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INVESTMENT POLICY MEMO

Declines in stock market prices have been widespread, but not indiscriminate. Telephone, Internet and computer stocks have plummeted by astonishing percentages all over the world. Stocks of large companies in health care, food, insurance and other industries that are less affected by the business cycle seem to have completed their own prolonged bear markets over a year ago and have recovered modestly since then. While equities all over the world have slumped, the Chinese market stands out as it reaches new all time highs and many of its neighbors on the Pacific Rim have held up very well.

In sum, what went up the most has come down the most. Can we infer that what went up too much has now come down too much? Most Internet stocks or "dot.coms" were close to pure bubble stocks. They had no earnings and their plan was to continue operating at a loss until they gained dominant market share. This was everybody's plan. If some of them had succeeded in this objective clearly large numbers of others would have disappeared as a consequence. And the ones that did succeed still might not have been able to raise their prices enough to be profitable and remain competitive with "old economy" firms. Amazon.com, for example, loses money on every book it sells. If you bought a $20 book from Amazon last year, on average it cost them $31 to provide the book to you.

Amazon has tried, as the old joke goes, "to make it back on increased volume". As long as the stock market was willing to buy its stock at fantastically high prices, Amazon could go right on selling more books and losing more money replaced by selling more stock. Now that the Internet bubble has burst – Amazon fell 92% from its high in 1999 – there are many hundreds of companies that cannot continue losing money because there is no market for their stock and little hope of borrowing more money either. The potential damage extends beyond the herd of dot.coms. Manufacturers of fiber optic cables, servers, switches and countless other items of Internet hardware along with providers of software and consulting services to the dot.coms are also facing sharp declines in their businesses as a result of the slide in dot.com prices. Wall Street underwriters, San Francisco office buildings, telephone service companies and numerous other providers are also suffering unpleasant declines in demand.

When bubbles collapse there are consequences. I have argued in previous memos that the consequences of this bubble bursting would be relatively contained because the bubble itself was mostly contained to a particular segment of the market. That remains true. But the recession that is now apparently underway has been caused by more than the bursting of the Internet/Technology bubble. Corporate investment in information technology has experienced an historic boom, accounting for about half of all corporate investment in the past five years. Like all investment booms, this one has now ended. Both businesses and consumers have bought just about all the new computers, cell phones, cars, houses and buildings that they can handle. And the sense of excess grows more acute as business sales decline and unemployment among consumers rises.

Of course none of this disproves that the Internet, the computer and the wireless telephone will become increasingly large parts of our lives and our economy in the future. Many companies

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will earn large profits from this evolution. At least some of them are among today's battered stocks in these industries. But, we should finish our survey of the forces causing and cushioning the current recession before we start to enthuse about investment opportunities. The list of cushioning effects has gotten shorter since our last memo. The United States continues more than ever to be a service economy less subject to business cycles. Inflation and interest rates are low, thus removing two classic sources of economic distress. The government continues to have enormous capacity to provide fiscal stimulus to the economy; but looks even less likely to use it effectively than when I last wrote.

This leads quite directly into the new salient concern on the negative side of the ledger. George W. seems bent on proving himself as bad for the economy and the stock market as Clinton was good. As predicted in my last Memo, he has held fast for his tax cuts targeted at capital gains, estate taxes and high income brackets. Any hope of swift tax relief through reduced withholding taxes this year has now been squandered along with the pretense that Bush would be a unifier across partisan divides.

In the campaign Gore claimed that Bush's proposals would squander the hard-won surpluses that Clinton had created for the first sustainable time in 70 years. Sure enough the presidents tax cuts coupled with spending increases that are encouraged by his mantra that "the surplus doesn't belong to the government; it belongs to the people", already have sent projected future surpluses tumbling with a further shove from a slowing economy. Bill Clinton was one of the best friends Wall Street ever had (and the data indicate that Wall Street paid well for his friendship). Robert Rubin, former managing director of Goldman Sachs and now a leading player at Citicorp, was the man who defined economic policy for the Clinton years and then served as Secretary of the Treasury. Policy was focused on disciplining government spending to encourage the market and to reduce, and ultimately reverse, government borrowing. The result was a very significant decline in interest rates and inflation over the Clinton years. While Bush is not exclusively to blame, he seems destined to preside over increases in interest rates and inflation over the next four years. These are demonstrably bad developments for profits and for stocks.

The ramifications of our new president's policies overseas are even more ominous from a stock market perspective. The general theme seems to be to start the Cold War all over again. A Star Wars missile defense system that mystifies most scientists and proves equally frightening to our foes and allies is apparently the highest administration priority. When the president of South Korea came to visit our new president he was harangued for two days by teams of officials trying to persuade him to break off his initiatives for a peaceful reconciliation with North Korea for which he had already received a Nobel Peace Prize and which he had undertaken with the encouragement of the Clinton administration and most of the world. The result was a dramatic worsening of relations between the United States and its South Korean ally and a slump in confidence in South Korea.

And then there is the confrontation with China, which has been far and away the largest contributor of any other country in the world to the recent success of the American economy. First it was announced that we were no longer going to view our relationship with China as one of strategic partnership. From now on we would view the Chinese as dangerous competitors. Shortly thereafter came the spy plane standoff. To a newspaper reader the U.S. appeared eager to use the incident as a way of increasing tension and hostility between our two countries.

This week the White House released a budget that proposed a 24% cutback in the funds available to the Export-Import Bank for financing exports by U.S. companies. In addition the Bush budget calls for cutbacks in spending on transportation despite the observable crisis in many parts of the U.S. transportation system and the obvious importance of the transportation network to economic health and business profits. So far the new White House policy appears as hostile to business interests as it is friendly to wealthy individuals. The only exception is an increased willingness to violate what remains of our environmental heritage to add a few months of consumption to our reserves of petroleum and a small increment to the profits of fossil fuel producers and users.

So, the list of negatives is longer and the list of positives is shorter than each was three months ago. Nevertheless, the most likely outcome remains that this recession began at the end of last year or the beginning of this year and that it will be over in the late summer or the fall. If that turns out to be the case stocks should anticipate the recovery about six months in advance, which would be now. As is always the case in downturns there is a small probability that things could turn out much worse in which case the stock market could also do much worse. It is also possible that we are not even in a recession and will not be in a recession. The economy may now be so dominated by service industries that the traditional indicators of recession are no longer relevant except for the unfortunate minority that still produce steel, or bricks or airplanes. In this case the stock market again has a bright future.

On balance I think this is a time to be close to fully invested. Many large growth companies are selling at reasonable prices. Among them are firms in almost every industry. So I am moving rapidly back into these most desirable holdings. At the same time many smaller companies are still selling at low valuations. On a global scale, I continue to think that Europe will provide higher and safer growth than the United States. The Japanese stock market is at twelve-year lows. This is mostly for good reasons; but some Japanese companies that compete effectively all over the world -- like Canon, Fuji and Sony – are attractive.

The most interesting stories are in Latin America. Mexico, in particular, is entering a new era. President Fox, whose recent election ended a long and dismal epoch of Orwellian repression in the name of the Revolution, has demonstrated a clear commitment to ending centuries of discrimination against Mexico's indigenous Native American population. He has moved forcefully against the endemic corruption of his country's police, army and judiciary. And he has launched an assault designed to remedy Mexico's classic failure to collect sufficient tax revenues to fund necessary social programs. All of these efforts are enmeshed in a program designed to build a model of development different from the so-called Washington Consensus. I have markedly increased the portion of portfolios devoted to Latin America in general and Mexico in particular.