

THE EPIC BATTLE BETWEEN ALAN GREENSPAN AND THE GHOSTS OF AUSTRIAN ECONOMISTS

While we consistently opine that most of our value-added as an investment management firm is created through generated research directed at the analysis and valuation of individual companies, occasionally a macro-picture theme or debate emerges that manages to detract from our normal efforts. So we will expand upon recent comments by our colleagues at Northern Trust in order that we may cleanse it from our day-to-day thinking and get back to work.

There is no more blatant statement of the obvious than to say that the economy is hovering at or near zero percent growth. Let's say 1%. Since this deceleration began at the end of the third quarter of 2000, the Federal Reserve, led by demi-god Alan Greenspan, has cut short-term interest rates (since that is all he can cut)...aggressively. In fact, as aggressively as any Fed chairman has ever cut short-term rates.

Thus we have the Alan Greenspan camp, which postulates that an analysis of 20th century economic history concludes that, with two major exceptions (the early 1930s and the early 1970s), aggressive Fed moves translate into a strong economy and, hence, major upward stock market moves begin within a fairly reasonable time period. Additionally, while recessions or slowdowns can be painful, they tend to be mercifully short on average – ten months is the 20th century average. So if you assume that November was the first month of decline and it is now June, we are right in the middle of things. Since the stock market always looks forward (see the Mr. Market Chart on page 2), the last 50 basis point cut in interest rates has put the icing on the cake of a very nice rally, taking major market averages close to or nicely above the line, depending upon who is keeping score. And there seems to be more to come.



Alan Greenspan vs. The Austrians

Mr. Market, Forward Thinker
S&P 500 earnings growth versus S&P 500 performance, 1947-2000

Earning Environment	No of yrs	No of up yrs	No of down yrs	Avg S&P 500 performance
Earnings down 5% or more	9	9	0	20.30%
Earnings down 0% to 5%	10	8	2	13.20%
Earnings up 0% to 9%	9	3	6	4.10%
Earnings up 9% to 14%	11	9	2	12.80%
Earnings up 14% to 22%	8	7	1	16.80%
Earnings up 22% or more	9	5	3	10.00%

Source: Steven Leuthold, Leuthold Group

This is compelling and well-documented logic, but as noted above, a blind commitment to it would have had disastrous consequences in the two periods in which it did not work, the 1930s and the early 1970s. And if Federal Reserve magic works so well here, then what the heck is going on in Japan, which has just completed a decade of 1% economic growth and a disastrous stock market, even though interest rates are less than 1%? Also, why are the people who are pointing to lower interest rates as manna from heaven the same people who completely ignored a near doubling of interest rates with a concurrent doubling of the stock market?

This brings us to the Austrians. Led by Friedrich Hayek, a group of Austrian economists published over the first two thirds of the 20th century a body of work that has its roots both in classic laissez-faire capitalism and a deep suspicion of the ability of governments to successfully intervene in markets without completely mucking it up. The Austrian School theory was naturally the complete opposite of what constituted polite economic talk in Washington from the 1930s until the 1980 election of Ronald Reagan, which centered on what Lord John Maynard Keynes did or did not say or mean.

The relevance of all this is that the Austrians felt, deep down, that business cycles were produced and exacerbated by government policy and in particular, central bank manipulation of interest rates. In obvious bouts of political kow-tow calisthenics, central banks are prone to over-promoting the creation of credit primarily through the lowering of interest rates below what would otherwise be dictated by the market. This produces a very natural and large over-investment in productive and financial assets, as the discount rate hurdle sinks below what would normally

be considered to be rational. And this over-investment takes a combination of pain and time to dissipate. Thus, interest rate policy becomes a particularly ineffective tool to produce the desired goal – a resumption of robust economic growth.

So there are those (naturally I will refer you to the home team, GrantsInvestor.com, for whom the RCB Chief Investment Officer pens a weekly piece) who say that is exactly where we find ourselves today. Conceptually, beginning in the summer of 1998, the Fed grossly over-stimulated the economy to respond to the Asian/Connecticut financial crisis and the resulting wave of liquidity was akin to throwing gasoline on the technology bonfire. This was the final stage of a massive over-investment in many things, but in particular information technology (whose productivity is now being severely questioned) and worthless adventures in investment banking and venture capital. Thus, the realization in the middle of the 2000 that a mistake had been made in epic proportions has put us in the economic torpor through which we slog today and a simple bout of rate cuts is not going to motivate the economic team for a big fourth quarter 2001 comeback.

As often is the case, we don't have any real conviction about throwing our hat in either camp. Clearly, a sustained economic bog would slowly dissolve stock prices as consensus expectations for American corporate earnings growth are still aggregating around 12%, a grossly over-optimistic expectation, albeit down from the fantasy of 19% growth logged about 6 months ago. For the record, earnings growth for the past 70 years has averaged a remarkably consistent 7%, a number that appears to have a bit more credence with the disappearance of the lunatic

New Economy fringe. It occurs to us that what was overbuilt in the last three years was overbuilt with little regard to the cost of capital; therefore a few percentage points of decline is not going to re-stoke a burning economic fire either.

But lower interest rates beat a sharp stick in the eye by a real long shot and that gives us confidence that we will not see a repeat of the early 1970s or anything dismally like Japan. Our 67% guess is for 18 more months of bumbling around within 10% of where we stand now as far as the major averages are concerned, which will allow better businesses to accrete value and catch up to prices that are still in many cases "fair," down from silly.

That's all nice, but what are we really doing day-to-day? In the large cap world, our initial purchase of Sealed Air in the low 30s has proven fortuitous, as it has benefited from a modest cessation of disaster chatter regarding everything from asbestos to Mad Cow disease. While it may be very early to declare victory, Sealed Air presented the rare alignment of all the important stars: a consistently excellent business franchise; a huge discount to our estimate of intrinsic value and an outstanding management team focused on shareholder value creation. Gifts like this don't come along often. We are about even on our addition of Motorola in the mid-teens as the first step into an attempt to discern value in the cratered technology and telecom world. Motorola has a number of well-documented and obvious cyclical problems, but at an enterprise value less than one times sales, we feel that the price more than compensates us for the additional business risk and this is a stock that can easily be \$35 in two years with simply a reversion to mere mediocrity, although we do not want to discourage the achievement of excellence by any means. Performance remains solidly ahead of relevant indices year-to-date.

In the small cap world, opportunities remain plentiful. Recent takeovers of Vicorp Restaurants and Scott Technology have freed up cash for new holdings in Arbitron, a truly world class business franchise, albeit a small one, which was spun off from troubled parent Ceridian, and Pegasus Communications, a mini-DirecTV which will undoubtedly be the next domino to fall in place once the saga surrounding DirecTV parent Hughes Electronics plays out. Performance is again excellent. (As

a self-serving P.S - the RCB Small Cap Fund now has an official ticker RCBSX...operators are standing by.)

We are also looking carefully at some formerly ugly, commodity areas as some interesting things are happening. Entire worldwide economic sectors like steel, aluminum, coal etc. have been starved for capital over the past decade and if you are one of the last left standing, your return on investment can be significant, as is being evidenced by the natural gas industry, and now coal and aluminum producers. The third degree effect of the utterly moronic destruction of wealth in the state of California due to completely inept political leadership and the managements of Pacific Gas and Electric and Southern California Edison is that huge increases in electricity rates are forcing the closure of significant capacity in the energy-intensive production of basic materials, and a little capacity closure can go a long way as far as profitability is concerned in a commodity-like business. We're bystanders for the moment, but this bears watching as it relates to both equity investment and something we haven't talked about in eons - inflation.

Jeffrey Bronchick

Chief Investment Officer

Reed, Conner & Birdwell Investment Management

jbronchick@rcbinvest.com

June 2001

RCB NEWS

We are pleased to welcome James Henderson as Senior Vice President and Portfolio Manager/Analyst to the RCB Portfolio Management and Research team. Jim comes to us with many years of experience and we look forward to his important contributions as we go forward in 2001 and beyond.

As always, we are making every effort to transfer our mailing list to e-mail where possible in order to get these Strategy Letters to you in the most timely fashion. Please forward your e-mail address to marketing@rcbinvest.com or call Tricia Robbins at 877-478-4722. For any general questions, please use the same e-mail or call Daryl Ann Weber or Michelle Gosom toll-free at 877-478-4722.



TO REACH US AT RCB:

INVESTMENT MANAGEMENT

Donn B. Conner, CFA, President & Principal dconner@rcbinvest.com
Jeffrey Bronchick, CFA, Chief Investment Officer & Principal jbronchick@rcbinvest.com
James C. Reed, CFA, Executive Vice President & Principal jreed@rcbinvest.com
James P. Birdwell, Jr., Executive Vice President & Principal jbirdwell@rcbinvest.com
Victor F. Hawley, CFA, Senior Vice President & Principal vhawley@rcbinvest.com
James R. Henderson, CFA, Senior Vice President jhenderson@rcbinvest.com
Thomas D. Kerr, CFA, Vice President tkerr@rcbinvest.com

BUSINESS DEVELOPMENT & CLIENT SERVICES

Daryl Ann Weber, Senior Vice President & Principal dweber@rcbinvest.com
Michelle Gosom, Marketing Associate mgosom@rcbinvest.com
Tricia Robbins, Marketing Assistant trobbins@rcbinvest.com

TRADING & ADMINISTRATION

Daniele Beasley, Chief Administrative Officer & Compliance dbeasley@rcbinvest.com
J. Fred Aguilera, Trader faguilera@rcbinvest.com
Madge Alston, Portfolio Administration malston@rcbinvest.com
Hailey Campbell, Office Administration/Receptionist hcampbell@rcbinvest.com
Kimberly Charmaine, Director of Operations kcharmaine@rcbinvest.com
Kimberly Sherwood, Portfolio Administration ksherwood@rcbinvest.com