LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "The wind may not be directly in our face, but it certainly is no longer at our backs."
> – Unknown

As usual, this year's Contrary Opinion Forum, sponsored by Fraser Management Associates of Burlington, Vermont, was informative and thought provoking. The speakers, offering a wide variety of views, seemed especially focused on their topics, probably because the long and easy bull market we have had for many years finally has been interrupted for reasons that are not yet fully understood.

One of the more thought provoking presentations was given by Martin Barnes, Managing Editor of *The Bank Credit Analyst*, who spoke on, "Should Investors Fear Deflation?" We have been long-time followers of The Bank Credit Analyst and have found its views helpful over the years, particularly since they tend to focus on longer-term thinking.

Mr. Barnes feels the era of extraordinary stock and bond market returns is now drawing to a close, and an extended period of single-digit returns is in prospect. The past 16 years have witnessed the greatest combined stock and bond bull markets in modern history. As related in *The Bank Credit Analyst* of October, 1998, "The secular bull markets in both bonds and stocks began in 1982. Since then, total real returns from stocks have increased at a stunning compound rate of almost 16% a year, far above the long-run average of 6.5%. Long-term Treasury bonds have delivered compound returns of almost 11% a year over the period, compared with historical real returns of 3% a year." Not surprisingly, investors have become conditioned to expect double-digit returns from securities for the foreseeable future.

Throughout what Mr. Barnes identifies as the financial era, what has been good for bonds has been good for stocks. The fundamental ingredient that drove both markets was declining inflation or disinflation. With inflation now running at a relatively subdued 1%-2% rate, that process is about over. Mr. Barnes feels we are likely in a prolonged period of low inflation, and, in fact, worries about deflation. In such an environment he expects long-term bond yields to decline to perhaps 4% over the next two years (enough for two years of double-digit returns). From that point on, bonds would just earn their 4% coupon in Mr. Barnes' view. He further states that going forward, stock returns will be driven purely by earnings that will, at best, grow by 6%-7% in a low inflation and slower growth environment. Hence, he expects a prolonged period during which stocks return 6%-7% and bonds return 4%.

One of the axioms of forecasting is that events usually take much longer to develop than expected, but once they begin, they occur much faster and go much farther than anticipated. The recent events in Asia, Russia, and other developing countries are a case in point. At first it was hoped the Asian financial problems could be contained. They became a crisis. Problems in Russia escalated and fears about Latin America followed. Meanwhile, at home imports increased, exports plummeted, and profits deteriorated. It is this new economic environment that tempers Mr. Barnes' view of the future.

No one knows the future, but we are most assuredly going to experience a more difficult economic environment going forward than has been the case for the past several years. From an investment point of view, nearly everything worked in the near perfect environment of low inflation and robust profits of recent years. Both stocks and bonds rose in price in a seemingly effortless fashion. Now, with the wind no longer at our back, successful investing will become more challenging. That challenge requires a focus on company fundamentals, proper diversification, and a balance between stocks and bonds commensurate with an individual investor's risk profile.

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