

# FORECASTS & TRENDS

STRATEGIC ANALYSIS OF THE ECONOMY & INVESTMENTS

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## ECONOMIC & INVESTMENT OVERVIEW

The U.S. economy is finally slowing down. The Commerce Department reported that GDP rose at an annual rate of only 2.7% in the 3Q, versus 5.6% in the 2Q and 7.6% in the 1Q. The 3Q report was below advance estimates which were around 3.5%, so there have been questions about the accuracy of the latest GDP estimate, and predictions it will be increased in the next report. The GDP report included other indications that it may have understated the economy. For example, consumer spending, which accounts for at least two-thirds of the economy, expanded at an annual rate of 4.5% in the 3Q, up from 3.1% in the 2Q. Elsewhere, the unemployment rate held steady at only 3.9% in September and October, the lowest figures in more than 30 years. So while the economy is slowing down somewhat, there is no guarantee it will continue and no reason yet to expect a recession next year. More on the economy in this issue.

The GDP report also indicated that inflation remains in check. The GDP price deflator put inflation at 2.2% in the 3Q, up only slightly from 2.1% in the 2Q. The Fed elected to leave monetary policy unchanged at its October 3rd FOMC meeting. With the latest economic figures, most analysts expect the Fed to leave rates unchanged again at the November 15th policy meeting. Yet I would not expect the Fed to lower rates until sometime next year when it is more certain that the economy has slowed down.

The stock markets were a madhouse again in October. The Dow Jones plunged to close below 10,000 on October 18th, while the Nasdaq fell to near 3,000 at one point the same day. Then, almost as quickly, the markets soared again. Many analysts have since predicted that the October 18th lows will mark the bottom and the end of the downward correction, the beginning of a renewed bull market, and an end to the extraordinary volatility we've seen this year. I, however, am unconvinced. It remains to be seen when these incredibly difficult markets will return to more normal patterns.

The Diversified and Alternative Funds were fractionally unchanged in October. The Long/Short Growth Fund temporarily suspended trading on October 13th due to additional losses by Hampton Investors. This year, the markets have been more treacherous than I have ever seen them in my 25 years in the investment business.

## The Economy - Finally There Are Real Signs Of A Slowdown

### GDP Slows Significantly In 3Q

The latest Commerce Department report showing GDP slowed to a 2.7% annual growth rate in the 3Q was welcome news to those who have feared that the Fed would have to hike interest rates several more times and perhaps spark a recession in 2001. Many economists and market analysts proclaimed the latest report to be confirmation that the Fed will not have to raise interest rates further, and should begin to think about when rates will be lowered.

There is little or no disagreement that a growth rate of 2.7% is well within the Fed's non-inflationary target. However, there is considerable evidence that the government may have understated growth in the 3Q. Consider consumer spending which accounts for two-thirds or more of GDP. Consumer spending in the 3Q rose at a 4.5% annual rate as compared to growth of 3.1% in the 2Q. So it is questionable how the economy could have slowed so much in the 3Q. Several other reports released in the last month suggest that the government will have to adjust its latest GDP estimate upward, at least somewhat, in subsequent reports due out later this month and in December.

Based on his own remarks, Alan Greenspan's new non-inflationary target for the economy is in the range of 3-4%, rather than his old target of 2.5-3%. If so, even if the government adjusts its 3Q GDP number to 3-3.5% in subsequent reports, it is widely believed now that the Fed will not raise interest rates again. Now the pundits are focused on how soon rates will be cut.

### A Year Later, The Economy Finally Slows

After almost a year of speculation, it is finally clear that the economy is slowing down, although perhaps not as much as the latest government report on the 3Q indicates. Yet it remains to be seen if the slowdown in the 3Q will be matched in the next two or three quarters. Clearly, consumer spending will have to slow down if the economy is to stabilize at a non-inflationary pace.

The question is, what will it take to slow down consumer spending and stabilize the economy at a non-inflationary pace? After all, consumer spending has gone up strongly, year after year, for several years now. Even repeated interest rate hikes by the Fed over the last year and a half have not daunted US consumers. So what will it take?

### A Stock Market Meltdown, Perhaps?

You won't hear the following argument on the financial programs on cable TV or in the Wall Street Journal, or among most equity money managers, but I would argue that the single most important threat to the economy is a further blowout in stock prices.

Despite all the volatility, despite all the whipsaws, despite all the scary moments in the last two years, the public's confidence in the stock market is still unwavering. The buy on dips mentality is still very firmly entrenched. Mutual fund inflows, for example, have remained very strong in the last couple of months, despite the October roller coaster.

Let us not forget that the investment public has been conditioned over the last 10-15 years to believe that the stock market always goes up; that 15-20+ % returns are virtually automatic; that buying the dips is the only prudent thing to do; that you don't get scared and sell when the market goes down; because it will always come back. As a result, people continue to pour enormous amounts of money into the market, even in a year like this when the market averages have, for the most part, made nothing or gone down. Net purchases of equity mutual funds, for example, went up \$24 billion in August and \$17 billion in September. Final figures for October are not out yet, but the largest fund families indicate more money came in than went out, despite the huge sell-off in the markets last month.

Yet I have to ask, what would happen to consumer confidence - and in turn, the economy - if the stock markets were to turn in a losing year, down 10-15% or more, for 2000? Would that be enough to spark a recession in 2001?

The Tech Stock Bubble Has Burst,  
But Will It Turn Into A Historic Bear Market?

There have been three great market manias in this century: 1) Wall Street in the 1920s; 2) precious metals in the 1970s; and 3) the Japanese stock market in the 1980s. After each of these bubbles burst, prices plunged to only 20-45% of where they were at their peaks, with the average being 30% of the peak values. If we assume the Nasdaq peaked in March at just over 5000, that would put it at 1,500 if it were to fall to 30% of its high. This is a common argument put forth by the bears.

I don't expect that to happen this time around. There are several reasons why the Nasdaq should not collapse to 1,500 in line with previous manias. Perhaps most important is the fact that there has been a substantial and fundamental improvement in productivity and the economy as a direct result of the information technology and high tech boom.

This is very different from the Japanese mania where most of the increased investment went into unproductive areas such as real estate. The Nasdaq boom is also very different from the 1970s mania in precious metals, which was fueled almost entirely by rampant speculation on commodities that provide no income.

Also, the government is not likely to make the dangerous policy errors it did in the 1929 crash and the years immediately thereafter. In fact, we've seen quite the opposite as recently as the 1987 crash when the Fed flooded the markets with liquidity. There is little doubt that the Fed would act in similar fashion if the recent declines in the markets were to get out of hand. Clearly, the Fed has learned from mistakes in the past.

Nasdaq Still Over-Valued?

While there are reasons to believe the current downturn in the Nasdaq will not end as did the previous three market manias, it is still unclear whether the latest plunge to 3,000 has fully corrected the excesses in the tech stocks. In the short-term, the huge decline in October has put the Nasdaq in oversold territory, and it is likely to rebound in the days just ahead (and

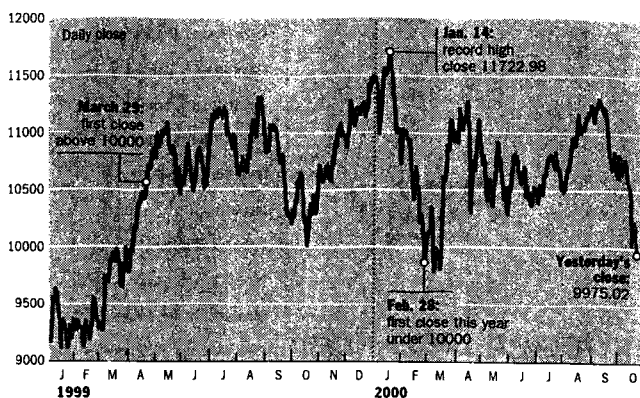
perhaps before you read this). However, the decline below 3,500 in October violated critical support levels.

Also, the number of Nasdaq stocks at new lows is still well above where it was at the bear market bottom in 1998. These and other indicators suggest that the Nasdaq could see even more weakness once the latest oversold conditions are corrected. The next major support area is around 2,500. The point is, while I don't expect the Nasdaq to fall to 1,500 or lower, as in past manias, it could well have more on the downside. As discussed below, this and weakness in other sectors will have negative effects for the economy.

Stock Market Headlines On  
October 12th Near The Lows

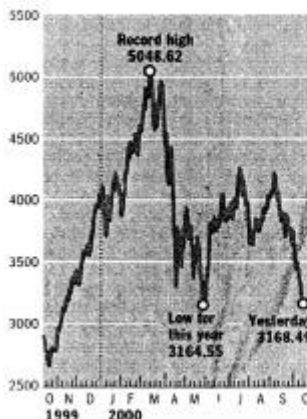
Volatile Times for the Dow Industrials

As the blue chips revisit lows for the year...



Time Warp: Nasdaq Returns to Pre-Surge Levels

The composite is nearer to 3000 than to 5000 ...



Sources: WSJ Market Data Group; Birny Associates

And big stocks are taking big hits  
The 10 worst-performing large U.S. stocks<sup>1</sup> since Sept. 1

	% change in share price from	
	Dec. 31	Sept. 1
Apple Computer <sup>2</sup>	-61.8%	-69.1%
Internet Capital Group <sup>2</sup>	-92.6	-64.7
CMCI <sup>2</sup>	-66.1	-58.0
SCI Systems	-34.8	-57.0
Lexmark International	-64.3	-52.9
InterNAP Network Svcs. <sup>2</sup>	-60.3	-52.3
Intel <sup>2</sup>	-14.0	-52.2
Metromedia Fiber Ntwk. <sup>2</sup>	-23.3	-52.1
Micron Technology	-3.0	-51.6
InfoSpace <sup>2</sup>	-63.1	-50.9

<sup>1</sup>With market values of \$5 billion or more  
<sup>2</sup>Nasdaq stocks; others are NYSE

### Weak Stock Markets Hurt The Economy

The weakness in stocks this year has effectively shut down the market for initial public offerings. This has occurred at the same time as demand for corporate bonds is weak, and as banks are tightening lending requirements. Venture capital groups have also retreated due to massive losses in Internet stocks.

The difficult market for fund raising will mean that corporations will have to cut back on capital spending. The National Federation of Independent Business (NFIB) reports that capital spending plans for the next six months have fallen to their lowest level since 1994. While this doesn't portend a recession, it is clearly not good for the economy.

Unemployment remains very low because companies are reluctant to lay off workers due to the very tight labor market. However, with the current credit squeeze and cutbacks in capital spending plans, it is almost inevitable that layoffs will increase and unemployment will rise as the economy slows down. Layoffs have already been huge in the dot.com companies, but these workers have so far been able to find work elsewhere. This will change if the economy slows further in the next 3-6 months.

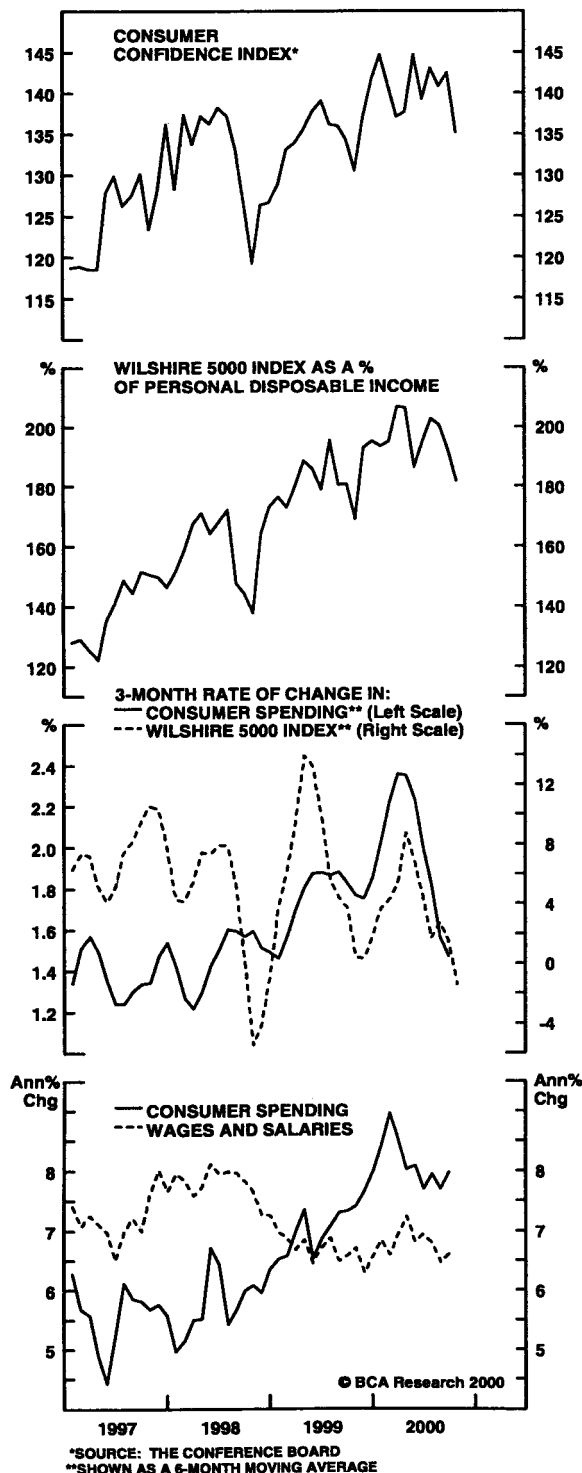
Considering the effects of a weak stock market and a slowing economy, we may finally have the combination of conditions that will make consumers pull in their horns. The consumer spending binge that began in 1998 appears to have peaked (see charts at right) and could contract considerably more, especially if there is more negative news on the economy or further declines in the stock markets.

### Consumer Confidence & Spending Appear To Have Peaked For This Cycle

Until October, consumer confidence held at a high level, despite increased stock market volatility and high oil prices. However, the latest plunge in the stock markets, coupled with the latest report showing the economy has slowed significantly sent consumer confidence down sharply to the lowest level since late 1999. This strongly suggests that consumer spending will slow.

As you can see from the third chart below, there is a close correlation between short-term swings in stock prices and consumer spending.

**Consumers Under Pressure**



Source: The Bank Credit Analyst.

Should there be further weakness in the stock markets, that will mean further cutbacks in spending. Consumer spending should fall back to the levels of wages and salaries (bottom chart on page 4), and could even go lower if the stock markets continue to weaken.

In many ways, this is a self-feeding cycle: a weaker stock market leads to reduced consumer spending; reduced spending leads to a slower economy; a slower economy leads to a reduction in capital spending; a reduction in capital spending leads to lower productivity which, in turn, leads to lower share prices.

### Will A Recession Follow In 2001?

Alan Greenspan has been repeatedly praised in the days following the government's latest report that 3Q GDP rose by only 2.7%. Countless observers have proclaimed that the "soft landing" has been achieved. In particular, if the next 3Q GDP report is adjusted upward to 3-3.5%, I expect you will hear talk of a recession next year all but disappear. However, while there is currently no reason to believe that a recession will occur in 2001, it certainly cannot be ruled out, especially if the stock markets continue to fall.

Another important factor will be how quickly the Fed moves to lower interest rates. If the Fed leaves rates high too long, that will increase the likelihood of a recession next year. While I don't expect rates to come down before the end of the year, I would expect the Fed to ease early next year, especially if the economy stays on a non-inflationary course.

I would expect the Fed to ease sooner if the weakness in the stock markets worsens over the next month or two. Crumbling equity markets and weakening economic conditions at a time of high leverage increase the odds for a financial accident. Let us not forget that there has been massive speculation in the last few years. Accordingly, many financial institutions have suffered large losses in technology stocks. There are also rumors that one or more large investment banks have incurred large losses in junk bonds.

So, we are in a period that could be marked by a recession, or a financial accident, either of which could spark a further plunge in equity prices. Uncertainty

has become increasingly commonplace in the investment markets over the last several years. But then there are other indicators.

### Latest Barron's "Big Money" Poll

Just when you thought you were sure the economy was going over the edge, just when you thought the long-awaited recession was upon us, the latest Barron's Big Money Poll comes out. Whether you are bullish or bearish on the US economy, the stock markets, interest rates and inflation, it is instructive to look at the results of the latest Barron's poll.

As it has been for most of the last decade, the latest Barron's poll is positive. Each quarter, Barron's surveys over 100 portfolio managers ranging from large brokerage firm analysts to large equity mutual fund managers to boutique investment firm analysts. Each quarter, Barron's gives us a synopsis of their views on the markets and the economy going forward. Here is a summary of the average results of the latest survey of over 100 portfolio managers and market forecasters.

### Stock Markets At Yearend & Mid 2001:

Dow Jones	10,989	11,309
S&P 500	1,481	1,531
Nasdaq	3,832	4,023

### GDP growth rate for year 2000 & 2001:

4.6%	3.7%
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### T-Bill Interest Rates for 2000 & 2001:

5.9%	5.6%
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### Crude Oil Prices for end 2000 & 2001:

\$31.7	\$28.3
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### Current Recommended Allocations:

73% Equities
16% Bonds
11% Cash

Favorite Stocks (on average):

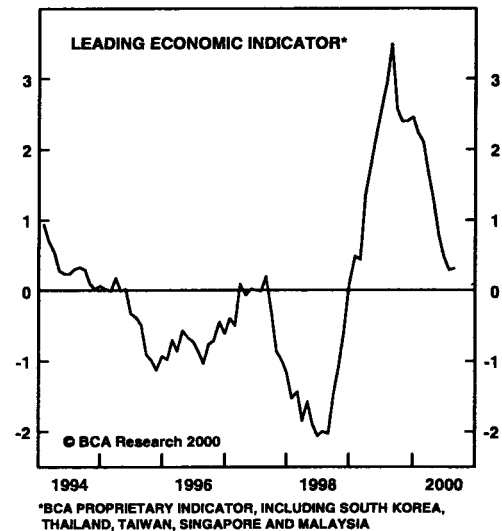
Intel	Microsoft	Worldcom
Cisco	EMC	General Electric
AOL	AT&T	JDS Uniphase
Human Genome Sciences		

Is Asia Headed For Another Crisis?

The BCA editors devoted an entire section of their November report to the worsening conditions in Asia. They fear a replay of the 1997-98 economic and financial crisis. Asian stock prices have plunged by 35% on average from their peaks in late 1999. Leading economic indicators for the region show that the economies which bottomed in last-half 1998 have turned decidedly weaker in 2000.

Granted, these are estimates from mainstream money managers, but as you can see their outlook (on average) is at least mildly positive, with no threat of a recession.

**Asia: A Sharp Slowdown Ahead**



**BCA's Latest Thinking**

In their November issue, the editors of BCA maintain their very positive long-term outlook for the US economy. They believe the economy has now slowed to a non-inflationary pace that is acceptable to Greenspan & Company. They believe the Fed will lower interest rates sometime soon after the first of the year.

Actually, the BCA editors are now more concerned about deflation than about inflation. They cite the slowing global economy, excess global inventories, pricing pressures, etc. As discussed below, they are particularly worried about the deterioration in the Asian economies and stock markets.

The editors maintain that they don't expect a recession in the US next year; however, they do not rule it out. They share my concern that a continued drop in the stock markets would be the most likely catalyst for a recession next year. However, they continue to believe that a recession, were there to be one, would last only a few quarters at most and would be relatively mild. Beyond that, they still expect their "longwave" economic upturn to continue, led by the US.

The BCA editors still favor high quality bonds over stocks and caution that the tech stocks could still have more on the downside. They believe the time to go back into a fully invested position in equities will be when the Fed begins to lower interest rates, presumably early next year.

Excess capacity remains a problem in all of the Asian Tigers. As a result, deflation is widespread across the region. Soaring oil prices have also contributed significantly to the Asian slowdown. Adding to the problem is the fact that most Asian countries have not disposed of their banking systems' bad debts. Asia's loan-to-deposit ratio has never recovered from the 1997 crisis, and most large banks in the region are unwilling or unable to lend.

While the editors stop short of predicting another Asian crisis, they are very concerned. They worry that if the US equity markets worsen, the effects on the already weak Asian markets could be substantial. Likewise, if the US economy were to slip into a recession next year, they believe this could push Asia over the edge once again. Conversely, they fear that if Asia goes over the edge, that could be enough to rattle the US equity market sufficiently to send our economy into a mild recession. In conclusion, they do not recommend investing in the Asian markets at this time.

## **Oil Prices Revisited - Will There Be A Glut Next Year?**

### **Crude Prices Remain Above \$30**

Last month I predicted that oil prices would not come down as a result of Clinton ordering the release of 30 million barrels of oil from the Strategic Petroleum Reserve (SPR). While oil prices dipped momentarily, they are back above \$30 per barrel again. And we are just now entering the winter season when energy consumption always increases.

In a series of four increases, OPEC has raised daily oil production by approx. 3.7 million barrels per day. Worldwide refinery runs are now estimated to be approx. 3.5 million barrels per day higher than this time last year. Yet oil prices are stubbornly holding above \$30 per barrel.

Oil industry analysts, for the most part, continue to predict that prices will begin to trend lower any day now. They point to the production and refining increases, and the supposedly sizable amount of oil that is en-route to the US aboard supertankers, and assure us that it's just a matter of time before oil prices decline. Most predict prices will move back to the \$20 area before long, provided we don't have an extremely cold and/or long winter.

Yet as I discussed last month, the main problem is not a shortage of crude oil. The problem is limited refining capacity in the US. This problem is not going to go away anytime soon.

### **OPEC To Meet On November 12th**

The next meeting of OPEC will be over by the time you read this. However, after four production increases this year, the discussions in Vienna on November 12th are expected to take a longer-term view and focus on avoiding a glut of oil on the markets next year. Several OPEC ministers have stated recently that there will soon be too much oil on the world market. Thus, the oil ministers are expected to discuss when and by how much oil production will be reduced when winter ends. As discussed last month, OPEC would love to see oil prices remain at \$30 or above.

### **Oil Analysts Call For A Bear Market**

Larry Goldstein, president of the Petroleum Industry Research Foundation in New York, predicts that oil prices will begin to fall by January at the latest, unless this winter is unusually harsh. The International Energy Agency in Paris now estimates that if prices remain high, world oil demand will drop by almost 3 million barrels per day as winter turns to spring. Specifically, they estimate daily demand to fall from 78.4 million barrels per day in the 4Q to 75.6 million barrels per day in the 2Q of 2001.

These estimates could well prove to be true, especially if the world economy continues to slow down. If the US dips into a recession next year, demand could fall even further. Ditto if there is another Asian crisis. However, as discussed earlier, there is no assurance the US will have a recession next year, or that Asia is going over the edge again.

Fred Leuffer, senior oil analyst at Bear Stearns, predicts that oil prices are going to come crashing down whenever they peak next year. "When the price comes down, it's going to be harsh. It's not going to be gentle." Leuffer argues that OPEC will not cut back production quickly enough to head-off a major price decline early next year when demand is projected to fall. He is correct in that it has always been harder for OPEC to agree to curtail production after enjoying those increased revenues. Leuffer says he will not be surprised if we see oil prices sink all the way back to \$10 a barrel next year, unless OPEC is more farsighted than in the past.

As is always the case whenever any commodity triples in price, there are strong arguments by the bears. As noted last month, high prices always lead to lower prices, sooner or later. However, I would not recommend shorting the oil market at this time, or buying put options on crude futures as some clients have asked me. There could easily be more on the upside, especially if we have an unusually harsh winter.

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## You Need To Be On The Internet

It is utterly amazing how much financial and investment information you can get on the Internet! There are numerous websites where you can monitor the markets as closely as you like, where you can track your favorite stocks and mutual funds, and where you can get research reports and analysis. With the explosion in online trading, you can buy and sell stocks and other securities with the click of a mouse at many different websites.

You can get news earlier than in the traditional media at these investment websites, and some of the news is only available on the Internet. And it doesn't have to be financial or investment news. You can get a wealth of information on almost anything on the Web.

Best of all, you can read Forecasts & Trends on our [profutures.com](http://profutures.com) website the day after it is written, as opposed to receiving it a week or more later in the mail.

You can also receive our frequent "Updates" that we send out during the month. If you have an e-mail address but haven't given it to us, please do, and we will automatically send you these updates and other valuable information.

To those who feel that they are too old to get a computer, or those who feel that it's too complicated, let me assure you it is not that difficult or expensive. In a very short period of time you can be cruising the Internet, reading news you won't find elsewhere, watching your investments as never before and sending and receiving e-mail like a pro.

You can do it! You just have to make the decision and then get going. Help is available everywhere.

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## The Toughest Year Ever

This year has been the most difficult year in the markets that I have seen in 25 years in this business. Treacherous is the best word I can think of to describe the markets this year. About the only safe harbor has been bonds. With the benefit of 20-20 hindsight, we would have been better off to put all our money with an Advisor like Central Plains, stayed in bonds all year and earned approx. 18% as of early November.

Most of our recommended Advisors have struggled this year, as have the futures funds. Some of our Advisors have experienced their worst losses in their careers this year. It is of little consolation that this kind of performance is rampant this year, and is not isolated to those Advisors we use.

For the last six months we have been aggressively seeking Advisors who have done well in the last two years, despite all of the unusual market volatility. I can tell you, there aren't a lot! And some who have done very well in the last 12-24 months have very short track records (see Professional Investing this month). However, we are finalizing our due diligence on several new Advisors, and we hope to have some exciting information for you soon.

Obviously, in a period like this we monitor our recommended programs and Advisors more closely than ever. Should we make any changes in our recommendation of any Advisor you are invested with, we will notify you immediately in writing. Hopefully, that will not be necessary.

Whenever we go through losing periods, and especially a period like the last year, I take it very personally! As a result, I have not been a happy camper, especially not in October. While I am very disappointed with our results this year, I am, as always, available to take your phone calls if you would like to talk.