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**INVESTMENT POLICY MEMO**

The business pages are full of gloomy news. Unemployment is rising. Profits are down sharply for many companies. Japan is back into its on-again/off-again twelve-year recession. Argentina is experiencing a currency crisis reminiscent of those that shook the world in 1997 and 1998. Every day brings new revelations of accounting irregularities, fraud and larceny by the brokers and businessmen who rode high in the recent boom. None of these stories has changed my mind about the likely course of future events. The recession or virtual recession that began eight or nine months ago is still likely to end sometime between now and early in the fall.

Unemployment is always a lagging reflection of the economy, typically continuing to rise for many months after a recession ends as companies attempt to restore their fallen profit margins by cutting payrolls. Profits look worst at the moment the recession ends. Weakness in Japan is a negative indicator; but it is more a reflection of the slowdown that has already occurred in the rest of the world than an indicator of future global weakness. The problems in Argentina appear to be unique to its history, politics and currency system. And, as John Kenneth Galbraith and Charles P. Kindleberger have pointed out in several splendid books, evidence of skullduggery is always the detritus left behind after financial bubbles pop.

More than a financial market setback is required to produce a crisis in the real economy. Declining stock market prices do discourage spending by businesses and by consumers. However, in this case, since the bubble was confined to a particular segment of the market, the decline in total stock market wealth has been modest – about the same as used to occur roughly every three years in the booming 1950's and 1960's. The Crash of 1929 was enormously greater than our recent experience and the economy was far more vulnerable to its effects. Although the stock market has declined and unemployment has risen, consumer spending remains very strong. This is partly because so much more of consumption is now services, which are relatively immune to economic cycles. Sharply lower interest rates have also supported consumption and business investment. The tax rebates that are now being mailed to households may also bolster consumption to some extent.

New Economy areas -- such as cell phones, personal computers, equipment and software for corporate presences on the Internet and carrying capacity for phone and Internet transmissions – accounted for a significant part of the strength in investment spending and consumption during the boom years. Now businesses and households have reached high levels of ownership of computers and wireless telephones. Some 95% of the fiber optic cable lines that were installed in the past few years are said to be idle. However, it is a mistake to assume that investment by American corporations or the government will remain on hold until the use of fiber optic cables grows from 5% to something nearer 100%. As in previous investment booms, while the favored sector was extremely overdeveloped other areas have been neglected and cry out for more spending.

Consider the nation's and the world's ability to produce sufficient energy. Vast investments are required in electric power generation, especially with technologies that are environmentally sustainable. Almost everyone who has flown a plane in the last few years has confronted the inadequate capacity of our airport and air traffic control system. This is another area requiring huge expenditures. The increase in the birth rate that started about ten years ago has already produced a scramble to build more elementary schools. There will be an ongoing impact on constructing and equipping middle schools, high schools and colleges. In addition much more of the capital stock of businesses and consumers than was formerly the case, consists of items that wear out or become obsolete rapidly, including computers, cell phones, autos and trucks. Investment has been subdued for over a year. Inventories have been reduced to near record low levels. The stage is set for a renewal of business and consumer spending on durable goods and inventories.

Export growth may also resume. With Argentina as an exception for the moment, conditions for strong economic growth in Latin America are better now than at any time in the past fifty years. This will provide opportunities for increased U.S. capital goods exports to countries like Brazil and especially Mexico. China has barely faltered in its prolonged period of strong growth and modernization with concomitant demand for investment products. It is also quite possible that Europe, responding to the benefits of monetary union, will begin to grow more rapidly than the U.S. The U.S. dollar is now a substantially overvalued currency by a wide variety of measures. (Which is a significant part of Argentina's problem since the peso is firmly linked to the dollar.) If this bubble were also to pop, the effect on U.S. exports and economic growth would be distinctly positive; although there would also be an acceleration of inflation.

All of this is not to say that we are about to enter another boom; but only that the U.S. economy is very likely to begin growing again at 2% or 3% a year. That would be the same rate of growth as 1992-1995, the first four years of the last, record economic expansion.

In this environment many equities are reasonably priced. As mentioned in the last Investment Memo, large growth companies in health care, technology and financial services are all at modest or fair valuations. This makes it possible to restore these companies to their central place in growth-oriented portfolios. Telecommunications stocks are now at extremely depressed levels as many of my clients are painfully aware since I purchased them at much higher levels. In addition I remain very sanguine about the potential for equities in Mexico, Brazil, Europe and certain export-focused companies in Japan.