

BORROW AND SPEND, GUNS AND BUTTER, OVERCONSUMPTION

In my continuing series of "two-cents worth" opinion *Hotlines*, I have long been knocking the U.S. policies of "borrow and spend, guns and butter, overconsumption" in reference to, for example, the "twin deficits" of near record trade and budget deficits. Today I would like to use the recently released Fed Flow of Funds data to further back up my case.

On chart S1065 note that at the cyclical stock market lows in 1966, 1970, 1974, 1982, 1990, 1994, etc. one of the most distinguishing characteristics of the bottoms and early rises were low levels of household debt growth. My "two-cents worth" opinion is that this is what recessions should be all about - correcting the excesses of the previous expansion cycles. But in the last cycle, the Fed was so scared of the stock market bubble (that they helped create) that rather than letting the excesses correct, they shifted to a "make cash trash" policy that actually encouraged more borrowings and at an increased rate. Some clients have argued that much of the household debt this cycle was in mortgages, and that getting people to quit renting and instead borrow to buy a house is not a bad policy, and my response has been two-fold: (1) increased mortgages at low interest rates and low down payments are not a bad policy in good times, but in bad times when people might lose jobs, it is very high-risk and, (2) our analysis on S1065 shows that the market has done some 15 times better with low rather than high debt growth.

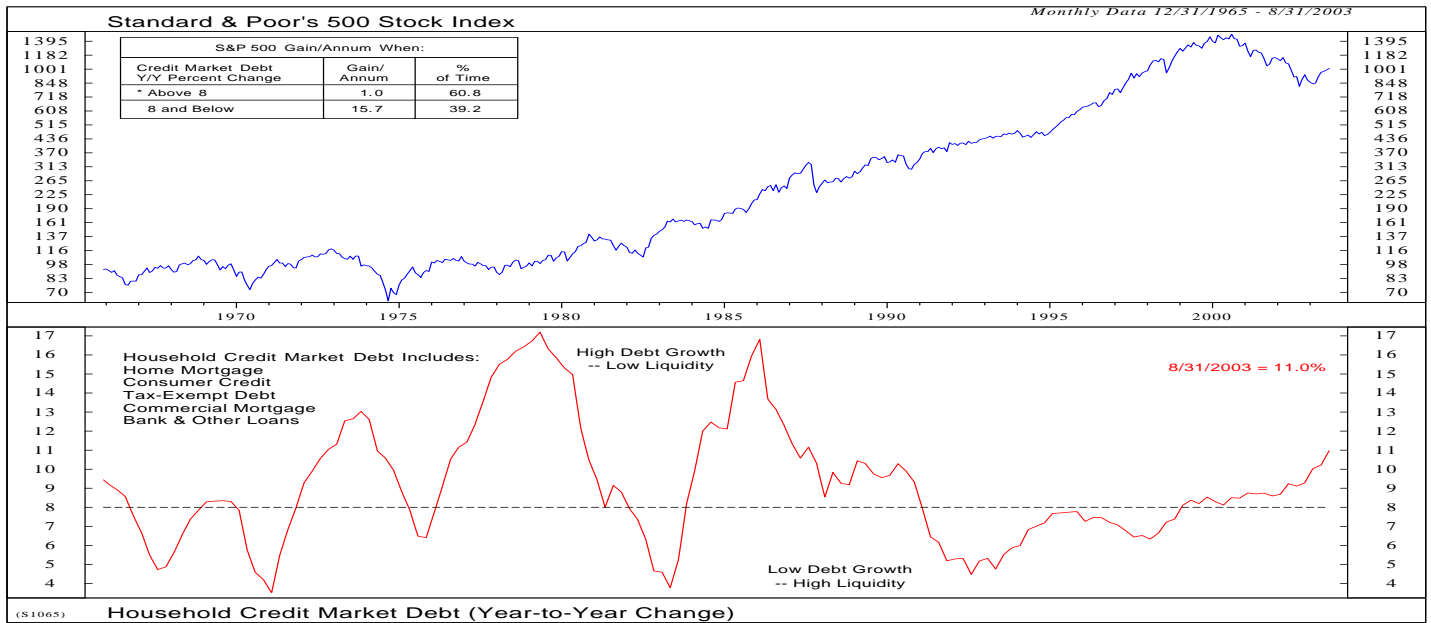
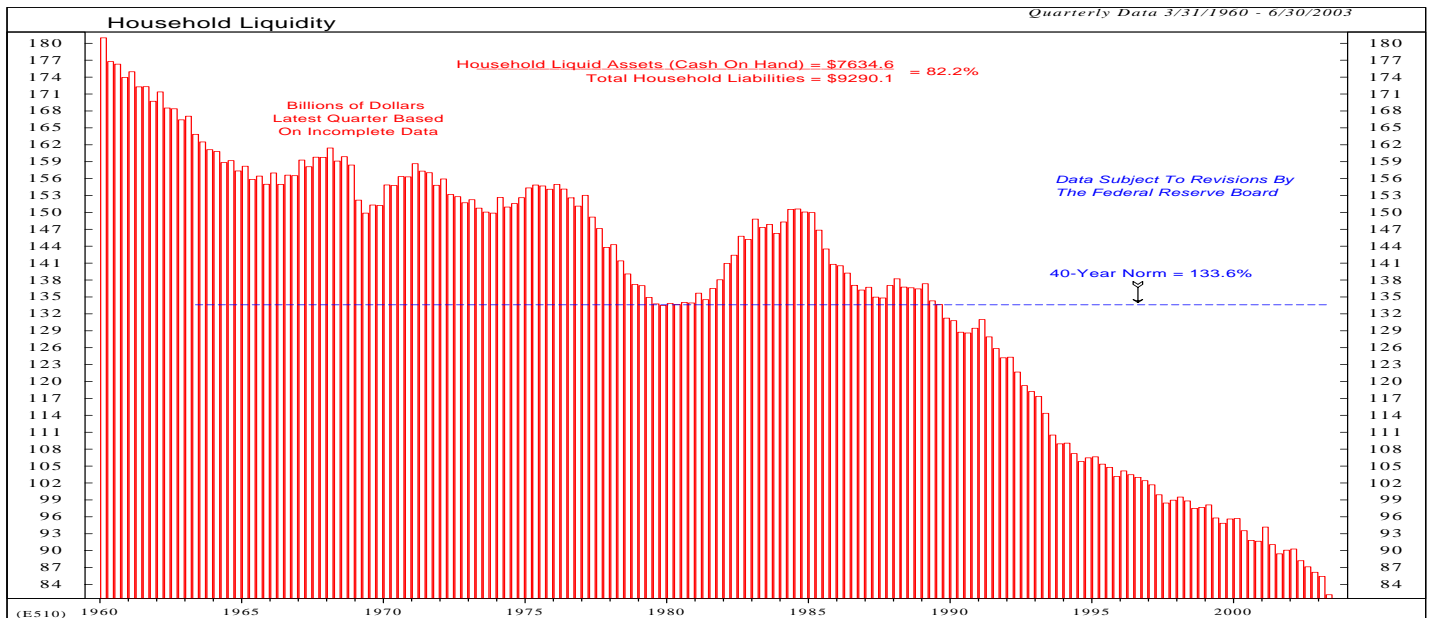
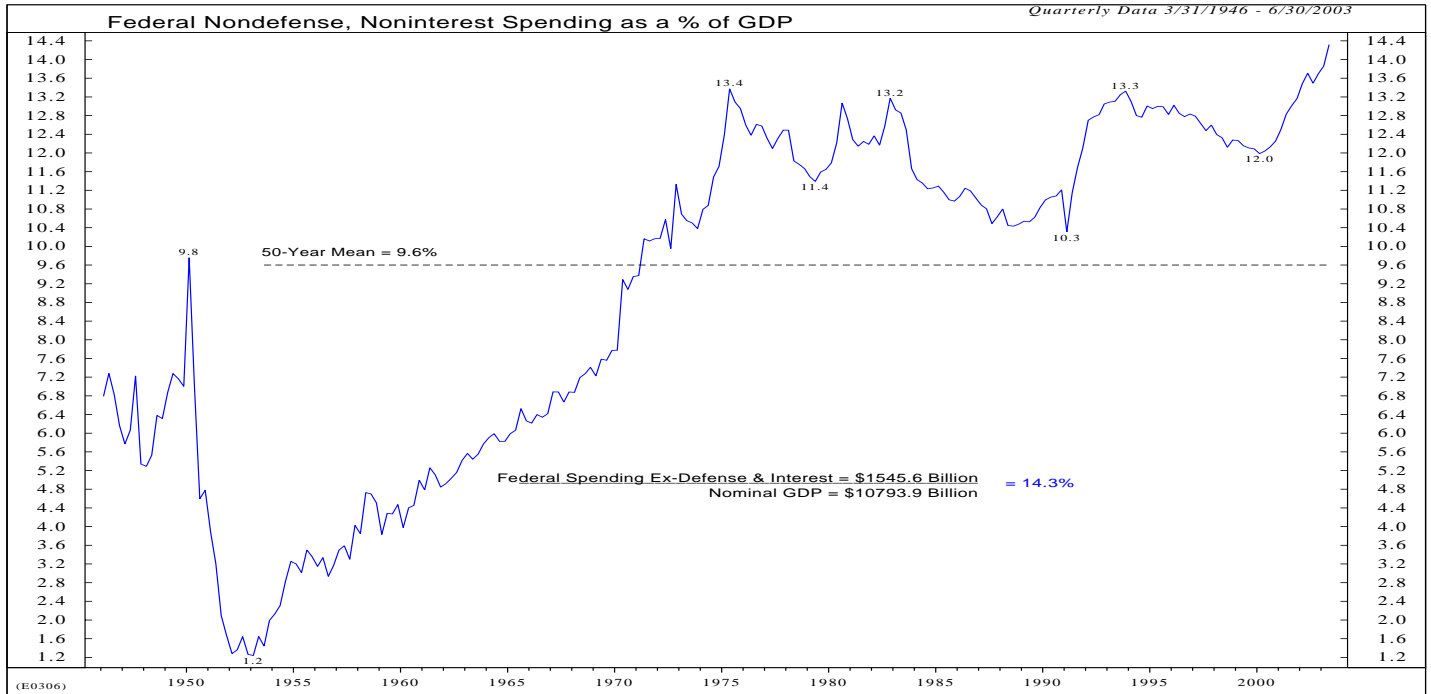


Chart E510 below now shows households at a record low level of liquidity. Economists can say over and over that low savings and high debt is manageable at low interest rates, but the nearly four million bankruptcies over the last 10 quarters, when the economy has generally risen, calls that into question. (continued on page 2)

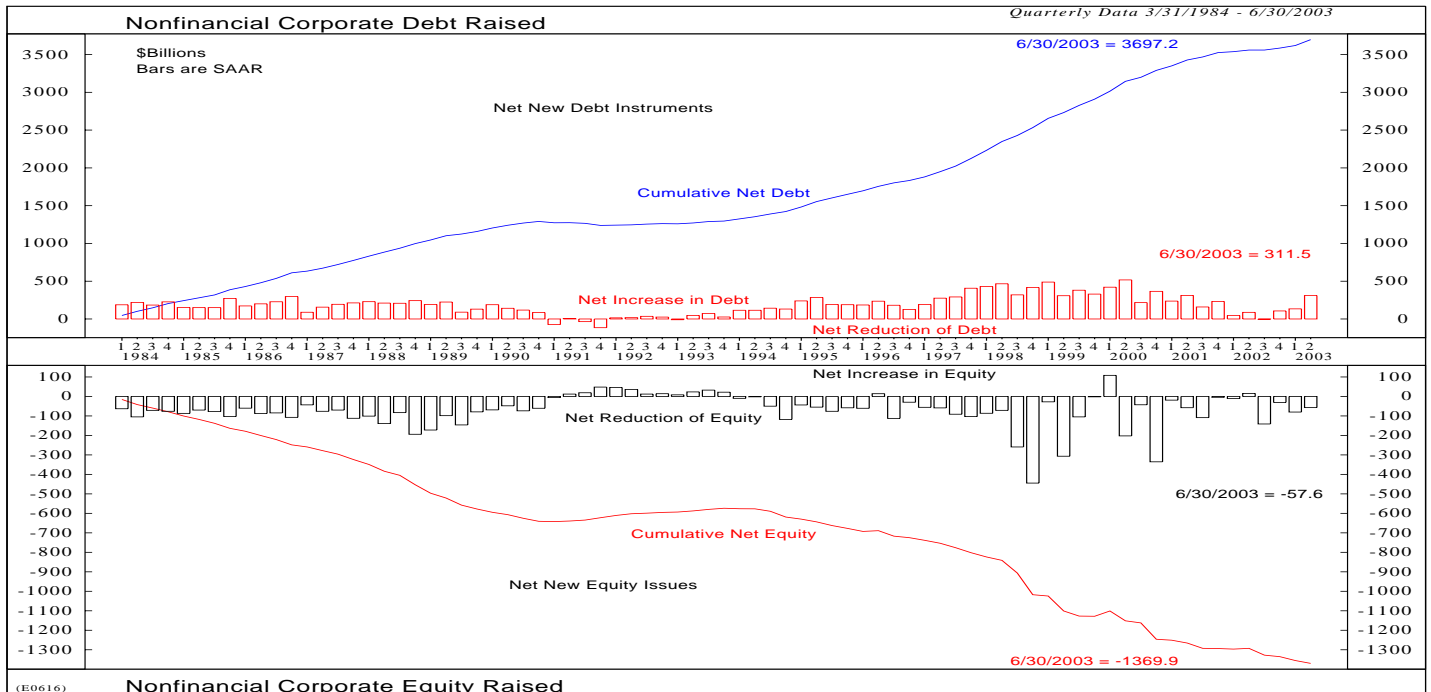


NED DAVIS RESEARCH INSTITUTIONAL HOTLINE Page 2 of 3
FRIDAY, SEPTEMBER 12, 2003

Moving on to fiscal policy, the government has argued that they should not be responsible for a deficit caused largely by wars in Afghanistan and Iraq. I am sympathetic to the war on terror, yet chart E0306 below shows that after stripping out all spending on servicing the record level of government debt plus all defense spending, this still leaves the government with record spending on other items as a percentage of GDP. I am also uncomfortable that some 40% of U.S. Government debt is now owned by foreigners.

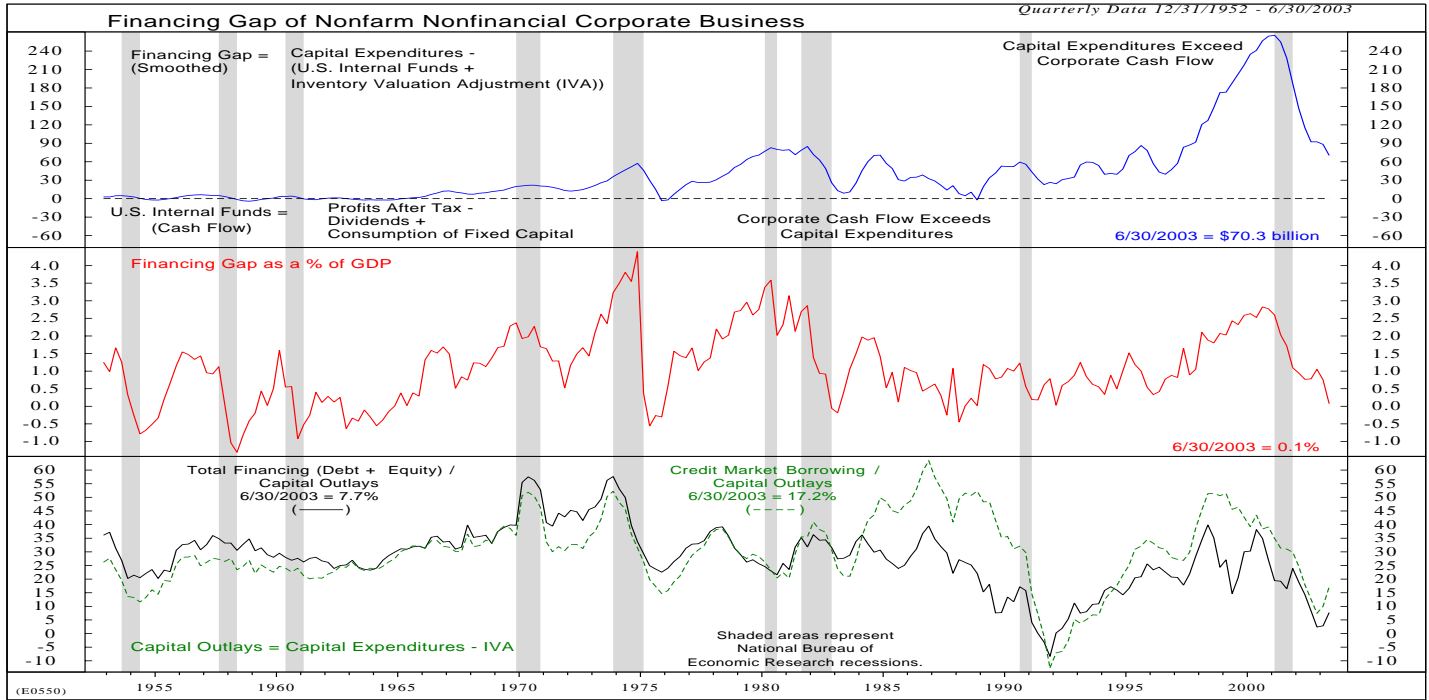


Moving on from the Fed, households, and the government, what about corporations? They too are leveraged like crazy as shown on chart E0616. Since 1984, corporations have added \$3.7 trillion in debt to their balance sheets while retiring \$1.4 trillion in equity. We used this leverage to predict that the 2001 recession would be mild due to all the Fed and tax cut stimulus, but that corporate profits would have a **hard landing**. But leverage works both ways, so now corporate profits are having a "boom-like" rise. If it were all productivity gains that are causing the profits to rise, why is it U.S. exports of goods and services are not much higher than they were in 1997? In my opinion profits have done extremely well recently due largely to all the leverage in corporate balance sheets. This is probably why corporate insiders are selling stock like crazy - they know the gains represent mostly leverage (plus tax relief, subsidies, booming defense spending, and weak dollar) rather than a real improvement in our competitive position and manufacturing base.

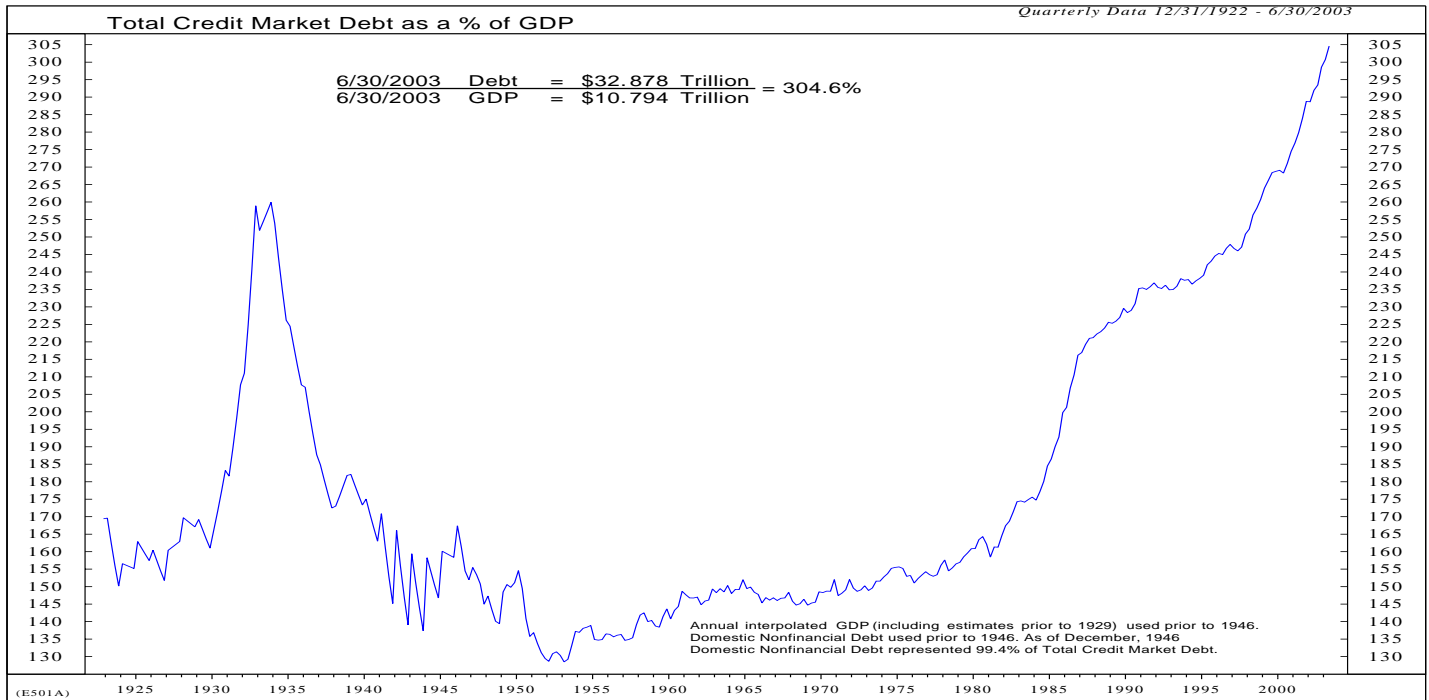


FRIDAY, SEPTEMBER 12, 2003

A few years ago corporations were spending on capital expenditures way over cash flow causing a record financing gap, which allowed us to predict a sharp slowdown in capital spending. One piece of good news on the corporation front is that this financing gap has mostly closed, as shown on chart E0550 below. That helps the capex outlook.



For a perspective picture of what all this debt looks like relative to the size of our economy, chart E501A below shows total debt is now \$33 trillion or more than three times the size of the economy which must service the debt.



In conclusion, a likely ongoing cyclical bull market and a "boom-like" surge in profits notwithstanding, it remains my "two-cents worth" opinion that the "borrow and spend, guns and butter, overconsumption" policies in this country currently are extremely high risk. My answer to all the risks is to try to buy during cyclical bull markets and then sell when cyclical risks get too high, as shown by our indicator composites. (Some gold ownership insurance - purchased at oversold conditions - is also advisable.) --Ned

The analysts contained herein is provided "as is", without warranty of any kind, either expressed or implied. Neither Ned Davis Research, Inc. nor any of its affiliates or employees (NDR) shall have any liability for any loss sustained by anyone who has relied on the information contained in an NDR publication. All opinions expressed herein are subject to change without notice, and you should always obtain current information and perform due diligence before trading. NDR, accounts that NDR or its affiliated companies manage, or their respective shareholders, directors, officers and/or employees, may have long or short positions in the securities discussed herein and may purchase or sell such securities without notice. NDR uses various methods to evaluate investments which may, at times, produce contradictory results. The securities mentioned in this document may not be eligible for sale in some states or countries, nor be suitable for all types of investors; their value and income they produce may fluctuate and/or be adversely affected by exchange rates, interest rates or other factors. Further distribution prohibited without prior permission. Copyright 2003 © Ned Davis Research, Inc. All rights reserved.