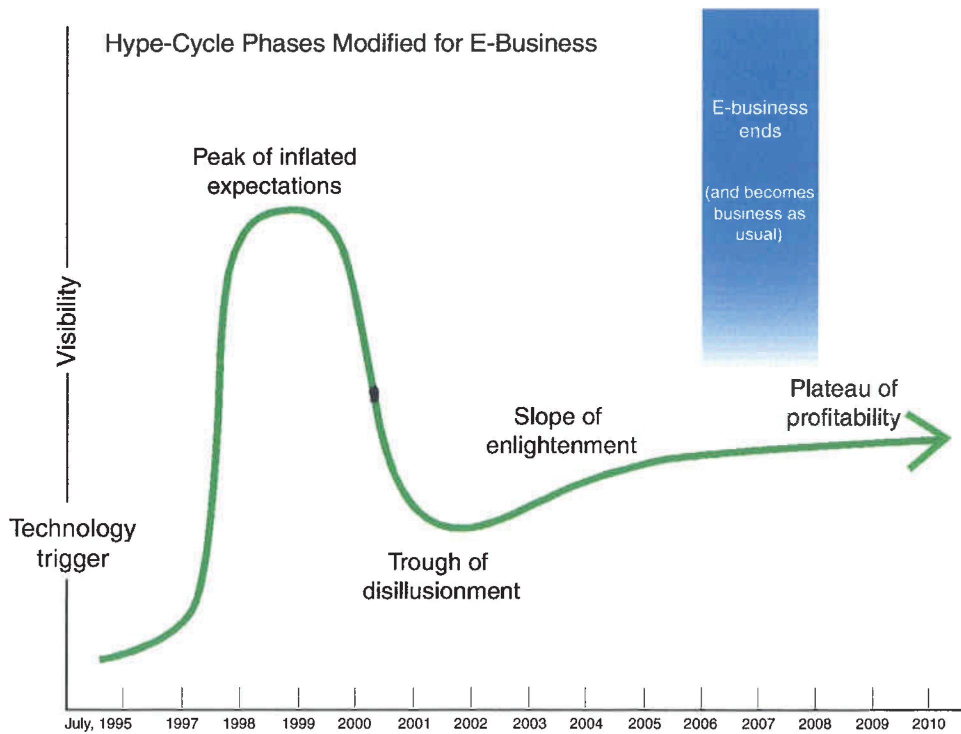
CUMBERLAND ADVISORS INC

AN UPDATE!

Is ~~Will~~ the NASDAQ sell off ~~become a~~ (crash?) over?

A Value Perspective
By David R. Kotok
June ~~April~~, 2000

Chart 1



SOURCE: GARTNER GROUP AND FORTUNE MAGAZINE (December 20, 1999)

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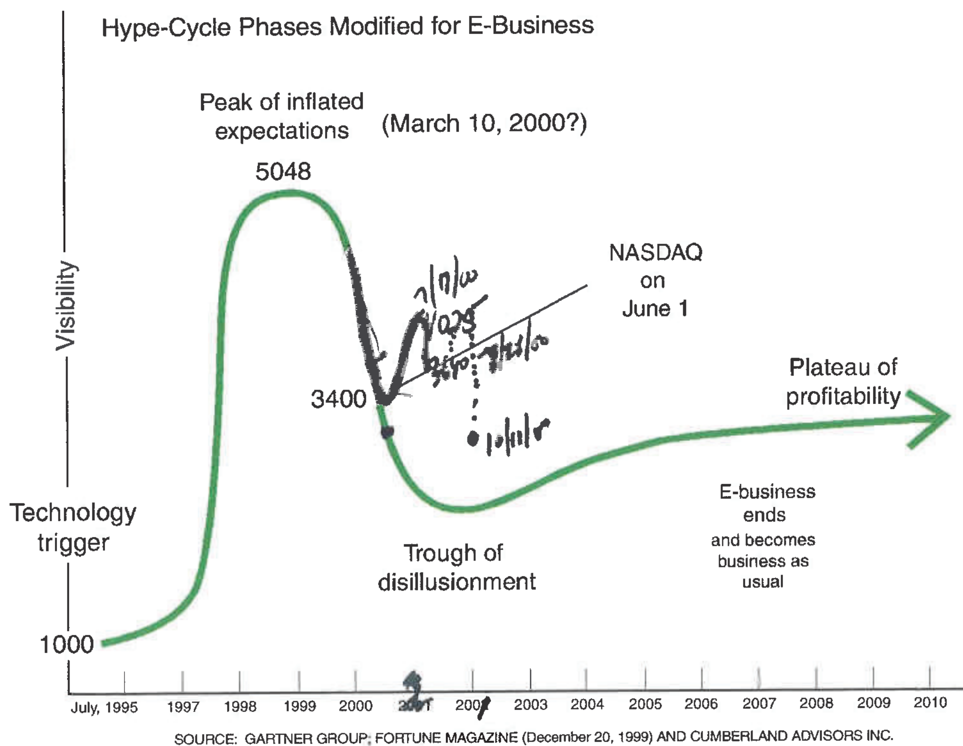
When we drafted the original NASDAQ 5000 crash essay in March, we selected the Gartner chart to depict the nature of The NASDAQ tech bubble and its aftermath.

CHART 1 was created by the Gartner Group and appeared in the December 20th issue of Fortune Magazine. Gartner suspects that "most of today's large E-Commerce projects won't finish on time or on budget and will under-deliver based on the hype that surrounds them." Gartner does not predict an end of E-business; rather, they believe that "E-business will ultimately become business as usual."

In March we speculated that the NASDAQ 5000 level represented the "peak of inflated expectations" projected by Gartner.

Assuming that NASDAQ 5000 was the "peak," let's project the next few years using the Gartner chart to demonstrate what things might look like.

Chart 2 - NASDAQ crash and aftermath?



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At the end of February the NASDAQ index stood at around 5000. The NASDAQ consisted of about 4800 stocks worth a combined market capitalization of about $6 trillion. Collectively, those stocks traded at 247 times this year's earnings estimates.* At that time, two stocks, Microsoft and Cisco, exceeded $1 trillion in market cap; those two were collectively over 100 times forward estimated earnings. At that point in time Cisco and Microsoft together brought DOWN the P/E of the NASDAQ.

By the end of May, the NASDAQ traded at 3400, a loss of 1/3 of its value. We estimate that it was still trading at a lofty price/earnings ratio of 175.* Cisco and Microsoft had declined in combined market value from $1 trillion to $700 billion. Combined trailing earnings on the two companies were 11.7 billion. The revised P/E was down from 100 to 60.

* Many NASDAQ issues are unprofitable and these companies are excluded from the P/E calculation.

WHAT HAPPENS NEXT?

Scenario 1

NASDAQ gets back to 5000 in ten years

We give the benefit of the doubt to the NASDAQ for this hypothetical valuation. At the end of May, the NASDAQ had a market capitalization of about $4 trillion. We'll ASSUME that it can grow profits at 17.5% per year for the next decade without interruption, without recession and without diminution of the growth rate. Those are lofty assumptions but we'll use them.

We'll also assume that in the year 2010 the NASDAQ will be accorded a P/E of double its growth rate. In other words, we'll price the NASDAQ ten years from now at 35 times its then earnings and we'll compound today's earnings for the entire 10 years at 17.5% growth. That means the NASDAQ $34 billion net income today will be $170 billion then. Multiply those earnings times a 35 P/E and we derive about $6 trillion in market value. This means the NASDAQ would be priced at about 5000 ten years from now.

The numbers speak for themselves. These are based on very optimistic assumptions. Are we saying that the NASDAQ is going down to 2000? Maybe. Are we saying that the NASDAQ will be 2500 in ten years? Maybe. Or 5000? Maybe. We have no idea how the stock market will value NASDAQ companies or what P/E will work on the future earnings of those 4800 companies.

BUT!

We do know that all securities represent an exchange of present dollars for future dollars. And we know that the future dollars have to be earned.

Scenario 2

NASDAQ matches The Low Risk Alternative

Suppose you manage a pension plan with a ten-year time horizon. Your decision today is to chose either (1) a "AAA" ten year bond strip or (2) the NASDAQ. In March, we used the "AAA" ten year bond interest rate to derive the discount percentage. Then it was 7.2%.

Now rates are higher; therefore, we are using 8% to reflect a market driven discounting mechanism. The results are below. We take the NASDAQ today and calculate what is needed to reach the "AAA" bond.

In ten years the NASDAQ will have to reach $8.6 trillion just to match the low risk threshold.

We applied our value method to the NASDAQ to derive a $8.6 trillion market cap in ten years. Those 4800 companies would have to grow their collective earnings by 20%, compounded each and every year, to obtain $210 billion in earnings. At 40 times earnings in 2010, a $8.6 trillion NASDAQ would equal the low risk alternative.

	P/E In 2010	10 Year Compound Earnings Growth Rate	NASDAQ index Value in 2010
Scenario 1 NASDAQ gets back to 5000 in ten years	35	17.5%	5000
Scenario 2 NASDAQ matches the low risk alternative	40	20%	7300

Our conclusion: the NASDAQ correction is not over. Lower NASDAQ stock prices are needed to restore reason to these still extreme valuations.

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