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Special Report:

A Change in the Winds

"Where is the bottom?" We are asked that question over and over. The market continues to make new lows, and the economy and corporate earnings appear to be crumbling rather than beginning to uptick. A second question that usually follows the first is, "The Fed's interest rate cuts have not had any real effect. What is it going to take to pull us out of this hole we seem to be falling into?"

Initially, we answer these two questions with two questions of our own. We believe if we can answer these questions, we can offer something a little more rational than the talking heads we see flooding the financial media. Our first question is: "What were the economic forces that pushed the markets and the economy into the current sharp contraction?"

After some coaching, a short list is usually forthcoming.

1. The economy was overheating in 1998 and 1999 and the Federal Reserve began raising rates.
2. Oil prices more than doubled between the beginning of 1999 and mid-year 2000.
3. The US dollar has been very strong, hurting corporate earnings in two ways.
4. Technology boomed then collapsed.
5. The worldwide economy began to slow.

Our second question is: "Thinking back to mid-year 2000, did you ever imagine that one year later the economy could be in the shape that it is today?"

In answering the second question, almost everyone admits that they have been surprised at the steep falloff in the economy. Indeed, only a year ago most people were saying that the Fed's rate increases were not having any effect on the new economy because the tech companies were growing so fast. They appeared immune to Fed interest rate increases because they were funding their growth by issuing new common stock instead of debt. Just like today, a group of barking dogs and camp followers were insisting that the Fed had lost its power to influence the new economy. They were dead wrong! They will be wrong again.

Let's now address the points raised by our two questions.

1. The Fed Raised Rates. From June of 1999 to May of 2000, the Fed raised interest rates seven times. Simply put, raising interest rates has the exact same effect as raising prices on goods and services. The law of supply and demand says that if you raise prices enough you will slow demand. Ultimately, the Federal Reserve has the power to raise prices until they bite,

that is, until the higher prices cause demand to begin to fall. This is how the Fed manages the economy. Their actions do not cause an immediate reaction in the economy because the economy always has some momentum, either up or down. It takes a while for the built up pressures in the economy to bleed off, so to speak.

2. Energy Prices Double. The Fed's work in raising prices enough to slow the economy was made both easier and harder by the increase in energy prices. Think of the rise in energy prices as a tax. Whereas interest rates operate with a delayed effect because of all the goods in the pipeline, increases in energy prices have an immediate impact on the economy. Energy is approximately 15% of the economy. This means that last year's nearly 100% increase in energy prices would have put an extra drag on the economy that would have also raised the prices of many items and taken money out of the pockets of individuals and institutions.
3. A Strong US Dollar. The 50 companies domiciled in this country dominate the major US stock market indices. These companies generate nearly 40% of their earnings outside the US. A rising dollar hurts their earnings in two ways. First, a rising dollar makes US goods more expensive overseas because it takes more yen or pounds to buy a particular product. This again runs headlong into the law of supply and demand. When US products cost more to purchase overseas this year than last, demand for US products falls. These companies take a second hit when they bring the yen or pounds they earned overseas back home because they translate into fewer dollars than a year ago.
4. Technology Collapses. Technology is approximately an eighth of the economy, yet in recent years it has produced a third of the growth. The economists will be computing the cost of the tech wreck for years to come, but it is very possible that the demise of tech companies may have been responsible for over 40% of the fall in economic growth in the last twelve months.
5. The Worldwide Economy Slows. The US is the economic engine of the world. If we sneeze the rest of the world gets a cold. Europe and Asia have a cold. Go figure.

The year 2000 saw an unprecedented combination of headwinds pressing upon the US economy and corporate profits. Interest rates, energy prices, the dollar, the bursting of the technology bubble, and slowing economies around the world, all took their turns taking the wind out of our sails. Indeed, it is as though the United States has been afflicted by a cold or the flu, but our economy certainly does not have a terminal illness.

In 2001, we have now seen all of the major headwinds that flattened the US economy swing around to become tailwinds. The stock market is acting like it will never return, but in this environment, economic growth is inevitable. We don't know how long or how strong the next growth cycle will be, but it will come. The Fed has aggressively lowered the cost of credit, which has the ultimate effect of lowering the prices of most big-ticket items we buy. As the cost of these items falls, eventually more products and services will be demanded -- unless, of course, the law of supply and demand has been repealed and pigs start flying.

And, that is just the beginning. Energy prices have fallen sharply in the last twelve months. The US dollar has begun to fall in the past three months. The collapse in technology earnings over the last year should make for easy comparisons going forward, at a minimum putting a floor under their stock prices. Additionally, Europe, Britain, and Asia have all begun to lower interest rates to stimulate their economies. And, finally, a tax cut has been implemented in the US.

Last week, the stock market took another scary dip. It appears, at least in part, this was a reaction to the belief that the Fed may be done lowering interest rates. To some economists and investors, this is bad news. To us, it would be good news to hear that the Fed believes they have now done enough to stimulate growth in the economy. It took three months after the Fed's last rate hike in

2000 for the economy to show signs of slowing. Our belief is that it is only a matter of a few months before the Fed's recent rate cuts take effect and the economy and the stock market turn toward higher ground. We think we are in good company if the Fed holds a similar view.

Blessings,

Greg Donaldson

Mike Hull