



What experience and history teach us is this - that people and governments never have learned anything from history, or acted on principles deduced from it.

From the Introduction, *Philosophy of History* by G. W. F. Hegel

The big news this past quarter has been in the interest rate arena. We started the new year with 30-year Treasury issues at about 6.7% and the two year issue at a little less than 6.5%. This is known in the trade as a “flat” yield curve. You don’t gain much of anything by extending maturities. Recently, the Treasury announced a plan to repurchase longer-term Treasury issues which caused prices on those issues to go up and yields to fall. This created what is known as an “inverted” yield curve because short-term issues could be purchased at a higher yield than longer-term issues. While this is good for buyers of short-term issues, this usually presages a period of economic stagnation or a recession. Recession? The “R” word? How can one talk of recession in the midst of all this prosperity?

It’s easy. Just look at the recent actions of the Federal Reserve. Alan Greenspan decided a year ago that stock market gains were fueling inflation. Inflation is nothing more than too much money chasing too few goods. As stock prices went up and retirement assets blossomed, people felt better about their financial circumstances and were willing to spend money they really didn’t have. This is the “wealth effect” that is so worrisome to the Fed. Spending is growing at a faster rate than wage income and the Fed believes that spending needs to slow down to prevent a new round of inflation. The Fed can manipulate the economy by targeting interest rates through its open market operations or by tightening the money supply. Since July, 1999 we have seen five .25% interest rate increases from the Fed with virtually no impact on the economy or the broad stock market averages. Recent reports show that consumer demand is still strong in spite of higher interest rates and significantly higher oil prices which cuts into disposable income. The money supply spiked up late last year to assuage “Y2K” hoarding but it has returned to trend line growth since January. If too much money was the cause of the year-end jump in stock prices then removing that money from the system is not a good omen.

We should expect more interest rate increases unless or until we have a significant drop in the stock market that makes folks feel much poorer than they are. The worst of it is that we could get both the increases and the market drop. It has happened before, in 1974 when Alan Greenspan was chairman of the Council of Economic Advisors during Gerald Ford’s administration. Back then inflation was “domestic enemy #1.” Prices were growing at 12% a year, double what they were during Nixon’s term. President Ford inherited an economy from Nixon that was in recession with rising unemployment and falling stock prices. His first act was to convene an “economic summit meeting” with business and labor leaders to extract promises to put a hold on prices. Ultimately, with the help of Alan Greenspan, Ford was stuck with a feeble attempt to “Whip Inflation Now” using slogans and “WIN” buttons.

Ford’s grand plan was to tax citizens into saving with a 5% surcharge on high income earners (defined as \$15,000 a year for families and \$7,500 a year for singles) and cuts in Federal programs to get the budget into balance. It was only when the economy went into free fall at Christmas, 1974 that folks in Washington got nervous. Chrysler and Ford Motor Company closed fourteen assembly plants putting 230,000 workers on the street and GM idled 100,000 in January, 1975. Even as the economy fell apart, Arthur Burns, chairman of the Federal Reserve at the time, continued to squeeze the money supply because the Fed believed any expansion would be seen as “reflating” the economy. The Ford Administration, and Alan Greenspan, had to watch the economy suffer until inflation showed some signs of abatement.

Alan Greenspan was in the trenches, but not in charge, when the administration couldn’t decide if it was fighting inflation or recession. We know that today’s problem is the



possibility of more inflation and that Greenspan has learned from experience to make the right call at the right time. The primary prescription for fighting inflation now is higher rates. Back in 1974, Greenspan said it could take "one or two years" to control inflation. If he still believes that, we could see fifteen more months of rate increases, taking short-term borrowing rates over 10%. If the Fed really wanted to slow the stock market, the easiest way is to raise margin requirements to 100%. (To buy on "margin," you only need to put up \$50 of your own money to buy \$100 of stock. You borrow the other \$50 from the broker.) Many of the most speculative stocks are being purchased with borrowed money so a 100% margin would slow speculative activity immediately. Since 60% of the trading in Nasdaq issues is by individuals, raising margin requirements could also precipitate a crash in those same speculative issues. The only crash to date has been in the "old economy" stocks that actually produce goods and services we use and need every day. These stocks are reacting (badly) to the rise in interest rates which is typical of the old economy. Some investors believe that the favored "new economy" growth stocks are immune from high interest rates because they don't borrow. That may be true, but their customers are old economy borrowers who may curtail some spending to control costs.

There's a saying "To the man whose only tool is a hammer, everything looks like a nail." When a government program doesn't work, whether its public housing or education or fine tuning the economy, the normal reaction is to redouble the effort until it does work. It never occurs to anyone to stop what isn't working and try something else. Mr. Greenspan is correct that inflation hurts everyone but the recession will be even more painful. The Fed can slow or stop growth but it can't make it start. Hopefully, in the next few months, the Fed will declare victory over the inflation threat and move on.

The other significant event this quarter took place just this week. The market value of Cisco Systems, high tech backbone of the internet, passed that of Microsoft. Cisco was valued by the market on March 29 at \$520 BILLION! Because of the build-out of the internet, Cisco is among the fastest growing companies in the world in addition to being the largest. Cisco had sales last year of \$12 billion and earnings of a little over \$2 billion. This means that it is trading at 200 times last years' earnings per share but only 145 times fiscal 2000 earnings.

When I buy a stock I like to think that I am buying the whole company, not just a few hundred shares. Buy ALL of Cisco or, for the same money, I could buy ALL of Ford Motor Company, Johnson & Johnson, Hershey Foods, Southwest Airlines, Dow Chemical, Weyerhaeuser, Boeing, Federated Department Stores (Macy's), Campbell Soup, Walgreen, Clorox, Gillette, Chevron, Northern Trust Company, Merrill Lynch, GTE and I'd still have \$10.6 billion left over to spend foolishly. This portfolio of companies had earnings in 1999 of \$29.3 billion (2.4 times Cisco's sales) on sales of \$434 billion. If I owned all of these companies, that \$29.3 billion belongs to me. For the same cash investment, Cisco pays me \$2 billion.

But Cisco is growing so fast! Growth is never perpetual. Let's say you have the choice of two jobs at age 22. One pays \$5,000 to start but you are guaranteed a 15% raise every year until you retire. The other job starts at \$50,000 and you'll never get another raise. After grinding away for seventeen years, you finally make \$54,000 a year on your 39th birthday. On your 48th birthday, you finally catch up the slug who took the \$50,000 a year job. From then on it's all gravy, peaking at age 67 with a salary of \$2.7 million a year. But after 45 years, the company is probably out of business. By the way, in the history of our economy, only IBM achieved fifteen years of 15% growth. Then it fell on its head.

As investors, we want to believe but we also need to be realistic, skeptical, and learn from history.

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