

The Consultant to Wall Street (The Wizard of Oz)

June 1, 2004

How long will Wall Street cast the future in line with the past? Is it ever going to be possible for those who have command of the financial media to understand today, not yesterday, when evaluating the future? The U.S. economy is no longer alone in this now global economy. Rather than being both the world's producers and consumers we, of late (since at least 1995), have become primarily a first class consumer. Other countries, primarily Asia, are now the producers. The only way this will change any time soon is if the world resorts to tariffs and other restrictive measures. This, of course, would be the classic cutting off your nose to spite your face – hardly a wise thing to do. Where is Europe in all of this? The answer is nowhere – at least as it concerns “old Europe.”

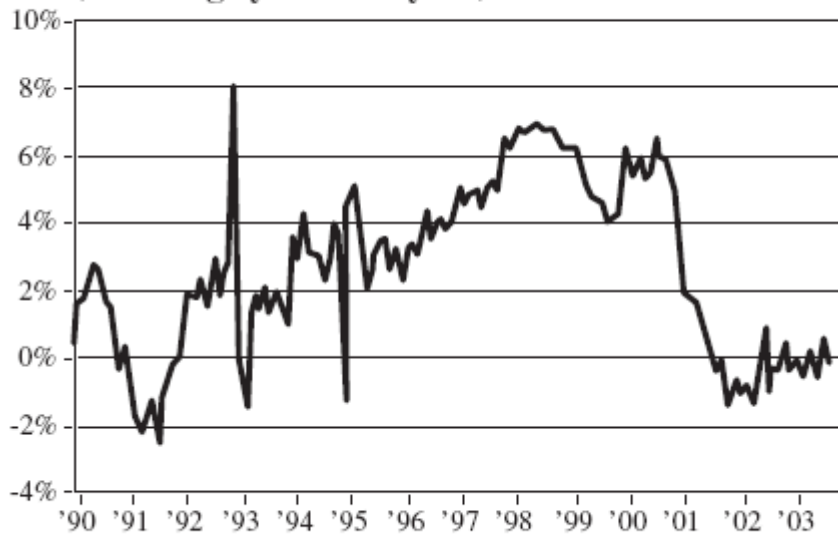
Socialism has reduced the European economic unit into a basket case - high unemployment, high cost structures, and high welfare costs. Russia and most of Eastern Europe are following somewhat the U.S. and/or China economic model. It would be our guess that the economic community of Europe at some point will start losing its members as they continue to fall behind in an extremely competitive world.

Why are we mentioning all of the above? It has to do with the once again myopic fear of returning to the inflationary 1970's just as we have periodically since 1980 when inflation peaked out in double digits. For almost 25 years, the financial markets have been fighting the last war. It's as if the Wizard of Oz is advising Wall Street and its view of the future. Please keep in mind that labor costs are approximately 75% of total costs compared to something like 8% for material inputs to production. Stephen Roach of Morgan Stanley writes extensively about what he calls the great “labor arbitrage.” Another term might be outsourcing. In a global economy there will, over the long term, be a confluence of labor rates commensurate with the tools with which each country provides its people. That is just the way it's going to be . . .period.

The crux of this matter is that secular inflation is nowhere in sight. On a cyclical basis, it has moved from around 1% to 2%, but in our opinion, it will not become imbedded in the economy. We are probably very close to a cyclical peak as this is being written. Keep in mind that on an historical basis a 2% inflation rate should produce no more than a 4 ½% long-term government rate. As soon as Wall Street wakes up to these conditions, it will be there and of course at 1% inflation – 3 ½% government yield is reasonable. What do you think it might be if we enter a deflationary period? We very much expect this to happen if and when Wall Street grows up. Other long-term rates (less than investment grade) may not do nearly as well.

Does this look like inflation to you?

**Growth in Wages and Salaries Less the PCE Deflator
(% change year over year)**



Source: Bureau of Economic Analysis & Merrill Lynch