THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 337 **JUNE 2001**

We live in a society organized in such a way that the activity of production depends on the individual businessman hoping for a reasonable profit, or at least to avoid an actual loss. The margin which he requires as his necessary incentive to produce may be a very small proportion of the value of the product. But take this away from him and the whole process stops.

John Maynard Keynes, *Essays in Persuasion* (1931)
Macmillan St. Martin's Press, 1972

NEMESIS

Has the U.S. economy seen the worst? Apparently, the consensus refuses to see anything but the V-shaped recovery that most experts are predicting for the second half of this year.

The worst forecast that we have read so far from a leading Wall Street economist is for a growth recession lasting for about three years with an average growth rate in the 1.5% to 2% range. According to the Organization for Economic Cooperation and Development in Paris, the United States will have an economic growth rate of 1.7% this year, followed by 3.1% in 2002. That significantly bettered the earlier forecast by the International Monetary Fund of 1.5% to 2.5% growth. The only person in despair, if not panic, seems to be Fed Chairman Alan Greenspan, who is cutting rates furiously.

The most striking token of the still high-riding faith in the U.S. economy's impending rebound is certainly the dollar's persistent strength. Oddly, it was the Fed's surprising 50 basis point inter-meeting rate cut on Jan. 3, 2001 that stopped and even reversed the U.S. currency's plunge against the euro. Strikingly, every time an American statistic is published which by any past experience ought to cause the dollar to fall, any initial downward blip is rapidly corrected. For the euro, on the other hand, any kind of news appears to be bad news. Year-over-year, by the way, euro area real GDP growth is up 3%, as against U.S. growth of 2.7%.

America's asset bubble has been pricked, but this has only happened in the marketplace. Several trillion dollars of paper wealth went up in smoke, badly impacting the economy, but nothing much has happened with the exuberant expectations of the great majority of investors about future growth and future corporate profits. Familiar hype and hubris remain preponderant.

What is it that really drives the business cycle? In short, two things: rising credit and rising confidence. What is it that has driven the U.S. bubble economy of 1995-2000? In short, the greatest money and credit excesses in history together with unimaginable hype about a new paradigm economy creating nothing but miracles. It was virtually hammered into people's heads that this boom would go on forever, creating prosperity as never before. Readily believing this wonderful message, people and businesses borrowed and spent as never before.

Ever since Jan. 3, the Fed has been cutting its rates frenetically in an obvious effort to lure investors back into the stock market and to jump-start the economy again. Money growth has been surging again with double-digit annualized growth rates, almost equaling the pre-Y2K money explosion that set the stage for the final Nasdaq burst in early 2000. A critical observer might well interpret the rapid succession of five 50 basis point rate cuts within less than five months as an augury of panic on the part of the Fed. A few commentators have, in fact, made that point. But these are lonely voices of which the consensus takes no notice. Investors just see what they want to see. Any crumb of good news is seized upon to trumpet recovery all around.

WILL IT WORK?

It is the most aggressive monetary easing by the Fed in such a short period of time since 1929-30, begging the biggest question of all: Will it work? Essentially, monetary easing works its way into the economy through the financial system. Invariably, it has its first-round effects in the money and capital markets, most conspicuously in sharply higher prices of stocks and bonds, the latter implying a corresponding fall in longer-term market rates. Following the steep fall of stock prices in October-November 1929, the Fed reduced its rediscount rate twice in November and four more times until June 1930, always in 50 basis point steps. In response, the stock market rapidly recovered, ending 1929 up 25% from its low on Nov. 13. Despite the lower interest rates, the economy's reversal turned rapidly into a steep slide.

What could be the effects of the Fed's rapid rate cuts this time? For sure, they have given a big boost to psychology as reflected in the strong stock market rally. The idea of a V-shaped economic recovery starting in autumn or winter has, in general, apparently been swallowed. Very few, however, have ever understood in the first place why the U.S. economy has slowed down so dramatically in spite of huge infusions of money and credit. Post-bubble shocks are a very rare occurrence in history. Who wants to see the true reason? Inordinate excesses in business and consumer borrowing and spending that have accumulated over years have to be unwound before the economy can return to its longer-term sustainable growth path, and this is sure to take years, too.

Outright worrying, if not frightening, however, is the total absence of any effect of this quick succession of rate cuts on the U.S. bond market, in other words, on the credit markets. The fed funds rate is the rate that banks charge each other for lending overnight funds. Thus, it directly affects only banks among themselves. Yet consumers and businesses are indirectly impacted by the banks' practice of tying their lending rates to the fed funds rate. But the further point to see is that this interest rate has lost its former central importance in the financial system simply due to the fact that the activity of borrowing and lending in the United States in the past boom years has shifted heavily away from the banks and towards the markets and a huge panoply of nonbank financial intermediaries that largely fund themselves in the money market. This is unique to America.

Pondering the efficacy of the Fed's successive rate cuts on the economy, the reaction of the credit markets and the nonbank intermediaries is clearly far more important than changes in bank lending. Looking first at interest rates in the capital markets, we notice a total failure of the Fed's rate cuts. While short-term rates are down steeply, longer-term market rates have risen, showing in an unusually sharp steepening of the yield curve. Contrary to this experience, long-term rates normally fall in times of monetary easing, though mostly less than short-term rates. In 1991-93, U.S. corporate Aaa bond yields fell by more than 3 percentage points.

For monetarists the best measure of monetary policy is money growth. All bulls are presently monetarists because they like what they see: a money supply that has soared since the beginning of the year. M3, the broadest money aggregate, shot up by $321.8 billion in the first four months of 2001 after an increase by $184.5 billion in the last four months of 2000. M2 growth surged in step by $200.6 billion, after $110 billion prior. Broad money in the last few months has been expanding at an annual rate of 12% and higher. Compared to a year ago, M2 is up 8.2 % and M3 even 10.4%. The general comforting conclusion is that any money growth in excess of GDP growth is a very reliable assurance for a rebounding stock market and a recovering economy.

The most astounding event in the U.S. financial system has been the new deluge of mortgage refinancing triggered by the Fed's rate cuts and generously accommodated by Fannie Mae and Freddie Mac, the government-sponsored enterprises. During April, Fannie purchased a record $53.5 billion of mortgages and Freddie another $41 billion. In principle, by buying existing mortgages from their holders, the two institutions provide the credit markets with massive new liquidity, allowing or forcing the sellers of these mortgages to reinvest the proceeds into other asset-backed securities. Principally, the two impact the credit system in two ways: first, backed with government guarantee, they turn junk bonds into government bonds; and second, their activity results in artificially low rates for consumer borrowing.

Rampant borrowing against home equity is clearly playing a key role in sustaining consumer spending. The Mortgage Bankers Association reported dollar amounts of purchase applications up 11% and applications to refinance up 465%. By no means, though, are GSEs alone in aggressively playing the mortgage bubble. Essentially, it has to be done at floating rates in order to benefit from the Fed's rate cuts.

What about actual or future effects of the rate cuts and the soaring money supply on the economy? That is, of course, the central question behind all other questions. American monetarists believe that there exists a virtual mechanic link between money growth and GDP growth, implying a more or less fixed demand for money. Once available money balances exceed desired balances, spending increases. Financial markets and the economy take off. No further question is asked.

In reality, the owners of increasing money balances can use them in four different ways, and depending on their choice, the effects differ widely. The four alternatives are: buying goods and services, which increases GDP; buying domestic assets, which boosts their prices; buying foreign goods and services, which boosts the trade deficit; and last but least, money balances can be kept idle because their owners want to increase their liquidity.

What, exactly, is it that has suddenly stalled the booming U.S. economy and its roaring stock market? Tight money is the favored explanation. But comparing recent GDP growth with the simultaneous money growth, their gross divergence strikes the eye. Rampant money and credit growth continues unabated. But real GDP growth, after sharply accelerating in 1999 from 3.5% in the first quarter to 8.3% in the fourth quarter, decelerated just as sharply in 2000 from 4.8% in the first quarter to 1% in the fourth quarter. There was definitely no warning sign in the money and credit figures. How can this rapid collapse in GDP growth in the face of unchanged, runaway money and credit growth be explained?

Trying to understand this unusual economic development, we consult both theory and history. Today's generation of economists cares not at all or very little about both. Our theoretical adviser is European credit theory; not just Austrian school, but also British Cambridge school (Marshall, Roberson etc.). As for the lessons of history, there is, in our view, but one precedent for the present U.S. economic downturn to look at, and that's the American boom of the 1920s and the following downturn. It's the one and only era that most closely resembles the boom of the 1990s in its rare combination of financial excesses and structural distortions.

Please compare: The boom of the 1920s was rooted in exploding demand for automobiles as the outstanding technological innovation of the decade. The wealth effects of the booming stock market and runaway consumer credit propelled demand growth. To wit, heavy gearing of economic growth to consumer borrowing and spending is the extraordinary common feature of both booms. Yet there is one big difference between them. The financial excesses of the 1990s have been far worse. They simply defy reasonable imagination.

Now to the present: America's GDP has slumped from 5.2%, annual rate, in the first half of 2000 to 1.6% in the second half. The downturn's speed is very unusual and therefore very ominous, but its pattern is even more unusual and even more ominous. It is centered in sharply weaker consumer and capital spending, while inventories kept growing. There is no precedent for this in the whole postwar period. This recognition, so one would think, ought to induce policymakers and economists to do a thorough job of diagnosing the facts. Instead, they look away.

EVADING THE ISSUE

What we generally read are optimistic forecasts, bare of any serious analysis of the actual facts of the downturn. In one of his congressional testimonies earlier this year, Mr. Greenspan seemed to put his finger on the key problem: *"It's not so much the recession call itself that matters — it's more the type of recession that determines the risks on the downside."* He then depicted those risks as hinging on the potential for a *"breach of confidence."* Against his better knowledge, apparently hoping to bolster confidence, he told his audience that the present U.S. downturn was of the garden-variety type, reflecting a rapid inventory correction.

Actually, we note in the public discussion a peculiar emphasis on the key role of confidence in sustaining economic growth. Mr. Greenspan explained and justified the rapidity of his rate cuts with his explicit intention to restore confidence. For the time being, he has certainly succeeded. Nevertheless, we regard this narrow focus on confidence as grossly misplaced. It essentially distracts from the objective facts behind this downturn that Mr. Greenspan, for good reasons, certainly doesn't want to discuss. Another possibility to be taken into consideration is, of course, that he effectively is at a loss to understand the true underlying causes behind this downturn, for which nobody is more responsible than he himself. In any case, such talk about confidence serves to evade the issue.

In Congress not so long ago, Mr. Greenspan hailed it as a great positive for the economy's prospects that thousands of analysts and executives still expect robust long-term profit growth, at well over 15% by some estimates. That, he said, is likely to underpin continued investment-led growth in the years to come. Please note, *in the years to come*. When we first read this statement a few months ago, we wondered about the wisdom of a central banker who believes in the self-fulfilling power of rosy expectations without asking whether they are right or wrong.

To us, this focus on the fuzzy concept of confidence suggests a general refusal of the great majority of economists and policymakers, among them prominently Mr. Greenspan, to recognize the true nature of the unfolding economic and financial quagmire and its underlying objective causes, which, incidentally, become more conspicuous by the week. To quote Schumpeter again on this question: *"No great crisis has ever come about that was not fully explainable by the objective facts of the situation. Expectation not so conditioned never has produced more than short-lived spurts or breaks."* The fact is that big, lasting swings in confidence and expectations don't happen at random.

CONFIDENCE, TOO, CAN GO TO DANGEROUS EXCESS

What, exactly, is it that has driven the U.S. economy and the stock market all of a sudden downward? Tight money is the favored explanation. True, Mr. Greenspan raised rates twice in 2000 by 0.25% baby steps. Yet, money and credit continued to expand no less abundantly than in the preceding years. Total borrowing by consumers and businesses soared in 2000 by $1,146.5 billion as against an increase the year before by $1,140.4 billion. These numbers do not include the financial-sector borrowing, amounting to $1,900 billion altogether in the two years. M3 grew $571 billion, or 8.8%, in 2000, as against $499.5 billion, or 8.3%, in 1999. Yet real GDP growth all of a sudden dramatically slowed in 2000.

The favored explanation among American economists, next to tight money, is a change in psychology. They seem to believe that economic policy is just a confidence game. For ages, economists have dismissed the notion that psychology could dominate real economic forces. But the rising importance of the stock market is supposed to have changed that. Indeed, never before has the market played such an important role in real economic activity as during the last five years. Here is a quote from *Business Week* that perfectly characterizes the psychological climate of the past few years: *"It was market psychology more than fundamentals that drove the technology share prices up so rapidly in 1998 and 1999. The resulting change in wealth was the jet fuel that powered the growth rate of consumer spending and the economy into the 5% to 6% range…"*

For sure, Mr. Greenspan has to cope with a big confidence problem. But that problem is rooted in the overblown, unreasonable expectations that he himself and others have systematically implanted into people's heads with their ludicrous new paradigm propaganda. Too little confidence is bad, but too much of it is even worse. In a congressional testimony in June 1998, he put it: *"Our economy is still enjoying a **virtuous circle**, in which, in the context of subdued inflation and generally supportive credit conditions, **rising equity values** are providing impetus for spending and, in turn, the expansion of output, employment and productivity-enhancing capital investment."* Not so long ago, Larry Summers, then still secretary of the Treasury, proclaimed: *"Financial markets don't just oil the wheels of economic growth; they are the wheels."* Apparently, it eluded them that the "virtuous" model of Wall Street-led economic growth was in essence the very prototype of a

"bubble economy," being by definition an economy in which demand creation depends heavily on soaring asset values.

It is a historic fact that every great financial crisis has been preceded by excessive confidence and absurdly inflated expectations that misled consumers and businesses to overextend themselves during the boom. One cannot explain the Great Depression of the 1930s with a collapse of confidence without pointing to the prior creation of inordinate confidence and expectations that had propelled the earlier borrowing and spending binges. Confidence, too, can be driven to dangerous excess. Yet, never forget: credit excess is the indispensable primary condition.

While "New Era" ballyhoo had also played an important role in fuelling the boom of the 1920s, it definitely pales in comparison to what happened in this respect during the 1990s. The trumpeted claims of economic miracles resembled more Hollywood style than that of the world's leading financial center. It happens that Mr. Greenspan outdid everybody else in creating those exuberant expectations not only by his policy but even by his mouth.

According to the regular surveys, consumer confidence has suffered a sharp decline. However, the stock market's plunge started early last year when euphoric expectations were still in full reign. It emerges, moreover, that the decline in confidence applies only to the short term. There manifestly remains a widespread conviction that, thanks to Mr. Greenspan's rate cuts, the good times will soon return. Just look at P/E ratios. Most of them are higher than a year ago as profits have fallen even faster than stock prices. We would say that this rather reflects overconfidence. Not understanding the causes of the high-tech collapse and still convinced of the Greenspan magic, expectations remain grossly in excess of what can reasonably be expected of the economy. Few people are ready to sweep the miracle stories of the past few years into the dustbin.

MORE DELUSION

On the surface, the economy and markets seem to have stabilized after their earlier steep fall. On closer look, though, you realize that there are extremely powerful recessionary dynamics at work driving the U.S. economy relentlessly downward. These dynamics are mainly the correlated collapse of two aggregates: profits and fixed capital spending. Earnings for 1,433 of the 1,700 companies tracked each quarter by the *Wall Street Journal* declined 42% during the first quarter after a 20% drop in the prior quarter. Even though recession has not even started according to the official statistics, this is already by far the worst profit performance in the whole postwar period. That's profit depression.

But how is that possible? What are the reasons? Where is the former productivity and profit miracle? In the last letter we explained that the profit miracle of the New Economy Wall Street has been selling the past few years was just another delusion and illusion. Considering profits the lifeblood of the capitalistic economy, we elaborate in this letter further on these questions. First, however, let's take a look at the most recent economic data. Do they justify the new optimism in the stock market?

Is the worst over for the U.S. economy? Essentially, this is presently the key talking point. The optimists have been pointing to quite a variety of indicators and aggregates that have recently been "stronger than expected": (1) the 2% annualized rate of real GDP growth reported for Q1 2001, up from 1% in the prior quarter; (2) consecutive gains in the National Association of Purchasing Management surveys; (3) the 3.5% monthly gain reported for March durable goods orders. Company after company is reporting a steep fall in profits. It's horrible, but, miraculously, all profits are "better-than-expected," measured against estimates that had been slashed.

When the Labor Department reported the loss of 223,000 jobs in April, compared to an expected increase of 25,000, the stock market cheerfully headed north. It was the largest single-month employment decline since the depth of the 1990-91 recession. Nevertheless, it was "good news" because it made the next rate cut more pressing.

It appears that the great majority of Wall Street economists wears a special kind of glasses that shows them only the silver lining of everything and not the big, dark cloud. A concerted effort to make the best of overwhelmingly bad U.S. economic data is rather manifest. Take, for instance, the NAPM survey. Yes, it has slightly rebounded from its earlier vertical decline. Nonetheless, it remains far below the 50 expansion/contraction line that marks the beginning of a recession in the overall economy.

A report that industrial production had risen a sizable 0.4% in March was immediately hailed as a sign of recovery. Revisions a month later turned it into a drop of 0.1%. Due primarily to a massive downward revision of tech industrial production from +5.1% to –4.3%, overall industrial production for the first quarter was revised down from a 4.7% quarter-over-quarter annual rate of decline to –6.5%. It is already the worst run of production figures since the recession of 1990-91.

Reported March durable goods orders showed a remarkable rise by $6.9 billion, or 3.5%, compared to February. On closer look, the whole of the increase and a lot more resulted from Pentagon orders and highly volatile orders for civilian aircraft, amounting to $10.4 billion. Specifically, orders for electronic and other electrical equipment slumped 5.5% month-to-month and 17.7% year-over-year.

Many reports convey the impression that consumer spending has remained strong, in particular the report of a 0.8% rise of retail sales in April. In reality, the increase resulted entirely from sharp downward revisions for the two prior months. A steep decline of car sales during April strongly suggests moreover that this surprising rise in retail sales had more to do with flawed, Easter-related seasonal adjustment than with reality. Sales of domestic cars had, in fact, slumped. Compared to the prior month, sales of domestic autos had plunged from 603,340 to 520,394 and sales of trucks from 729,407 to 587,336.

Next, we hasten to add that the general perception of rather stable consumer spending is another illusion. The consumer-spending boom is definitely over. Year-over-year, nominal retail sales are still up around 2%-3%. But this comes from a stellar growth rate of over 11% early last year. Looked at in this way, this represents quite a dramatic slowdown that is highly unusual in comparison to past recessions. Take a look at the following chart, showing that the *rate of growth* of retail sales has literally collapsed over the year.

The general, great hope is that a debt-addicted consumer will keep the economy out of recession. Don't bet on it. He has no chance. The longer he keeps borrowing and spending against extremely negative odds, the sharper his later pullback in spending will be. His finances are in rapid deterioration: losses in the stock market and sharply lower growth in real disposable income implying interest payments have become a quickly rising burden. We learn from the Levy Institute that something unusual happened in the first quarter: a coincidence of surging mortgage refinancing and accelerating growth in expensive revolving credit. In the past, households always used part of their mortgage refinancing to pay down costlier credit card debt. This time, sharply slower income growth forces them to step up their

credit-card borrowing to maintain their lifestyle.

Next to be taken into consideration is the fact that companies, facing a savage profit squeeze, are shedding labor with a vengeance, and doing so they curtail consumer incomes with a vengeance. Capital investment has so far been the major area of business retrenchment. Still, by cutting employment in the capital goods industries, it directly hits consumer incomes.

Hoping to moderate a steep fall of profits, businesses are extending their cutbacks to all kinds of outlays: advertising outlays, travel budgets, etc. But from a macro perspective, they are only accelerating the contraction of overall revenues and profits. To think that the extremely financially stressed consumer is the Hercules who will stem this avalanche thanks to Mr. Greenspan's rate cuts is just ridiculous. Envisage a scenario in which a combination of new sharp falls in stock prices, worsening news from the labor market and its associated slowing income growth will induce the consumer to restart some saving. That's the reality we are looking for.

PROFIT DEPRESSION

Most worrying in assessing the U.S. economy's prospects is the sickening slide in profits. In past letters we have repeatedly criticized Wall Street's practice of measuring reported profits principally against "expected" profits that management has "guided" downward, rather than against actual profits a month or a year earlier. With profits now down so dramatically, this fraudulent practice is going to absurd lengths.

The other day, Gap's stock soared on the news that per-share profits would be 12-13 cents, compared to the "expected" 11 cents. A year earlier, profits were 27 cents. Cisco made a splash in the market by reporting a profit of $230 million, earning 3 cents per share, one penny better than expected. The ugly reality was a charge of more than $3 billion of "nonrecurring" items against earnings, resulting in an effective loss of $2.65 billion. Choose what you prefer: a mammoth loss or "better-than-expected" profits per share. Hewlett-Packard reported a 66% decline in profits. Excluding "nonrecurring" items, the company said per-share profit was 18 cents as against anticipated per-share income of 17 cents.

Again we note a general denial to take notice that this profit decline is the sharpest in the whole postwar period. To put it in perspective: During the recession of 1979-80, overall profits of the nonfinancial sectors dropped, year-to-year, from $153.9 billion to $138.5 billion, or 10%; during the recession of 1990-91, the fall was from $229.4 billion to $218.1 billion, or 4.9%. In last year's fourth quarter, nonfinancial sector profits fell 11% from the third quarter and 4.3% from a year ago. Nasdaq reported composite negative earnings for its listed companies. Many of them, if not most, never made a profit.

NOTHING BUT BUNK

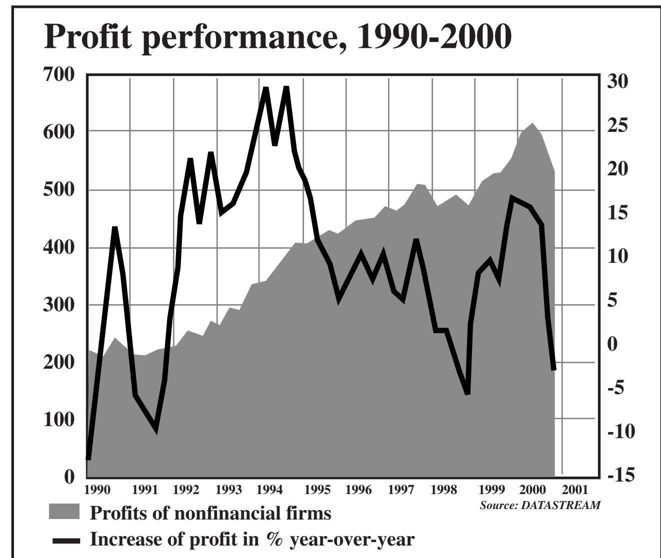
American economists tend to focus on the consumer as the pacesetter of economic growth. In accordance with the "classic" schools of economic thought in Europe, we focus on profits and capital spending as the crucial pacesetter. Our long-standing, great skepticism about the ability of the new information technology to create wonders of prosperity starts with our view that it totally lacks the qualifications to create real wealth **in** the economy, in contrast to the paper wealth that the stock market creates **outside** the economy.

As we elucidated in the last letter, the actual profit numbers for 1995-2000 make it clear that the great profit miracle in the U.S. economy that Wall Street and others have been selling for years has never taken place. The chart on page 8, showing profit growth year-over-year in percent, highlights the development over the whole decade. The most important point to see, as already stressed in the last letter, is the timing of the great profit boom. While readily ascribed to the high-tech miracles of the second half of the 1990s, in reality it occurred during the first half of the decade, and its obvious main reasons during these years were the business cycle and the interest cycle; in other words, sharply falling interest expenses and cyclical productivity gains.

Looking at the whole decade, profits rose overall by 138.5%, or 13.8% per year, comparing most favorably

with an overall rise in nominal GDP by 80%, or 8% per year. For the consensus, this is the compelling proof of the productivity and profit miracle. Yet this way of measuring misses the salient point: For the reasons explained, profits increased 90% in the first half of the decade but only 30% during the second half. It is a grotesque irony that the "new paradigm" years of 1995-2000, famous for the trumpeted U.S. productivity and profit miracles, saw in reality the exact opposite: collapsing profit growth. For good reasons, Wall Street analysts and corporate management in these years resorted to ever more tricks in order to maintain the pretence of booming profits.

A recent article in *Business Week*, titled "The Numbers Game," offered most shocking insights into how the companies use every trick to pump earnings and fool investors:



> *In the great bull market of the 1990s, companies and their CEOs used aggressive tricks to deliver the continually rising sales and earnings that Wall Street wanted to see. It's gotten far worse in the market slump. The pricking of the Wall Street bubble has stepped up pressure on desperate CEOs to shore up earnings ravaged by the sudden economic slowdown…. Sure, companies have always tried to present themselves in the best possible light. But some of today's practices, though perfectly legal, sail close to the wind. They seem designed to mislead unwary investors about the real financial state of companies that use them. Fading dot-coms, new tech giants and venerable blue chips all hype their earnings. The full extent of the bad stuff that happened during the boom is only now becoming clear — and it is worse than anyone thought.*

According to official calculations published by the Commerce Department (*Survey of Current Business*, June 2000), the average rate of return before interest for domestic nonfinancial corporations on the net stock of produced assets has risen from 7.8% in the recession year of 1990 to 9.4% in the boom year of 1998. The share of profits in national, domestic income increased from 16.8% in 1990 to 18.5% in 1998. Keep in mind this compares a recession year with a boom year. Both measures hardly reflect an underlying profit miracle.

If you want to know what a true postwar golden age for Americans was, you have to go back to the years 1960-65. Labor productivity rose at an average rate of 3.5%. Core inflation fluctuated around 1%. The rate of return before interest on the net stock of produced assets during those years hovered between 10%-13%, and profits accounted for 21%-23% of national domestic income. We quote the late Otto Eckstein: *"It was an era of strong investment growth and steady increases in the capital-labor ratio.* ***These years, which at the time were not considered years of outstanding economic performance, can now be seen more clearly as a kind of golden age."*** By the way, it was the conservative Eisenhower heritage.

If you think all this over, you wonder first about the integrity and the acumen of all those financial experts who have been duping the public with their fairy tales about a productivity and profit miracle. But the other question that inherently comes to mind is a possible explanation of this profit misery. Why have profits fared so poorly?

One plainly evident reason is, of course, that productivity growth was not what it was cracked up to be. We have been hammering on this crucially important point for more than two years. Finally, it appears to be finding growing acceptance. ***Even so, few people seem to realize that this robs the whole new paradigm construct of its key plank***. Faith in the productivity mirage primarily spurred the stampede of the American public into the stock market in expectation of a profit miracle. What's more, it misled the Fed to back away from earlier

tightening. Just remember Mr. Greenspan's repeated remarks about the economy's higher "speed limit" substantially reducing inflationary pressures and allowing the Fed to keep money and credit looser than in the past. As we have always stressed, the reality behind the productivity miracle was the hedonic price indexing — not actual capital spending — that made the U.S. economic numbers look so appealing. In the perverse logic of these statistics, simply the act of buying technology equipment grossly inflated measured output and productivity performance.

ANOTHER CULPRIT: SHAREHOLDER VALUE FIXATION

Our deep skepticism about U.S. corporate profitability derives, however, from still another consideration. It has to do with the other great Wall Street delusion: the miracles of efficiency that are supposed to come from the shareholder value fixation of corporate management. For sure, among CEOs it has created a single-minded obsession to maximize shareholder value. But as was to be expected, in practice it resulted in a relentless pursuit of short-term profit maximization — and that happens to have turned corporate strategies heavily towards measures promising profit improvement in the shortest possible run. The recommended and generally admired strategies are familiar: cost cutting, restructuring, downsizing, mergers and acquisitions.

Unfortunately, all these strategies have one fallacy in common: It's pure microeconomic logic with zero regard to inherent negative macroeconomic implications. Take the example of labor costs. Plainly, they are a major cost item. Accordingly, it is concluded that cutting wages implicitly improves profits. But that's true for the individual firm or a group of them only so long as they are alone in doing so. If wages are cut across the whole business sector, it benefits no one because it reduces overall revenue as much as overall expenses. The old economists have always warned of this logical trap, calling it the fallacy of composition. To judge the benefits of microeconomic action requires a macroeconomic perspective. That, however, is non-existent in Wall Street's shareholder value model.

We go a step further and say that the cost-cutting mania resulting from the shareholder value mania instead of boosting profits has in reality the exact opposite macro effect on profits, diminishing them in the aggregate. The single most important profit source in the capitalist economy, from a macroeconomic perspective, is typically net fixed investment because — looking at the business sector as a whole — it creates business revenue without generating an expense. No expense is occurred until the first depreciation charge is recorded. It is a reasonable conclusion that Corporate America's emphasis on cost-cutting through mergers, acquisitions, restructuring and downsizing tends to be substantially at the expense of new fixed investment, and thereby at the expense of overall profits.

But hasn't the U.S. economy just been through its greatest capital investment boom of all times? Fixed non-residential investment accounted for 15.1% of real GDP and even for 32% of real GDP growth in 2000. The respective numbers for 1994 were 10.8% and 21%. But assessing these numbers needs two caveats: What matters for aggregate profit creation is, first of all, only capital spending in current dollars (not in hedonic dollars); and second, what matters is investment spending after depreciation charges. That is, net investment, and net investment only.

If you look at *net capital investment in current dollars* as a percentage of GDP or of GDP growth, America's investment boom shrinks at best to a boomlet. A second, highly negative factor is moreover a dramatic shift toward short-lived high-tech information investment, essentially implying rapidly rising depreciation charges, accounting now for about 75% of gross fixed, non-residential capital spending. These depreciation charges cut deeply into profits. Actually, their rise in the NIPA statistics looks to us rather slow. For the near future consider that sharply lower new investment spending against the backdrop of rising depreciation charges on the existing capital stock is a great profit killer. As for the New Economy, it has effectively vastly more capital destroyed than created. Think of the epic telecom debts that have largely financed capitalized costs.

PROFITS TO FALL STEEPLY

The bullish view about the U.S. economy and its stock market has many friends again. Once again markets

are taking a break from reality. All it takes to head off a recession is five half-point interest rate cuts in as many months and the promise of more of the same. For many, the new surge of the money supply is early proof that the rate cuts are effective. We see it very differently. It puzzles and disturbs us that the economy started its slide last year in the face of unabated, rampant money and credit growth. There never was any true monetary tightening. Far from ever harnessing entrenched, outrageous financial excesses, the Fed has fostered even more outrageous financial excess. Having created a badly maladjusted bubble economy, Mr. Greenspan no longer has a choice. The beast needs more and more financial excess just to stay on its feet. But more and more of it has patently less and less effect.

Our second highly critical observation about the U.S. economy's prospects concerns the downturn's unusual pattern, being centered in capital and consumer spending. Oddly, the New Economy that was supposed to be the great stabilizer for the economy as a whole is in virtual collapse. Another nightmarish imbalance and challenge is the negative personal saving rate. Though a return to new saving is a compelling condition for healthy economic growth, it would be the virtual death sentence for the expansion. Still, the greatest immediate threat definitely comes from the unfolding profit disaster, since profits crucially influence business decisions about production, employment and investment. Various reasons speak for a long, steep fall of profits

What makes us so pessimistic about U.S. business profits? Well, the first reason is our observation that the profit performance was already anything but stellar even during the last boom years. Conspicuously, the sharp downtrend in profit growth during 1995-98 reversed sharply in late 1998, early 1999. What happened to do this? Well, it was the beginning of the consumer's big dissaving binge. From the first quarter of 1998 to the first quarter of 2000, personal saving plunged from $285 billion to $204 billion and in the following 12 months further to $11 billion. (All figures are annualized.) Within just two years, consumer dissaving poured almost $300 billion into the economy.

It should be clear that this dissaving binge was the absolutely dominating influence on the U.S. economy in these two years, and in the same vein, it was also the dominant profit booster. What is the link between consumer dissaving and business profits? Well, it lies in the difference between two potential sources of the money that the consumer spends: wage money or credit money. Wage money has been the business sector's expense. If the two flows are equal, the profit meter reads zero. Wage money spent principally brings no profits to business as a whole.

Credit money is crucially different. Spent on domestic goods, it raises overall business revenues. But in contrast to wage money, this money has not been a business expense. It swells business revenues courtesy of the financial system. Borrowed money that the consumer spends, therefore, is net profit for the business sector as a whole. In this way, the consumer's dissaving binge of 1999-2000 became the business sector's profit bonanza during these years. A lot of it, though, emigrated to foreign producers who provided the U.S. economy's soaring imports, swelling their profits.

Now to the reasons for our deep pessimism about the profit outlook for American business: Earlier we said that — for the reasons explained — net investment is typically the business sector's most important single profit source. The omens are for savage corporate retrenchment in fixed capital spending, far worse than in any prior recession. It's the Fed's immediate greatest worry so far. Yet the second blow, already predetermined, will come from the financially stressed consumer feeling compelled to save again. In combination, the reversal from a negative to a positive personal saving rate plus drastic retrenchment in business capital spending will smash business profits as never before.

PUSHING ON A STRING

While Wall Street likes to regard the sharply sinking fed funds rate and the soaring money growth as the infallible harbingers of economic recovery and a new bull run of stocks, we think it should rather sound an alarm that such prolonged, runaway money and credit creation has had such little impact on the economy and the markets. What's going wrong?

The fact is, contrary to the simplistic monetarist gospel, the link between interest rates, money growth and actual spending of the money is anything but straightforward. At all times, there are other factors at play on spending decisions of consumers as well as businesses. Think of wealth effects, income and job expectations in the case of consumers, and of profits and profit expectations in the case of businesses.

We come to what we regard as the most important monetary cause of the Great Depression. In 1930, America's GDP suffered an abrupt plunge of about 9% whereas the money supply declined in the course of the year just minimally by 1.2%. The conventional trivial explanation of this extreme divergence between economic activity and money is sharply slower money velocity. Unfortunately, this explanation says absolutely nothing about causation. We prefer a more refined, though completely forgotten, type of analysis, formerly developed by the Cambridge school. Labeled the "cash balance" approach, it focuses on changes in the demand for cash balances (money) during "transition periods" in which money is "out of order."

We have no doubt of what happened in 1930 to generate this strange result of a collapsing economy vis-à-vis a stagnating money supply: it reflected a general, frustrated attempt of the community to rebuild cash balances (liquidity) which, during the boom, had been recklessly depleted. Analyzing the development of a boom, the emphasis is usually exclusively on the highly visible credit excesses, showing also in a soaring money supply. In reality, though, behind the spending binges there is always a second, invisible, factor at work: a drastic decline in the desire for liquidity; in other words, in the demand for money balances.

During the bubble years, there is a general race out of money balances and into the purchase of financial or real assets. Remember the triumphant slogan of some years ago: cash is trash. Conversely, when the bubble bursts, sooner or later there essentially develops, with disastrous consequences for the prices of goods and securities a general, a desperate rush for liquidity — to get out of illiquid assets piled up during the boom and back into cash balances, that is, into bank deposits. That's what obviously happened in America in 1930 and what is bound to happen again in the foreseeable future.

A general desire to increase liquidity implicitly means that people or businesses want to hold a greater fraction of their wealth in "available money." It's the famous "liquidity trap" to which Keynes largely ascribed the failure of the Federal Reserve in the 1930s to pull the American economy out of its depression. The trap arises from the fact that the public is collectively not able to increase its "available money," whether by selling assets or by curtailing their expenditures.

For that to happen requires money creation — that is, creation of bank deposits — through higher bank lending or higher bank purchases of securities. But that failed to happen in 1930, completely frustrating the attempts of the public and businesses to improve their liquidity. The outcome was a stagnating money supply and a rapidly shrinking GDP. Late in the year, the liquidation turned into panic as, in the face of a rapidly deteriorating economy, the realization spread that stock prices had no chance to recover. Confronted with this dismal development in the economy and the markets, the banks were more than reluctant to expand, thereby thwarting the Fed's rate cuts. This evoked the popular slogan that it was "pushing on a string."

America's experience of 1930, just like Japan's current experience, speaks flagrantly for the possible development of economic conditions that completely frustrate monetary easing for a protracted period. As to the reasons for this experience, there exist two different explanations: One says that the failure of the lower interest rates to revive the economy owed everything to the dislocations imparted to the economy through the credit excesses that occurred *during the prior boom*, and the other one says that all of this is irrelevant and that the inefficacy of the lower rates arose from monetary tightness due to insufficient reserves *after the boom*. The first view has always prevailed among economists around the world, except in America. The second view prevails only in America, along with a widespread conviction that intelligent monetary policy is all-powerful in warding off any recession.

This extremely high opinion in America of the power of central banks to keep economies out of recession dates back to 1963 with the publication of *The Monetary History of the United States*, by Milton Friedman and

Anna J. Schwartz. Until then, in America it, too, had been the overwhelming opinion that the economic collapse of 1929-33 was the inevitable reaction to the excesses in the prior boom.

The book asserts that lack of money growth and the ensuing depression were predominantly due to a shortage of bank reserves. These, in actual fact, rose 4.3% over the year. That, of course, pales in comparison to the egregious injections with which Mr. Greenspan has been treating the banks and the markets even during the boom years. Still, it requires boundless fantasy to ascribe a GDP collapse of 9% in 1930 to nothing but an insufficient rise in reserves. To make sense, this essentially implies several things not mentioned in the book: that the bank's customers wanted to borrow more than they did, that their credit standing was sufficient and that the banks had adequate capital to allow a stronger credit expansion. Last but not least, it completely ignores the preponderant role of the securities markets as a source of financing during the boom. Formerly heavy equity financing collapsed in 1930, while bond financing shrank dramatically.

Which brings us to the key issue at hand: Will the Fed's aggressive monetary easing work this time? Money and credit are soaring. That's the one, apparently positive, difference to 1930. But where are they going? It needs a lot of borrowing simply for the rising debt service when profits plunge and incomes shrink. And there is far too much financial speculation in the system absorbing money and credit. Can and will consumers and businesses indulge in new borrowing and spending binges? Weighing many things, we have no doubt that the Greenspan Fed will soon find itself pushing on that ominous string.

CONCLUSIONS:

It seems the financial markets have well and truly swallowed the idea that the U.S. economy's recovery will arrive sometime in the autumn. For the time being, it helps the stock market and the dollar while hurting the bond market. But there is no trace for that to happen in the economic data. There will be a long slump.

The most important single negative, as to business spending, is the developing profit depression. As to the consumer, it's the combination of negative current saving and his heavy investment in stocks that spells certain disaster for him and the economy.

Inflation is reeling its head again. By hurting the bond market, it complicates the situation as well as policies. But the great danger "around the corner" is a deep prolonged recession in the United States.

The dollar is the wild card for the U.S. and world economy. False optimism about the former is holding the currency up. The possibility of a sharply falling dollar is the nightmare of central bankers. In Europe, policymakers are blind to the highly positive effects of a lower dollar to domestic purchasing power and inflation rates through lower import prices. American policymakers have to fear it most. It will further boost inflation and, worst of all, it will have devastating effects on capital inflows and thereby on the U.S. financial markets.

THE RICHEBÄCHER LETTER

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