Appendix 1.3

Wall Street Seer

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Superbull Ed Yardeni—whose market forecasts have been on the money—sees Dow 15,000 in eight years.

Perhaps its his glibness and fondness for Baby Boomer catch-phrases. Or maybe it's his sunny faith in the future of the U.S. economy in a field in which cynicism and pessimism are often mistaken for profundity.

But market strategist Edward Yardeni, chief economist at Deutsche Morgan Grenfell, never has gotten his due despite a decade or more of canny calls on the stock and bond markets and on the economy. He finished a disappointing third this year in the Smart Money magazine stock market strategist rankings, behind Goldman Sachs's Abby Joseph Cohen and runner-up Byron Wien of Morgan Stanley. The latter (who has been featured several times in *Barron's*) has made some excellent calls but has executed enough flips in the past year to qualify for the world free-style gymnastics competition and, of late, has declined to offer specific year-end market forecasts.

Likewise, Yardeni perennially finished second to Edward Hyman of the ISI Group in Institutional Investor magazine's poll of money managers for fixed-income economists on its All-Star Team. Both have been long-term disinflationists and bond bulls. In Yardeni's estimation, Hyman's edge arises from the fact that he's "the best marketer on Wall Street."

Ironically, that's precisely the kind of statement Yardeni's own critics make about him. But a number of Yardeni's market forecasts have been startling in their prescience. Back in the post-Crash days of 1988 when the Dow Industrials were flatlining around the 2000 mark, and many market pundits waited in grim expectation for the devastating second leg of the bear market, Yardeni boldly predicted that the Dow would hit 5000 by 1993.

The call proved two years premature, but was nervy nonetheless. When the Dow finally busted through 5000 in the fall of 1995, Yardeni boosted his target to 10,000 by the year 2000. And now that the Dow is less than 2,000 points from that goal with three years to go, Yardeni is already talking of a Dow of 15,000 by the year 2005. "This may sound like another one of my farfetched forecasts, but actually it's pretty conservative, given the bullish secular trends that I see continuing to unfold," Yardeni enthuses during an interview in his book-lined office in midtown New York.

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Market calls are a dime a dozen on Wall Street. And frequently, the more outlandish they are, the more ink they garner. But what makes Yardeni's work noteworthy is its thorough grounding in classical economic theory, demographics, geopolitics, technological developments and complexities of monetary charts flows. He has written dozens of "topical studies" during his 20-odd years at three different Wall Street firms, and he expounds on major secular market themes in presentations and articles replete with and statistical backup. At the same time, these themes are constantly "stress-tested" with the latest economic data in his weekly economic and market reports and the blizzard of daily faxes he sends to his more than 2,000 institutional clients.

Yet he concedes that his long-term perspective can cost him—and his clients—sometimes. His belief in disinflation and a continuing decline in interest rates caused him to miss a rise of better than two full percentage points in long-term bond rates in 1994 and another rate spike in 1996. He admits to "flinching" unnecessarily in predicting a recession in 1988 that never happened. Then, he compounded the error by missing the 1990-91 recession because of his conviction that the end of the Cold War and the triumph of capitalism dramatically had reduced the risk of economy-wide recessions for years to come.

"There's always a danger in this business of getting too dogmatic and egocentric about how the world works," Yardeni avers. "I think what my clients appreciate is the fact that I've gotten the big picture right over the years and I don't simply serve up the usual analysis du jour on the latest government statistics. The markets and the economy are like a soap opera. You don't have to see every episode to know how things will turn out."

Even so, Yardeni has begun to get uneasy over the stock market's short-term prospects on its way to his long-term targets. In a study dated July 14, he recommends that global investors lighten up on their stock positions and buy bonds as the market moves higher over the next two years. He likewise assigns a 30% chance to a worldwide recession in the year 2000. "We well could have a 20%-25$ stock-market correction in a year or two after reaching 10,000. Once we repair that damage, though, we'll be on our way again towards 15,000 by 2005," he contends.

Among the factors that concern him are signs of irrational exuberance. He points to the recent Business Week cover story trumpeting Fed chief Alan Greenspan's embrace of the "New Era" economic theory that technology and productivity improvements can deliver strong economic growth without inflation. And Wired magazine, the cybernaut Bible, asserts in its July cover story that the nation is in the early stages of a "long boom" that will bring 25 years or more of prosperity, freedom and a better environment, not just for America but for the world as a whole.

"I've got too much company now in the New Era camp, and it worries me. I was a lot happier five and ten years ago when people like the Wall Street Journal's Alfred Malabre, investment banker Pete Peterson and Philadelphia Inquirer reporters Donald L. Bartlett and James B. Steel were putting out their silly doom-and-gloom books and attracting much attention," grumbles Yardeni, who has an entire shelf devoted to such tomes.

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Another current risk to the economy is the possibility of a deflationary implosion that could hurt both economic growth and corporate profits. He wonders whether the soaring stock market could be exerting negative G-force on the economy by diverting money to equity mutual funds from spending on goods and services. Especially when financial assets are going up in value while plain old consumer goods are constantly getting marked down or superseded by higher-quality products at the same price. Such a phenomenon might explain the anomaly in the second quarter when soaring gains in real income and consumer confidence resulted in only weak retail sales.

The ultimate fear, says Yardeni, is that weak corporate sales from this "negative wealth effect" might impel businesses to take regressive measures, such as cutting payroll and chopping capital-spending levels, rather than continuing to follow a growth strategy of pushing product innovation, enhancing productivity and boosting volume through price cutting.

Finally, there's the year 2000 problem (alias Y2K), which Yardeni claims may be more serious than most observers realize. The cost of fixing corporate computer software systems to recognize the digits 00 as 2000 will run from $300 billion to $600 billion worldwide over the next three years. That's a big number when compared with last year's $407 billion in total U.S. after-tax corporate profits. "More than likely, the market will ignore the one-time expense like it did FASB 106 post-retirement health-benefits write downs in the early 'Nineties," opines Yardeni. "But one can also imagine a scenario in which Y2K outlays cause an exogenous shock to the economy and trigger a recession just like the Arab oil embargo did in the mid-1970s. Information, after all, has become as important today to the world economy as oil."

Despite these risks, Yardeni remains unremittingly bullish on the course of the economy and the markets. The overriding fundamentals are just too powerful, in his estimation. Or, as he likes to put it, the Forces of Light have triumphed over the Forces of Darkness in the past decade and will continue to hold sway.

One sea change that Yardeni sensed long before most pundits was the death of post-World War II inflation. He first began to write of disinflation and falling interest rates in the early 'Eighties, when he toiled as an economist and market strategist, first at E.F. Hutton and later at Prudential-Bache. He seized on the disinflationary impact of secular changes like OPEC's loss of pricing power over oil and the Reagan Revolution's attack on Big Government and Big Labor.

In 1983, Yardeni, then a self-described pisher (roughly translated, a Yiddish word for "greenhorn") of just 33, coined a descriptive phrase that has become part of the Wall Street lexicon and won him enduring fame. He described how bond investors—or "bond vigilantes"—would bring discipline to U.S. economic policy and hold inflation at bay. After a decade or more of negative returns, he reasoned, they would no longer tolerate overly stimulative monetary or fiscal policies. Instead, the vigilantes would ride herd by instantly boosting long-term interest rates at the first whiff of inflation to effectively choke off overheating in the economy.

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Bond vigilantism has since become one of the most successful privatizations of a government function—the triumph of free markets over statist controls and that sort of thing. As a result, Yardeni maintains that recessions have become less frequent and severe.

The economist was also one of the first strategists to see the bullish implications for the markets and the economy of the aging of the Baby Boomer Generation—that population cohort of some 76 million strong born between 1946 and 1964. Back in 1988, he wrote his first major report on the subject. He predicted that, with the subsiding of the Boomer surge into the workforce after 1980, jobless rates would fall and productivity rise. The latte was a consequence of the Boomers' increased longevity, job experience and the incentive that employers had to invest in labor-saving equipment now that the tidal wave of cheap Boomer labor had run its course.

Yardeni theorized that the Boomers' again had yet other important implications. He predicted that the generation's insensate spending on fancy clothes, cars, stereo and video equipment and as much house as could be debt-levered would give way to Calvinist thrift as older Boomers lapse into couch-potatodom and began at last to save for retirement.

That, of course, would be good for financial assets. Thus, Yardeni was one of the first commentators to pick up in the early 'Nineties on the swelling monthly flows into bond funds and then into stock funds. He'd been expecting it for some time.

Nor does Yardeni think the Baby Boomer mania for stocks and other financial assets has crested—not with that generation figuring to hit its peak period in personal income and savings after the year 2000. And, he adds, withdrawals from retirement accounts shouldn't begin in earnest until after 2010, when the leading edge of the Boomer generation turns 65.

"One can't dismiss the impact of Baby Boomer spending," Yardeni observes. "Their frenetic buying of residential real estate caused home prices to jump as much as tenfold in some areas from the late 'Sixties to the early 'Eighties. Now they're in the process of doing the same thing in the stock market. The market is already up more than eight times in the past 15 years."

Surging U.S. productivity is yet another trend that has turbocharged share prices and it figures to continue, says Yardeni. This alone explains several of the mysteries of the 'Nineties. First, enhanced efficiency and productivity allowed corporate profits to rise smartly from 1991 through 1995 despite lackluster growth in the general economy and in company revenues. And now continued productivity gains are pushing inflation rates lower, despite strong economic growth and surging employment.

Yardeni began harping on the productivity theme in the dreary days following the 1987 Crash, when he sometimes was on the Prudential-Bache squawk box three to four times a day trying to rally the broken spirits of the brokerage house's registered reps all over the U.S.

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He laid out the same message again and again: The Crash was just a random event, triggered by an overreaction to trivial outside events, rather than a reflection of any fundamental problem in the economy. Investors ought to focus on the remarkable restructuring of Corporate America since the early ‘Eighties—the drastic paring of redundant plants and jobs, the revamping of work processes, the adoption of just-in-time inventory techniques, increased spending on automation, and tough bargaining on the labor front—all of which were yielding “awesome” cost savings and productivity gains. “American companies are leaner and meaner. They are very profitable now.

They are more responsive to their markets,” he trumpeted in one report from the period.

Productivity growth is still booming, Yardeni asserts. However, U.S. statistical measures are failing to capture the fact, creating what some economists have called the “productivity paradox.”

There are several problems with the official numbers, Yardeni maintains. Unit output (the key variable in computing productivity) is difficult to measure in some of the fastest-growing sectors, such as technology, communications, health care, and the service industries as a whole. Quality improvements in these areas prove particularly elusive. The calculation of real output growth is further skewed by the increasing overstatement of America’s inflation rate, which the Boskin Commission recently addressed.

Studies of growth in sales per employee of S&P 500 companies have led Yardeni to conclude that output per man-hour of labor is, in fact, rising at a sprightly 3% or so annually, rather than the anemic 1% reported by Uncle Sam’s pencil pushers. This is even after he adjusts his S&P number to eliminate goods or services produced overseas or the sales of raw or intermediate output in order to make his measure comparable to the government’s figures.

“Just looking at the way I operate today with fax machines and E-mail connections to all my customers, and a Web site that automatically updates 7,000 different economic charts, I know I’m infinitely more productive than I was just five or ten years ago, when to get a chart into one of my reports, I had to messenger it over to a graphic designer for overnight turnaround,” Yardeni notes. “Yet I doubt that this would show up in government productivity numbers, which were developed, after all, for the Industrial Age.”

The end of the Cold War is yet another theme that Yardeni has intently focused on. In the aftermath of the 1989 fall of the Berlin Wall and the subsequent breakup of the Soviet Union, many on Wall Street worried that the liberation of hundreds of millions of new consumers would unleash torrid additional demand for commodities and capital and ignite inflation in prices and cost of credit. The “capital shortage problem” alone was deemed the ‘Nineties version of the oil crisis of the ‘Seventies.

Yardeni was quick to brand such broodings as misguided Malthusianism. As a student of Adam Smith (a well-thumbed copy of Wealth of Nations sits behind his desk), Yardeni maintains that the epochal political events of the early ‘Nineties are both disinflationary and profoundly bullish.

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According to the economist, the Cold War created a huge barrier to trade, hindering the untrammeled interplay of free-market forces around the globe. As a consequence, productivity and social welfare suffered from less-than-optimal allocation of capital and labor. Vast resources had to be wasted on military spending, for example.

The triumph of capitalism and free trade in recent years has created the first truly global market in human history, Yardeni adds. And with the creation of this vastly expanded marketplace come the benefits that Smith wrote of more than 200 years ago. Fierce competition among producers and accessibility to cheaper labor lower the prices of goods and services. Larger markets also promote increased productivity and efficiency by allowing for enhanced specialization and division of labor over a wider spectrum of products. This pursuit of comparative advantage redounds to the benefit of all nations and consumers.

Lastly, the more attractive opportunities afforded by larger markets fire the entrepreneurial spirit and spur innovation and better-quality goods.

“The U.S. is seeing business opportunities today that absolutely dwarf anything that existed in our supposed Golden Age of the ‘Fifties and the ‘Sixties. Total world exports have risen some 70% from 1989 to today, hitting over $5 trillion last year, according to International Monetary Fund estimates. That total could easily double by 2000,” gushes Yardeni.

The final factor that bodes well for the U.S. economy and stock market is the accelerating high-tech revolution. Business and consumer spending on computers, telecommunications equipment and software was a trivial component of real GDP even a decade ago, accounting for less than 5% of the economy. These days, such spending accounts for more than 10% and will hit 20% by 2000, according to Yardeni. Emblematic of its growing weight, spending on computers alone accounted for roughly a quarter of the 4% growth in GDP over the past 12 months.

Even more important, in the economist’s estimation, has been the deflationary impact of the high-tech revolution on the economy. One can see this most dramatically in the microprocessor market, where computing power continues to double every two years or so and yet prices per MIPS, or millions of instructions per second, continually fall (from 1982 to 1995, MIPS per $100 rose from one to 30). “That plunge in MIPS prices is the most extraordinary deflation in the history of the planet,” Yardeni enthuses, indulging in, perhaps, a bit of hyperbole.

Likewise, technology spending is yielding increasing productivity gains after billions of dollars in capital investment. That, as much as any other factor, explains why inflation is so well-behaved so late in the economic cycle and with unemployment at such low levels, Yardeni theorizes.

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To Yardeni, information is quickly turning into a fourth factor of production, substitutable in many instances for land, labor, and capital. Automation and high-tech process controls increasingly replace workers on the factory floor. The insurance industry has eliminated the need for support personnel and warehousing space for archived files with optical scanning and information stored on disks. Just-in-time delivery chops working-capital needs for companies. And on and on.

Yardeni sees yet other ways that technology promises to work its magic on excess costs. He foresees a growing commoditization of most products and services, as a result of the Internet. “Even today, some Internet-savvy consumers are using search engines like Alta Vista, Yahoo!, and Excite to find the lowest prices for goods and services they desire in what’s fast becoming a global auction market,” Yardeni observes. “The Internet lowers the cost of comparison shopping to nearly zero. To survive in this dynamic global pricing environment that’s developing, competitors will be forced to slash prices, boost productivity, and constantly introduce new and better products.”

Yardeni was anything but a bull earlier in his Wall Street career. He cut his teeth on the business during the stagflation of the Carter Administration and Federal Reserve Chairman Paul Volcker’s scorched-earth attack on inflation in the late ‘Seventies and early ‘Eighties. Yardeni worried as late as early 1982 that there was a 30% chance that Volcker’s tight money policies might throw the U.S. into an economic depression. At the time, Yardeni was much influenced by the Kondratieff Wave theory, which posited 50- to 60-year cycles of alternating booms and busts in capitalist economies. Yardeni was so convinced of a coming crash in asset values that he dumped his house and 16% mortgage in Scarsdale, N.Y., in 1981 to move his family into a rental apartment in Manhattan until the dust cleared.

Of course, the Big Kahuna never arrived. And by late 1982, Yardeni proved supple enough to embrace the now-rallying stock and bond markets. He even sheepishly bought back into real estate four years later, moving his family into a home on Long Island. He, of course, had missed five years of housing-market appreciation and he paid through the nose for the misstep.

He learned from the experience to remain flexible and not be caught up in any one economic model or single view of reality. He had seen his long-time hero, the former Salomon Brothers economist Henry Kaufman, “commit professional suicide” by sticking with his Dr. Doom act for too long. Nor does he think that rival market commentators like Lacy Hunt or Larry Kudlow added much to the party in the ‘Eighties with their slavish adherence to monetarism and supply-side economics. “They were just far too predictable,” Yardeni contends. (That, of course, is what some of his competitors say about Yardeni, whom they deride as “Ready Eddie,” a publicity hound always ready with a quote or sound bite for the press. Yardeni’s recent record probably has his detractors gnashing their teeth.)

The economist credits much of his change of heart in the mid-‘Eighties to immersion in the writings of Adam Smith. Among other things, he was struck by the similarities between the England of Smith’s day and a U.S. emerging from the economic and political traumas of the ‘Seventies. Both were wracked with pessimism. Just as American pundits worried about the growing budget and trade deficits (the so-

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called twin peaks), pamphleteers in Smith's England inveighed against the huge debt England had run up to the Dutch and other foreigners in winning the Seven Years War in 1763 and what they perceived as the permanent decline in England's economic might.

But Smith was, in Yardeni's words, "the original optimist" who believed that "universal opulence" was indeed possible with a few major policy changes to free up market forces. And indeed, Yardeni was soon heartened by the fact that around the world the tide seemed to be turning toward free trade, deregulation, lower taxes and international cooperation.

Yardeni claims to be an optimist by nurture as well as nature. He had a happy childhood. Born in Haifa to Israeli parents, he came to the U.S. at age seven in 1957, when his father won a scholarship to attend graduate school in engineering. The family decided to stay in the U.S., moving from Cleveland to San Jose and finally to New Rochelle, a suburb north of New York City, as Yardeni's father pursued the American Dream at various corporations before landing at IBM.

Yardeni still speaks with a slight accent. "I learned English by watching Rin Tin Tin and other television shows I liked," he recalls. It didn't affect his academic performance, however. He graduated magna cum laude from Cornell with a dual major in government and economics. A Ph.D. in economics from Yale followed in 1976. His adviser was Nobel laureate James Tobin.

He had a short stint at the New York Federal Reserve in 1977. "My specialty was flow of funds in the savings and loan industry, which soon became an important topic. Even so, all my memos went straight to the files unread by anyone," he recalls.

These days, Yardeni has emerged as a hot property among institutional investors. Nobody on Wall Street has gotten the big picture more right than he over the past decade. Even Alan Greenspan seemed to be embracing his views when he talked during recent congressional testimony of the "puzzling quiescence of inflation" and a "once-or-twice-in-a-century phenomenon that will carry productivity trends, national and global, to a new, higher track."

Often during speeches, Yardeni lapses into his Yakov Smirnoff act by exclaiming, "America, it's a great country." Only with Yardeni, the line is more than mere shtick. He clearly believes it and thinks investors should, too.