

SARS, Infectious Diseases and Their Economic Consequences

This report consists of two parts. First, we shall discuss some peculiarities of infectious diseases, and their economic consequences. Then, in the second part, I have the pleasure of reprinting an essay by Fred Sheehan. Fred has worked in the institutional money management field for 15 years, including over a decade of writing market commentary. He came to see that he could not influence clients' decisions and that writing to them was not productive. He wrote in the October 2002 issue of the *Gloom, Boom & Doom Report* about the inability of institutional money managers, and their consultants and clients, to escape the trap of continuing to invest the way they have always invested, no matter what their convictions. Here, he writes about the difficulty of reaching investors who might consider taking a contrarian position, but who are only faintly aware that opposing views exist. He writes here in a private capacity, as someone who is trying to understand how to reach this audience, whether individual or institutional, which is a problem that many GBD report readers may share.

INTRODUCTION

Although I am not an epidemiologist, the subject of plagues and epidemiological diseases such as the Spanish flu, Hantavirus, Machupo, BSE, Lyme disease, Lassa fever, HIV/AIDS, Ebola, Ross River virus, Japanese encephalitis, bird flue, mad cow disease, and, more recently, Severe Acute Respiratory Syndrome (SARS) has always captured my interest. A few years ago, that interest led me to read the historian William McNeill's highly informative book,

Plagues and Peoples (Doubleday, 1977), where he focuses on how infectious diseases have affected the course of history and economics. Lately, the subject has been on my mind because it seems to me that some parallels exist between modern warfare, the proliferation of terrorism, and the nature of new pandemics. When one considers that today's superpower, the United States, has such an overwhelming technological and quantitative superiority in its weapons arsenal that — with the exception of Russia, China, and a united Europe — no other country would have even a small chance of victory in a traditional military conflict, it is not difficult to see why terrorism and dirty war tactics are resorted to in the face of such superiority.

Similarly, modern medicine has been so effective in reducing previously fatal diseases that the only way for disease-causing organisms to survive is to undergo a process of adaptation and adjustment to their environment. As an example, the plasmodium falciparum parasite, which is one of the most effective malaria-carrying parasites in terms of infecting people, has undergone four mutations since it was first discovered early last century. The latest mutation, which emerged a few years ago in Thailand, is particularly alarming, because it shields the parasite from SP, a mixture of sulphonamide and a pyrimethamine, which is one of the most affordable and widely used medicines in Africa. Since this deadly, mutant strain of malaria has now arrived in Africa where 90% of the world's estimated one million malaria-related deaths occur each year, scientists are terrified that a massive new malaria epidemic could spread.

In fact, medical experts have been playing cat and mouse with falciparum for years. This one-celled protozoan hitches a ride in the saliva glands of a female mosquito and enters a person's body via a mosquito bite. Moreover, if a mosquito bites an already infected person, it picks up the parasite and passes it along when biting its next victim. Originally, chloroquine, derived from quinine, was extremely effective against the disease, until resistant strains emerged in the 1960s. Newer drugs were then developed, but they were principally based on the original quinine molecule, which could easily be overpowered by the rapidly mutating falciparum. In the meantime, Chinese scientists tested traditional medicines as a cure and identified quinghaosu (pronounced 'king how shu'), a 2,000-year-old fever cure — known as sweet wormwood — as being effective in the treatment of the new strain of malaria. They extracted from the plant artemisinin and devised a water-soluble form of it, called artesunate, which became extremely successful in the fight against malaria in China, where the annual number of infected people has declined from several millions in the 1970s to fewer than 100,000 at present. According to epidemiologists, artemisinin — or, in the form of tablets, artesunate — acts like a bomb. Artemisinin has two oxygen atoms, which break apart when they encounter iron. Since the malaria parasite lives in a person's red blood cells, which are rich in iron, once the artemisinin molecule encounters those cells it explodes and releases lethal toxins that destroy the parasite. Quinghaosu has also proven effective in preventing the spread of malaria, because mosquitoes that bite malaria

patients who have been treated with it don't pick up the parasite for further transmission with the next bite! The problem, however, is how to get these new drugs to Africa, where many impoverished countries are ill-equipped to pay for artemisinin, which is effective against the new strains of malaria but is ten times more expensive than the by now largely ineffective chloroquine.

Another parallel to warfare is the following. Microparasites such as viruses, bacteria, or multi-celled creatures depend on finding food in animal or human tissues that are suitable for sustaining their lives. Some microparasites kill their host after a brief period, or they may themselves be killed by immunity reactions inside the host's body. Other microparasites, however, achieve a more stable relationship with their hosts, as the infection, while absorbing some energy from the host, does not threaten the host's normal functioning and survival. According to McNeill,

... prolonged interaction between human host and infectious organism, carried on across many generations and among suitably numerous populations on each side, creates a pattern of mutual adaptation which allows both to survive. A disease organism that kills its host quickly creates a crisis for itself, since a new host must somehow be found often enough, and soon enough, to keep its own chain of generations going. Conversely, a human body that resists infection so completely that would-be parasites cannot find any lodgment, obviously creates another kind of a crisis of survival for the infecting organism.... Optimal conditions for host and parasite occur, often though not necessarily always, when each can continue to live in the other's presence for an indefinite period of time with no very significant diminution of normal activity on either side.

Above I mentioned the plasmodium falciparum parasite, which feeds on the mosquito's tissues but

neither affects its life nor reduces its activity. The biological reason for this is quite simple. If the plasmodium wants to reach a new human host, the mosquito carrying it must be strong enough to fly normally and carry the malaria-causing parasite. Conversely, a sick and weak human being does not interfere with the life cycle of the parasite. Therefore, according to McNeill, it is not surprising that malaria, which has been around since antiquity, can be harmless to mosquitoes while still preserving its malignant effect on people.

In warfare, it was never the goal of the conquerors (the parasite) to totally destroy their opponents, but rather to feed on or take advantage of their opponents' resources, which may vary from enslaving people and taking away the female population, to taking control of part of the opponent's agricultural or mineral (or oil) production, while leaving behind sufficient production to enable the plundered people to survive and to continue to feed the conquering "macroparasite". According to McNeill, one can think of most human lives as being

... caught in a precarious equilibrium between the microparasitism of disease organism and the macroparasitism of large bodied predators, chief among which have been other human beings.... Disease immunity arises by stimulating the formation of antibodies and raising other physiological defenses to a heightened level of activity; governments improve immunity to foreign macroparasitism by stimulating surplus production of food and raw materials sufficient to support specialists in violence in suitably large numbers and with appropriate weaponry. Both defense reactions constitute burdens on the host population, but a burden less onerous than periodic exposure to sudden lethal disaster.

Another point to consider is that some infectious organisms must accommodate themselves to more than one host. As an example, the

deadly Nipah virus, which resulted in the deaths of more than 100 pig farmers in Malaysia in 1999, may have jumped from bats to pigs before infecting humans. Of the more than 300 Malaysian bats that were tested, it was found that 20 had antibodies to the Nipah virus, which meant that they had been infected with the virus, but that their immune system had mounted a defence against it. (No other animal specie had antibodies to the virus.) In Australia, the Hendra virus had been carried by fruit bats. The farm workers who fell ill in Malaysia had most likely breathed in or ingested fine particles that had been coughed up by Nipah-infected pigs. The Nipah outbreak came to an end when the Malaysian government ordered the army to shoot, bludgeon or simply bury alive more than a million pigs, or about half of the country's pig population. (The biggest killer in the 20th century, along with HIV/AIDS, was the Spanish flu of 1918, which killed more than 20 million people worldwide. It is thought to have originated in southern China. The Spanish flu virus — so called because the king of Spain fell ill at the onset of the epidemic — was first identified in Kansas, in the United States. Unlike the HIV virus, it jumped species twice; first from birds to pigs, where its genes were delicately reshuffled, and then to man. It spread rapidly to the United States as a result of immigration, and to Europe as thousands of Chinese labourers were sent to the Western front to dig trenches during World War I.)

What is important to understand is that if the non-human host is more relevant to the parasite, the adaptation towards a stable biological balance will concentrate on adjustment to the non-human host. These infections, when transferred to people, can therefore remain violently destructive to human life. According to McNeill,

... this was the case with the bubonic plague, for instance, since *Pasteurella pestis*, as the parasite is called, normally infects rodents and their fleas and only occasionally invades human bodies. In communities of ground-burrowing

rodents, the infection can endure indefinitely. Patterns of infection and recovery, often involving more than one species of rodent host sharing the same burrows, are very complex and not fully known. Among some of the burrowing rodents that live in large underground “cities”, however, an encounter with *Pasteurella pestis* is a childhood disease much as smallpox or measles used to be among human city dwellers above the ground. Accommodation, in other words, between rodent host and this parasitic bacillus has achieved reasonably stable patterns. It is only when the disease invades previously unexposed rodent and human populations that extraordinary consequences ensue, such as those which made visitations of bubonic plagues especially awful to our ancestors.

In fact, most, or probably all, infectious diseases throughout civilisation were transferred from animals to human populations. Since contacts are closest with domesticated animals, many of mankind’s common infectious diseases have recognisable affinities with diseases that affect domesticated animals. (Measles is probably related to rinderpest and canine distemper, while smallpox is connected to cowpox, and influenza is shared by humans and pigs.) According to Thomas Hull, author of *Diseases Transmitted from Animals to Man* (Springfield, Illinois: 1963), the diseases shared by human populations with domestic animals number as follows:

Poultry:	26
Rats and mice:	32
Horses:	35
Pigs:	42
Sheep and goats:	46
Cattle:	50
Dogs:	65

Obviously, the incidence of shared infections increases the closer the intimacy is between man and animal. Cattle, horses, pigs, birds, rabbits, rats, sheep and bats (and, possibly, cockroaches in the case of SARS)

have been chronic bearers of infections, which can be traced to the conditions of their natural existence. Since these animals exist in large numbers, they provide the ideal conditions for bacterial and viral infections to become endemic because, in a sufficiently large population, there is always another susceptible and available host to perpetuate the chain of infection. Therefore, most viral and bacterial diseases became endemic among wild herds of animals without provoking serious symptoms. These infections in animals are similar to our childhood diseases, relatively harmless; but when they are transferred to human populations, they can become virulent since human bodies, in contrast to the population of their accustomed hosts, lack — at least initially — any acquired immunities to the new invaders. Eventually, however, viral and bacterial infections that successfully transferred to human populations established an ongoing relationship with their new host — usually after a more or less catastrophic initial adjustment. How these adjustment periods can change the course of economics and history will be discussed below.

THE IMPACT OF INFECTIOUS DISEASES ON SOCIETIES

Although SARS does not appear to be as contagious as the 1918 Spanish flu (its mortality rate is, however, higher), the current pandemic shows that in future new infectious diseases will be increasingly a global problem. Modern air transportation can spread a disease all over the world within a very brief period of time. In other words, as was the case with food-borne epidemics, antibiotic-resistant bacteria, insect-borne diseases such as the West Nile virus and AIDS, an outbreak anywhere in the world is soon a threat everywhere. Moreover, as we experienced with the Hong Kong bird flu in 1997 (when more than a million chickens were slaughtered), the dense mingling of humans, wild and domestic birds, and livestock (principally pigs) in southern China provides a natural breeding ground for genetically new pandemic flu strains that will continue

to threaten Hong Kong, due to its proximity to China and its porous border, which around 400,000 people cross each day. (The number of people crossing the border has recently fallen by 50%.)

The current SARS outbreak is a devastating blow to the already fragile Hong Kong economy, as well as to other Asian economies where tourism makes up around 10% of GDP. In Hong Kong, retail sales have tumbled by 50%, and hotel occupancy rates are running at around 20%! Restaurants and bars are suffering, airlines are reducing the number of flights into and out of Hong Kong as well as around Asia, and a very large number of conferences and conventions in the region have been cancelled. In fact, the SARS scare (whether justified or not) has affected the Asian economies to a far greater degree than the war on Iraq, which hardly affected the apolitical Asian populations. That infectious diseases can influence economics and geopolitics is hardly news, since there have been a number of instances in the past when plagues shaped the course of history. I am not suggesting that the current SARS scare will have a long-lasting and major impact on the global economy, but if this highly infectious disease spreads unchecked, or another even more virulent infection emerges sometime in the future (as is likely, according to some experts), then we should at least be aware of the risks involved.

I should like to point out, in this respect, that in one of its very rare moments of intellectual glory, the *Far Eastern Economic Review* (owned by Dow Jones & Co.) published, in June 2001, an article by David Lague entitled “A Deadly Flu Ready to Strike”. The article made the point that there are three prerequisites for a real viral pandemic in humans: a population without enough exposure to develop immunity; sufficient virulence to lead to deadly disease; and the ability to jump easily from person to person. Referring to the 1997 bird flu, Lague explained — quoting Graeme Laver, a retired professor of virology and a pioneer in establishing that influenza strains infecting humans

originate in animals — that the bird virus only scored two out of three, since it did not spread from person to person. The decision to kill all the chickens in Hong Kong may have averted a “global tragedy”, because if the virus had “learned to transmit between people, it would have killed millions of people”. Well, now the SARS bug has learned how to spread among humans and, therefore, serious future pandemics should certainly not be ruled out. According to Graeme Laver, “this is a dress rehearsal for a real pandemic. If it was a lethal flu, there would probably be hundreds of thousands of people dead by now.” (See *Far Eastern Economic Review*, June 7, 2001 and March 27, 2003.)

An infectious disease that had a lasting impact on the global economy was the Pest (also called the Oriental Plague or Black Death) caused by the above-mentioned *Pasteurella pestis*. It was primarily a disease of rodents, and epidemics in human beings originated through contact with infected rodents, most commonly rats or their fleas. The disease in man had three clinical forms: bubonic, characterised by swelling of the lymph nodes; pneumonic, in which the lungs are extensively involved; and septicemic, in which the bloodstream is so strongly invaded by *Pasteurella pestis* that death ensues before the bubonic or pneumonic forms have had time to appear. It appears that the plague had already made its appearance at the time of the Philistines in the 11th century BC. It reappeared in the sixth and seventh centuries AD in Europe and then, with great virulence, in the 14th century (as the Black Death), which most likely had originated in Mongolia and travelled with the overland caravan movement across Asia and reached its peak under the Mongol empires founded by Genghis Khan (1162–1227). At the peak of its power, the Mongol empire extended across China and almost all of Russia, as well as Asia, Iran and Iraq. A vast communications network, with messengers capable of travelling 100 miles per day and slower caravans and armies moving across the enormous expanse of the empire, knitted the empire together. But along with this movement of people and horses, it is

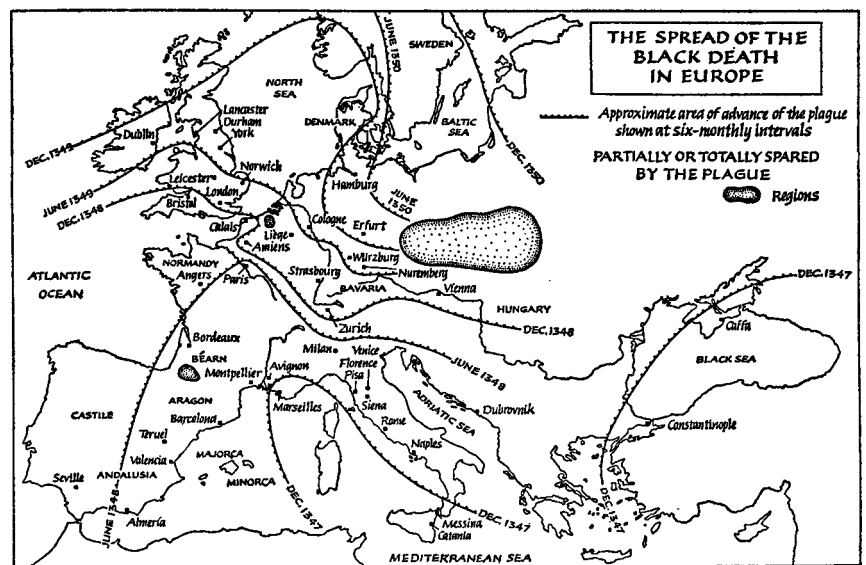
believed that burrowing rodents, which had become carriers of the *Pasteurella pestis*, reached parts of China and eventually Kaffa in the Crimea. (The Mongols probably brought back infected rodents from their invasion of Yunnan and Burma in the 13th century.)

The Black Death, after having decimated a large portion of the population of China (in 1331, an epidemic in Hopei is believed to have killed 90% of the population) and Turkistan, made its first serious appearance at the Genoese port city of Kaffa in 1346, when it was besieged by the army of the Mongol leader, Kipchak khan Janibeg. The plague wrought havoc among his troupes and compelled his withdrawal, but not before he had catapulted plague-infected corpses into the city in order to infect the population. (This is the first use of “biological weapons” in the history of warfare, that I am aware of.) From Kaffa, the plague spread rapidly to Mediterranean port cities on Genoese ships and then inland to the north of Europe (see Figure 1). It moved at high speed from city to city (Sicily suffered in 1347; North Africa, Corsica, Sardinia, Italy, Spain and France in 1348; Switzerland, France, and southern Germany in 1348; and England in 1349) and was halted neither by prayers, and all sorts of

alchemy and physics, nor by the mass burning of Jews, who were popularly believed to have spread the plague by poisoning the wells. Contemporary archives and detailed research carried out about mortality rates in England suggest that Europe’s population declined by approximately 30% between 1346 and the end of the 14th century. (According to J. C. Russell in *Late Ancient and Medieval Population*, Europe’s population had declined by 40% at the end of the 14th century.) Moreover, by 1500, the population of the whole area including Europe and North Africa was still markedly lower than it had been just before the Black Death, more than 150 years earlier. It was only in 1550, more than 200 years after the outbreak of the pest at Kaffa, that Europe’s population again reached pre-plague figures.

In China, it is estimated that the population declined from 123 million prior to the Mongol invasion in 1200, to only 63 million at the end of the 14th century following the final expulsion of the Mongols from China and the establishment of the Ming Dynasty in 1368. It should be noted that, in general, cities with a dense population suffered far more than the countryside and dry areas in Europe. In addition, following the outbreak of the plague in 1346, numerous recurrences took place in 1361–1363, 1369–1371,

Figure 1 The Spread of the Black Death in Europe, 1346–1350



Source: William H. McNeill, *Plagues and Peoples* (Doubleday, 1977)

1374–1375, 1390 and 1400, and then with less frequency after the 15th century. (Venetian statistics show that in 1575–1577 and 1630–1631, a third of the city’s population died of plague.) The Great Plague of London occurred in 1665 and was followed by the Great Fire of 1666, which accelerated the replacement of thatch roofs by tiles and so reduced the habitats of rats and fleas and therefore, also, the incidence of the plague epidemics. (The last great plague in the western Mediterranean occurred in Marseille in 1720–1721.)

One can only imagine the economic impact of a 30–40% decline in Europe’s population between 1346 and the early part of the 15th century, and of an even greater fall in some of Europe’s thriving commercial centres. A declining population must have put severe pressure on property prices, and considerably reduced trade and commerce. Moreover, grain prices collapsed by close to 70% between the start of the 14th century and the end of the 16th century, as demand for food diminished. However, there were also beneficiaries of the plague. Due to a contracting population, labourers were in short supply, which meant that real wages rose. Port cities introduced the quarantine regulations whereby ships arriving from any port suspected of plague had to anchor for 40 days in a secluded place and without physical communication with the land. This practice was a heavy burden for trade and was not particularly effective, as rats and fleas could usually still make their way to shore. In addition, I suppose that consumer confidence must have suffered a serious blow in times of plague outbreaks, which would have further reduced consumption, travelling, and visits to crowded places such as inns and fairs. It isn’t hard to imagine what would happen if in today’s economic environment, a “mild” infectious disease were to reduce the population of a city, a region, or, given the intense connectivity between the various world economies, the entire world by, say, 5% — let alone 30–40%! And while I certainly would not wish this to happen to humanity, it would show just how ineffective is Greenspan’s and Bernanke’s economic “wisdom”, which seems to rest on the

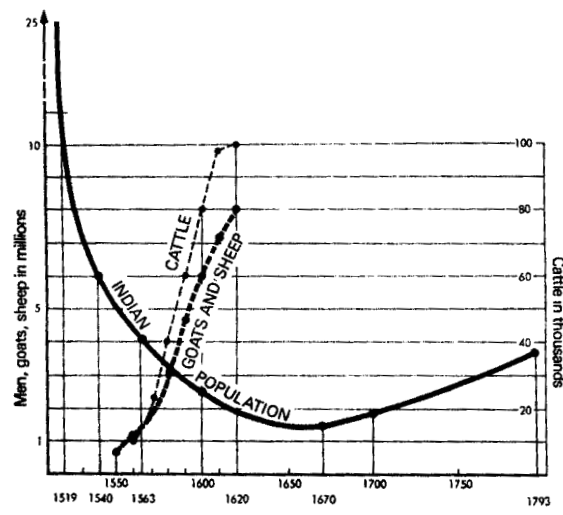
belief that all economic ills can be cured by monetary policy measures!

The second instance when infectious diseases had a fatal and lasting impact on the world was when the conquistadors sailed to the Americas at the end of the 15th century and inaugurated the free exchange of infections between the Old World and the New. According to William McNeill, the inhabitants of the New World were not bearers of any serious new infection that was transferable to the European and African populations that intruded upon their territory, while the sudden confrontation with the long array of infections which European and African populations had encountered over time provoked a demographic catastrophe among the Indian populations of North and South America. (Contrary to popular belief, syphilis did not originate in the Amerindian population, but was related to the spirochete of yaws, which enters the skin as a result of direct skin-to-skin contact with an already infected person. When, however, woollen textiles and better clothing proliferated during the Middle Ages, skin-to-skin contact diminished and the spirochete-causing yaws was faced with a crisis of survival. It then mutated and found a new path of infection within the body from another port of entry. The infection caused by a spirochete-causing yaws, which medieval doctors would have diagnosed as leprosy, is indistinguishable from the organism that causes syphilis.)

The first encounter of the Americas with European infectious diseases occurred in Hispaniola, when smallpox attacked the Indian population and almost wiped them out. From there, smallpox travelled with the Spanish soldiers who joined the expedition by Cortez in 1520 and infected a large portion of the population in Tenochtitlan, which allowed Cortez to capture the capital. From Mexico, smallpox spread to Guatemala and to the Incan empire. The magnitude of the decimation of the Amerindian population brought about by infectious diseases carried by the European voyagers and conquerors has been underestimated in the past. However, it is now a fairly well-established fact that, when Columbus landed in Hispaniola, the Amerindian population numbered around 100 million, with 25–30 million assignable to the Mexican and an equal number to the Andean civilisations. However, from the time of Cortez’s conquest to about 1568 (less than 50 years), the Mexican population had shrunk to around three million people, one tenth of the pre-conquest era figure (see Figure 2). According to some epidemiologists, the decline in population continued for another 50 years or so, reaching a low point of around 1.6 million by 1620. Thereafter, a very slow recovery in the population began, which after 1800 accelerated. But it was not until well into the 20th century that Mexico’s population exceeded the pre-Cortez conquest peak. According to the historian Fernand Braudel, “what is quite certain

Figure 2
Indian Population in Mexico, 1519–1793

Source: Fernand Braudel, *Civilization and Capitalism*, Volume I (Harper & Row, 1979)



is that the European Conquest brought a colossal biological slump to America, perhaps not in the ratio of ten to one but certainly enormous and quite incommensurate with the Black Death and its concomitant catastrophes in Europe in the disastrous fourteenth century” (Fernand Braudel, *Civilization and Capitalism*, Harper & Row, 1979).

The catastrophic reduction in the population of pre-Columbian Amerindians also occurred in other parts of the Americas and continued into the 20th century. According to McNeill, “disaster is to be expected whenever some previously remote and isolated tribe comes into contact with the outside world and there encounters a series of destructive and demoralizing epidemics”. McNeill illustrates this point by describing how, in 1903, a South American tribe, the Cayapo, accepted a single missionary who apparently made every effort to safeguard his flock from the evils and dangers of civilisation. When he arrived, the tribe numbered between 6,000 and 8,000 people; yet, by 1918, only 500 survived. By 1927, only 27 were alive; and in 1950, just two or three people who traced their descent from the Cayapo still existed. And this was despite every effort being made to shield the Cayapo Indians from disease and other risks arising from contact with the outside world!

CONCLUSIONS

The reader may be wondering what infectious diseases have to do with financial markets. You might be thinking that, while the above account of the history of infectious diseases is all very interesting, what does it have to do with whether the stock market will rise or fall next week, or over the next 12 months? I believe that investors who focus strictly on economic and financial statistics may not be sufficiently informed to make sound judgments about the course of stocks, bonds, real estate and commodities in the years to come. Last month we looked at war cycles and at the possibility that increased tensions would have an impact on the valuation of stocks (see GBD report of March 29, 2003, entitled “Of War Cycles and

their Economic Consequences). In the meantime, the battle at Baghdad has been won, but what about the chaos that has ensued?

Another question surrounds the Kurds in northern Iraq. If there was ever a lifetime opportunity for autonomy or their own independent state, it is now. My advice to the Kurdish people would be to immediately declare independence and the foundation of the Republic of Kurdistan, with Kirkuk as its capital. Naturally, this would not be acceptable to the Turks or, for whatever reason, the Americans. However, I don’t see why Turkey should meddle in the internal affairs of Iraq, or why the freedom-loving Americans, whose only and sincere concern, they are at pains to tell us, is the well-being of all people in the best of all possible worlds, would not support an independent Kurdistan! Moreover, I have some advice for the world’s most useless organisation — the United Nations. Hands off and stay out of Iraq! Why anyone would wish to get involved in such a colossal mess is beyond my understanding. Also, if the world now has such a strong anti-American bias, the UN should be more than happy to let the US and Britain solve the Iraqi mess on their own, because it will ensure that both Mr. Bush and Mr. Blair won’t be re-elected.

As an aside, I shall never forget a French member of the Foreign Legion whom I met, in the 1960s, while on a boy-scout excursion to Corsica. He had fought in 1954 in Vietnam at Dien Bien Phu and served during the Algerian uprising prior to Algeria gaining independence in 1962.

According to him, his regiment was relieved when they left Vietnam. Every Legionnaire was looking forward to being stationed in Algeria, which they thought would be like a paradise when compared to the tough campaign and eventual hellish defeat they had experienced in the Far East. However, this proved to be an illusion. According to him, the Arab resistance in Algeria turned out to be far worse than anything they had experienced in Vietnam, because the French troops in Algeria never knew who was friend or foe. They incurred tremendous casualties in continuously recurring

ambushes, acts of sabotage, and raids on their camps. So, good luck to anyone who wants to stay in Iraq!

To return to the subject of infectious diseases and their economic consequences, I was recently in transit at Hong Kong’s airport and was shocked to find it like a ghost town. I am not exaggerating! There were hardly any passengers in this usually hyperactive and crowded place! And it is no wonder: as at the time of writing, 164 flights per day have been cancelled. Cathay Pacific, the Hong Kong-based airline, is presently carrying just one-third the passenger numbers of a year ago. Many hotels and restaurants are, for all practical purposes, empty. Unless the SARS pandemic is eliminated immediately, more economic hardship is likely to follow. Under normal conditions, one might be tempted to buy tourism-related shares in Hong Kong and the rest of Asia, since they have been sold off following the SARS outbreak. However, if SARS continues to spread and leads to further travel restrictions, then lower prices are only a matter of time. I might add that, in a bizarre twist of events, China (where SARS originated) has banned its citizens from travelling to Singapore, Malaysia, and Thailand in retaliation for these countries’ accusations that SARS started in China! For destinations like Thailand, Singapore, and Hong Kong, where tourism and business travel account for a large proportion of their economies, the effects of SARS or any future infectious disease can be catastrophic and may have a long-lasting impact on the valuation of real and financial assets. This would particularly be true for Hong Kong as its economy is gradually integrated into the southern China region, which is, and will remain for a long time, the epicentre of infectious diseases. **Therefore, while I am tempted to use the present weakness in Asian hotel and airline companies as a buying opportunity because of their very favourable growth potential in the long term, I am equally very concerned that, the Middle Eastern situation aside, we are dealing here with a very negative development for the overall valuation of equities.**

An Investor's Manifesto

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"Bonds beat stocks, they beat losing money and they beat the living daylight out of money market funds. People have lost so much money they're willing to maintain their principal at a modest rate of return."

Marilyn Cohen

President of Envision Capital Management
Wall Street Journal, March 11, 2003, p. 1

Please excuse the melodramatic and misleading title. High hopes spawned this essay, but I realise that, like Sisyphus, I will never achieve my objective. That is, to warn off the millions who read Cohen and invest as she directs. It is time the public stopped listening to professional investment advice of the bull market persuasion. Their predictions are deadly, and simply because they've been wrong for so long does not mean they are due to be right. No. It is just the opposite. It is because they have been wrong for so long that they will continue to lose their customers' money until there is no money left.

Cohen's errors make plain one of the dirty little side deals of the Information Age: information is not knowledge, nor is it understanding. First, bonds promise no protection of principal. They trade in a market in which prices go up and down all day. Second, bond funds *have* beat the living daylight out of money market assets, but that is the reason they probably will not do so now. (Quickly now, some bond math. Bond prices go up when yields go down. The two-year Treasury yields about 1.6%. That means; those who hold on to the bond until it matures will receive 1.6% a year (compounded) from the semi-annual coupon payments and the return of principal at maturity. For the five-year Treasury, the total return is around 2.9% a year, for the next five

years.) Is that "beating the daylight out of money market funds"? No. So, third, Cohen is presuming that bond prices will keep rising (which causes yields to fall — a certainty probably not understood by most of Cohen's readers) and she may be right. But, is making the presumption that the two-year Treasury will fall to a 1.0% yield an attractive investment? Fourth, she may be talking about agency or corporate bonds, but if so, there is a great deal of risk today that some may tumble 30% in a day. Funding is erratic; we can read about companies every day that are desperately trying to line up loans. American Airlines, Ford, and Philip Morris are recent miscreants. Fifth, the Treasury market is obviously the latest bubble. Chances are investors today will lose far more money than if they hold assets in a money market fund or a bank account

Now, maybe you see my problem. Cohen is quoted on the front page of the *Wall Street Journal*. The story is written in a way to affirm what most investors sort of know, or think they know. She echoes what they are hearing elsewhere and to repeat, she holds forth on the front page of the *Journal*. One reason she is quoted is that of simplicity. She helps a reporter shorten a 600-word article by lending him a voice of authority. (As always, there is the possibility that she was misquoted, but that doesn't interest me here. I am addressing the advice most people use to make their investment decisions.)

Where might we find investment converts? Identifying them is the problem. I use "intelligent" person, but that simply fills in the blank. Intelligent people often think they know it all; less intelligent people may be more practical, recognise they don't know what they're doing, weigh competing views of the market, and won't feel so embarrassed at the recognition that they blew it.

Instead of IQ, a useful distinction is the mental activity of one's mind.

What follows is an amazing contribution to the growing docility of the human race. Some weeks back, the *Wall Street Journal* published a story about one Henry Camferdom. Mr. Camferdom received advice on how to protect the US\$70 million profit on the business he had sold. Ernst & Young offered a tax shelter that Mr. Camferdom could not resist. He also couldn't evaluate it, since he had to "sign papers agreeing not to tell anyone how the strategy worked". He "was not allowed to take the marketing materials with him to study later. But he says he signed on the firm's reputation and the advice..." It appears he bought a tax sham and the IRS does not like it.

Dismissing the inert, we move to the supple-minded. This is from a letter written by Winston Churchill to a colleague who accused Churchill of being old-fashioned.

I think we differ principally in that you assume the future is a mere extension of the past whereas I find history full of unexpected turns and retrogressions. The mild and vague liberalism of the early twentieth century, the surge of fantastic hopes and illusions that followed the armistice of the Great War have already been superceded by a violent reaction against Parliamentary and election procedure by the establishment of dictatorships real or veiled in almost every country. Moreover the loss of our external connections, the shrinkage of our foreign trade and shipping brings the surplus population of Britain within measurable distance of utter ruin. We are entering a period when the struggle for self-preservation is going to present itself with great intensity to thickly populated industrial countries. In my view, England is now beginning the period of struggle and fighting for its life.... Your ideas are twenty years behind the times.

Martin Gilbert, the author of this Churchill biography, then writes: “The times were indeed moving rapidly; on April 7, [1933], Hitler formally imposed Nazi rule on each of the German states, ending their century-old autonomy.” Churchill was the world’s worst investor, but he got the important thing right. It is this agility of thinking and mental activity that probably are requisite for saving investors before they have nothing left to save.

Particularly troublesome in Cohen et al. is the timing — today. We live in a moment of heightened market aberrations — aberrations because they occur once in a decade, or in a generation. That is, each on its own reaches such a level (very high or very low) infrequently; that all turned out for this morning’s reveille is extraordinary. Not much has been written on this coagulation; I will try to make sense of it here.

Another reason for writing now is the misleading, disingenuous, or ignorant nonsense that the public hears day after day. One very wrong and repeated pronouncement is: “The war fears ... the national anxiety ... it’s put everything on hold until Iraq is behind us.” So say the Authorised Suits on Wall Street, or on CNBC, or from most anyone else who talks about the markets. This manifesto faces impossible odds at penetrating the national idiom, but let’s have a go of it. Having disappointed those who thought this essay would unlock the dungeon door that separates investors from common sense, a look at *how* the typical investor thinks may light the imagination of readers who can then write a successful manifesto.

Here’s the agenda: (1) a juxtaposition of examples: worthwhile advice vs. the regurgitated slop; (2) an attempt to make sense of the market aberrations; leading to (3) a stab at understanding how investors think, and a stab at understanding the influences under which investors think; and (4) a look at the fast-changing investment world and how this may shift our view of incidents.

I will start with a rebuttal directed at the financial press and their echo chamber on Wall Street. Whether

intentional or not, they are incapable of giving money-saving advice given their incapacity to understand the past decade. Particularly enraging was a recent, front-page headline in the *Wall Street Journal*: “War Fears Send Markets Down; Treasury Yields Hit 44-Year Low.” The war talk has undoubtedly forestalled business plans, but even if Hussein were governor of Idaho now, our economic problems are monumental.

Another problem with wars is the erratic emotion that swirls around. It is often not easy to know from one hour to the next what’s in store. From his *History of South Africa*, Frank Welsh’s description of the London bond market at the beginning of the Boer War:

In 1899 there was no possible threat to the gold supplies — the Bank of England was the customer who fixed the world price — *except* in the event of war. As war appeared inevitable the City became jittery. Consols fell to their lowest since the [Jameson] Raid; the bank rate went up suddenly ... from 3½% to 4½. Once the war was declared, however, the Stock Exchange was swept by patriotic fervor, exhibited by the beating of a pro-Boer member on the floor of the Exchange.

Among other lessons, we have a *major* diversity-training problem here.

Further nonsense: Todd Clark, of Wells Fargo Securities: “Not only is this Iraq uncertainty keeping investors away from the market, but it is also hurting corporate America.” Of course, there is some truth to that, which is why it is assumed to be true. But war fears really miss the point. These economists or whatever they title themselves (titles being very important in the money business, since they avert questions from a jargon-free and timid — or intimidated — public) jabber on about productivity growth or new car sales or consumer sentiment or declining sales in the rickshaw market, blah, blah, blah. Almost everyone I speak to who is not in the money business doesn’t understand what the Title Bearers are talking about. (Those in the business who have anything useful to teach

couldn’t interpret either. They don’t listen at all.) We hear broad predictions based on speculative assumptions that rely on highly suspect percentages.

Conventionally minded analysts draw amazingly precise interpretations from opaque data (say, the same-store sales report) and will surely reverse their market prediction tomorrow if the next (say, GDP figure) will help their latest (but easy to revise) market prediction. According to Paul Krugman, two years ago, the Congressional Budget Office (CBO) projected a US\$5.6 trillion federal budget surplus over the next ten years. Now, the CBO predicts a US\$1.8 trillion deficit through 2013. We could have fired the entire Congressional Budget Office apparatus and obtained a far more accurate prediction if a single person looked at the incredible rise in capital gains tax receipts. The general trend of household net worth from stock market gains rose from US\$2.8 trillion in 1995, to US\$2.5 trillion in 1996, to US\$3.8 trillion in 1997, to US\$3.3 trillion in 1998, to US\$4.75 trillion in 1999.

So armed, the average Denny’s burger chef would have seen that the surpluses were never to be. Or this: the US states’ pension plans have swung from a US\$112 billion surplus in 2001 to a US\$180 billion deficit in 2002. Did many (still addressing the average *Wall Street Journal* reader and believer) stop and ask how did this enormous mountain of money grow so quickly? If they spent five minutes hunting for an answer, doubts to the future would lie exposed.

I think we are at a similar point today. During the (ongoing) bubble, hotshot ideas attract massive inflows which, in time, become outflows. First was the Internet, then telecom (which locked arms with the disappearing corporate bond market), then all of technology, then these avalanches of federal, state, and municipal debt sprung up from nowhere (at least to those busy spending the huge and unanticipated tax receipts), and next it will be us. Once the housing market goes, the means of expansion is the Collateralised Debt Obligations (CDOs) and Collateralised Bond Obligations (CBOs) market. CDOs

are a collection agency of every debt owed by anyone that the lender is willing to sell. Investment banks corral thousands of these debt claims and turn them into CDOs, a bond. The CDOs are impossible to understand in detail, so they are mathematically modelled to predict how they will behave in aggregate. These jigsaw puzzles include such loans as houses, cars, boats, motorcycles, and ... facelifts. Yes, in Doug Noland's February 28 *Credit Bubble Bulletin* (free of charge on the Prudent Bear website), we learned that facelifts are now being packaged into CDOs and the receipts from those loans will pay the bond buyers. So, for those asking whether this credit bubble can possibly go on, yes, at least for awhile. If facelifts, why not dental bills, barber shops, the idyllic lemonade stand? A last second addition: funeral home receivables are being packaged into a bond by Dignity Finance (in Britain).

The media holds a special cache that seems to mesmerise the public, a public that does not understand what they are told, but is afraid to disagree, at least with their own money. Let's call this a problem of abstraction. Nothing "they" discuss is materially real, touchable, and edible; there is no physical form to these brainstorm. This leads to a discussion about models and projections and data mining, but that's enough. The investor is not sure how the soothsayers arrived at their conclusions, which is just fine with the false prophets.

What follows is a typical economic outlook, recorded here the way an average reader's mind will comprehend it. You will note the limited attention span as the mind wanders after the initial barrage of data and data interpretation.

The latest GDP revision confirms the 3.2% rise in productivity is understated. The GDP, formerly thought to be 1.6%, has been revised to a more robust 1.7%. The additional growth of the economy shows that consumers, while not quite as dour as the reading in July 1932, increased their spending by 1.6% (annualised, seasonally-

adjusted, undercooked, and marinated), which is particularly notable since Ford sold only eight cars in March. This, of course, highlights why average hours worked and non-durable goods spending veered in opposite directions, the former being a second derivative of the latter. The CBO considers this ample reason why the inflation rate always must remain a prime number. ... So, buy stocks.

Well, it's something like that. For me, trying to read such research calls to mind Keats' reaction when viewing the Elgin Marbles: "Mortality weighs heavy on me like unwilling sleep."

I will now quote from an analyst who writes about the real world. When Mary Meeker was "Queen of the 'Net'", holding daily TV interviews and signing ball caps, Fred Hickey was checking the shelves at Best Buy and Circuit City and asking the salesmen about their Christmas bonuses. Long before the rest of the world caught up, Fred told his readers that the stuff was sitting on shelves. The retailers couldn't sell it, and Dell was not a stock to own.

I turn now to Hickey's February 20, 2003, *High-Tech Strategist*. In the first paragraph, he explains the vacuity of thinking on Wall Street. I'll only add: they still don't understand why the market collapsed, so they won't understand what is required for a real recovery. In the second paragraph, he writes what we will not read in a general circulation periodical. As far as I know, Wall Street research is equally ill-prepared for such a discussion. Hickey plants a physical image in the mind of the reader. Of the here and the now. Of why this bear market is different from any that most of us have lived through. We are sinking under several trillion dollars worth (as carried on the balance sheet) of capital equipment that will never be used. The debt load is so great at every seam of the economy that companies cannot keep up with their debt payments, never mind investing in equipment that might find a new application.

From the *High-Tech Strategist*:

The stock bulls remaining in this market have never grasped how enormous the bubble of the late-1990s was. They've never understood just how great the imbalances were. They've never comprehended the vast amount of tech overcapacity created during the bubble period. For three consecutive years they've suffered compound double-digit losses in their favorite Nasdaq tech stocks as they've hung on to the notion that a rebound was imminent. There have always been excuses to explain away their incorrect bullish forecasts. If not for the 9/11 terror attack, the economy and the stock market would have recovered in 2001. If not for the corporate scandals (Enron, WorldCom, etc.) the economy and the stock market would have recovered in mid-2002. If not for the Iraq worries, the economy and the stock market would currently be booming.

However, when the war is over (hopefully quickly and successfully), the bulls will learn that the excesses generated during the 90s boom are still with us and will need further time to correct. There's still years worth of fiber optic capacity in the ground. Distribution channels (including EBay) are still littered with excess networking equipment such as switches and routers and gateways. A tiny fraction of the Internet hosting capacity that was built is currently used. Thousands of unprofitable, cash draining, start-up companies are still barely eking out an existence by living off funding received during the boom. There are too many wireless carriers with too much debt. Excess semiconductor foundry capacity is enormous and is exceeded only by the capacity of semiconductor equipment manufacturers themselves. There's so much DRAM manufacturing capacity that prices fall every day, yet even more capacity is being brought on line. There's a current glut in cell phone inventory, particularly at the low end. Retailers and resellers such as Tweeter Home Entertainment,

Circuit City, CDW Computer Centers, Insight Enterprises and even industry giant Wal-Mart have excess inventory that needs to be cleared. There are several weeks of excess inventory of PDAs, DVDs, and game consoles. There's too much automobile manufacturing capacity and a current glut of SUV vehicles. There's too much steel making capacity. There's too much capacity of almost everything worldwide.

That's it. That is our financial burden and will remain so for a long, long time. When the analysts coo about the "productivity miracle" (another sign of the times: miracles have been downgraded faster than Ford Credit), they are talking about assets sitting in the junkyard. *High-Tech Strategist* readers know that. There is no sign that the media conduits (the intermediaries between Wall Street and investors) have a clue. If they do, they aren't talking.

If only this was the extent of the problem. Far worse, the junk is still sitting on the balance sheet, labelled an "asset". The left side of the balance sheet is often rubbish. It doesn't help that the worst of these companies borrowed far too much and are facing long odds to pay back their debt. Nor does it help that corporations are making less money every day. Kurt Richebacher, in *The Daily Reckoning*, writes that profits, as a percentage of GDP, have fallen from 6.7% in 1997, to 4.3% in 2000, to 3% today.

To contrast again. Here are a couple of more forecasts from an article written in March 2003 on *CBS MarketWatch*. The writer, David Calloway, draws from the *Wall Street Journal* of January 18, 2000. Unfortunately, Calloway does not name his sources. Such is a form of etiquette for which he should be commended but this is a time when a higher public good can be served by identification, retribution, and humiliation.

Now the fun begins. Here we are on January 18, 2000: "The opportunity is so huge that you have to own (tech stocks)," said one analyst. "If you have to ask about valuation you can't afford

it." And: "It's a new world order," said the chief investment strategist at a well-known fund manager... The manager advised readers to buy shares of Cisco Systems, Intel, and Motorola at any price. "We see people discard all the right companies with the right people and the right vision because their stock price is too high — that's the worst mistake an investor can make."

The important lesson here is that those who are quoted — then, now, or in the twilight zone — will reflect the mood, the biases, the catch phrases, the implicit assumptions of the day. Today, we hear "The War" chorus, which, three years from now, may look as foolishly inaccurate as does the manager who loaded up on Cisco. (If he still has a job, he's probably still doing it.)

It should be obvious now that lower interest rates won't help in the least. Greenspan did more damage to the economy and destruction of families, marriages, college plans, and retirements than I thought possible in such a bureaucratic age. Those who say, "It's time for Bush to do something" are wasting their time. Bush would also be wasting his time even though he doesn't know that. Nobody around him understands the vast liquidation of capital assets that will turn many a prince into a pauper.

This ignorance can be inferred from the lack of public debate on how far US strength can go, which ends in ruin if you go beyond it. The assumption (since nobody raised the question) is that adding US\$75 billion to a US\$400 billion fiscal deficit is there for the taking. Since the dawn of time, a *sine qua non* of military campaigns has been the economic self-sufficiency of the protagonist. But today, it seems, deficits don't matter; access to foreign credit is there for the taking; just as long as that skinflint Greenspan doesn't starve the economy of dollars, as he did in 1999.

It may be worth a stroll through the minds of those who are highly regarded by the administration. "Highly regarded" may be wrong. More importantly, what they write below implicitly instructs government and think tank policy. These sages also influence readers of economic opinion. Presumably, subscribers who read

editorial pages are more reflective than those looking for the inside scoop on the ten hottest stocks.

A note to bears: many in the contrarian fraternity expect a reversal of opinion when the war is behind us. "The bulls will realise the folly of their advice, and so admitting, will awaken investors to the awfulness of the economy and the markets. Then we will see the long-anticipated capitulation."

Some will. Since most of what is written today (next paragraph) is as far-fetched as when the Politburo claimed the Russians had invented baseball, chances are they will carry their theories to the grave. The debates still rage over the Fed's loose money policy in 1927 and whether that led to the crash. That was over 75 years ago.

From Steve Forbes in the February 3, 2003, issue of *Forbes*: "The economy has sufficient liquidity for the first time since the late 1990s, as confirmed by the higher commodity and gold prices." From Lawrence Kudlow in a February 26, 2003, *Wall Street Journal* op-ed: "Falling prices from a shortage of money have robbed businesses of the pricing power... When gold descended in price between early 1997 and mid-2001, it signaled that the Fed was getting tighter with cash... the Bush plan requires a steady flow of new cash for true firepower. Simply put, more money will be needed to finance the creation of more goods." From a *Wall Street Journal* editorial on February 24 (titled, "Hurray for the Trade Deficit"): "[I]t can easily be argued that U.S. assets are in such demand, even with Treasury yields at historic lows and after three down years in the U.S. stock market, that Americans have to find \$1.5 billion a day worth of foreign goods just to spend all the money that is coming in." Steve Hanke wrote in the February 3, 2003, issue of *Forbes* that, "Our current account deficit is mirrored by surpluses elsewhere. A full 80% of the total surpluses globally come from countries beset by declining industrial production or deflation, like Japan." George Gilder, on the *Journal's* op-ed page, in February 2003: "Telecom was never really a bubble since it was in the process of improving its cost

effectiveness by a factor of 11,000 in six years to accommodate a 4,000-fold rise in Internet traffic during that period.”

Reading Iraq War suppositions, one might detect other-worldly influences to make the world safe for democracy. Jude Wanniski trained at the *Wall Street Journal*. From that tutorial, he gathered his thoughts in his 1978 *The Way the World Works*, an influential book in the early Reagan years. The 1988 edition revealed a deep, dark secret. Wanniski used a ghostwriter: “I actually believed that God had chosen me, of all people, to bring the good news of supply-side economics to mankind, thereby saving the world from perpetual economic decline.” It should be said that Wanniski opposes the Iraqi War, but we are not short of messianic leaders today.

In mid-March, Warren Buffett launched a Tomahawk missile against the dangers of derivatives. The *Journal* took exception in an editorial, titled, “Derivative Thinking.” In a compare and contrast exercise: we start in the first column: “Derivatives are one of the major innovations of the past three decades. These instruments are little miracles [another downgrade] of financial engineering, permitting investors to take a position, or make a bet, without actually having to hold the physical asset. Rather, the value of a derivative rests on the underlying security or a particular reference....” Now, from the second column: “... [F]inancial accounting for derivatives is a mug’s game. Valuing derivatives on a mark to market basis can be an exercise in fantasy. For many derivatives, the trading is so thin that valuation models must be used and those models can contain a great deal of unwarranted optimism. The result is inflated earnings.”

So, these little miracles cannot be valued; can be highly illiquid; hold the characteristics of non-continuous markets, which is a contradiction of derivative models; the models can be rigged; and successfully so since nobody knows how to value derivatives. It is from these voices that many intelligent people form their knowledge of the markets.

How to explain such a different view of the world? Facts conform to

theory rather than deriving theory from facts. Ideological investing does not seem the brightest path to follow. The writers above were quite influential during the Carter denouement and the first Reagan administration. Theirs are the ideas that stoked the boom and defeated the Soviet Union. Again, it is not important whether they were right; it matters whether or not the intelligent investor believes these writers to be correct today. It is a matter of trust. Circumstances are entirely different now, and their theories do not apply to a mass liquidation of assets and credit.

How to explain why more intelligent people don’t debate these claims, despite ample contrary evidence? In Owen Barfield’s *World’s Apart* (1963), two characters hold a discussion that may help explain the passivity of the landscape. Burgeon, a scientist, has proved a fallacy to a widely held scientific belief. Brodie is a more perceptive critic of the world.

Burgeon: Do you think, then, that I shall be given castor oil to drink or whipped if I go about the place saying the sort of thing I have just been saying to you?

Brodie: No. From what I know of the twentieth century I think something quite different will happen to you.

Burgeon: And what is that?

Brodie: You will be totally ignored.

Let’s assume we’ve collected a few willing listeners; what do we tell them? A good place to start is Peter Bernstein’s interview in the February 28, 2003, issue of *welling@weeden*. A large number of his clients are institutional managers and pension funds. He is telling them that, “the traditional institutional approach, ‘I will structure my portfolio in this way and make variations on the theme,’ won’t work. So what I’m suggesting is, throw it away. *You have to be much more unstructured, opportunistic and ad hoc than you have been in the past.*”

Later in the interview, “...in this looser, more opportunistic environment I foresee the abandonment of the dreadful, depressing, defaulting process of

putting managers into cubbyholes — large-cap growth, small-cap value and such foolishness — along with the stifling, stupid, obsession with tracking error instead of absolute returns and risks incurred.”

Even though this is addressed to an institutional audience, the way of thinking is not dissimilar to the retail investor. Replace “portfolio managers” and “investment boards” with Uncle Bob and Aunt Millie. “... People forgot during the 20-year bull market ... that investing is all about *taking risks* to get rewards. You’ve got a whole generation of portfolio managers and investment boards who’ve convinced themselves that if they diversify, stick to a style, and hold on for the long-term, they’re home free.”

The problem is getting people to understand this. Since I already declared this manifesto a failure, the reader can pick up the ball.

That’s the end of the critique. Now, to the markets today. Comparisons are made to the last period when paper assets vaporised — the 1930s. There are many problems with this analogy, but it’s the closest historical parallel we can draw. Some of the problems are misunderstandings. The stock market crash did not usher in the Depression. It was not simply a stock market bonfire on Wall Street. 1929 was preceded by (and would feed well into the 1930s) *A World in Depression*, written by Charles Kindleberger, and which becomes more timely by the day.

We are living at the long end — if “end” it is — of gross financial imbalances. Most people don’t understand this, or won’t acknowledge it. This fog of extremity and perplexity is a financial maelstrom that has been building for a generation. What follows is a look at some of the extremities and what they might mean. I should say that the convergence of markets below occurred in mid-March 2003. Most markets have backed off these levels. Maybe we have started the inevitable contraction. Or maybe, with bombs over Baghdad, markets are sorting out the extent of victory.

- *The Japanese ten-year bond fell to its lowest yield ever.*

- *On March 10, 2003, the Nikkei (Japanese stock market index) fell below*

8,000, which is where it stood 20 years ago. The Nikkei peaked on December 31, 1989 at 38,916. It is now 80% below that level. By coincidence, March 10, 2003 was the three-year anniversary of the Nasdaq peak: 5,048. It has fallen 75% over the past three years. Most Wall Street strategists, the guys who really make the big bucks, parrot each other by stating the stock market never goes down four years in a row. Thus, the stock market *will* rise this year. They exhibit parochial, loosely-educated, non-inquisitive minds subject to peer and corporate pressure.

- The two-year US Treasury hit an all-time low of 1.4% and on March 11, the ten-year Treasury bond traded at a 44-year low.

- Oil futures reached a 12-year high in March and are considerably lower today. The extrapolation implies that oil will trade at US\$20 to US\$25 a barrel. We can only hope.

- Yet, oil stocks have collapsed over the past year. The same is true of natural gas and defence companies.

- In mid-March, the European Central Bank lowered its short-term rate by ¼%, to yield 2½%. This was a response to the weak European economy, pronounced to all when Germany cut its expected growth rate to 1.0%. This might be interpreted (at least, by me) that the German economy is in a recession and the true growth rate is, in fact, negative and diving deeper. That the European Bank cut the rate a couple of days after the German announcement gives me more confidence in this opinion. It was even more reassuring to read that the CEO of Deutsche Bank warned the government to prepare to bail out the German banks.

- Americans, I think, tend to gloss over the collective European economy. We have more colourful scandals, melodramatic indictments; the press doesn't really care about the outside world (except, for instance, during a colourful cheese-hurling contest with Jacques Chirac); and it's the guy next door who lost his job. A look at unemployment figures is worth considering, of Us and Them. According to government numbers (which surely understate any bad

news), the US unemployment rate rose from 5.6% a year ago to 5.8% today. The change over the same period in Belgium was 10.8% to 11.7%, France 8.8% to 9.2%, Germany 9.6% to 10.6%, Switzerland 2.6% to 3.9%, and Spain 11.1% to 11.9%.

- Of note is the *continuing decline of the US dollar*. There are three currencies deep enough (in volume) to accommodate world trade: the dollar, the euro, and the Japanese yen. The Japanese have done their best to knock the yen down against the dollar, to aid foreign trade. They have been unsuccessful, to which one could say this matches the futility of every other Japanese financial initiative since 1989, and this is true. So, leave the yen aside and let's talk about the euro.

The euro can do no wrong, in comparison to the dollar. Europe, like a washed-up nightclub singer, wallows deep in its cups. The European Bank confirmed this melancholy assessment by cutting its short-term rate. Even with the lower yield and economic prognosis, people still want to dump the dollar. *The dollar fell through parity level (when \$1 equals one euro), sank to \$1.10 cents to buy one euro, and is floating around \$1.07 today. A couple of years back, it only cost 82 cents to buy a euro.*

The dollar's fall from grace might be enlightened by a look at our debt obligations. What we owe is growing at a clip many multiples in excess to the growth of the economy. *During the fourth quarter of 2002, total credit debt grew by US\$2.3 trillion, but the economy grew (measured by GDP numbers) US\$363 billion. The paper debt grew 6.3 times faster than the economy.*

To look at a longer view, US total credit market debt was about US\$7 trillion in 1985; it is over US\$30 trillion today.

What if Americans don't want to buy all of this paper? Well, we haven't bought it for quite awhile, so we ship these IOUs overseas. About 80% of the world's savings was spent last year investing in the US. How much more will the rest of the world buy? (According to Steve Hanke, it is 100%.) Isn't there some farm equipment company at home with a decent shot at success?

- Another notable decision in that week of hyperactive central bank activity was *the Canadian Central Bank's announcement to raise its short-term rate by ¼%*. It decided the threat of inflation is greater than that of recession. It occurs to me that a more subtle reason might be to attract US investments into the Canadian dollar, but not having spent more time thinking about Canadian banking than the time it took to compose this paragraph, my suspicions may be groundless. More importantly, *the Canadian unemployment rate has fallen from 7.9% a year ago to 7.4% today; Canada holds a trade surplus with the rest of the world (+\$34 billion over the past 12 months vs. a \$484 billion deficit for the US). Canada also manages to produce a budget surplus.*

These are four reasons to own the Canadian dollar rather than the homegrown, printing-press variety. Of interest rates as a whole, I think we are now at the far and opposite end of the seesaw from that of September 30, 1981. That was the day 30-year US Treasuries yielded 15.84%, the highest yield ever (some Confederate paper bills and possibly Continentals aside). At that juncture, nobody wanted to touch USTs. "Certificates of Confiscation" as they were called, since "inflation always goes up". As it turns out, an investor who parked money into 30-year Treasuries and hung out with *The Grateful Dead* for the last 22 years would have done better than most stock market investors.

It so often happens that way. Nobody wants to buy when the potential returns are the greatest. (What would you do if you were offered a 30-year return of 15.84% today? Yes, it is a very different environment, but there were very few people in 1981 who anticipated such a world within the 30-year lifetime of those bonds. If they had, the yield would never have reached double digits.) The most attractive market is the one that always goes up. Thus, in the March 11, 2003, *Boston Globe*, one Jeffrey Hall, economist at Thomson IFR, incants: "There is nowhere for investors to hide, except Treasuries. Equities aren't doing it for them. [What does that mean? — "Aren't doing it for

them”.] Because of corporate misdeeds — Tyco and so on — corporate bonds have a stigma to them. Foreign bonds aren’t doing much, so what’s left is Treasuries.”

Hall’s is the people’s voice. He might believe that. And he might be misquoted or selectively quoted. (I’ve been there, man.) That doesn’t matter here. I have no doubt that Hall’s statement relieved the minds of many a nervous bond investor who now feels reassured. “Bonds are doing it for me.” Even though two of his four sentences are utterly meaningless — which some might take as a warning — plenty of readers’ confidence will rise enough to buy a two-year Treasury that will compound at a 1.6% annual rate. (Another oddity: the consumer price index is rising at a 3.0% rate (supposedly). Thus, owners of the two-year Treasuries are paying the government 1.4% a year for the honour of holding Treasuries.) Hall’s is the current view today and it fits the common view of the markets and of what to do.

(A quick reminder about market timing and 1981. Of course, the trick is to get into that market sometime close to the ebb. Someone who bought at a 10% Treasury yield in around 1980 was right: inflation was yesterday’s problem. That someone may still have lost his shirt, as yields rose from 10% to 15%.)

In 2003, we’ve reached the opposite end, give or take another 1% drop in rates. Yields cannot go much lower, and considering that our financial health is exactly the opposite of Canada’s, there are reasons galore for the 22-year Treasury bear market to announce its entrance any day. (Actually, we won’t know when it begins. In 1984, three years into the bond boom, investors panicked and sold out, sure that the bull market was over.)

To contrast the US dollar to the Canadian dollar is to understand much of the unwired financial world we live in today. Throw in the other hard asset dollars, too — Australia and New Zealand — as well as the South African rand. The rand has appreciated 50% against the US dollar over the past few months.

Just as Bush the Elder had his vision thing, I have mine. The recent talk about the American Empire is growing just as it cedes its power around the globe. We’ve sold ourselves to a world that is not as keen as we are to make the world safe for democracy. To speculate, might the French and Germans decide to sell their dollars? After all, their investments (more particularly, those of the Asians) in dollar assets are financing the war.

We’re in tough shape, with a long road to recovery. As the credit bubble bursts, other countries are better prepared. The lesson is well applied to each of us: stay out of debt. Hold money. Money markets, savings accounts, and municipal bonds are shelters. (But: the municipal bonds’ yields are attractive for a reason. The fear of bloated municipalities going broke cannot be dismissed. Know your collateral. Even better: find collateral that the market has overlooked. Then sell it when investors catch up.) It is not clear why the oil, natural gas, gold, and defence stocks are fading, but it is at least in part due to a reluctance to hold US paper claims: a stock certificate. It is also partly due to the geriatric tendencies of institutional money managers. According to the March 20, 2003, *Boston Globe*, “[O]ut of 1457 diversified equity (mutual) funds that own energy stocks, fewer than 10% have energy holdings exceeding 6.1%. [The weighting of energy stocks in the S&P 500] according to Lipper....” Lethargy works both ways: technology stocks still trade at a price:earnings ratio of 50:1 and a price:sales ratio of 8:1. It is obvious which damsel is being courted.

The top priority is to preserve your purchasing power. “Purchasing power” is not “principal”. Domestic money market assets will yield limited protection in the US. They will not protect an investor from the ravages of a collapsing dollar. It fell 70% against the Swiss franc in the seventies. It fell 63% against the deutschemark between 1985 and 1995. It may very well do so again. There are funds that invest in a combination of foreign money markets and gold. To look at the securities held in one of their funds is to create a short list of countries with

strong balance of payments surpluses. Other types of securities in these countries, such as common and preferred stocks, are worthy of study.

A way to think about investing today is to stand in the opposite corner of all that has reached untenable levels and proportions. Start with US Treasury bonds. Second, do not feel any compulsion to buy common stocks. However, the data from Lipper above shows where the dumb money is overweighted and where it is underweighted. Residential real estate is in for a real thumping. This is an example of where liquidity can pay off in spades. In the early 1990s, banks auctioned foreclosed properties in the Boston area, and people showed up with the cash to buy houses at deep discounts. Third, explore other continents. Past issues of the *Gloom, Boom & Doom Report* include articles by specialists in Africa, the Middle East, India, Thailand, Asian bonds, China, Russia, and so on. Fourth, explore anything that is ignored by the press. The US press does an abysmal job of covering foreign economies, stock markets, commodity markets, and foreign real estate. Many of these investments are outside the reach of the intelligent investor, but perhaps within reach of *Gloom, Boom & Doom* readers to construct funds to meet a rising demand.

Being on top of the world is a precarious spot and it can end in a flash: the Spanish Armada in 1588 and the Japanese at Midway in 1942 are just two examples. In 1914, the US was a debtor nation. It owed, mostly to the Europeans, US\$3 billion. (That really was a lot of money back then. It really was! Please trust me.) By 1919, foreigners owed us US\$10 billion and the US booked a US\$3 billion surplus. We were on top of the financial world and sit there today. We displaced Britain in a very short period of time. (A half-century later, Britain had spent itself so thoroughly into the poor house that the IMF bailed out the pound sterling.) By 1929, the national income of the US was greater than that of Great Britain, Germany, France, Canada, Japan and several other countries — combined. Jim Rogers tells us that today we owe foreigners US\$6.4

trillion and overseas interest payments alone cost US\$333 billion last year.

Empires are a lot of fun, don't you think? Especially if you've got one. Empires are a sort of hobby of mine. It seems an appropriate topic today, since so much of the US economy, especially the dollar, is priced at an imperial premium. I've read books about the Spanish, Byzantine, Ottoman, Dutch, British, Habsburg, Soviet, Vienna Philharmonic, Cracker Jacks, and the New York Yankees empires. A common characteristic is of inexpensive acquisitions that produce great wealth. Silver deposits, tea, opium, a great foreign port, slaves, and a sophisticated trading system are examples. Another common characteristic is the ability to run the empire on the cheap. That was true of the British Empire. As Lord Salisbury (British Prime Minister, off and on, between 1886 and 1903) predicted, the Boer War (1899–1902) would strain the national finances. At about that time, Salisbury reflected on the conquest-happy inclinations of some contemporaries.

[They believe] it is our duty to take everything we can, to fight everybody, and to make a quarrel of every dispute. That seems to me a very dangerous doctrine.... [We would] overtax our strength. However strong you may be, whether you are a man or a nation, there is a point beyond your strength will not go. It is madness; it ends in ruin if you allow yourself to pass beyond it.

To look at empires from Salisbury's position may be as clear-eyed a look as we can find. He was the antithesis of a politician, with no desire to hold his office. He turned down the Premiership twice before accepting. ("It is an office of infinite worry but very little power.") He had no interest in ceremony, society, or accomplishment. ("Whatever happens will be for the worse, and therefore it is in our interest that as little should happen as possible.")

Andrew Roberts, a biographer, wrote:

Salisbury worried about the outbreak of jingoism that accompanied [Queen Victoria's 50th anniversary jubilee in 1897.] [Salisbury]: 'It was like having a huge lunatic asylum at one's back.' Skeptical, practical, and anti-determinist, Salisbury had absolutely no sense of Britain possessing any type of Manifest Destiny such as Americans were claiming for the U.S.

Not caring a fig what anyone thought of him, he warned his countrymen that the 250,000 Britons who held an Empire of 250 millions [India] were only able to do so because "your greatness is acknowledged", but if that reputation was lowered or power weakened, "do not for a moment delude yourselves with the belief that any benefits you have conferred or any benefits which you can promise will lengthen by a single day your empire...." The Empire was highly leveraged on admiration and very low maintenance costs.

Joe Chamberlain, Salisbury's Colonial Secretary, was sort of a Dennis Kozlowsky of his day. Tyco bought out 600-odd companies and Chamberlain made it his mandate to ensure the sun always shone on the British Empire. I hasten to add that Chamberlain was not shower-curtain-greedy, but rather, Rand-McNally-greedy. He abetted those who stirred the pot. Unlike Salisbury, he was an accomplished politician, and had fought his way to the top. He made his fortune in screw manufacturing and possessed the qualities we see today in a hard-charging, growth-oriented CEO: determined, a good manager and problem-solver, self-confident, and endowed with a capacious though unoriginal mind. These are admirable qualities and prominent administration figures such as Bush, Cheney, Rumsfeld, and Powell seem to be of the same stripe.

Salisbury was right. The Boer War was a decisive culmination to the Empire. Beyond his control (ministers such as Chamberlain had manoeuvred the Boers into a war), he stated at the beginning, "[High Commissioner of South Africa, Sir Alfred] Milner and

his jingo supporters would force the government to make a considerable military effort — all for a people we despise, and for something that will bring no power or profit to England."

A sceptical Englishman may have asked, "What are we doing there?" That is a question that would not naturally occur to Chamberlain, whose mind operated along straight lines. The high-achieving Colonial Secretary would say in 1904, "The day of small nations has passed away; the day of Empires has come." Another accomplished success story, John Chambers, CEO of Cisco, would announce, on December 4, 2000, "I have never been more optimistic about the future of our industry as a whole, or of Cisco."

Both were exactly wrong, at precisely the time their world had passed, as was true and is true of many accomplished though unimaginative CEOs today.

The British had become accustomed to fighting Gilbert & Sullivan skirmishes. It was, and thought like, a sea power, not a land power. Its battlefield instincts had not been put to the test since Waterloo. As Thomas Pakenham wrote in *The Boer War*:

The war [was] declared by the Boers of South Africa on October 11, 1899.... The public expected it to be over by Christmas. It proved to be the longest (thirty-three months) the costliest (almost half a billion dollars) the bloodiest (at least 22,000 British, 25,000 Boer, and 12,000 African lives), and most humiliating defeat that Great Britain fought between 1815 and 1914.

The Boer War, in many ways, anticipated a radically different 20th century. Our past century is generally regarded as an evolutionary step of Western civilisation that was nurtured in the Italian Renaissance. Looking back some time from now, we may see it as a century with growing pains as we embarked on a new era. (No, not that juvenile New Era stuff.) As the 25-year-old Winston Churchill wrote (as a war correspondent):

All the pomp and magnificence of Omdurman, the solid lines of infantry, the mighty Dervish array, bright with flashing spears and waving flags, were excluded. Rows of tiny dots hurried forward a few yards and vanished into the brown of the earth. Bunches and clusters of brown things huddled among the rocks or in sheltered spots. The six batteries of artillery unlimbered....

We, too, are finding the Iraqi War to be full of tactical surprises.

Great Britain was not prepared for an enemy that abandoned conventional warfare, one that fought on horseback and engaged in guerrilla warfare. It did not know how to deal with Boer wives and children whose farms had been burned to the ground and were then herded into concentration camps, which is what they were called. (Humanity grew much more adept at herding masses of people in the 20th century.) Over 20,000 of the Boer prisoners died in captivity. This not only provoked much foreign hostile criticism, but, also at home, sullied many illusions of Empire, the loss of prestige of which Salisbury warned. It should be added that the Boer War did not kill the British Empire. But, the signs of destruction loomed uneasily to the more perceptive. Salisbury warned, "You notice on all sides the instruments of destruction, the piling of arms, are becoming larger and larger. The powers of concentration are becoming greater, and the instruments of death more active and are improving with every year; and every nation is bound, for its own safety's sake, to take part in the competition...." A decade after Salisbury died, the accumulated capital and a generation of the young men of the European powers were slaughtered at the Somme and Ypres. As Dick Diver, in Scott Fitzgerald's *This Side of Paradise*, laments, "[T]his was a love battle — there was a century of middle-class love spent here.... All my beautiful lovely safe world went up with a great gust of high explosive love."

I think, in the paragraph above, the Great War was in the back of Salisbury's mind, but not in the front of

it. He is really making a larger observation here. Roberts' description of Salisbury was of an "anti-determinist", yet this warning is decidedly pre-determinist. The language and phrases Salisbury uses is of an old, creaky, inflated structure with no imagination and bound to follow this determinist path into the oblivion of death. Diver survived what Salisbury feared and said the same thing, from a different perspective. Western civilisation had matured, its energy and passion spent. Democracy was the next leg in Western culture. Its roots in the distant past, it caught a tailwind towards the end of the 19th century. Salisbury's forebodings of universal suffrage, state-paid (so: state-regulated) education, and the apparent forces of reducing the culture to the lowest common denominator were manifest. The age of the common man would cheapen quality and compound quantity ("the piling of arms, are becoming larger and larger").

The list of goods caused by democracy could go on all day. I, for one, would rather not speculate on how I might be making a living now if it weren't for democracy. But most (all?) political developments rise, peak, and fall. All political developments have their good as well as their bad. Jacob Burkhardt, a Swiss historian, wrote in 1891 that immeasurable requests of the masses would be addressed to the state. "[Society] would assign to the state never-heard-of and outrageous tasks, which could be accomplished only by a mass of power which also was never-heard-of and outrageous."

The Founding Fathers' guiding principles of personal responsibility and duty have evolved to a much greater interest in personal rights. Our rights accumulated; our responsibilities dwindled. These outrageous rights include the tacit understanding (between politicians and voters) that every American has the right to own a home. By the millennium, a large constituency concluded that we were all due a Dow 36,000, and we were owed that *now*. The momentum built through January and February until, in March 2000, our beautiful lovely safe world went up with a great gust of high-explosive hysteria.

Subsidised home loans. Subsidised student loans. Medicaid. The question that no longer is a question is whether the government should involve itself in such areas at all. We carry so many implicit assumptions, maybe comparable to a tennis match, of which the rules' committee might tinker with the types of rackets and balls, but would never even consider changing the size of the court or the height of the net. There is no thought given to debating them. So it is with tearing apart government programs. It is also true for the way large corporations organise themselves and how financial securities are regulated and traded.

If you look back at Peter Bernstein's interview, his description is of a tired, exhausted mind. In the past century, we have grown and grown, but lacking originality, only compounding behemoth structures in most every walk of life. Bernstein calls for a renewal, a re-birth. He repeatedly emphasises the convulsion we face:

"[W]e are going to have to learn to live without the crutch of things like policy portfolios — because the conditions that justified their existence for so long have been shattered."

"In Streetspeak, it's 'This market is where we want to be in the long run.' *Simply because it always has been.*"

"[L]ong run data are commonly misread on a number of scores.... [P]olicy portfolios, if you will, are obsolete."

In my opinion, Salisbury's foreboding is true of the US as well as of Europe. Donald Rumsfeld might talk of an old and new Europe, but the truth is, we're all old and bloated now. The United Nations is no longer capable (if it ever was) of making a large decision. It is too big and too entrenched in its ways. Politicians fiddle around with microscopic changes to programs that will bankrupt us all (Medicare, the NHS, welfare, etc.). They give no thought to tossing them out the window and starting over again. Institutions as a whole have grown to a size at which they can no longer act because of girth. They must follow a set of implicit assumptions that stifle imagination. What, for instance, can really be done to restructure Fannie

Mae if its financial models go awry? One can go on and on: public school systems, the airlines, the auto companies, the multinational consumer goods companies (Coke, McDonald's), pension consultants and their benchmarks, the central-bank created money flows, trillions of dollars a day flowing between markets with little attention paid to economic valuation, financial derivative contrivances, the IMF, professional sports, the Olympics and stockholders of fractional interests in the companies they own with little knowledge or ability to act as an owner.

This is not only a problem of advanced age; it is also of wealth. We live comfortably; our houses are filled with material possessions. To reform radically could endanger our cosy living rooms, fervently encased with rolls of duct tape.

It is not by coincidence that countries with the oldest demographics find it harder to change their ways. Japan is Exhibit A; Europe and the US are right behind. Older countries worry more about things like car seats, tamper-proof bottles, smoking and bicycle helmets; are up-to-speed on the latest FDA warnings; and cling to the television set if a large storm threatens. With younger demographics comes greater flexibility and dexterity. A ten-minute visit to Johannesburg or Marrakech is a lesson in how adaptable street traders are jumping into the market-of-the-hour. Sure, these countries have and will continue to fall on their faces, look awkward, embarrass themselves, but, some at least, also get quickly back on their feet and learn more from their mistakes (to the extent that we really learn from our mistakes).

The US spent the entire 19th century booming and crashing, and it will probably be so in China and Mexico and Egypt this century.

By the beginning of the 20th century, the age of empires was eroding. The colonies were not only a great economic burden, but empires also competed with the rising national consciousness around the globe. It proved impossible for the British to retain allegiance; it is notable that the Soviet Union was never able to add property to its empire, other than the territories occupied after World War II. This leads to an interesting conundrum of the new American Empire. National consciousness still runs strong; although tendencies towards larger commitments (the EU, the United Nations, Kyoto) and pointillism (the Basques, Scottish, Quebec) may lead to something much different. All of this veers into the incomprehensible when the mass migrations around the world — on a scale last seen in the late-Middle Ages — redefine who we are. The US Empire is not one of military conquest, but of trade and ideas. This, then, should probably be looked upon as a virtual empire, fitting for our times.

A virtual empire can be more easily dismantled than the pith-helmet-and-sundowner variety. Also, the last quarter-century was marked by the growing difficulty of posting corporate profits. Profit margins, as a percentage of GDP, have been falling since the 1960s. There are many reasons, including the observation that the amount of staff and stuff (the rising ratio of administrators to teachers, the requirement for hot lunches, wheelchair access, diversity training, OSHA, social security taxes, the

loathsome lawyers who keep every company in America within gunshot range of a bankrupting lawsuit, etc.) weigh on the more productive part of the economy. This is not cyclical, but is a cumulative burden. We've fought it by borrowing (leveraging profits more), replacing people with computers; this past decade saw the constant exporting of jobs to countries with cheaper labour that make the stuff we demand. (It is a wonder that 25% of S&P 500 profits recently have been in the financial sector until one recognises that financial cleverness kept some of these behemoths in the black.) This Empire can expand as we satisfy our material needs if foreigners remain satisfied with the return on their US assets.

That might seem determinist, but it isn't meant to be. At the end of the Middle Ages, a similar breakdown and stagnation gripped Europe. Then Columbus discovered America, Michelangelo painted the Sistine Chapel, and Martin Luther rent the Catholic Church from top to bottom. Whatever one thought of these developments, life was much more riveting. As Orson Welles philosophises in *The Third Man*:

Don't be gloomy. After all, it's not that awful. You know what the fellow said ... in Italy for thirty years under the Borgias they had warfare, terror, murder, bloodshed.... They produced Michelangelo, Leonardo da Vinci and the Renaissance. In Switzerland, they had brotherly love, five hundred years of democracy and peace, and what did that produce? The cuckoo clock.

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