The end of this week’s e-letter will be Part Two of “Why P/E Ratios Will Not Rise As They Normally Do After a Recession.” The whole piece will be a chapter in my new book, Absolute Returns. Of course, I will have to think of a snappier chapter title. But snappy or not, it is important you understand the dynamics that are working to hold down P/E ratios today, and why this means the long term secular bear market now in session will remain so for several years to come.

But first, and briefly, let’s look at the economic scene. We quickly turn to just about my favorite trader and analyst, Greg Weldon, who has been right on target about the Fed for several years. Early this year, we both wrote that mainstream economists and the bond markets were wrong in pricing in a Fed funds rate increase of 2% for the year. It was as much a “slam dunk” trade as we have seen all year. I felt that the earliest we would see an increase in the Fed funds rate would be after the elections, and then it would be small. Greg agreed, and a little sooner than I, he began to write that there would be no rate increases this year.

Lately, he has been writing that he expects a Fed rate CUT this year. Other analysts I respect who have been on target for quite some time are also beginning to hint at the possibility of a rate cut. Yesterday, the traders in the futures market for Fed funds began to price in a rate cut for the AUGUST Fed meeting.

(You can get a free month of access to Greg’s excellent website by going to: www.macro-strategies.com. If you are a trader, it is a must-have service.)

It is one thing for arm chair quarterbacks (analysts) to talk about rate cuts. It is altogether another thing when traders place their money on such an outcome. While Greg does not think we will see a rate cut in August, he does think one is possible later this year.

Frankly, this worries me. While I do not think the Fed will raise rates until well into next year, What,” I ask myself, “would be the conditions which would cause the Fed to cut rates?” The answers aren’t pretty.

Would a serious drop in the stock market cause them to cut rates? Maybe, but I think it would have to be a lot more than we have experienced. What good would another 25
basis point cut do for the stock market? Would it encourage more lending? Would it materially decrease interest rate costs for corporations?

I think a rate cut because of a serious stock market decline is in the category of doing something just to show we are concerned, and not because the Fed thinks it would do any good.

If the economy started to slow down fast enough to suggest we are entering a second phase of the recession (the classic double dip), would the Fed cut rates? Yes, but what would be the trigger? Right now, the economy is still Muddling Through. The Manufacturing Index points to growth. The most recent IPI numbers indicate the recovery is still on track. We are still growing, albeit I believe slower than we did last quarter. If you are a Blue Chip economist you think we will grow even faster in the second half. I will let you know who is right in January.

**Whose Hand is on the Trigger?**

There would have to be a significant trigger for the economy to lurch back into recession this year.

There are plenty of potential triggers in the world today: terrorism, Brazil possibly collapsing, consumers starting to pay down debt instead of spending, etc. But these types of triggers have been there all along. At some point in our economic life, we are going to have to deal with the debt this nation has built up, but I can’t see that trigger getting pulled this year.

If housing started to significantly weaken or mortgage rates started to rise, I think the Fed would step in to “do something,” or at least attempt to do something. They have not been all that successful in bringing long rates down, and it is not clear that any effort, short of monetizing the debt on the long end, would have a real affect. And this would be temporary if the money supply grew too fast as a result. But again, housing is still doing relatively well, and mortgage rates don’t appear to be poised for a significant increase.

So we are back to the original question: What could cause the Fed to lower rates? Deflation is the one thing that comes to my mind.

One of the basic rules of central banking as espoused by Paul Volker is “Don’t do anything you can’t fix.” If the Fed creates a little inflation they can fix that. Everyone knows what to do about inflation.

But if they allow deflation, it is not altogether clear they can fix that problem. We only have to look at Japan to see how difficult it is for a major capitalist market economy to pull itself out of the doldrums of deflation.

I wrote this in the middle of 1999, and I repeat it. I believe Greenspan is far more concerned about deflation than he is inflation. If inflation was the concern, he would not have pumped the money supply almost 50% in just five years. In any other environment or country, that would be sending inflation and interest rates through the roof.
I get asked all the time, “Won’t the dollar dropping bring inflation back?” My answer is that is usually the case, but not likely this time. The world has a massive problem of too much production capacity. The dollar has dropped 10% or more against most currencies, and yet prices of imported goods are now 3.9% lower than in June 2001. They were lower again last month. How can prices be lower if the dollar is dropping, you ask?

In a theme oft repeated here, manufacturers have no pricing power. Period. In this type of environment, inflation ahs a hard time getting any traction.

Foreign producers will do what they have to do to get American consumers to buy. If that means taking less money to keep their factories going, it appears they are willing to do so, at least for now.

Further, as Greg Weldon says, “Paper is Burning” around the world. As companies file bankruptcy, this reduces the supply of money. Debt deflation is the one trigger that could start a second and more severe recession. If you thought Argentina was a problem, Brazil could be a far more serious issue, as many banks would have to write off massive amounts of debt if Brazil defaults, which is a real possibility.

(For those of you who missed it, that was a great pun. The Brazilian currency is called the real – pronounced Re-Al.)

In summary, things are not all that bad in the economy. (Remember, the stock market is NOT the economy.) The housing market is holding up. Cutting rates probably wouldn’t help the stock market, and would possibly send a signal the Fed was panicking.

If the Fed cuts rates this year, I think it will be likely because they are worried about deflation, and it would indicate the feel that simply printing money is not doing enough to stave off deflation. For me, this would be a huge warning flag. I believe the Fed will do as much as they can to keep the economy out of outright deflation. The rest of the economic fight is up to the markets and the business economy. Deflation is the arena where the Fed needs to be focused.

For those of you who want to read more about debt deflation, I suggest you go to www.pimco.com and read Paul McCulley’s excellent article on this topic. When the Managing Director of the largest bond firm in the world speaks as serious and as plainly as he does, it should make one sit up and listen.

Part 2: “Why P/E Ratios Will Not Rise As They Normally Do After a Recession.”

(For those who want to read part one, you can go to www.2000wave.com and check the archives for last week's letter. Essentially, in that piece, I pointed out reasons [which I summarize below] why P/E ratios are going to have a difficult time of rising in the current business environment.)

Investors of the World, Unite!
John Bogle, head of Vanguard and some of his stalwart brethren are beginning to band together to form what I call a “stock-holder’s union.” Pensions, index funds and large endowments all have an interest in accurate accounting. I think you will see these groups use their clout to directly elect independent board members charged with the responsibility to make sure accounting practices are correct.

As Bogle and other shareholders unite in their efforts to make sure companies are run for the benefit of shareholders and not management, we will see public companies run in the same manner as private companies: for the benefit of the owners. Yes, they will begin to put a clamp on the more outrageous practices and management pay. But even more importantly, they will begin to demand an accurate set of books.

Further, I think this will lead to a climate where options will start to be deducted from earnings. There are numerous estimates that the hidden earnings’ impact of stock options are in the range of 10%-20% of the peak earnings in 2000, or around $50-$100 billion.

The mood in the country is grim, and this ridiculous accounting standard which allows companies to ignore the cost of options in their public earnings statements when they get to deduct them from their taxes, will be changed.

What this means is that between overly optimistic pension assumptions and proper accounting for options will mean that earnings will have to rise by 20% or more just so that high P/E ratios can stay the same!

And it may be worse. Arnott tells us, in another report, that “These two factors [pension assumptions and options] combined would mean that true earnings are around $100 billion less than reported earnings. These, in turn, mean that the peak earnings of nearly $60 per S&P 500 share, may have been in the context of true, normalized earnings of $40 per S&P 500 share. Current trailing 12-month reported earnings of around $25 per S&P 500 share may be in a context of true (but depressed) earnings of around zero.”

But given the current investment climate of more rigorous earnings standards it is entirely likely we will see more conservative accounting standards develop over the next few years. It won’t happen all at once, as that might be too much a shock to the system, but you will see these and other changes become standard practice over time.

On this subject, my good friend Mac Ross notes that this is not a problem in the world of private corporations. Those of us who own a company are only interested in the accounting standards which accurately show the amount of money which flows to the bottom line.

If anything, the problem is the opposite, as each year end private companies all over the country try and find more expenses in an effort to lower taxes.

Whose Neck Is On That Chopping Block?
The SEC has put into the code that Chief Executive Officers and Chief Financial Officers are going to have to swear to the numbers they submit to the SEC. They are going to have to certify recent filings as well. The penalties for being wrong are fines or jail time. (You think this won’t cause some re-stating of performance?) That doesn’t even begin to count the cost of shareholder lawsuits. I know a lot of people think that may be a little stiff. But that is no less a standard than the SEC has held me to for the past decade.

Is it possible that senior management is going to start doing some serious reviewing of aggressive accounting practices? My prediction: the next few earnings periods are going to see some serious revision and restatement of earnings.

This is another death knell for earnings management. If you think you could be facing a fine for fudging the earnings number to meet some analysts expectations, then you are either going to tell the analysts to lower their expectations, or you are going to disappoint them. Either way, when your neck is on the line, you will get more conservative, especially when you know the shareholder’s lawyers have their long knives out.

Of course, this might mean that management now has to concentrate on managing the company for earnings rather than managing the accounting. Over the long run, this will be a good thing for productivity and profits. But it could get ugly over the next few years and is almost certain to depress earnings for the next few years.

**EBITDA, We Hardly Knew Ye!**

EBITDA is the expression for Earnings Before Interest, Taxes, Depreciation and Amortization, as if taxes and interest and capital costs aren’t all that important. Some people feel that it gives them a picture of earnings and others think it shows cash flow. The reality is it doesn’t do either very well.

If you are a capital intensive industry, that means you have to depreciate your investments against earnings. It is far more convenient to use EBITDA. The number just looks nicer. Also, if you are acquiring other companies and have large amounts of goodwill on your books, or have large amounts of real estate, it is nice not to have to talk about the amortization. Maybe it is better to call Arthur Andersen and create a special purpose vehicle to hide those nasty numbers.

As the Wall Street Journal recently noted, “Various versions of such tweaked earnings – often called “pro forma earnings” or “core earnings” or “operating earnings” or “recurring earnings” – have proliferated in recent years, as companies felt pressure to continue posting strong results even as an economic slowdown was cutting deeply into results. All along, critics have lambasted these alternatives to net income, saying they give companies too much flexibility in deciding how to account for expenses.” (July 5, 2002)

Investors are going to start insisting that companies and analysts use net income. Net income is that number a company reports to the IRS. It is amazing how much lower net income is than all of the other income euphemisms. Not coincidentally, you can also go to jail for knowingly falsifying tax returns.
Analyze This: Analysts Are Useless

David Dreman points out in a study that he conducted from 1982 through 1997 analysts were ON AVERAGE wrong by 200%. (Forbes, July 8, 2002)

Another longer-term study published by the National Bureau of Economic Research shows that analysts typically overstate earnings by at least a factor of 2. It would appear that when you look at both studies, the problem of too much optimism in the tea leaves is getting worse.

Dreman tells us, “Earnings performance for 2002's first half was a sorry one. Company after company was forced to lower expectations or restate past results downward. How can the consensus justify such a healthy-looking multiple for the year as a whole? By forecasting a second-half profit boom that gushes up from nowhere: a 48% gain (from a year earlier) in the third quarter and a 45.7% one in the fourth, according to S&P analysts' forecasts. Included in the forthcoming profit explosion, as reported in First Call, are a 127% income increase in technology stocks in the third quarter and a 73% jump in the fourth and a hardly modest 19-fold rise in transportation earnings in the third quarter (mainly airlines), with an even larger gain forecast for the fourth.”

Given the new accounting standards, the probability that these estimates are realistic is exceedingly slim.

Here’s a business opportunity for some enterprising new analyst. Start your own analysis firm. Go to First Call (a firm which compiles estimates from numerous sources) and look at the consensus estimates for earnings on any given company. Cut it in half and publish your estimates. Hire a few MBA financial types to write reports that reflect your “estimates.” Then go to work on your golf handicap for the rest of the month.

Results: you will be closer than 90% of all analysts. After a year or two, you will look like a genius. You will be able to sell your analysis to firms all over the world for big bucks. You will be rich and you will have a single digit handicap. The irony is that your analysis has a better basis in historical fact than the guys who are actually trying. If you can deal with the conscience thing (which does not seem to be a problem for many analysts), it would not be a bad life.

“To restore investors' confidence in earnings quality, Standard & Poor's in May brought out a stricter definition of its operating earnings, which is meant to capture profits from the ongoing business apart from such one-time events as goodwill impairment. From now on, S&P will treat employee stock options and restructuring charges as an expense and no longer add pension gains to income. The trouble is that companies aren't required to use S&P's methodology and will keep on reporting earnings whichever way makes them look the best.” (Forbes, Dreman, ibid.)

The world of investment analysts is getting ready to change dramatically. First, we are going to see some of them go to jail. The public demands blood, and blood they will get.
Let me tell you, that will be a wake-up call on Wall Street. Being wrong will cost you more than a negative employee review. The analysts are going to start insisting that they no longer need to consider investment banking business for the firm. Does anyone really think that highly paid analysts can be so wrong so often without noticing a pattern?

The pattern is simple: if they forecast reasonable and lower returns than their peers, their firm is liable to lose investment banking business. If they are wrong to the downside, they lose stature in the community. In the past it has been much better to make excuses for being too high than to say why you missed the (obvious to everyone else) reasons why things were getting better.

Over the next few years, we are going to see a new type of competition among investment firms and analysts. Investors are going to start ignoring overly optimistic analysis, and look for some accuracy. This won’t happen all at once, as there is still a demand for analysts who will tell investors what they want to hear. But as the secular bear market wears on, and the patience of investors begins to wear thin, you will see projections become more in line with reality. It will take 4-5 years at the least for this to become standard, but the S&P announcement is the beginning of what will become a trend.

Just as you tell your friends you use a conservative attorney, investors will start to look for conservative analysts. Optimists will come to be seen for what they are: dangerous to the health of your portfolio. Realistic and on target forecasts will become the style for which we all aspire.

**The Earnings Road Just Got Steeper**

Let's look at the list:

1. Pension assumptions must be made reasonable.
2. Accounting standards will become more conservative.
3. Options will likely be treated as an expense.
4. Boards of Directors will demand more open and conservative accounting.
5. Accountants and lawyers will be under serious pressure to justify any and all aggressive accounting and financing positions, with real consequences for being wrong.
6. CEOs and CFOs are now criminally liable for accounting misstatements.
7. Investors will increasingly be interested in true pictures of income and start ignoring EBITDA and other misleading “earnings” numbers.
8. Analysts will be under pressure to start making more accurate predictions.

Little of this will happen overnight. But as time goes on, it will begin to take effect. And what it means is that P/E ratios are going to suffer. And that is not the climate in which a bull market starts to take shape.

If analysts had told the truth about the last half of 2002, they would be projecting earnings which would show P/E ratios in the mid-40’s rather than the 21 they now forecast. Since 21 would have been almost a record high just a few years ago, how comfortable do you think investors would feel if the best they could look forward to was more of the same?
The recent woes of the stock market would pale by comparison.

No, none of this will happen overnight. Secular bear markets are akin to being nibbled to death by ducks. They are slow and painful. Each of the above will take its toll on earnings, and slowly, as investors demand more value, it will take its toll on the stock market.

Even as the economy rebounds and true earnings rise, the impression will be that earnings are going nowhere because we have grown used to a Hollywood fake set of numbers. With each round of disappointments, more and more investors will start to look for higher and higher standards of real value. And when the next recession hits, as it eventually will, the latitude given to corporate values will be small, and then we will begin to maybe start talking about a bottom. But that is not this year, and probably not next year.

In the meantime, investors must start looking for ways to get Absolute Returns. Simply beating the market when the market is down by 10% is not going to let the Baby Boomer generation retire in comfort.

**Living on Austin Time**

I could take my family on a two week vacation to Africa, and they would still point out that summer vacation isn’t over until we go to Austin and stay at my good friends (and former partners) Gary and Debi Halbert’s cabin on Lake Travis. They graciously let the Mauldin horde (all seven kids and added attractions) invade their property and even feed and entertain the troops. Eating at Chez Halbert is one of then highlights of my culinary year.

Over the next few weeks, we will be adding several new websites and services to serve readers better. I will let you know as each new site comes online