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Climbing the Wall of Worry— Again

February 25, 2001

When Investors Are Most Frightened Is When Investment Opportunity Is Greatest

- Like the bull markets of the 1930s and 1950s, today's bull market has had to climb the proverbial Wall of Worry. And since this bull market began in the early 1980s, there have been four periods when a Wall of Worry created significant undervaluation. Today is the fifth such period. *Yet the market scaled previous Walls of Worry and eventually hit new highs.*
 - 1981: Inflation! OPEC could pretty much name its price and it seemed that the government had simply given up the fight for price stability. In came Reagan and Volcker—stocks were 43% higher in September 1983 than in September 1981.
 - 1984: The huge Federal deficit, debt and an overvalued dollar. But the real story was continued disinflation, which would further boost P/Es —stocks +47% in two years.
 - 1990: Recession, Saddam Hussein and bad real estate loans. But, as they discounted victory over Saddam, the survival of the U.S. banking system, and a resumption of economic growth in the second half of 1991, stocks rose 34% in 14 months.
 - 1998: Financial panic led to deflationary danger. As the Fed provided liquidity, from their October 1998 bottom through December, stocks soared 33% in two months.
 - 2001: Fears of U.S. recession, weak earnings, troubled technology sector, California utility crisis, demoralized consumers. Once again the Fed wants growth to resume—never fight the Fed! All know it, but few seem to believe it.
- By comparison to previous Walls of Worry, there are many positives today—low inflation, a Federal budget surplus, likely tax cuts, low bond yields, moderately weaker dollar, continued U.S. GDP growth.
- The current climate of fear creates an outstanding buying opportunity. Valuations today are at or near levels reached at the bottoms of the four prior market pullbacks that have occurred since this bull market began two decades ago. Still see 1715 S&P 500 year-end 2001.

How quickly things change! After last year's misguided Y2K paranoia was assuaged, the consensus then saw a seemingly unending boom. The ephemeral consensus now sees risk of a U.S. recession. And technology, recently viewed with unbridled enthusiasm, is now viewed as in a death—or near-death—spiral. In fact, fear has always been an intrinsic part of this—and all—bull markets.

Way back in November 1985, when the DJIA was trading at 1400 and investors were brooding about a weak U.S. economy, disappointing profits, a huge Federal deficit and a flood of imports from Asia, we wrote a report titled “Climbing the Wall of Worry” (November 1, 1985). Whether it was the harrowing depression of the 1930s or the Cold War of the 1950s, we argued, those times when investors were most frightened by political and macroeconomic problems were precisely the times when investment opportunity was greatest.

We updated that report in 1998 when the DJIA dropped to 7400, as investors were confronted with a possible Clinton impeachment, recession in Asia, financial meltdown in Russia, a slowdown in Latin America and fears of a recession in the U.S. (see “Still Climbing the Wall of Worry,” September 20, 1998). That 1998 Wall of Worry created the fourth period of significant undervaluation since this bull market began in the early 1980s. Today is the fifth such period (Table 1).

The average performance of the S&P 500 12 months after our P/E model first signaled that the market was 20% undervalued is +17%; 24 months after, it is +43%, even with at best modestly declining earnings in each of these periods.

Table 1: S&P 500 Performance After First Date of +20% P/E Valuation

	First date of +20% P/E valuation	# of months S&P bottom from first date of +20% valuation	S&P 500 Price from First date of +20% P/E valuation		S&P 500 Trailing 4Q EPS		% change in EPS
			+12 mo	+24 mo	Peak	Trough	
1	Sep-81	+11 mo	+4%	+43%	1981 Q4 (\$15.36)	1983 Q1 (\$12.42)	-19%
2	Oct-84	0	+14	+47	1984 Q4 (\$16.64)	1986 Q1 (\$14.52)	-13
3	Apr-90	+6	+13	+25	1989 Q2 (\$26.33)	1991 Q4 (\$20.34)	-23
4	Aug-98	0	+38	+58	1998 Q2 (\$45.07)	1998 Q3 (\$44.52)	-1
5	Dec-00				2000 Q3 (\$56.71)		
	Average	+4.25 mo	+17%	+43%			-14%

Source: UBS Warburg LLC.

As we noted recently (see “Bull Market Playbook,” January 28, 2001), “the average performance of the S&P 500 12 months after our P/E model first signaled that the market was 20% undervalued is +17%; 24 months after, it is +43%, even with at best modestly declining earnings in each of these periods.”

Once again the Fed wants growth to resume. Never fight the Fed! All know it, but few seem to believe it. Why? When the investment environment seems particularly bleak, it can be hard for investors to focus on stocks' upside potential. With stock prices down sharply from their highs and investors fixating on the potential implications of a U.S. recession, now seems a good time to revisit “Climbing the Wall of Worry.”

Previous Walls of Worry

This bull market that began in the early 1980s has had its Walls of Worry to climb.

- In the early 1980s it appeared that inflation would continue to accelerate indefinitely. It seemed that OPEC could name its price for oil, while the Carter Administration had given up the fight for price stability. However, in 1980 two newcomers to Washington (Paul Volcker and Ronald Reagan) led an anti-inflation crusade. When inflation was finally tamed, the great bull market, which continues today, got underway. Stocks rose 43% between September 1981 and September 1983.
- In 1984 many investors were preoccupied with a gaping Federal budget deficit and the related problems of high real interest rates, an overvalued dollar and a huge trade deficit. But the real story was continued disinflation, which would further boost P/Es. Stocks rose 47% between October 1984 and October 1986.
- In 1990 America had the worst of both worlds—deflation (in the financial sector) and inflation (in the energy sector) simultaneously. Many firms were overleveraged and banks—burdened by bad real estate loans—were becoming cautious, causing a “credit crunch.” Saddam Hussein’s invasion of Kuwait exacerbated these deflationary pressures because rising oil prices triggered a consumer-led recession. But, as they discounted victory over Saddam, the survival of the U.S. banking system and a resumption of economic growth in the second half of 1991, stocks rose 34% from their October 1990 bottom to the end of 1991.
- In 1998 investors confronted deflationary danger. Collapsing currencies plunged much of Asia and Latin America into recession, while weakening demand in developed markets caused global commodity prices to collapse. Battered by weak oil prices, Russia defaulted on its international debts, which in turn caused the U.S. bond market to freeze up. This short-term calamity came as a surprise to the folks at Long Term Capital Management, whose financial distress created the specter of a financial panic that would spread from trading desks on Wall Street to factories and stores on Main Street. But as the Fed provided liquidity, stocks rose 33% from their October 1998 bottom through December.

This bull market that began in the early 1980s has had its own Walls of Worry to climb.

Today’s Walls of Worry are reminiscent of those that confronted earlier bull markets.

- In the 1950s, Americans feared that the return of peace would mean a return of the Great Depression. When this proved to be untrue and stock prices started to rise, this was interpreted as a repeat of the rampant and ruinous speculation of the late 1920s. Both fears were unfounded—stock prices rose 405% between 1950 and 1966.
- In the early 1930s unemployment was nearly 25% and industrial production was down 50% from its 1929 high. That was the good news; the bad news was that national leaders did not have a clue how to deal with the economic collapse. President Hoover raised taxes in 1932 and FDR considered doing the same. But the economy recovered and stock prices rose 372% from the 1932 low to the 1937 high.

2001 Wall of Worry: A Tech-Led U.S. Recession?

Scrawled on the Wall of Worry today are the words “Silicon Valley’s newest invention: an investment-driven recession.” It would, say the worriers, have the following set of causes:

- The dot.com segment of the U.S. economy imploded, throwing thousands of people out of well-paid jobs and killing off demand for everything from advertising, consulting and Web hosting services to office space, computers and legal work.
- To meet the apparently limitless need for broadband, big new telecom firms were created while established ones expanded aggressively. With capacity overbuilt and new services such as DSL proving to be surprisingly difficult to roll out, the profitability of telecommunications has plunged. This in turn has led to a cutback in orders for all sorts of telecom equipment.
- Consumers’ incomes have been pressured by surprisingly high costs for both crude oil (which affects gasoline and fuel oil prices) and natural gas. Consumers are also suffering the negative “wealth effect” of a collapsing NASDAQ, which is about 50% off its high. Plus, the consumer is being weighed down by an increasingly rotund Uncle Sam, whose tax burden is close to the highest share of GDP in peace-time history—a hefty 10.4%, versus a 1980-95 average of 8.1%.
- Weak consumer spending (which has hurt demand for such things as TVs and PCs), plus cutbacks at dot-coms and telecom firms, have spearheaded a sharp slowdown in demand for high-tech capital goods. Silicon Valley has gone from boom to bust in just a few months. Companies that were double- and triple-ordering components to make sure they could meet demand are now stuck with unwanted inventory.
- It’s not just technology that is hurt by the consumer slowdown. Many industries have been caught between slower demand and rising capacity, including retailers, autos, casinos, cruise ships—even laser eye surgery! So profits are under pressure along a broad front. Weak profits, say the worriers, will further curb demand for technology, which will hurt stock prices, which will further depress consumer demand.
- The U.S. current account deficit is a huge 4.5% of GDP. If (as UBS Warburg expects) the dollar declines against the euro in the context of a U.S. economic slowdown, look for bears to agonize about how a weak dollar reveals that foreign investors are abandoning the U.S., with the likely consequence that the dollar will fall further and increase U.S. inflation.

Figure 1: The 2001 Wall of Worry

THE WALL STREET JOURNAL.
**Consumer Confidence
Index Plummets**

January 31, 2001

**DAILY
NEWS**
**NASDAQ OFF 7.23%,
LOW FOR 22 MOS.
Recession fears rise**

January 3, 2001

The New York Times
U.S. Manufacturing Slumps

February 1, 2001

The New York Times
**Earnings Disappointments
Continue to Rattle All Gauges**

December 15, 2000



December 18, 2000

California: Crash? Whoops?

The center of America’s tech industry is, of course, California, the country’s richest and most populous state. Not only does that state have to deal with the tech slowdown, but it is also confronting an energy crisis, with the two biggest public utilities on the verge of bankruptcy (Figure 2). Today, the Californian Wall of Worry is that, on top of a tech-led recession, the state is also facing a crisis similar to the Washington Public Power Supply Systems (“WPPSS” or, more popularly, “Whoops”) crisis of 1983.

Figure 2: The California Energy Crisis



December 26, 2000

Today, the Californian Wall of Worry is that, on top of a tech-led recession, the state is also facing a crisis similar to the WPPSS crisis of 1983.

In the summer of 1983, the U.S. experienced the largest bond default in its history (Figure 3). Washington Public Power Supply Systems stopped making interest payments on \$2.25 billion of municipal bonds used to finance the construction of two nuclear power plants. The unprecedented magnitude of the default increased the bond market’s perception of the amount of default risk associated with municipal bonds, particularly those issued by public utilities. As a result, interest rates on municipal bonds, particularly those issued by publicly owned utilities, rose sharply. And the nuclear plant financing catastrophe threatened an economic meltdown in the Pacific Northwest. Today, the California energy crisis seems to threaten both economic and financial turmoil in the state that accounts for one-eighth of U.S. GDP.

Figure 3: The 1983 “Whoops” Crisis



June 27, 1983

It's Always Darkest Before the Dawn

We do not deny that these are serious concerns—just as the concerns weighing on the stock market in the 1930s, 1950s, 1980s and 1990s were serious. But the history of these earlier occasions points to some things that should be kept in mind. Most important, when stock prices have fallen and investors are staring at the Wall of Worry, they tend to overlook the positives, which in the present situation are rather impressive.

- Today inflation is under control, even with an unemployment rate of less than 4½%. It is when inflation is high early in an economic slowdown, and the Fed is unable to ease, that the risk of a recession is greatest. Low inflation means that the Fed has plenty of leeway to cut interest rates further in order to prevent the economy from tipping into a recession. The recent energy-distorted data notwithstanding, UBS Warburg expects just a 1.7% gain in the PPI, and a 2.5% gain in the CPI, in 2001. Note that the UBSW Leading Indicator of Inflation—which indicates future inflation with around a one-year lead time—peaked in April 2000 and has fallen since then.
- The U.S. is forecast to have a federal budget surplus of \$281 billion (2.7% of GDP) in the current fiscal year, and more than \$5 trillion over the next ten years. This gives President Bush ample scope to cut taxes.
- Though it has disappointed some investors and vendors, the dot.com implosion is far from surprising. As we pointed out in “Net for Naught?” (May 10, 1998), it is normal for revolutionary new industries, ranging from autos in the early 20th century to biotech in the early 1990s, to spawn hundreds of companies with no viable business plan. The dot.com shakeout is a normal part of the process of discovering how the Internet can be integrated into the fabric of the U.S. economy.
- Nor is the current downturn in technology surprising or shocking. Technology has always been a cyclical growth sector; as recently as the first half of 1998, technology earnings declined significantly. But though cyclical, technology is still the preeminent growth sector: All that hype about how the Internet will revolutionize the economy and society is still true. Yes, some applications such as e-advertising and e-commerce have been a disappointment, and there have been glitches in providing broadband access to the home. But U.S. firms are just beginning to benefit from the Web; look for them to make enormous IT investments over the next five years.

Further, the fact that some of the hype about the Internet has proven to be premature does not negate that hype. History shows that the power of technology has consistently been underestimated, with even the most prescient tech observers sometimes making gross underestimations about future trends.

In 1977, Ken Olsen, the founder of Digital Equipment, argued that “there’s no reason for individuals to have a computer in their home.”

In 1981, Microsoft’s Bill Gates stated that “640,000 bytes of memory ought to be enough for anybody.”

It is when inflation is high early in an economic slowdown, and the Fed is unable to ease, that the risk of a recession is greatest. Today inflation is firmly under control.

History shows that the power of technology has consistently been underestimated, even by the most prescient tech observers.

- The current account deficit, which measures the flow of capital into the U.S., is as big as it is *precisely because foreign investors have so much confidence in the U.S. economy*. An economic slowdown that led to a weaker dollar would actually be *positive* for several reasons. It would benefit U.S. profits; if UBS Warburg's currency forecasts are correct, a weaker dollar could mean as much as a 400 basis point swing factor for S&P 500 EPS growth between Q4 2000 and Q4 2001. And because a weaker dollar equals a stronger euro, it would be bullish for European growth because it would reduce pressure on the ECB to boost interest rates in order to defend its currency.
- While growth has slowed, UBS Warburg expects 2001 real GDP growth of +1.7%.
- Today bond yields are low. The UBS Warburg Asset Allocation model gauges an 83% probability that stocks outperform bonds.
- As for the Californian energy crisis, just as regulatory interference created the problem, it will likely take regulatory involvement to solve the problem. And while a major electric utility might need to resort to bankruptcy protection, the overall financial impact of the crisis seems limited. Prompted by rumors about their exposure to California utilities, several major banks announced that they remained comfortable with their 2001 credit quality outlook. And leading power generators have pointed out that they derive just a small portion of net income from California.

Indeed, in the annals of financial history, the California utility crisis of 2000-01 is likely to represent no more than an interesting footnote, much like the Whoops crisis of 1983. Although the WPPSS default led to a widening of spreads in the market for electric utility bonds (with companies having nuclear exposure being hardest hit), the Whoops crisis had minimal impact on the overall U.S. economy. Amidst a period of gradual Fed tightening, both short- and long-term Treasury yields rose modestly in 1983 but, with earnings growth strong, stock prices rose a solid 17%.

While today's problems are for the most part very real, it is when those problems are real and recognized and the market has fully reflected them that the next inflection point is likely to turn benign.

When Investors Are Most Frightened Is When Investment Opportunity Is Greatest

While today's problems are for the most part very real, it is when those problems are real *and recognized* and the market has fully reflected them that the next inflection point is likely to turn benign. Consider the depression of the 1930s or the Cold War of the 1950s, or the four prior interruptions to this bull market. Those times when investors were most frightened by political and macroeconomic problems were precisely the times when investment opportunity was greatest.

The current climate of fear creates an outstanding buying opportunity. Valuations today are at or near levels reached at the bottoms of the four prior market pullbacks that have occurred since this bull market began two decades ago. Still see 1715 S&P 500 year-end 2001.

1981: Inflation to Accelerate Indefinitely? —A Slow Start, but Stocks 43% Higher in September 1983 than in September 1981

In the early 1980s, two lines of reasoning suggested that inflation would continue to accelerate indefinitely. When crude oil prices tripled during the Iranian Revolution of 1979 it became axiomatic that OPEC could pretty much name its price. Yes, supply might rise and demand might fall as oil price hikes exceeded the overall inflation rate, but OPEC's hegemony was clearly unassailable.

The second reason for continued high inflation was that the Federal government had simply given up the fight for price stability. The Carter Administration's anti-inflationary resolve had never been impressive. The 1980 Economic Report of the President, reiterating the conclusions of the previous report, insisted:

“Using monetary and fiscal policies to produce a very sharp and immediate reduction in the growth of nominal GNP in the hope of reducing inflation quickly by a large amount would almost surely fail. It would produce a large decline in output and employment and only a modest reduction in the underlying rate of inflation.”

Given these two factors, it seemed that the price level was sure to keep rising quickly. If that was the case, financial assets had pretty much had it. Long-term bonds were fast becoming quaint curiosities of a bygone era. Losses in the bond market were so dramatic that they were qualitatively different from any other phase of the postwar bear bond market. *Barron's* warned that “the long term bond market may not survive,” (Figure 4), while *Fortune* agreed that the “old-fashioned bond . . . has finally been done in by inflation.”

In the early 1980s, two lines of reasoning suggested that inflation would continue to accelerate indefinitely.

Figure 4

EDITORIAL COMMENTARY

Go for Broke?

The Long-Term Bond Market May Not Survive

AS AN AMATEUR market watcher (and, incidentally, on the staff of a bond-and-stockers' top forum), I am not immune to a recurring temptation: to look for a "bottom" in the long-term bond market. For example, last May and June, when the price of 10-year Treasury bonds was reaching a peak, we carried a number of ads for low-coupon bond funds and portfolios of Citicorp New American Bond Fund to look to their owners for a "bottom" in the market.

Now, without cause, for one thing, we have repeatedly suggested in these pages, the recession of 1980 is over. Unlike the recession of 1975, which lasted 16 months, the recession of 1980 lasted only 11 months. In fact, the stock market has risen 15% since the start of the recession. Other observers see the sudden emergence of short-term commercial paper to the rescue of municipal finances, with variable-rate municipal bonds trading at a steep discount.

After last week's non-dealer, in which Treasury and corporate plunged toward their old lows while municipal made two runs, the question grows more pressing than ever: True, some big borrowers, notably the U.S. Treasury, which has scheduled the sale of \$2 billion worth of 10-year Treasury bonds, are making rapid moves. However, the market mechanism is not so sure, but there is another side of the coin: By incorporating inflation into the financial structure, the market will make a first quarter 1981.

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BARRON'S MAILBAG

"SURVIVAL OF THE FITTEST"
To the Editor:
I have read with interest the letter in your Oct. 13 issue from Ron J. Galt, president of the California Association of Utility Shareholders, which references your article with me which appeared in Barron's on Aug. 19.

There are probably standing here, and which have been from the base of one or two years.

November 3, 1980

- You hadn't needed stocks to beat inflation because money market funds and bonds had offered attractive high nominal returns.
- Another reason to steer clear of stocks was that, given their dismal record in the 1970s, and the spate of bankruptcies plaguing key parts of the U.S. economy in the early 1980s, stocks seemed just too risky.

Those investors who stayed away from stocks in the early 1980s missed the start of the great bull market that continues to this day. This was truly a remarkable episode in economic history, because by the end of the recession in 1982, the Fed had successfully killed off the double-digit inflation fears that had begun to affect the behavior of many economic participants—businesses, consumers and governments. Then, with inflation tamed, and the bankruptcy of Mexico threatening a global financial panic, the Fed sharply started expanding the money supply to bring the country out of recession by cutting the Fed Funds rate from 15% in June 1982 to 8.5% in December 1982.

This expansionary monetary policy, coupled with the death of double-digit secular inflation, led to a surge in stock prices between 1982 and 1983 and, as mentioned, prompted the start of the great bull market that continues to this day. Indeed, back in September 1981 our P/E model assessed that stocks were 23% undervalued. However, our asset allocations gauges were overwhelmingly bearish on stocks because bonds and T-bills yields had risen to 15%. So, despite attractive P/E valuation factors, our asset allocation gauges remaining so negative led us to maintain a cautious market view. Then expansionary monetary policy in the summer of 1982, coupled with the death of double-digit secular inflation, led to a surge in stock prices. Indeed it was the combination of attractive P/E valuation in concert with what had become positive asset allocation relationships that led us to make a major "bull market" call in August 1982.

Not surprisingly, in 1981 many investors felt they had little reason to bother with stocks.

1984: Depressed by Deficit, Debt, Dollar —Stocks Up 47% in Two Years

In the fall of 1984 the U.S. stock market paradoxically offered investors profits without pleasure. The S&P 500 had risen 55% between August 1982 and October 1984, and economic fundamentals were generally bright. Inflation had been in a secular downtrend for several years, OPEC was on the ropes (as the laws of supply and demand hadn't been repealed after all), and bond yields were down 300 basis points from their 1981 highs. Given these favorable conditions one might have expected Wall Street sentiment to be decidedly bullish, with investors looking forward to still greater stock market profits in the years ahead.

In the fall of 1984 the U.S. stock market paradoxically offered investors profits without pleasure.

Figure 6



November 2, 1984

Figure 7



November 18, 1984

Figure 8



December 31, 1984

Figure 9

THE WALL STREET JOURNAL MONDAY, FEBRUARY 4, 1985

Rapid Climb in Debt Casts Doubt on Growth Outlook

By ALAN MURRAY

Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—The federal debt will surpass \$2 trillion in fiscal 1986, giving President Reagan the dubious distinction of having presided over a doubling of the nation's debt burden.

That extraordinarily rapid rise in debt, which will occur even if the president succeeds in winning the drastic budget cuts he proposes, casts doubt upon the economic assumptions that underlie the budget.

The President's economic forecasts are un-

grow weary of economists' warnings about the dangers of budget deficits. But even administration economists concede those dangers are much greater over the next few years than they have been in the past two. The strong stimulus to the economy from deficit spending can provide a big boost in the early years of an economic expansion, when unemployment is high and factories are under-utilized. But as the expansion matures, huge deficits are more likely to cause either inflation, or—countered by tight monetary policy—rising interest rates.

Deficits that are 3% or 4% of the gross national product when the economy is coming out of a recession are manageable, says Ben Laden, chief economist at Laden Associates, a Baltimore investment firm. "If you still have a

Wall Street Journal, February 4, 1985

Instead, investors were skittish and, by the fall of 1984, stock prices were no higher than they had been in the spring of 1983. A key reason for investor skittishness was a preoccupation with the gaping Federal budget deficit (Figure 6) and the related problems of high real interest rates, an overvalued dollar (Figure 7) and a huge trade deficit (Figure 8). With the strong dollar depressing the industrial sector, profits were flattening out in late 1984. Private sector debt levels were of concern too, given high levels of consumer debt (Figure 9). These worries about “unprecedented problems” frightened investors and kept stock prices at historically modest valuations.

The mistake investors made was that they followed the usual pattern of projecting into the future the problems of the recent past, and so were transfixed by the *inflationary potential* of the heavy debt loads in both the public and private sectors. However, inflation had not only been checked but overchecked, and disinflation was to remain a key investment theme of the late 1980s.

As it turned out, the federal budget deficit had peaked as a share of GDP in 1983, and then continued to decline throughout the remainder of the decade. And while conventional measures of consumer debt had caused alarm in some quarters, what tended to be overlooked was the substantial gains that had taken place in consumer *net worth*, thanks to appreciation of real estate in the '70s, and of stocks and bonds in the '80s.

As the rate of inflation came down, so too did interest rates, with the Fed Funds rate dropping a whopping 400 basis points in just under 12 months (from 11.75% in August 1984 to 7.75% by mid-1985). Not surprisingly, fueled by these rate cuts, the stock market shook off its lethargy, with the S&P 500 rising 47% in the two-year period October 1984 through October 1986.

The mistake investors made was that they followed the usual pattern of projecting into the future the problems of the recent past.

1990: The Saddam Hussein Market —Stocks Rise 34% in 14 Months

In the autumn of 1990 investors suddenly found themselves squeezed between deflationary and inflationary pressures. On the deflationary front, all the sins of the debt-driven 1980s were weighing on the economy. Even after eight years of economic expansion, the Federal government still had a deficit of \$144 billion, which was being increased by the gigantic S&L bailout. The nation was still running a monthly trade deficit of \$9 billion, and America's creditors, the mighty Japanese, were buying up some of America's choicest assets, ranging from Columbia Pictures to a majority interest in Rockefeller Center to a large chunk of downtown Los Angeles. Worse still, some major corporations were weighed down by heavy debt incurred to finance leveraged buyouts. The bankers who had financed these aggressive deals were getting nervous—particularly because they had also bankrolled a real estate building binge that littered the American landscape with half-empty buildings.

In the autumn of 1990 investors suddenly found themselves squeezed between deflationary and inflationary pressures.

An overextended banker is a cautious banker. Already in the summer of 1990 there were signs of what would come to be known as the “credit crunch,” prompting Federal Reserve Chairman Greenspan to suggest that it might be necessary to lower interest rates. As *The New York Times* reported, “Shifting from a long-held position that tight credit conditions were confined to real estate, Mr. Greenspan pointed to slow growth of the money supply and rising rates for commercial loans as evidence of a restriction of credit that poses a threat to continued economic expansion.”

The threat posed by these deflationary pressures increased dramatically in August 1990 when Saddam Hussein invaded Kuwait, raising the specter of a lengthy war that might interrupt the flow of oil from the Persian Gulf or even destroy some of the world’s most productive oil fields. With the news dominated by the deployment of U.S. troops in Saudi Arabia, oil prices rose and consumer confidence sank. A consumer slowdown would compound the problems of heavily leveraged corporations, real estate developers, and their bankers. By October a recession was looming and banks—whose stock prices had been declining for over a year as loan losses mounted—reported horrendous earnings. Many of them slashed dividends.

Figure 10: Headlines from 1990

The market bottomed on October 11, 1990 and was 34% higher by the end of 1991, as it correctly discounted victory over Saddam Hussein, the survival of the U.S. banking system, and a resumption of economic growth in the second half of 1991.



October 8, 1990



All in all, the news for U.S. investors could not have been much worse—war, recession, rising oil prices, an over-leveraged U.S. economy, a bank credit crunch, a real estate glut, and big budget and trade deficits. What better time for investors to reduce their exposure to equities? Actually, the market bottomed on October 11, 1990 and was 34% higher by the end of 1991, as it correctly discounted victory over Saddam Hussein, the survival of the U.S. banking system, and a resumption of economic growth in the second half of 1991.

1998: Deflationary Danger —Stocks Soar 33% in Two Months

In 1996 and 1997 it seemed as if there was a “Goldilocks” investment environment—not too hot, not too cold, just right—but in October 1997 the porridge became too cold as deflationary winds blew in from Asia.

The global response to the Asian contagion was not particularly effective, and the contagion infected new countries. Weakened by collapsing commodity prices and a capital flight out of emerging markets, Russia was thrown into economic turmoil. Latin America seemed threatened too. And the troubled Japanese banking system, already struggling before the southeast Asian collapse, seemed to be deteriorating rapidly.

Most worrying perhaps was that the global economic authorities seemed unable to halt the turmoil. Bailouts that the IMF undertook of struggling economies showed few signs of quick success. South Korea, Indonesia and Thailand remained mired in recession, while Russia seemed to be in financial meltdown. And while policy makers in the U.S. lectured the Japanese about the painful steps they had to take, policy paralysis continued to grip Tokyo even as the economy was in a recession.

Bearish observers also pointed to a multitude of indicators that appeared to signal that the U.S. was slipping into recession late in 1998:

- In August 1998, the yield curve inverted for the first time since late 1989, with the short rates the Fed controls above longer rates set by the market. This, the bears argued, was a classic recession signal.
- The NAPM New Export Orders Index fell to its lowest level ever in August 1998.
- Retail sales declined in July and rose just 0.1% in August, possibly portending weakening in the consumer sector.
- For the third consecutive month, the widely watched National Association of Purchasing Managers index came in below 50% in August, suggesting a contraction in manufacturing.

In 1996 and 1997 it seemed as if there was a “Goldilocks” investment environment—not too hot, not too cold, just right—but in October 1997 the porridge became too cold as deflationary winds blew in from Asia.

- Stock prices were tumbling, with the S&P 500 dropping 15% in August.

Further, instead of addressing these myriad economic issues with 100% of his energy, President Bill Clinton was fighting for political survival as Congress considered the report of Independent Council Kenneth Starr. The central issue was whether, after reading Starr’s report, Congressional Democrats would conclude that President Clinton was guilty of impeachable conduct.

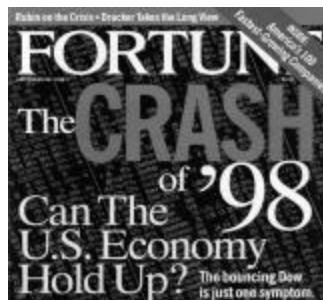
Figure 11: The 1998 Wall of Worry



September 13, 1998



September 10, 1998



September 28, 1998



September 14, 1998

In summary, in 1998 investors confronted deflationary danger. Collapsing currencies plunged much of Asia and Latin America into recession, while weakening demand in developed markets caused global commodity prices to collapse. Battered by weak oil prices, Russia defaulted on its international debts, which in turn caused the U.S. bond market to freeze up. This short-term calamity came as a surprise to the folks at Long Term Capital Management, whose financial distress created the specter of a financial panic that would spread from Wall Street to Main Street.

With the entire global financial system under severe strain, the U.S. Federal Reserve stepped up to the plate and cut interest rates three times in late 1998. As we noted at the time the Fed was “doing what it is there to do—provide liquidity to the system at a time of need. And as long as it feels the need, it will keep adding liquidity” (see “Uncrunching,” October 15, 1998).

Anticipating the positive impact of the Fed rate cuts on the U.S.—and global—economy, stock prices rose sharply from very depressed levels, with the S&P 500 soaring 33% between October and December 1998. And indeed, with the U.S. economy as the locomotive of global growth, the struggling emerging economies recovered in 1999 so that, by early 2000, it was *inflationary dangers* that had become a key concern of investors.

The Bull Market of the Fearful Fifties (1950-66)—DJIA Up 405%

World War II, like World War I, greatly strengthened the American economy, both relatively and absolutely. Real GNP grew faster in the 1940s than in the 1920s, and by the late '40s industrial production was running at nearly twice its 1935-39 average. Between 1950 and 1955 real GNP grew at a robust 4.3% rate. The international prestige of the U.S. was unprecedented in this period, and after 1952 Republicans controlled the White House.

But investors viewed these favorable developments with nervous skepticism. In the late 1940s NYSE volume was low by historical standards, the S&P 500 stood about where it had during the mid-1930s, and the market P/E multiple was about 8x. Noting the divergence between economic boom and stock market lassitude, *Fortune* in 1948 ominously asked, “Is the Market Right?” (Figure 12).

Figure 12



The fear was that a new depression would strike the economy once demobilization was completed.

Five main concerns weighed on the market to produce conservative valuations:

- Most important was the fear that a new depression would strike the economy once demobilization was completed.
- Moreover, high inflation had induced aggressive investors to speculate in real estate and commodities rather than stocks.
- Investors also feared that corporate profits were lower than they appeared to be because inflation was creating illusory gains via inventory profits and under-depreciation of plant and equipment.
- Moreover, the tax programs of the New Deal and World War II had made income taxes steeply progressive, thereby relieving wealthy Americans of funds that might have been invested in equities.
- Finally, the onset of the Cold War, dramatized by the “loss” of mainland China in 1949 and the outbreak of the Korean War the following year, required burdensome defense spending, which in 1953 claimed nearly 13% of GNP.

The stock market did not easily shake off such fears, even after the Korean War ended in 1953 and the U.S. economy made a smooth transition to steady, non-inflationary economic growth. NYSE market volume between 1951 and 1956 merely matched volume in the mid-1920s, when the U.S. economy was less than half as large. When in January 1955 the Dow Industrials began to explore the uncharted territory above 400, the Senate Committee on Banking and Currency thought it prudent to hold hearings on the dangers of Wall Street speculation (Figures 13, 14). To Democratic critics of the Eisenhower Administration, the stock market’s ebullience, if not quite a replay of 1929, looked suspiciously like 1927 or 1928. During the hearings, Harvard Professor J.K. Galbraith unsettled the market by drawing parallels between the ’20s and the ’50s, prompting such newspaper headlines as “Egghead Scrambles Market.” When in 1959 the market experienced its first postwar boom in small high-technology stocks, authorities at the NYSE contrived to curb the speculation by imposing 90% margin requirements. Three decades after the trauma of 1929 investors were still keenly aware of the uncertainty of the economic future.

So were policymakers in Washington. The operative word in the Fed and the Treasury Department during the 1950s was “balance.” Economic policy benefited from a tension between the competing goals of avoiding recession on the one hand and inflation on the other. Aided by the much discussed “automatic stabilizers” introduced into the economy by the New Deal, Washington guided the economy through the recessions of 1949, 1953 and 1958 with considerable finesse. To maintain business confidence, government officials held the hands of business leaders who spied a new depression on the economic horizon. As the Korean War wound down in the spring of 1953, for example, Secretary of the Treasury George Humphrey stated emphatically: “There is no reason to fear peace. We have achieved greatness in peacetime—inflation, debt and high taxes from wars. Adjustments yes, but no depression.”

Figure 13



Business Week, January 8, 1955

Figure 14

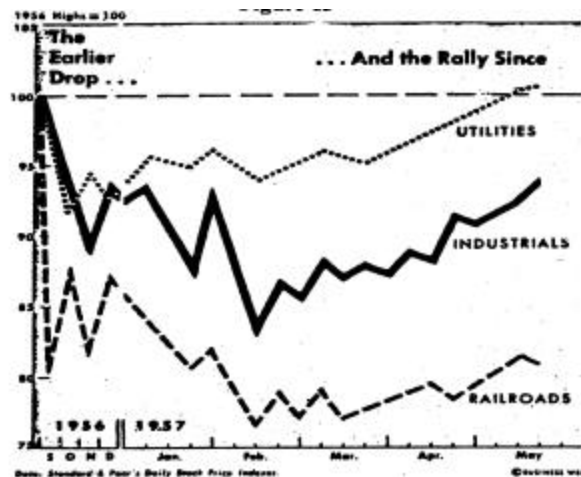


Business Week, March 12, 1955

But in preventing depression the Eisenhower Administration did not ignore the danger of inflation, in part because sensitivity to the problem was heightened by rapid price increases after World War II and again during the Korean War. In a 1956 press conference the President cautioned, "If this country is going to prosper and be strong at home it's got to have a sound dollar. If you don't have a sound dollar, this, my friends, is what happens: all of your pension schemes begin to fall to the ground." An official of the New York Fed likened inflation to a pernicious habit-forming drug: "The longer a nation resorts to it the more its awareness of its presence and its dangers is dulled, until it reaches the point where it has become so used to inflation that it accepts it as a necessary evil."

Fostered as it was by heavy military spending, strong unions and limited foreign competition, inflation was not easily controlled, hitting an annual rate of 3% in 1957. But Eisenhower was up to the task. He managed to balance the Federal budget in 1960 and was willing to trade national income for stable prices—even if it cost Richard Nixon the Presidency in 1960. Between 1955 and 1961 GNP grew at an annual rate of just 2.1%, but consumer prices were quite stable (and the DJIA was up 50%). Fully cognizant of the dangers of inflation and recession, investors bid up stock prices cautiously in the 1950s (Figure 15).

Figure 15



A High, But Few Cheers

Stock indexes reach a peak for this year.

But Streeters remain cautious in predictions.

ON MONDAY, the stock market resolutely stopped the backing and filling of recent weeks. Standard & Poor's daily indexes of industrial and utility prices moved to their highest levels of the year (chart).

At midweek, though, the breakthrough had aroused nowhere near the expected enthusiasm among brokers, or among traders and investors generally. Few analysts seized Monday's news to speed "buy, buy, buy" advice to their clients. "A-"

—since mid-February—to recover 61% of all the ground lost since the bull peak of the 1956 market. And as one market pro points out, "a recovery of such proportions alone would justify a pause for consolidation or technical correction," especially since there has been no such pause before in the post-February rally.

It must also be remembered that since February the market has pushed back into the much advertised "zone of resistance" which it had repeatedly failed to pierce in earlier upthrusts. It's a moot point whether this resistance zone will prove as impenetrable as ever, but in recent weeks the market has markedly lost momentum as it has pushed closer to the zone.

Gap in Yields—Bullish enthusiasm doused with cold water from action; the sharp narrowing seen yields available on stocks.

Business Week, May 18, 1957

Terror and Opportunity in the 1930s— DJIA Up 372%

After climbing steadily to unimagined financial heights during the 1920s, U.S. stocks fell off a cliff between 1929 and 1932. The DJIA declined from a peak of 381 to a low of 41 in 1932, but many glamour issues fared still worse. RCA fell from 574 to a low of 12; GM from 1075 to 40. The market slide was so prolonged and catastrophic that even market operators savvy enough to recognize 1929 as a market top almost invariably bought in too soon and, if they were operating on margin, were wiped out in the end anyway.

But past trading losses were only the first of a long litany of woes that tormented American investors in 1932. The U.S. economy seemed to be grinding to a halt. Historian John Brooks describes the macroeconomic carnage:

“In early 1932 unemployment was above ten million and heading for twelve million, or not quite a quarter of the civilian labor force; industrial production nationally was down to half its 1929 rate; industrial stocks listed on the stock exchange were worth about one-fifth of their 1929 peaks; foreign withdrawals of U.S. gold were running at a rate of \$100 million a week; and more than a billion dollars worth of currency and coin, much of it gold, was being hoarded by terrified Americans—in sum, a nation in the throes of economic disaster.”

That was the good news. The bad news was that no one in power had a clue as to how to end the depression. Insisting that “we cannot squander our way into prosperity,” President Hoover in 1932 raised taxes in order to balance the Federal budget (Figure 16).

After climbing steadily to unimagined financial heights during the 1920s, U.S. stocks fell off a cliff between 1929 and 1932. The DJIA declined from a peak of 381 to a low of 41 in 1932, but many glamour issues fared still worse.

Figure 16



Literary Digest, March 19, 1932

Figure 17

Manufacturers' (and importers') sales tax (2 1/2 per cent.)	\$295,000,000
Increase in individual income taxes (higher rates and lower exemptions)	112,000,000
Corporations (12 to 13 per cent.)	21,000,000
Estate tax increases and new gift tax	35,000,000
Admissions to amusements (10 per cent. on tickets costing 25 cents and over)	90,000,000
Stock transfers (increase from 2 to 4 cents per share and 4 cents on shares borrowed by "short" sellers)	28,000,000
Lubricating oil (4 cents a gallon)	25,000,000
Malt syrup (35 cents a gallon), grape concentrates (40 per cent. ad valorem), worts (5 cents a gallon)	50,000,000
Telegraph, radio, telephone messages (5 cents on messages costing 31 to 49 cents, and 10 cents on messages costing over 50 cents)	35,000,000
Imported gasoline, crude and fuel oil (1 cent a gallon)	5,000,000
Administrative changes in tax law	100,000,000
Post-office Department savings	25,000,000
Congressional reductions in Budget Bureau estimates	125,000,000
Total	\$1,246,000,000
Needed to balance budget	1,241,000,000
Surplus	\$5,000,000

Literary Digest, March 19, 1932

The theory was that recovery depended on a revival of business confidence, which depended on balancing the budget. In the campaign of 1932 Franklin Roosevelt promised to do the same thing if he became President. A variety of inflationary schemes was discussed within the Roosevelt camp, as was social planning and more vigorous trust busting, but no one in power seriously contemplated large-scale deficit spending to stimulate aggregate demand.

At the microeconomic level, the American banking system was seriously damaged. Upon taking office Roosevelt declared a ten-day banking holiday and passed emergency legislation ordering regulators to decide which banks were healthy, which banks could be saved with an infusion of funds and which banks should be allowed to collapse. Eventually several hundred banks were shut down.

Figure 18



As for Wall Street, it was not merely restructured during the New Deal but chastised and dishonored. The Glass-Steagall Act of 1933 forced all banking firms to split themselves into an investment bank and a commercial bank, and still more severe legislation ended Wall Street's tradition of self-regulation by creating the Securities and Exchange Commission. In highly publicized hearings the Pecora Commission delved into the transgressions of dozens of Wall Street luminaries, while 5,000 unemployed veterans marched on Washington and clashed with the U.S. Army.

One can understand why Joseph Kennedy later remarked, “I am not ashamed to record that in those days I felt and said I would be willing to part with half of what I had if I could be sure of keeping, under law and order, the other half.” Investors were concerned about the “unprecedented” problems of the day—ranging from the Federal budget deficit (Figure 16), with a Democratic plan to balance it (Figure 17), to the Chicago bank failures (Figure 18), the growth of consumer credit (Figure 19), and the arms race (Figure 20).

Figure 19

THE LITERARY DIGEST

The 1902 Model



... a great car in 1902

COMMERCIAL CREDIT COMPANY
COMMERCIAL BANKERS
HEADQUARTERS • BALTIMORE



WHEREVER YOU ARE • WHATEVER YOU MAKE

SELL • OR BUY • INVESTIGATE COMMERCIAL CREDIT SERVICE •

Literary Digest, March 19, 1932

Figure 20

THE LITERARY DIGEST JULY 2, 1932

World Reaction to the New Hoover Arms Plan

COURAGEOUS, CLEAR-CUT, TREMENDOUS: was to understand.

With such adjectives and similar words of praise the *Times* of London, Berlin, and Rome greet Mr. Hoover's "armament program"—his proposal to cut all world armaments one-third.

To reconsider the scheme of peace, Paris seems an almost unanimous opinion.

After five months of quibbling and dawdling, the Disarmament Conference was suddenly and unanimously galvanized into

The bold plan for "universal action, practically in the interests of all," as the *New York Herald Tribune* characterizes it, evokes a spirit of peace and protest from the press of Europe. Italy, through its spokesman at Geneva, Foreign Minister Dino Grandi, accepts ardently and promptly, vouching praise for the proposition and reserved expression to join.

A cable poll of the European press, undertaken by The *Literary Digest*, indicates, however, the divided and divergent of opinion. The French press repeats its expected attitude as for the severity:

The note of distrust, of suspicion, of incredulity, is reflected with modern variations throughout the Paris dailies from *Right to Left*. Most of them doubt the sincerity of Mr. Hoover. No matter how his words have been read by Hugh Gibson in Geneva, the Paris afternoon papers were interpreting and misinterpreting the motives behind the American armament proposal.

"A grand-manière play—a way to delay to insure its realization," commented the widely circulated *Intermédiaire*. "Geneva needed a session to bury it alive," proclaimed the *Paris-Gazette*, an organ of the *Left*. "Will the words of President Hoover save any value the world has now? Had we recall President Wilson and his effort?"

The influential and conservative *Journal des Debats* springs into action by condemning the Hoover project as "an American ultimatum," interpreting the suggestion as conveying the threat that unless European—and especially French—armaments are unilaterally reduced, no further negotiations on war debts may be expected from the United States.

A political organ of *Le Matin*, a financial daily of Paris, typifies a large variety of French editorial opinion in its acceptance for all suggestions emanating from the side of the Atlantic. It writes:

"The time is past when Europe may attack any considerable importance to American suggestions so long as which we are to accept. However, this is not an ultimatum to Europe. It is a proposition to American voters."

It is *Matin* which again calls the Hoover plan "doubting a sword through the water," and predicts its failure:

"The United States Government would not have done better if it had deliberately set out to torpedo the conference."

In *Republique*, organ of the young radicals opposing the extreme wing of Hoover's party, reduce the importance of the issue:

"The bulk of the French delegation at Geneva inclines to common sense. An extremely active and powerful minority favors the Hoover plan. The Senate agrees with which the disingenuous reversal Grandi's announcement of Italy's unqualified adherence to the Hoover suggestion shows that this is the most favorable position which the French Government has been able to obtain."

Literary Digest, July 2, 1932

In the midst of all this disorder, Jackson E. Reynolds of New York's First National Bank did a remarkable thing, recounted by his assistant as follows:

"At that period in 1933 ... Mr. Reynolds called me into the bank and told me that a lady, who was a writer and a friend of Mrs. Reynolds, was pestering him for investment advice. The lady's estate consisted of \$100,000 entirely invested in U.S. Treasury 4.25% bonds. Her income derived from her writing and the interest on the bonds. 'Prepare for me a list of good common stocks. We'll go over them, and then you can sell the governments and use the proceeds for the common stocks,' he ordered. 'Mr. Reynolds,' I exclaimed, 'You're not serious! Selling the primest of investments at a time when stocks have dropped through the floor, and no one knows what's going to happen or when the end has been reached.' He replied, 'I certainly mean to do this. Run along and get the list ready.' "

Jackson Reynolds was not clairvoyant; he could not have known that U.S. economic conditions would not deteriorate further. But that was precisely what investors feared, and these fears were already reflected in stock prices. In an exact reverse of the 1929 pattern, virtually any surprise was likely to be a positive one.

In an exact reverse of the 1929 pattern, virtually any surprise was likely to be a positive one.

As events unfolded, there were indeed some positive surprises. Roosevelt turned out to be a mediocre economist but a superb leader who reinstalled a sense of direction in the nation. By virtue of deficit spending, the natural dynamic of the business cycle and inflationary monetary policies, the U.S. economy recovered significantly during FDR's first term. The New York Times Weekly Index of Business Activity, having declined from a 1929 high of 115 to just 64 in March 1933, rose to 111 by August 1937. GNP grew at a 9.5% annual rate between 1933 and 1937 and the U.S. unemployment rate dropped from 25% to 14%. And although the economy experienced another recession in the late '30s, the 1933-1939 GNP growth rate was still 6.8%. For investors like Mr. Reynolds who were brave enough to buy stocks, returns were spectacular; the Dow rose 372% from the 1932 low to the 1937 high.

Additional information available upon request.

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