As We See It

"To understand what is happening today or what will happen in the future, I look back"
– Oliver Wendell Holmes

Economics is often referred to as "The Dismal Science" because it entails the allocation of scarce resources. We were reminded of this definition recently at the Contrary Opinion Forum, a meeting one of us frequently attends. In past issues of *As We See It* we have discussed the long wave theory of economic cycles and our belief that nominal U.S. long-term growth and stock market returns will slow. Two of the Forum's speakers, Dr. Marc Faber, a noted international investment manager based in Hong Kong and Richard Hokenson, Chief Economist and demographer at Donaldson, Lufkin & Jenrette discussed this subject and had the following observations.

As Dr. Faber pointed out, long economic cycles have, on average, lasted about 55 years, peak-to-peak and are marked by long periods of economic expansion and contraction averaging 25-27 years each. The focus of most economic observers tends to be on the shorter business cycles which, while important, are merely fluctuations within the long cycle. Most of these long cycle expansions result from major scientific, political and technological advances that jolt the world economy out of an extended period of slow growth. Significant examples include the development of railroads in America, gold rushes in California and Australia and immigration to the New World in the 1840-1870 era; vast improvements in the electrical, communications, chemical and auto industries in the 1896-1920 time period and the explosive growth of the electronics, aerospace, consumer and service industries in the post World War II era, 1949-1978. As the long cycle peaked, each of these periods of economic expansion was followed by periods of excess productive capacity, economic stagnation, technological pause and political instability, leading to a long-term decline. Eventually the excess capacity is worked off, new technologies develop, political stability returns and conditions are ripe for another economic expansion. The last major upswing ran from 1949 through 1978 which would indicate that we are now in a period of slow growth.

Since one of the key variables in long-term economic growth is the size of the working and consuming population base, a look at U.S. demographic trends is in order. According to DLJ's Hokenson, there have been four distinct periods of live births since WW II, a baby boom (1947-1965), a baby bust (1965-1977), a baby boom "echo" (1977-1991) when the boomers started having children and a baby bust "echo" where fewer Baby Busters have fewer children (1991-present). While Baby Boomers are much discussed and maligned, they are a key factor in U.S. economic growth. The largest single birth year in U.S. history was 1961. It is no coincidence that 1986, when the "birth class" of 1961 reached the prime age for marriage and household formation of 25, housing starts, car & truck sales and other economic measures peaked. Since 1986 smaller and smaller "birth classes" have entered the workforce and formed new households. Since the creation of a new household results in an average of $12,000 in new purchases to set up house, new household formation is a critical factor in overall consumer spending. Due to the multiplier effect, the $12,000 spent during one household formation becomes someone else's profit and income which is then spent again and ripples throughout the economy. Obviously, the cumulative impact of households that *don't* get formed has a profound negative effect. In Mr.

Hokenson's view, with fewer new entrants to the workforce it is logical to expect slow economic growth until 2002 when the Baby Boom "Echo" children start to reach that magic age of 25.

It is interesting to note that the start of the next major long wave economic expansion according to Dr. Faber's analysis should be in the year 2004 and the onset of the Baby Boom "Echo" of new household formation and increased consumer spending is in the year 2002. While approaching this situation from entirely different perspectives, each observer comes to a similar conclusion. What this implies for investing is that many of the comfortable, old assumptions are no longer valid. Many of the winning stocks of the last decade were those of companies whose sales and earnings were driven by increased consumer spending. This increased consumer spending came from new household formation and rising real incomes as baby boomers matured, entered the workforce, married and started families. This trend has reversed and those stocks may be in for an extended period of slow growth. The large price declines of these former high flyers lure unsuspecting investors who don't understand that the market for these companies has changed. Many of these issues have become value traps. The ability to tell the difference between true values and value traps will be one of the keys to long-term performance. Now, more than ever, careful stock selection is much more important than overall market exposure.

The key to future investment success is an understanding of the economic setting and adjusting to that environment. We concur with the observations of Messrs. Faber and Hokenson and that has had an impact on how we structure portfolios. As someone once said, we cannot direct the wind, but we can adjust the sails.

October, 1993

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