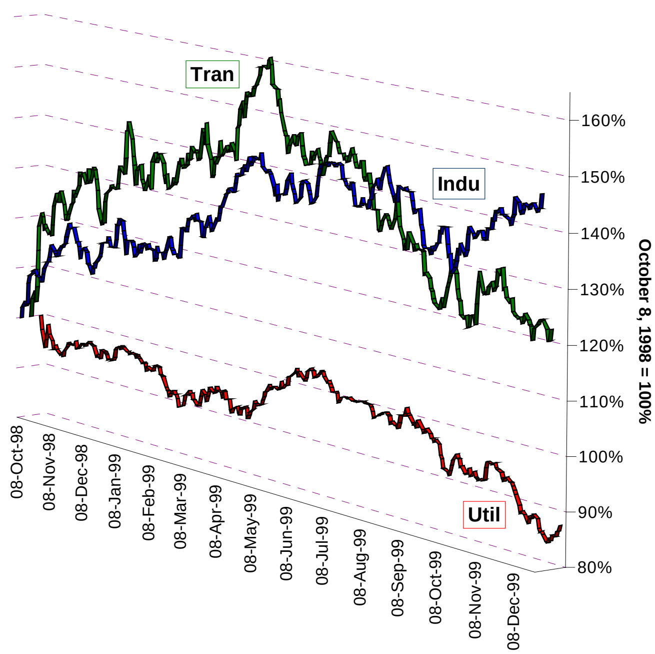
How Now, Dow Jones?

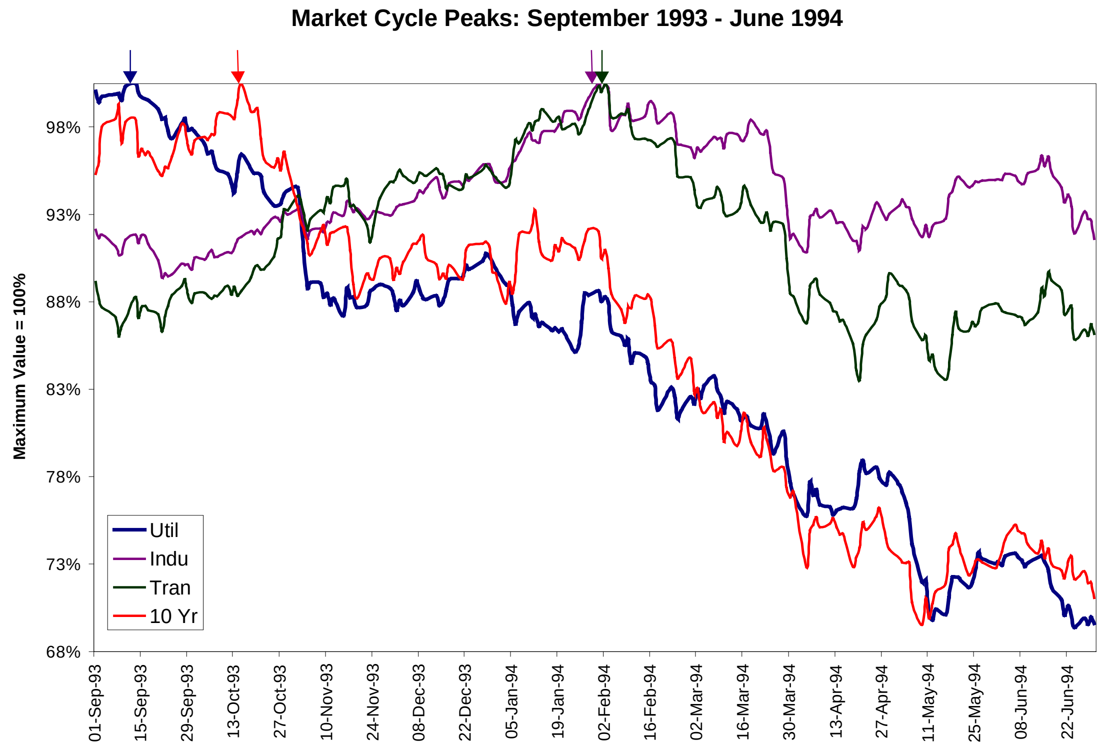
Maybe this index stuff ain't what it's cracked up to be: As the NASDAQ prepares to close out one of the best years ever, at least since the United States emerged from emerging market status, and as the venerable Dow Jones industrial average has finally joined the broader S&P 500 in hitting a record, other Dow Jones indices are struggling along. It's hard to believe both the transportation and utility averages are down on the year in 1999. Even more telling is their relative performance since the general market low of October 8, 1998. The transports were the strongest of the three indices all the way to August 6, 1999, after which the industrials took over the top slot for good.

Dow Jones Averages Since October 1998



Market technicians of all stripes owe a huge debt to Charles Dow, one of the founders of *The Wall Street Journal* and the author of the eponymous Dow Theory. One tenet of his theory was the need for different segments of the market to confirm one another in making new highs for a bull move to continue. Failure of the averages to confirm one another signaled a dangerous divergence in the market, a narrowing if you will, with the likelihood of a massive correction to follow. The transports and utilities are not confirming the industrials, and the industrials themselves took their sweet time -- August 25 until December 23 -- in confirming the broader S&P 500. The cumulative advance-decline line on the NYSE reached its post-October 1998 high on May 13, 1999, and has been declining steadily toward new lows ever since.

Dow Theory made sense fundamentally: If you make it, you've got to ship it. Transportation stocks, principally railroads in Dow's day, tended to be the leading indicators of general economic activity. Utilities, protected by regulation and cost-plus pricing of their services, paid generous dividends to their risk-averse shareholders, and were seen as a barometer of interest rate changes. As recently as the 1993-1994 market cycle, we could see the utilities index behaving as the miner's canary of interest rate increases.



The utility index peaked in September 1993, 10-year notes in October 1993, but the transportation and industrial averages did not peak until February 1994, days before the Fed embarked upon its course of seven increases in interest rates. While the these two averages confirmed one another, the upward course of interest rates put equities into a trading range until November of 1994.

Maybe It Is Different This Time

We haven't repealed the laws of finance or human nature, or the law of gravity for that matter. What may in fact be different this time -- and that phrase has an ominous "famous last words" quality -- is the nature of the underlying economy. The utility index has not led interest rates higher in this market; utilities are no longer a completely regulated industry. Both the natural gas and electric utility segments have been undergoing wrenching changes to competitive markets, and therefore their stocks can no longer be treated as surrogate bonds.

What about the transportation index, you ask? To a certain extent, rising fuel prices throughout 1999 have penalized this segment of the economy, as seen later, but that may be masking a longer-term fundamental shift. To the extent we are shipping bits of information rather than atoms of goods, our new transportation barometer should be weighted toward telecommunications and Internet stocks. These stocks, on the off chance it has escaped your attention, have been leaping toward new highs, not just in the U.S., but throughout what passes for the civilized world. Substitute the NASDAQ telecommunications index or the Inter@ctive Week Internet index, up 92.27% and 158.82%, respectively, on the year through December 23, for the Dow Jones transportation index, and the confirmation problem disappears.

Viewed in this light, companies like Cisco Systems or Sun Microsystems, key providers of Internet infrastructure, are really in the transportation business. This does not suggest we ignore movers of atoms, such as railroads, airlines, pipelines, and trucking firms; no matter how high-tech we get, somebody, somewhere will need to make and ship… stuff.

Good old stuff. A year ago, many pundits, present company included, thought Federal Express and United Parcel Service would be the ultimate beneficiaries of e-commerce, and FedEx stock nearly tripled between October 1998 and May 1999, only to lose a third of its value since. What happened? Rising fuel costs outweighed strong international growth and drove earnings down 6.6% from a year-ago in the most recent quarter. The company is now embarking on a fuel-hedging program.

Commodity risk management matters, absolutely and positively. What a thought as our New Economy moves into the new millennium.