Economic Consequences Of The Peace: 2002

Topical Study #57

All disclosures can be found on the back page.

Dr. Edward Yardeni
(212) 778-2646
ed_yardeni@prusec.com
I. Introduction

In my opinion, there are three historical analogies that may be relevant for predicting the outlook for the economy and financial markets today:

1) America in the 1990s,
2) Japan in the 1990s, and
3) America in the 1930s.

I pick the first scenario as the most relevant analogy for today and the rest of the decade. It is obviously the most optimistic of the three. If I am right, then both the economy and profits should continue to recover, though at a relatively slow pace for another year or two. In the late 1990s, many investors started to believe that the economy might never fall into another recession. Now, there seems to be mounting concerns that the economy will never recover again, or that it will remain very depressed for a long time, as was the case in Japan in the 1990s and America during the 1930s.

II. First Scenario: Time Heals All Wounds

The similarities between 2000-02 and 1990-92 are eerie. A president named “George Bush” was in the White House then and now. Saddam Hussein was Bush enemy number one then, and is again. Both the current and previous decades started with very short and moderate economic downturns. Both were followed by lackluster economic recoveries, with weak employment growth. Indeed, the pattern of initial jobless claims now and then looks remarkably similar (Figure 1). The same is true for the monthly survey of manufacturers conducted by the Institute for Supply Management (Figure 2). In the early 1990s, the savings and loan bubble burst. The financial system was a mess. Today, the Tech Wreck is the major structural problem in the economy.

In both periods, the Federal Reserve lowered the Federal Funds rate dramatically and kept it low for some time. The Federal Funds rate plunged from 9.8% during the middle of 1989 to 3% by August 1992, and it remained at this level through the beginning of 1994, when the Fed started to tighten again. At the end of 2000, the Federal Funds rate was 6.50%. It dropped to 1.75% by December 2001, and it remains at this level (Figure 3). A combination of easy money and time revived the economy by 1995. Easy money and time should do so again over the next couple of years.

Both now and then, Americans were concerned about going to war with Iraq. Tactical weapons of mass destruction were viewed as a potential threat to American soldiers. U.S. troops face the same dangerous scenario today if they attack Iraq. After 9/11, Americans are more fearful of their own vulnerability to terrorists at home.
The relatively quick victory in the Persian Gulf War helped to revive consumer confidence, but consumer spending remained lackluster during the first half of the 1990s. This time, consumer spending has been more robust because solid gains in productivity have boosted real pay per worker. Also, historically low mortgage rates are currently supplementing consumers’ purchasing power by reducing monthly payments and increasing “cash-outs” of residential equity. The Federal National Mortgage Association reports that an estimated $1.4 trillion of mortgages will be refinanced this year, up from $1.1 trillion last year. Furthermore, in each year, homeowners took out an estimated $100 billion of equity.

The early 1990s marked the end of the Cold War. If the U.S. can deliver a quick and decisive regime change in Iraq, then the so-called Clash of Civilizations might be aborted quickly. President George W. Bush seems to believe that the most dangerous terrorists are sponsored and supported by states such as Iraq and Iran. I happen to agree. If so, then a decisive win in Iraq—through diplomacy or military means—could have enormously positive geopolitical consequences for Americans, who might rightly feel less alarmed about the potential for future 9/11s and more confident about the future.

**III. Second Scenario: Deflation Menace**

One of the most significant differences between now and the early 1990s is deflation: We are much closer to it now than we were then. This is why more and more investors are concerned about the similarities with Japan’s deflationary and depressed economic experience since 1990. I am, too, but I see this second scenario as the second-most-likely one.

During the 1990s, I wrote a series of Topical Studies titled “The Economic Consequences of the Peace.” One of my themes has been that there are only two eras in human history, namely, wars and peace. A glance at the Consumer Price Index in the United States since 1800 strongly suggests that wars are inflationary and peace times are deflationary (Figure 4). This makes sense to me. Power is concentrated in the government during wars. Markets tend to be monopolized, protected, subsidized, corrupted, and inflation-prone. Power shifts to business and consumers during peace times as governments negotiate free trade agreements to gain access to foreign markets. Markets around the world become more competitive, and prone to deflation.

Since the end of the Cold War, deflationary forces have been offset by easy monetary policy. However, these forces were not defeated and were actually reinforced when China joined the World Trade Organization (WTO) at the end of last year. The Bank of Japan ran out of basis points to fight deflation when the official bank rate was dropped to near zero in the late 1990s (Figure 3). The Fed has only 175 basis points left.
Japan’s GDP implicit price deflator has been falling modestly for the past several years. During the second quarter of this year, it was 6.1% below its second-quarter 1997 peak. The U.S. inflation rate—based on the yearly percent change in the GDP implicit price deflator—is down from 4.2% at the start of the 1990s to only 1.1% currently. The implicit price deflator for nonfinancial corporations has been deflating, showing a drop of 0.6% over the past four quarters—the first such negative comparison since the data were first collected in 1958 (Figure 5).

The weakness in pricing is depressing the growth in nominal GDP in both Japan and the United States. Nominal GDP growth has been mostly negative in Japan since 1998. In the United States, it remains positive but relatively weak, with a gain of only 3.3% over the past four quarters through the middle of this year (Figure 6). This means that top-line growth for many businesses is very challenging.

Perhaps the most disturbing similarity between the United States and Japan today is the extraordinary liquidity preference of consumers in both countries. Japanese households have been pouring money into bank deposits with a zero return. Americans have been pouring money into savings deposits with near-zero yields. The liquidity preference increased in Japan after the Nikkei crashed in the early 1990s. It has been doing the same since the Nasdaq crashed (Figure 7).

The difference is that there is a “liquidity trap” in Japan, because the banks remain challenged by a huge pile of bad loans and have sharply curtailed lending activities since 1997 (Figure 8). The banks invested some of their deposit liabilities in equities, which are also distressed. They have been investing in government bonds as well, with near-zero interest rates. The government has used the proceeds to build roads and bridges to nowhere that anybody needs to go. In the U.S. the massive inflows into savings deposits are mostly financing a housing boom, which could potentially become another bubble (Figure 8).

A recent worrisome development in both Japan and the United States is that bank stock prices have been a source of weakness in the Nikkei and the S&P 500 (Figure 9). Both markets are likely to remain under pressure as long as their bank stock indexes are falling.

Perhaps the most important difference between Japan and the United States is demographics. Japan has a population of 128 million people, whose birth rate is so low that demographic projections show a shrinking population over the years ahead. The median age in Japan is 41. It is 36 years in the U.S., where the birth rate and immigration are increasing the population. Close to 100 million people are 26 years old or younger in the United States (Figure 10).
IV. Third Scenario: The Zombie Problem

Deflation is a very unstable and potentially dangerous economic environment. Macroeconomists, particularly monetarists, believe it can be overcome by pumping up the money supply. I am not so sure. I believe that it is a consequence of increasingly competitive markets resulting from peace, free international trade, industrial deregulation, technology, and productivity. The end of the Cold War was Big Bang I for deflation. Big Bang II occurred when China joined the WTO last year.

China has a population of 1.2 billion people. Even with effective population control measures, China’s population rose by 100 million over the past ten years. By some estimates, 20 million people per year leave the rural villages of China looking for construction and manufacturing jobs in the urban areas. In the United States, the number of manufacturing jobs is only 17 million in total! Before the end of the decade, the Three Gorges Dam project will open up the Yangtze, China’s longest river, to large container ships. That will open up a vast interior area of China, including 350 million people, to global trade. The consequences are likely to be deflationary.

Above, I suggested that deflation is inherently a microeconomic problem rooted in the competitive structure of markets and therefore not easily eliminated by stimulative monetary and fiscal policies. It is also a political problem. As economist Joseph Schumpeter has observed, capitalism is a process of creative destruction. But what if uncompetitive companies remain in business even when market forces make them unprofitable? They can do so by gaining political support, either through corrupt means or by claiming that too many jobs will be lost if they are not protected by the government.

The result is Zombies, the living-dead companies that should be buried but continue to produce, thus causing deflation in their industry. Japan is full of such zombies. The U.S. steel industry has zombies, and now so does telecommunications. WorldCom became a zombie a couple of years ago, although we only found out about it at the end of June 2002, when the company disclosed that its earnings had been fraudulently overstated for the past few years.

If deflation is a structural global problem that defies macroeconomic solutions, then there are two possible scenarios for the economic outlook--sweet and sour:

In the sweet version, companies offset the competitive pressure on their prices with productivity gains (Figure 11). The gains benefit mostly consumers as wages rise faster than prices (Figure 12). As long as consumers spend their real income, productivity continues to grow and the overall economy continues to prosper. Individual companies can prosper and be very profitable in this scenario, but they can also go out of business if they fail to stay ahead of their competitors.
In the sour version, competition is so intense that profits are depressed, forcing companies to slash their payrolls in desperate attempts to cut costs and boost productivity. Consumer confidence falls as the jobless rate rises. Consumer spending is depressed by the worsening employment situation and perceptions that there is no rush to buy when prices are falling.

Some students of economic history believe that wars are often the solution for deflation. My war and peace model supports this view. Could the war on terrorism revive inflation? I doubt it. As President Bush recently said, the war on terrorism is actually more like an international manhunt.

V. Profits, Valuation, And Deflation

In the classic film The Wizard of Oz, when Dorothy's tornado-swept home lands in Oz, her first reaction is to tell her dog, “Toto, I've a feeling we're not in Kansas anymore.” Most stock investors probably feel the same way about deflation. We've never been there before. We can read about it in the economic history books. We can look to the Japanese and wonder if their experience might be relevant. My view is that deflation isn’t likely to be good for corporate profits or equity valuations.

One of the lessons of the past few years is that corporate profits can't grow faster than nominal GDP on a sustainable basis. If profits' share of national income rises too high, then workers won't have enough income to drive the economy and profits. Furthermore, a political backlash is another restraint on profits' relative growth. Corporate profits have averaged 6.8% of national income and 5.5% of nominal GDP since 1948. Profits' shares of national income and GDP have fluctuated around these averages and cycled along with the profit margin and the business cycles (Figure 13).

Since 1960, nominal GDP has grown at an annual rate of 7%. So have after-tax corporate profits (Figure 14). So have the GDP of nonfinancial corporations, the sales of the 400 companies included in the S&P Industrials, and S&P 500 forward operating earnings (Figures 15 and 16). The S&P 500 reported earnings per share have grown between 5% and 7% annually since 1960 (Figure 16). Interestingly, while the S&P 500 is down 48% from its record peak in 2000, it has also appreciated at about the 7% rate since 1960 (Figure 17). In other words, the trend in earnings growth accounts for virtually all of the trend in stock prices.

The bottom line is that if deflation depresses the potential growth of nominal GDP, then it is bound to do the same to profits. In other words, 7% may no longer be the magic growth number. Trend growth for profits could be lower as long as markets remain so competitive. Productivity gains might help; but as argued above, they mostly benefit consumers, not profits.
What should stock investors do? Lower your expectations for sustainable long-term earnings growth. Overweight consumer-related stocks in your portfolio. Consumer staples should be viewed as growth stocks rather than defensive stocks. Housing-related businesses are likely to remain very profitable as long as the Fed is forced to keep interest rates low to offset deflation. Look for companies that have a history of successfully competing in highly competitive businesses and are paying dividends. Healthcare services, medical equipment, and biotech companies may continue to have more pricing power than can be found in other industries. Media companies might do relatively well as companies are forced to spend more on advertising to boost their sales.

Finally, while the Fed’s Stock Valuation Model has been useful for gauging whether stocks are overvalued or undervalued since 1979, it may be less useful during a period of deflation. Currently, the model shows that stocks are undervalued by a record 46.7%. The model suggests that the fair value forward P/E is 27, which is simply the reciprocal of the current ten-year Treasury bond yield. However, the actual forward P/E is 14.9. Apparently, equity investors are concerned that today’s historically low bond yield is confirming their deflationary concerns. They may be lowering their expectations for long-term earnings growth as a result, and may be lowering the P/E they are willing to pay for “E.”

***
Jobless claims are tracking a pattern very similar to that of the early 1990s.

ISM Manufacturing Composite Index advanced and declined often during the economic recovery of early 1990s and may be doing so again.
The Fed’s response to the Tech Wreck is reminiscent of easing in response to the S&L Wreck during early 1990s. Fed still has 175 basis points left. Japan has run out of room to lower interest rates to fight deflation.

Economic history lesson: Wars are inflationary. Peace times are deflationary. The end of the Cold War marked the end of a 50-year war including World War II. We live in a deflation-prone era.
Japan has deflation. The U.S. appears very close to deflation. In fact, many U.S. corporations are facing deflation now.

Deflationary pressures are depressing nominal GDP growth in Japan and also in U.S.
When bubbles burst, the depressing consequences can be long lasting. That has certainly been true for Japan since 1990. It could be the same in the U.S. for a few more years.

Japanese banks curtailed lending significantly during the 1990s. U.S. banks are still lending, especially to home buyers.
The banking system is broken in Japan. It still works in the U.S., but let’s monitor U.S. bank stock prices, which are looking weaker recently.

There are close to 100 million young people in the U.S. who are 26 years old or under. They should be a source of growth in the years ahead.

* Numbers in parentheses are the youngest and oldest ages of group members during 2002.
Business boosts productivity to offset deflationary pressures on prices caused by intensely competitive market conditions.

The productivity rebound since 1995 has mostly benefited consumers as real pay per worker has soared.

Figure 13.

AFTER-TAX CORPORATE PROFITS INCLUDING IVA & CCAdj

- As a percent of National Income
- As a percent of Nominal GDP

PROFIT MARGIN
(percent)

All Corporations

Average = 8.2%

PROFIT MARGIN & CAPACITY UTILIZATION

* After-tax profits of nonfinancial corporations including Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj) divided by nonfinancial corporate GDP.


October 7, 2002
7% is the Magic Number: This has been the trend growth rate of the economy, sales, and profits since early 1960s.

Figure 14.
NOMINAL GDP & AFTER-TAX CORPORATE PROFITS
(1960=100, ratio scale)

- 7% Growth Path*
- Nominal GDP
- Reported to IRS
- Adjusted**

* Compounded monthly to yield 7% annually.
** Includes Inventory Valuation Adjustment and Capital Consumption Adjustment.

Figure 15.
NONFINANCIAL CORPORATE BUSINESS GDP & S&P INDUSTRIALS SALES
(1964=100, ratio scale)

- 7% Growth Path*
- NFC Nominal GDP
- S&P Industrials Sales**

* Compounded monthly to yield 7% annually.
** Four-quarter sum.
S&P 500 reported earnings have been growing between 5% and 7% per year since 1960. Forward consensus expected earnings are still hugging the 7% trend.

Figure 16.

S&P 500 EARNINGS PER SHARE*
(dollars, 4-quarter sum)

* Growth paths are compounded to yield 5% and 7%.
** 12-month forward consensus expected operating earnings per share.

Source: Standard & Poor’s Corporation and Thomson Financial.

Back to the Planet Earth for the S&P 500. The plunge from the March 2000 peak means that the S&P 500 has increased roughly 7% per year on average since 1960.

Figure 17.

S&P 500 INDEX*

* Growth paths are compounded monthly to yield 5% and 7% annually.

Source: Standard & Poor’s Corporation.
The research analyst(s) or a member of the research analyst’s household does not have a financial interest in any of the tickers mentioned in this report.

The research analyst or a member of the team does not have a material conflict of interest relative to any stock mentioned in this report.

Prudential Securities has no knowledge of any material conflict of interest involving the companies mentioned in this report and our firm.

When we assign a Buy rating, we mean that we believe that a stock of average or below average risk offers the potential for total return of 15% or more over the next 12 to 18 months. For higher risk stocks, we may require a higher potential return to assign a Buy rating. When we reiterate a Buy rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

When we assign a Sell rating, we mean that we believe that a stock of average or above average risk has the potential to decline 15% or more over the next 12 to 18 months. For lower risk stocks, a lower potential decline may be sufficient to warrant a Sell rating. When we reiterate a Sell rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

A Hold rating signifies our belief that a stock does not present sufficient upside or downside potential to warrant a Buy or Sell rating, either because we view the stock as fairly valued or because we believe that there is too much uncertainty with regard to key variables for us to rate the stock a Buy or Sell.

Rating distribution

<table>
<thead>
<tr>
<th></th>
<th>Firm</th>
<th>IBG Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>40.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Hold</td>
<td>58.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Sell</td>
<td>2.00%</td>
<td>1.00%</td>
</tr>
</tbody>
</table>

Excludes Closed End Funds

Any OTC-traded securities or non-U.S. companies mentioned in this report may not be cleared for sale in all states.

Securities products and services are offered through Prudential Securities Incorporated, a Prudential company.

©Prudential Securities Incorporated, 2002, all rights reserved. One Seaport Plaza, New York, NY 10292

Additional information on the securities discussed herein is available upon request.