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Blue Skies Ahead?

Economic seer John Moffatt thinks the worst may soon be over

BY JENNIFER ABLAN

Last Fall, Many people were annoyed, if not shocked, to hear candidate George W. Bush talk up the notion that the U.S. economy, then in an unprecedented 10th year of growth, was heading for a slowdown or “possibly a recession.”

His views on the financial state of the union might well have derived from the research of John Moffatt, a Lamesa, Texas, native who now hangs his 10-gallon hat in Hopkinton, New Hampshire. Moffatt, whose clients in Midland, Texas, have close ties in the Bush Administration, runs an investment-research boutique called Analytic Systems, which uses economic-sensitivity analysis to determine the investment prospects for various stock-market sectors.

By August 2000, Moffatt's macro-economic indicators were already pointing to recession, although government reports still showed, and continue to show, U.S. gross domestic product expanding. Among the telltale signs of trouble Moffatt cited in a report were the inverted yield curve, which usually signifies a slowdown in GDP growth; unsustainable consumption levels and persistent inflationary pressures, as measured by the consumer and producer price indexes. Moffatt's client, Nicholas Taylor, a Midland, Texas, corporate lawyer, says he passed Moffatt's report at the time to Karl Rove, Bush's campaign manager.

The Bush camp would hear something very different, however, if it checked in with Moffatt today. The current quarter probably will mark the low point in this economic cycle, Moffatt says now, and a recovery soon will follow.



Specifically, Moffatt expects GDP to move into the red in this year's second quarter, as corporations purge inventories and slash payrolls. But the drop in third-quarter GDP is likely to be much less severe, as long as most consumers don't stop spending. “We're looking for a V-shaped recovery,” he says, noting that “timely and dramatic easing by the Federal Reserve” is key to a speedy rebound. Since January, the Fed has cut short-term rates five times, bringing the current rate down to 4% from 6½%.

Moffatt expects GDP to grow 2½-3% in this year's fourth quarter, and suspects

revisions to prior-quarter statistics will reveal that the “technical parameters” of a recession – two quarters of contraction in GDP – had, in fact, been met. But he doubts the robust growth of the late 1990s will stage an encore performance.

His summer forecast bodes well for the shares of cyclical companies, energy producers and retailers, although it suggests that industries with stable earnings growth will command less of a premium in a more robust economy. That's the sort of guidance that many professional investors – primarily pension-fund and mutual-fund managers – have sought from

ECONOMIC RECOVERY PLAYS

- ♦ *“We’re looking for a V-shaped recovery,” says Moffatt, citing the Federal Reserve’s timely and dramatic easing of short-term interest rates. He expects a turnaround in the fourth quarter.*

Moffatt’s Picks

Consumer Cyclical:

Retailers, Autos	A play on continued consumer spending
Paper	A stronger economy will enhance the prospects
Chemicals	for these cyclical industries, while a more inflationary
Basic Metals	environment will boost their pricing power
Energy	Benefits from a supply shortage and greater inflation

Pans

Foods	In a stronger economy, the group’s stability is less attractive
Electrical Utilities	A recession play that peaked with the bond market
Health Care	
Pharmaceuticals	Another defensive sector, inflation is a negative
Banks	Personal bankruptcies rising; telecom lending issues yet to be resolved

Neutral-to-Negative

Technology	Capital spending outlook is poor, and “death toll” of non-viable companies is mounting.
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Moffatt since he hung out his shingle in New England 19 years ago.

After graduating from the University of Texas and obtaining a masters in engineering from New York University in 1968, Moffatt, now 60 years old, headed for Wall Street, where he worked for a time as an analyst and portfolio manager under George Soros, at Arnold and S. Bleichroder. Later, as a technology analyst at Blythe Eastman Dillon, he experienced firsthand the dark side of Wall Street’s research machine; he says he was fired for writing a negative report on IBM, recommending that the firm’s clients sell the stock.

Moffatt claims that the price of virtually

any common stock is attributable to three factors: 25% is due to the macroeconomic backdrop, 25% to the fundamentals unique to that company and 50% to market influences. Accordingly, his quantitative research model relates changes in 20 macroeconomic factors to the universe of Russell 2000 stocks, with the aim of determining which industry groups are likely to perform best over the coming six months to a year.

Every May, Analytic Systems selects those 20 factors from the wide world of economic data that Moffatt expects will be relevant in picking winning stocks in the next year. The company then follows the monthly trends in the factors and

updates the impact on specific industries. In the next year, Moffatt expects measures of inflation, such as the consumer price index, producer price index and GDP deflator, to play key roles in determining stock performance. That’s because “inflation is already a bigger problem than people think,” he says.

In his most recent newsletter, Moffatt observes that while the economy slumped dramatically in April and May, inflationary pressure remains. Weighing changes in other factors, such as the dollar, interest rates, inventories and the general economic climate, he concludes that consumer cyclical’s are now the best investments.

Moffatt also is keen on paper, chemicals and basic materials stocks, as he believes a more inflationary environment will boost their pricing power. Too, energy-related stocks are bound to benefit from a nationwide power shortage.

Conversely, Moffatt recommends that investors avoid food, consumer growth, electric utility, insurance and health-care stocks. These groups perform best when the economy begins to slow significantly, he explains.

Like any market seer, Moffatt has made his share of misguided pronouncements. His macroeconomic indicators pointed mistakenly to a recession in 1995.

He also steered clients clear of the run-up in technology stocks in the late 1990s. And, he was right to call techmania a bubble long before the rest of the world came to view it that way.

Yet, Moffatt’s clients have stood by him, and appreciate his early-warning system. “He has been 75% right with his calls, which is an unbelievably great batting average in this business,” says Dan Szente, chief investment officer for the California Public Employees’ Retirement System.

If Moffatt’s current call on the economy proves correct, chances are he won’t be the only Texan smiling.