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INVESTMENT POLICY MEMO

The U.S. economy has been showing the clearest signs in recent years that it is finally slowing down. Business investment spending is down. Auto sales, truck sales, home building, commercial construction are all down in the first half of this year. After a long spending spree consumers are increasing savings more than consumption for the first time in many years. Rising short-term interest rates, rising inflation, a flat stock market and a declining money supply are among the factors contributing to these results or reflecting them. In the past these factors, along with such other current indicators as declining consumer confidence, declining capacity utilization and early signs of declining profitability were often correct predictors of subsequent recessions or severe slow downs.

In recent years many of these indicators have appeared less reliable because the economy has been transformed into something new and different. Interest rates, stock prices, and capacity utilization work most directly on decisions to buy automobiles or build paper mills, core activities in the "old" economy. They have a more tenuous impact on decisions to log on to the Internet or visit the doctor, archetypal activities in the "new" economy. Inventory cycles, capital equipment investment cycles, automobile and home building cycles have far less relative importance in the economy than they did in the past. Nevertheless, automobiles, houses and other material creations are still an important part of the total economy and still strongly affected by interest rates and the stock market. And it remains as true as ever that after people have bought a lot of cars and computers, and corporations have bought a lot of machines demand for these products is reduced.

So is the longest boom in American history about to end? The answer is an unequivocal "maybe." If the past is still a useful guide, current signs of weakness are not enough to indicate the start of a recession for at least the next three to twelve months. Moreover, the economy has slowed to a similar degree only to rebound again a number of times during this boom, including the second quarter last year and the year before. After so many of us have cried "wolf" so often, why should we believe that this time the recession wolf really will leap out of the woods? For one thing, unless we live in the first genuinely New Era of the last 600 years, the longer the wolf doesn't appear, the more likely that he or she soon will.

More specifically, in the current expansion that started in early 1991 this is the first time that a slowdown in growth has been accompanied by what is now a noticeable and persistent increase in the rate of inflation. As I have mentioned in other recent policy memos, higher interest rates coupled with higher inflation have been the twin markers of the onset of all previous recessions. When the Federal Reserve increased interest rates in 1994, growth was strong and inflation was evident only in certain commodity prices.

Why is inflation rising? There are many reasons. Labor markets are truly tight for the first time in forty years. The prolonged economic expansion has also set the stage for high and rising oil and gas prices. And, at the same time, it has increased the ability of corporations to pass these higher costs on to consumers. In the earlier stages of this boom, inflation was moderated by two other factors that are no longer favorable. The continual increase of the dollar meant a continual decrease in the dollar price of imported goods. Now the dollar is no longer rising. For most of the boom medical inflation disappeared. As a result labor costs rose even more slowly than wages. Now medical costs are again rising much faster than wages, which are also accelerating.

Another reason is little appreciated because it is so paradoxical. When economic growth slows, as it has recently, the immediate result is almost always higher inflation. Most businesses cannot reduce their capital costs at all (interest, rent, lease payments, depreciation) and cannot or choose not to reduce their labor costs as fast as they reduce production. Hence costs per unit of output rise when production slows or declines. The “great discovery” of the last nine years, that we can enjoy rapid growth, low unemployment and low inflation all at the same time, is actually very old news.

And not only is strong growth compatible with inflation, so too is a high level of output compared to capacity. Since the end of World War II, when we started to carefully measure unemployment for the first time, low unemployment and low inflation have been very closely correlated. The same truth is even more evident in a comparison of the current circumstances of different countries. Inflation is highest in countries where unemployment is highest (Latin America, Africa, Eastern Europe, etc.) and lowest where unemployment is lowest (Western Europe, Japan, U.S.).

But this is a digression. The point is simply that as growth slows and inflation rises, the Federal Reserve may be tempted to raise interest rates in response to rising inflation which is partly a symptom of slowing growth, rather than declaring a cease fire because growth is declining. In the past this reaction from the Fed could be anticipated with certainty. However, Alan Greenspan has already distinguished himself by the restraint he has exercised in using the Fed’s growth-killing weapons. So there are grounds for supposing that he will continue to exercise such restraint. On the other hand, the reasons he has advanced as justifications for his restraint do not encompass the universality of the high-output/low-inflation relationship I have described. His public remarks have attributed the strong productivity gains of recent years to the New Economy even though they are normal for a period of strong growth. If a recession brings equally normal declines in productivity the Fed might reason that the need to raise interest rates has increased. So, I think we do not know how the Fed will behave in the next few months.

Many have worried that the large size of the Federal budget surplus and the fervent, bipartisan rhetoric in favor of continued surpluses will provide a deadly downward push to any economic decline. This ignores the equally strong bipartisan appetite for every imaginable tax cut under the sun or the moon. In the golden age of Keynesian policy from 1945 to 1980, the American government was actually very slow to increase spending in response to recessions. And the same has been true for most other governments. Recessions are hard to identify until they are already underway. By the time the President proposed, both houses of Congress

approved, and the executive actually implemented a spending increase, all the recessions were already over. Given the enthusiasm for tax cuts and the speed with which they can be implemented it is quite conceivable that, contrary to all appearances, the Federal response to a recession might turn out to be more Keynesian than it was when it was committed to a Keynesian response. A timely tax cut could be worth more in halting a recession than a better planned and targeted spending program that came to late.

Another widespread worry is the strong dollar. The dollar has risen steadily but modestly for the past five years. This has kept our inflation rate lower and it has also kept our growth rate lower by decreasing our exports and increasing our imports. If U.S. growth declines relative to the rest of the world, the dollar will surely decline as well. In and of itself a lower dollar should stimulate our growth rate. However, to the extent that it increases our inflation rate or provokes the Federal Reserve to “defend” our currency, it may also lead to still higher interest rates that cause still lower economic activity. Given the number of things that the rest of the world continues to buy from us, and given that the dollar is at about the same level it was twenty-seven years ago when the dollar was first floated against other currencies, it is hard to believe that it is wildly overvalued against other currencies as some of the more extreme alarmists have claimed.

That leaves one more big worry, the same one that has captured our attention (and Alan Greenspan’s) for some time. The stock market. If the stock market were to collapse, a major underpinning of the growth of consumer spending and business investment would disappear. Stock markets in the rest of the world would possibly follow suit with negative consequences for the export markets that have also driven this boom. The dollar would almost certainly swoon despite my reassurances in the previous paragraph. Initially, many U.S. interest rates would be forced upward. We would be very dependent on swift and supportive responses from the Federal Reserve and from the governments of the wealthiest countries to avoid a serious economic implosion.

In my opinion such a catastrophe is unlikely because, as I have argued in recent memos, the stock market is not that overpriced. A covey of soaring Internet and technology stocks may be at excessive levels and were even more so three and six months ago. But many thousands of stocks, the vast majority, in a wide array of different industries, continue to be attractively valued by the standards of the past and by reasonable expectations for the future. Moreover, stock markets in the rest of the world, where growth prospects are often greater, sell at even more reasonable prices.

In summary, a slowdown is quite possible. A recession late this year or next year also is quite possible. A catastrophic depression and/or stock market crash are highly unlikely. Slower growth or negative growth, flat or declining profits, higher interest rates and higher inflation are all good enough reasons to be cautious about stocks. While a disaster seems unlikely, a continued decline seems highly probable.

I continue to favor stocks that sell at reasonable prices and where growth of earnings is less dependent on growth of the U.S. economy. These include pharmaceutical, food and telephone companies, as well as many smaller and overseas companies in these and other industries.