LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "One of the worst occupational hazards of the investment business arises out of our extraordinary ability to rationalize whatever is, and our common inability to foresee what will be."-
>
> -Unknown

It is the year 2829 on the planet Xomax. We are observing a class–"The Ancient Cultures of the Planet Earth"–taught by Professor Abulia. Today, Professor Abulia is talking about the stock market in the United States in the early 1990's.

"The stock market was the vehicle through which these primitive people purchased and sold interests in the major corporations of the day. The value of the stock market was often determined by evaluating how "rich" or "cheap" it was relative to either historical benchmarks or alternative investments. A classic case developed in the Spring of 1992 when a popular market index–the Dow Jones Industrial Average–was selling at an all-time high. Those who felt prices were too high pointed out that: interest rates were on the rise and that this rise would divert money from the stock market to the bond market; the economic recovery was tenuous; stocks were quite expensive based on such quantitative measures as dividend yields, price-earnings ratios, and price-to-book ratios; and speculative enthusiasm, always a sign of danger, was quite prevalent."

"But," countered Zoloft, a student whose interest in this topic was stimulated by his father's collection of ancient stock certificates, "there were arguments to refute each of those claims. In the first place, there were valid reasons to think that the concern about rising interest rates was misplaced. Rising inflation did not seem inevitable as there were surpluses in most goods and services and money supply growth had been the lowest in decades. Moreover, the population of the country was getting older and seemed to be moving from consumption to saving so borrowing demands would lessen. Given the combination of low inflation, increased savings, and reduced borrowing there was little reason to fear higher interest rates."

According to the Professor, many discounted this view. They felt credit demands would increase with a strengthening economy. Moreover, the Federal Government, lacking discipline, was likely to continue borrowing increasing sums. The environment, in their view, suggested rising interest rates.

Qiana was especially concerned about valuation levels. She pointed out that valuation had not been this high since the 1960's.

"True," said Professor Abulia, "and that was the last time the U.S. economy had experienced low inflation. The lower the inflation rate the higher the price-earnings ratios and vice versa. The entire decade of the 1960's witnessed relatively high price-earnings ratios and moderate inflation. There were those who argued strongly that the valuation levels of the 1960's would be repeated in the 1990's. This argument was based on the prospect of an extended period of low inflation which would eventually lead to a decline in interest rates."

Norvasc, who had been quietly studying some statistics which the professor had previously made available, pointed out that in the Spring of 1992 households had less than 20% of their financial assets in individual equities. This proportion was less than half of that seen during the 1960's. He suggested that the decades-low yield on short-term investments would prompt investors to direct more of their assets toward common stocks. This process could continue for

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several years and lend support to the argument that valuation levels could remain at the higher end of their historical range for some time.

"Tell us more about the speculation that was occurring in the market Dr. Abulia," said Qiana.

"Well, the new issue market was robust. Demand for many of these stocks was so strong that many of them went to substantial price premiums as soon as the offering was complete. As an example, the stock of a golf club maker went public and was not only the most active stock, but nearly doubled its first day, a sure sign of speculation," replied the Professor.

"So, what eventually happened?" asked Zoloft, his voice filled with anticipation. "Did interest rates rise or fall? Did the economy recover? And how did the stock market respond?"

"Unfortunately, we do not know," said the professor, "as all the records regarding the stock market and the economy from this point forward were destroyed by the asteroid that struck in 2477."

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