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Inflation, Lessons from History, The Euro and Growth vs. Value

In recent days, the share prices of some base metals and natural resource companies have rebounded sharply following a five-year period of relative under performance. This recovery can, in part, be traced to the impact of a handful of newly released upbeat economic forecasts and analyst's buy recommendations which foresee a vigorous economic expansion causing metals prices to firm later this year. While we share the view that stronger global business conditions are likely to emerge as the Asian economies first stabilize and then begin to recover in the second half of the year, we see little reason to expect the commodity price deflation we have experienced in the past few years to reverse course. In fact, the basic conditions for a continuation of worldwide deflationary economic growth, which we have discussed both with clients and numerous times in these letters, remain in place. Lest we lose sight of these favorable fundamentals, let me catalog them as follows:

(1) *The end of the cold war* has permitted governments, particularly in developed nations, to reduce non-productive inflation-inducing spending on defense. This, combined with growing voter disapproval of inflationary spending by politicians, is causing government spending growth and budget deficits to shrink and, in the case of the U.S., budget deficits are turning into surpluses.

(2) *Government deregulation* in the U.S. and other developed nations has removed many price floors that previously served to institutionalize inflation by creating what Barnard College economist Robert Heilbroner described as "floors without ceilings." For the past 20 years, the U.S. government has allowed competition to lower airline fares, trucking rates, natural gas prices, electrical rates and long-distance and local telephone charges. In addition, new cost

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efficiencies are being realized in financial services as states remove restrictions on branch banking and traditional structures that previously kept banks, brokerage firms and insurance companies from competing in each others markets.

(3) *The aging of the population* in the U.S., Japan and in other developed nations implies some slowdown in consumption spending following years of strong growth, particularly in the U.S., when Baby-Boomers were forming families and purchasing homes. These Boomers will have little choice but to reduce their spending in the years ahead as they save more of their disposable income to secure their retirement.

(4) *Corporate restructuring*, first in the U.S. in the 1980's, and now in Europe seems a permanent strategy for businesses globally. Flattening organization structures, cost saving, outsourcing, pay-for performance and the refining of work processes are ongoing activities that continuously seek to cut costs and drive enhanced productivity.

(5) *Technological advances* are also spurring deflation by cutting costs and increasing productivity. While high-tech capital spending still appears to be a small part of the U.S. economy, accounting for only about 7% of economic output, this 7% does not include such expensed items as semiconductors in cars, appliances or industrial control systems nor does it embrace genetically enhanced seeds or spending devoted to software. The deflationary impact of technology extends far beyond the constant declines in computer prices, memory chips and microprocessors. Technology enhances the efficiency and reduces the operating costs of almost every activity, from telecommunications to oil prospecting to financial services.

(6) *The deflationary impact of the Internet* on business is most obvious. The Internet practically eliminates the cost of comparison shopping for airline tickets, books, cars or life insurance. Whole layers of middlemen and showrooms will disappear in this virtual marketplace and the resulting savings will translate into lower prices for consumers and at the same time they mean higher profits for manufacturers.

(7) *The opening of the world to the free flow of capital*, the advance of modern telecommunications, deep tariff cuts and relaxation of capital controls allow U.S. corporations and other multinationals to globally

search out the cheapest labor, real estate, productive capacity and support services.

(8) *The Asian economic crisis* has intensified the deflationary trend by creating a glut of unused industrial capacity, raw materials and manufactured products. Commodity prices have fallen not only because of reduced worldwide demand but also because developing nations are hard pressed to boost their exports so they can pay for their imports and retain as many jobs as possible. In fact, the need for foreign currencies has become so dire in some developing nations that there is an incentive to operate at a loss and increase commodity production thereby causing their prices to fall still further.

Lessons from History

Evidence of slowing inflation has been greeted with concern by some economists who worry that falling commodity prices and a flood of cheap Asian imports will push the U.S. into a deflationary spiral in which still lower prices will roil the world's economies. They fear that if prices in general slide over the next year or two, they could trigger an economic depression of the sort the U.S. experienced in the 1930's. Such fears have been heightened by the Asian crisis, Japan's seeming inability to stimulate its economy and Brazil's economic and political problems. A review of economic history, however, shows that protracted periods of falling and/or stable prices can be beneficial for both consumers and businesses. In fact, studies show deflation to be a largely benign phenomenon that has accompanied some of the most important periods of economic growth in America, and indeed, the world. One such era, encompassing the Industrial Revolution, was the final four decades of the 1800's. Another was the 1920's which benefited from surging production of automobiles, electric appliances and radios as the nation experienced rapid electrification of factory equipment and the revolutionary mass production techniques perfected by Henry Ford and others. In both periods, we enjoyed productivity–enhancing technological innovation, rising real wages and strong economic expansion.

Brandeis University historian, David Hackett Fischer in his book The Great Wave, which tracks the ebb and flow of inflation from the 12th century to the present, identifies three earlier periods of relative price stability each averaging 70–80 years

in length: The Renaissance (1400 – 1480); The Enlightenment Era (1660-1730) and; The Victorian Age (1830 – 1900). What distinguishes these periods of little or no inflation from the hyper–inflation eras that immediately preceded them was the sharp improvement in the economic fortunes of a broad range of the population resulting from sharp declines in the costs of food, shelter and interest rates.

The Euro

The birth of the "Euro" on January 1st of this year is one of the most important financial events of this decade, possibly of this century. Eleven countries in Europe have adopted a new currency, the Euro, joined together by a single monetary policy administered by the New European Central Bank. Financial market transactions are now taking place in Euros while local currencies for daily usage (French francs, Deutsche marks, etc.) will be exchanged for Euros in 2002. Britain, Sweden and Denmark have opted not to join at this time.

For investors in the Eurozone, adoption of the Euro expands the base of "home currencies". Assets and liabilities can be matched from a much broader list of "domestic" possibilities and a more active market in corporate bonds will open up. Stock investors are redefining their benchmarks and will more readily cross borders in search of better returns. Capital market activity will increase. Sector diversification will become more important than traditional country diversification. In fact, this is already happening, ushering in a new area.

What does the Euro mean for U.S. investors? Beyond the answer of simplifying the process of investing in Europe, some macro-impacts are likely here, as well as in Europe. The eleven countries making up the Eurozone have a population and a combined economy that rivals that of the U.S. The Euro, as a currency, will probably attract funds from those seeking diversification away from the U.S. dollar. Many economists expect that the Euro will begin as a "hard" currency relative to the dollar and the yen. Thus, the Euro will provide a sound alternative for global investors worried about the current account deficit in the U.S. and the shaky banking system in Japan. Interestingly, a weaker currency here may be beneficial to U.S. investors. Historically, economists have worried that a weak currency encourages price inflation. In the current deflationary environment, however, a weaker currency may be a blessing since exported U.S. manufactured goods will be more attractively priced to foreign buyers. A weaker dollar will also help the competitiveness of emerging market countries which, directly or indirectly, peg their own currencies to the dollar. Some of these countries are also burdened with dollar denominated debt. For them, a weaker dollar would relieve

certain pressures. Domestic multinationals would also benefit from both enhanced competitiveness and the translation of foreign earnings into dollars. On the negative side, a weakening currency does not usually encourage foreign investment allocations. Given our current account deficit, real interest rates in the U.S. may need to be higher than otherwise would have been the case. On balance, then, for those in the U.S., the Euro brings a mixed blessing.

Economic Outlook

Over the near term, we continue to forecast a slowdown in U.S. economic growth during the first half of this year for the reasons detailed in our December letter to clients. Inflation and interest rates are likely to remain within their recent ranges through much of the winter. However, if business slows as forecast, the Fed is likely to resume cutting its Fed Funds rate possibly by another 50-75 basis points by year-end. Despite the recent devaluation of the Brazilian *real* and the additional uncertainties it has created, we continue to expect improving business conditions in Asia and Latin America by this summer or fall. This should provide a lift to domestic business activity, particularly manufactured exports, and serve as the basis for improving business profit margins and profitability as the year wears on. In summary, we see slower growth immediately ahead with a firmer economy later in the year benefiting corporate bottom lines.

Growth vs. Value

For the last three years, *growth* stocks have out-performed *value* stocks. Last year, the disparity was extreme. The Vanguard Value Index Fund (comprised of the half of the S&P 500 with the lowest price/book ratios) advanced 14%; the Vanguard Index Growth Fund (comprised of the top half of price/book ratios) climbed 43%. Other large cap style indices showed similar divergences. We believe 1999 will be another year that favors growth. In a year of little or not profit growth, companies that show decent earnings advances will continue to out-perform. Without pricing power, companies with growing unit demand will have a strong head start in producing higher earnings. Once again, *value* stocks will depend upon mergers and acquisitions to save the day.

Another factor favoring large cap growth is the changing composition of the widely indexed and benchmarked S&P 500. Last year, more than 40 companies turned over as record M&A activity required the replacement of one S&P 500 entry after another. Much of this activity took place in the slower growing economic sectors driven by companies’ desires to combine operations and cut

costs. Exxon-Mobil, Norwest-Wells Fargo, and Daimler-Chrysler are recent examples. Typically, these old, tired names are replaced by fast-growing companies with increasingly important market capitalizations. America Online, with a $70+billion market cap and a stratospheric P/E ratio, replacing Venator (formerly known as Woolworth) was the latest and most extreme example. We may think America Online's valuation is much to high, but if you are "indexed" or benchmarked to the S&P 500, you are forced to play the game. The poor value investor is at a handicap.

But some good cheer may be heading toward value investors - - and we do not mean a collapse in the prices of growth stocks. If our economic scenario is close to the mark, value stocks should begin to perform as the millennium approaches and we look ahead to a globally synchronized expansion in 2000 - - that is, if the Y2K bug does not bite. All in all, 1999 may not look much different from 1998. For now, liquidity rules. Financial assets may realign but not this year. Stay tuned.

Finally, given the outlook for slowing business and benign inflation, we continue to favor investments in companies with prospects for superior top line growth and strong cash flows. Therefore, in our firm's never ending quest to properly blend *growth* and *value* shares within a single stock portfolio, we continue to tilt strongly toward companies which have control of their pricing destinies and to avoid those whose profitability will suffer in the absence of higher commodity prices. In recent weeks, we have begun adding three new holdings (Tyco International, TimeWarner and Medtronic) to the *growth* portion of our clients stock portfolios. UNUM, an insurance company with lines in disability and the employee benefit area, has also been added to the *value* portion given its attractive valuation and the likelihood of accelerating earnings growth over the next 2 – 3 years.

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