

January 5, 2003

## A Market With Plenty of Room to Grow

By KENNETH N. GILPIN

**A**FTER three years of stock market losses, investors are still staring at a mound of problems.

These include the uncertain outlook for the economy and corporate earnings, unsettled conditions in Iraq and North Korea, and the persistent problem of terrorism.

But James W. Paulsen, chief investment officer at Wells Capital Management in Minneapolis, has been loading up on stocks since July. Last week, he explained why he thinks 2003 is going to be a good year. Following are excerpts from the conversation.

Q. What is your outlook for the market?

A. I am optimistic. Generally, I don't remember another time, or at least not many, when there are as many clear and present risks as there are right now. That is all that is thought or written about. But I think the time of real risk was a couple of years ago, when nobody was talking about risk.

When perceived risk is high, I would argue actual risk is low. It is the high perceived risk right now that has changed the environment in a way that should make things better. It has caused the business sector to contract and investors to get overly bearish. If there is any change toward optimism, there is a lot of room for stocks to move higher.

Q. What is your take on the economy?

A. The thing that is different today than a year ago was that back then all we had was a relaxed monetary policy. We were still running a fiscal surplus, the dollar was rising in value and long-term bond yields were stubbornly high.

Now we have four easing policies, and as a result we will get a more normal recovery.

Q. Do you expect corporate profits to grow?

A. By spring, we should get a profits season that exceeds lowered expectations. Profits melted so badly in the last couple of years because of very high fixed costs as a percentage of total sales. That has been a huge negative. But it is now a positive, because if we get back to an expansion, any incremental demand will fall right to the bottom line.

The other part of the profit story is that we have had an abnormally irregular pricing world for corporations: it's called deflation. The fact that the dollar has fallen so much is a huge positive for the corporate sector. Without such stiff price competition, profits will do better.

Q. Is the market cheaply priced?

A. Absolutely not. But it shouldn't be at a time when we have short-term and long-term interest rates at 40-year lows, positive economic growth, record-setting productivity and low inflation.

Relative to gross domestic product, the market's capitalization is no longer at a record high. And prices-to-forward-earnings ratios are close to their historic averages.

But what people are missing here is that there has been an incredibly breathtaking revaluation of stocks relative to bonds. How often do investors get the chance to step in and buy stocks after a record cheapening relative to bonds?

Q. What advice do you have for investors?

A. I think exposure to international stocks should be lifted, because I think the dollar is in the early stages of a long-term period of weakening. I also still like large-cap stocks over small-cap stocks. They have the most to gain from economies of scale. And if we are going to return to optimism, investors will come back to large, recognizable names. I also think the road back to optimism has to go back through technology stocks, at least for a while. I think they will be the leaders. I also like industrial and basic-materials stocks, because of their cyclical nature and the fact that they have been hurt the most by a rising dollar.

And I like financials, for a variety of different reasons. If the economy returns to health, that should help creditworthiness. A return to a rising stock market should help investment banking and brokerages. And lending companies should benefit, because the yield curve will remain steep. The Fed will be reluctant to raise interest rates this year.

Q. What investments would you avoid?

A. I would underweight some of the more defensive areas, like consumer staples and health care stocks. And I don't like bonds. If you are going to be in bonds, overweight corporates and municipals.

Q. Are you expecting a good year for the markets?

A. It might be a really good year. But this is not the start of a fresh new bull market, but a cyclical rebound.

This is a lot like the 1970's. In December of 1970 you could have argued the market would go up 25 percent in a year but would be flat for 10 years. I would not be at all surprised that by the end of this year or in the middle of 2004, it might be time to go back to bonds.

We could go up 25 percent from here, and that would still only get us back to where we were nine months ago. But

it would feel great.