# 'Old Economy' of Dow Non-Industrials Is Just As Fundamentally Unsound

by John Hoefle

The claim is made, with increasing frequency as the once-mighty Nasdaq Composite Index slides inexorably toward reality, that the decimation of the dot-coms is not a danger, because the "old" economy is stronger than ever. It is admitted that there were elements of the "tech stock bubble" which were foolish and unsustainable, among them being the idea that corporations can exist in perpetuity without the slightest whiff of profit, as long as they gain sufficient "mindshare" in cyberspace. It was an interesting idea, the experts tell us, but some people got carried away. Still, there's no reason to worry, because we still have the old economy, with its old-style "offline" profits, made even more efficient and profitable by the Internet.

To which we reply: nonsense.

The Internet mania, with dot-coms springing up almost overnight into multi-billion-dollar corporations, has indeed imploded. Many of the dot-coms disappeared in 2000, and most of the rest saw their stock prices plummet; drops of 75% were commonplace, and many Internet stocks lost 90% or more of their value during the year. Even the biggest Internet companies got hurt.

Take America Online and Yahoo!, which both made the list of 100 largest corporations in the world—ranked by market capitalization—in 1999. AOL, with a market cap of $125 billion, was number 31 worldwide, putting it ahead of such companies as French oil giant TotalFinaElf, Swiss pharmaceutical giant Novartis, Germany's Siemens, Sony, and Procter & Gamble. Yahoo!, with a market cap of $70 billion, was number 72, ahead of DaimlerChrysler, Chevron, and Fujitsu.

In fact, three of the top four companies on the 1999 list were computer-related companies: Intel, Cisco Systems, and Microsoft, with Oracle, IBM, Sun, and EMC joining them in the top 20. Other computer-related companies in the top 100 included Hewlett-Packard, Texas Instruments, Dell, JDS Uniphase, Motorola, SAP, and Compaq. The list was also studded with telecommunications, financial, and pharmaceutical firms. In 1999, services, information, and finance were riding high, with many pundits asserting that the Information Age had finally broken free from the clutches of the Industrial Age.

That fantasy was smashed in 2000, with the Nasdaq losing a third of its value in March and April, and sliding inexorably downward from there. The Nasdaq, which soared 86% in 1999, finished 2000 down 50% from its March peak, wiping out over $3 trillion in market value. The Internet companies were the hardest hit, with the Goldman Sachs Internet Index falling 75% for the year; Amazon.com, the one-time e-business superstar, saw its market cap fall 82% from its peak, and the big computer companies also fell sharply: Dell fell 70% from its peak, Microsoft 62%, Intel 60%, AOL 56%, Sun 56%, Cisco 50%, and Oracle and IBM 37% each. Many of the telecommunications companies also took large hits, as their abilities to pay their huge debts came into question.

## General Decline

With such a dramatic collapse, once can see why the spin doctors suddenly started touting the alleged vigor of the old economy, which the year before they had relegated to the dustbin of economic history.

Leading this resurgence was General Electric, which regained the title of world's most valuable company from Microsoft, thanks to the anti-trust suit by the U.S. Department of Justice and the decline of the computer sector. GE has a proud tradition as one of the world's great industrial corporations, tracing its roots back to the laboratories of Thomas Edison, but that is only one part of the story. While Edison provided the genius, the company itself was put together by financier J.P. Morgan, as a vehicle for controlling and profiting from Edison's breakthroughs.

As such, the company has always represented the uneasy alliance between production and finance, and in recent years finance has gained a firm upper hand. Under chairman and chief executive officer Jack Welch, GE has become a bastion of that parasitic philosophy known as shareholder values, in which corporations are viewed not as contributors to the general welfare, but merely as money machines, spinning off profits to Wall Street. Under Welch, GE has become as much a bank as a manufacturer, with half its profits generated by its financial operations. In 1999, 50% of GE's revenue came from its GE Capital subsidiary, compared to 10.4% from its industrial products and services sector, 9.5% from its aircraft engines division, 9% from power systems, and 5% from appliances. GE's television network, NBC, provided another 5% of the company's revenue in 1999.

The situation at GE is even worse than the above numbers suggest, since finance dominates even the productive aspects



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of the company. Decisions regarding research and production are made more on the basis of how they will affect the company's stock price and its standing on Wall Street, than on how they will affect the world. Each GE subsidiary is expected to meet ever-tighter annual financial criteria, and those managers who don't meet their numbers are quickly replaced. Such dedication to shareholder values has made GE and Welch the darlings of Wall Street, with Welch touted as the top executive of the decade, or maybe of all time. But choosing to worship at the altar of finance has left GE much diminished in its ability to improve the physical economy. The world would be much better off were GE to return to its scientific and industrial roots; the world has more than enough banks, but desperately needs advanced technology.

The ascension of finance and services over industry can also be seen in the composition of the Dow Jones Industrial Average (**Table 1**). The Dow consists of 30 stocks, including such noted "industrials" as Citigroup, J.P. Morgan Chase, American Express, Microsoft, Walt Disney, Home Depot, Wal-Mart, and McDonald's. J.P. Morgan Chase is the largest derivatives bank in the world, with some $23 trillion of derivatives bets, while Citicorp is number two in the United States, with nearly $8 trillion, giving the Dow "industrials" more derivatives bets than any country in the world, except for the United States.

Even the industrial companies in the Dow, have shifted significantly over to the service sector, as the example of GE shows. The two phone companies (AT&T and Baby Bell SBC Communications) have become largely service companies, though they do have important infrastructure components. Coca-Cola, Johnson & Johnson, Procter & Gamble, Merck, and Philip Morris manufacture products, but hardly qualify as heavy industry. Intel, IBM, and Hewlett-Packard are all world-class manufacturers, but their products are predominantly used in the overhead sectors.

Fortunately, there are still some heavy-industry companies in the Dow, such as Boeing, Exxon Mobil, Minnesota Mining and Manufacturing, Caterpillar, United Technologies, International Paper, and Alcoa. But even these companies are heavily influenced, if not dominated, by the post-industrial shareholder values disease. Exxon Mobil's identity is at least as much informed by its role as a key member of the global oil cartel as it is by its industrial might.

TABLE 1

**The 30 Stocks in the Dow Jones Industrial Average, as of Dec. 29, 2000 (year-end)**

(Market Capitalization in $ Billions)

| Company | Symbol | Market Cap |
|---|---|---|
| Alcoa | AA | 29.0 |
| American Express | AXP | 73.1 |
| AT&T | T | 64.7 |
| Boeing | BA | 58.6 |
| Caterpillar | CAT | 16.3 |
| Citigroup | CAT | 229.4 |
| Coca-Cola | KO | 151.1 |
| Walt Disney | DIS | 60.2 |
| Du Pont | DD | 50.2 |
| Eastman Kodak | EK | 11.8 |
| Exxon Mobil | XOM | 302.2 |
| General Electric | GE | 475.0 |
| General Motors | GM | 28.8 |
| Hewlett-Packard | HWP | 62.4 |
| Home Depot | HD | 106.1 |
| Honeywell | HON | 37.7 |
| Intel | INTC | 202.3 |
| IBM | IBM | 149.1 |
| International Paper | IP | 19.6 |
| Johnson & Johnson | JNJ | 146.0 |
| McDonald's | MCD | 44.6 |
| Merck | MRK | 215.9 |
| Microsoft | MSFT | 231.3 |
| Minnesota Mining | MMM | 47.5 |
| JP Morgan | JPM | 26.5 |
| Philip Morris | MO | 97.8 |
| Procter & Gamble | PG | 102.3 |
| SBC Communications | SBC | 161.6 |
| United Tech. | UTX | 36.8 |
| Wal-Mart | WMT | 237.3 |

Notes:
1) As of Dec. 31, 2000, Chase Manhattan Corp. acquired Dow component J.P. Morgan & Co. As of Jan. 2, 2001, Chase, which changed its name to J.P. Morgan Chase & Co., replaced Morgan in the Dow, under the symbol JPM.
2) General Electric is in the process of acquiring Honeywell (Honeywell, in turn, is the former AlliedSignal, which adopted the Honeywell name when it acquired that company).

Sources: Bloomberg; Yahoo! Finance.

## Overhead Soars

On top of that, in conjunction with the overall economy's shift from production to finance and other services, the output of the industrial sector increasingly goes to support the overhead sector.

Compare the case of machine tools with computers. Machine tools have one purpose, and that is to make other machines. As such, not only is the production of machine tools clearly productive, but the resulting tools are also used for productive purposes. The most modern machine tools are controlled by computer, which allows them to make parts with unparalleled precision. That is an example of how computers increase manufacturing productivity, but relatively few computers are used for such purposes. Most computers are used in the service sector, and thus count as overhead. They may make overhead workers more efficient, but they do not make them more productive, since, strictly speaking, those workers are not engaged in productive activities. Office workers may

perform useful, even necessary jobs, but from a physical-economic standpoint, those jobs fall into the overhead category and as such must ultimately be supported by factory output, agriculture, and related productive activity.

The same principle holds true for the auto makers and the oil companies, much of whose production goes to support the overhead sector. Many of the automobiles produced in the United States are bought by workers who commute to office jobs; the production of these cars, and the gas and oil they consume, go to supporting the overhead sector.

The failure to distinguish between the productive and overhead sectors, renders virtually every "mainstream" discussion of economics irrelevant. The rise of financial aggregates and money supplies around the world in recent years is presented as proof of growth, while what they really represent are growing—increasingly unpayable—claims on a deteriorating productive sector. Federal Reserve Chairman Alan Greenspan's claims that the U.S. economy is more productive than ever reflect this fundamental error; Dr. Greenspan is declaring that the patient is growing, but that growth is in the tumor, not the healthy tissue. Not only that, but Greenspan actively nurtures the tumor, to keep the "growth" going.

The reality is that the old economy has decayed significantly, and is no more fundamentally sound than the Internet economy. Any sound economy is based upon creating a continuous series of fundamental scientific discoveries, then developing the technological means to spread the new knowledge throughout the economy. What we have seen in the last decade in computers, should be the norm across the board, but it is not. Where are our new nuclear power plants? Where are our magnetically levitated high-speed trains? Where are our sterilized, irradiated foods?

The U.S. economy is largely living off the technologies of the past, particularly the breakthroughs generated by the NASA space program. Our physical plant is deteriorating. The electricity grid is breaking down, water shortages are rampant, diseases which were once virtually eliminated are making a comeback. Our health care system is decaying, despite technological advances; our labor force is rapidly losing the skills required to fix things; our transportation grid is approaching gridlock in many areas. Only a fool would call the economy, old or new, fundamentally sound.

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# Retail Sales Slump A Sign of Breakdown

by John Hoefle

The bankruptcy announcements by retailers Montgomery Wards and Bradlees in the week after Christmas, are but the most obvious retail-sector examples of the breakdown process which is under way in the U.S. economy. Overall, retail sales for the November-December holiday season—in which retailers generally get about one-quarter of their annual sales—came in well under projections, with company after company reporting stagnant same-store sales and warning that they will commit the cardinal sin of failing to meet Wall Street's earnings projections.

After adjustment for even the understated "official" inflation rate, U.S. retail sales fell, across the board, from previous years' levels. More ominously for the real economy: more than 40,000 immediate-term layoffs are involved, in only the biggest of the "casualty" announcements made by the U.S. retail-sales sector since Christmas—Sears, Bradlees, and Montgomery Ward.

The reasons presented for the sales shortfall are several: a declining stock market; bad weather; higher energy bills, which reduce the amount of money households have to spend for presents; the changing structure of the retail market, and consumer worries about a recession. These explanations remind one of the fable about the blind men and the elephant: Each man accurately presents one aspect of the problem, but none of them explain the whole, global breakdown—economic, political, and cultural.

The full picture of the 2000 holiday retail season has yet to emerge, but the early indicators show that the hoped-for surge in sales over last year simply did not occur. Same-store sales, the statistic which measures this year's sales against last year's sales in the same store, were up 2.1% for this holiday season (November-December), the lowest increase since 1995, while December's same-store sales were up just 0.7%, the smallest rise since at least 1969, according to Bank of Tokyo-Mitsubishi analyst Mike Niemira. These statistics are based upon sales at 81 retail chains, and do not indicate the carnage at the thousands of smaller stores, whose sales are being steadily eroded by the growth of giant superstore chains.

During the last ten years, same-store sales in December have increased an average of 4.3% a year, and increased 6.7% in 1999. Both the nominal 0.7% increase in December 2000, and the 2.1% November-December combined increase reported, are actually significant drops in sales, when inflation is taken into account.

## Reality Creeps In

In preparation for each holiday season, retailers have to project the level of future sales for a wide range of products, then buy inventory accordingly; a company which underestimates the level of sales can wind up without sufficient inven-