John Mauldin's Millennium Wave Online
2000WAVE.COM

November 2, 2001

R.I.P. 30 Year Bonds. Maybe.
Doing the Interest Rate Limbo
Economic Viagra – Not
GDP Games
Opportunity Knocks
Meet Me In New York, New York
Afghan Update

What a week! There is so much to talk about, and the good news is that it is not all bad! The theme of today's e-letter is going to be : "The Games People Play". My less than sainted Dad was a games player. I have a letter on the wall over my desk from John Wayne to my Dad referring to some legendary WW II poker games. (The Duke was gloating. He won. Dad lost. But Dad made it up from Wayne's scotch horde.) Dad's dictum: "Tell me the rules and deal the cards. Just don't change the rules in the middle of the game."

Are the rules changing? Maybe. Today we look at rate cuts, bond offerings, GDP, employment, stimulus packages and a private, you will read it only here update from 10 miles from the Afghan front where the B-52s are carpet bombing. Let's jump right in.

R.I.P. 30 year bonds. Maybe.

If you have invested in my oft-mentioned favorite bond fund, the American Century Target 2025, you are a happy camper. You are up 9.5% for October, half of that on Halloween as the Treasury announced they would no longer sell 30 year government bonds. There is more to this than meets the eye, in my opinion. **That being said, it was a brilliant move.** It almost makes me bullish. Let's go behind the scenes and see if we can find some clues as to who is really driving this move.

Clue #1: The Fed has cut short term rates 9 times, and most observers now concede we will see two more cuts, as advertised here months ago. But the problem the Fed has is that long rates have not come down very much and it is long rates that really make a difference in the economy. Long term rates are what affect corporate bottom lines and spur recoveries. Greenspan could help a lot of companies get profitable again if he could somehow get long term rates to come down.

Greenspan cannot be happy about the economy. The economy is in severe risk, not to mention his aura of financial wizardry, as it is beginning to look like he is pushing on a string.

Clue #2: Peter Fisher. Remember that name. He was a former executive vice president at the New York Federal Reserve. He was point man for coordinating currency moves among central banks, and was a key figure in the rescue/fixing of the Long Term Capital debacle in 1998. At 44, he is on the fast track.

He is now undersecretary at the Treasury department. He was the one who coordinated and made the announcement about 30 year bonds no longer being sold.

Clue #3: Home values have declined for two straight months at a significant pace, somewhere in the neighborhood of 6%. This is significant. We learned this week consumer confidence is down to 85. Now in the grand scheme of things and given the circumstances that is not all that bad. It is certainly no where near any long term low. There have been times in recent memory when 85 sounded pretty good. It is just that we have come from such extreme highs that 85 looks bad.

The reality is that the consumer confidence number is not all that bleak. As a country, we are still pretty optimistic. But those who really study these things know that consumer confidence is related very closely to employment and home values. We all know unemployment is headed much higher. But home values have been holding up surprisingly well. Since homes values are our central source of personal wealth, we are not all that negative.

But if home values continue to drop for another few months, the mood could turn sour very quickly.

Mortgage rates are a key component of home values. Mortgage rates are closely linked to the rate of the 10 year Treasury. But the Fed can only affect short term rates. What's a Fed chairman to do?

Clue #4: The country needs some economic stimulus. The $100 billion dollar stimulus package being shoved through Congress is peanuts in the grand scheme of things. We have just watched $5 TRILLION dollars disappear in stock market value. There are scores of companies who have watched their values drop by more than $100 Billion.

If mortgage rates dropped by 1%, consumers save $1,000 per year on a $100,000 mortgage. Multiply that across the country, and that becomes huge. And it is every year, not a one time shot. And it doesn't run up the deficit.

Clue #5: Goodbye surplus. Hello deficits. The country is now going to need to raise money. Let's see. Short term rates are really low and long term rates are relatively high. If we borrow only short term money, it will help the budget.

Clue #6: Long term bonds serve a real role in the economy. They are used by businesses and pension funds to control risk. International investors and banks love them. Without going into a lot of detail, long term bonds can be used as a way to guarantee returns on other, more risky, offerings. There is a real demand for these investment instruments.

If you cut off the supply of new long term bonds, the remaining bonds become more valuable. It is the law of supply and demand in action.

Yesterday, long term bond rates dropped over 40 basis points in one day, as investors scrambled to get a "piece of the Rock". But did you notice that rates on 10 year bonds dropped to 4.25%?

Let's see if we can figure out what happened. Mind you, this is just my speculation. First, Greenspan can't get long term rates to come down. He calls his buddy Fisher, now the senior guy at Treasury who actually understands where the levers are, and asks for help. Fisher goes to O'Neill and points out that if you stopped selling 30 year bonds you could:

1. Lower finance costs for the government for the growing deficit.
2. Push down the key rate to which mortgages are linked, thereby stimulating the economy.
3. Help prop up home values, thereby helping consumer confidence.
4. Lower the cost of corporate long term borrowing, helping corporate profits.
5. You get to look brilliant and the only people who get hurt are bond traders and a few hedge funds, and who cares about those whiners?

It is a no-brainer. And who better to do it than Fisher, who has a history of making surprise economic moves? It is like declaring Jacks are wild after you deal the hand and notice you are holding a pair of them.

And because no one suspected or planned for it, it will have a big effect. When we look back 5 years from now, I predict that many economists will point to this Halloween Trick or Treat as a big reason for the economic rebound.

Doing the Interest Rate Limbo

Rate cuts do nothing to offset the deflationary winds sweeping the world economy. Deflation is going to push long term rates even lower, which ultimately is bullish. Then things will change, and we will talk of inflation. But not for awhile.

Jamaican tourists invariably get prodded into a round of Limbo, seeing who can bend back the lowest to get under the bar. Interest rates are now doing the Limbo. How low can we go? Many of the interest rate gurus I follow think we will see 30 year long term bond rates below 4% in this cycle. Some are talking closer to 3% than 4%. That means 10 year rates could approach 3%. That means mortgage rates could approach 5%. Already you can get 5.125% on a variable rate mortgage with a five year lock-up before adjustments.

I have been saying for years I think we will be able to borrow money at 5% for 30 years in this economic cycle. When that happens I will tell them to back up the truck. I might buy two homes just for the heck of it.

And here's the best part if you are the government. Just as you changed the rules and said "no more 30 years bonds," you can change the rules again when rates drop close to 3%. Yes, you heard it here first. The government will sell 30 year bonds again. Hide and watch.

I am reminded of the Mel Brooks line in History of the World, Part Two, when he looked at the camera and dead-panned, "It's good to be King."

The guys up at Treasury must be thinking, "It's good to make the rules, especially after the hand is dealt."

Economic Viagra - Not

Congress is working on a stimulus package. As stimulants go, this package is more like oysters than Viagra, more of a urban myth than any real use as an aphrodisiac. Like oysters, some people will like it, but it won't do much actual good for the area it is supposed to help.

The House version is pretty much a loser, I am sad to say. I do not understand how my GOP friends could let that dog get out of the yard. It is fine to get rid of the Alternative Minimum Tax for corporations, but offering a rebate is ridiculous. Does anyone really think giving Ford a check for $2.3 billion is going to stimulate their investment strategy one bit? Why send $25 billion back to corporations who will not invest any more than they have already planned? And the useless spending provisions in the package to get bi-partisan Democrat support are even more ridiculous. I could go on in detail, but you get the picture.

Rebates are one time actions. Government spending is a waste, and usually a poor allocation of resources. As stimulus, they don't do much. **If you really want to stimulate the economy, you cut tax rates.** You could start by cutting capital gain taxes for all new investments. Now THAT would be stimulating. Why not accelerate the tax cuts scheduled for 2004? That could get me excited.

Hopefully, President Bush can get into the conference committee and talk some sense into Congress. As it stands now, we will get very little stimulus and another $100 billion in debt. I am really disappointed about this. Conservatives are wasting a perfect opportunity to cut tax rates.

GDP Games

The GDP was only down .4% for the third quarter. That's good, right? I mean, after September you would think it would be worse.

The fact of the matter is that it will be worse. Count on it. The game is rigged. The GDP estimate yesterday does not include numbers from September. They estimate those numbers, using trends and curve fitting, etc. That is why they come back every month or so and give revised estimates. In times of growth, the estimates go up. But in times of decline (like last quarter), the number will be revised downward.

Did you hear this on CNBC or any other cheerleader outlets? I didn't think so.

Last quarter, if memory serves correct, we were first told that the economy grew at 1%, but later it was revised to only .3%. What has really happened is that GDP declined .4% (more or less) in the first two months of the current quarter. **It will get worse.**

I called around to a few hedge fund friends who have no stake in being market cheerleaders. The consensus seems to be down 1% or more. I have a bet with Greg Weldon that the final number is -1.2%. He thinks -1.1%. He has been hot lately, so he will probably win.

So why not come clean when you make the announcement? The markets are already nervous enough without saying down 1%, which could really drive them down. You hope that something positive happens between now and the time you bring out the revised number. Eventually the number will come out, but the natural response for cheerleaders is to minimize bad news. When the real numbers come out, it will be seen as "old news", and that is how the cheerleaders will present it. Those in the know (like you are now) already know the numbers will go down.

That being said, I think down only 1% would be great. I actually find that encouraging. It could have been MUCH worse. Consumer spending dropped 1.8% in September, the largest dorp in 40 years. Sales tax receipts in Texas are off 4%. I can tell you our state budget is in big trouble. I imagine state budgets everywhere are under pressure. Expect the drum beat for state and local tax hikes to become loud.

Further, our Three Amigo indicator, The National Association of Purchasing Manager's Index came in at 39.8, down from 47 and the lowest number since 1991. Economists expected 44.5. This was a shocker. **However, in an odd way, I can also see this as somewhat bullish.**

We were headed to below 40 on this important indicator anyway. Now, rather than slowly getting there, we have arrived. I keep saying we cannot have a recovery until we see some numbers begin to recover. Below 40 is pretty ugly. It could get uglier, but there are a number of reasons I can come up with that it won't get too much worse. Barring some new terrorist event, we could start to see a base building in this number from which we can rebound.

I would expect to see some recovery in November, as business tries to get back to "normal". **The key NAPM number will come in December.** If it is up as well, that would be very good. Remember, this number will probably turn up 6 months or so before the end of the recession. That is why we look for it to help us decide when to get back into the stock market.

More Good News

Junk bonds have stopped falling through the floor. Like a patient in the Intensive Care Unit, the machines now show a faint pulse. At the rate they are going, they too could be signaling a bottom in a few months.

The average recession is about 12 months, and my guess now is this is going to be an average recession. That would be six months down and six months to get back up, more or less.

The numbers for the fourth quarter are going to be brutal. The unemployment numbers this morning came in far worse than expected. Unemployment leaped from 4.9% to 5.4% in just one month. The 415,000 job loss was the biggest since 1980. Factory orders were showed major drops this week. Manufacturing in the US is in a long 15 month slump. The European Purchasing Managers Index was dismal.

All of the above and lots more is why I still do not feel comfortable getting back into the stock market in any big way. I still think we will test the recent stock market lows. But one more leg down may be it. Like a marathon runner hitting the wall in the last six miles, I keep telling myself just a few more months.

I know there are a lot of problems. I especially worry about the world economy dragging us down into a much longer and deeper recession. The numbers from England came in weak today, and that economy had been one of the bright spots. However, betting against the American economy has generally been a losing proposition. Because of the world situation the recovery will be much slower than most analysts think. We will not leap frog to 3% growth by then end of next year. But we can get back on track and start to pull the world with us. If Europe will help, this time next year we will be talking about the recession in the past tense.

Opportunity Knocks

Lower rates mean some real opportunity. There are going to be a lot of businesses that have good core cash flow, but have too much debt or their costs are too high. Healthy businesses will be able to borrow money at cheap rates to buy companies in bankruptcy for a fraction of their value. SBA loans will be cheap. You will see two sick companies merge in order to cut overhead costs, increase profit margins and create one healthy company.

Just as in 1991, there are going to be some very good opportunities for entrepreneurs to create some real wealth in the small business arena.

There are hundreds of micro-cap stocks selling for less than hard asset replacement costs. Buying them today in this climate is not all that wise, but in a few months, as the wind shifts from a recessionary direction and starts to blow in the direction of growth, there will be some real opportunities for large profits.

Investors will be looking for value and opportunity for growth. They will not find it in large companies. Smaller companies will become the "next hot thing". Reliable and trustworthy research will be crucial. There will be a lot of "promotions" but there will also be a lot of solid companies who will get their day in the bright sunshine.

I know that some of you are wondering what I have been drinking. Who is this optimist writing Mauldin's letter?

I think Halloween may have been a watershed day. Fisher's Trick on the bond market will be our Treat. We could finally be setting up for recovery. It is still in the future, but it is coming. And when it does, the opportunities are going to be on every corner. We will have been rewarded for our patience.

In a few weeks the World Series will be over. Baseball fans will take a short breather, but then they will start to anticipate the coming of Spring. As it grows closer, the excitement increases. Next year, the World Series could be in their ballpark. And so, baseballs fans go through the winter knowing April will arrive. This year we will win the pennant.

Investing is not so much different. **Even in the face of nine more months of recession, I am starting to anticipate the Spring.** You don't get many opportunities to get in at the beginning of an economic cycle. But what a thrill when you do.

Understand, this next cycle will not be like the last. Trying to invest like you did in 1991 or 1982 will not work as well. Like older ballplayers coming back to Spring training for our 15th season, the pitchers will be young and new to us. We will need to learn a few new batting techniques. But it will be fun if you do. I can almost smell the hot dogs and hear the crack of the bat.

Afghanistan Update

On a more sanguine note, this morning I got a call from Ed Artis, who is inside Afghanistan (via satellite phone). He was awakened today as the ground was literally rolling under him. Earthquake? No, B-52s were carpet bombing a few miles away. He has been delivering food, medicines and tents to remote villages and refugee camps in Northern Afghanistan that have not had any help in a long time. There are few groups who can get in with aid. He crossed the Afghan border as "press" and has set up what you might charitably call "alternative methods of delivery".

Over 60 tons of food is getting to people who desperately need it. He has partial access to a local helicopter that he can use to fly to remote mountain villages, assess their needs and then set up ways to get them food.

The locals have told him that he and his companion, Walt Ratterman, have a bounty on their lives. They do travel with a group of Northern Alliance militia for protection. At times, they are only a few miles from the front.

I asked him what the local feeling about the war was. Frankly, up until the carpet B-52s showed up, he told me, the local militia thought the US was being to easy on the Taliban, and did not understand the US strategy.

When the bombing started this morning in their area, he ran out to see what was happening. The militia all thought it was cruise missiles, but Ed recognized the sound of B-52s and carpet bombing from his Vietnam duty. The results have seemed to encourage the local opposition.

The money you gave is saving lives. There will be children who will live another winter because of your generosity.

But the need is great. If you would like to help, you can send money to:

Knightsbridge International
P.O. Box 4394
West Hills, California 91308-4394

It will be sent to them ASAP. Without going into too much detail, Ed has arranged for cash to eventually come into Tajikistan by diplomatic courier (not US), where food and tents are bought. Then they make it into Afghanistan. There is a desperate need for tents for the refugees. They cost about $200 and can be brought in from Iran. Don't ask how. They just can. And they save lives.

They need cash, not volunteers. The food, medicine and tents are available at reasonable prices. If you are part of a group which would like to help, you can contact me at 800-829-7273. Ed will be glad to be your representative.

Ed and Walt were typically joking and laughing about the danger and hardship. You will probably see them on the news as a few reporters find them and send back pictures and video. There have been a few stories on them in USA Today. One producer from a major national show is trying to get in to them. The producer's wife called Ed on his satellite phone and asked if he knew where her husband was. Just about that time, a B-52 flew over. The wife asked, "What was that?" Ed just said, "It was a truck." Didn't want to make her nervous.

It makes me nervous, though. Pray for their safety.

New York, New York

I am on my way to New York. I will have dinner with analyst supreme Greg Weldon at his home on the Atlantic beach Sunday afternoon. Dinner will be BBQ with a big side helping of deep dish deflation, as I pick his brains to get some insight for you about the future of our economy and ways to turn a profit.

I will be glad to meet with clients or potential clients late Monday afternoon and evening. Happy Hour is on me. Call the office at 800-829-7273 for details. Then Tuesday I will be having dinner with good friend and fellow analyst Bill Bonner of Daily Reckoning Fame. I should have plenty of useful thoughts for next week's issue.

Have a great weekend.

Your hoping to find the sweet spot analyst,