LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> The powerful equity bull market has been supported by three pillars: falling inflation, a revival in corporate profitability, and a move from low to high valuations. These three trends have largely been exploited and this implies that future returns will be more in line with historical experience.
>
> –Martin H. Barnes, at the
> 2000 Contrary Opinion Forum

In 1995 Martin H. Barnes, Managing Editor of *The Bank Credit Analyst*, addressed the Contrary Opinion Forum on the topic of long-wave economic theory. At that time he argued that the U.S. was experiencing a technological shift and had embarked on what he called a long-wave expansion that would last at least twenty years. He returned to the Forum this year with a presentation in which he indicated events since 1995 have strengthened his view on the long-wave expansion.

In the opinion of Mr. Barnes, we are in the midst of a rare technological shift, led by information technology, that is having a major impact on the way the economy operates. The invention of the printing press and the development of electricity were given as examples of technological advancement which had an impact on the economy similar to what information technology advances are having today.

The key defining development, according to Mr. Barnes, is the huge increase in capital spending on technology which has driven an increase in productivity growth which in turn has allowed non-inflationary economic growth and rising profit margins. Moreover, there is no reason to believe that the pace of technological innovation is slowing. Meanwhile, the Federal Reserve and other central banks around the world have cooperated with policies that brought inflation down to a low and stable level. And the fiscal environment has been encouraging as suggested by the current and projected federal budget surplus.

However, he expressed how all of this good news has not been lost on the stock market which has risen some 18% per year since 1982. Over these eighteen years, inflation declined from double digits to low single digits, corporate profit margins rose to a level seldom reached in the past, and the price of the S&P 500 increased from 8.5 times earnings to the mid 20s.

According to Mr. Barnes, going forward, capital spending on technology and improving productivity will continue to give rise to an impressive overall GDP, i.e., about 6% a year. Profit growth can at its best match GDP. He concluded, unless price earnings ratios can rise further (a dubious proposition given the already low level of inflation) aggregate stock market returns are, at best, likely to be near 7% per year: 6% from profit growth and 1% from dividends.

On the other side of one's investment portfolio, bonds have also been in a phenomenal bull market for the last eighteen years with the long Treasury dropping from a yield of about 14% to less than 6%. While Mr. Barnes expects the long Treasury to decline to 5% or so over the next few years, that will likely be the low. From that point forward, one could expect more stable prices for bonds so that the total return will be close to the bond's coupon or about 5% per year.

There have been good reasons for the stock and bond markets to have performed so well for the past eighteen years. While the long-wave economic upswing remains intact, it is unrealistic to expect the financial markets to extend their past heady performance. If Mr. Barnes' observations continue to be valid, the future will be more choppy and investors will need to temper their expectations dramatically.

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CRISIS EVENTS, DJIA DECLINES AND SUBSEQUENT PERFORMANCE

Event	Reaction Dates	Date Range % Gain/Loss	DJIA Percentage Gain Days After Reaction Dates 22	63	126
Fall of France	05/09/1940 - 06/22/1940	-17.1	-0.5	8.4	7.0
Pearl Harbor	12/06/1941 - 12/10/1941	-6.5	3.8	-2.9	-9.6
Truman Upset Victory	11/02/1948 - 11/10/1948	-4.9	1.6	3.5	1.9
Korean War	06/23/1950 - 07/13/1950	-12.0	9.1	15.3	19.2
Eisenhower Heart Attack	09/23/1955 - 09/26/1955	-6.5	0.0	6.6	11.7
Sputnik	10/03/1957 - 10/22/1957	-9.9	5.5	6.7	7.2
Cuban Missile Crisis	10/19/1962 - 10/27/1962	1.1	12.1	17.1	24.2
JFK Assassination	11/21/1963 - 11/22/1963	-2.9	7.2	12.4	15.1
U.S. Bombs Cambodia	04/29/1970 - 05/26/1970	-14.4	9.9	20.3	20.7
Kent State Shootings	05/04/1970 - 05/14/1970	-4.2	0.4	3.8	13.5
Arab Oil Embargo	10/18/1973 - 12/05/1973	-17.9	9.3	10.2	7.2
Nixon Resigns	08/09/1974 -08/29/1974	-15.5	-7.9	-5.7	12.5
U.S.S.R. in Afghanistan	12/24/1979 - 01/03/1980	-2.2	6.7	-4.0	6.8
Hunt Silver Crisis	02/13/1980 - 03/27/1980	-15.9	6.7	16.2	25.8
Falkland Islands War	04/01/1982 - 05/07/1982	4.3	-8.5	-9.8	20.8
U.S. Invades Grenada	10/24/1983 - 11/07/1983	-2.7	3.9	-2.8	-3.2
U.S. Bombs Libya	04/15/1986 - 04/21/1986	2.6	-4.3	-4.1	-1.0
Financial Panic '87	10/02/1987 - 10/19/1987	-34.2	11.5	11.4	15.0
Invasion of Panama	12/15/1989 - 12/20/1989	-1.9	-2.7	0.3	8.0
Gulf War Ultimatum	12/24/1990 - 01/16/1991	-4.3	17.0	19.8	18.7
Gorbachev Coup	08/16/1991 - 08/19/1991	-2.4	4.4	1.6	11.3
ERM U.K. Currency Crisis	09/14/1992 - 10/16/1992	-6.0	0.6	3.2	9.2
World Trade Center Bombing	02/26/1993 - 02/27/1993	-0.5	2.4	5.1	8.5
Russia Mexico Orange County	10/11/1994 - 12/20/1994	-2.8	2.7	8.4	20.7
Oklahoma City Bombing	04/19/1995 - 04/20/1995	0.6	3.9	9.7	12.9
Asian Stock Market Crisis	10/07/1997 - 10/27/1997	-12.4	8.8	10.5	25.0
U.S. Embassy Bombings Africa	08/07/1998 - 08/10/1998	-0.3	-11.2	4.7	6.5
Russian LTCM Crisis	08/18/1998 - 10/08/1998	-11.3	15.1	24.7	33.7
Mean		-7.1	3.8	6.8	12.5
Median		-4.6	3.9	6.7	12.1

Days = Market Days

Source: Ned Davis Research, Inc., September 2001