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There has been more important and interesting economic analysis that has come across my desk in the last few weeks than at any time I can remember. I have spent a lot of time pondering the meaning of several very different items, and trying to see how the dots connect. I think it will give us some clues as to what our investment posture should be. I think you will find this letter to be much different from the usual economic analysis.

First, I have masochistically thought long and hard about Greenspan’s recent speech in Idaho. Most of the analysis I have read seems to say that Greenspan was saying: “...

1. Yes, there was a bubble in the stock market, but how could we have known it at the time? and;
2. Even if we did know it, tightening the money supply to bring about a recession as a way to pop the bubble would have been unacceptable, and further;
3. The mission of the Fed is to control inflation and to provide stimulus to promote growth in times of weakness, therefore;

“The Bubble wasn’t my fault because it was not in my job description. Anyway, there was nothing I could have done about it.”

Greenspan has been drug over the coals for that speech. Many have commented upon the fact that Greenspan clearly identified the presence of a stock market bubble in 1996, and in one very well documented remark stated that he could absolutely deflate the bubble by raising the margin requirements on stock brokerage accounts. There were calls from many quarters, including this one, for him to do so. He did not, and he is now, quite correctly, catching grief for that failure.

I don’t have any quarrel with that analysis. But reading the speech left me feeling there was something else that Greenspan was saying. I couldn’t put my finger on it until I read Paul McCulley’s brilliant analysis (You can read it in its entirety at www.pimco.com):

“Greenspan was honest in acknowledging that the putative stabilizing properties of entrepreneurial capitalism, if believed by the masses and embedded in equity prices, lose their stabilizing properties. Heady, heady stuff, borrowing (without saying so) from Hy Minsky’s thesis that macroeconomic stability itself can be de-stabilizing, if and when the widespread belief in macroeconomic stability begets unstable financial arrangements.”

Let me translate: Greenspan said the Fed did its job and slowed down inflation and created an environment of economic stability and growth. When combined with an increase
in productivity, a favorable international trade environment and new technological innovations, this priced an unusually favorable and growing economic environment.

Investors, businessmen and consumers began to assume that these conditions would continue into the future. We made investments in stocks, production capacity and spent money on a burst of consumption based upon our own over-sized expectations, or what Greenspan called in 1996 “irrational exuberance.”

He tells us that the sheer fact that things were so stable and so positive led to the conditions that created the instability. This is not a new concept. It is called boom and bust economics.

**Greenspan seems to be saying that the Fed can do nothing that is politically feasible to combat the boom-bust stock market cycle, other than administer some aspirin (rate cuts and easy money) after the party!** Let me quote directly from Greenspan’s speech:

> “Moreover, it was far from obvious that bubbles, even if identified early, could be preempted short of the central bank inducing a substantial contraction in economic activity—the very outcome we would be seeking to avoid.

> “Prolonged periods of expansion promote a greater rational willingness to take risks, a pattern very difficult to avert by a modest tightening of monetary policy.”

I may be missing something, but this seems to me to be a complete rejection of New Era economics! He seems to be saying that the longer the period of economic stability, the greater the bubble that will result.

In essence, Greenspan was saying that the stock market trends with a mind of its own, and there is nothing the Fed can do about it, short of causing a recession, which they have the power to do. In another section, he even stated that if the Fed had tightened the money supply, and thereby choke the Bubble, that as soon as they began to ease again, the Bubble would resume, unless the Fed actually caused a recession!

> “See,” he says, “I was helpless. You guys were determined to drive the stock market up.”

What is fascinating to me, and what is missing in his post-speech analysis, is what is implied but not said in this speech. Again, laying aside Paul Krugman’s argument that we will never know what would have happened if Greenspan had raised margin requirements, let’s look at the other side of Greenspan’s coin.

**If the Fed, short of destructive policy, can do nothing to stop a bull market, then why do so many analysts assume that the Fed has some power to forestall a bear market?**
The point of the speech was not simply to justify his actions (or lack thereof), but to clearly communicate that the Fed can only do so much, and that controlling investor sentiment is not one of the levers they have. The main goal of the Fed has been to control inflation, which they have done. In fact, I have argued that much of the increase in the money supply we have seen in recent years is now an effort to combat deflation.

I will not address the argument that the increase in the money supply resulted in the stock market bubble. There may be some justification to that. The point to be understood here is Greenspan’s explicit admission of the lack of Fed power over the stock market. This is a clear challenge to those analysts and cheerleaders who think that somehow Fed policy will return the stock market to its former bullish ways.

**P/E Direction is Critical to Market Direction**

Moving on to the next new item, Ed Easterling of Crestmont Holdings in Dallas recently shared with me some of his research into primary stock market trends. Ed manages money for a number of institutional and high net worth clients, and has been analyzing what is a reasonable expectation for stock market returns. He showed me a set of charts I find remarkable in their clear presentation of what we should expect to see in the way of stock market returns over the next decade. Next week, I am going to have them placed on my website so you can see them directly, and then we will do a commentary on them.

What Easterling has done is to look at stock market performance for the past 100 years. His tables show what type of annualized performance an investor would have achieved over any period of time starting from any one year. He has tables showing the affects of inflation, taxes, dividends and fees. Then he has color coded those returns so you can see patterns. He has also correlated them with P/E ratios.

There are two overwhelming patterns that bear upon our discussion today. First, investing in times of rising P/E ratios gives very good results. Investing in times of falling P/E ratios is a prescription for long-term frustration.

Secondly, there are four very clear and separate periods of rising and falling P/E ratios in the last 100 years. These naturally correspond with secular bull and bear markets. When P/E ratios are rising, returns over time will often rise to over 10%. **Once a downward trend starts, returns over the next 10 and 20 years are very small, often less than 1%. In real inflation-adjusted terms, returns for investors can be flat or negative for decades.**

(The Ibbotson study says stocks return 6-7% over the long haul. Mutual fund managers and brokers tell you this, and suggest you stay invested in stocks for the long haul, presumably in their fund. Easterling’s charts show that indeed, 6-7% is probable, but over the REALLY long haul. There are often periods of 20-30 years or more where returns are far below 5%. If you take into account taxes, fees and inflation, real returns can often drop to 2%, even over many decades. Since most of us pay taxes, experience inflation and have to pay fees and commissions, this real world picture is quite different than the statistics your cheerleader manager throws at you to get you to buy and hold his fund. There are times, like the 80’s and 90’s, when buy and hold works like a charm, However, if you inconveniently
live during the wrong side of the long haul, your investment experience can be frustrating if
you practice buy and hold.)

Going back to the chart, once this period of rising or falling P/E ratios begins, it
seems to run its course, corresponding to a bull market top or a bear market bottom.

Now, back to Greenspan’s speech. What Greenspan implied was that these periods
are the result of entrepreneurial capitalism, and they are part of the economic landscape.
There is nothing the Fed, or anyone else for that matter, can do about them.

This is exactly the case I make in the chapter on secular bear markets in my book in
progress *Absolute Returns* (www.absolutereturns.net).

It is precisely this almost mystical force that Richard Russell has written about so
compellingly for 40 years in his *Dow Theory Letter*. Why do we continue to repeat this
pattern? Why don’t we learn? It is what allows writers like Russell to make these major
market calls and be so right so often.

History clearly shows these trends have a force and dynamic all their own. Fighting
them because this time its different, will result in investment failure. We are in a secular bear
market, and you should invest in ways that go with this trend, and not fight it.

**Danger, Will Robinson, Danger**

I am completely mystified as to what economic data the majority of economists are
looking at when they project a return to 3% growth in the 4th quarter. Just a few months ago
S&P was telling us that the US economy will grow 4.5% next quarter and 4.3% for 2003. I
still believe that we will Muddle Through this year, but 4%+ growth is just not in the cards.
The evidence says that we may not even see 2% by then end of the year.

Unemployment claims are beginning to climb back up, and are now over 400,000 on
a four week average. The recent Fed Beige Book, which chronicles economic activity in each
of the 12 Federal Reserve districts suggests “… that the growth of economic activity has
slowed in recent weeks.” Since we were only growing at 1.1% in the second quarter, which
does not suggest a climate for a return to 4% anytime soon.

Greg Weldon reports the number of mortgages in foreclosure is at 1.23%, which is
the highest in the 30 years since the statistics started being collected. It is likely to get worse,
as 4.77% of all mortgages are behind in their payment, which is a nine year high. Housing
sales are still holding up, as the Beige Book reports nearly all Federal Reserve Districts
reporting strong residential sales and construction activity -- more evidence of Muddle
Through.

The Producer Price Index shows a danger of deflation. Core prices are down 0.3% in
the last 12 months, the biggest year-over-year decline on record. Indeed, the prestigious
Bank Credit Analyst argues that the Fed may indeed cut rates once again.
They write this week, “If the economy grows at a sub-potential pace (below 3%) for a few more quarters, then there will be a considerable risk of deflation. ... the recent weakness in the economy implies further downward pressure on prices at a time when the inflation rate is only around 1%. The Fed cannot stand pat in the face of a rising deflation risk, even if it knows that cutting rates will have only a modest near-term impact on growth.”

But the US consumer is still buying, and as long as that force remains, the economy will Muddle Through. US retail sales rose more than expected in August, spurred by low-interest financing for automobiles and purchases of furniture and building supplies. This also helped mortgage and non-mortgage debt service burdens to rise close to historical highs.

And we are buying more and selling less offshore. The trade gap widened to a record $130 billion in the second quarter. Not to worry, though. “A record current account deficit isn’t a threat to the U.S. economic recovery,” said John Taylor, undersecretary of the Treasury for international affairs. (Taylor also predicts 3% growth in the 4th quarter.)

This is sheer nonsense. We are closely approaching a trade deficit that will be 5-6% of GDP. This has everywhere and without historical exception produced a drop in the currency of the country experiencing the deficit. While I note that the dollar is only slowing dropping, which is good (as a fast drop would be very bad for the economy and markets), the direction of the dollar is clearly downward.

I could go on and on, but you get the picture. The US economy is still growing, on the back of an increasingly debt burdened consumer. Some wonder if this is not yet another bubble?


Everything seems to be a bubble, and everywhere we are pointed to a world full of pins. The important thing that we need to remind ourselves is that if we stick to our personal knitting, how often things seem to work out just fine. They seldom work out as we expected, but things do work out.

And that brings me to my final observation. It is abundantly clear that much of the Boomer Generation is not financially ready for retirement. One would think, then, that savings would be growing faster than they are, and thus consumption would be less.

What is there that drives us to consume? Not that I am against consumption. I participate in the process with a ready heart and willing credit card. My consumption (like yours, I am sure) is of the type that is modest and necessary. It is others who are conspicuous in their profligacy.

But they may not be at fault. Perhaps there is something in their psyches or in the very social fabric that drives them to mass and conspicuous consumption.
Consuming Like a King

I am reading a rather interesting and well researched book by Jacque Le Golf called Medieval Civilization. (I am sure it is less dense in the original French.)

We all know that during the Middle Ages that economic progress took a great leap back. Trade throughout Europe, as well as the infrastructure and economic growth, went downhill from the time of Rome.

Why, given the base of knowledge, did not Medieval Europe improve upon Roman commerce? It seems that the fault lies partially in that this era of poverty was also an era of conspicuous consumption.

Le Golf analyzes the reasons for the lack of growth. A primary reason was the lack of capital, and an unwillingness to invest in economic enterprise.

The sovereign class (kings, dukes, knights, barons, etc.) took everything from the peasant and serfs but what was needed for subsistence. In a few places they would build mills or roads, but there was not much long term economic investment. Things went seriously downhill from the Roman period.

What was not used for war, crusades, tithes or for the maintenance of the fief, was consumed by the purchase of luxuries, giving parties and spent in other ways to establish personal esteem and impress the locals and others of the seigniorial class. Consumption was the rule of the day among the upper class.

Life expectancy was 30 years old. A man was called old at 40. Children were unmentioned in any of the literature. Famines, floods, wars, plagues and more contributed to a world of great uncertainty. In such a climate, why worry about anything but the immediate future, except the future of your soul?

Now, admittedly there was a great distrust of economic activity, and work for economic gain besides subsistence was frowned upon by both society and the church, but a great part of the problem was simply that no one saved money; therefore there were no investments in enterprises which could insure a future stream of income. Without such, there was no economic growth.

Today, while there is certainly a different economic and social climate, we too have created a society where consumption is the rule of the day. We live like Kings while we can.

But like that medieval period, what is consumed cannot be invested. Buying a car, a larger home or a new suit or golf clubs -- eating out and fine wines do not make us wealthier (although golf clubs could arguably be deemed a necessity). They are part of the quality of life, and have their place. But in the end, our consumption will result in less wealth and more uncertainty, both on a personal and national level.

Investment and savings help contribute to a more certain future. Like those who lived a 1000 years ago, not saving leads to uncertainty and hardship. I worry about a world in
which a generation who expects to be able to retire with certainty finds that to be an elusive dream. It will make for an interesting social and political climate. I hope there is not a move in the next decade (more than there already is) to take from those who did save and give to those who did not. I worry about these things late at night, as I ponder an uncertain future.

But then again, it’s good to be King.

**AT&T Problems?**

In the last decade, AOL had customer service problems because they couldn’t deal with their growth. This was a good problem from a business standpoint, as they fixed the problem and grew to become a dominant player. Other internet companies did not handle the growth as well, and died.

My own wearying experience with AT&T Broadband suggests they are having growing problems as well. If they get it fixed, that bodes well for their future. If not, then there will be other firms which step in and take market share from them.

As a reminder, I will once again speak at the New Orleans Investment Conference November 6-10. This conference features an extremely strong line-up of speakers, along with a rare appearance by Richard Russell and Sir John Templeton. You can find out more by going to [www.neworleansconference.com](http://www.neworleansconference.com). I would love to meet you there.

I hope to post a new chapter on earnings for my book Absolute Returns next week. If you are an accredited investor, you should go to [www.accreditedinvestor.ws](http://www.accreditedinvestor.ws) and sign up for my free letter on hedge funds. Next week I will also have a new site recommending investment managers and funds for those whose net worth is less than $1,000,000. I hate these distinctions, but I don’t make the rules. I just play by them.

Your glad he can live better than King Richard analyst,

John Mauldin