WALL $TREET WEEK WITH FORTUNE

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Reagan roundtable

KAREN GIBBS: While the country was mourning a beloved ex-president, there were lots of undercurrents moving through the markets. Gas prices fell, giving temporary relief at the pump, but rising import prices signal higher energy prices down the road. The group of eight industrialized countries met off the coast of Georgia, but they might as well have been playing golf for all the attention the meeting received. Fed chairman Alan Greenspan warned of higher interest rates to combat inflation, and a telecom ruling favoring regional bell companies could affect millions of consumers. And a new study showed that being rich doesn't guarantee you'll get lucky. But all of that took a back seat to the news of the death of the 40th president of the United States.

No other president has an economic theory named after him. He left an indelible imprint on government an Wall Street. John Rutledge was an early architect of the Reagan economic plan. He now runs Rutledge Capital and joins us from New York City. Steven Leuthold, chairman of Leuthold Weeden Capital Management, credits Reagan for winning the Cold War but fears the Reagan legacy of higher deficits. Steve joins us from Portland, Maine.

Well, John, let me ask you, the Reaganomics theories of increased defense, reduced taxes, lower government spending, and deregulation are still with us today. How do we grade Reaganomics?

JOHN RUTLEDGE: Well, you know, we should have called him the Clipper instead of the Gipper, because he wanted lower taxes, lower spending, lower regulations, and lower inflation. And his basic idea was let's get the incentives right to get out of people's way and let them run their lives and run their businesses. And I think it's done very well today.

GIBBS: Well, Steven, it certainly has given the stock market, or at least he's being given credit for the longest bull run market, up since 1982 some 1,000 percent, but we still have the specter of deficit spending hanging over us. How do you look at that?

STEVEN LEUTHOLD: Well, back in Reagan's day in Reaganomics, one of the ideas was that if Congress didn't have the money, they wouldn't spend it. And unfortunately that proved to be wrong, because they still continued to spend. They went out and borrowed more, and that's what created the deficit. John, would you agree pretty much with that?

RUTLEDGE: Well, I think Congressmen love to spend money, and it doesn't matter which uniform they're wearing. They all like to spend. And today of course we've got a war, we've got terrorism, and we had a recession, so it's really hard to make sense out of the short-term numbers.

LEUTHOLD: Oh, I think that's true.

RUTLEDGE: But, yeah, I think that's always going to be a problem. When he was elected, inflation was 15 percent. Today it's 1 or 2. Interest rates were 21 percent. Today they're 1 or 2. Tax rates were 70 percent, and today they're half of that, and lower than that on capital gains. And the Soviet Union only exists in the history books today. That's a pretty good scorecard by my way of counting.

LEUTHOLD: Oh, yeah. I wouldn't disagree with that, but I was not a great fan, being a deficit hawk, of Reaganomics back in the '80s, and one of the reasons was that I also didn't really believe in the Laffer curve in that if people took home more, they'd work harder, because most of the people I talk to, if they're taking home more, wanted more free time. But maybe it's the circle that I was running in.

GIBBS: John, do you think that investors are overreacting to the fear of higher interest rates and higher energy prices?

RUTLEDGE: I really do. You know, the bump in inflation in the first quarter, Karen, was caused by Chinese growth pushing up commodity prices, by the dollar pushing up import prices, and by a one-time housing price change driven by refinancing mortgages. Those are largely behind us now. We're already seeing the numbers begin to soften up.

I think the Fed is going to be forced to back up and not to tighten as much as they're giving us warning today. And that's because the job growth isn't as strong as you'd like to see in a recovery. Costs are actually under control. Profits are growing very strongly, which is good for the market. But we do not have an inflation problem.

GIBBS: So you're saying that this is actually a very conducive environment for a continuation of the stock market rally, John.

RUTLEDGE: Well, yeah. You know three times in the last two years you had the opportunity to buy the stock market for 40 percent below its fair value. In the last 10 weeks, we've had another opportunity arise, because people were afraid of the Fed and afraid of the inflation numbers, so they sold the bond and the stock markets off. But unit profit growth is increasing 27 percent annual rate because of the productivity boom, and for another factor, all of the productivity growth we've seen so far has come from giving high-speed telecom to a group of large corporations in big cities. In the next five years, the small companies in the small towns are going to get it. Productivity drives costs down, inflation down, and profits up. That's great for stockowners.

GIBBS: John, and I should mention that not only are you a money manager, but you are doing some work on the telecom industry, is that correct?

RUTLEDGE: I am. I'm in the middle of doing a study of telecom deregulation and its impact on the economy.

GIBBS: John, from your perspective, from an investor's perspective, who do you think are going to be the winners and losers in the telecom industry?

RUTLEDGE: Well, you know, this move the White House made this week has essentially paved the way to free telecom up from the regulatory burden that has made us number 11 in the world in terms of network speed. India, China, Taiwan, Singapore, Korea all have speed of light fiber optics running to their businesses. We do if you work in Los Angeles or New York or a major city, but not in the small towns.

We've got to learn to outsource to our own small town companies, not to small companies in India. Those changes are going to favor people who have network, so the RBOCS who are going to do the fiber optic and wireless investing are going to be favored relative to the MCIs, the AT&Ts and the Sprints that are network users and renters. Within those users, you'd rather own Sprint than AT&T or MCI because of their fiber backbone.

But the best gains are going to happen in equipment makers who sell the little boxes and switches and fiber optic cable that's going to be used to do about $100 billion worth of new capital spending. And the biggest winners of all will be companies in towns that don't have broadband communications now that will be able to compete with someone in Korea for the first time.

GIBBS: Let's talk about some of the demographic shifts we're seeing, particularly with the baby boomers really pushing this market. We have seen the economic recovery, focus on consumer confidence, and we've talked about the importance of unemployment and inflation. But health care now seems to be a really big push. John, can you give me your feelings on the health care sector?

RUTLEDGE: Absolutely. I'm an expert on health care, because I'm the oldest baby boomer in America. And currently, if I start at my head and work my way to my toes, nothing works and everything hurts. So I thin the baby boomers are not afraid of pharmaceutical intervention to solve our problems. We were the childre of the '60s remember?

Pharmaceutical companies I think have been sold too short because of this cash flow squeeze, margin squeeze recession, and I think there's very strong long-term fundamental demand. And as you bring more and more of the third world into the growth part of the world, they're going to begin thinking about health care, too. So health care is a very positive sector I think, long term.

LEUTHOLD: I certainly would agree with John about that. The big drug companies are under a big cloud, and I think it's creating some of the best values for people that are courageous enough to be, to go against the current political winds. But we think that companies that are involved in containing health care costs, something we call our health care cost containment theme, is really more timely. And I think you buy the big drugs, but you put them away and be pretty patient.

GIBBS: You're also under weighting biotechnology. Tell me why you don't like biotech right now.

LEUTHOLD: Well, we had liked biotech. It was a very significant part of our portfolio, but again, when we'r managing money and we're selecting industry groups to be invested in, we do pay attention to a very exacting type of quantitative model with 28 factors, and this work has shifted to neutral with biotech. So we've moved out the biotech stocks and we bought a package of life insurance stocks.

GIBBS: Let's talk about the life insurance stocks, because it's part of the financial sector, Steve, that is sensitive to interest rate movements. Why do you feel that life insurance is a better play?

LEUTHOLD: Well, Karen, you're certainly right about that. Most of the financial groups are very sensitive t interest rates, and rising interest rates is not a very good environment for most financial groups. Now, I think life insurance is less immune to a rise in interest rates than many of the other financial groups like banks, money center banks, regional banks, and so on. And we look at them as being quite undervalued. We look at the life insurance stocks, many of them as being candidates for maybe acquisitions by others, and it just represents in our mind a good value part of the market that is not terribly susceptible to rising interest rates.

GIBBS: We're also seeing global growth really power some of the industrial metals, but that also is going t ignite some inflationary pressures, John. What do you think the market reaction will be to that?

RUTLEDGE: I think that's a head fake. I think that the big push on the metals was last year, and that som of the measures taken in China have taken the top off that. We had a tight market in scrap steel and in nickel and in aluminum and copper and other things, but truth is I think you're going to see those be modest increases or even decreases coming up, likewise with oil.

China bought all the oil could deliver last year. They're trying to increase their electricity capacity, but that push is mostly behind us at this point. I'd much rather buy the ignored companies that are the branded consumer products companies. You know, big margin companies, they get hurt a lot during a recession when cash flow weakens, but when the economy recovers, those gross margins lift their cash flow significantly.

GIBBS: Do you have any examples of those, John?

RUTLEDGE: I think, you know, the branded consumer product names, the Procter & Gambles and the Unilevers and the like are companies that have both brand equity that's going to gain from the recovery an they also have significant business in China, which is really the epicenter of world growth right now, Japan right behind it. Japan has really turned the corner now and is doing good things.

LEUTHOLD: Well, I do disagree with John regarding the industrial metal stocks. I think the whole problem there has been we've gone through a decade from 1990 to 2000 of under investment in terms of the metal industry because the pricing just wasn't there and it didn't pay. There was I think about 2 percent per year was the investment growth in the industrial metals area, all the way from smelters to the mines.And at the same time, we were seeing demand growing at 3.5 to 4 percent per year, so we're right now is some pretty slack inventories, pretty small inventories, and I think that it's going to take quite a bit of time to turn around and jack up the production of things like copper and zinc and lead.

And it's not like, well, Karen, back in your commodity days, you know, if you ran short of corn, the farmers could plant a lot more the next year. But in terms of copper, where it takes seven years, six years to develop a new mine, and when you need major capital investment, I think we're in for a period of short supply compared to the demand.

RUTLEDGE: Well, the prices, Steve, I think have been tightened by exactly what you're describing. And las year China's industrial capacity or production grew 17 percent, and that's not going to go away either. But the sort of company we're talking about ends up doing capital spending exactly at the moment when their cash flow comes on, which means their free cash flow disappears. And over longer periods of time, they have a hard time generating return on capital that beats the cost of their money, which means I think they're mainly leveraged commodity price plays.

LEUTHOLD: But see, John, one of the things we've done that's unusual is that we have not necessarily jus bought the companies that are benefiting from this; we've bought the actual physical industrial metals as well. So we don't run any risk with those in terms of dumb management decisions or accounting gimmicks or whatever.

RUTLEDGE: Well, good. Now we have a buyer and a seller, so we have a market.

LEUTHOLD: That's right.

GIBBS: We also have a market in the rebuilding of Iraq. I think you're on record as saying, John, that the rebuilding of Iraq could mimic or rival the gold rush of 1849. Talk about that for me.

RUTLEDGE: I think maybe even a better example would be the Oklahoma land rush, because on the borders of Iraq it's surrounded by billionaires whose return on capital is the same as Steve's and mine, which means single digits on fixed income investments and equities that are a 10 at best. They have enormous incentives to invest in their own region. They have experience in investing. So I think that the money that's going to rebuild Iraq is going to be Kuwaiti money, Saudi money, Dubai, Abu Dhabi, Qatar an the other Gulf oil producers.

GIBBS: Steve, what will be the impact then on the price of oil?

LEUTHOLD: I think we're temporarily up here around the $40 mark and maybe you're going to see some kind of a setback here with the normal cyclicality that we see with prices. But I still think you're going to se oil averaging maybe above $30 a barrel, maybe $32 to $33. In this country I think we overreact. I mean the fact is that a gallon of gasoline right now takes about 7 minutes of labor by the average manufacturing worker that's getting maybe $16 an hour, and back in 1980, when things were really tight, it took like 11 o 12 minutes of labor with the base salary at $7.40, $7.50. So and certainly if we compare prices with what we see in Europe and in England where we're looking at $5.75 to $6.00 a gallon, our prices look pretty cheap.

GIBBS: Gentlemen, this has been a fascinating discussion. John Rutledge, Steve Leuthold, thanks so much for joining us.