A Bubble Is A Bubble

By Ralph Weil

As most of you know, Clifford Associates has a long history that dates back to 1915. While none of the current principals were around at that time, many of us have a long history of managing investments and advising clients on their financial needs. Also, we have had the benefit of reviewing past records and comments from our predecessors. The point of this is that we learn by previous examples and personal experiences. These experiences and formal education help us to form our investment philosophy and expectations for the stock market.

In establishing our outlook for the next twelve months and longer, we review both current and historical data. We have been writing these quarterly comments to clients for many years. Usually, at year-end we incorporate our forecast for the coming twelve months. For a historical perspective, we would like to quote from a prior newsletter:

> *Have basic conditions so changed that the old standards of value are no longer applicable and must be either drastically revised or completely discarded? Is the United States – now a wealthy capitalistic nation – entering upon an era of such industrial prosperity, that Corporate Earning Capacities will mount in the geometric progression and within a reasonable time support the present high prices for Common Stocks?*
>
> *Or are we wandering from the straight and narrow path of financial virtue, and pursuing a dangerous course, resting upon false financial doctrines, which will ultimately lead to distress and disaster?*
>
> *The writer is inclined to the opinion that the present rise of Common Stocks has been carried to excessive levels and that the time will come when we will look back to this period as a wild orgy of speculation during which we lost our sense of financial equilibrium.*

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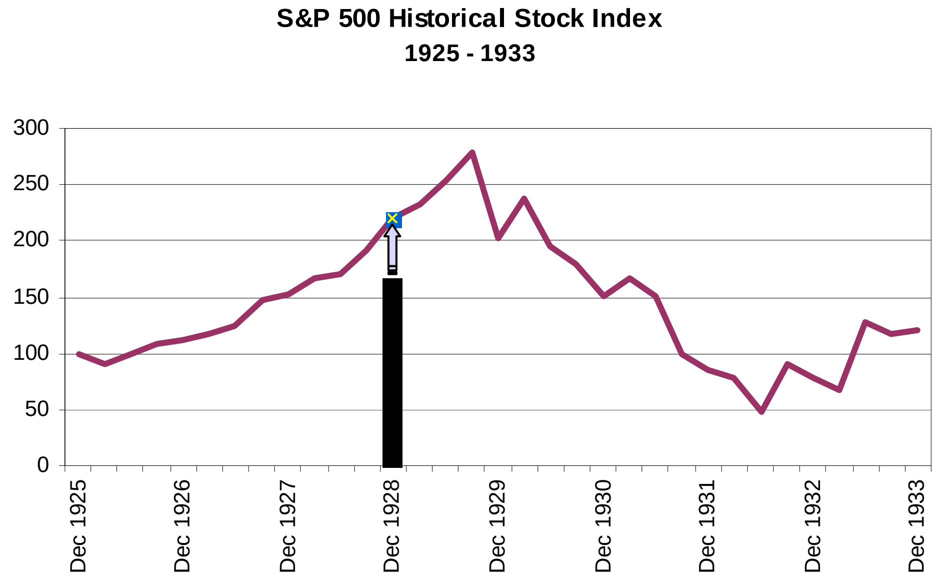

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Those comments could, most certainly, have come from one of our quarterly pieces in 1999, because as you remember, we were very cautious about the technology bubble at that time. In fact, those comments were written by A.M. Clifford in December of 1928. A bubble is a bubble is a bubble, and we have seen them before and our guess is we will see them in the future, most likely the distant future when a new crop of inexperienced professionals try to convince us that it is different this time around. The last big bubble prior to the 1999/2000 spectacle was in 1971/1972, which some of us witnessed first hand.

The cycles in the investment markets correspond with the major cycles in the economy. The extreme peaks in economic activity and the subsequent dismal troughs occur at the end of a long growth phase. At the peak, the equity market will also go to an excess which requires a long and painful correction. We believe we are now through the most painful part and the equity market is poised to move upward from here.

So what is the current condition of the economy? On the positive side, we see that real Gross Domestic Product (GDP) grew at a 4% rate in the third quarter of 2002, and grew an estimated 1½% rate in the fourth quarter. Productivity continues to improve, orders for durable goods are showing positive trends, and consumer sentiment is holding steady. Housing remains strong, interest rates are down, and inflation remains low. All is not positive, however. The employment picture looks fuzzy at best and businesses in general are still working through excessively high inventories. Because of over-spending on capital items by businesses in the latter part of the 90's there is still a great amount of excess capacity in certain industries. Both state and federal governments are running large deficits, as well. Overall, we feel that at this time the positives outweigh the negatives by a small margin.

Both the current environment and history suggest to us that the recovery in economic activity will continue at a slow pace and result in GDP growth in the range of 3% for at least the next couple of years. This translates into a more average growth rate in income and cashflow at the corporate level. Earnings increases over the next couple of years should be in the 8-9% range for most of corporate America.

In this environment, valuations play a very important role in estimating stock price movement in the future. Currently, the market overall, when measured by multiples of either earnings or cashflow, could be considered fairly valued. Price Earnings Multiples (P/E's) are in the range

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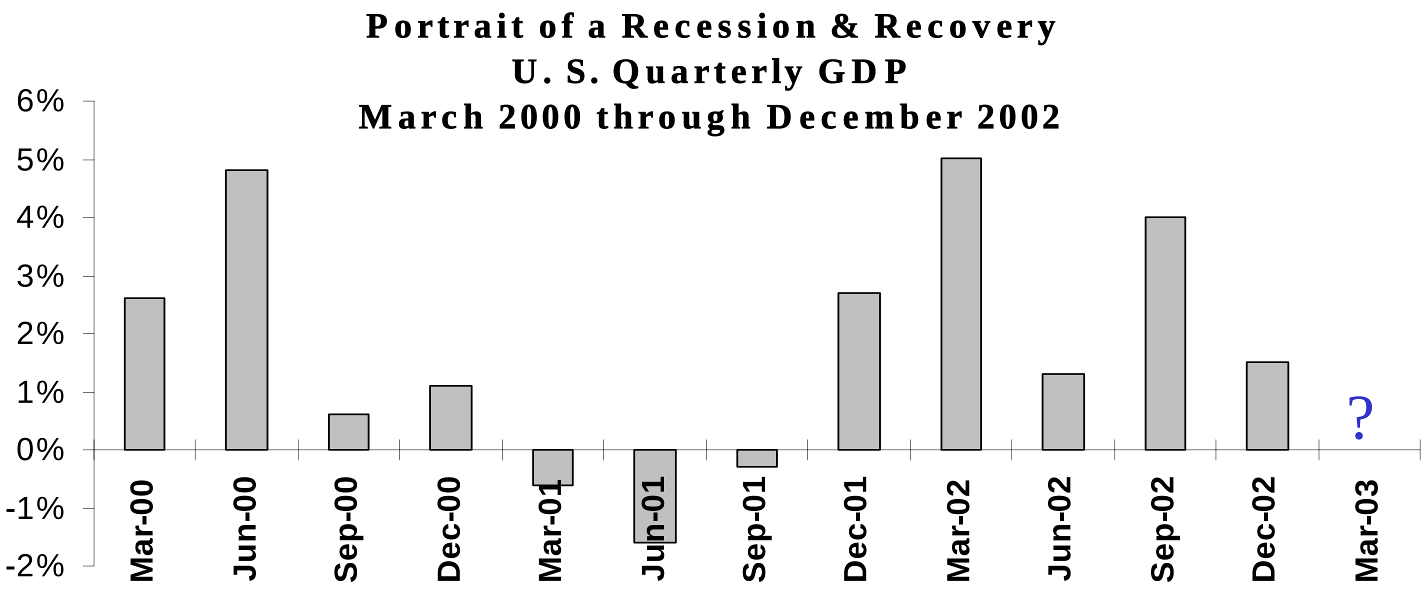

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of 15 to 16 times 2003 estimates. Historically, this is high for a market bottom, and would normally concern us were it not for the current low inflation and low interest rates.

Our outlook for the fixed income market is not strongly positive. Increasing economic activity generally results in rising inflation rates, which in turn causes higher interest rates. Given our belief that this recovery will be slow, inflation pressure should not return quickly and cause an early end to the recovery. Even with that said, we expect the bond market will likely turn negative some time this year with bond prices falling and yields rising. This means we will remain cautious with our bond investments and generally purchase short maturities in quality issues.

Our new equity purchases will reflect our long-held belief that companies we establish positions in should demonstrate an ability to control their own destinies, have demonstrated management success and commitment, exhibit increasing rates of profitability and offer attractive current and future valuations.

In summary, we believe the economy has bottomed and is in a slow growth recovery. The equity market has successfully tested its July lows and should move up from here and have a positive return for the full year. The fixed income markets will most likely have mildly negative returns this year, reflecting what we believe will be a rising interest rate environment.

Principals:

Maye Albanez, CFA

David Andrew

Peter Boyle, CFA

Ken Dike, Esq., CPA

Jim Fox

Terry Price

Ralph Weil, CFA

Bruce White

Randy Zaharia, CFA

Offices:

Pasadena,
California
(626) 792-2228

Huntington Beach,
California
(714) 846-2851

Evergreen,
Colorado
(720) 746-1244

Stimulus Proposal

By Jim Fox

The administration's tax change proposal has been presented and the usual political challenges are surfacing. As a result, what is enacted will likely be different from what has been presented. We are analyzing the components of the plan in an attempt to understand the investment implications of each element. While it is too soon to offer clients a detailed reaction, we do feel every item will have a generally favorable impact on the financial markets and therefore investors in stocks and bonds. In contrast to those who scream that this part or that part will not add to economic growth, we feel each part will contribute in some way to an improvement in the psychological atmosphere which may be as important as a direct economic benefit.

A Warm Reception For Clients

By Peter Boyle

For those of you who visited either our Huntington Beach or Pasadena offices last year, you realized 2002 was a year for remodeling. In Pasadena, after seven years of expansion in our current location, we were bursting at the seams and in need of a facelift. A similar facelift was sorely overdue for our Orange County office.

To close out the year and just before the holidays, we welcomed our clients to an open house not only to showcase our facilities, but to express our gratitude for their continued support.

As we commented during during the evening, many of our new clients are referred by existing clients. Over wonderfully prepared food we listened to comments by two of our partners on the basics of planned giving vehicles and Clifford's thoughts on the economy and markets in 2003, (Ralph Weil has summarized his comments in the lead article.)

We have received nothing but positive comments from those who were able to attend. For those of you who were not able to join us, please call us and make a point to visit our new offices in the coming year, and hopefully you can join us next time.