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#33 Productivity Must Be Booming

Topical Study #34

Populist Capitalism And Other Wildly Bullish Themes

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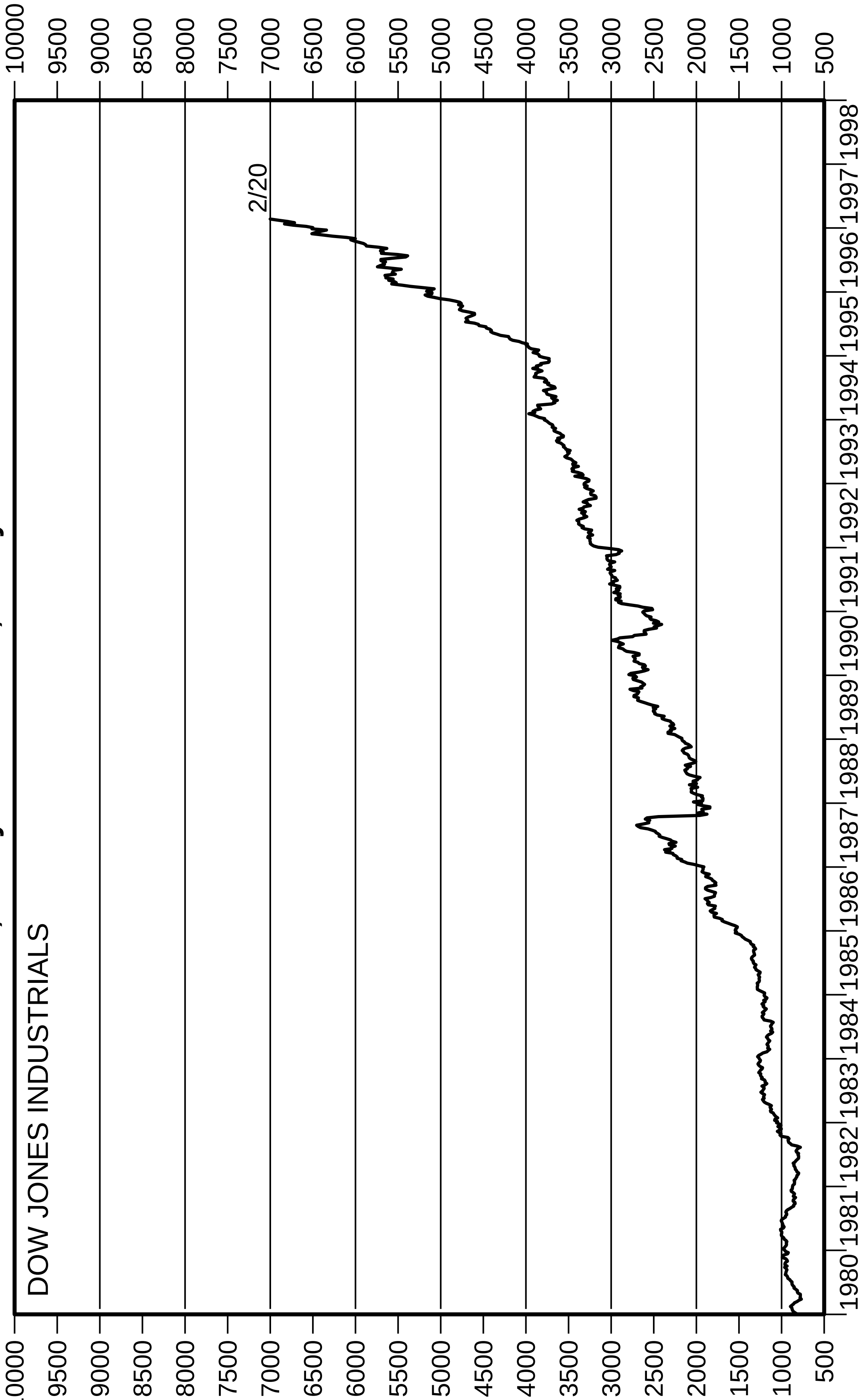
#1 On the road to Dow 10,000 by 2000 and 15,000 by 2005.



I. Wildly Bullish Themes: Just The Beginning

The Dow Jones Industrials Average rose above 7,000 for the first time ever on February 13 of this year. The move from 6,000 to 7,000 took only 82 trading days, the fastest 1,000-point gain on record (Exhibit 1). My forecast of 10,000 by 2000 certainly looks more realistic than it did in 1995 when the DJIA first rose above 5,000. Is the bull market vulnerable to a major correction? Yes, if it is driven by "irrational exuberance" and speculative excess. Obviously, I don't think so. I believe that investors are only starting to recognize the Wildly Bullish Themes that I've been writing about since the late 1980s and early 1990s in my weekly commentaries and Topical Studies (TS).

Many of these Wildly Bullish Themes drove the Dow up to 5,000 during the first half of the 1990s. (See TS #18,*Dow 5000*, dated May 9, 1990.) If these WBTs can propel the Dow to 10,000 by 2000, I expect that they could push the Dow to 15,000 by 2005 because most of the themes still have lots of life left in them.

For example, I believe that inflation will remain near zero through at least 2005. Near-zero inflation is certainly still wildly bullish because both short-term and long-term interest rates have plenty of room to move still lower (Exhibit 2). I still expect to see a 5% government bond yield before the turn of the century. Such an interest rate scenario could easily sustain the current lofty stock market valuation multiples of 17-to-19 times earnings. Indeed multiples of 20-to-22 times earnings become realistic (Exhibit 3).

Lower interest rates would also boost profits. Corporate net interest expense peaked at $157 billion during the third quarter of 1989. It was down to $124 billion during the third quarter of last year. Clearly this drop in interest costs was an important contributor to the $205 billion jump in profits over this period to a near record $402 billion during the third quarter of 1996 (Exhibit 4). Furthermore, record corporate cash flow reduces the need for additional debt financing (Exhibit 5).

The extraordinary business opportunities created by the end of the Cold War are just starting to get realized and should also help to deliver the earnings growth necessary to lift the Dow to 10,000 by 2000 and 15,000 by 2005. If valuation remains at current levels, then profits would have to rise 42% by 2000 and another 50% during the first five years of the new century to achieve my Dow targets. I think this is quite possible. Lower interest rates would also help by lifting the valuation multiple.

The High-Tech Revolution is just beginning, in my opinion. Many homes have PCs. However, few have the powerful multimedia computers with the fast communications speeds necessary for Internet commerce. I predict that almost all homes will have them by 2005. Internet retailers should also flourish at the expense of the traditional floor-space retailers. IBM is already marketing "Commerce," a powerful new software system for electronic retailing. The new multi-media MMX chips from Intel, faster PC and cable modems, and new satellite networks promise to dramatically improve the quality and lower the cost of video communications very soon. Business travel expenses should plunge along with telecommunications costs. (See TS #25: *The High-Tech Revolution In The US of @*, March 20, 1995.)

II. Populist Capitalism: Power To The People!

At the beginning of the present century, American Populists sought to reform capitalism to protect the individual from some of the harsher consequences of unregulated industrialization and the excesses of Wall Street. As a result of the Great Depression of the 1930s, many of their proposals were implemented in the regulatory bodies and social security programs created during the New Deal.

Today, as we approach the next century, “Populist Capitalism” is flourishing and proliferating. Many workers have acquired stock in their companies through incentive-compensation and profit-sharing plans. The compensation of more and more company managers is even more directly tied to the performance of the company’s stock price through warrants and options. During the first half of the 1990s, the relationship between workers and management was often hostile and sometimes violent. Now the differences between the two classes are becoming less distinct as both are becoming Populist Capitalist or Equity Cheerleaders, who want stock prices to rise. The common enemy is “the competition” and the common goal is to get richer through higher stock prices.

More and more individuals, especially Baby Boomers, are buying stocks through mutual funds for retirement (Exhibits 6 and 7). They are fast becoming a globally powerful new special interest group. In the past, companies and countries in need of venture and development capital went to the big banks in London and New York. Now they are increasingly pitching their stories to the equity mutual fund managers in Boston, Chicago, Milwaukee, Minneapolis, Baltimore, and Houston.

Old-fashioned populists in the media have tried to stir up the job-insecure masses with no success. For example, the editors of *Newsweek* ran a front cover story a year ago titled “Corporate Killers,” about cold-blooded chief executive officers who had fired tens of thousands of hard-working employees in an effort to restructure their companies and drive up their stock price. Ironically, as stock prices soar, so does consumer confidence. Consumers are reporting that jobs are plentiful (Exhibits 8 and 9). They seem to understand that corporate restructuring strengthens the competitive position of their companies and actually increases job security in the long run, at the cost of some short-term insecurity. Workers may be starting to associate higher stock prices with greater job security.

III. Equity Cheerleaders Replacing Bond Vigilantes

The Populist Capitalists are likely to become as influential and as powerful as the Bond Vigilantes became in the 1980s. The political agenda of the bond crowd was to promote disinflationary monetary and fiscal policies. They succeeded beyond their wildest expectations. So much so that many of them still don't fully appreciate their triumphs:

1) The inflation rate is the lowest since the mid-1960s. The price of gold has been virtually "fixed" around $400 an ounce since the late 1980s.

2) The federal deficit is only 1.5% of GDP, the lowest since 1981.

3) A secular upturn in the foreign-exchange value of the dollar probably started in early 1995.

Nevertheless, the Bond Vigilantes remain vigilante, although there is probably no need for them to be so anxious about reflation. Furthermore, the federal deficit is now close to $100 billion, with net interest costing the government almost $250 billion a year. In other words, excluding interest, the federal budget is running a huge surplus of nearly $150 billion. The interest payments to US Treasury debt holders is sufficient to finance the deficit twice (Exhibits 10 and 11).

The Populist Capitalists share the anti-inflation, narrow-deficit agenda of the Bond Vigilantes. However, the Equity Cheerleaders are pro-growth. The bond crowd is happiest with no growth, or better yet a recession. Today's populists are free traders. They want their companies to have open access to foreign markets. They are opposed to protectionists at home who want to isolate American companies and workers from foreign competition. *Unlike the early populists who sought to protect workers from capitalism, today's populists want to share in capitalist prosperity.*

IV. The Wildly Bullish Bunch: An Even Dozen

The bullish implications of Populist Capitalism is just the latest of numerous Wildly Bullish Themes that I have explored since the late 1980s. The following is a brief list of 12 of them. You might want to pin them to your bulletin board for comfort and support whenever the market seems to be rising too far too fast, or when it takes a bungee jump.

1) The disinflation trend should persist for many years to come. The end of the Cold War was the end of the 50-Year War of the Twentieth Century and the end of a major barrier to world trade. In the past, free trade during peace times dramatically increased competition and stimulated technological innovation. This is happening now. Consequently, the microeconomic model of perfect competition is becoming more relevant. (TS #17: *The Triumph Of Capitalism*, August 1, 1989.)

2) Price measures, particularly the CPI, are overstating inflation possibly by as much as one percentage point a year. The consumption deflator has been roughly that much lower than the CPI inflation rate for more than a year because it more accurately reflects the weight of health care and computer purchases by consumers. Of course,

the Boskin Commission listed several other sources of upward bias in the CPI in their report to Congress last December.

3) Real GDP and productivity growth have been and continue to be understated by as much as inflation is overstated.

4) A secular rebound in productivity growth has been underway in the 1990s though the official statistics have failed to measure it. Sales per employee data suggest that productivity may be growing 3% per year rather than 1% per year as officially measured. (TS #33: *Productivity Must Be Booming* January 20, 1997.)

5) The high-tech sector will continue to grow much faster than any other sector of the economy. Last year, computer sales accounted for one-third of real GDP growth. The High-Tech Revolution has really just begun, and the best is still to come. (TS #25: *The High-Tech Revolution In The US Of @* March 20, 1995.)

6) The unemployment rate has been in a secular decline since the early 1980s and should fall to 4% by the start of the next century. (TS #12: *The Baby Boomers Are Changing The Economy*, April 6, 1988.)

7) While the labor markets may be tight now and are likely to get even tighter, price inflation will remain near zero. (TS #30: *Backlash: Workers Vs. Bonds*, May 8, 1996.)

8) Nominal wages have been growing faster than prices (if properly measured) for many years. In other words, the stagnation of real wages over the past three decades has been a statistical illusion.

9) The quality of new jobs created in the 1980s and so far in the 1990s has been very good. Indeed, in recent years, most of the new jobs were in highly-paid occupations in the services sector. (Federalist Paper No. 90: *Hamburger Flippers Vs. CEOs*, July 30, 1996.)

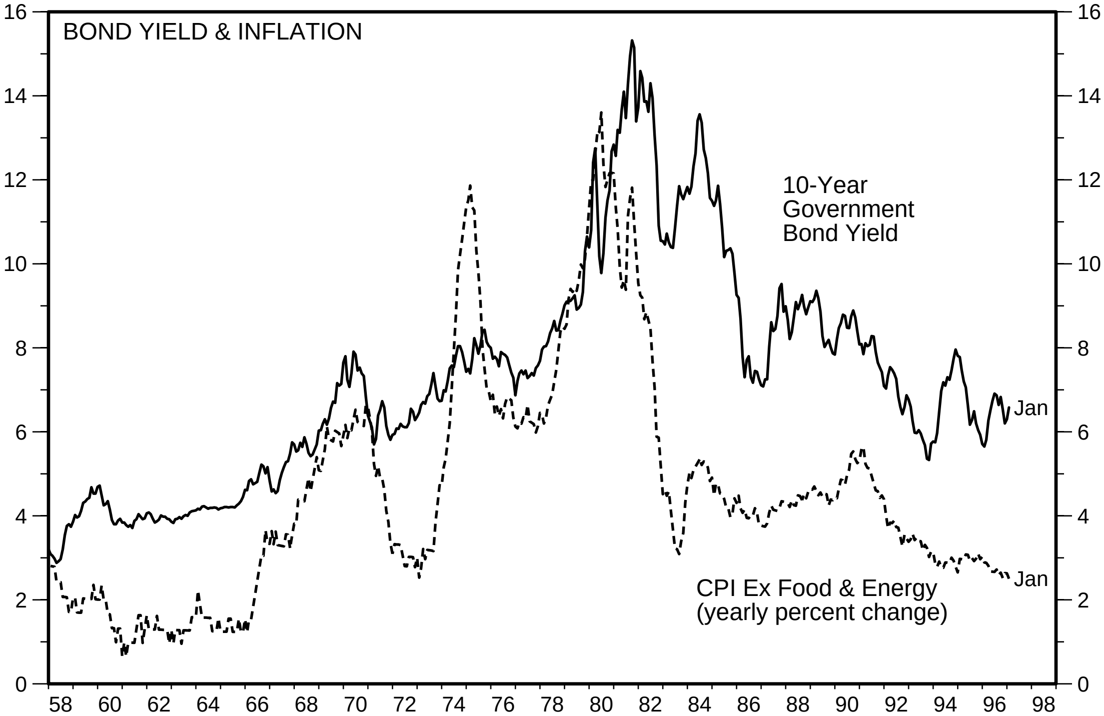
10) Corporate restructuring has not been bad for workers and it has been very good for profits and cash flow. (TS #11: *The Restructuring Of Corporate America Is Bullish*, December 9, 1987.)

11) Demographic forces related to the aging of the Baby Boomers should continue to boost the demand for equities through at least the first decade of the next century. (TS: numerous *Baby Boom Chart Books*.)

12) The newest addition to my list of Wildly Bullish Themes is the popularity and the rapid proliferation of Populist Capitalism as discussed above.

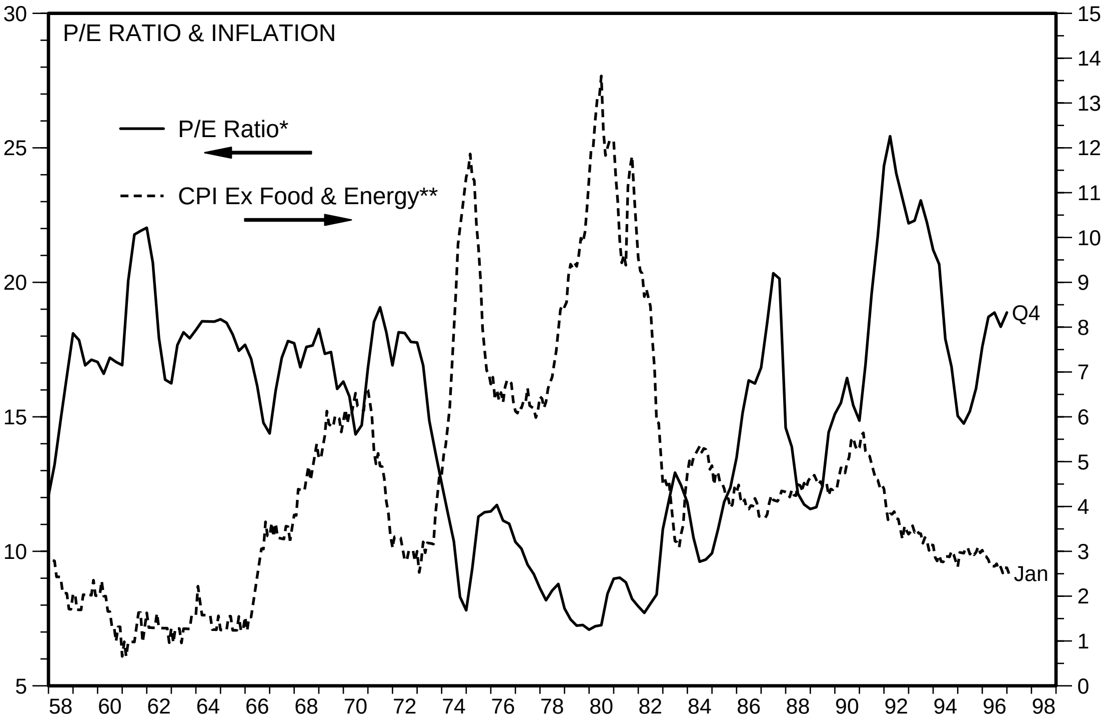
- Valuation -

#2



CPI overstates inflation by at least one percentage point. So there is room for bond yields to fall, especially if inflation trend remains down. In this scenario, valuation is sustainable and could move higher.

#3

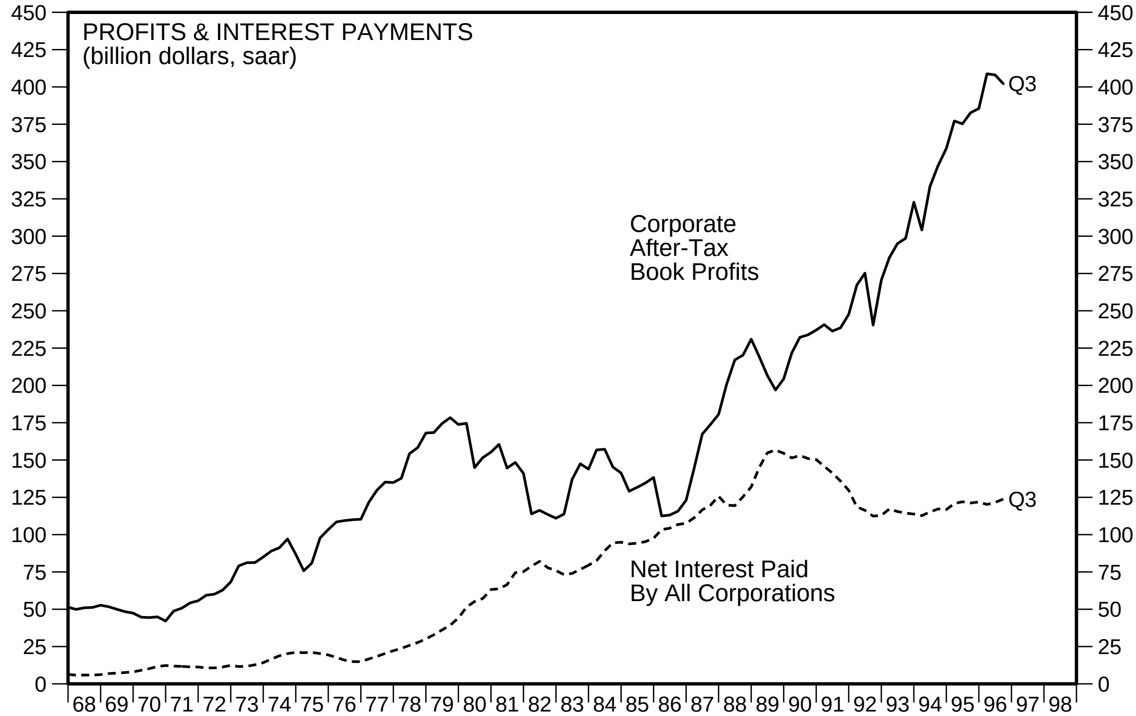


* For S&P 500 using four-quarter trailing earnings.
** Yearly percent change.

- Profits -

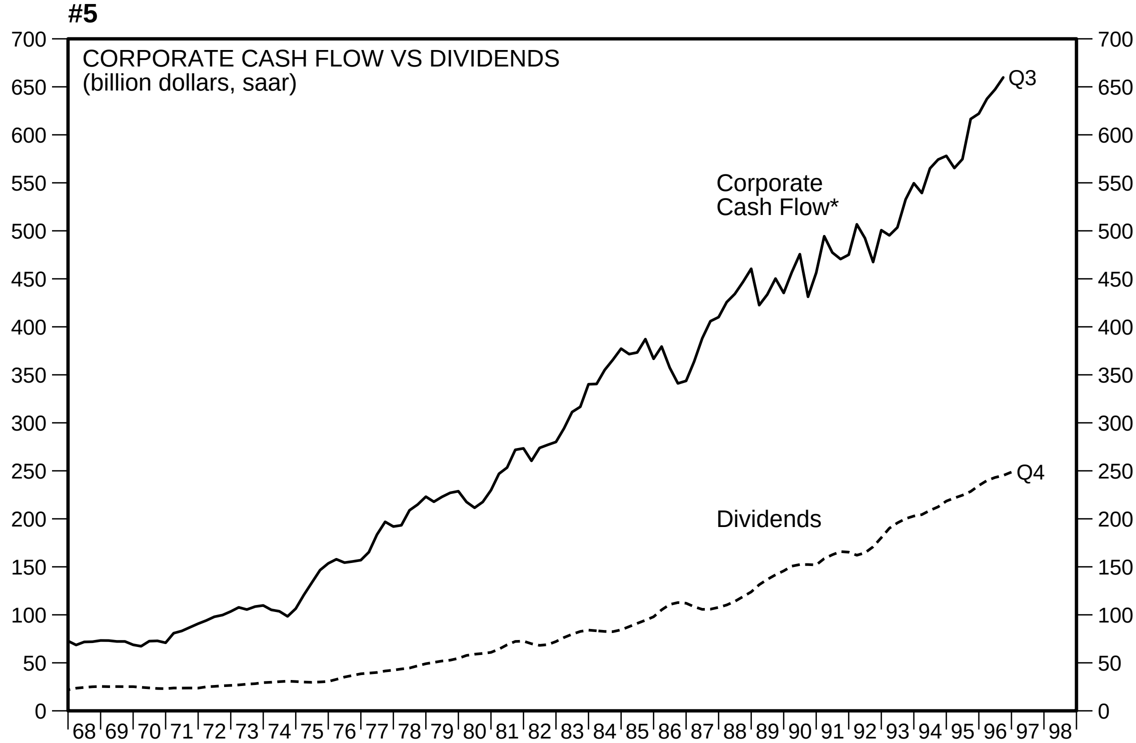
Rising interest costs depressed corporate profits during 1980s. During 1990s, profits are soaring partly because interest costs are flat to down.

#4



Corporate cash flow is at a record high. Corporations are less dependent on debt financing. They are repurchasing their stock. They are likely to boost dividends.

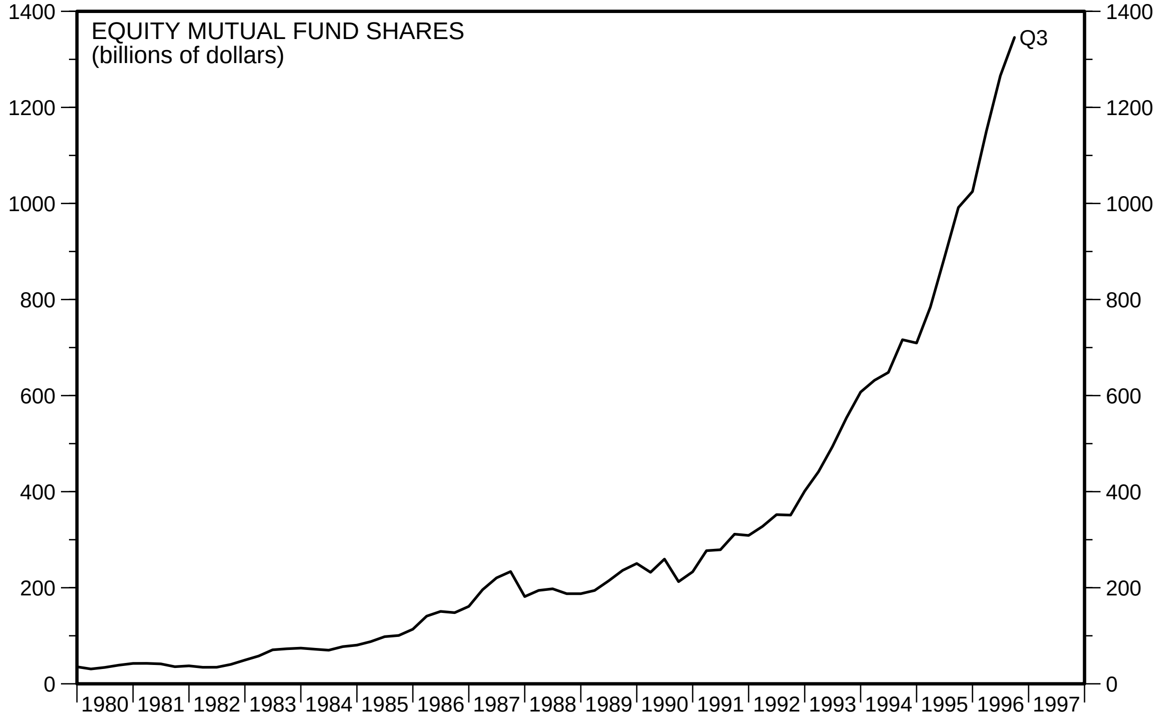
#5



* After-tax operating retained earnings plus tax-return-based depreciation.

- Equity Mutual Funds -

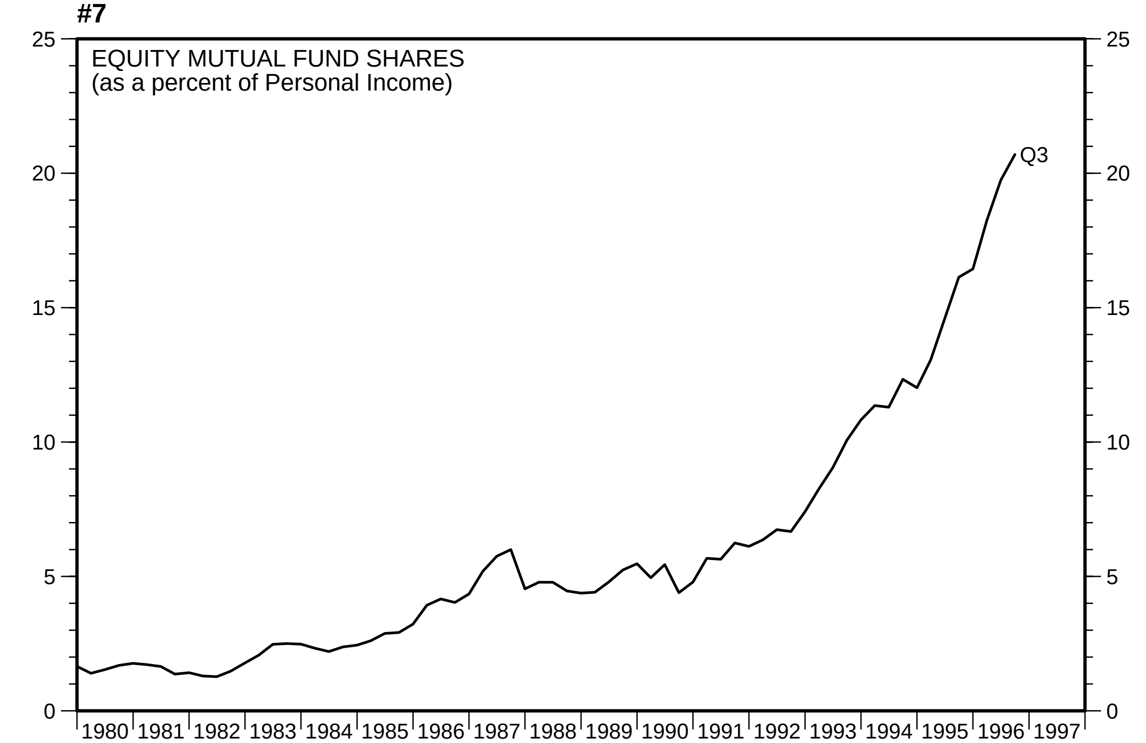
#6



Source: Federal Reserve Board, Flow of Funds Accounts.

Populist Capitalism: More and more individuals have a significant stake in the stock market.

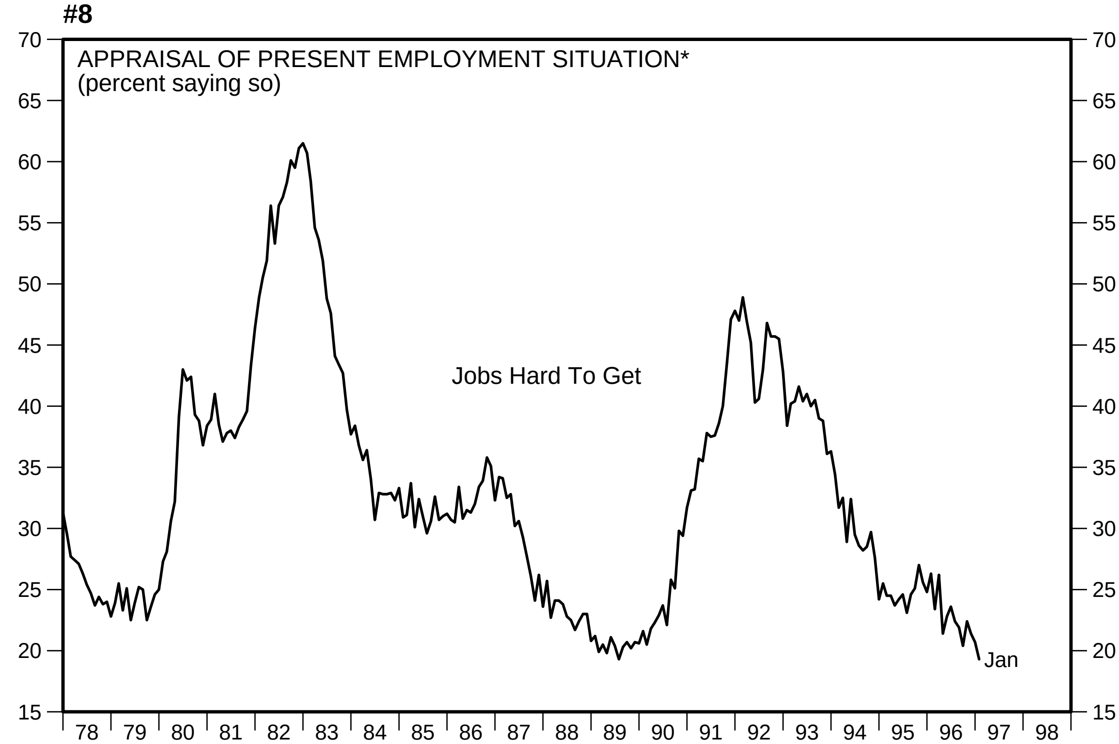
#7



Source: Federal Reserve Board, Flow of Funds Accounts.

- Consumer Confidence -

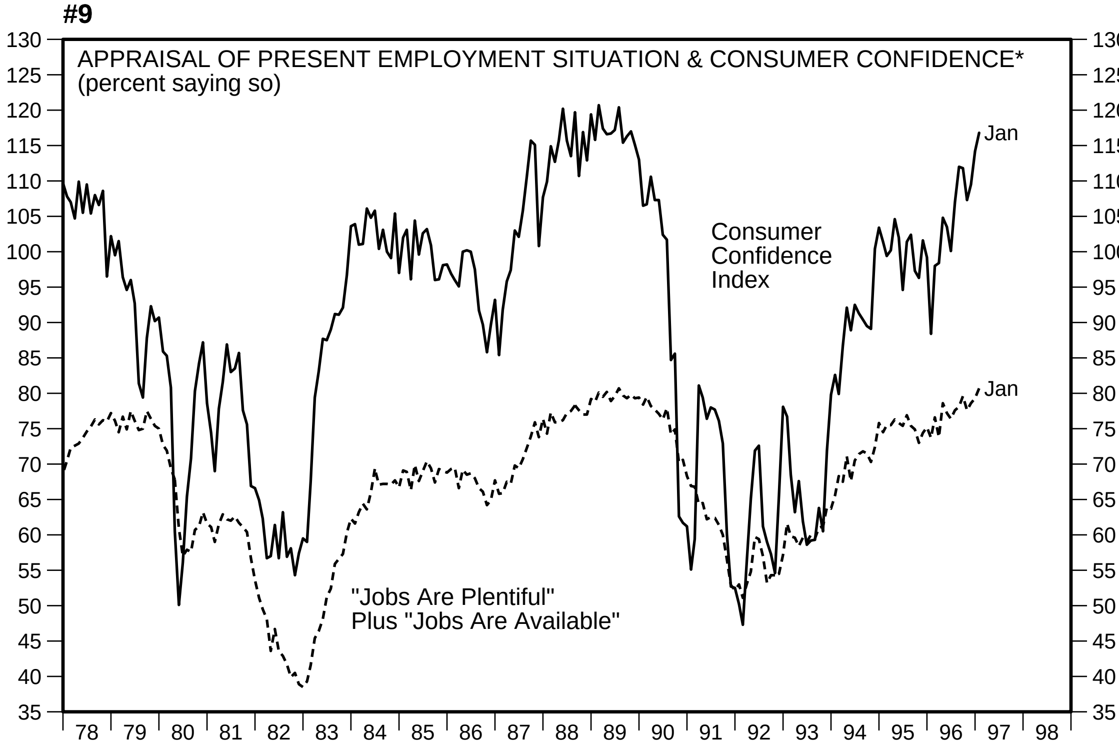
#8



* Survey conducted for the Conference Board by NFO Research Inc.

Despite the media hype about "job insecurity," consumers say jobs are plentiful.

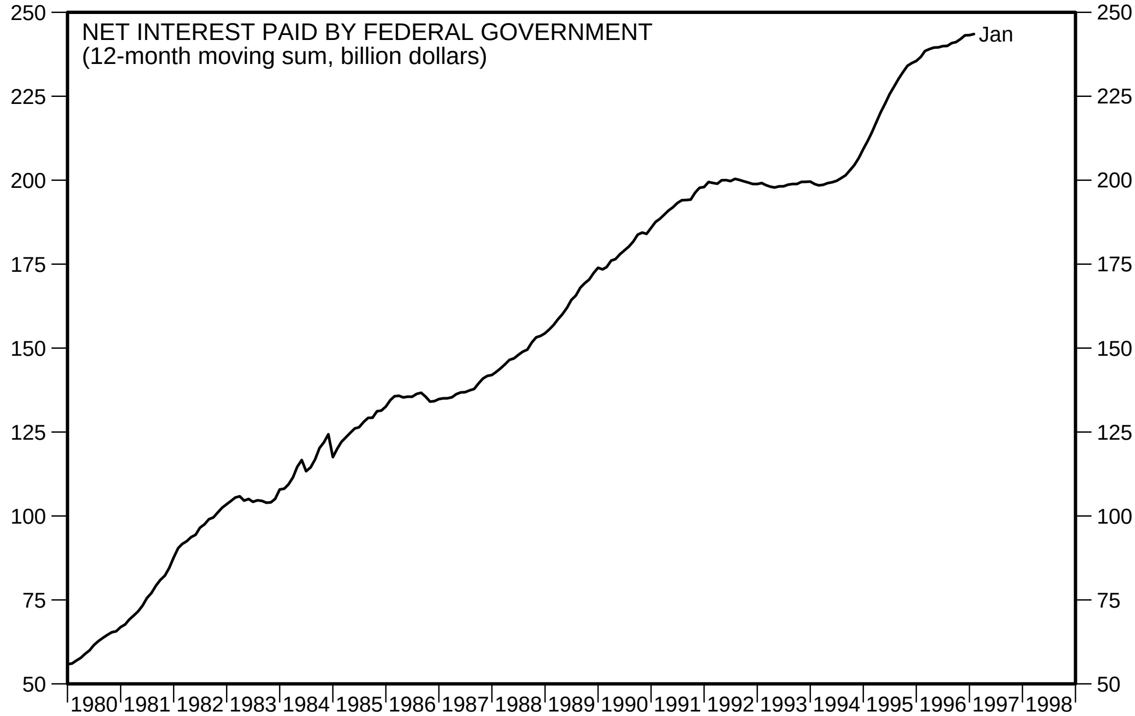
#9



* Survey conducted for the Conference Board by NFO Research Inc.

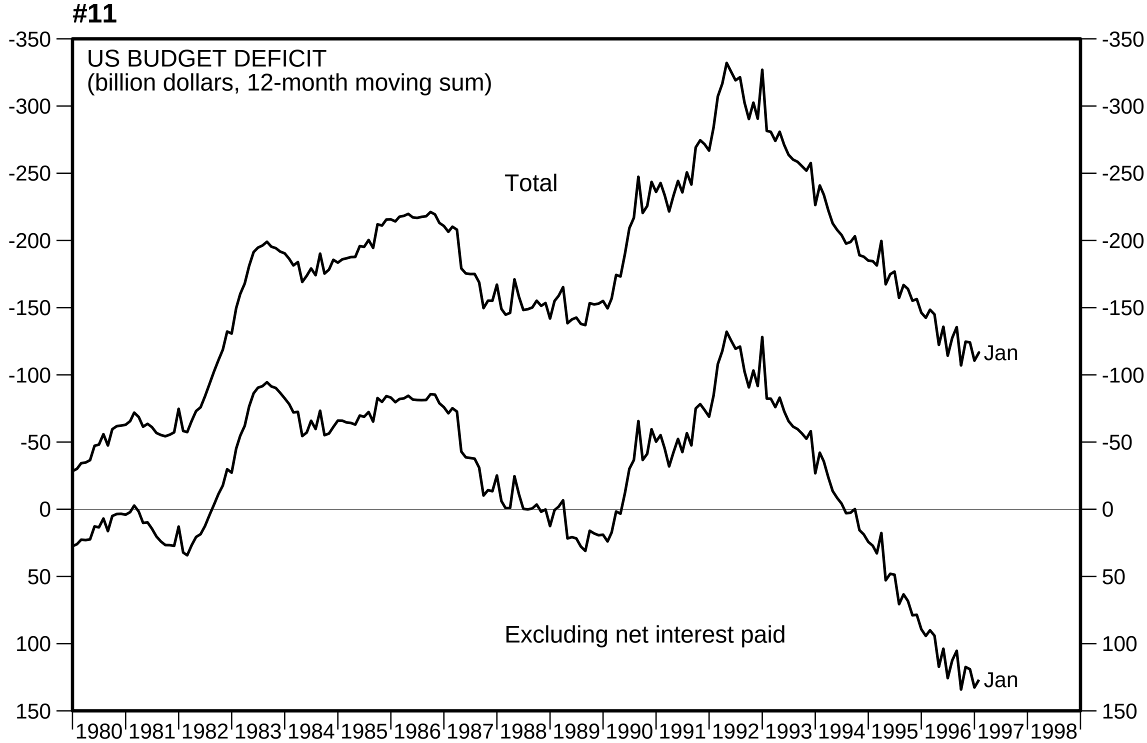
- Federal Deficit -

#10



Net interest paid by the federal government is more than twice as much as the entire Federal deficit. In this sense, the deficit is self-financed.

#11



TOPICAL STUDIES

Topical Studies #19 and higher are available on http://www.yardeni.com/yardeni/topical.html

#33 Dr. Edward Yardeni, *Productivity Must Be Booming*, January 20, 1997

#32 Dr. Edward Yardeni, *The Undefeated Forces Of Deflation*, October 28, 1996

#31 Dr. Edward Yardeni, *Economic Consequences Of The Internet*, October 22, 1996

#30 Dr. Edward Yardeni, *Backlash: Workers Vs. Bonds*, May 8, 1996

#29 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book 1996*, March 28, 1996

#28 Dr. Edward Yardeni, *Liquidity Story Is Wildly Bullish*, February 12, 1996

#27 Dr. Edward Yardeni, *10,000 In 2000*, November 6, 1995

#26 Dr. Edward Yardeni, *The US Economy's Mega-Trends*, July 10, 1995

#25 Dr. Edward Yardeni, *The High-Tech Revolution In The US of @*, March 20, 1995

#24 Dr. Edward Yardeni, *Hard Or Soft Landing?*, February 6, 1995

#23 Dr. Edward Yardeni, *The End Of The Cold War Is Bullish*, September 10, 1993

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

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

#20 Dr. Edward Yardeni, *The Collapse Of Communism Is Bullish*, September 4, 1991

#19 Dr. Edward Yardeni and David Moss, *The Triumph Of Adam Smith*, July 17, 1990

#18 Dr. Edward Yardeni and Deborah Johnson, *Dow 5000*, May 9, 1990

#17 Dr. Edward Yardeni, *The Triumph Of Capitalism*, August 1, 1989

#16 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book*, January 25, 1989

#15 Dr. Edward Yardeni and David Moss, *The New Wave Manifesto*, October 5, 1988

#14 Dr. Edward Yardeni, *Could Real Estate Prices Fall? And What If They Do?*, August 24, 1988

#13 Dr. Edward Yardeni, *The Coming Shortage Of Bonds*, June 20, 1988

#12 Dr. Edward Yardeni, *How The Baby Boomers Are Changing The Economy*, April 6, 1988

#11 Dr. Edward Yardeni and Deborah Johnson, *The Restructuring Of Corporate America Is Bullish*, December 9, 1987