

WARREN BUFFETT DISCUSSES THE EFFECTS OF INTEREST RATES ON STOCK PRICES

The last time I tackled this subject, in 1999, I broke down the previous 34 years into two 17-year periods, which in the sense of lean years and fat were astonishingly symmetrical. Here's the first period. As you can see, over 17 years the Dow gained exactly one-tenth of one percent.

Case 1: ① →

- DOW JONES INDUSTRIAL AVERAGE
- Dec. 31, 1964: 874.12
- Dec. 31, 1981: 875.00

1 point in 17 years!!

And here's the second, marked by an incredible bull market that, as I laid out my thoughts, was about to end (though I didn't know that).

Case 2: ② →

- DOW INDUSTRIALS
- Dec. 31, 1981: 875.00
- Dec. 31, 1998: 9181.43

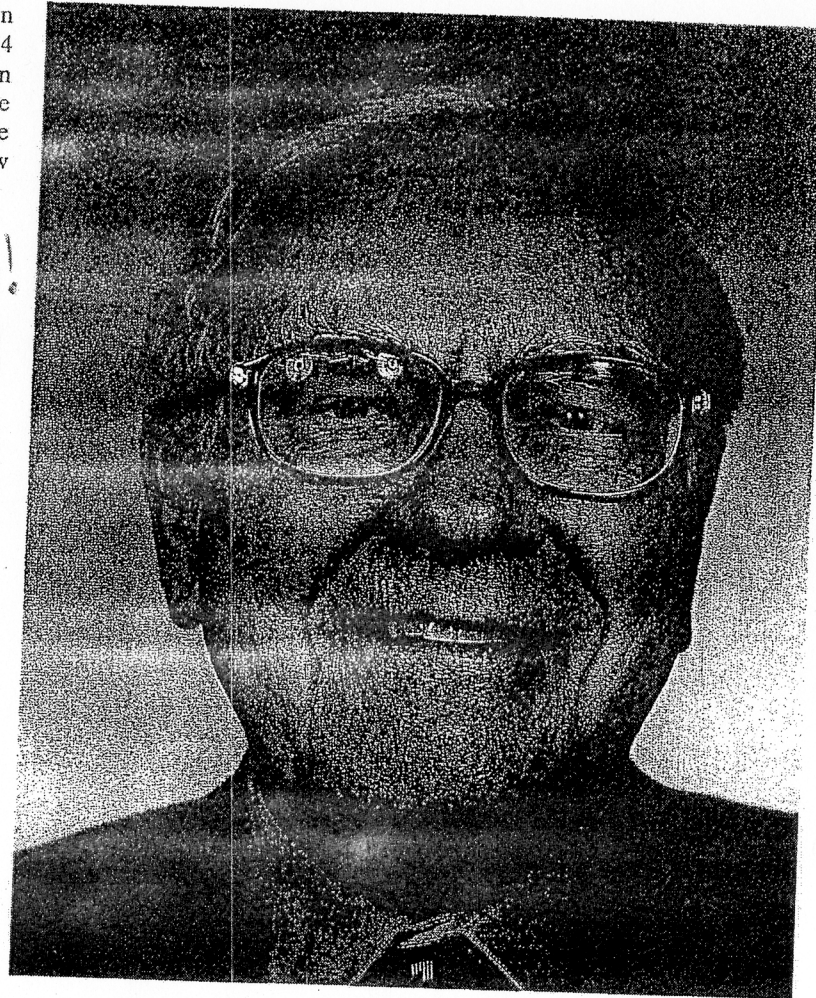
SkYROCKETS next 17!!

Now, you couldn't explain this remarkable divergence in markets by, say, differences in the growth of gross national product. In the first period—that dismal time for the market—GNP actually grew more than twice as fast as it did in the second period.

- GAIN IN GROSS NATIONAL PRODUCT
- 1964-1981: 373%
- 1981-1988: 177%

So what was the explanation? I concluded that the market's contrasting moves were caused by extraordinary changes in two critical economic variables—and by a related psychological force that eventually came into play.

Here I need to remind you about the definition of "investing," which though simple is often forgotten. Investing is buying...



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The impact of Rising vs. falling Interest rates

Here I need to remind you about the definition of "investing," which though simple is often forgotten. Investing is laying out money today to receive more money tomorrow.

That gets to the first of the economic variables that affected stock prices in the two periods—interest rates. In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world, the tiniest change in rates changes the value of every financial asset. You see that clearly with the fluctuating prices of bonds. But the rule applies as well to farmland, oil reserves, stocks, and every other financial asset. And the effects can be huge on values. If interest rates are, say, 13%, the present value of a dollar that you're going to receive in the future from an investment is not nearly as high as the present value of a dollar if rates are 4%.

So here's the record on interest rates at key dates in our 34-year span. They moved dramatically up—that was bad for investors—in the first half of that period and dramatically down—a boon for investors—in the second half.

• INTEREST RATES, LONG-TERM GOVERNMENT BONDS

Dec. 31, 1964: 4.20% > ①
Dec. 31, 1981: 13.65% > ②
Dec. 31, 1998: 5.09%

The other critical variable here is how many dollars investors expected to get from the companies in which they invested. During the first period expectations fell significantly because corporate profits weren't looking good. By the early 1980s Fed Chairman Paul Volcker's economic sledgehammer had, in fact, driven corpo-

rate profitability to a level that people hadn't seen since the 1930s.

The upshot is that investors lost their confidence in the American economy: They were looking at a future they believed would be plagued by two negatives. First, they didn't see much good coming in the way of corporate profits. Second, the sky-high interest rates prevailing caused them to discount those meager profits further. These two factors, working together, caused stagnation in the stock market from 1964 to 1981, even though those years featured huge improvements in GNP. The business of the country grew while investors' valuation of that business shrank!

And then the reversal of those factors created a period during which much lower GNP gains were accompanied by a bonanza for the market. First, you got a major increase in the rate of profitability. Second, you got an enormous drop in interest rates, which made a dollar of future profit that much more valuable. Both phenomena were real and powerful fuels for a major bull market. And in time the psychological factor I mentioned was added to the equation: Speculative trading exploded, simply because of the market action that people had seen. Later, we'll look at the pathology of this dangerous and oft-recurring malady.

Two years ago I believed the favorable fundamental trends had largely run their course. For the market to go dramatically up from where it was then would have required long-term interest rates to drop much further (which is always possible) or for there to be a major improvement in corporate profitability (which seemed, at the time, considerably less possible). If you take a look at a 50-year chart of after-tax profits as a percent of gross domestic product, you

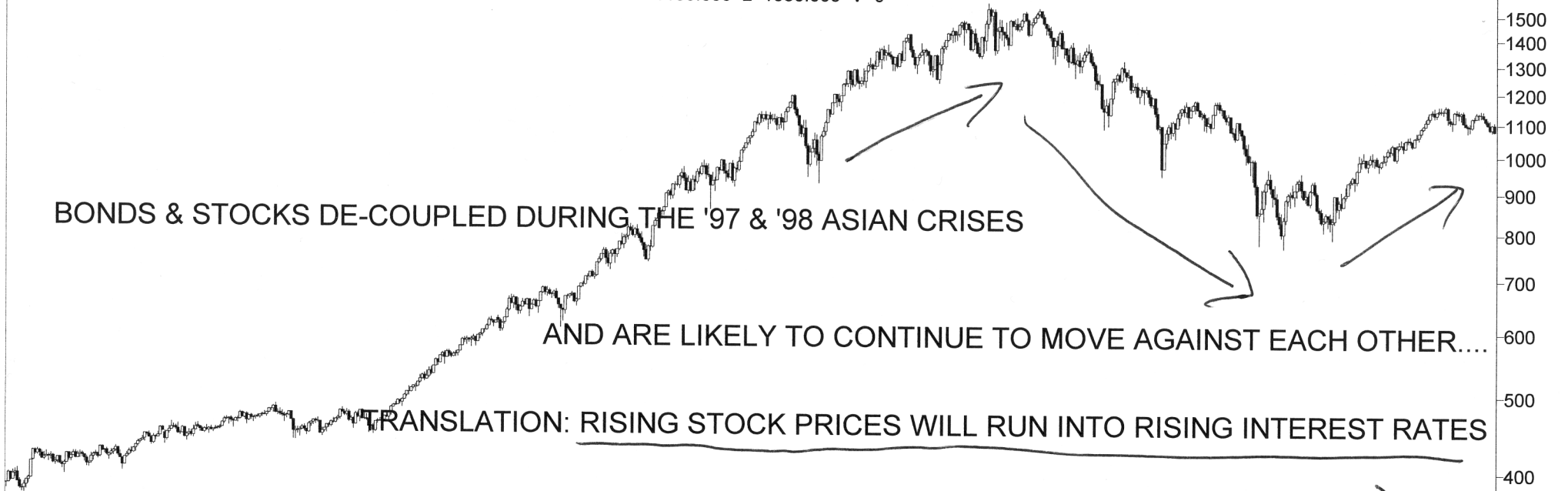
1987

10/11/1991

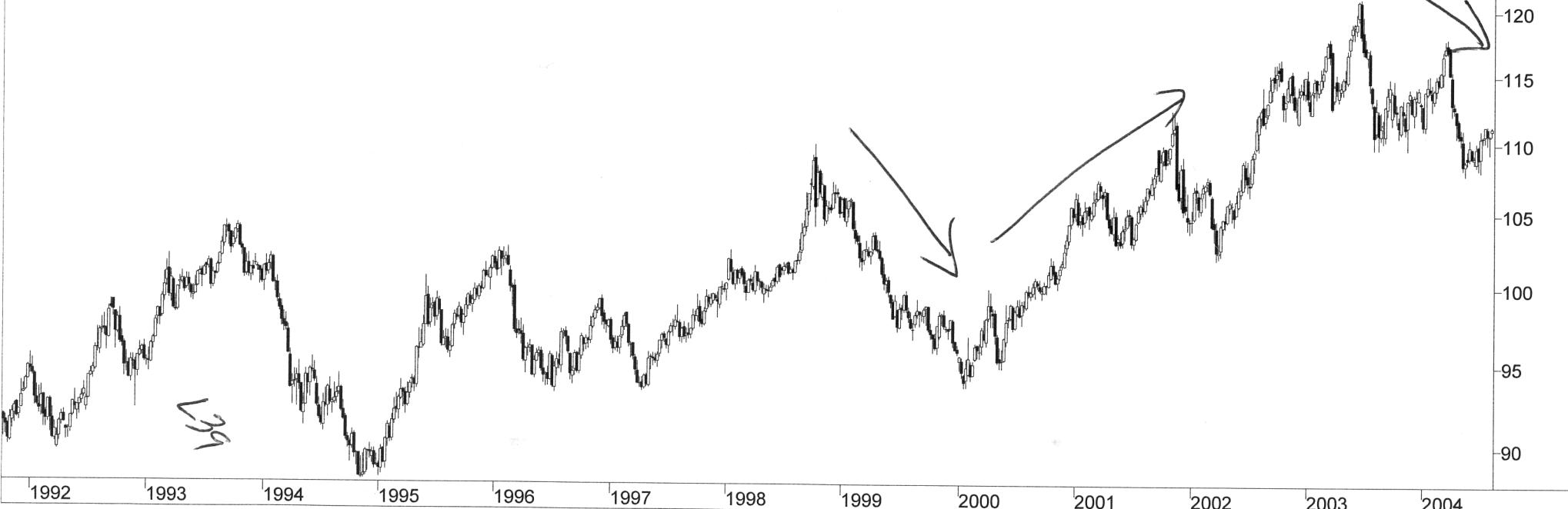
(*SPX) S & P 500 Index

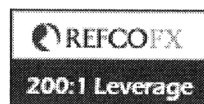
08/06/2004

S & P 500 Index-Weekly 08/06/2004 C=1080.700 -21.000 O=1101.700 H=1108.600 L=1080.000 V=0



US 10 Yr T-Note-Weekly 08/06/2004 C=111.250 +.531 O=111.063 H=111.375 L=110.719 V=19038





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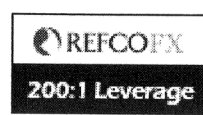
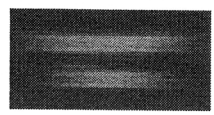
Select Symbol:

Symbol	Contract	Month	Time	Last	Real-Time Quotes		Open	Custom Quotes	
					Chg			High	Low
FVU04 [10]	Treasury Note 5 Yr	Sep '04	16:08:39	110'31.5s	1'04.0		109'29.0	111'12.0	109'28.0
USU04 [10]	US Treasury Bond	Sep '04	16:09:07	110'27s	1'27		109'01	112'00	109'01
MBU04 [10]	Municipal Bonds	Sep '04	16:10:27	103'04	1'06		102'03	103'30	102'02
TYU04 [10]	Treasury Note 10 Yr	Sep '04	16:07:10	112'23.0s	1'15.5		111'08.5	113'10.5	111'08.5
EDQ04 [10]	Eurodollar 3 Month	Aug '04	16:12:26	98.285s	0.055		98.240	98.345	98.230
LEIQ04 [15]	Euribor 3 Month	Aug '04	17:48:59	97.890s	0.005		97.885	97.890	97.880
LGLU04 [15]	Gilt - Long	Sep '04	17:59:50	107.19	0.57		106.75	107.54	106.55
LSSQ04 [15]	Short Sterling	Aug '04	16:18:48	95.060s	0.030			95.060	95.060
DGBU04 [15]	BUND	Sep '04	19:08:19	115.58s	0.72		114.90	115.78	114.80
DSBU04 [15]	Schatz	Sep '04	19:10:11	106.190s	0.170		106.040	106.350	105.995
AYBU04 [10]	Treasury Bond 3 yr (Day)	Sep '04	16:39:37	94.58s	0.03		94.55	94.59	94.54
AXBU04 [10]	Treasury Bond 10 yr (Day)	Sep '04	16:39:18	94.345s	0.030		94.325	94.360	94.315
TBXU04	US Treasury Bond	Sep '04	16:00:00	110'27.5s	1'27.0		109'05.0	111'17.0	109'05.0
TNLU04	Treasury Note 10 Yr	Sep '04	16:00:00	112'23.0s	1'15.5		111'11.0	113'05.5	111'11.0
TNMU04	Treasury Note 5 Yr	Sep '04	16:00:00	110'31.5s	1'04.0		109'31.0	111'11.5	109'29.0
TNSU04	Treasury Note 2 Yr	Sep '04	16:00:00	106'06.2s	0'16.5		105'22.7	106'10.0	105'22.7

Delayed data retrieved on Aug 06 21:52:43 GMT • All quotes are in exchange local time • Data provided by FutureSource
 s - Settlement Price y - Yesterday's Settlement Price e - Estimated

HUGE BOND + NOTE GAINS AFTER 8-6-04 jobs report.

A perception of weaker economy, less demand for credit + less pressure on interest rates.



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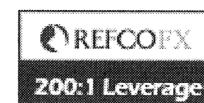
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	Symbol	Contract	Month	Time	Last	Chg	Open	High	Low
	SPU04 [10]	S&P 500	Sep '04	16:15:32	1063.60s	-14.90	1078.60	1083.00	1061.00
	ESU04 [10]	E-Mini S&P 500	Sep '04	16:18:21	1063.50s	-15.00	1078.75	1083.00	1060.75
	NQU04 [10]	Nasdaq 100	Sep '04	16:13:27	1317.50s	-36.50	1353.50	1360.00	1315.00
	ENU04 [10]	E-Mini Nasdaq 100	Sep '04	16:19:03	1317.50s	-36.50	1353.00	1360.50	1315.50
	DJU04	Dow Jones Indus.(Day)-\$10	Sep '04	15:40:13	9800s	-133	9960	9965	9776
	EYMU04	Mini Dow Jones Indus.-\$5	Sep '04	16:01:05	9800s	-133	9935	9970	9775
	YUU04 [30]	NYSE Composite-Revised	Sep '04	16:16:10	6215.00s	-60.00	6238.00	6238.00	6215.00
	CRQ04 [30]	Reuters CRB Index	Aug '04	14:40:30	268.25s	-0.75	269.50	269.50	267.75
	LFTU04 [15]	FTSE 100	Sep '04	17:29:59	4337.0s	-71.0	4372.5	4394.5	4329.5
	DAXU04 [15]	DAX	Sep '04	20:07:51	3724.00s	-95.00	3780.00	3796.00	3720.00
	GMCTQ04 [15]	CAC 40	Aug '04	19:59:57	3534.50s	-95.00	3594.50	3599.50	3517.50
	HHAQ04 [30]	Hang Seng	Aug '04	21:10:40	12513s	38	12425	12525	12372
	APIU04 [10]	SPI 200 (Day)	Sep '04	16:36:06	3514.0s	-24.0	3512.0	3520.0	3506.0
	SNIQ04 [15]	Nikkei 225 (Day)	Aug '04	14:27:03	11010s	-65	11010	11010	11010
	STWQ04 [15]	MSCI Taiwan Stock (Day)	Aug '04	13:47:29	227.30s	-1.40	228.00	229.50	225.40
	VIXQ04 [15]	S&P 500 Volatility	Aug '04	15:47:53	183.7s	7.6	181.1	186.2	180.6

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*STOCKS
MOVE DOWN,
INVERSELY
TO BONDS
ON JOBS
REPORT*

*Perception of weaker economics, less spending,
& thus pressure on corporate earnings.*



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Symbol	Contract	Month	Time	Last	Chg	Open	High	Low
ADU04 [10]	Australian Dollar	Sep '04	16:11:49	0.7110s	0.0094	0.7002	0.7134	0.6992
BPU04 [10]	British Pound	Sep '04	16:13:26	1.8351s	0.0162	1.8181	1.8430	1.8147
CDU04 [10]	Canadian Dollar	Sep '04	16:11:51	0.7616s	0.0031	0.7582	0.7645	0.7555
ECU04 [10]	Euro	Sep '04	16:12:24	1.22690s	0.02130	1.20500	1.22840	1.20370
JYU04 [10]	Japanese Yen	Sep '04	16:13:14	0.9068s	0.0100	0.8968	0.9125	0.8951
SFU04 [10]	Swiss Franc	Sep '04	16:15:30	0.8000s	0.0150	0.7853	0.8014	0.7837
BRU04 [10]	Brazilian Real	Sep '04	16:11:50	0.32630s	0.00350		0.32630	0.32630
MEQ04 [10]	Mexican Peso	Aug '04	16:13:24	0.087725s	0.000200		0.087725	0.087725
DXU04 [30]	US Dollar	Sep '04	15:02:55	88.46s	-1.32	89.88	89.89	88.37
ADJYY [20]	Aust. Dollar / Jap. Yen	Index	22:31:55	78.93	0.09	78.84	78.93	78.83
ADUSY [20]	Aust. Dollar / US Dollar	Index	22:31:55	0.7136	-0.0001	0.7137	0.7137	0.7136
BPJYY [20]	British Pound / Jap. Yen	Index	22:31:55	203.47	-0.02	203.36	203.47	203.36
BPUSY [20]	British Pound / US Dollar	Index	22:31:55	1.8401	-0.0016	1.8416	1.8416	1.8401
EUBPY [20]	Euro / British Pound	Index	22:31:55	0.6674	0.0007	0.6671	0.6674	0.6671
EUJYY [20]	Euro / Japanese Yen	Index	22:31:55	135.70	0.05	135.68	135.74	135.66
EUSFY [20]	Euro / Swiss Franc	Index	22:31:55	1.5360	0.0004	1.5350	1.5366	1.5350
EUUSY [20]	Euro / US Dollar	Index	22:31:55	1.2283	0.0001	1.2282	1.2283	1.2279
SFJYY [20]	Swiss Franc / Jap. Yen	Index	22:31:55	88.36	0.02	88.36	88.42	88.34
USCDY [20]	US Dollar / Can. Dollar	Index	22:31:55	1.3131	0.0011	1.3133	1.3133	1.3131
USJYY [20]	US Dollar / Jap. Yen	Index	22:31:55	110.52	0.04	110.48	110.52	110.47
USSFY [20]	US Dollar / Swiss Franc	Index	22:31:55	1.2512	0.0006	1.2502	1.2512	1.2502

U.S. Dollar cracks on

8-6-04

after weak

U.S. jobs report,

... increasing the likelihood of a re-test of DX lows

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Going Global / By Michael R. Sesit

Why U.K. Market Is So Dreary

Regulators Press Insurers, Pension Funds to Shift Out of Stocks

INVESTORS AROUND the world who are smarting from lackluster stock markets might look at Britain if they want to feel a bit better.

The British market has been buffeted like everyone else by rising interest rates, doubts about world growth, geopolitical uncertainty and fears that the corporate earnings recovery is peaking. But unlike the rest of the world, the London market is also cursed with its own special agony: massive selling by domestic pension funds and life-insurance companies. Furthermore, investment strategists don't see the dumping letting up soon.

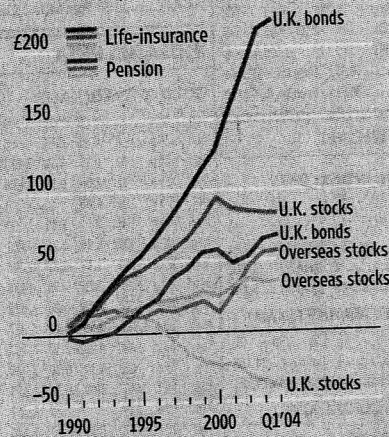
This is no minor matter. The U.K. stock market is home to many well-known international companies, and it is the foreign market most favored by U.S. investors. At year end 2002, Americans owned \$299.2 billion of British shares, according to the most recent data compiled by the Securities Industry Association. That was more than double what they invested in any other foreign market and represented 22% of their total holdings of non-U.S. stocks.

British life insurers have traditionally had a voracious appetite for U.K. stocks: They were net purchasers year after year for more than a decade. That is, until 2001, when they turned into sellers as inflows into life-insurance funds declined and stock markets fell. For each of the past three years and the first quarter of 2004, life insurers have been net sellers of U.K. shares, dumping a net £11.9 billion (\$22.03 billion), according to Citigroup. During that period, they pur-

Paris

Not in Stock

British life-insurance funds and pension funds are moving their investments. Below, cumulative net change in fund purchases, in billions of pounds (£1=\$1.8401).



Sources: U.K. National Statistics; Citigroup

chased a net £91.2 billion of U.K. bonds and—while unloading U.K. shares—gobbled up £10.6 billion of non-U.K. equities.

Meanwhile, since the start of 2002, U.K. pension funds have sold a net £16.1 billion of British stock. Like their life brethren, they also have been buying U.K. bonds and overseas equities.

The backdrop for the massive selling is pressure from regulators seeking to bolster domestic insurers' capital bases. Specifically, new rules mandate that assets

and liabilities be annually "marked to market" to reflect their true worth. So, rather than show swings on an annual basis from the stock market's roller coaster of the past several years, many companies reduced their stock holdings and went into safer and more-predictable bonds.

On the pension-fund side, regulators and actuaries are also pressing for more accurate accounting of pension funds' fair value and a more transparent disclosure of companies' defined-benefit pension plans—plans that guarantee retirees a certain amount of money. Many of these plans became severely underfunded with the collapse in share prices in 2000.

In the past few years, such plans have become rarer, because they are expensive for companies to maintain and many are closed to new employees. That puts additional pressure on fund managers to match their assets and liabilities as payouts approach for older workers and continue for retirees. Holding bonds rather than stocks makes that process more predictable.

With defined-benefit plans maturing in the U.K., "there's pressure from actuaries to reduce the equity portion and make sure [plan sponsors] aren't faced with an asset class falling before their eyes," says Darren Brooks, a European equity strategist at Citigroup in London.

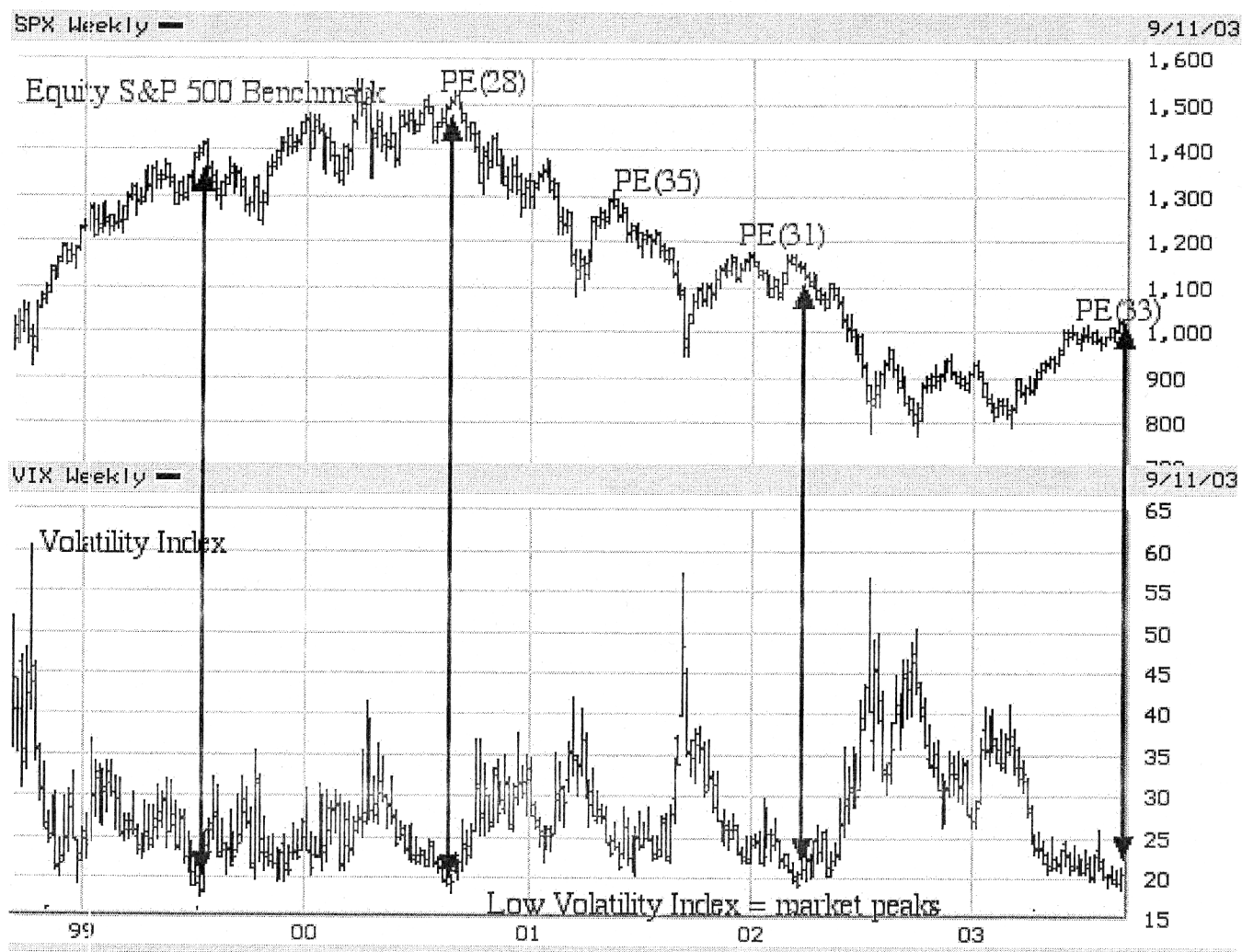
From the start of 2003 through Tuesday, the benchmark U.K. FTSE-100 stock index is up 10%. That compares with Japan's 31% rally, the German market's 28% climb, Hong Kong's 32% advance and Canada's 28% rise, according to Morgan Stanley Capital International. During the same period, the Dow Jones Industrial Average rose 22%.

PORTFOLIO ALLOCATION PERCENTAGES
ARE SHIFTING... REDUCING STOCKS.

L43

FUTURE MARKET RALLIES WILL STRUGGLE WITH:

- 1) Rising interest rates
- 2) High P/E's

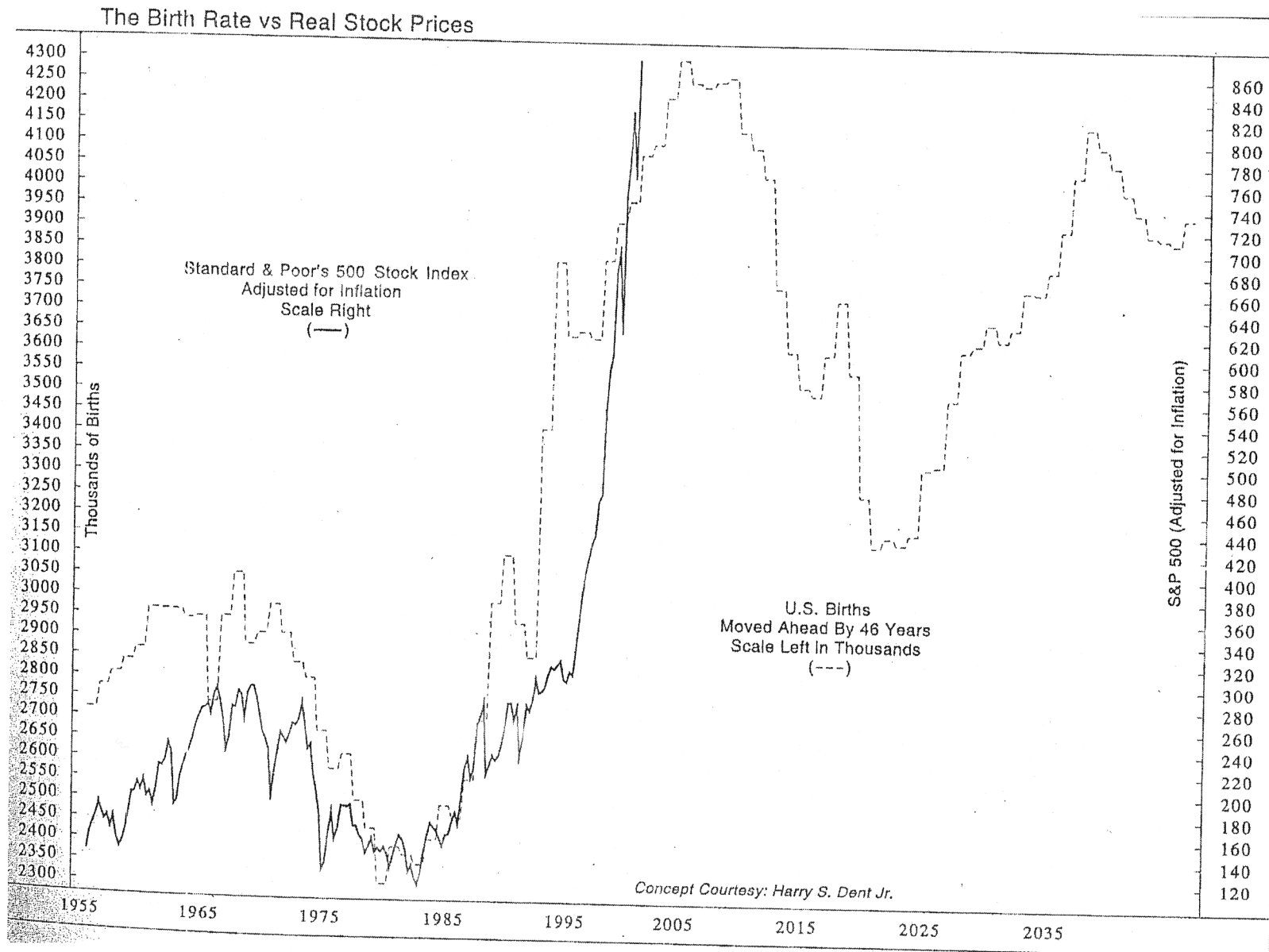


L44

...the market needs rising earnings to sustain price growth

86

Birth rates vs. Stock Prices: Will we face this pressure soon?



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CAUSES of A PROLONGED SIDEWAYS MARKET

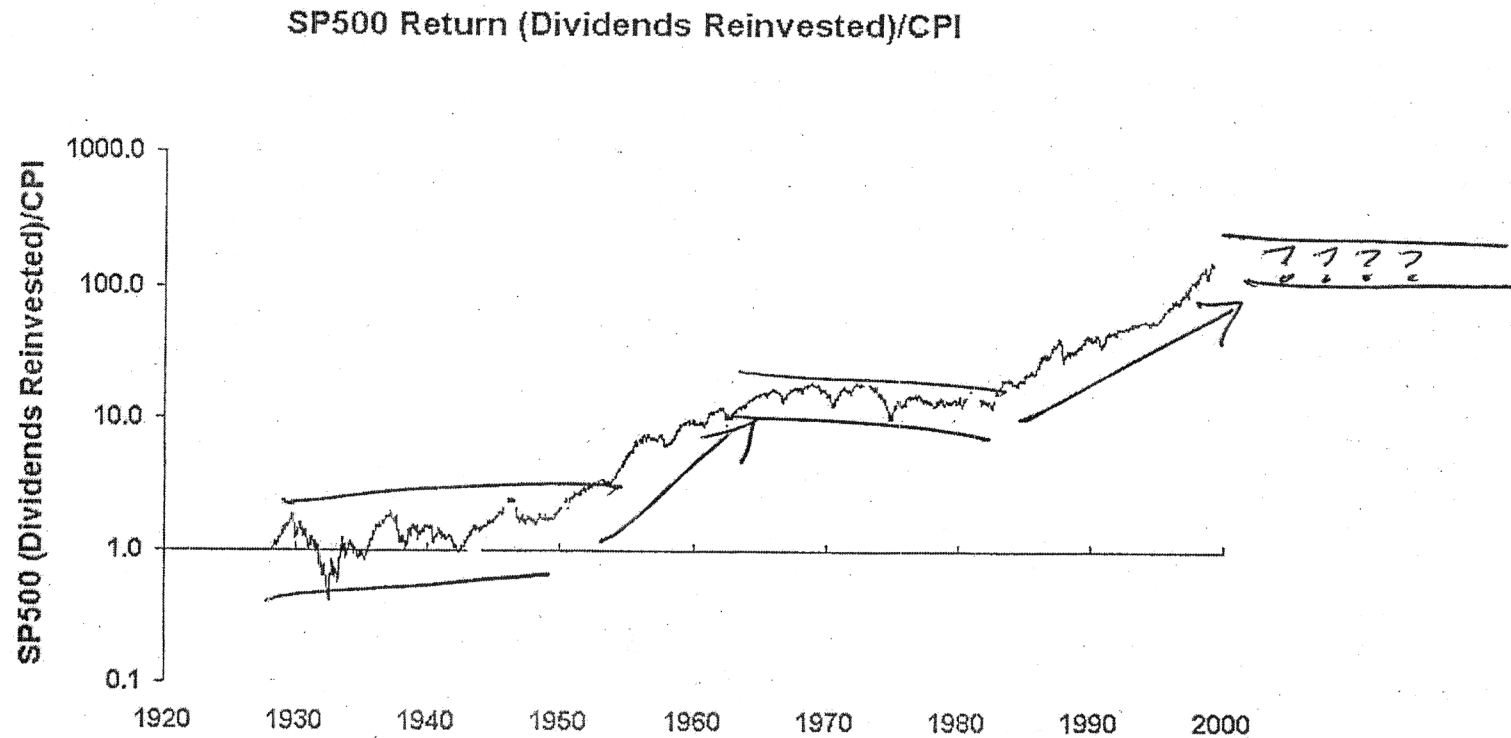
- 1) **Stocks & bonds move inversely, with interest rates pressuring P/E's & prices**
- 2) **Institutions and advisors slowly reduce allocations to stocks**
- 3) **Uncertainties regarding long-term baby-boomer retirement overhang the market & economy**
- 4) **Peaking population trends may cap rallies.**

One implication: income will be important as price growth may be erratic. This would favor securities with yield, companies able to raise dividends, etc.

✓
9/16

FF

IF INTEREST RATES ARE FIGHTING STOCK PRICES, ARE WE HEADED FOR ANOTHER SIDeways MARKET?



From Jan. '02 Outlook

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FR

BUSINESS

TUESDAY
JANUARY 7, 2003

THE BUSH ECONOMIC PLAN

Dividend comeback

DIVIDENDS MAY BE GREATEST SOURCE OF RETURNS NEXT 20 YRS.

United's business fares cut at 2 hubs

Chicago, Denver routes affected

BILL BARNHART

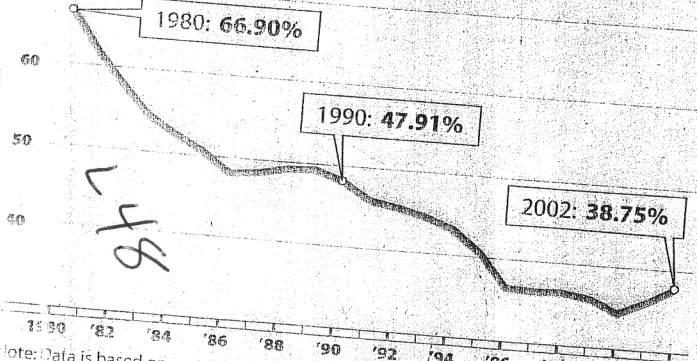
Stocks get a lift from dividend tax-cut plan

President Bush's plan to slash federal taxes on dividend income got a thumbs up review on Wall Street Monday. To no one's surprise, stocks advanced broadly as investors cheered prospects of tax cuts aimed specifically at stockholders.

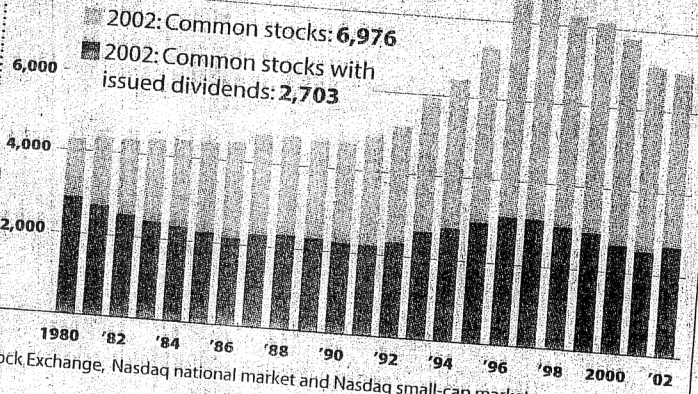
IN SIDEWAYS MARKETS, YIELD COUNTS!

SHARE OF PUBLICLY TRADED COMPANY STOCKS PAYING DIVIDENDS

Percentage of public company stocks paying dividends



Number of publicly traded stocks with dividends



Note: Data is based on common stocks trading on the New York Stock Exchange, American Stock Exchange, Nasdaq national market and Nasdaq small-cap market. Source: Standard & Poor's

OUTLOOK 2003: RETAILING

Chicago Tribune: Melissa Deegan, Dionisio Muñoz, Rick Tuma