

Consumer Comeback

Older and wiser: The consumer sector drives the U.S. economy in the coming decade

Highlights

- The role of “driver” of the U.S. economy over the last 50 years has rotated among the corporate, government and consumer sectors:
 - 1940-52:* WWII government military spending propel economy out of depression.
 - 1952-60:* Corporations restructure from war-time footing, prosper while Eisenhower reins in government and consumer is hurt by frequent recessions.
 - 1960-67:* Strong consumer spending propels rapid growth.
 - 1967-82:* Government expands—Vietnam War and Great Society; rising taxes, accelerating inflation, weak productivity growth hurt corporations and consumers.
 - 1982-87:* Consumer boosted by tax cuts, lower inflation. Corporations hurt by disinflation, strong dollar, foreign competition; Reagan shrinks government.
 - 1987-95:* Corporations restructure aggressively, slowing employment growth, suppressing wage gains, trimming benefits. Government’s influence slips further.

- The consumer sector should be the driver in the coming decade. Key reason: “Anorexic” corporations can’t get much leaner; politics argues against rebirth of “Big Government.” After more than 20 years of stagnation, real wages should climb:
 - Demand for labor should be healthy as U.S. avoids a *severe* recession.
 - Supply of labor grows more slowly than in 1970s and 1980s because women and boomers already have entered the labor force.
 - Corporations can afford to raise wages to get skilled workers, thanks to strong productivity growth, low unit labor cost increases, slower benefits inflation.

- When government drives economy, inflation tends to be high, resource-oriented stocks outperform; when corporations drive, industrial/capital goods stocks do well; when consumer leads, consumer stocks outperform.

- As consumer incomes rise more rapidly and the savings rate rises, interest rates will be pushed still lower. But consumer spending also will rise, albeit more slowly than incomes. Investing to benefit from these developments is not a simple matter of just lining up *all* the “usual suspects”—the “power brand” growth stocks and/or the cyclical auto/housing/retailing troika. Now “older and wiser,” John Q. Public is not the “ebullient youth” of the 60s nor the “conspicuous consumer” of the 80s; accordingly, there will be a new set of opportunities.

Table 1

The Consumer Comeback 50

Page	Company	Symbol	PW Rating	8/29/95 Price	Comment
18	American Medical Response ²	EMT	buy	\$27 5/8	Ambulance services to benefit from rapid growth in 75+ population
18	Apria Healthcare ¹	APRA	buy	26 7/8	Home healthcare services to benefit from rapid growth in 75+ population
16	Barnes & Noble ²	BKS	attractive	39 5/8	Aging boomers are big buyers of books
19	Bed, Bath & Beyond ¹	BBBY	neutral	25 9/16	Heavy spending on household furnishings and equipment by 45-54 age group
21	BellSouth Corp ³	BLS	attractive	67 7/8	Good telecom play on fast-growing South
15	Belo A.H.	BLC	buy	34 1/4	Strong growth in classified ads, help wanted, display ads by retailers
20	Carmike Cinemas ²	CKE	attractive	20 3/4	Entertainment company benefiting from prosperity of country western consumer
15	Central Newspapers	ECP	attractive	28 3/8	Strong growth in classified ads, help wanted, display ads by retailers
14	Chrysler Corp ^{2,3}	C	attractive	52 7/8	Less frequent, but more costly and profitable auto and truck purchases
21	Circle K ²	CRK	buy	19 3/4	Convenience stores located across fast-growing South
20	Compaq Computer ³	CPQ	buy	46 1/8	Continuing rapid growth of home PC sales
20	CUC International	CU	attractive	34 3/8	One of few consumer companies well-positioned to sell products via computers
15	Del Webb Corp*	WBB	not rated	19	Growing number of senior citizens moving to active adult communities
16	Disney (Walt) ³	DIS	neutral	56 3/8	Big spending increase on entertainment by aging boomers
14	Eaton Corp	ETN	attractive	52 3/8	Increased auto content of expensive components
15	Federal National Mortgage ^{2,3}	FNM	buy	96 3/4	Government trying to increase home ownership by middle class
15	Federated Department Stores ³	FD	buy	27 1/4	Best positioned player in constricted, consolidating middle of retail market
15	Fifth Third Bancorp ¹	FITB	buy	56 1/8	Offers affluent customers financial services, investment advice
14	Ford Motor ^{2,3}	F	attractive	30 1/8	Less frequent, but more costly and profitable auto and truck purchases
15	Gannett ^{2,3}	GCI	attractive	53 3/8	Strong growth in classified ads, help wanted, display ads by retailers
20	Gaylord Entertainment	GET	attractive	26 7/8	Entertainment company benefiting from prosperity of country western consumer
14	General Motors ^{2,3}	GM	attractive	47 1/4	Less frequent, but more costly and profitable auto and truck purchases
17	General Nutrition Centers ^{1,2}	GNCI	attractive	41	Aging boomers spend heavily on vitamins and health foods
20	Hewlett-Packard ³	HWP	attractive	77	Continuing rapid growth of home PC sales
18	Integrated Health Services	IHS	buy	29 1/4	Nursing homes to benefit from rapid growth in 75+ population
20	Intel Corp ¹	INTC	buy	58 7/8	Continuing rapid growth of home PC sales
16	LodgeNet Entertainment ¹	LNET	buy	9 3/4	Aging boomers' increased consumption of entertainment, propensity to travel
15	Masland ¹	MSLD	attractive	14 1/2	Increased auto content of expensive components
17	The Men's Wearhouse ^{1,2}	SUIT	attractive	30 3/8	Good place to buy "work clothes" with minimum of fuss and expense
15	MGIC Investment Corp	MTG	buy	55 1/8	Government trying to increase middle class home ownership
20	Microsoft Corp ¹	MSFT	buy	91 7/8	Continuing rapid growth of home PC sales
20	Motorola ³	MOT	buy	73	Cellular phones indispensable to home office workers
20	Officemax	OMX	attractive	24	Rapid growth in number of home office workers
20	Paging Network ¹	PAGE	buy	38 3/4	Many home office workers also use paging as well as cellular phones
14	Price/Costco Inc ¹	PCCW	attractive	16 7/8	Warehouse club format attracts impecunious consumer
15	Republic New York Corp ²	RNB	buy	55 3/4	Offers affluent customers financial services, investment advice
18	Rural/Metro Corp ¹	RURL	buy	24 1/4	Ambulance services to benefit from rapid growth in 75+ population
14	St. John Knits ²	SJK	attractive	45 5/8	High-end designer, manufacturer, retailer of up-scale women's apparel
19	Service Corp International ³	SRV	buy	34 1/2	Rise in number of older Americans will lead to increase in death rate
19	Staples Inc ^{1,2}	SPLS	attractive	25 3/4	Rapid growth in number of home office workers
14	Starbucks Corp ¹	SBUX	attractive	38	With rising incomes, consumers willing to pay up for gourmet coffee
20	Thomas Nelson ²	TNM	attractive	24 3/4	Leading publisher of Christian books that appeal to country western consumer
16	Tiffany & Co ³	TIF	not rated	42	Consumers in 45-54 age group biggest buyers of jewelry
16	Time Warner ³	TWX	buy	42 3/8	Big spending increase on entertainment by aging boomers
15	Toll Brothers ^{*,2}	TOL	not rated	18	Affluent families to trade up to more expensive homes
14	Tower Automotive ¹	TWER	buy	12 13/16	Increased auto content of expensive components
21	UST Inc ³	UST	attractive	28 1/8	Smokeless tobacco particularly popular in South
16	Viacom ³	VIA	buy	48 5/8	Big spending increase on entertainment by aging boomers
14	Wal-Mart Stores ³	WMT	attractive	25 1/8	Discount store business attracts impecunious consumer
16	Zale Corp ¹	ZALE	attractive	14 1/8	Consumers in 45-54 age group biggest buyers of jewelry

* This company is not rated by PaineWebber but is followed by the analyst as part of his industry research. PaineWebber has limited its analysis to the specific topics addressed in the report and, as is the case with all unrated securities, recommends neither purchase nor sale.

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Figure 1

Trends from the Consumer Comeback:

1. **A bifurcated market.** Focus on companies that serve the *extremes* of the income distribution, such as *St. John Knits* and *Starbucks* at the high end, *Wal-Mart* and *Price/Costco* at the low end. Avoid the constricted middle except for a few consolidation plays such as *Federated Department Stores*.
2. **Boomers are getting richer, older and wiser.** They will be spending more on jewelry (*Zale*), entertainment (*Disney, Time Warner, Viacom*), books (*Barnes and Noble*). Fashion is a low priority, but a sensible source of work clothes (*Men's Wearhouse*) should do well. As they age, boomers are becoming more health conscious, a plus for *Starbucks* (coffee is healthier than booze), *General Nutrition* (vitamins).
3. **The golden years:** rapid growth in the over-75 age group is bullish for nursing homes (*Integrated Health Services*), ambulance companies (*Rural/Metro*), funeral services (*Service Corp.*).
4. **Home improvement:** Now that they own a home, boomers are spending more to make it comfortable (a plus for *Bed Bath and Beyond*) and to create home offices (bullish for *Staples*, personal computer companies).
5. **The country western consumer:** The South should continue to prosper, and country western culture will become more mainstream, a plus for *Circle K, Gaylord Entertainment, Thomas Nelson, UST*.
6. **The savings surge:** Income should rise faster than consumption as savings rate rises, a plus for trust-oriented banks (*Fifth Third Bancorp, Republic New York*), brokers, mutual fund companies.

The rotating drivers of the U.S. economy

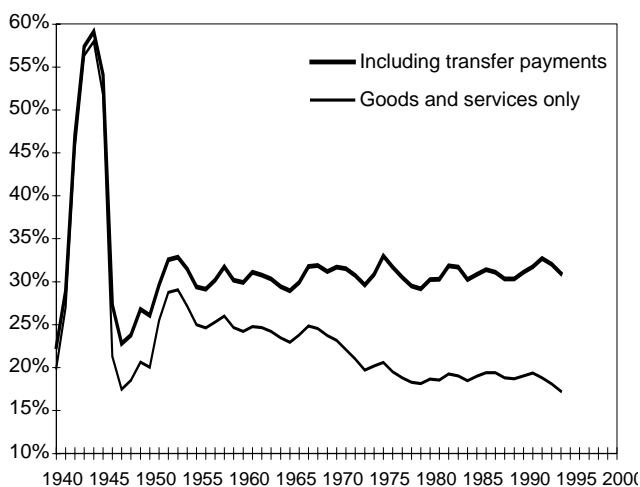
Although consumers, business and government each are indispensable to economic growth, the balance of power between them shifts over time. Indeed, at any given moment one or another sector functions as the “driver” of growth—the sector that sets the pace and tone for the overall economy, not to mention the stock market. Broad historical forces, including wars, depressions, and changing political ideologies, all affect which sector is the driver at any given time.

In the 1930s the U.S. economy plunged into the Great Depression because *no* sector successfully drove economic growth. The New Deal tried to make government the engine of growth, but the effort was too small and tentative to do the job. Since the 1930s, the driver of economic growth has rotated among government, business, and the consumer with a fair degree of regularity. Understanding which sector is in power has been a key to successful stock market investing.

1940-52: Government spending revives growth

Unfortunately, it took the marauding of Adolf Hitler to accomplish what the New Deal could not—revive the U.S. economy. Total government spending rose from 19% of GDP in 1940 to more than 50% in 1943, 1944 and 1945 (Chart 1). Many Americans feared in the late 1940s that hard times would return with demobilization from war, but this didn't happen. The return of peace ushered in a boom, as Americans spent money that had piled up during the war years, when few consumer goods were available in

Chart 1

Government spending as a percent of nominal GDP
Including, excluding transfer payments

stores. Demobilization was temporary in any case; in the early 1950s the U.S. fought the Korean War and plunged into the “Cold War.”

1952-1960: The rehabilitation of big business

During the presidency of Dwight Eisenhower, government's influence on the economy waned and business regained the ascendancy it had lost in the 1930s. Eisenhower embraced the Jeffersonian dictum that “...government is best that governs least,” and he constantly warned of the dangers of budget deficits and inflation. So, Eisenhower struggled to restrain government

spending, which was relatively flat as a share of GDP during his administration. The Federal budget even ran surpluses in three years. Nor was “Ike” afraid of recessions if such were required to contain inflation; recessions occurred in 1954, 1958 and 1960.

Frequent recessions plus rising taxes to finance the Cold War constrained consumer spending. Per capita consumer spending grew just 1.6% annually, much more slowly than in the 1940s or early 1960s, and only a little faster than 1987-94 (Chart 2).

While government and the consumer were on the defensive during the Eisenhower years, business stepped to the fore. Liberated from the government controls of the war years, and facing minimal foreign competition, firms maintained high profit margins despite sluggish economic growth (Chart 3). With productivity rising rapidly, corporations’ prestige recovered to the levels of the 1920s. CEOs posed as corporate statesmen, who, deftly balancing the demands of labor, shareholders, consumers and government, constructed the “sinews of war” in the forties and peacetime prosperity in the fifties. CEOs also strongly influenced the business cycle via pricing decisions. When costs climbed during expansions, corporations raised prices, creating “cost-push inflation” that set the stage for the next recession.

The 1960s: High tide of post-war consumerism

In the 1960 presidential campaign, John F. Kennedy scorned the Nixon/Eisenhower preoccupation with inflation and promised to use Keynesian strategies to accelerate economic growth and boost living standards without boosting inflation. Remarkably, Democrats accomplished precisely that, partly by cutting tax rates in 1964. 1960-67 were the golden years for the U.S. economy in general, and the U.S. consumer in particular. Productivity growth was strong, economic growth was strong, there were no recessions, yet inflation was remarkably restrained until 1966. With confidence at high levels, personal consumption per capita grew at a remarkable 2.9%, twice the pace of 1952-60 (Charts 2, 4).

Corporations certainly shared in the prosperity of the early 1960s, but with the Democrats in power their stature slipped. President Kennedy swatted U.S. Steel like a cockroach when it dared to raise steel prices “excessively” in 1962. Despite this show of force, government intrusion on the economy was limited; after all, there were few economic problems for the government to address.

1967-82: A program for every problem

The stunning prosperity of the 1960s infected America with hubris, a belief that to achieve economic and social progress one did not have to endure the vagaries of the free market (as President Eisenhower had done by fighting inflation with recessions). Every problem was deemed amenable to a “government program,” and if the first program failed one simply devised a new one (without ending the first one). The resulting litany of policy disasters included: the decision to fight both the War in Vietnam and the War on Poverty without raising taxes; introduction of wage and price controls in 1971; efforts to restrain inflation through government persuasion (remember “Whip Inflation Now?”); and the tortuous, futile effort to devise a national energy policy. The ballooning power of government went beyond macro-economic bungling. Transfer payments rose from 7.4% of personal income in 1965 to 14.2% by 1980. Government regulation expanded in such areas as pollution, consumer product safety and employment practices.

While government power waxed, the confidence of consumers and corporations waned. After 1973, productivity growth pretty much stalled out, real wages started to fall, profit margins declined sharply, and the tax burden increased (Charts 3, 5). Stock prices declined 30% in real terms between 1968 and 1980. Consumer confidence and per capita consumer spending collapsed while the “misery index”—the sum of the inflation rate and the unemployment rate—doubled (Charts 2, 4, 6). In 1979 President Jimmy Carter concluded that America was stricken by “malaise,” a “crisis of confidence.”

1982-87: Reaganomics revives the consumer

There was nothing wrong with Americans’ self-confidence that could not be fixed by cutting inflation from 14% to 4%, as Ronald Reagan and Paul Volcker did in the recessions of the early 1980s. Aside from slashing inflation, the central tenets of Reaganism were reducing regulation, cutting taxes, trimming government spending (except defense) and taking an optimistic view of the future in preference to Carter’s melancholy moralism.

Reagan’s economic U-turn benefited consumers more than business—except well-paid, unionized workers in heavy industry. Consumers’ confidence soared as they enjoyed a benign combination of low inflation, lower taxes, fairly stable wages (better than the sharp declines of the mid-1970s), strong employment growth, a strong dollar and surging stock prices. The misery index plunged, and real per capita consumer spending rose even faster in the early 1980s than the early 1960s (Charts 2, 6).

Chart 2

Real personal consumption expenditures per capita
Compound annual growth rate

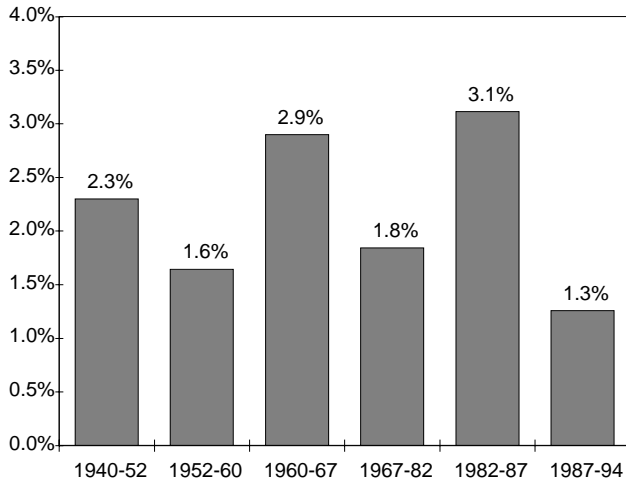


Chart 5

Personal taxes plus social security taxes
As percent of personal income

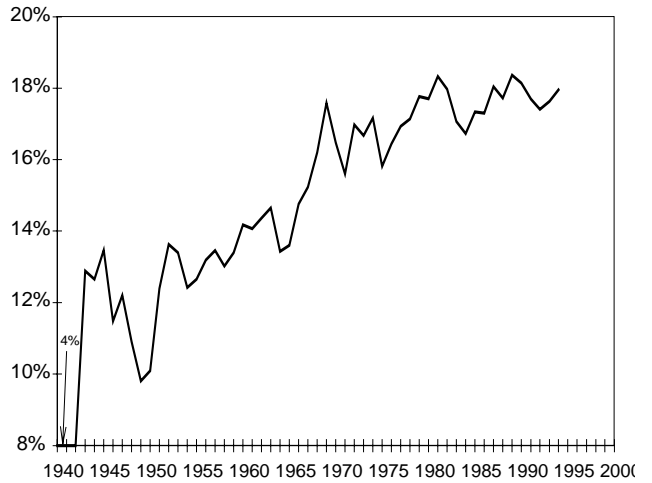


Chart 3

Profit margins
S&P Industrials margin, economic profits as a percent of GDP

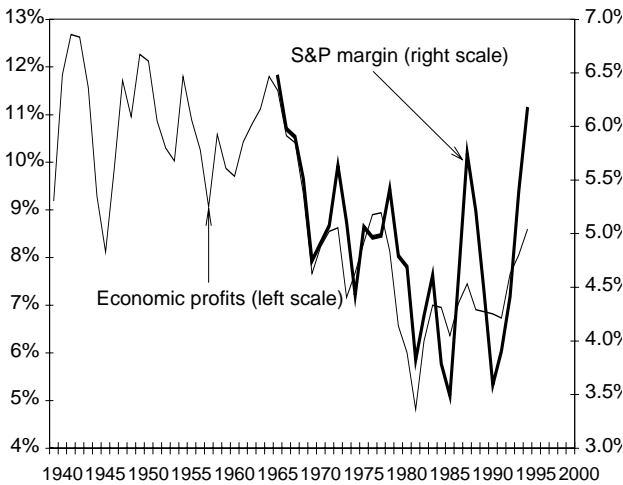


Chart 6

Misery index (inflation rate plus unemployment rate)

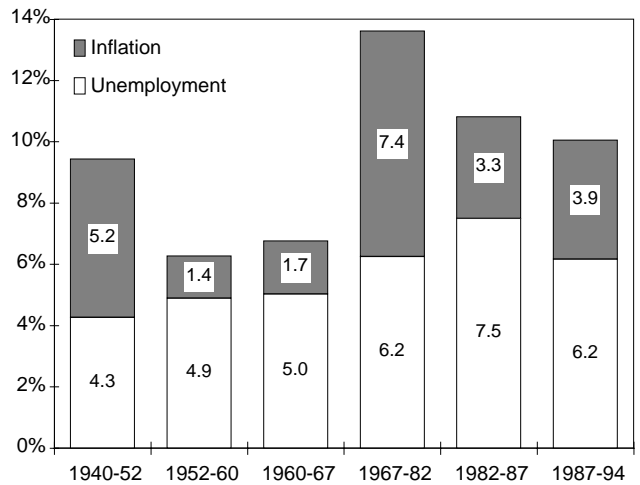


Chart 4

Consumer confidence

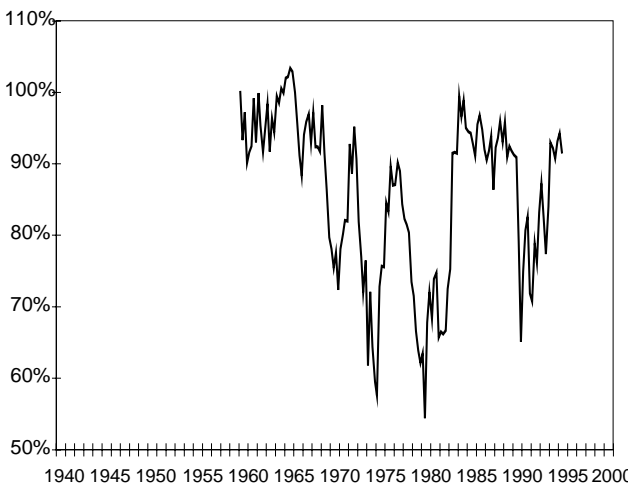
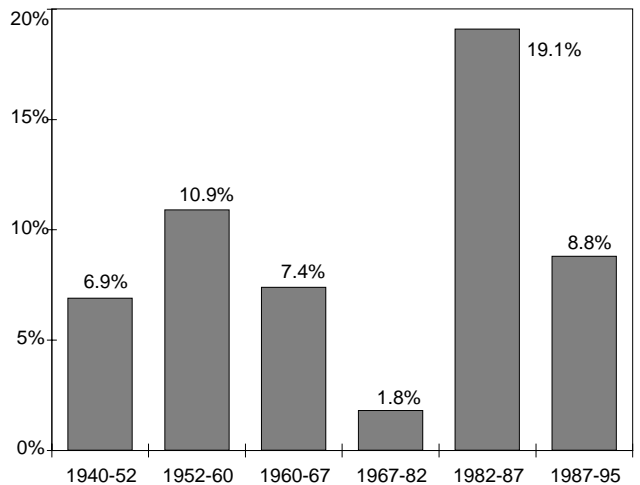


Chart 7

Stock market performance
S&P 500 compound annual price change



While Reaganomics helped most consumers, it hammered many corporations that had grown accustomed to raising prices at will. Adding to the pain of disinflation were the high real interest rates of the mid-1980s, the strong dollar of 1983-85, and brutal competition from industrializing countries in Asia. Corporate profit margins declined but the pain was unequally shared, with such major industries as steel, mining, oil service, and agriculture getting hammered while the consumer sector prospered. Every major bank in Texas went out of business.

1987-95: Business strikes back

Over the past eight years, business has assumed the mantle of economic leadership for the first time since the 1950s by adjusting to the harsh competitive climate of the late twentieth century. That means slashing headcount, trimming healthcare benefits, selling plush headquarters buildings, spinning off less profitable businesses, and using new technology to reengineer operations. Under pressure from shareholders, many corporations are being run to maximize profits, period. These initiatives have produced an explosion in profit margins (Chart 3). 1995 second quarter profit margins are now at a cyclical peak that is a 25-year high.

Meanwhile, consumers have been hurt by stagnating wages, slow employment growth, and a loss of employment security. Consumption has been anemic. And the government has been thrown on the defensive as voters who have themselves been pulled through the wringer of restructuring demand a leaner, meaner, smaller government. That was the message of the 1994 election. In 1994, even before Republicans gained control of Congress, government spending on goods and services was 17.3% of GDP, its lowest level since the 1940s. If Newt Gingrich and company have their way, this spending is headed lower, and government regulation will recede.

Stock performance and the rotating drivers

Given this rotation in the drivers of growth, stock prices followed a predictable pattern. Since government tends to allocate resources inefficiently, in the 1940s and 1970s, when government drove growth, inflation was high and resource-oriented companies outperformed the S&P 500 (Table 2), and stock market performance was fairly poor (Chart 7). During the early 1960s and the early 1980s, when consumer spending drove growth, consumer stocks did indeed outperform (Table 2). And during the 1950s and the years 1987-95, when business drove growth, industrial goods firms outperformed. (Note that while consumer stocks, as measured by *both* the global "power brands" plus domestic consumer cyclicals also outperformed in the period 1987-95 (+11.5%), this was largely due to the dramatic P/E expansion in a period of

Table 2

Stock market performance by sectors, 1940-95

Compound annual price change

Year	S&P 500	Industrial sector ¹	Consumer sector ²	Natural Resources ³
1940-52	6.9%	6.3%	5.4%	11.5%
1952-60	10.9	12.7	10.4	9.0
1960-67	7.4	7.1	7.7	6.4
1967-82	1.8	1.4	2.2	3.3
1982-87	19.1	19.1	24.2	19.5
1987-95	8.8	9.2	5.4	7.2

¹1940-1986: S&P Capital Goods Composite; 1987-1995: 25% high tech, 25% elec. equip., 25% machinery, 25% manufacturing

²1940-1986: S&P Consumer Goods Composite; 1987-1995: 33% autos, 33% housing, 33% retail

³1940-1995: 50% oil composite, 17% chemicals, 17% papers, 17% metals.

sharply falling rates that was accorded virtually *all* growth stocks. But, for *domestic* consumer stocks, particularly retailers and autos, it was not a great period in general.)

1995-????: Consumer comeback

That is the historical pattern. But what sector will be the next to drive American economic growth? Our candidate is the consumer sector. This may seem surprising. After all, the mordant mantra of the political talk shows, the dismal data that appear in speech after speech and editorial after editorial, is the fact that real wages in the U.S. have been stagnant for over 20 years. Worse still, the distribution of personal income is becoming more unequal. Some fear that the U.S. is becoming "Brazilianized"—deeply riven between a corpulent plutocracy of bond traders and corporate lawyers and a struggling proletariat of clerks and factory workers. *Business Week* recently ran a cover story ominously titled "Wages: They're stagnant while profits are soaring. Are we headed for trouble?" *Newsweek* ran an expose of "The Overclass." Stagnating incomes and rising inequality are certain to be central issues in the 1996 presidential election. *Business Week's* provocative article raises the Keynesian specter of the 1930s, that corporations will be plagued by "chronically weak demand"—which is a bit ironic, since a decade ago America was allegedly threatened by "overconsumption" financed with foreign debt.

However, as with the "energy crisis" of the late 1970s, the "industrial competitiveness crisis" of the early 1980s and the "healthcare crisis" of the early 1990s, by the time politicians and pundits latch on to an issue it is usually on the way to being solved. If one looks through the windshield rather than the rear-view mirror, one can see why wages should finally start to increase in the late 1990s for the first time since the early 1970s. This wage growth, in combination with moderate employment growth, will give the consumer sector a distinctly stronger tone in the late

1990s than we have seen recently. In essence, workers *finally will be reaping the benefits of the corporate restructuring of the 1980s and early 1990s*. The trend toward inequality may well continue. But by the end of the decade, with middle-income households enjoying rising wages and low inflation, magazines will have cover stories celebrating “The wage revival” and explaining “Why living standards are rising.” Whoever occupies the White House will take credit for this phenomenon, even though they will have had little to do with it.

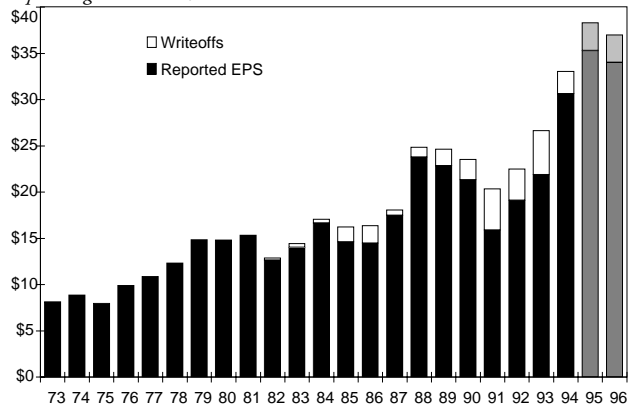
A process of elimination

A “process of elimination” suggests why the consumer should drive growth over the next decade.

- Government is on the defensive; the trend is toward privatizing and downsizing, rather than expanding the reach of the state. For example, the Clinton healthcare reform plan was a “non-starter” politically because it was viewed as a “big government” approach. The Clinton Administration and congressional Republicans are arguing not about whether, but when, to balance the Federal budget—and no one is talking about doing it through tax hikes. That means spending increases must be restrained. At the local level, the trend is toward trimming spending in such areas as healthcare.
- And, although it is not completely over, corporate restructuring is well-advanced in most industries. Indeed, some corporations are not merely “lean and mean” but positively “anorexic” after a decade of record write-offs that so far have totaled almost \$30 for the S&P 500—the equivalent of almost one full year’s worth of earnings (Chart 8). As we noted above, these restructuring initiatives have produced an explosion in profit margins (Chart 3). 1995 second quarter profit margins are now at a cyclical peak that is a 25-year high. So, corporations are not likely to set the pace of growth as they did over the past eight years.

To be sure, we are not expecting a consumer boom in the late 90s, in part because the savings rate also is expected to increase as baby boomers prepare for retirement. Consumer incomes will be rising faster than consumer spending. Hence, an important result of the consumer renaissance will be to power the secular decline in bond yields that we expect in the 1990s (see “6 in ’96”, April 1991 and “5 at the Turn”, March 1993). However, the consumer renaissance also will be a plus for many consumer stocks, which have been overlooked in the early 1990s as corporations, via capital spending and corporate restructuring, set the tone of economic growth. But investing to benefit from these developments is not a simple matter of just lining up *all* the “usual suspects”—the “power brand” growth stocks and/or the cyclical

Chart 8
S&P 500 EPS
Operating EPS since 1982



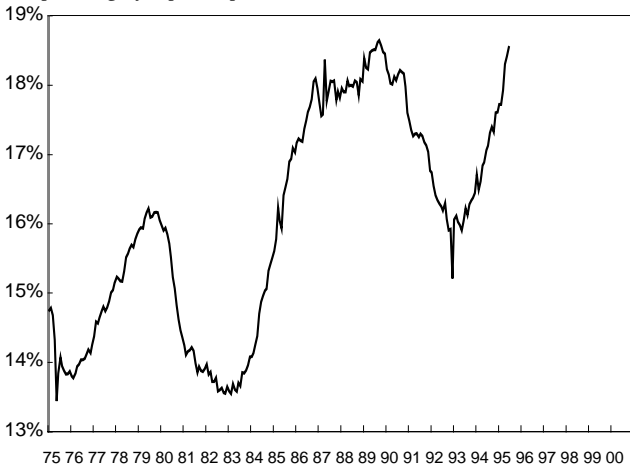
auto/housing/retailing troika. Now “older and wiser,” John Q. Public is not the “ebullient youth” of the 60s, nor the “conspicuous consumer” of the 80s; accordingly, there will be a new set of opportunities.

There is still cyclical risk in the consumer sector . . .

The consumer comeback is mainly a secular, not a cyclical, story; consumer spending could be fairly weak in 1996. With GDP growth slowing sharply in 1995, personal income has grown at just a 4.6% annual rate this year while consumer installment credit has grown at a 14.9% pace. So, consumer installment credit as a percentage of disposable personal income is near record levels (Chart 9). This credit growth is likely to slow in 1996 as loan losses rise at banks and other lenders; this in turn should restrain consumption growth.

We are reluctant to just “explain away” this heavy consumer debt by pointing to mitigating factors. Although expanding use of credit cards for convenience may indeed be boosting debt levels, the Federal Reserve recently concluded that this accounted for a “relatively small portion” of bank consumer-loan debt. Furthermore, consumer credit is *understated* in the sense that it excludes auto leases. Optimists also note that payments on consumer loans, as a percentage of disposable personal income, are well below the historical peaks. The good news is that one reason for this is that interest rates are lower than in prior cycles. The bad news is that these payment figures include *principal repayments* as well as interest payments, and a decline in principal repayments is the main reason for the decline in overall debt payments. Clearly, it is bearish, rather than bullish, for consumption growth in 1996 that consumers are slowing the pace at which they pay down debt.

Chart 9

Consumer installment credit*As a percentage of disposable personal income**... but the rebounding dollar is a relative plus for consumer stocks*

From the beginning of 1994 to its nadir in April 1995, the trade-weighted dollar declined 14.5%. Of course, it dropped far more against the Deutschemark and Yen, the currencies of America's two leading industrial competitors. The weak dollar boosted the earnings of many U.S. firms, including multinationals in the consumer and healthcare sectors, major technology companies, machinery companies, and commodity industries such as steel. IBM, for example, stated that about half its revenue growth in the second quarter of 1995 was due to currency. Now the dollar appears to have turned and could be headed higher in the weeks and months ahead. The same industries that were *helped* by the weak dollar in 1994 and 1995 could be *hurt* by a stronger buck in 1996. In a sense they will be hit by a double whammy in 1996 because they have to try to beat 1995 earnings (which were boosted by the weak dollar) at a time when the dollar is turning against them.

But while a buoyant buck is a negative for most industries, it is neutral or even bullish for domestically oriented consumer companies such as retailers, apparel makers, and service providers. Retailers are probably helped the most, because the cost of merchandise will tend to come down if the dollar is strong. More generally, a stronger dollar is good for domestic consumer firms because it is good for the U.S. consumer.

The productivity dividend: Why wages will rise in the late 1990s

Much as we predicted five years ago, (see "Squeezed," October 1990) the consumer was hammered in the first half of the 1990s for two reasons. As in the 1970s and 1980s, real wages did not rise much. However, unlike the 1970s and 1980s, employment growth slowed because

there was no longer a big influx of baby boomers and women into the labor force. Therefore, although growth in real disposable income *per worker* over the past three years is only modestly below the 1988 peak and is well above the average level in the 1970s (Chart 10), growth in *total* real DPI is far below the peaks of 1979 and 1987 (Chart 11). Over the next five-ten years, overall real DPI growth should be boosted by a resumption of wage growth for the first time since the early 1970s.

Chart 10

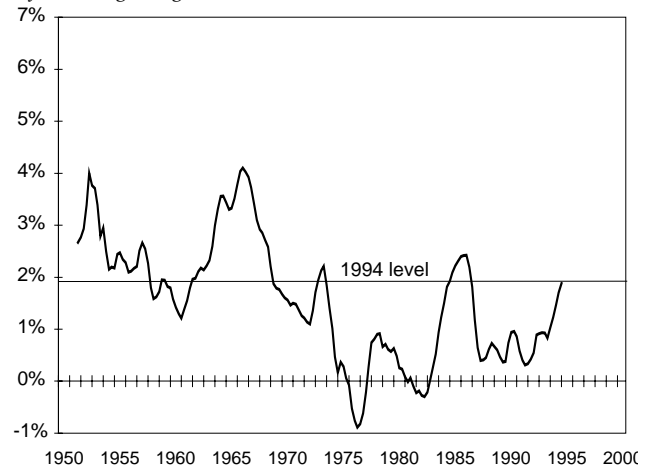
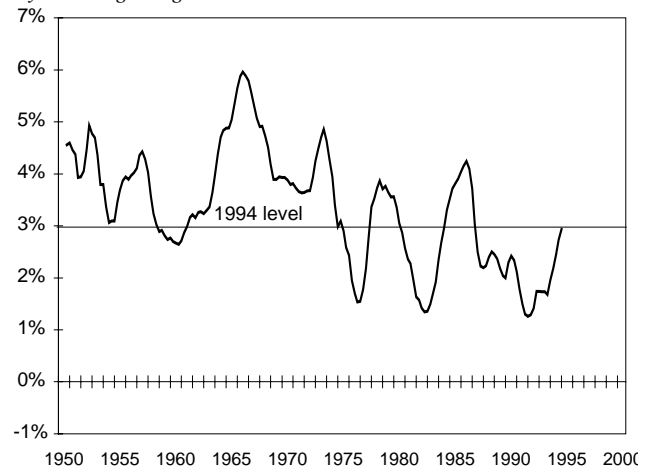
Real disposable personal income growth per worker*3 year moving average*

Chart 11

Total real disposable personal income growth*3 year moving average***Why wages have stagnated**

There is general agreement that real wages slowed dramatically after 1973. The magnitude of the slowdown depends on what time spans one measures; which price deflator one uses to compute "real" wages; whether one looks at hourly earnings, weekly earnings or total compensation (which includes benefits); and whether one discusses the income of an individual worker or of a family. (Figures for a family are affected by the shift to two-paycheck households and by the rising divorce rate:

when a family splits in two, per family income obviously declines.) Charts 12 and 13 show, respectively, the trend in hourly earnings and compensation per hour. Table 3 shows the pattern of long-term income growth before and after the watershed year 1973 for four measures of income.

Chart 12

U.S. real average hourly earnings growth

Year-to-year percent change, by quarter

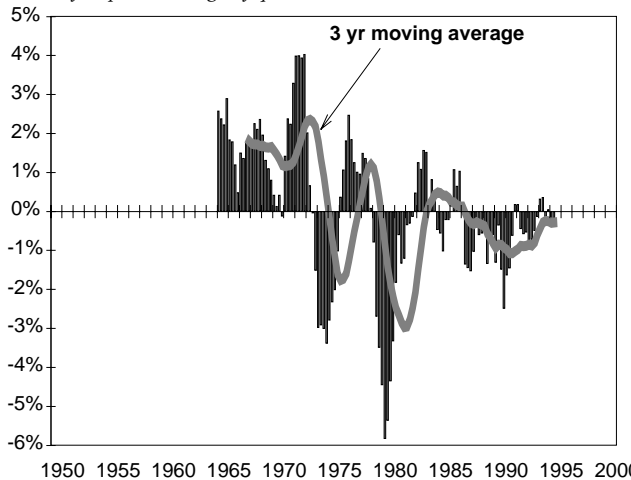


Chart 13

U.S. real average hourly compensation growth

Year-to-year percent change, by quarter

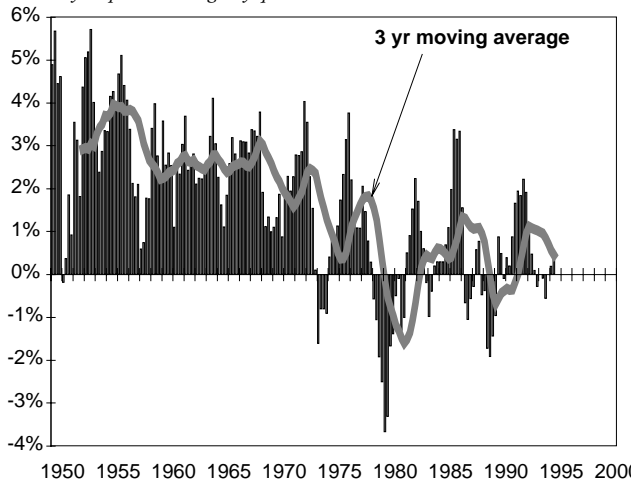


Table 3

Growth in real wages: Four measures

Compound annual growth rates

	1954-64	1964-73	1973-94
Real average hourly earnings	NA	+1.7%	-0.7%
Real average weekly earnings	NA	+1.2	-1.0
Compensation per hour	+2.9%	+2.3	+0.4
Real disposable income per worker*	+2.4	+2.3	+0.6

*Real DPI divided by total labor force, employed and unemployed

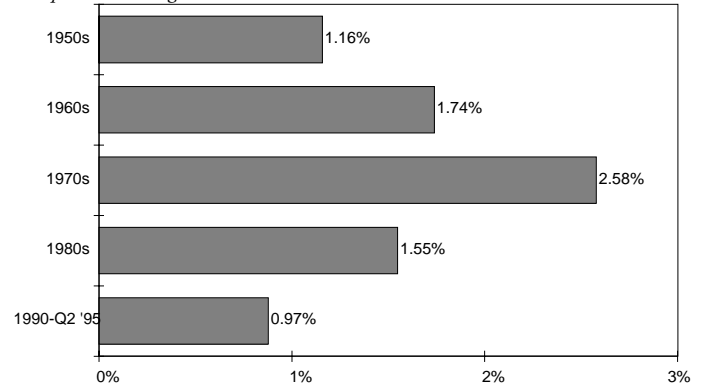
To understand why wage growth will resume, one needs to understand why it ended for 20 years. Among the causes were these:

- An increasing supply of labor, as women and baby boomers moved into the workforce in the 1970s and 1980s. Labor force growth more than doubled between the 1950s and 1970s (Chart 14). When the supply of a commodity increases, the price naturally comes under pressure.
- Stagnating productivity. After growing 2.5% annually between 1950 and 1965 and 2.1% between 1965 and 1973, non-farm output per hour grew at just a 1.0% pace between 1973 and 1994. The aforementioned influx of new workers was a drag on productivity growth, particularly because they were inexperienced. The “cultural revolution” of the late 1960s also hurt productivity growth, as did the upsurge in government regulation. And, during the 1970s much capital investment was geared to saving energy rather than labor. Finally, high inflation discouraged long-term planning, permitting firms to raise prices rather than cut costs.
- The decline of unions, which accounted for 27% of the work force in 1970 and just 15% in 1993.

Chart 14

U.S. labor force growth 1950-95, by decade

Compound annual growth rate



- Intensifying foreign competition and the depredations of corporate raiders inspired extensive corporate cost-cutting and restructuring, which curtailed wage growth. Many American workers today are competing with workers in emerging markets who receive much lower wages.

Of course, wages are only part of the consumer income story. Despite wage stagnation, income growth remained reasonably healthy until the 1990s because of rapid growth in employment. Real disposable income grew about as fast in the mid-1980s as in the 1950s (Chart 11). However, income growth over the past three years has been weaker than in the late 1970s or mid-1980s because we witnessed

a nasty combination of stagnant wages and slower employment growth, which in turn was driven by widespread corporate bloodletting and a lengthy period of economic weakness, 1990-93. This scenario was generally consistent with our 1990 report, "Squeezed."

Supply and demand should boost wages

Wages and income growth should improve in the late 1990s for three reasons. First, demand for labor should stay fairly strong as we avoid a long or deep recession, comparable to 1979-82 or 1990-93. Second, for demographic reasons the supply of labor should not increase very rapidly; by the late 1990s corporations will have to pay up for good workers. Third, after a good 15 years of corporate restructuring and productivity improvement, corporations can afford to pay higher wages without reigniting inflation or losing international competitiveness.

A deep recession can be avoided

Neither of the two classic causes of severe recessions exist today. Thanks to strong productivity growth, modest wage inflation and other factors, inflation is very well contained at the peak of the economic cycle. CPI inflation of just 3% is expected in 1995 and 1996, whereas it peaked at 4.6% in the late 1980s. Confidence in the inflation outlook encouraged Fed Chairman Greenspan to ease monetary policy in July even though the unemployment rate was a low 5.7%. So, it is unlikely that the Fed will jam on the monetary brakes and plunge the U.S. into a severe recession.

The second cause of severe recessions is a financial mania that blows up, precipitating a crisis that undermines business confidence and persuades bankers and investors to sit tight rather than invest. The 1980-83 collapse of the oil economy, which bankrupted Mexico and every major bank in Texas, was one example. Still more destabilizing was the confluence in 1990-92 of a real estate collapse, an S&L crisis, a banking crisis, and an LBO/junk bond crisis, which, despite deft management by the Federal Reserve, led to a prolonged credit crunch as banks bought bonds instead of lending to businesses. Today, no such crisis is on the horizon; the closest we came was the emerging market bubble, which has already burst.

Given the absence of inflationary pressure and financial excess, this cycle is likely to end either in a shallow recession, a la 1960 or 1970, or a "soft landing." While a severe recession is unlikely, there are two reasons to doubt that we can avoid a recession altogether. As noted, consumer debt is at high levels and headed higher in the near term; when banks experience rising losses and curtail loans, this could cause a modest recession. Second, it would be historically unprecedented to have a soft landing, followed by another complete economic cycle. Since 1950 there

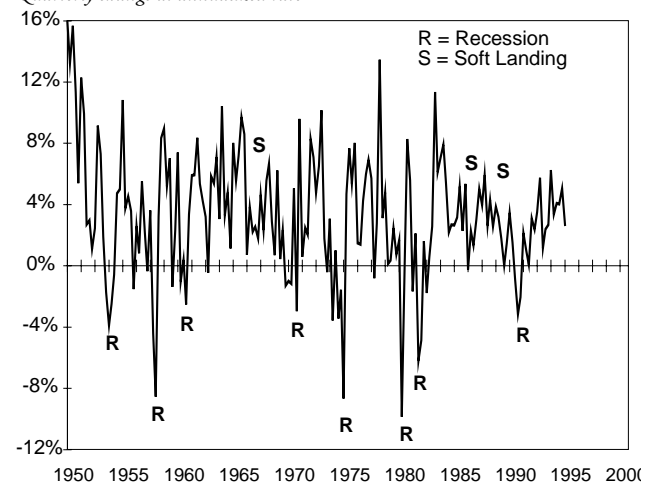
have been 11 economic slowdowns, of which 8 were recessions and 3 were soft landings (Chart 15). Of these soft landings, the 1985 slowdown occurred early in the cycle; the 1967 slowdown occurred late in the cycle and was followed by a year of strong, war-driven growth before we gradually slid into a recession, and the 1989 slowdown was followed by recession within a couple of quarters. We have never had a soft landing at the end of a recovery that was followed by a full cycle.

Aside from a benign economic cycle, another factor may also increase labor demand by the late 1990s, namely, the realization by some corporations that they have slashed their work force too much, creating what some pundits have called "the anorexic corporation." In the rush to cut headcount and improve profitability, some firms have slashed muscle as well as fat. It is hard to expand sales if your sales force is decimated, or to develop new products if your design staff has been cut in half. Large firms are recognizing that one cannot grow earnings indefinitely by cutting costs. At some point, you need sales growth, which may entail hiring new workers. Emerson Electric is one well-managed firms that has shifted its strategic emphasis from cutting costs to expanding sales. So, while corporate restructuring will certainly continue in many industries, the pace of corporate cut-backs is likely to be slower in the late 1990s.

Foreign investment boosts labor demand

Also adding to labor demand is strong foreign direct investment in the U.S., as shown in Chart 16. Actually, this trend is even more powerful than Chart 16 suggests, because whereas the foreign investment boom of the late 1980s centered on Japanese purchases of trophy properties such as office buildings and resorts, today it centers on factories, such as BMW's giant new plant in South Carolina.

Chart 15
U.S. real GDP growth
Quarterly change at annualized rate

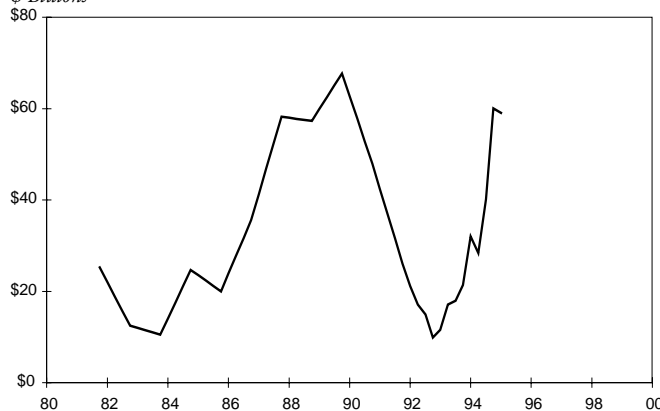


When foreign firms build facilities in the U.S., they get a lot for their money because the dollar is cheap. Furthermore, productivity growth is strong in the U.S.; the weak dollar makes exports competitive overseas; a U.S. factory enjoys preferred access to the NAFTA market (which may be expanded southward); and in times of economic weakness one can fire workers far more easily than in Europe or Japan. It is little wonder that *The Wall Street Journal* quotes an international consultant as follows: "Investment into the U.S. is going to be really strong. When you look at the planning of our clients—especially European and Canadian—there's a lot on the drawing boards." Recent academic studies suggest that foreign-owned establishments pay above average wages, in part because they are relatively large facilities.

Chart 16

Foreign direct investment in the U.S.

\$ Billions



Slower labor force growth

While demand for labor will remain relatively strong in the late 1990s, the supply of labor will grow far more slowly than in the 1970s and 1980s. Labor force growth already has slowed from 1.55% in the 1980s to 0.88% in the early 1990s. The backlash against immigration, symbolized by Proposition 187 passed in California, could also slow labor force growth. So, in the late 1990s the labor force should grow only around 1%. By the end of 1994 we were already seeing distinct signs of tightness in the U.S.

labor market. In Minneapolis, where the unemployment rate was only 3.2%, temporary help firms were paying skilled clerical workers \$16 an hour and were recruiting new workers in shopping malls.

Corporations can afford to raise wages

Faster growth in labor demand during the late 1990s, plus continued slow labor force growth, should produce a significantly tighter labor market in which firms will be obliged to raise wages in order to attract and retain qualified workers. Although they would prefer not to, they won't have an alternative. However, it is doubtful that most corporations will aggressively resist moderate wage hikes, because firms can easily afford them, for these reasons:

- Productivity growth has been strong in this cycle, particularly when one considers that GDP growth has been relatively weak (Chart 17). Of course, a key driver of productivity growth has been heavy investment in high-tech capital equipment; real business fixed investment currently accounts for a record share of GDP (Chart 18).
- As a result of weak wage growth and strong productivity gains, non-farm unit labor costs are growing at the lowest rate since the early 1960s (Chart 19).
- Thanks to healthcare disinflation, the cost of fringe benefits is under control. Benefits grew just 0.2% in the first quarter of 1995, the smallest increase in eight years, and 2.8% in the 12 months ending March, 1995. By contrast, in 1989 benefits were rising at a 6-7% pace (Chart 20).

The knee-jerk reaction to news of rising wages is to fear higher inflation. But this is not likely to occur because productivity is rising rapidly. In the early 1960s, for example, wage growth was strong but inflation was only 1-2% because non-farm output per hour rose at a blistering 3% pace (Chart 21). It is perfectly normal and healthy for the leading factor of production, labor, to share in the growth of the U.S. economy; as such, it should not be viewed as a problem.

Chart 17

U.S. non-farm output per hour

Year-to-year percent change, by quarter

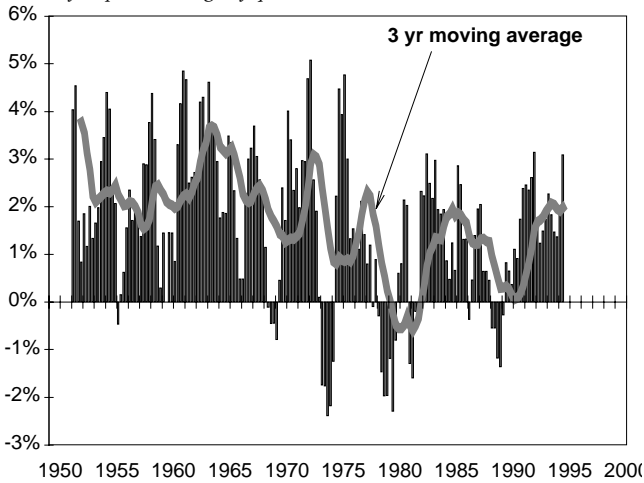


Chart 19

U.S. non-farm unit labor costs

Year-to-year percent change, by quarter

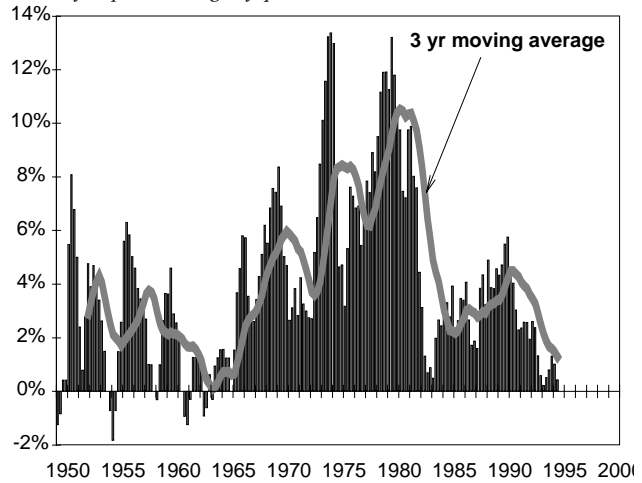


Chart 18

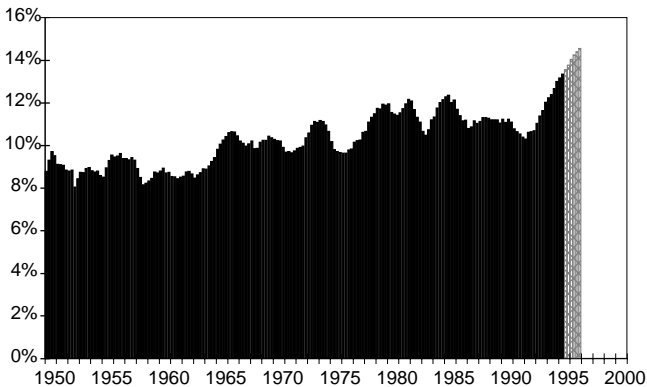
Real business fixed investment as a percent of GDP

Chart 20

U.S. employment benefit costs

Year-to-year percent change, annual

***The inequality increase***

Concomitant with the decline of real wages during the 1970s and 1980s, economic inequality increased. Between 1973 and 1993, real hourly earnings of the bottom tenth of full-time workers declined 16%, wages of the median fell 12%, but wages of the top tenth *increased* 2% (Chart 22). The trend toward inequality has been under way since 1968, but has accelerated since 1983 (Chart 23). The basic reason for increasing inequality is that affluent, well-educated, techno-literate workers were able to avoid the various factors—such as rising foreign competition, an expanding labor supply, and the declining power of labor unions—that hurt most workers.

This “favored tenth” has skills that are much in demand in an expanding global economy—skills ranging from designing microchips to selling telecom systems to trading derivatives to writing screenplays to marketing Doritos. The more proficient of these players in the global economy become quite wealthy, as do successful entrepreneurs who have benefited from the healthy IPO market of the last 15 years. Over the five years ending in 1993, the number of people with a net worth, excluding residences, of more than \$1 million increased a whopping 91%—despite a recession and bi-coastal real estate collapse. Household income also is becoming more unequally distributed because, as women move into high-income professions, there are more two-paycheck families where both paychecks are big.

Chart 21

The 60s: Wages, productivity and inflation

Annual change in real average hourly earnings, non-farm productivity, and CPI

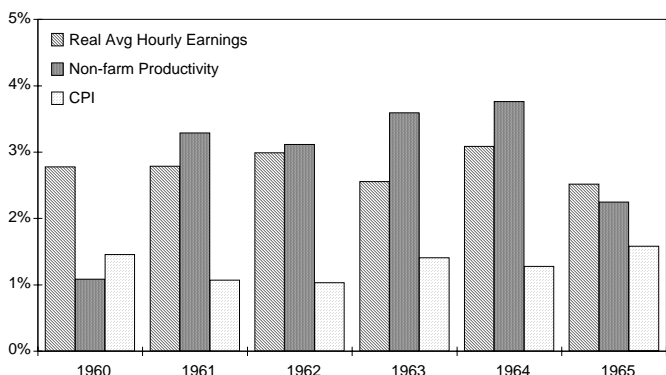
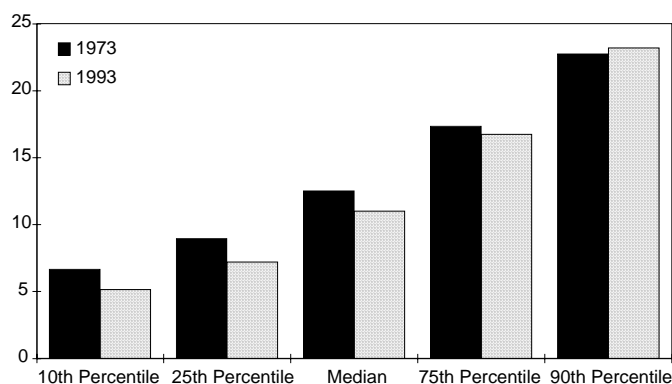


Chart 22

Real hourly wages for men by wage percentile, 1973 vs. 1993

1993 dollars

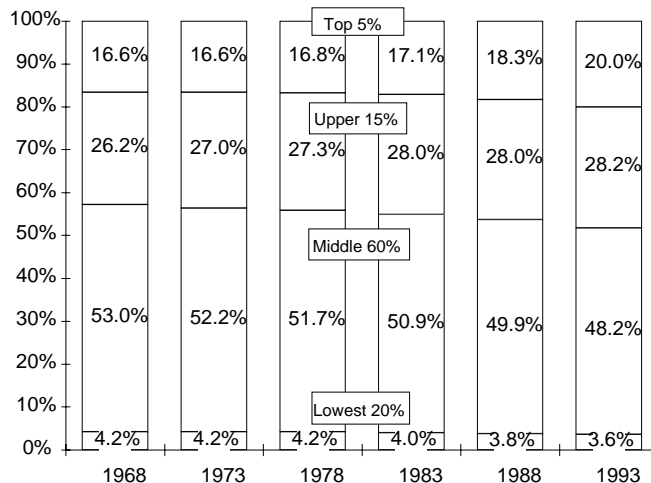


How will this trend toward inequality evolve in the 1990s? The trend is likely to continue, but for somewhat different reasons. Real wages are likely to continue to stagnate in the poorest 10% or 20% of the income spectrum. Partly because of a poor U.S. school system, workers in this segment lack the skills needed in a technocratic economy; they will be hurt by cutbacks in social programs such as food stamps; and they will continue to face competition from low-income immigrants.

On the other hand, skilled workers in the middle of the income distribution should fare better in the late 1990s than they did over the past two decades as corporations scramble to find workers in a labor-short economy. In and of itself, greater prosperity in the middle class will tend to diminish inequality. Even so, during the 1990s politicians, who are destined always to fight the last war, will be pushing certain policies (mainly policies that do not cost tax dollars) that are aimed at reducing inequality.

Chart 23

Share of aggregate household income, 1968-1993



From the point of view of stock-picking, over the next couple of years investors should use a “Tiffany/Wal-Mart” strategy of focusing on the top and bottom of the distribution. But by some time around 1998 it could be time to start buying a “Sears,” which benefits from rising wages in the middle of the income distribution.

Rich and richer

While the poor will be struggling over the next several years and the middle class will be doing better, the affluent will continue to prosper. This is good news for firms that cater to affluent households—ranging from luxury hotels and casinos to art auctioneers to upscale retailers to the trust divisions of banks. Several forces are increasing the number of affluent consumers.

- The U.S. and global economy continues to thrive, so Americans with world-class skills will continue to command excellent salaries and set up successful businesses.
- The stock and bond markets should be relatively buoyant in the late 1990s, as a result of low inflation, good international competitiveness, and a less cyclical economic environment.
- More liberal immigration laws are causing more of the newly rich in foreign countries, ranging from China to Russia to Latin America, to become U.S. citizens. Foreigners value highly the political and economic stability of the U.S., and the depressed dollar enables them to get a lot for their money. Recently, newly rich Russians have purchased dozens of luxury residences in New York City and Miami, often paying with cash.
- The Republicans who control Congress and might soon occupy the White House are more likely to lower than increase the taxes of the affluent. Obviously, this

would mark a huge change in direction from the Bush-Clinton tax policy, which boosted the top federal income tax rate from 28% to 40%. Among the provisions in the tax bill that passed the House of Representatives were:

- \$500 per child tax credit for those with incomes up to \$200,000.
- Lower capital gains tax.
- Lower estate taxes.

Most of these proposals may not pass, but some of them (particularly the lower tax on capital gains) probably will. And the “flat tax” that more and more Republicans are embracing would benefit the wealthy, whose income tax rate would likely decline.

Although the rich are always discovering new ways to squander assets, there are not many obvious manias today, comparable to the real estate binge of the late 1980s or the oil bubble of the 1970s. A great deal of capital is going into the stock market, which is a fundamentally sound investment.

Many affluent baby boomers will be inheriting significant sums from their parents and grandparents. A study by two Cornell professors estimates that boomers will inherit \$10.4 trillion. The value of inheritances is increasing because more decedents are individuals whose careers transpired entirely in the post-World War II period, rather than the depressed 1930s and war-torn 1940s. Consider, for example, an individual who was born in 1922 and died at the age of 73 in 1995. He returned from World War II in 1945, got married, had two children, and set up a successful professional practice in 1950 that generated a substantial amount of capital over the next 45 years that was invested in stocks and real estate. Those savings were granted to his two children, who are themselves financially successful, and who also inherit assets from the other side of the family. Baby boomer inheritances will add materially to income inequality, because well over half of Americans receive no financial inheritance.

Stock-picking themes for the consumer comeback

If we are right that the U.S. consumer makes a comeback over the next five years, what trends and themes should investors focus on in making stock selections? Here are six that should prove useful; naturally, many companies stand to benefit from more than one theme.

1. *A Bifurcated Market*

With income inequality continuing to rise, investors should generally avoid companies that serve the “middle” of the consumer market in favor of those serving the extremes. A good play at the high end is **St. John Knits**, a

leading designer, manufacturer and retailer of distinctive up-scale women’s apparel and accessories, which are distributed both through its own boutiques and through top-tier department stores such as Saks, Neiman Marcus and Nordstrom. Another good high-end play is **Starbucks**; consumers are more likely to shell out \$3.75 for a large mocha if their incomes are rising and their employment prospects are relatively good.

At the opposite end of the spectrum, firms that are effectively focused on the impecunious consumer should also do well. Our primary pick here would be **Wal-Mart** whose core discount store business remains a remarkably healthy and fast growing entity. Another play is **Price/Costco**, the second largest participant in the warehouse club industry, a format which continues to win market share from other forms of retailing given the values it offers.

As the cost and longevity of autos and trucks rises, consumers increasingly view them as investments to be held for a long time. While this dampens unit sales, it also means that affluent consumers are willing to splurge when they do buy a vehicle. Upscale suburbanites like to buy a 4 x 4, such as a Jeep Cherokee or a Ford Explorer, fully loaded with such costly features as anti-lock brakes, leather seats, and a good sound system. Retailing for around \$32,000, such vehicles carry hefty profit margins for the Big 3 auto makers. This trend is bullish for Detroit in its battle for market share with the Japanese, whose strength lies in cars rather than trucks. Our core holding in the auto sector would be **Ford**, although **Chrysler** and **General Motors** should also benefit from this trend toward less-frequent but more ostentatious purchases of automobiles.

Increased content of expensive components is obviously bullish for auto supply companies. Even more bullish for selected suppliers is the consolidation which will soon take place in the auto supply industry. The Big Three have acknowledged that to stay competitive they must become even more productive, with the result that they intend to cut down the number of their suppliers from the thousands to several hundred. Those auto suppliers that survive this consolidation will clearly be well positioned for sustained growth.

Some well-positioned auto supply companies include:

- **Tower Automotive**, a leading supplier of stamped components, with a particular focus on complex, value-added items.
- **Eaton**, whose electrical and electronic controls segment continues to grow rapidly. Electronic content on autos in the U.S. has risen at a 16% rate over the last ten years and is expected to continue to grow at this rate over the next ten years.

- **Masland**, a leading designer and manufacturer of carpet and vinyl floor systems, interior and luggage compartment trim components, dash insulators and other acoustical products. A key driver of Masland's growth is the aforementioned higher content per vehicle.

Rising inequality will be a hot topic in Washington for the next few years; Congress will be searching for ways to counter the trend without raising taxes or increasing spending. One popular approach, strongly supported by the potent housing lobby, is to encourage home ownership by Americans with moderate incomes. In the U.S., far more than Europe or Japan, owning your own house is a symbol of membership in the middle class. Historically, Washington has encouraged home ownership through the FHA insuring mortgage loans to low-income families, but the FHA will be under severe budgetary pressure in the age of Newt. This will in turn increase business opportunities for **Fannie Mae**, for whom mortgage insurance is a major business, and **MGIC Investments**, one of the two leading players in the private mortgage insurance market. Fannie Mae and MGIC are not direct competitors because MGIC and other PMI insurers provide coverage of small losses on mortgages while FNM insures for the excess.

At the other end of the spectrum, **Toll Brothers** should benefit from more affluent families trading up to larger, more expensive homes. The company builds luxury single-family houses mainly in the Boston to Washington, D.C., corridor. In addition, affluent baby boomers concerned about their parents living alone may purchase a home for them in an adult community in a Sunbelt state. A beneficiary of this would be **Del Webb Corp**, a real estate company that develops active adult communities located primarily in the Southwest.

Another good play on the inequality increase are firms that offer affluent consumers financial services ranging from investment advice to loans to custody services. Two good names here are **Fifth Third Bancorp**, a well-managed Cincinnati-based bank with a large trust department, and **Republic New York**, which is expanding its well-regarded "private banking" division into the U.S. market.

Avoid the constricted middle (for now)

In the age of the bifurcated consumer market, one should generally avoid firms serving the middle of the market, such as Dillard and Gottschalks, as well as other regional department stores, discount stores, and so-called "off-price" apparel retailers. Not only is the middle market segment growing slowly, but it is where the most excess capacity has been built up over the past decade. Discounters such as Caldor, K mart and Venture Stores are also at risk (while Bradlees has already slipped into Chapter 11), particularly as Wal-Mart, and soon Target, marches through the Northeast.

Of course, business conditions may improve in the middle market by 1998 or so, when much excess capacity has been shuttered and the middle market is finally benefiting from the pick-up in wage growth we are forecasting. Probably the best way to play a revival in the middle would be Sears.

Every rule has its exception, however, and one department store chain we would buy now is **Federated Department Stores**, which has been delivering better-than-expected earnings because of consistently "above plan" sales as well as tight cost control. In addition, Federated is an excellent play on the consolidation in the retailing industry, as witnessed by its recent agreement to buy Broadway Stores on the West Coast. And, like Sears, Federated stands to benefit in the late 1990s by a pick-up in real wages.

Another beneficiary of the improving fortunes of consumers should be the newspaper industry, which should enjoy stronger growth in classified ads and help wanted, as well as in display ads by retailers. A buoyant consumer environment is also positive for the broadcasting operations of newspapers. Our picks here would be **A.H. Belo**, **Gannett** and **Central Newspapers**. Soaring newsprint costs have been a depressant for the group, but this problem should begin to ease in 1996. And newspapers are better prepared for the digital age than many investors realize.

Chart 24
Percent change in U.S. age population, 1995-2000

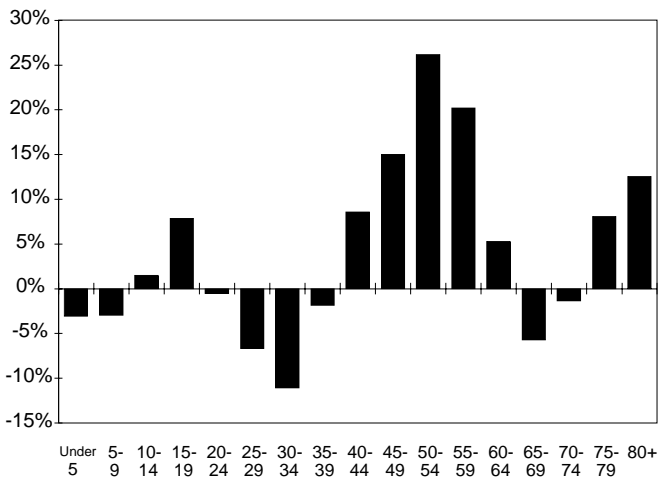


Chart 25
Absolute change in U.S. age population, 1995-2000
Millions

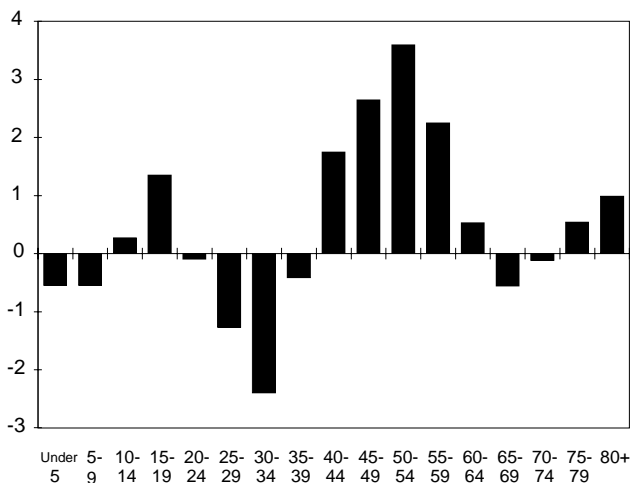
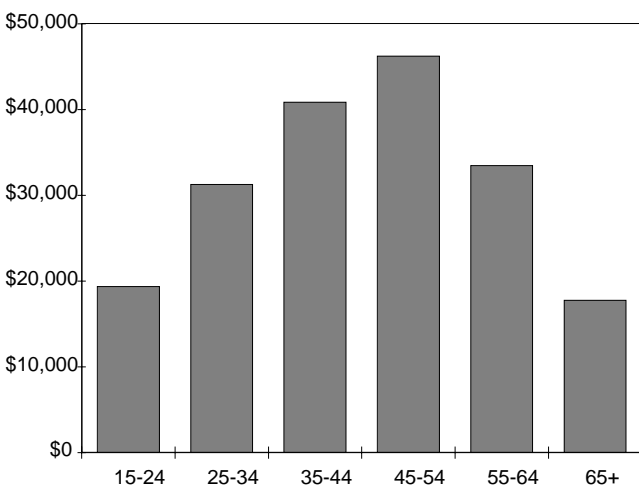


Chart 26
Median income of U.S. householders by age, 1993



2. Boomers: Richer, Older and Wiser

With baby boomers moving into middle age, the fastest growing age segment in the late 1990s will be people aged 45-60 (Charts 24, 25). Ever since they were riding tricycles, boomers have powerfully impacted the economy by virtue of their sheer numbers, but this impact will be amplified in coming years by the fact that boomers are entering their peak earnings years (Chart 26). As usual, there are a lot of boomers, but now they are making a lot of money. What companies will benefit?

Commerce Department surveys show that one of the spending categories with the biggest absolute *increase* between the 34-44 and 45-54 age groups is entertainment (Chart 27). Among the broadly diversified entertainment firms that could benefit from this fact, we particularly like **Disney**, **Time Warner** and **Viacom**, because they are very strong on content. Perhaps with an eye to the aging of boomers, Disney's Miramax movie division has broadened the company's offerings beyond "Bambi" and "The Little Mermaid" to more mature fare such as "Pulp Fiction" and "The Crying Game."

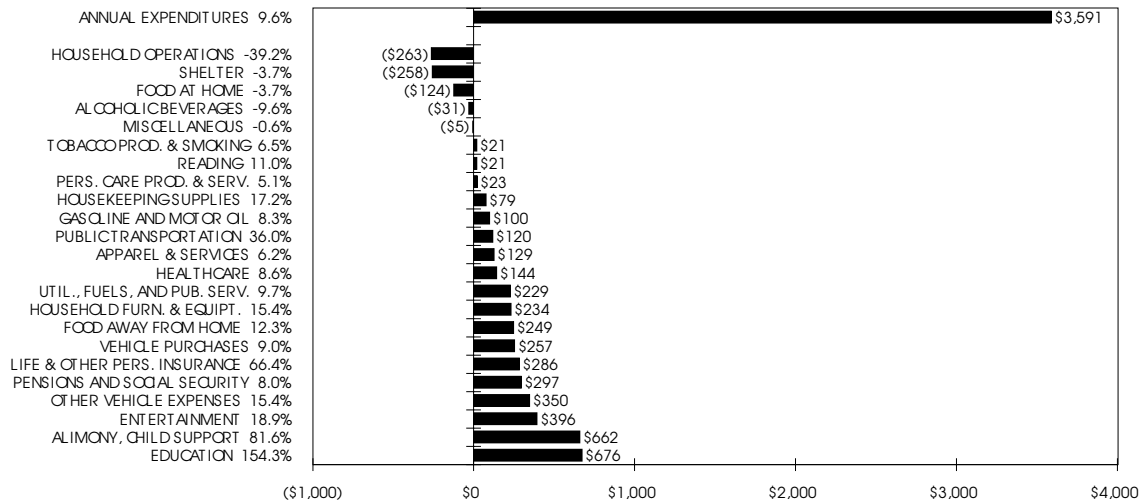
Consumers in the 45-54 segment are the biggest buyers of jewelry (Chart 28). An excellent play on this is **Zale**, the nation's largest specialty retailer of jewelry. While Zale has had a checkered financial history, including an LBO followed by bankruptcy during the 1990-91 recession, new management has reinvigorated and refocused the core business, resulting in increased market share and improved margins. Another play here is **Tiffany**, one of the most prestigious retailers of jewelry in the U.S.

A good play on aging boomers' increased consumption of entertainment products as well as their propensity to travel more is **LodgeNet Entertainment Corp.**, one of the largest and fastest growing providers of interactive entertainment and information services to the hotel industry. Guest room services include movies-on-demand and video games (i.e., network-based Nintendo). The company serves more than 330,000 guest rooms at approximately 2,300 hotel properties in the U.S. and Canada. By year-end, the company should have become the leading provider of on-line services, and games in the industry.

Boomers will also be opening their wallets to buy books; two industry studies forecast annual sales increases of 7% between 1994 and 1999. This is a plus for **Viacom's** book division, Simon and Schuster. A more leveraged play is **Barnes and Noble**, the nation's biggest bookseller and the developer of the superstore concept, which is pushing the cramped traditional book store toward extinction by making book buying relaxing and enjoyable.

Chart 27

Change in household expenditures from 35-44 to 45-54 age group

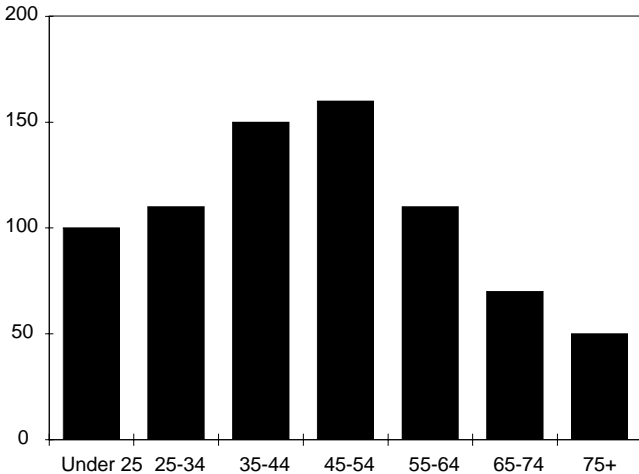


A variety of other companies could benefit from boomers' spending on entertainment, including boat builders, recreational vehicle companies, casinos and cruise lines. Of course, many of these companies are cyclical and could be hit by the 1995-96 slowdown in consumer spending, but they stand to benefit from the longer-term consumer comeback. Some of these industries, such as boat building, pretty much sat out the 1991-95 economic recovery.

Chart 28

Average annual jewelry expenditure (by age), 1991

Dollars



As they grow older and wiser, boomers are more discriminating consumers. Having already done this and bought that, it takes a lot to impress them. A major casualty of this trend is fashion-oriented retailers such as Limited and U.S. Shoe, as well as the vast undifferentiated "middle-of-the-mall" group of stores. One measure of fashion's fade is that August is no longer a bellwether month in the trade. In the good old days, when the fall fashions appeared on the shelves in August, women flocked to the stores to look

over the selections and begin updating their wardrobes. Now they wait until September, preferably after nervous retailers put autumn apparel on sale.

One example of consumers' more practical orientation is a trend toward "bifurcated" wardrobes. Instead of buying mid-priced garments for all occasions, they are purchasing inexpensive, durable, sensible clothing for everyday use (a trend accentuated by the rise of the home office) but investing in high-quality clothing for special occasions. Of course, this accentuates the bifurcation of the retailing world discussed earlier; consumers buy their everyday clothes at Wal-Mart and the Gap, but they might go to a **St. John Knits** for their "good clothes."

Although the trend toward the home office and toward casual attire can be viewed as a negative, **The Men's Wearhouse** is nevertheless a good play on the practical bent of consumers, because it is a good place to buy "work clothes" with a minimum of fuss and expense. **SUIT's** stores sell primarily name brand and designer apparel at everyday low prices that are typically 20-30% below department stores and full-price specialty stores.

The health kick

With their bodies starting to sag, wrinkle and wheeze, boomers are spending heavily on vitamins, health foods and fitness clubs. Hamburgers are out, mesclun lettuce tossed with raspberry vinegar and extra virgin olive oil is in. So, it is little wonder that the vitamin, herbal and mineral supplement market is projected to grow 6-9% annually—a boon to **General Nutrition Centers**. In fact, fully 63% of GNC's sales are to people over the age of 35, while 33% of the U.S. population now use some form of nutritional supplements regularly.

Even vices are becoming healthier as coffee bars replace the real thing, to the great benefit of **Starbucks**. Starbucks has 607 stores today, up from 240 two years ago; by 2000 it plans to have over 2,000 stores. An important strength of Starbucks is that it is both a *retailer*, operating small stores, kiosks and large cafes, and also a *consumer brand* of coffee, which can be sold via mail order or in off-site locales such as hotels and airlines. SBUX does not have a major national competitor, and since coffee is the second most popular beverage it has ample room to grow.

3. The Golden Years

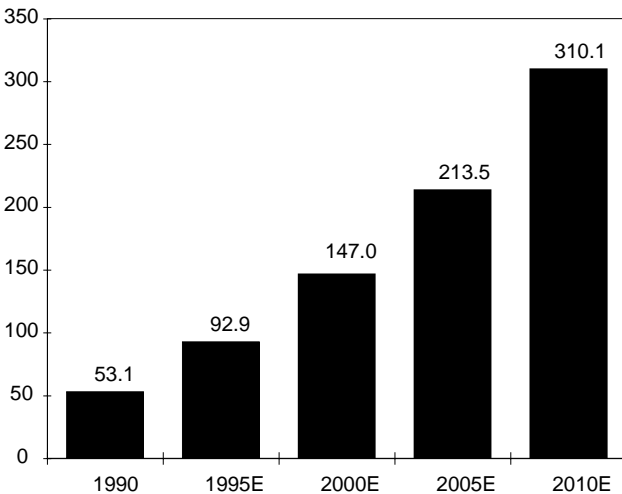
Another fast-growing segment of the U.S. population is people over 75 years old (Chart 24, 25). One of the biggest beneficiaries of rapid growth in the over 75-year population is nursing homes. Industry revenues grew 11.6% annually over the past five years and are expected to grow 9.6% per year from 1995 to 2000 (Chart 29). Demand is being driven not only by demography; regulatory and technological factors are allowing nursing homes to provide more intensive care than in the past and to grab a bigger piece of the healthcare dollar.

The 1983 Medicare reforms that created DRGs induce hospitals to *discharge patients to nursing homes sooner rather than later*, because hospitals receive the same reimbursement for a given procedure whether the patient stays two days or ten. New technologies enable nursing homes to do more for patients, and to do it more cheaply than could a hospital. Procedures such as cardiac surgery are saving more lives, but patients may require a period of recuperation before returning home. Sophisticated medical equipment and techniques enable nursing homes to provide “subacute” care once provided in hospitals such as ventilator care, intravenous therapy, complex wound care, traumatic brain injury care and post-stroke care. As

Chart 29

U.S. nursing home spending

Dollars in billions



nursing homes take on more responsibilities, the health services industry is becoming more differentiated into various segments, ranging from the hospital where surgery is performed, to rehab hospitals, subacute nursing homes and the plain vanilla nursing home.

A strong player in this sector is **Integrated Health Services**. A leader in the subacute sector, it operates over 1,800 medical specialty unit (MSU) beds. From a base of attractive, high private pay facilities, IHS introduced distinct MSU units that specialized in caring for ventilator-dependent patients, complex care patients and patients requiring subacute rehabilitation, as well as other medical services. As a result of its aggressive expansion of subacute beds and acquisition activity, IHS has more than doubled in size since 1991.

The home health care market also is benefiting from some of the same dynamics as the nursing home industry, specifically the push to treat patients in less expensive settings. A good play here is **Apria Healthcare Group**, formed by the merger of Abbey Healthcare Group and Homedco Group. The company is one of the largest providers of home health care services in the U.S., with estimated sales this year of approximately \$1.1 billion. Apria operates in three primary business segments: home respiratory therapy (about 55% of sales), home infusion therapy (e.g., administering medicines or nutrients through IV tubes), and home medical equipment.

One other sector that should benefit from rapid growth in the over 75-year population segment is providers of ambulance services. For some of the reasons discussed above, the average number of ambulance trips per patient has been *increasing*. In the past, patients were transported to a hospital, where they stayed until full and complete recovery. Now, after the initial emergency call, patients are moved to the most efficient provider. Non-emergency transports might include transfer to an HMO facility, and separate trips to centralized testing facilities. Finally, discharged patients who are not fully recovered might require ambulance services if they are sent to a post-hospital care facility to complete recovery.

Two plays on increased ambulance use are **Rural/Metro** and **American Medical Response**. Rural/Metro is the third largest integrated provider of local emergency services, including ambulance and fire services. The company operates ambulance services over a broad range of municipalities, including those in Arizona and Florida where an estimated 25% of ambulance revenues are derived. American Medical Response provides ambulance services in Northern California, plus parts of Connecticut, Delaware, New Jersey, Mississippi, Oregon, Colorado and Florida.

A previously mentioned play on the elderly is **Del Webb Corp**, a real estate company that develops active adult communities located primarily in the Southwest. As we noted, affluent baby boomers concerned about their parents living alone may purchase a home for them in an adult community in a Sunbelt state.

It has been estimated that the continuing rise in the number of older North Americans will lead to a 1% rise in the death rate through 2010, accelerating to 2.5% thereafter. One play on this is **Service Corporation**, the largest funeral service and cemetery owner in the U.S. As well as benefiting from a rising death rate, another positive for Service Corp is that the dollar amount spent on funerals is likely to increase, as the older generation has saved considerable sums in their (post-war) lifetimes, some of which can be spent by their heirs on a suitably elegant funeral ceremony and cemetery plot.

4. *Home Improvement*

The median age of first-time home buyers is 31.6 years, while the median age of repeat buyers is 41.7. Consequently, housing starts have declined as boomers move into their 40s (Chart 30). But even though starts are down and housing is no longer viewed as a “can’t miss” financial proposition, as it often was in the 1970s and 1980s, Americans still love to spend money on their dwellings.

For example, the average size of new houses has been climbing even though median household size has dropped (Chart 31). Spending on shelter ranks first in terms of absolute spending increases as households move from the under-25 age group to the 25-34 age group, and this continues to be true as they move into the next age group, 35-44.

By contrast, as they move into the next age bracket, 45-54 (i.e., the current age of many boomers) spending on shelter actually declines, but expenditures for “household furnishings and equipment” still rises strongly (Chart 27).

Evidently households stretch financially to buy a house and then, after the mortgage payments become more manageable, spend freely to make the dwelling more comfortable.

One of the best ways to play American’s love affair with their homes is **Bed Bath and Beyond**, whose houseware superstores have grown very rapidly in the past decade but still have less than 1% of the total market. BBBY’s stores average 40,000 square feet and sell a vast assortment of name brand items, ranging from towels to linens to table ware to bath accessories. Management runs a lean company and gives individual stores considerable leeway in responding to local tastes. Although not invulnerable to a cyclical slowdown in the housing market, BBBY should be able to grow at a 25% pace over the long term.

Chart 30
Housing starts
Thousands

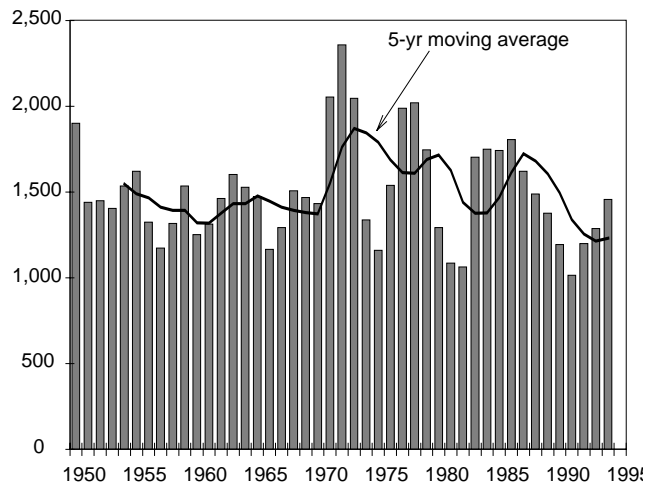
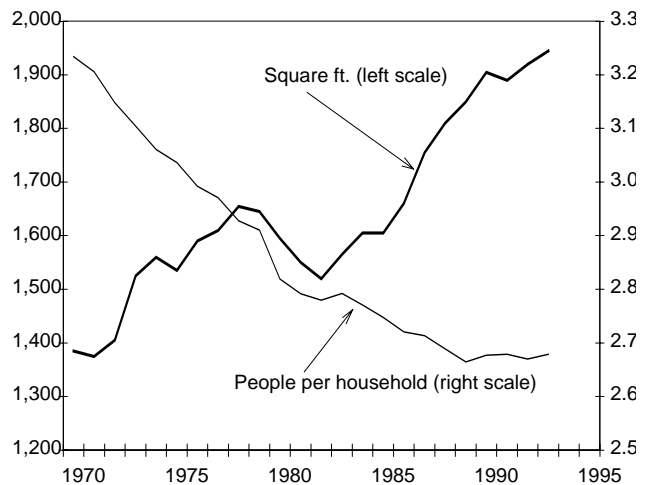


Chart 31
Average square feet per U.S. home vs.
average number of people per household



One force driving increased spending on the home is the rise of the home office, which in turn is driven by a combination of improving technology; corporate restructuring that has transformed thousands of middle managers into “consultants;” and employers encouraging their employees to work at home, both to save money and comply with environmental laws curbing commutation into congested and smoggy cities. The growth in home offices has been phenomenal in recent years. Fully 43 million Americans now work out of the home; the number of home office workers has been growing 15% annually over the last three-four years.

One firm benefiting from the home office explosion is **Staples**, the office superstore chain. SPLS should be able to grow at a 33% pace by selling office products, office furniture, computers, and consumables such as fax paper

and toner for copiers and printers. **Officemax** is also well-positioned to benefit from the growing but fragmented market for office products.

Of course, the centerpiece of the home office is computer technology and, as computing goes multi-media, more and more computers, printers, and modems also will be used in the den and the living room as well. In a few years, computers and TVs will converge into a device that can be used for computing, word processing, browsing the internet, playing games, reading CD ROMs or receiving movies over a modem connected to the cable company's wire. Parents will be spending freely on this technology to insure their kids are not left behind by the multi-media revolution.

Five years from now, we would wager, sociologists will consider computer ownership a litmus test of whether or not a household is part of the striving middle classes. Partly because of strong demand from the home, PC sales will grow at a mid-teens pace through the end of the decade, with the leading vendors gaining substantial market share as the industry consolidates. Stocks for playing this powerful trend include **Compaq**, **Hewlett-Packard**, **Intel** and **Microsoft**.

One of the few consumer companies well-positioned to sell products via computers is **CUC International**, which enrolls consumers in various clubs and offers them discounts on a wide variety of products and services. Most of CUC's business is done over the phone and through the mail, but it is moving on-line.

As well as having a computer, printer and FAX, many home office workers consider a cellular telephone to be indispensable. The attraction of a cellular phone to the home office worker can be attributed to several factors:

- Convenience: many home office workers are frequently on the move outside the house, either on the way to a client or to Staples to buy more fax paper. A cellular phone allows the roving home office worker to make calls in traffic jams, train stations, etc.
- Critical mass: as more people own cellular phones, a cellular caller is more likely to reach the person called, cutting down on wasteful "telephone tag."
- Fear of crime: workers in a large office downtown are less vulnerable to criminals than a home office worker in a broken down car along the side of a road—the faster you can dial 9-1-1, the safer you are.

An excellent play on cellular is **Motorola**, the preeminent supplier to the industry; over 90% of its revenues and profits are derived from the semiconductor, cellular,

paging and two-way radio markets. As well as cellular phones, home office workers also use pagers. One play here is **Paging Network**, in part because of its VoiceNow product. Developed by Motorola and Paging Network, VoiceNow turns a pager into an answering machine on your belt. Instead of receiving a numeric page (i.e., a phone number) a home office worker on the move receives a voice message that is stored at the pager and can be listened to with a press of a button.

5. *The Country Western Consumer*

A powerful consumer trend with important implications for stock selection is the rise of the "country western consumer," a consumer who lives in the South, goes to church regularly, votes conservative and prefers TNN (The Nashville Network) to MTV (Music Television). The income of this consumer is rising as the South prospers. With many firms fleeing the high taxes and strict regulations of the Northeast and Midwest, labor demand is strong. Since 1991, employment has been growing more than 2% annually in the South, while it was nearly flat in the Northeast (Figure 2).

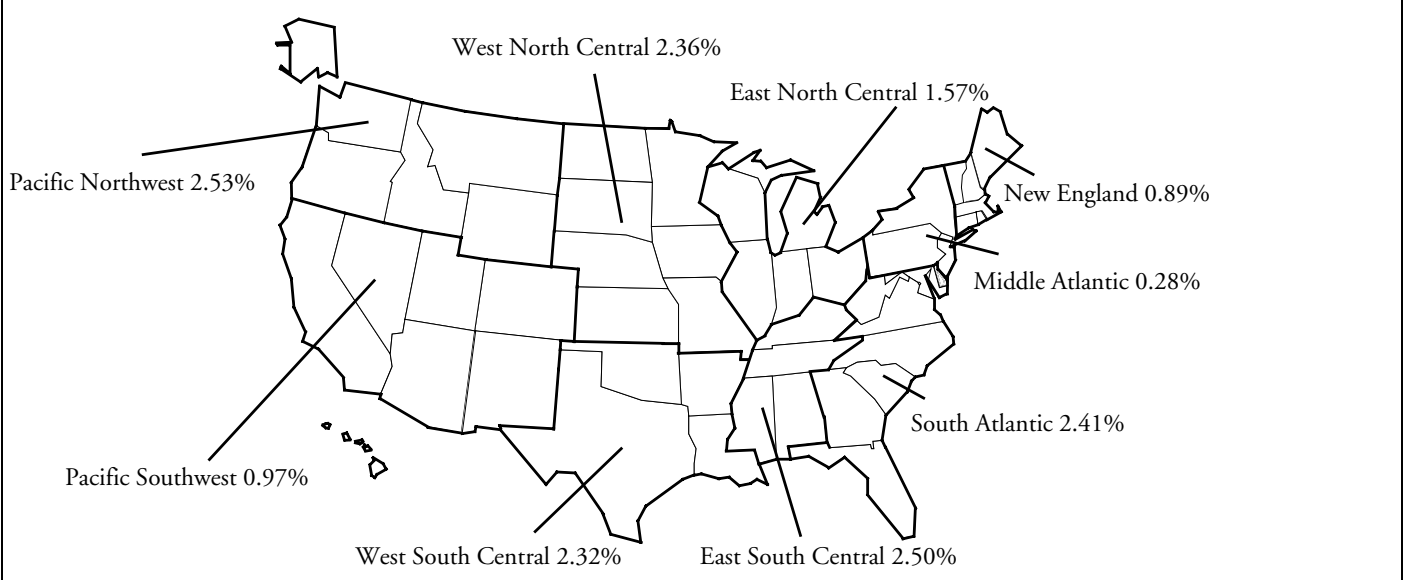
But, it is not just raw economics that makes the country western consumer an attractive investment concept. Cultural forces are also at work. As the South has become more influential economically and politically, its cultural clout has also increased.

In Washington, D.C., these days, the Ivy League is out and the Atlantic Coast Conference is in. No fewer than three of the most influential members of Congress used to teach at southern universities. "Family values" is now a mainstream political tenet.

As a result, what used to be regional niche markets are going mainstream, and companies that can ride this trend are growing rapidly. A good example is **Thomas Nelson**, the leading U.S. publisher of bibles and Christian books such as *A Dance with Deception* by Charles Colson and *The Turning Tide* by Pat Robertson. One factor boosting sales of these products is that they are now available in some mass market retailers such as Wal-Mart and K mart.

In the entertainment sector, two firms benefiting from the prosperity of the country western consumer are **Gaylord Entertainment**, operator of the Grand Ole Opry in Nashville, and TNN (The Nashville Network), and **Carmike Cinemas**, whose small-town movie theaters are located mostly in the South. **A.H. Belo**, owner of the Dallas Morning News and several broadcasting properties in the Southwest and South, also stands to benefit from this trend.

Figure 2
Growth in employment
Annual rate Q2 '91-Q2 '95, by region



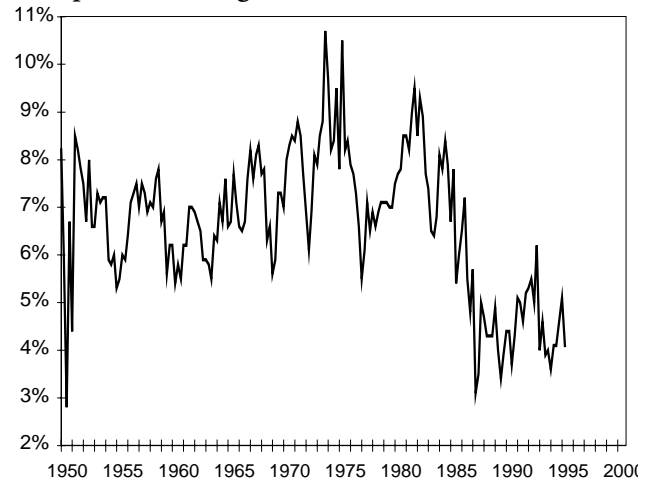
Even more directly tied to the fortunes of the South is **BellSouth Corp.**, whose unit growth, measured in terms of either access lines or minutes-of-use, is the second highest among the Baby Bells. Smokeless tobacco is particularly popular in the South, so the prosperity of the region is a plus for **UST Inc.** UST has an 83% market share and is one of the most profitable corporations in the United States with an ROE of 98%. Its market share has slipped a few points because of a dearth of new products, a problem that management is now addressing. Because the company depends on price increases for much of its revenue growth, a rise in real wages would be a significant plus for the company. The country western consumer might buy his smokeless tobacco at one of **Circle K's** convenience stores. The company (which has 541 stores in Arizona, 428 in Florida, and 263 in Texas) is heavily dependent on tobacco sales—convenience stores sold 28% of cigarettes ten years ago, and this has risen to 37% today. In addition, Circle K is the largest independent gas retailer, selling 1.5 billion gallons annually.

6. *The Savings Surge*

With retirement staring them in the face and Social Security apparently offering a tattered and treacherous “safety net,” baby boomers will likely be directing a growing share of their incomes toward investment. Spending on insurance and on pensions are two areas where households in the 45-54 age group increase spend the most (Chart 27). The personal savings rate is low by historical standards (Chart 32), but as boomers seriously

contemplate a retirement spent on a park bench it should finally turn up. Politicians also are becoming more concerned about this prospect, and any tax reform the Republicans devise is likely to encourage saving.

Chart 32
U.S. personal saving rate



A broad range of firms, including brokerage firms, insurance companies and mutual fund companies, stand to benefit from this trend. Two we would focus on are **Fifth Third**, a well-managed Cincinnati-based bank with a large trust department, and **Republic New York** which is expanding its well-regarded “private banking” division into the U.S. market.

Additional information is available upon request.

Prices of other companies mentioned as of 8/29/95:

Caldor Corp CLD \$8 7/8
Emerson Electric EMR \$71 1/8
Gap Inc³ GPS \$32
Int'l Bus. Machines² IBM \$102 1/2
K mart³ KM \$14
Limited Inc³ LTD \$18 3/4
Neiman-Marcus Group NMG \$15
Nordstrom, Inc¹ NOBE \$40 1/8
Sears Roebuck³ S \$32 7/8
Venture Stores VEN \$6

¹PaineWebber Incorporated makes a market in this security.

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September 4, 1995

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