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Contrarian Chronicles

Spinning Financial Illusions --The Story of Bubblenomics

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What is a bubble? Webster's New World Dictionary defines bubble as:

- A film of liquid forming a ball around air or gas.
- A transparent dome.
- A plausible scheme that proves worthless.

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Unfortunately, what has transpired over the last five years in the financial markets has been a bubble. While the entire market obviously won't prove to be worthless, the declines in store for most securities will be tremendous.

I would like to begin today by describing the various factors that collectively have created the financial environment in which we currently find ourselves. I shall then demonstrate that this *is* a bubble by comparing today to the late 1920s and offer some thoughts as to the potential severity of the aftermath of this bubble. Lastly, I will make a stab at guessing what might pop it.

The seeds of this bubble were sewn way back in 1980 when Congress passed the Depository Institutions Deregulation and Monetary Control Act calling for the phasing out of Regulation Q, which allowed financial institutions to compete with money market funds. A piece of that legislation was financial cancer: raising the insured deposit maximum to \$100,000.00. That seemingly innocuous change (thank you Fernand St. Germain) spawned "brokered deposits," the primary driver of the reckless lending practices of the 1980s. Money sought out the highest bidder with no regard as to how it might be used. As a result, we witnessed the funding of overleveraged LBOs and the overbuilding of real estate long after the 1986 Tax Act made it uneconomical to speculate in property. It is hard to overstate the significance of this legislation in creating the excesses of the 1980s, which set the stage for the even greater excesses of the 1990s.

It is important to realize that the 1990-1991 recession was not precipitated by the Fed. Yes, rates went up, but not enough to matter. The economic contraction was instead caused by two factors: one, the collapse of credit as

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banks and the S&L industry were destroyed by these bad loans and two, the subsequent newfound zeal with which the Office of the Comptroller of the Currency began to do its job. Unfortunately Greenspan didn't understand what was occurring, as he made painfully obvious in January 1990 when he stated, "But such imbalances and dislocations as we see in the economy today probably do not suggest anything anymore than a temporary hesitation in the continued expansion of the economy."

However, once he finally understood what was happening, he got busy; ultimately cutting interest rates 24 times in a row, to 3%, which of course drove the public (which was only just beginning to focus on its retirement needs) out of CD's and money markets, and into stocks and bonds. It is ironic that the enormous reckless frenzy of the 1980s, which nearly ruined the banking system, did little apparent damage, and instead spawned a great bull market, and ultimately an even greater bubble.

The collapse of communism helped precipitate this stunning transformation as it set off a mad dash for capitalism around the globe, creating the first post-cold-war economic boom. The boom eventually forced the Fed to begin raising interest rates, thereby causing the implosion of the carry trade, Orange County, Mexico, etc. Of course, by then the deregulated banking system had discovered rocket scientists with computers and had begun loading itself up with derivatives. The combination of the Mexican peso collapse and the unwinding carry trade posed a grave threat to Wall Street and the banks so Greenspan and Rubin bailed them out.

In doing so, they didn't just spike the punch bowl, they put LSD in it, triggering a new round of speculation both domestically and globally that finally began to unwind in the summer of 1997 when the bubbles in Southeast Asia burst beginning with Thailand.

Naturally, the central bankers attempted bailouts, once again trying to postpone the ill effects of too many years of speculation. However, with so many countries collapsing at once the Fed (& Co.) could not prevent calamity from hitting those countries. Yet they did succeed in adding more fuel to the stock market frenzy raging here in America.

The default by Russia one year ago caused a chain reaction that culminated with another implosion, that of Long Term Capital, the most recent episode in this long series of Fed bailouts. The real reason for the LTCM bailout appears to have been the stock market not the bond market as was professed. "We were most concerned about the equity book," Jon Corsine, Goldman Sachs' CEO, told Business Week. "The whole potential scenario of unwinding their equity portfolio under a forced environment could have

had extremely negative consequences on the (overall) market” was how David Komansky, Merrill Lynch’s CEO described the situation. This is why the Fed tried to get ahead of curve in a panicked attempt to change market psychology by, dare we say, market manipulation. Manipulation may be too strong a term, but what else can you call it when rates are cut 25 basis points with only 45 minutes remaining in the trading day in which all index options and options on futures are due to stop trading? In what is surely the biggest move in history, the S&P Futures exploded 4.9% in 4 minutes. The chaos created by this surprise rate cut caused a systems outage at the CBOE, forcing them to halt trading and hold a closing rotation for index options for the first time ever.

How was the Fed able to print money and create credit in unlimited quantities to manufacture this bubble? The absence of CPI inflation! Having learned nothing from the twenties or Tokyo either, the Fed and nearly everyone believes that nothing can be wrong if there is no CPI inflation. Yet it is only in a period of low inflation that the monetary spigots can stay open long enough to foment a bubble. Once created, the damage has been done and good policy options don’t exist. You are then in the bubble-management business. (After 50 shots of tequila you will feel crummy tomorrow no matter what you do.) We have created overcapacity and precipitated massive speculation, just as we did in the twenties. Inflation has been held in check not by prudent monetary policy but by a unique combination of events. In addition to the post-Cold War boom and NAFTA, the enormous productivity gains achieved by the massive invasion of powerful microprocessors into our lives conspired to keep CPI inflation in check, just as innovations such as autos, planes, and fractional horsepower electric motors suppressed inflation in the 1920s. Instead of CPI inflation we have created asset inflation in the form of the largest stock market bubble of all time.

I believe these bailouts since Mexico in late 1994 (when we crossed over from bull market to mania) have, in essence, socialized risk and are the principal reasons why the public feels that they cannot lose money in the stock market (over time). We have all seen the same surveys that show people expect compound returns from equities varying between high teens and 30 percent.

In addition to the Fed there are other catalysts that have precipitated the current craze. First, demographics have fostered a “need to believe” on the part of the public, and Wall Street has been happy to supply the rationalization and schemes with which to do so.

Secondly, technology. It is easy to see why technology is such a financial

aphrodisiac. Life without television, fax machines or cellular phones would be far less enjoyable, and life without Prozac would be a boring life at “book value.” Yet nothing heretofore has so seemingly demystified and so dramatically altered the investing landscape the way the PC has. It has simultaneously empowered the masses to believe that they are in complete control and has deluded them into confusing information with knowledge. Most know the price of everything and the value of nothing.

Third, television (and here I mean CNBC primarily – a/k/a Bubblevision) has helped seduce the public into an overconfident state bordering on arrogance. Folks are now certain that they possess the know-how and have earned the right to be rich.

Lastly, corporate America itself, the object of all this speculation has helped its own cause. Not so much through earnings, but through the creative expression of those earnings. The rascals in charge have enthusiastically and nearly unanimously elevated accounting into pure art via one-time charges, merger related write-offs, forward looking statements about the improvement in business “since the end of the quarter”, and of course stock options with their attendant absurd tax treatment. To show how acceptable outright fraud has become, Walter Forbes and “windbag” Al Dunlap are free and very rich men to this day. Having said all that about corporate America, it is not clear to me whether it actually has had a part in creating the euphoria or whether the euphoria has simply allowed it to occur. Collectively these factors have convinced today’s speculators that the only *real* risk associated with equities is in not owning them.

The total disregard for valuation, precedent, and risk that today’s “new era” mentality has engendered should terrify anyone with an understanding of the financial past. The denouement of this tragi-comedy is certain even if the timing is unknown.

Presently, only the GDP of the *entire* world at \$25 trillion overshadows the \$14-\$15 trillion capitalization of the U. S. stock market. At 160% of our huge \$8.8 trillion GDP, the ratio of market capitalization to GDP is over 60% higher than it was in 1929, the previous all-time high. We are light years from the 70-year average of 50% and from the low of 33% seen in 1974 and 1982.

In the last 2½ years, the stock market capitalization has increased over \$5 trillion, a gain equal to 60% of America’s current GDP. Unfortunately, earnings of the underlying companies have not been responsible for this surge. Since the end of 1996 the S&P 500 has rallied 75%, but S&P earnings have grown only about 6%.

Everyone has his favorite story of extremes these days. For instance, the six biggest tech stocks (Microsoft, Intel, IBM, Cisco, Lucent and Dell) are now valued at \$1.65 trillion or 20% of GDP. Microsoft alone is valued at \$500 billion, making it larger than the entire junk bond market!

My personal favorite anecdote illuminating today's hysteria is Internet Capital Group. It is an Internet venture capital fund valued at approximately \$12 billion (that has only one public holding worth about \$400 million). In a recent interview, a big-time Wall Street analyst justified the current valuation by explaining that recent venture capital returns have been 30-fold and that if all of ICGE investments and the cash received from the IPO were valued at 30 times the stock would be worth about what it was selling for, but that meant you would be getting management for free! Consequently, he liked it. It has rallied over 30% since the interview.

However, it is not the specific examples that are the primary concern. The risk is that the environment which has led to these individual excesses has produced a total market capitalization so out of proportion with the underlying businesses that it has altered the economy of the world.

Former Fed Chairman Paul Volcker recently summed up the situation quite succinctly when he said, "The fate of the world economy is now totally dependent on the stock market, whose growth is dependent on about 50 stocks, half of which have never reported any earnings." I urge you to think about that statement. It is the reason why any responsible person should be aware of these facts.

The numbers are so gargantuan and so completely beyond our range of experience that they have lost their ability to produce a visceral impact. For instance, we all know that light travels at 186,000 miles per second, yet how many can grasp how fast that is? We know that computers can add numbers in a fraction of a nanosecond (one billionth of a second, which is how long it takes light to travel one foot), but who can appreciate that? However, if we observe that the relationship between one nanosecond and one second is the same as one second and thirty-three years, we can begin to appreciate how magically fast light moves and computers work. We are able to do this because we have experience dealing with seconds and years.

In that same vein, I believe the best way to put the current mania in its proper perspective is not to compare facts and figures but to examine qualitative descriptions from our mania of the late 1920s. New era believers today roll their eyes at the mere suggestion of this analogy, yet most have no knowledge of what actually took place in those days. (Steve Forbes, for

example, says there was no bubble. Fed tightening caused all the problems.) What follows are excerpts from several books which illustrate how nearly identical the behavior of today's stock market participants is to that of 70 years ago. I will be editorializing some of these passages to make the obvious even more so.

In short, the late '20s bubble was caused by poor policy decisions, resulting in excess credit creation, which led to a bubble. "Modern Times" best describes in brief why policies were pursued, what resulted, and the consequences:

"The aim was to avoid trouble and escape the need to resolve painful political dilemmas. (*The Fed policies since Mexico's implosion in 1994.*) The policy appeared to be succeeding. In the second half of the decade, the cheap credit the Strong-Norman policy pumped into the world economy perked up trade... So the notion of deliberate controlled growth within a framework of price stability had been turned into reality. This was genuine economic management at last! The American experiment (*Greenspan experiment*) in stabilization from 1922 to 1928 showed that early treatment could check a tendency either to inflation or to depression...The American experiment was a great advance upon the practice of the nineteenth century.

"Yet in fact the inflation was there, and growing, all the time (*same as now*). What no one seems to have appreciated is the significance of the phenomenal growth of productivity in the U.S. between 1919 and 1929: output per worker in manufacturing industry rising by 43 percent. This was made possible by a staggering increase in capital investment, which rose by an average annual rate of 6.4 percent a year. The productivity increase should have been reflected in lower prices. The extent to which it was not reflected the degree of inflation produced by economic management with the object of stabilization.

"It is true that if prices had not been managed, wages would have fallen, too. But the drop in prices must have been steeper; and therefore real wages -- purchasing power -- would have increased steadily, *pari passu* with productivity. The workers would have been able to enjoy more of the goods their improved performance was turning out of the factories. As it was, working-class families found it a struggle to keep up with the new prosperity. They could afford cars -- just. But it was an effort to renew them. The '20s boom was based essentially on the car. (*PCs anyone?*)

"As the boom continued, and prices failed to fall, it became harder for the consumer to keep the boom going. Strong's last push, in fact, did little to help the 'real' economy. It fed speculation. Very little of the new credit

went through to the mass-consumer. Strong's coup de whiskey benefited almost solely the non-wage earners: the last phase of the boom was largely speculative. (*Three rate cuts in the fall of '98.*) Until 1928 stock-exchange prices had merely kept pace with actual industry performance. From the beginning of 1928 the element of unreality, of fantasy indeed, began to grow. As Bagehot put it, 'All people are most credulous when they are most happy.'

"Two new and sinister elements emerged: a vast increase in margin trading (*online/day trading*) and a rash of hastily cobbled-together investment trusts [Internet stocks]. By 1929 some stocks were selling at 50 times earnings. (*How about well in excess of 50 times revenues today?*) As one expert put it, the market was 'discounting not merely the future but the hereafter.' A market boom based on capital gains is merely a form of pyramid selling.

"The new investment trusts, which by the end of 1928 were emerging at the rate of one a day (*several Internet IPOs per day now*), were archetypal inverted pyramids. They were supposed to enable the 'little man' to 'get a piece of the action.' (*Again, online trading.*) In fact, they merely provided an additional superstructure of almost pure speculation, and the 'high leverage' worked in reverse once the market broke. (*Futures, options and OTC derivatives today*)

"It is astonishing that, once margin trading and investment trusting took over, the Federal bankers failed to raise interest rates and persisted in cheap money. But many of the bankers had lost their sense of reality by the beginning of 1929. (*William McDonough, president of the New York Fed recently embraced the new era stating "It's likely the American productivity boom will continue. I'm very confident about the future trend of the American economy. The forces that have allowed us to do so well are likely to continue."*)

"The 1929 crash exposed in addition the naivete and ignorance of bankers, businessmen, Wall Street experts and academic economists high and low; it showed they did not understand the system they had been so confidently manipulating. They had tried to substitute their own well-meaning policies for what Adam Smith called 'the invisible hand' of the market, and they had wrought disaster. Far from demonstrating, as Keynes and his school later argued (at the time Keynes failed to predict either the crash or the extent and duration of the Depression) the dangers of a self-regulating economy, the degingolade indicated the opposite: the risks of ill-informed meddling." (*This is my basic reason for continually harping about the Fed.*)

The “New Era of Investing” chapter of Ben Graham’s book “Security Analysis” written in 1934 describes the late 1920s investment climate. “A new conception was given central importance – that of *trend earnings*. If an attempt were to be made to give a mathematical expression to the underlying idea of valuation, it might be said that it was based on the derivative of the earnings, stated in terms of time. (*Momentum Investing – an oxymoron if ever there was one.*)

“Along with this idea as to what constituted the basis for common-stock selection, there emerged a companion theory that common stocks represented the most profitable and therefore the most desirable media for long-term investment.”

“These statements sound innocent and plausible. Yet they concealed two theoretical weaknesses which could and did result in untold mischief. The first of these defects was that they abolished the fundamental distinctions between investment and speculation. The second was that they ignored the *price* of a stock in determining whether it was a desirable purchase. A moment’s thought will show that “new-era investment”, as practiced by the trusts, was almost identical with *speculation* as popularly defined in pre-boom days... It would not be inaccurate to state that new-era investment was simply old-style speculation confined to common stocks with a satisfactory trend of earnings. (*Sound familiar?*) The impressive new concept underlying the greatest stock-market boom in history appears to be no more than a thinly disguised version of the old cynical epigram: ‘Investment is successful speculation’.”

“The notion that the desirability of a common stock was entirely independent of its *price* seems incredibly absurd. Yet the new-era theory led directly to this thesis. Instead of judging the market price by established standards of value, the new era based its standards of value upon the *market* price. Hence all upper limits disappeared, not only upon the price at which a stock *could* sell, but even upon the price at which it would *deserve* to sell.” (*I’m raising my price target to \$300.*)

“An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy “good” stocks, regardless of price, and then to let nature take her upward course...” (*How many times have you heard something like this repeated in the last month?*)

From the book “1929” by William Klingaman, the following captures the mood of that period:

"The boom had become a full-fledged stampede. Several years later, Otto Kahn looked back toward the early days of September 1929 and concluded that the speculative movement had gained so much momentum by that time that nothing short of a crash could have brought it under control. The American public, Kahn testified, was 'determined to speculate. They were determined that every piece of paper would be worth tomorrow twice what it was today. I do not believe the whole banking community could have prevented it...When it had taken full sway of the people and there was an absolute runaway feeling throughout the country, I doubt whether anyone could have stopped it before calamity overtook us.' (*Just like now -- slowly.*)

"To liberal journalist Gilbert Seldes, the final days before the crash were the true time of panic. 'I call it panic to be afraid to sell at a profit, lest additional profit be lost,' Seldes wrote. 'The panic which keeps people at roulette tables, the insidious propaganda against quitting a winner, the fear of being taunted by those who held on, all worked together. (*Today's motto: Never sell good stocks.* } It became not only a point of pride, but a civic duty, not to sell, as if there were ever a buyer without a seller.'

"Although the Wall Street Journal (*CNBC*), the chief journalistic promoter of the boom, maintained its traditionally optimistic front, the editors of Business Week (*The Economist*) charged unequivocally that 'stock prices are generally out of line with safe earnings expectations, and the market is now almost wholly 'psychological' -- irregular, unsteady and properly apprehensive of the inevitable readjustment that draws near.'

"In fact, only 388 of the nearly 1,200 issues listed on the New York Stock Exchange had advanced between Jan. 2 and Sept. 3, 1929, while more than 600 stocks already showed substantial declines from their highest point of the past few years. 'This has been a highly selective market,' observed the Cleveland Trust Company's resident market guru, Colonel Leonard P. Ayres. 'It has made new high records for volume of trading, and most of the stock averages have moved up during considerable periods of time with a rapidity never before equaled. Nevertheless the majority of the issues had been drifting down for a long time...In a real sense there has been under way during most of this year a sort of creeping bear market.' (*Exactly, today's market action.*)

Roger Babson (*the spiritual grandfather of Marc Faber, Jim Grant and me*) prophesized the coming debacle (as he often had before) in September 1929 as follows: "Fair weather cannot always continue. The economic cycle is in progress today, as it was in the past. The Federal Reserve System has put the banks in a strong position, but it has not changed human

nature. More people are borrowing and speculating today than ever in our history. (*These days even student loans are used for speculation.*) Sooner or later a crash is coming and it may be terrific.

“ ‘Things have never been better,’ Charlie Mitchell (*William McDonough*) told reporters on the evening of Friday, September 20... Mitchell cheerfully advised investors to ‘be a bull on America’. ‘Money is all right’ he assured everyone. ‘There's nothing to worry about in the financial situation in the United States’.” (*And everybody knows what happened one month later.*)

The best analysis of the economic and monetary policy of the 1920s comes from a book titled “Economics and the Public Welfare 1914-1946,” written by Benjamin M. Anderson. From 1920-1937, he wrote the Chase Economic Bulletin and was the bank’s chief economist. He was a contemporary critic of the monetary authorities, as he understood at the time that the policies being pursued were reckless and would lead to disaster. Since the book was not published until 1948, he had 20 years to reflect on that period. This is his opinion: “Those who see history only from the outside easily convince themselves that impersonal social forces are overwhelming and that individual men in strategic places make little difference. But this is not true. The handling of Federal Reserve policy by Strong and Crissinger in the years 1924-1927 led to ghastly consequences from which we have not *yet* recovered. Competent and courageous men occupying their positions would have avoided mistakes which these men made.”

Three years of irresponsible monetary policy set off a chain reaction of trouble that lasted nearly two decades. Today Tokyo is still floundering nine years after their bubble burst. Regrettably, future historians are unlikely to describe the current Fed as either competent or courageous. While rare, bubbles are not trivial – they are the financial equivalent of a nuclear holocaust.

Which brings us to the critical question: Should we expect the fallout from this bubble to be more or less severe than the 1930s here and the 1990s in Japan?

First let us acknowledge that every time is different and that much of the damage to occur post bubbles is a result of bad decisions made during the aftermath. Also complicating any assessment of the facts is the “unknown” factor. By that I mean dangerous practices that are occurring now during the bubble that will only come to light later.

Those who say the fallout should be manageable believe our situation is not

comparable to Japan. In hindsight, they say that Japan was a corrupt, overleveraged command economy that had forgotten about rates of return and obsessed instead with market share. In addition, the Japanese bubble was primarily a real estate bubble which the bureaucrats there have proved particularly inept at solving.

They will argue that the 1920s are a poor analogy because our economy is now far less cyclical than it was then, that we have huge financial shock absorbers in place and most importantly an enlightened, nay omniscient Fed, all of which make an economic debacle unlikely.

There is a fair amount of truth in all of these claims (along with some revisionist history) but the zeal with which that view is believed has caused us to dramatically push the envelope from a “balance sheet” perspective.

Let’s compare a few data points, recognizing that the old data may not be as accurate as today’s. In 1929 government debt stood at 17% of GDP versus 63 % today. Total debt is nearly 260% of GDP now versus 200% then. It is true that in 1929 broker loans were nearly 30% of GDP, while today margin debt is only 2% of GDP, however, consumer installment loans plus mortgage debt stands at nearly 70% of GDP. In addition, the national value of derivatives held by the banking system is \$40 trillion, nearly 5 times GDP and we have absolutely no idea how they might behave if the financial world were to function differently prospectively than it has in the last decade.

Further complicating matters, we currently run a trade deficit that is about 3% of GDP versus a unilateral surplus 70 years ago and we have a negative savings rate, both of which place our currency at a far greater risk than it ever was then, potentially complicating the Fed’s future rescue efforts.

Lastly, on top of this leverage, the value of equities to GDP now stands 160–200% (depending on which measure of total market cap you use) compared to roughly 100% in 1929. In short, valuations are 60-100% higher at the same time debt is 30% higher while we are being financed thanks to the kindness of strangers (foreigners).

You can easily see that those who believe that previous periods of trouble have no relevance have acted accordingly thereby “raising the bar” for the “shock absorbers” and the Fed. Unfortunately there are no roadmaps for the future, but we can be guided by precedent. The fallout from this bubble may be ameliorated for the reasons the new era apostles cite. The economic dislocations will probably not be as gruesome as the 1930s and might not even be as difficult as the Japan of the 1990s. However, given the facts I

think it is safe to conclude that it will be plenty bad enough and will be far worse than most have imagined.

So, what could end this bubble? Everyone knows the obvious choices and I won't elaborate on them. Likewise, I obviously can't elaborate on an unknowable shock. However, I believe that the bubble could burst if people lose confidence or faith in the technology stocks that have carried the bull market. I don't think the market can go down for real unless, and until the bull market in technology stocks ends.

What could derail technology stocks and bring them back to reality? In short, corporate America and the year 2000 dubbed "nuclear winter" by my good friend Fred Hickey, the world's best tech analyst. (For those of you who haven't heard the term used in this context, it refers to the fact that corporate America has purchased all the hardware and software it needs to be ready for the year 2000. Consequently order rates are in the process of collapsing and will stay that way for quite some time).

Quoting Fred, "Tech stocks have been on a gigantic tear based upon the perception that end-user demand for computer technology products is strong. They believe that surging PC demand is behind the pickup in semiconductor sales. While they do not know it yet, they are *wrong!* In fact, the second-half "nuclear winter" slowdown in computer sales anticipated by market researchers for two years is hitting with full force. Unfortunately, Wall Street is too blinded by greed to notice it. Just as it has never noticed a shift in spending in the past."

Here, some recent history will explain the previous statement. In 1995, almost all analysts and investors believed that widespread semiconductor shortages and surging prices were a sign of huge Windows 95-related pent-up demand for computer products and peripherals. Unfortunately, Windows 95 was a disappointment relative to expectations leading to a sizable tech stock decline that lasted until the middle of 1996. In fact, 1995's worldwide semiconductor sales of \$150 billion is a peak that has yet to be surpassed.

More illuminating still is the fact that there's been no revenue growth worldwide in the PC industry in the last 2 ½ years. Amazingly, despite the favorable impact of the Y2K upgrade cycle, unit growth has not been strong enough to offset ASP declines. Yet hope springs eternal as every year for four years running Wall Street has believed that the year's first-half PC debacle has had no relation to the one the year before. The analysts have been incapable of connecting the dots each time as they appear unable to grasp that the problem is horsepower saturation and excess capacity.

Last fall there was another channel stuff, primarily by Compaq. Weaker than expected PC demand in the first half of 1999 finally exposed this long running charade and led to the ouster from the company of Eckhard Pfeiffer and Earl (the pearl) Mason, two of the industry's biggest fibbers.

The weight of the industry's problems caused market-darling Intel to miss revenue estimates in both the first and second quarters by \$400 million. AMD corroborated this weakness as they couldn't find a home for almost 2.3 million processors. Yet shortly after Intel reported its results in mid-July, for no apparent reason DRAM prices began rising substantially. Strange happenings were occurring in the disk drive market too. All of a sudden, there were shortages in the popular 4 and 6 gig drives, and prices firmed. Semiconductor and PC related stocks celebrated these events by embarking on the (recently ended) enormous rally which saw Intel, for example, spring from 50 to 90.

What happened to create all this euphoria? Three things. First, the perennial belief in a strong second half for PC sales that I have described. Secondly, a brief surge in retail PC demand in June and July precipitated by the introduction of subsidized (so-called "free") PCs. Lastly, the fear of potential Y2K production disruptions outside of the United States led to a fear-driven Y2K inventory build complete with double and triple ordering. Human nature is such that the fear of shortages always leads to over-ordering and hoarding as we've seen many times in the past in the semiconductor (and other) industries. In the perfectly perverse fashion of markets, just as the free-for-all in component buying and stock ramping was reaching a speculative frenzy, nuclear winter sneaked in like the proverbial thief in the night.

While Wall Street focused on the fact that vendors at the back of the food chain were ordering parts and building hardware like there was no tomorrow, the folks on the front line, trying to sell products to corporate America, were hitting a wall.

The top three computer distributors with combined revenues of \$50 billion (in a world that buys \$150 billion of PCs annually) led by Ingram Micro, the largest with \$24 billion in revenues, divulged that results were disappointing. Privately, certain companies are advising that computer spending lock-downs are in place. This should come as no surprise, after all it takes time to stabilize and integrate software and hardware. If you expect it all to be tested and running smoothly by Jan. 1, 2000, you can't wait until the fourth quarter to install it -- that's too late.

Systems integration and sub assembly companies have also disclosed a fall-

off in business while Oracle just reported year-over-year revenue growth of just 12%, its worst in 30 quarters. This is an especially powerful indictment since they are direct beneficiaries of all the new Internet startups.

Recent body-English by IBM, Hewlett Packard and Intel tends to corroborate the view that business is worsening by the week, a trend that will only accelerate. Soon reports of additional problems should be flying fast and furious. There is little chance that Dell, Intel and IBM, to name three of the five biggest tech stocks, can make their fourth quarter estimates, and that is just the tip of the iceberg.

At some point, the cumulative damage should be sufficient to crack the misplaced confidence that investors have in these dramatically overpriced businesses which, by the way, have lower barriers to entry and are more commodity-like than most care to admit. When that light bulb goes off and the stampede for the exit ensues, it will be a debacle in which many stocks will fall over 50%.

Mainly, tech stocks are priced as they are not because investors have studied the businesses and judiciously bought them, but because people have piled into them due to momentum and blind faith. Everyone wants to own what is going up, not what is priced attractively. Consequently, we have created a dramatic disconnect between both expectations and valuations versus reality that can *only* be rectified by a huge downward adjustment in the price of these stocks. To quote Steve Ballmer, "there's such an overvaluation of tech stocks, it's absurd."

I should mention that it is not just PC related and semiconductor stocks that are at risk.

Networking companies have benefited from Y2K remediation efforts as well, they too could be susceptible to a falloff in demand. Ultimately the stock market itself via its ability to float Internet companies has helped create demand for networking and telecommunications products. If the companies that currently have problems indirectly shut the IPO window, more companies will experience weakness prospectively.

In summary, technology stocks bulls have placed over a trillion dollar bet that demand will stay strong when it is more likely that we will encounter not just our now-typical weaker than expected second half, but a true collapse in orders. Never since the mania leg of this bull market began in 1995 have so many factors been aligned so perfectly to pull the rug from under the feet of technology investors. Nuclear winter may just be the catalyst to end the mania.

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