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Topical Study #23

THE END OF THE COLD WAR IS BULLISH

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I. WRONG CONCLUSIONS

The Capital Shortage Myth. The Berlin Wall started to crumble on November 9, 1989. On December 3, President George Bush and Soviet Prime Minister Mikhail Gorbachev hailed the end of the Cold War in a summit off the coast of Malta. The Soviet Communist party relinquished exclusive power on February 7, 1990. West Germany and East Germany were united on October 3, 1990. The Soviet Union was dissolved during December 1991 when the Soviet republics became independent states. On December 25, 1991, the Soviet flag was taken down from the Kremlin. The United States and Russia signed Start II–the biggest nuclear disarmament agreement ever–on January 3, 1993. These dramatic events marked the end of the Cold War.

The immediate conclusion of the investment community around the world was that the global demand for capital would increase significantly. The press rounded up the usual economic experts who predicted that Eastern Europe would require $100 billion. So would Russia. The experts predicted a global capital shortage. They also predicted a boom for Western Europe as the monies lent to the liberated provinces of the former Soviet Empire were spent on imported capital equipment. Of course, the United States and Japan were also expected to benefit from the rebuilding of these ravaged economies.

Germany, especially, was expected to be the most immediate beneficiary of the end of the Cold War. United, Germany would combine the enormous capital and technology of the West and the cheap labor of the East. Some political experts predicted that Germany would leverage this new, awesome economic strength by taking more assertive stances on major foreign policy issues.

Another Post-War Bust. The experts were wrong. A global recession depressed the economies first of the English-speaking countries (the United States, Canada, the United Kingdom, and Australia) during 1990 and 1991. The recession spread to the entire European Community and also Japan during 1992 and 1993. The English-speaking economies coincidentally started to recover, but the recoveries have been extremely lackluster and fragile. Japan and Germany are mired in their worst recessions since the Great Depression of the 1930s. The global capital shortage never happened. Instead, interest rates plunged along with inflation rates all around the world.

Most economists blamed the global recession on the jump in oil prices triggered by Iraq's invasion of Kuwait in the summer of 1990. This certainly was a major cause of the recession in the United States. But it doesn't explain why the U.S. recovery has been so weak. This explanation doesn't really work for Japan or Germany, which fell into severe recessions last year–well after the end of the Gulf War.

History shows that wars are usually followed by economic busts rather than booms. The end of the Cold War is following this pattern.

II. THE BEGINNING OF A NEW ERA?

In our Topical Study #20, *The Collapse Of Communism Is Bullish*, we argued that rather than marking the "end of history"–the thesis of a widely read 1989 article by Francis Fukuyama, the end of the Cold War marks the beginning of a new era:

> We admit that "New Era" talk is heard most often around tops in bull markets in stocks. On the other hand, we started writing about "New Wave" trends back in 1988 when the Dow was still south of 2000.

The economic performance of the major industrial economies since 1990 isn't a very auspicious beginning for a new era. Maybe so. But we still believe that the end of the Cold War unleashed very powerful structural forces which are already radically changing the nature and performance of both the global economy as well as the American economy. The end of the Cold War sent a massive shock wave around the world that is destabilizing some economies and revitalizing others. Eventually, we believe that the reactions to the shock will be very good for global economic prosperity. The United States is especially well positioned to benefit from the revolutionary changes in the global economy.

III. THE SHOCK FELT AROUND THE WORLD

The Soviet Meltdown. When the Berlin Wall fell, so did the extreme form of protectionism which was a by-product of the Cold War. The Iron Curtain meant that the Soviet Empire was closed off to world trade. Shut off from engaging in free trade with the West, the Soviets fell behind to the point that their economy could no longer support their burdensome military budget. Soviet industry clung to outdated technologies and management systems. The Soviet economic system collapsed when it was forced to compete in an open world trading system.

The most inefficient producers are bound to experience the most adverse economic shock when confronted with more efficient competitors once trade barriers are removed. So the end of the Cold War triggered an immediate depression in the nations of the former Soviet Empire, including Eastern Europe.

Germany's Mistake. The shock also had unanticipated negative consequences for Western Europe, particularly Germany. The nations of the European Community have made a great deal of progress in reducing trade barriers within the EC. This was the consequence of the so-called EC 1992 movement. Ironically, instead of enjoying a burst of prosperity from free trade, the EC fell into a severe recession in 1992 that continues in 1993. What happened to derail the optimistic predictions for Europe?

The end of the Cold War not only expanded the global free trade system, it also dramatically increased the global supply of cheap labor. There are plenty of inefficient companies in the EC that might have continued to survive and maybe even prosper in a European free trade bloc. But the liberation of Eastern Europe changed all that. It opened a big pool of cheap labor.

West German workers suddenly became very expensive factors of production. The good news and bad news for them is that they have great benefits and take very long vacations. The German government made a big mistake by adopting policies that sought to raise the compensation of East German workers to levels comparable to those received by West Germans who were already receiving too much by global competitive standards. The result is massive unemployment in eastern Germany and very high joblessness in western Germany.

Japan's Shoku. Japan's mercantilist trade policies certainly contributed to the country's amazing recovery from the devastation caused during World War II. Japan's policies and institutional structure favor exports over imports–favor producers over consumers. This approach continued to work for Japan through the 1980s, but with increasingly hostile reactions from Japan's trade partners, particularly in the United States and Europe.

In the New Era, the Japanese are discovering that the mercantilist approach is more likely to lead to stagnation than to prosperity. Japan's huge trade surplus is probably the main reason the dollar plunged from a high of 262 yen during February 1985 to nearly 100 yen recently. The Japanese economy recovered quickly and solidly from the so-called *Endaka* recession of 1986 caused by the rapid rise in the foreign-exchange value of the yen. But this recovery was achieved by lowering interest rates so low that stock market speculators doubled the Nikkei stock price index between 1987 and 1989. Real estate speculators also went wild. Now that the bubble has burst, it is unlikely that monetary policy can offset the depressing effects of the latest jump in the yen.

The strong yen is exacerbating the deflationary forces that were unleashed when Japan's "bubble" economy burst. The monetary authorities claimed that they could limit the damage to the stock market. They expected a soft landing for the real economy. They were wrong. Japanese companies are responding to the competitive disadvantage resulting from the strong yen by moving production to China, Southeast Asia, and Latin America. They are moving where labor is cheaper. And of course, there is plenty of cheap labor now that the Cold War is over.

China's Great Leap Forward. So far, we have focused on the immediate losers. On the other hand, there are plenty of countries that benefited immediately from the end of the Cold War. They are countries with either low labor costs or that have been exposed to relatively free trade for many years so their companies are efficient and globally competitive.

Capitalists interested in investing in Russia are offered all sorts of opportunities to buy decrepit and polluted industrial facilities. In China, the officials escort the capitalists to a big vacant piece of land. The capitalists are assured that they can build brand new facilities with state-of-the-art technologies and operate within a free-trade zone. And, of course, there is no shortage of cheap labor in China.

China's approach to economic development is more likely to succeed than Russia's approach. Recently, of course, Chinese officials concluded that their approach has been too successful. Inflation is approaching 20%. Speculation and corruption are rampant.

The central bank responded during the summer by drastically increasing the cost and rationing the supply of credit. The Chinese bubble economy is starting to burst, and real economic growth is bound to slow. The break in the price of gold over the past few weeks suggests that the Chinese are losing their interest in this inflation hedge.

China's great leap forward into the global capitalist system is impressive and will probably continue. In the past, the "China story" was just a story. One could only imagine the potential of over one billion people unleashed to pursue their self-interests. The difference between today and the past is that the China story is no longer imaginary; it is real. It is starting to happen. Of course, China could always take a big leap backwards if the political authorities conclude that capitalism poses too great a threat to their monopoly of power. But we think this is a low-probability scenario.

IV. THE AMERICAN RESPONSE

The Insecure '90s. During the 1980s, many Americans, particularly the Baby Boomers, started to believe that as far as their financial futures were concerned, the sky was the limit. Today, most Americans just don't want to get buried. The optimism of the 1980s has given way to the pessimism of the 1990s. Most Americans no longer feel as secure in their jobs today as they did during most of the post-World War II era. The supply of new cheap labor around the world and the flood of illegal immigrants is heightening these anxieties. These same insecurities are widespread in Western Europe as well.

It is very distressing to see that companies are permanently reducing their payrolls rather than just temporarily laying off their workers. It is especially confounding because even companies that are reporting good sales and profits are cutting their labor costs by reducing the number of employees, minimizing wage hikes, and paring benefits.

The economic expansion is 30 months old. Yet companies continue to announce cutbacks. Layoffs in the manufacturing sector were common and expected during the recessions of the past. But the workers could expect to return to work for the same company with the same compensation when the recession was over. Today, workers in every industry are losing their jobs permanently, even though the economy is expanding.

Indeed, factory output is at an all-time high; yet factory employment has fallen by 780,000 over the past 30 months to the lowest level since February 1965. Indeed, factory employment is actually 380,000 below the 1982 recession trough.

Why are such bad things happening to so many good people? The secular downtrend in factory employment began in the 1980s in response to fierce global competitive pressures. The end of the Cold War increased the competitive pressures. Labor in the United States must compete with much cheaper labor in other countries. American companies must compete with foreign start-ups that can produce the same products at lower prices because they are employing cheaper labor.

The end of the Cold War forced even the services sector to manage labor costs more tightly. Today, many software development companies based in the United States are hiring programmers living and working in Russia, India, and Israel. They earn a lot less than their American counterparts.

Priceless Prosperity. Job insecurity, low wage gains, and diminished optimism are pushing consumers to shop at the discount department stores and to insist on everyday low prices from all their other retailers, including airlines, restaurants, and handymen. Consumers are very sensitive to the prices of many items they never paid much attention to during the 1980s. Back then, the Baby Boomers were yuppies and knew the prices of Mercedes and BMWs. Today, it is truly amazing how many of them know the price of a box of tissues or a tube of toothpaste!

The price sensitivity of consumers explains why so many companies in so many industries are unable to raise prices. The discounters are continuing to gain market share from name-brand producers. As their market power increases, the discounters can turn to their vendors and insist that they cut their costs and pass most of the savings on to the discounter.

The High-Tech Revolution. So, not only can't suppliers increase their prices, but they are also under intense pressure to cut their prices. They can only do this by cutting their costs. Since labor accounts for the bulk of the cost of production, workers continue to lose jobs, lose benefits, and receive meager wage hikes. Consumers remain insecure about their jobs. And they are struggling to stretch their dollars by hunting for discounts. The process feeds on itself.

In addition to cutting labor costs outright, many companies are also spending more and more money on high technology equipment in an effort to boost productivity. This equipment gets more powerful and cheaper every 12 months or less. Technology consumes few resources. Silicon chips, fiber optics, and fiber glass composite materials are all made out of sand.

High-tech capital spending is very strong in the U.S., especially if software outlays were capitalized rather than expensed. Americans seem to have a natural advantage in this area. There is something in the American spirit that drives bearded nerds to go off to quiet mountain retreats in Oregon and Utah and write 300,000 lines of software code.

V. 5% BONDS & DOW 5000

Bullish. It was back in 1988 that we first started to predict that the government bond yield would fall to 5% by 1993 and that the Dow would soar to 5000 by then. Along the way, we've wavered and flinched a few times. Honestly, we are just as shocked as everyone else is that the bond yield is under 6% already. Indeed, 5% looks very doable by the end of this year. Dow 5000 doesn't look doable by the end of this year, but it could still happen by the end of next year.

The structural forces of disinflation received another boost with the end of the Cold War. Our analysis suggests that inflation could remain low at least through the middle of the decade, if not through the end of the decade. If inflation stays low, so will short-term interest rates. The economic environment should remain favorable for bonds. The current bond-buying mania is setting the stage for a huge rally in stocks over the next 12 to 18 months.

TOPICAL STUDIES

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#3 Deborah Johnson, *Behind The Corporate Borrowing Binge*, June 13, 1984 *

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#21 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book 1991*, October 9, 1991

#22 Dr. Edward Yardeni, *Apocalypse Now! (NOT!)*, May 8, 1992

* Out of print.