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Economic Commentary

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Warren vs. Stuart

We have now spent over 15 months hearing from the talking heads on television (the icons of the ivory tower and unfortunately Alan Greenspan) that the economy is growing too fast and inflation was sure to come. As this is being written, none of the above has been or is now true. The year over year increase in the CPI is barely above 2%, near the lowest in over 30 years, and we have just completed almost 9 years of economic recovery and expansion, the longest in our experience. How wrong can Wall Street be? They can be very wrong short term (a year or two) but not long term. The year 1999 was only the third time in the last 20 years that stock price increases and interest rate increases have occurred simultaneously to such an extent. When were the other two? 1981 and 1987. What happened then? Major trend corrections occurred in the financial markets as well as the real economy. Facts finally overcame perceptions. We are having a classic battle between value investors (Warren Buffett being the most noted advocate) and the "Stuarts" of the world. In case you don't know, Stuart is the "sick" kid on the TV commercial, so named by the matronly office manager, that helps his boss buy 100 shares of K-Mart, on line. My friends, Stuart is our competition and it's absolutely unbelievable how many otherwise reasonably informed and normal-acting good and decent people are "buying in" to his program. It's the age old "madness of the crowd syndrome" that on every day and in every way there are attempts to seduce us by advocating "new eras" and suggesting that the conservative value people just don't "have it" anymore. For all of those who have bought into this new era business, we wish you the best. This particular phase will pass just as so many have before. It's very difficult to know just when this will happen. We live in a circular world that thinks linear and we believe that this along with many other human frailties just don't change.

The Dr. Jeykle Mr. Hyde Markets

Having said all of the above, it's important to make a few observations.

1. During 1999, all stocks which showed a loss in earnings, were **up** an average of 50% and all those with earnings were **down** an average of 2%.

2. 54% of all stocks in the U.S. were down in 1999, yet the media was falling all over itself proclaiming the huge market gains.

3. There are thousands of common stocks selling for less than 10 times earnings that do have tremendous long-term value.

If ever there was a Dr. Jeykle and Mr. Hyde market it has been the one we have just experienced. Our research tells us that the averages are terribly overvalued, however there is probably more value out there then at anytime over the last 5 years. This value rests in the stocks nobody wants, (i.e. the "old economy" equities.) We personally know of a NASDAQ company that's pre tax income has grown from $100,000 to almost $9,000,000 over the last 4 years and is selling @ 7 X after tax earnings. It's well managed, has an excellent back log and is paying dividends. Who cares?? No one!! Who will care? In time, thousands!

Nowhere, however, is there more value than in the government bond market. The damage being done to the economy by raising rates simply means that during the next slowdown and/or recession, interest rates will go lower than they would have otherwise. The move from 5% to 6 ½% over the last year means that rather than going to 3 ½% after the next recession it will probably be 2 ½%. This will be the bond market **rally of a lifetime** and the 1999 pain will be what was incurred to obtain the gain. False ill-advised selling by the "Stuarts" of the bond market is similar to the buying of the internet stocks by that self named group.

Can This E-Mail Be True?

"Can you imagine working at the following company? It has a little over 500 employees with the following statistics:

- *29 have been accused of spousal abuse.*
- *7 have been arrested for fraud.*
- *19 have been accused of writing bad checks.*
- *117 have bankrupted at least two businesses.*
- *3 have been arrested for assault.*
- *71 cannot get a credit card due to bad credit.*
- *14 have been arrested on drug-related charges.*
- *8 have been arrested for shoplifting.*
- *21 are current defendants in lawsuits.*
- *In 1998 alone, 84 were stopped for drunk driving.*

Can you guess which organization this is? Give up? It's the 535 members of your United States Congress. The same group that perpetually cranks out hundreds upon hundreds of new laws designed to keep the rest of us in line."

What is not a part of this is the current administration and its various former cabinet members. We don't have enough fingers and toes to count their misdeeds. Certain types of persons seem to be drawn to certain professions.

Economy

We remain concerned that the new global economy has seriously over-invested during the last 20 years. Over capacity is everywhere. If that is the case then the WWII and cold war inflation will soon be a distant memory and deflation will become a new long-term economic condition recognized by all. Let us give you an interesting statistic. Since 1749 wholesale prices rose 12% per year on average during war times, but fell 1.3% annually in peacetime. The single closest correlation to goods and services inflation is excess government spending. The closest correlation to asset inflation is excess private sector spending. The former is over and the latter is accelerating and much of the spending is going into a select group of "on the come" stocks. This is the wealth effect. The concern is that unlike the Federal Government, the private sector cannot deficit spend forever. Only the Government can tax to spend. The private sector eventually needs income.

The above is our worry. On the other hand the economy continues to be blessed by near full employment and low inflation. We appear to have had a good Christmas from a retailer's standpoint. One interesting comparison, Tiffany sales were +27% and Wal-Mart +9%. Does that tell you anything about the difference between Wall Street and Main Street? Our best guess is that the 4th Quarter Real GDP was something on the order of 3½%. If this is correct then the yearly number will be close to 4%, somewhat less than 1998's 4.3%, but none the less very, very acceptable. We believe the year 2000 is dependent more than anything else on the state of the stock market. In the past a good economy resulted in a good stock market, now it seems to be the other way around. A flat year will suggest a slowdown – say 2% real growth. A down year will probably yield a recession and an up year will, in all likelihood, produce 3½% real growth. Please keep in mind that all of these numbers are plus some ½%, because of reporting changes made retroactive to 1995. Some $300 Billion has been added to real GDP due to changes in accounting for computers. We are not saying this is necessarily wrong, but rather than it is an important factor when comparing growth rates today vs. yesterday.

Is Debt a Problem?

As indicated previously, the shift in deficit spending over the last two years has been from the public sector to the private sector. The question is – how long can this continue? We feel confident that at some point lenders will pull the plug. It appears, however, that they won't do this as long as the collateral (stock market and real estate values) continues to appreciate.

What we are experiencing is a virtuous circle whereby more deficit spending by the private sector propels the stock market, which in turn increases the GDP. Thus, the circle is complete and the process repeats itself all over again.

Please note the following numbers:

Total Debt to GDP

1948 – 1973	\$1.40 to \$1.00	(private and public)
Early 1980's	\$1.84 to \$1.00	(private and public)
1st half of 1999	\$2.88 to \$1.00	(private alone)

Wayne Angell, from Kansas, a former Fed member and now chief economist at Bear Sterns, and a personal friend of mine once told us that he didn't worry about debt very much as he had confidence in those whom are lenders. He says, "they want to be re-paid." Our opinion is that most of these people are the least qualified in the financial industry. Is debt a problem? **YOU BET!!!!!**

A Tough Market to Call

At the first sign of GDP weakness, we expect the stock market (those with P/E's of 20 or more) to rest or more probably decline. As we have expected for some time that will be **the trigger** for the bond market to roar!

Don S. Peters

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