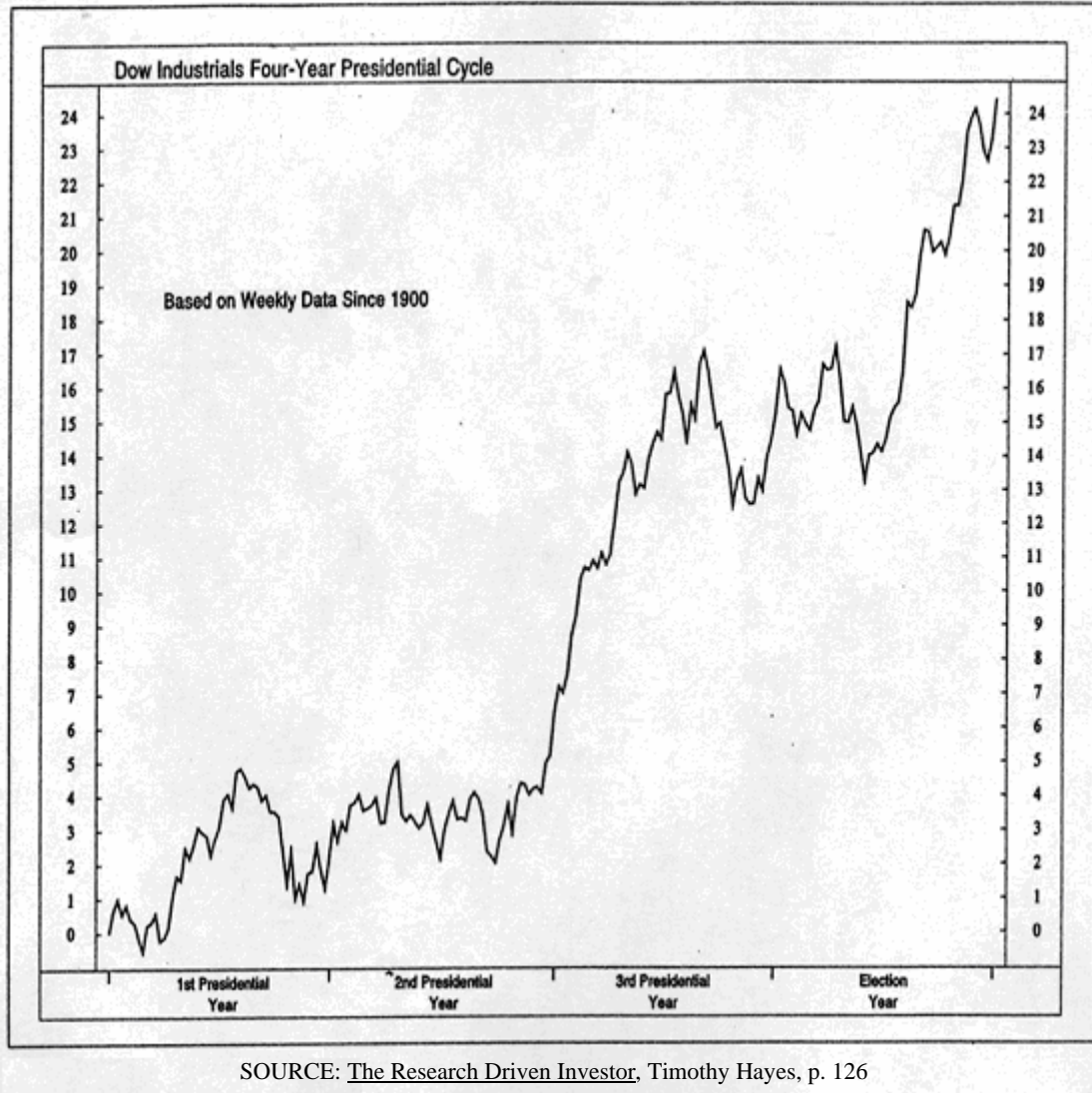
- c.) **Historic Low Returns on Bond and Money Market Funds.** Bond and money market fund assets are not only at their highest levels ever but their returns are at one of their lowest levels ever. Historically, such low returns on interest bearing assets have coincided with stock market lows. For example, when the dividend yield on the S&P 500 was greater than the federal funds rate in 1974 and in 1991, it marked a major bottom for the stock market. Right now, as you can see in the Chart below, the dividend yield for the S&P 500 is much higher than for those two periods.



2.) THE PRE-ELECTION YEAR KICKER

One of the strongest re-occurring phenomena of the stock market is the strength it shows during both the pre-election year [this year] and the election year that follows. As you can see from the Chart on the next page, the pre-election, or third year of the election cycle, is the dramatic up year of the four. **Taken together, the third and fourth years of the cycle have produced an astonishing 75% of all the market gains during the last 100 years.**

Unlike the fanciful “Super Bowl Theory” which has no logic behind it, the election-cycle phenomenon does. The third and fourth years of an administration show market gains because the incumbent White House does everything it can to spur the economy to get itself re-elected.



The election-cycle kicker may be especially relevant now because President George W. Bush does not want to have happen to him what happened to his father in 1992. The older Bush lost the election because he ignored the economy until it was too late. **The reason the third year is the best performing year is because most presidents know that they need to get started early in order to get the voting public's attention.**

In any case, the younger Bush blasted out of the gate in the first week of the 2003 pre-election year by dramatically shaking up his economic team – Paul O'Neill and Lawrence Lindsay were both replaced – and by proposing a bold new economic stimulus package that was recently signed into law. So, if Bush loses in 2004, you can be sure it will not be for lack of fiscal and monetary firepower.

3.) A SLOW GROWTH EARNINGS RECOVERY

In the long run, earnings are the most important driver of stock prices. During the bubble, corporations were doing everything they could to produce short-term earnings in order to justify their high stock prices. **For example, in 2002, the S&P 500 earnings would have been 41% lower if special charges for so-called one-time events had not been taken.** Also, the accounting for stock options and pensions has been used as a way to overstate earnings. **The gradual correction of accounting abuses, and its drag on earnings, is one reason why it takes a while for a “post-bubble” recovery to play out.**

Nevertheless, we are now starting to see the beginning of a gradual earnings recovery because companies are finally beginning to bear down hard on controlling costs and reducing debt. Some investors say that cost-cutting is not the ideal way to improve earnings, but cost-cutting early in the recovery tends to be the way most recoveries start.

4.) THE SMALL-CAP INDICATOR

Not well known but with a good track record as a market prognosticator is the small-cap indicator. Usually when the market drops, the small-cap stocks go down more than the average stock. But, if in a down year, the small cap stocks outperform the large cap stocks, the market is telling us something. In the last 75 years, there have been only 10 times when the small caps outperformed in a down year. As you can see in the Table below, in every case the market was much higher three to five years later.

Down Year	Large Caps	Small Caps	Subsequent Performance of the S&P 500		
			1 Yr	3 Yr	5 Yr
1932	-10.4	-2.2	53.9	100.1	99.1
1940	-7.4	-6.0	-11.6	34.6	90.7
1941	-10.0	-9.7	20.3	65.9	94.2
1966	-9.4	-7.5	23.9	26.5	44.8
1974	-27.6	-27.2	37.3	53.5	78.5
1977	-7.8	17.6	6.5	57.5	74.1
1981	-4.9	2.0	21.6	50.2	100.9
2000	-9.1	-3.0	-11.9	----	----
2001	-11.9	2.5	-23.4	----	----
2002	-22.1	-20.5	----	----	----
Average			+13.0	+55.5	+83.2

CONCLUSION

There are many good reasons to support a market recovery. However, this recovery probably will not be classically v-shaped, but rather a more gradual and drawn out “post-bubble” recovery. It most likely will present a challenge to investors as the excesses of the bubble slowly unwind. In such a market, value investing tends to have its best periods of relative and absolute performance.

Jim Cullen

Disclosure:

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