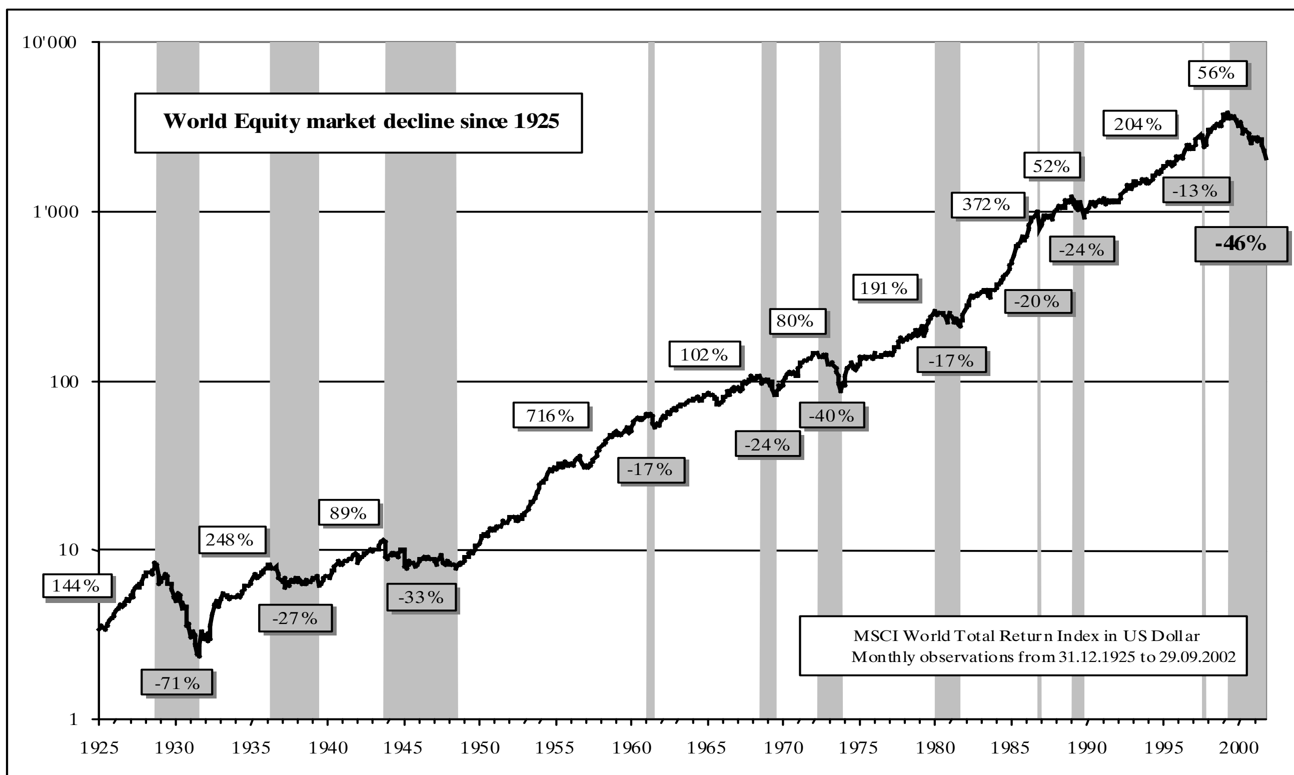
To be or not to be – growth or disaster

1. It'll all come to an end

People have not really become accustomed to losing money. Rather, the mood among the financial market participants is characterized by a gallows humor. Accepting the unavoidable is increasingly acknowledged by a tired shrug as stock market indices every day shed two or three percentage points and individual stock prices give up ten percent or more. Those who still own equities have had to turn their attention away almost forcibly from the daily prices. The intellectual process of separating the growth oriented component of the assets into a separate part of the overall balance sheet may turn into the decisive survival method in these difficult times. "Forgetting" this phase for a while and letting it slumber, as it were, until better fundamental conditions revive the engine for stock price gains and healthy returns – composure is a talent that must be organized!

Those who no longer owned any stocks in July and September may have felt fortunate. Perhaps. Because maybe they are not entirely honest or, if they were, their good luck will be of short duration. The chart below shows the movement of the global stock markets over a period of nearly a century. The presentation points up a couple of remarkable features. First, the non-shaded area is markedly larger than the shaded one. The periods of stock price gains clearly exceeded those of declines. The curve of the (nominal) total return generally points upwards. Second, the period under review was by no means devoid of major events. These include World War II with the depression of the thirties that preceded it, the Cold War with its open conflicts of the Korea and Vietnam wars, as well as the oil shocks of the seventies. Despite all, the stocks survived. Adjusting for inflation and allowing for currency differences, equity investments would have been the only instruments suitable to attain capital preserva-



tion and growth. Third, all periods with negative price movements came to an end. The longest lasted 58 months (1945-1949). As to duration, the current stock market crisis resembles the historical bear markets of the thirties and forties. Fourth, the price declines also ended. Approximating 46 percent, the losses since the spring of 2000 are the second highest after those sustained in the wake of the Crash of 1929.

Presumably, the current seemingly unending bear market plaguing us will at some point in time come to an end. Verging on acts of desperation, the emergency selling by institutional investors and the resulting historical lows of share holdings in the portfolios of investors which in theory should be qualified to withstand risks and have an adequate growth component, point to the approach of a trend reversal.

The chart and, of course, the underlying economic data clearly suggest a long-term oriented investment strategy with broad diversification. Long term – unless one or one's investment adviser is expected to have the capability of recognizing periods with adverse developments in advance and with the necessary clarity. Of course, much would be gained by avoiding negative periods. But would this also result in the timely investment in the periods of positive returns? Broadly diversified – unless one has the ability to recognize in advance the immense diversity of individual changes that cause upturns as well as declines in stock prices. It should be noted that changes in stock prices always constitute inflows and outflows of capital for entire economic sectors as well as individual enterprises. Into the automotive industry (1925-1929), out of the automotive industry (1929-1933), into the defense industry (1939-1945), out of the defense industry (1945-1949), into the IT and telecom industry (1990-2000), out of this sector (2000-2002). Behind the index numbers, there is a vast amount of individual fates, which in the event of a downturn might mean bankruptcy of businesses and a total loss for the shareholder.

2. Avoided, strengthened or unleashed?

The regular readers of this publication know our answers to the questions of the ability to recognize long-term trends in a timely fashion and the possibility of making the appropriate selection decisions for entire sectors and individual firms. The answers are rather cautious. At best, we can further the understanding of complex processes through an unbiased and independent analysis. As a result, one might occasionally gain a slight advantage over the presumably more inflexible "mainstream thinking." Ignorance is tantamount with risk. With clear vision and straightforward thinking, it is possible to mitigate ignorance and hence a little bit of risk. That's all!

The long-term chart inspires a couple of expanded thought processes. Quite obviously, the period from 1929 to 1949 turned out to be particularly disastrous for the investors, because they had to endure frightfully devastating intervals three times in a row and within a short period. For twenty years, they made no money with equities on a nominal basis – an outright catastrophe, adjusted for inflation! Of particular interest is the depth of the downturn after 1929 as well as the ensuing 1937-1939 crisis. Today, there is broad consensus that the bursting of the 1929 stock market bubble was particularly brutal due to an exceptionally unfortunate combination of interventions that prevented a reasonably normal recovery thereafter. What happened? In 1928, it was recognized quite correctly that stock prices on Wall Street had climbed to absurd heights. Speculation appeared to have no limits. The remedial action consisted in the Federal Reserve raising interest rates massively. With the crash of 1929, the monetary authorities believed that the correctness of their actions was confirmed. They reasoned that without the rate hike, the bubble would have expanded further and the crash would have been worse. From today's vantage point, stock prices probably would have collapsed without the Fed's help.

After 1929, the frightened investors fled into gold. The Fed's second mistake was trying to prevent this by maintaining the gold parity of the dollar at any price. The price consisted of interest rate hikes in 1931 and 1932, which hit the economy at its core and let the whole world slide into a deep depression. As always in times of crisis, gold possessed the aura of the uncontestable, purity, moral high ground, and one apparently believed that the currency would reflect gold's glitter and succeed in restoring the shattered confidence. Regain confidence by betting on a substance that is devoid of any thought of growth. This was the psychological background of the monetary policy at the time. Prior to 1929, "growth" had proved to be speculative, immoral and a thing of the devil.

By firmly establishing the gold parity, one sought to bury that despicable phase.

3. The war against the wealthy

Stock market bubbles are closely linked with fraudulent and corrupt practices on the part of the participants. This also held true at the time of the tulip bubble in the 17th century as well as the era of the industrial pioneers around 1870, when all over the world people blindly invested in the build-up of railroads. Fraud driven by speculation existed well ahead of 1929. Characterized by criminality and ugly graft, another heap of rubble was created by the technology rush of the late nineties. The bursting of a bubble invariably generates a vile smelling junk pile of creative destruction à la Schumpeter. Schumpeter was right, of course: Only through the destruction of projects which before the bursting of the bubble presented themselves as promising, innovative and enticing, economic growth materializes, chaff is separated from the wheat and the survivors are kept apart from the freaks. The destruction per se, therefore, should be deemed as positive. The drawback of the junk pile, though, is the need to dispose of the failed perpetrators by society, i.e. the legal prosecution of the deceptive business practices.

In America and Europe, the thirties deteriorated into an outright war against the wealthy and the entrepreneurs. As the world economic crisis spread, the search for the guilty was on. As a result, numerous laws and regulations were tightened. Under the pressure of events and the population at large, the originally moderate American President Roosevelt moved sharply to the left of the political spectrum and introduced a wealth tax, which enabled him to win the 1936 elections with overwhelming ease. In Europe, the hunt for the wealthy assumed quite different forms that transcended fiscal measures. The general sentiment against everything that was prosperous, productive and entrepreneurial helped the Hitler regime to translate its insane racial ideas into action. The traditionally productive, entrepreneurial and occasionally well-off Jews were persecuted and eventually gassed.

Society's handling of the leftovers of phases of economic excess is no trivial problem by any means. Altogether too often, the political power groups were (and still are) closely implicated in the schemes, and altogether too often it is attempted to salvage and perpetuate one or more of such excesses. In other words, the public and its representatives are accomplices in, if not partially responsible for, the excesses. If one reviews the history of Europe's telecom industry over the past ten years, this implication of the political powers is striking. Under the title of so-called privatization, cash was generated for the first time for the normally cash strapped government. With the granting of UMTS licenses, the newly "privatized" companies were subjected to a special tax on future earnings that are not remotely in prospect and thus forced into a deadly debt situation. In this manner, Europe's mostly socialist governments were ensured the necessary leeway for their own largely inactive survival and, last but not least, compliance with the Maastricht criteria.

The safest way to treat complicity and partial responsibility is to organize a witch-hunt on those who are virtually unable to defend themselves due to lack of physical power. This was clearly the case in Europe in the thirties. There are signs that this is beginning to develop today both in America and on this side of the Atlantic. Furthermore, the laws, regulations and controls are tightened in order to prove that henceforth law and order will prevail. The return to regulation is readily apparent and its impact can be felt clearly.

Speculative bubbles and excesses do not necessarily have to end in an anti-entrepreneurial climate. In America of 1873, a few years after the collapse of the railroad euphoria, technical innovations and an increased demand for transportation services already led to the next and by far more sustained investment boom. It carried America's economic growth well into the twentieth century. In contrast with the 1930s, no climate hostile to business developed after 1873. Why not? Presumably because the political powers at the time still were too weak for a comprehensive action against business.

4. What happens after 2005?

Basically, we should no longer be concerned with the current bear market. Incurred losses have been incurred and will not be reversed by being reviewed. At most, we might learn something from behavior that in retrospect turned out to be mistakes, but the consequences can't be erased. One might be angry at fraudulent individuals and structures, and even hold them responsible, if need be. Yet, since people have acted for years on end as both conspirator and victim of a system that increasingly viewed everything in an overly positive manner and out-

witted itself in this euphemism, moralizing is uncalled for.

Stock price losses are followed by gains. Once the companies, based on their shorter and longer term profitability, are rated as inexpensive, some marginal buyer will outnumber the large crowd of sellers and set off the stock price reversal. Stock price upswings from low levels do not occur because a hitherto undiscovered energy source opens up. Instead, we are dealing with a gradual change in the mood regarding the question of what is "cheap" and what is "expensive." In times like these, of course, the meaning of cheap and expensive is particularly questionable. Obviously, the solution is sought in the quantification of the problem. Average levels of price/earnings ratios at previous bear market lows, the dividend yield, the price/sales ratio, the price/book value ratio, etc are ratios used in argumentation. And, these are compared with the calculated actual averages to previous presumably comparable situations. Interestingly, from a historical point of view, the current valuations, above all in the USA, are despite recent declines still high.

Bear bottoms - S&P Industrials					
Date	P/E	Dividend Yield*	Price to Book	Price to Sales	Bond Yield*
13.06.1949	5.4	7.6	0.89	0.43	2.4
22.10.1957	12.0	4.4	1.43	0.75	3.7
25.10.1960	16.3	3.6	1.64	0.93	3.9
26.06.1962	14.9	3.9	1.54	0.85	3.9
03.01.1967	14.9	3.5	1.85	0.93	4.4
26.05.1970	12.9	4.4	1.45	0.66	6.9
06.12.1974	7.5	5.1	1.07	0.38	6.8
28.02.1978	8.3	5.3	1.14	0.40	7.6
21.04.1980	6.8	5.7	1.08	0.34	10.8
12.08.1982	7.9	6.3	0.97	0.33	12.2
24.07.1984	9.4	4.4	1.36	0.44	12.8
19.10.1987	12.7	3.4	1.92	0.58	9.6
11.10.1990	13.9	3.6	2.24	0.60	8.9
Average	11.0	4.7	1.43	0.58	7.2
Today	**17.3****	**1.83**	**2.91**	**1.16**	**3.7**
	23.6**	**(Measured by "core earnings")**			

* In percent

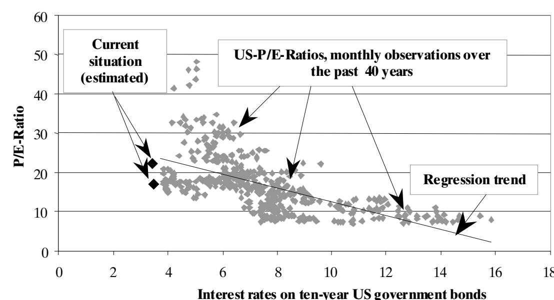
**Consensus estimates of financial analysts for 2002

Are equities still expensive...

Source: Bloomberg, own calculations

It can be viewed differently, however. If the price/earnings ratios are set in relation to the applicable interest rate level, these American companies are quite fairly valued. The consideration is that the investor must decide between equity investments and, if need be, interest bearing instruments as an alternative and, therefore, demands less corporate earnings per dollar invested if the yield on an interest bearing investment is lower.

...or are they cheap now?



Source: analysis

Empirically, such a connection between interest rates and the fair price/earnings ratio can be readily ascertained, as shown in the above regression analysis. It may be noted, however, that the question of the corporate earnings under consideration is an extremely difficult one nowadays. After the uncovered balance sheet fraud and the "forgotten" items of stock options programs and pension obligations, it is almost impossible to form a valid picture of the real earnings situation of the companies. Therefore, dramatic surprises – positive as well as negative – are quite conceivable. Obviously, the volatility has therefore remained on high levels.

In our opinion however, such a short-term view is questionable anyhow. In boom times, both managers and financial analysts were criticized for their extremely short-term orientation and basing their work merely on not particularly indicative key ratios, such as return on equity (ROE) and quarterly results, while disregarding longer term interests and growth prospects. What was wrong in boom times is not any more correct when the market is in the doldrums. On the contrary, the historically low level of interest rates makes future earnings discounted to present value more important than would be the case at a higher interest rate level. Put in another way – what will happen with the companies in two to three years is highly relevant for today's price formation. Therefore, the question is what will happen after 2005. Will the industrialized world persecute all the prosperous, productively thinking and entrepreneurial types? Or will it revert to growth strategies?

5. Don't count anything!

At a recent tour of a very modern machinery manufacturing plant near St. Gall, the visitor noticed a production motto in large letters hanging on the walls, which seems strange at first glance: "Don't run, don't look for anything,

don't count!" The company is divided into production teams, which have a high degree of autonomy for the production and timely completion of their partial output. The ongoing and mostly aimless movement of employees, continuous search for the proper tool and incessant counting of screws, nuts and other components – this would not constitute a single relevant step in the production process. Rather, the working hours should be focussed on the product. Pseudo-precision of inventories, under-allocation of tools that are not at all expensive, as well as an excessive organization of the process planning resulting in computer lists that are difficult to read – all of this is poison for a genuine enhancement of productivity. Nothing is gained by a mere bustle of activity.

The concept is convincing. It dispenses with unnecessary controls and places confidence in the decentralized and optimized production teams in lieu of an overly centralized management. Zero-sum games in the form of unnecessary circulation of staff are avoided. The unfortunate situation of the current state of the economy and politics on both sides of the Atlantic lies in the fact that everything seems to be going in the other direction. After the admittedly massive derailments of the boom years, the authorities are now betting on rigorous controls, sworn statements by managers with respect to the accuracy of their financial figures, supervision of chartered accountants (thus, the supervision of the supervisors – until such time as supervisors of the supervisors' supervisors will have to be appointed. A Kafkaesque image!). These additional control organs and mechanisms release the defense and security reflexes. The manager who must swear on his balance sheet will demand numbers that are signed with the blood of a third party, and he will arrange for an insurance policy protecting him against claims for damages if some clever lawyer should still find out that something was hidden somewhere sometime.

Walking around, searching, counting – nothing has been produced as yet! The particular misfortune also lies in the fact that the bills of charges written by auditors, lawyers, opposing lawyers, advisers and opposing advisers, as well as all salaries of government officials who contribute to the counting, searching and walking around, are added to the gross domestic product. Plenty of zero-sum and negative-sum games that make no economic sense whatsoever but are part of the economic bill of charges!

This is why it is advisable to refrain from measuring growth merely on the basis of statistics but to investigate repeadedly how indicative these measures really are. The comparison of productivity measures probably tells more about the state of different economies than the rates of change in the GDP. Bustling activity alone is of no interest! The war against the wealthy, productive and entrepreneurial people can be extremely subtle. The road to serfdom exists under the cover of entirely good intentions and under the pretext of rectifying actual abuses of the system. Especially dangerous is the combination of best, ethically fully supported intentions with a deep-seated contempt for any kind of individual and economic freedom. Under pressure from the media, which promulgate and demand morals (which they themselves frequently ignore) practically every day a new commission consisting of equal members, organized by all sorts of criteria, is appointed with the aim or repealing the market mechanism and distributing the responsibility among many and actually unidentifiable heads. In the wake of the boom years, the trend in politics and society clearly runs in this direction – the result will comprise bustling activity on one side of the spectrum and negative incentives for assuming entrepreneurial responsibility and initiative on the other side.

A high density of regulation favors companies that can apply economies of scale. Only large organizations can afford a full-fledged legal department equipped to handle all questions of accounting regulations, rulings of supervisory authorities and international liability laws, etc. And if the large organizations begin to increasingly predominate due to the high density of regulation, the cartel commission and competition regulators must step in. In point of fact, they primarily make the changing of hands of companies more expensive and cement existing structures... This is extremely unfortunate, because the only really effective remedy for corrupt management would be the unfettered opportunity to take over the companies in question.

6. Does the United States wage two wars?

In a recent "Finanz und Wirtschaft" article (No. 71, page 43). Johns Hopkins University economist Steve Hanke quite aptly pointed out that the US government is running the danger of being involved in two wars with a questionable outcome, and that waging such a twofold war

could burden the American economy and, of course, the world economy in general in such a way that a renewed recession might be imminent.

One "war" is against terrorism, an elusive enemy who was first localized in Afghanistan, where he could be fought quite successfully, and a second time was spotted in Iraq. Notwithstanding the initial successes, though, the problem is far from being resolved. In Afghanistan, the conflict was fought with more or less traditional military means and the use of superior force. This would unlikely be repeated in Iraq. But with the elimination of two possible hotbeds of terrorism, the war is just beginning. The use of military power against "needles in a haystack" spread all over the world is not particularly promising. The next phases of the conflict, which will undoubtedly be unavoidable for the Western civilization, will have to be more covert and more narrowly focused.

The danger of collateral damage for the economy and society is enormous and far greater than the direct cost of a military campaign. It is extremely difficult to find needles in a haystack without messing it up completely or, if necessary, even lighting it. One year after the terror attacks on the World Trade Center and the Pentagon, the strategies selected so far are not encouraging. With the introduction of the Patriot Act, the Americans opted for some kind of club. Since its enactment, it has not only drastically impeded air traffic, but – even much worse – has partially killed the free flow of capital and the international exchange of goods. In view of the future demand for funds for renewed growth in the capital investment sector (precisely what ails the American economy today), it is not irrelevant whether Arab or other foreign capital even dares cross the US border.

About a year ago, we stated the greatest danger facing Western civilization after the terror attacks lies in the possibility that everything that is more or less "bad," regardless of whether it is tax delinquency, smuggling electronic equipment or buying and selling prohibited goods, will be equated with terrorism. A year afterwards, we note that not only more or less "bad" things but also whole population segments are included in this process. The chance that one discovers and destroys the cancer cells with such a chemo-therapeutic club is slight. The danger for the organism as a whole is considerably more significant.

The second conflict, as outlined above, would be directed against the entrepreneurs, the actually productive ones, and finally the wealthy. One gains the impression that, on the regulatory level, the initial positions have been built up. The hour of truth, however, will strike when the financing of the newly created budget deficit has to be decided. The Democrats unequivocally disapprove of tax reductions. In this regard, the upcoming Congressional elections will be pivotal. However, in order to boost business activity and regain confidence in the economy, the United States in the years ahead does not need a well fed and grasping Internal Revenue Service but a series of new incentives that look promising to investors.

7. Half-time considerations on Schröder

On this side of the Atlantic, elections have already taken place. With a slight majority and presumably only thanks to the flood disaster, the coalition around Chancellor Schröder could be saved. In a sense, one must be grateful for this result, because (1) The government can now complete what it never started, and (2) It is not clear whether a team led by the opposing candidate would have been appreciably more successful in view of the weighty pending issues.

Never started: This relates to Germany's great structural challenges, which are expressed, among other things, in a continually high unemployment rate, perpetually anemic vitality when it comes to creating new jobs, a languishing inclination to form new enterprises, stubbornly heavy taxes and a widening budget deficit. Germany quite obviously is not capable to throw off the shackles it chose itself. It is clear to everyone that a labor market that is so tightly regulated and monopolized by the unions has no room in an era of global competition. If it is practically impossible to organize night shifts, if every year with extraordinary constancy and insistence the activities of whole management boards are paralyzed by wage negotiations, if every small and medium-sized firm must watch out with extreme care that it won't be caught in a joint employee-management scheme, if it takes an extreme effort to enforce the closing of an operation – then one will not stay competitive for long. The political system does everything to preserve structures, as the subsidy shortly before the elections for insolvent Mobilcom in the handsome amount of EUR 400 million proved once again.

Subsidies designed to maintain existing structures naturally burden not only the taxpayer and hence the economy as a whole. They also invariably place the businesses which kept their finances in order at a competitive disadvantage, thereby offering disastrous incentives for poor management. Germany is by no means alone in tolerating such practices. The conditions West of the Rhine are at least just as bad in this respect. We are looking for the day when the governments of France and Germany will have to face up to the mountainous debt loads of their telecom giants.

From a structural policy perspective, the privatization wave of the nineties largely proved to be a failure. Former state owned enterprises were replaced by still partially government controlled entities that were maneuvered into utterly stupid risks. On the one hand, this took place in line with the technology euphoria. On the other hand, though, it also reflected the straightforward intention to improve the situation of the government finances through privatization gains and licensing income (UMTS). It all turns out to be a flash in the pan. The privatized enterprises are not about to weather the economic and stock market slump of recent years, and the government coffers are already empty again. On the insistence of Germany, France and Italy, the budgetary balancing arrangement for 2003 concluded among the EU member states must be postponed until 2006. In doing so, disincentives are offered to countries which have straightened out their finances and kept their accounts in order.

Everything suggests that the German government will continue to burden the economy in the years ahead by maintaining or even raising the already high taxes and widening instead of shrinking the budget deficit. The climate will remain extremely growth averse precisely where growth is needed most, namely the medium-sized to small business segment. The incentives to establish a business in Germany or to keep it going are very small. Calculated over the life of an enterprise or its founder, the investment will practically be taxed away in its entirety. Included in this calculation is the wear and tear on one's patience involved in dealing with government offices and unions. Thus, it is better to move to another place in the world or stay an employee.

Growth aversion, envy of successful and prosperous people, escalating transfer payments – under such conditions, a genuine economic recovery that is also carried by the domestic market is a remote prospect. Additionally, Germany's banking system, also for structural reasons, is in a crisis and therefore hardly in a position to finance a broadly based rebound without running into problems.

In its present economic state, Germany would require a different specific monetary policy than the European Central Bank is prepared to formulate and carry out. In other words, Germany today needs still lower interest rates. Current real interest rates are clearly too high for a broadly based economic recovery. The ECB, however, can not go along with this line of thinking for reasons of maintaining the value of the euro as well as monetary considerations vis-à-vis other European regions. From the monetary side, therefore, little help is available.

For these reasons, it is not possible to offer the Schröder government any favorable forecasts. In two to three years, pressure from the economic front will become so heavy that new elections will be necessary. This is when the question will arise in which direction Germany and all of Europe along with it will be headed. The liberal forces, notably the Free Democrats, again have failed miserably in the last elections. Is there a chance that the freedom and growth oriented forces will find a way to get together, in whatever party? Will Germany once again produce a politician of the stature of an Erhart with the courage to launch radical reform? The danger of a substantially more negative development should not be disregarded. It might, for example, consist of a tendency toward stepped up external political activity, conceivably along the lines of EU eastward growth and NATO expansion. Remember, Europe's experience with German foreign political activity is not very encouraging.

8. A new equilibrium on a lower level

The "morning after" is obviously a thorny phase not only with respect to human relations and activities. It is also dangerous after an economic boom or a stock market bubble, inasmuch as important and far reaching social and political decisions are imminent. Do we want to bet on stagnation and increasing regulation, do we want to choke off and overtax the last remaining creative and productive forces of society, or do we seek new growth strategies?

It is still not clear in which direction the world and the world's important forces will move. For

the investor, the problem is probably not imminent as yet. First, we are approaching the end of the great shock. By way of so-called technical recoveries, a new equilibrium on a lower level will be formed. The peril of a renewed extended and again costly market downturn, however, will become imminent when too many of the above-mentioned wrong paths will be chosen.

It should be born in mind that our world encompasses a few other regions than Europe, which is aging and crusty, and America, which is increasingly entangled in its assertion of power. Positive signals from the Far East and Eastern Europe, notably eagerly reforming Russia, point to the fact that the concept of growth is by no means a thing of the past. And perhaps it will happen without us and elsewhere as time progresses. It will be our fault.

K.H. September 30, 2002