

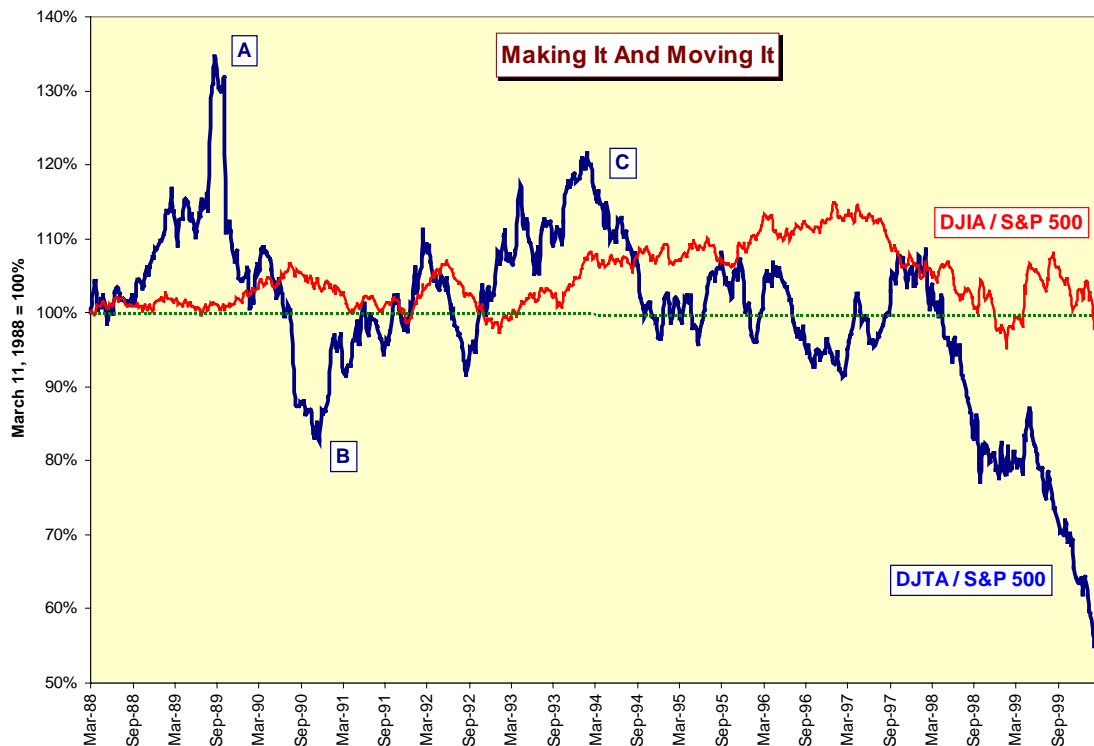
## The Other Divergence

It's now official: The first decade of the new millennium will be known, henceforth and forever, as The Divergence Decade™. And why not? "Divergence" is on the same page as "diversity" and "diversification" in most dictionaries. The former is the darling of Human Resources Enemies Of The People, and the latter is the favorite of financial textbook writers and recently unemployed value managers.

By now, everyone knows about the divergence between the NASDAQ and everything else. But what about the other divergence, the one between the Dow Jones Transportation index and the other senior indices? The Transports are underperforming even the much-maligned Industrials so far in 2000, and they don't even have a Procter & Gamble or some other exploding cigar to blame. Their P/E ratio is a dinky 7.25, which is less than half of the equivalent coupon yield on a 10-year Treasury note. The P/E of the NASDAQ Composite, by way of comparison, is 400.54.

The original Dow Theory (see "Dow Averages' Guiding Power Fades Under Digital Sun," December 29, 1999) held that confirmation of one of these indices by the other was necessary to establish and continue a major trend. The logic was compelling: Whatever the Industrials made, the Transports (then the Rails) had to move. Right now, both of these indices are confirming a broader bear trend, which must be news to anyone within a five-mile radius of a tech stock.

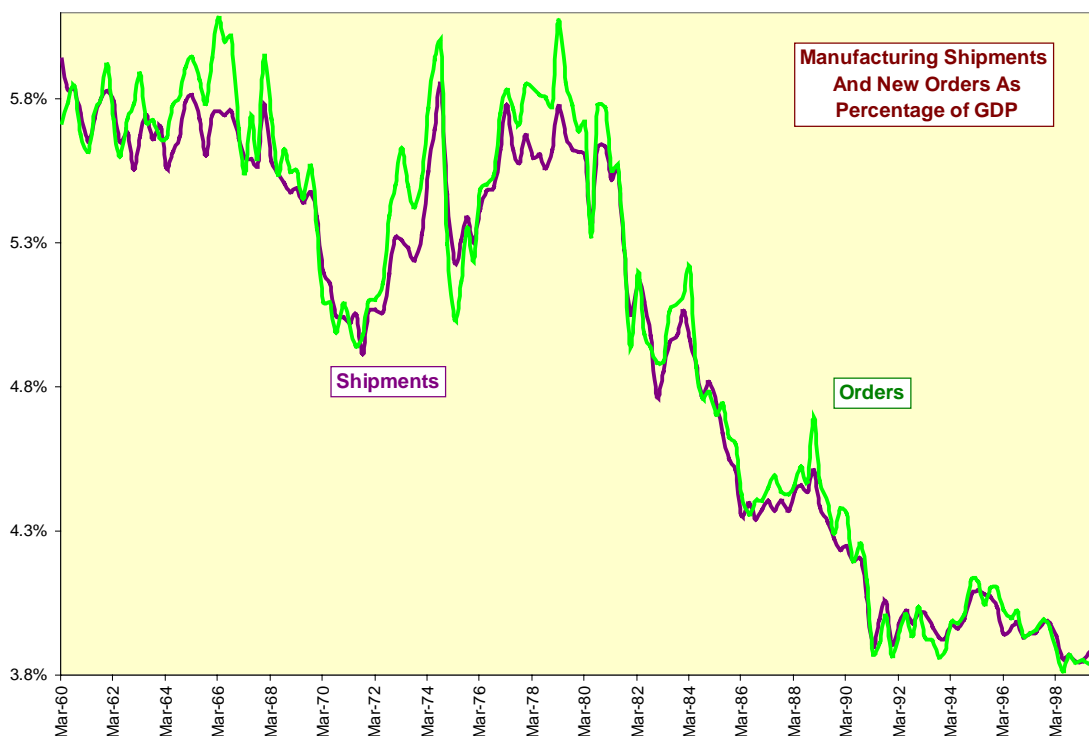
The extent of the present divergence is shocking by historic standards. If we compare the relative movements of the Industrials and Transports, both price-weighted indices, against the capitalization-weighted S&P 500 since 1988, we find only a few outliers. Point A, in 1989, represents the huge rally and subsequent collapse of UAL in association with its leveraged buyout offer. Point B represents the high fuel prices associated with the Persian Gulf War. Point C represents another oil-linked development, the drop in prices ending in February 1994.



The conventional wisdom, shared to some extent here last week, is the present difficulties of the Transports must be related to the recent jump in fuel prices. If this was the whole story, however, why didn't we see relative strength in the Transports going into the December 1998 - February 1999 low in oil prices, and why did the present relative weakness begin in mid-1998, well in advance of either the oil price rally? More important, Transports should be economically sensitive, and their real relative move downward occurred once economic growth started to accelerate in 1999.

### It's The (Old) Economy, Stupid

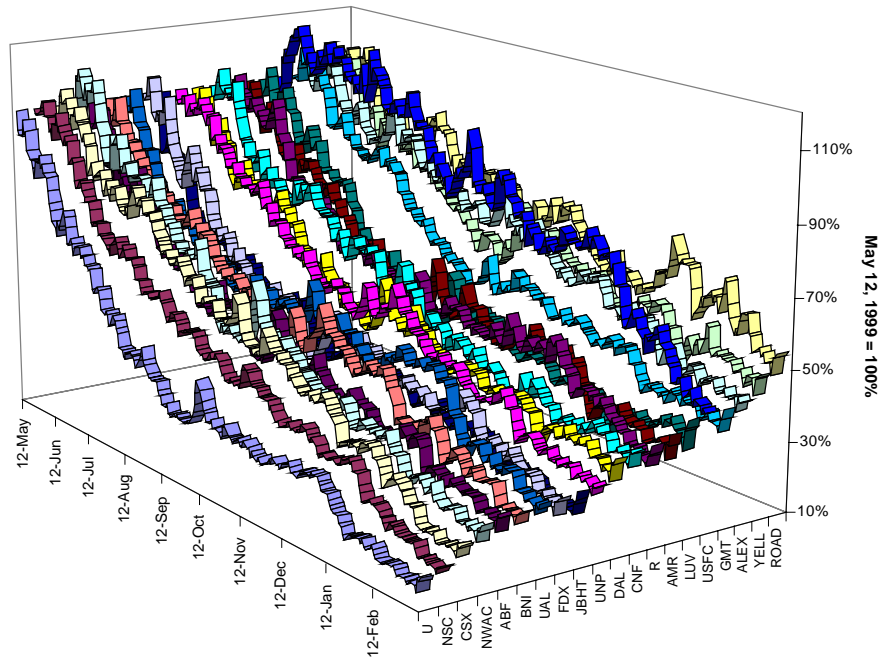
The Transports are about the shipment of goods, although some of the backside moves by the airlines may have a service component as well. Unlike most Wall Street prattle, there is something to the division of Old Economy and New Economy. If we take two of the best measures of goods as part of the economy, manufacturing shipments and new factory orders, as a percentage of GDP, we find these ratios described whether or not the nation was in recession or not up until the mid-1980s. Then these ratios took a sharp and apparently permanent drop below previous lows, and have hovered near 3.9% since 1991.



Economic value is no longer dependent on factories and manufacturing, and this cannot bode well for the long-term relative growth prospects of the railroads, trucking firms, and other goods transporters in the index. We might think the airlines are another story. These hearty pioneers of rude customer service have not been the culprits in the Transports' decline despite much higher jet fuel prices. The airlines learned from the Persian Gulf War and began hedging their fuel prices. In addition, the airline industry is in a position to pass much of their unhedged fuel cost on to their passengers.

Yet if we compare the stock price movement of the twenty members of the Transportation index to their values at the index' high on May 12, 1999, and adjust these movements for the sharp jump in either jet fuel or diesel fuel prices, we cannot come with any simple conclusions. Trucking firms such as Roadway Express, Yellow, and U.S. Freightways have held up best, as have terminal operator GATX and ocean shipping firm Alexander & Baldwin. Railroads such as CSX, Norfolk & Southern, and Burlington / Santa Fe are among the worst relative performers, while the airlines range from moribund U.S. Airways near the bottom to Southwest Airlines near the top.

### After The Fall: Fuel-Adjusted Relative Price Movement



### Technical Outlook

We cannot blame the usual suspects, a weakening economy or higher fuel prices, for the widespread carnage in the Transports. So, for those of you afraid to belly up to the bar for those wildly overvalued tech stocks, is this a good time to dive into the Transports? The index just punched below its October 1998 low of 2282, but closed at 2365 on Friday, March 10, 2000. A break lower would encounter long-term support near 2100, a relatively minor downside risk relative to the rest of the market. Not a bad trade, unless you think we're going to stop moving things from Point A to Point B forever.