John Mauldin's Millennium Wave Online
2000WAVE.COM

June 30, 2001

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If you are confused by the blizzard of news that came out this week, then you are in great company. The level of disagreement among analysts and investors is becoming more and more shrill. How could PMC Sierra show such really bad numbers, get downgraded across the board, and open up 5% on the day? With all the bad telecom news, how could Lucent and JDS be going up?

Before we examine the data to get some idea of where the economy is headed, I should note a general principle I use in deciding who I REALLY listen to. First, I look at how an analyst or talking head makes his or her money. Then I try to understand the logic behind their opinions. Then I look at their track record.

But the most important thing is where they get their income. The head of a mutual fund is ALWAYS biased to the upside. Why would he tell you the stocks his fund is invested in are going into the toilet? He makes a percentage of the money he manages, and if you pull your money he makes less money. At most, they say things have been rough, but we see a bottom soon (or last week) and now is a good time to invest. "NOW" is always a good time for mutual fund managers to invest. Ditto for brokers. Ditto for those who work for companies which sell advertising to mutual funds, investment bankers which must keep companies happy in order to keep their large fees, etc. When was the last time you heard the head of a publicly traded company tell you his stock was over-priced? Not if they want to keep their jobs and options.

Who do I like? People who make their living no matter which way the market goes, or are so famous or rich they don't care. There are some very good independent analysts. You see me quote Greg Weldon frequently. He gets up at 2 am every day. He gets VERY big bucks to interpret the daily economic data. I like ECRI (below) and the Bank Credit Analyst, among many others. I like to talk to hedge fund managers. My favorite managers have systems that make money no matter which way the market is headed. They are trading every day, and usually have VERY good news sources.

For instance, I was interviewing a hedge fund manager this week in Dallas in prospect of placing some money with him on behalf of clients. We had his full attention, until 15 minutes before the Fed announcement. He excused himself, saying he had to limber up his fingers. He had one button for a 25 basis point cut and another for a 50 basis point cut. He would listen to the news and quickly hit the appropriate button, automatically executing his trades.

For over 36 straight months this low profile manager has made a consistent profit, which is why I was there. He really doesn't care what happens, as long as he has a trade on his "buttons" to take advantage of it. For the record, I lost the bet on what the rate cut would be. But they still bought lunch.

Summary: If an advisor or promoter primarily makes his money only if the market or his stock goes up, or if they need companies or mutual funds to buy advertising or have to keep large investment banking clients happy, then they are going to be biased to the upside. Take their advice with a LARGE dose of skepticism.

This week I may have looked at almost 100 news reports, articles and newsletters, plus numerous conversations with hedge fund managers and analysts. There is a lot of information to look at, so let's get started.

Cause For Optimism?

A consistent theme in this letter has been that before we see a turn-around in the economy, we need to see some data begin to show us things may be starting to improve. Since some things improved, we need to look at them first.

The cheerleaders told us 6 months ago that things would begin to turn around this summer, so buy stocks. They were wrong. Now they tell us that things will turn around in 6 months so buy stocks. Will they be right this time?

This week we got the first glimmer that things ***might*** be getting better. Maybe. A very small light. But as I repeatedly say, something has to start getting better first.

This week we saw several things that are good signs. New unemployment is down, breaking the trend. Oil and gas prices are beginning to show signs of really easing up. Just as higher energy prices acted as a "tax" on consumers, lower energy prices will have the same effect as a tax cut.

Optimists view the rate cut of only 25 basis points as the Fed saying things are going to get better soon, and so they won't be going to lower rates much more (see more below).

The crucial housing sector is holding up, despite mortgage rates not dropping along with Fed interest rate cuts.

While a lot of people haven't noticed, what Greg Weldon terms "pipeline" inflation is going down. By "pipeline inflation" we mean: what are the sources for future inflation or deflation that are "in the pipeline"?

Commodity prices are generally down across the board. Energy prices are going down, as predicted here last winter (I get some things right). That is what you expect in a recession. Inflation is going down from here. (By the way, that should be good for bonds.) Very few analysts think we will be growing at 3-4% next year. Most of the "optimists" think 2%. That is not enough to make commodity prices jump substantially, especially with the rest of the world slowing down as well (see below).

That means that the luckiest man in the world, Alan Greenspan, can continue to pump the money supply without seriously risking inflation. In fact, he tells us consistently that he is not worried about inflation and that he is much more worried about the softening of the economy. Many observers think that the NASDAQ Bubble of 1998-2000 was partially created by a huge expansion in the money supply. Today, in spite of a continuing spate of bad news, the market refuses to drop substantially. Could it be that the large increases in money supply we are currently experiencing are propping the stock markets up?

You can bet dollars to donuts that Greenspan is trying to maintain consumer confidence so that consumer spending will remain steady. I believe he now believes that the stock market is a significant part of the consumer confidence equation.

If as a by-product of his trying to engineer a soft landing with large money supply increases, some of that money goes into the stock market, then for him that is a fortuitous circumstance. It helps consumer confidence, which helps him get the economy growing again.

And consumer confidence is higher, or so the University of Michigan tells us. This is in spite of a large number of announced lay-offs the last two weeks. Those who study such things tell us that employment rates and consumer confidence are highly correlated.

Going, Going……Gone?

Most of what inspires optimism in the bulls is in the "look at what is **going** to happen" department. The $300 rebate is **going** to stimulate consumer spending. Beginning next week analysts are **going** to be making new projections for next year which will start to reflect the view that the economy will be turning around. It seems many investors actually listen to these guys. Microsoft has a new powerful version of its operating system and Intel has a new chip so we lemmings are **going** to rush out and buy new computers.

Plus, the dirty little "secret": all the huge write-offs and losses that companies have taken this quarter were too large. Since the news was **going** to be bad, they decided to write off everything they could, so they would not have to do it again. Better, so the reasoning goes, to have one large disappointment than a number of small ones. They did this on purpose so they could post higher earnings in the last half of the year, and thus boost their stock prices and year end options bonuses.

I would mention that a new survey of economists now thinks we will avoid a recession this year as a cause for optimism. But I remember reading a study once (I wish I had saved it) that no group of economists had ever predicted a recession until we were actually a quarter into one.

But on balance, the good news bulls have something to be cheerful about.

On the Other Hand?

Despite the above, little has really changed. I will refrain from quoting the litany of historical items that tells us we are headed for recession this quarter.

Please notice that all of the above "positive" is focused on the US. There is very little to be happy about when viewing the world scene. The new Japanese government apparently is reform minded. That is good. But reform causes pain, and the Japanese economy is already in the dumpster. If the reformists actually do something, which would be a first for Japan, we can expect more and deeper problems from the Land of the Rising Sun. While in the long run, fixing their problems as quickly as possible would be better, in the short term it will cause world-wide problems.

Germany is the world's third largest economy. Anirvan Banerji is the director of research for the Economic Cycle Research Institute. He tells us: "Germany may also be headed toward a recession. German Economics Minister Werner Muller warned last week that the German economy could see zero growth in the current quarter. You can read between the lines…. If Germany goes into recession, which now appears to be a serious possibility, it would be the first time since the first oil shock a quarter of a century ago that the world's three largest economies would be in synchronous recessions. And you can be sure that their neighbors would not remain unaffected."

The consumer confidence numbers from France clearly reflect a growing concern.
Australia, Korea, Taiwan and Mexico are clearly in recession and getting worse.

My point? The US is in a global economy. If the rest of the world slows down, it will affect us. We have only seen the beginnings of woes on the international front.

The Real Issue: Consumer Confidence

"The Bank for International Settlements recently published a sobering report noting that falls in private-sector net saving on the scale that the US has experienced – a MINUS 6.5% of gross domestic product in 2000 – have almost always been followed by sharp falls in economic growth two years later." (source: TheStreet.com)

What that means is that US consumers, rather than cut their lifestyles as they make less, choose to spend savings or charge credit cards to the max. (CNBC says the average credit card debt is $8,000.) The BIS study suggests that historically, this process can only go on for about two years without a recession following.

And that is the crux of the problem.

US companies are clearly in a "profits recession". Profits are shrinking, and have been doing so for at least two quarters.

Because there is so much unused production capacity of every type, not only in the US but world-wide, companies are having a hard time maintaining prices and margins, let alone raising prices. Some analysts, even a few (gasp) normal cheerleader types, are starting to whisper about no earnings growth for the next year. This means more lay-offs are in our future.

There is little reason to believe the tech sector is going to recover within the next 12 months, let alone the next 6 months. I don't have the space, but much of the tech boom the last few years was fueled by Y2K buying, the internet craze and the gold rush to install fiber optics and other types of telecom infrastructure.

Y2K buying is over. Internet buying is now a negative factor, as all the equipment bought by internet start-ups is now coming back onto the market. Growth in telecom infrastructure is dead. We have a monster over-supply of fiber optics and other "infrastructure". Many of the start-up telecom companies will be going bankrupt. Much of their purchases were financed by the very companies which sold them the equipment. The bills will be coming due over the next year.

Now, if it was only the tech sector that was having problems, I would blow the all-clear signal. The broad US economy could handle a recession in the tech world. That is only 10% or so of the economy. Just as a Texas recession in the 80's did not slow down the rest of the country by much, a single sector recession can be contained.

Evening news reports to the contrary, the real engine of the US economy is not Cisco and Intel, but the consumer.

Bulls will tell us that stock market gains over the past years, plus other types of savings leave the consumer in good shape. They expect consumer spending to continue to grow dramatically, just as it did in the first quarter of this year.

Bears look at the increasingly poor credit reports, growing bankruptcy filings, increasing numbers of delinquent accounts, tightening personal and business credit and wonder when it all will come down around our heads.

The reality will probably be, as usual, somewhere in the middle. The world will not end, but neither can consumers continue to spend more than they make. Obviously, at some point, they can't. But it might be a long time before they reach that point. The real question is whether consumers will continue to forego savings so they can keep up their lifestyles. If they do not, this could be a real problem for our consumer spending driven economy.

The argument bulls make is that baby boomers will keep spending for another 8-10 years, fueling a growing economy. And so far, they have been right.

But I look over at Japan and wonder. There an aging population began to start saving early last decade, shocked into reality by a dropping stock market. Instead of continuing to spend, they did what aging populations do everywhere. They consumed less. Food for thought: their "boomer" generation is not that much older than ours.

Last week I quoted my wife's comment: "He who needs the least toys is free". As we get older, we find that "things" do not give us the adrenaline rush they once did. We don't need every new toy. If the new gadget improves our lives, we buy it. But buying simply for the sake of buying seems to go out of style as we get older.

What if this trend starts sooner? What if the shock of lower stock values and personal balance sheets coupled with reduced expectations for a comfortable retirement start to have an effect, as they clearly did in Japan? What if a recession snaps an entire aging boomer generation back to the reality of "normal" stock market returns?

The only really good news I noted above was the unemployment news and the facts that consumer spending and new housing have not turned down. Everything else is secondary.

Employment drives consumer spending and confidence. If unemployment is at a bottom, then we are likely going to avoid a recession, as consumer spending will not drop all that much, in spite of massive debt problems.

Are we at the bottom of unemployment? Just as there is little in the way of future inflation in the pipeline, how much future unemployment is in the pipeline?

My guess, for what it's worth, is that we have not yet seen the worst. The very large announcements over the past month have yet to show up in the employment figures. If you are going to lose your job in August, you don't file unemployment today.

Therefore, I think unemployment will rise and thus consumer confidence will fall. The real and very hard question is: Will it fall enough to cause consumers to spend significantly less?

History, the BIS study tells us, says yes. But we are now in an era where investors and consumers alike keep ignoring history. How long can that condition go on? Only as long as consumer confidence remains high. How long can consumer confidence stay high? Only as long as unemployment stays low. Stay tuned.

My Take on the Interest Rate Cut

I know Greenspan and his fellow central bankers like to quote this statistic and that report, but I think it is in an effort to make us think that there is some central equation governing their actions. In reality, being a central banker is more like being an artist than an engineer.

Like any artist, they are painting a picture, and while they have an idea of what they want the picture to look like, the results depend a great deal upon their skill, luck and the tools they use.

If you read the words accompanying the rate cut decision, they tell us the economy is still in jeopardy. But they only cut rates 25 basis points. It seems like a big disconnect. Larry Kudlow on CNBC, among others, thinks they should have cut 75 basis points.

As noted above, Greenspan is worried about consumer confidence. I think he is "saving" 25 basis points if he needs them between now and the next Fed meeting on August 21 to shore up consumer confidence or a flagging stock market.

If everything goes along well, he can make the next cut at the regular meeting. If he has a problem, then he pulls out his magic rate cut wand. If he had used the full 50 point cut today and then made another intra-meeting 25 basis point cut, that could spook the market more than boost it.

All in all, not a bad strategy if you are trying to paint a recovering economy.

By the way, many mainstream figures like Lawrence Kudlow and Wayne Angell are in favor of more and deeper cuts. I agree. I think we will see at least another 50 basis points before this round of cuts is over. There is the real possibility of another full 1% if we are not clearly beginning to recover by October.

Bonds

The volatility in the bond market is outrageous. Yesterday, long term rates were 5.59%. Today, 30 year rates are 5.76%. What has happened in 24 hours? This is why we are moving clients slowly into the new bond positions. The traders in this market have no clear direction. The volatility is caused by the smallest bits of news. Recession and deflation oriented news make rates go down. Inflation and recovery makes rates go up.

Maybe we get a recovery this month. If we do, we will have to re-think our bond positions. But for now, I continue to think the data tells us that we are headed for a recession. This will be good for our bonds.

On Other Fronts

A number of you ask questions about the strong dollar. This week has seen the dollar make new highs against the Euro and a number of recent highs against currencies around the world. Lots of people have been predicting the demise of the dollar. But I keep asking, "as measured against what?" Do you want to own yen? If Europe is going into recession, will the Euro rebound 15-20% simply to get back to even with the dollar? Do you really have the courage to recommend Mexican pesos, one of the few currencies which has been stronger than the dollar this year?

Long story made short, a famous financial writer and friend of mine (now sadly departed) told his readers to back up the truck and buy pesos in the late 70's to get the high yields. Many of them did. The peso was re-valued and many of these investors were wiped out within less than a month of making their investment.

Betting against the dollar has not been a profitable wager for some time. Not because the dollar is so good, but because, comparatively speaking, everything else is so poor. Many of you just want to know what I think. My thinking is flavored by the many reports I read. On balance, I think the Asian currencies will not gain that much, if any, on the dollar. They need weak currencies to compete against US companies and each other.

I think the Euro is likely to gain, as it is too low on a relative basis. But we could be waiting a long time to see the Euro and the dollar at 1 to 1.

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Next week, I take off on Wednesday for a too short vacation with the kids (all 7!). The hotel occupancy rates in San Antonio take a noticeable upturn when the Mauldin clan shows up. Then we end up in Austin for what my kids think of as the best vacation resort in the country. We go to a "cabin" on Lake Travis as the guests of long term friends and ProFutures founders Gary and Debi Halbert. If they let my clan come back year after year then you know they must be good friends. I seriously doubt I will write anything next week, but am angling for a surprise guest.

Have a great 4th of July,
Your confident his kids will do their part to consume analyst,

John Mauldin

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