

**O**F LATE, negative social news like thefts and murders has hogged the headlines of local papers. Many would probably be wondering why criminal cases and social illnesses seem to be rising in recent years despite the country seeing fairly good economic growth. The government has even recently announced quite a good set of second-quarter gross domestic product (GDP) growth numbers. So, what gives?

Many blame the crime phenomenon on higher interest rates and petrol prices that have resulted more in a spike in the cost of living for ordinary people rather than big corporations. Interestingly, the increasing crime rate is actually one of the syndromes that may signal that the economic environment is slowly turning to the autumn or winter season under the economic K-Wave analysis. If this is true, then there may be more negative news ahead for the ordinary households in the country.

#### K-WAVE DEFINED

The Kondratieff Wave, or more commonly known as the 'K-Wave', is a 60-year economic cycle (averaging 54 years in duration) suggested by a Russian economist - Nicolai Kondratieff - in the 1920s. The K-Wave cycle goes through four distinct phases of beneficial inflation (spring), stagflation (summer), beneficial deflation (autumn) and deflation (winter).

Since the last full cycle that ended around 1949, the world has apparently seen another new beneficial inflation cycle (1949-1966), stagflation (1966-1982), beneficial deflation (1982-2000) and according to Kondratieff's theory, we may now be in the (winter) deflation cycle which should lead to depression even while the majority of the world anticipates an economic expansion.

The backbone of the K-Wave theory is actually derived from the relationship between accumulation and consumption. During periods of relatively cheap prices, assets accumulate. As prices increase, the consumption of assets is necessary to maintain a reasonable standard of living.

# A White Wintry Economy, Anyone?

Based on certain characteristics that the Malaysian economy is displaying, it would seem that the nation is in the throes of an 'economic winter' as propagated by the K-Wave theory. The remedy? ■ By James S

When new production fails to keep up with consumption due to relatively high prices, the economy begins to decline to another period of cheap prices, and a new growth cycle begins.

The theory states that one cycle of accumulation and consumption process consists of the afore-mentioned four distinct phases with dramatic mood changes, the tone of which determines the actions of individuals involved in the economy. The awareness of these characteristics allows for the anticipation of the change in the economy and the psychological mood that will prevail.

#### The past and present of the Kondratieff (long) wave cycles

Note that successive K-Waves tend to trend higher. This indicates that despite periodic declines, capitalist economies should become more and more prosperous as witnessed by history. The table shows the K-Wave cycles that the United States (or the world) has gone through. Note that the

periods of 'autumn' were normally characterised by massive debt growth and speculative bubbles. Some advocates of this theory have suggested that the current war on terrorism and the geo-political tension of late seem to fit well into the characteristic of a winter (or summer to a certain extent) period under the K-Wave.

#### WHERE IS MALAYSIA IN THIS PERSPECTIVE?

With limited historical data, it's difficult to estimate which K-Wave cycle the country is in at present. However, if one uses technical analysis (the theory of Elliot Wave and Fibonacci numbers), then the results are interesting.

The basic assumptions are:

- i. It takes five major impulsive waves (three bulls and two bears) and three corrective waves (two in bull periods and one in bear periods) to complete a cycle,
- ii. The bull cycle is longer than the bear

## ■ The Past and Present of Kondratieff (Long) Wave Cycles

Spring (expansion)	Summer (recession)	Autumn (plateau)	Winter (depression)
1784-1800	1800-1816 (War of 1812)	1816-1835 ("Era of Good Feelings")	1835-1844 (Mexican American War)
1845-1858	1859-1864 (American Civil War)	1864-1874 ("Reconstruction")	1875-1896 (Spanish American War)
1896-1907	1907-1920 (World War 1)	1920-1929 ("Roaring 20's")	1929-1949 (World War 2)
1949-1966	1966-1982 (Vietnam War)	1982-2000 ("New World Order")	2000-? (War on Terror? Or?)

Source: www.kwaves.com

cycle (assuming a ratio of 1.000:0.618), and

iii. The number of periods are rounded up to the nearest Fibonacci numbers (such as five, eight, 21, 34 and 55) whenever possible.

The outcome under the above assumptions is as follows:

- Spring and summer (bull phase – three impulsive up-legs and two corrective down-legs) last 34 years.
- Autumn and winter (bear phase – two impulsive down-legs and one corrective up-leg) last 21 years.
- Each impulsive leg lasts eight years while the corrective legs last five years each.
- Assuming 1997 as the peak of the bull phase, the result suggests that Malaysia could probably be in a transition period of autumn and winter, with a counter trend rally on the market likely to start from 2006 and ending in 2010.

To try to check the validity of the above estimate, one can go through some of the main characteristics of the K-Wave periods. Recall that under the theory, in the period of autumn, there are:

- i. changes in price structure,
- ii. a period of relatively flat economic growth and mild prosperity,
- iii. selective industry growth,
- iv. termination of the feeling of euphoria,

- v. economic growth mainly driven from consumption, and thus
- vi. a rapid increase in debt.

Further, the notable characteristics of winter are:

- i. a low profit margin era as a result of products made cheaper and more widely distributed due to keen competition, leading to industry consolidation,
- ii. lower employment opportunities and hence an increase in social problems,
- iii. changes in the political sense, and
- iv. social issues being played out.

At a glance, these characteristics do look familiar in the current environment in the country, don't they?

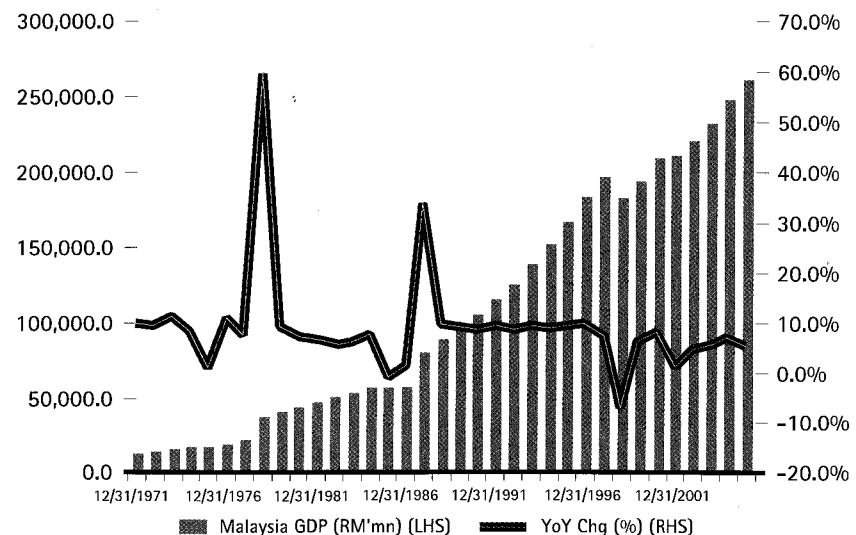
Some observers suggest that the events unfolding in Malaysia currently, such as that listed below, fit into the criteria of the winter period highlighted above:

- price war in industries such as banking, the inability to pass down rises in operating costs and hence a margin squeeze,
- the focus of banks on consumer lending, hence higher household debt,

## ■ A Rough Estimation of the K-Wave In Malaysia

Spring + Summer						Autumn + Winter		
1963	1971	1976	1984	1989	1997	2005	2010	2018

## Malaysia: GDP Level and GDP Growth



Source: Bloomberg

- vertical and horizontal mergers and acquisitions (M&As) to maintain profitability and growth,
- a two-tier equity market, where only the blue chips perform while the performance of the lower liners are disappointing,
- organic growth is seen only in selective sectors such as oil and gas, and
- the recent hostile developments in the social and political landscapes of the country.

In short, these observers conclude that the above events collectively suggest an autumn period, if not a winter, under the K-Wave theory and hence point to potentially tougher times ahead.

### POSITIONING FOR TOUGH TIMES AND UNCERTAINTIES AHEAD

Fortunately, even if the country is stuck in a K-Wave autumn or winter period, there are ways to lessen its effects, such as through some of the ways below:

#### The Keynesian Theory

On the domestic economic front, the most commonly used technique available to the government is, of course, using the tenets of the Keynesian Theory. Essentially, this traditional economic theory states that the primary cause of business cycles is due to the wide fluctuations in private investment. According to the theory, recessions would be long even with lower interest rates and falling prices due to the insufficiency of these factors to offset the decline in incomes and spending.

Further, the theory argues that prices and wages are downward sticky, as they resist falling even during recessions. This makes the classical adjustment process slow and explains why long-term unemployment can occur. As such, advocates of the theory or Keynesians reckon that an expansionary fiscal policy is the best way to increase spending and push the economy back to full employment. This can be done either by reducing taxes or increasing (government) spending, as a budget deficit is a counter cyclical move.

Judging from the recently announced Budget 2007, the government appears to be on the right path to address the issue with a planned budget deficit at 3.4%, and with almost every sector getting some incentives. In line with the 9<sup>th</sup> Malaysia Plan (9MP), the government has also encouraged more private investment via private finance initiatives (PFI) apart from the conventional pump-priming strategy. The cut in corporate tax by 1% to 27% in 2007 and another 1% thereafter to 26% in 2008 is also, without a doubt, a counter cyclical strategy.

Prime Minister Datuk Seri Abdullah Ahmad Badawi said in Budget 2007 that the proposals were tailored to meet the

people's needs to help reduce their burden of expenditure owing to the rising cost of living. On the political front, the Prime Minister also said that it was the Barisan Nasional's tradition to thrash out and solve any misunderstandings among the coalition parties in the best possible manner. These appear to be strategies to mitigate the ills of the K-Wave winter period highlighted above.

### Positioning, positioning, positioning

It is also fortunate that the K-Wave theory also suggests that even during the autumn and winter seasons, selective sectors in the

# The Four Seasons of the K-Wave Cycle

## Spring – Inflationary Growth Phase

According to Kondratieff, in this phase, inflation is an inevitable part of growth, and governments, at the same time, are passive participants in the inflation cycle. Growth begins from a depressed economic base and expands in an ever-increasing spiral. The interaction of the participants within the economy causes wealth, as represented by savings, and the production of capital equipment to be accumulated for the future.

The expansion of production and affluence causes prices to rise, and the increased volume of goods requires a higher velocity of money, thus creating a higher price structure. During this phase, unemployment falls, wages and productivity rise and prices remain relatively stable. Historically, the growth phase requires 25 years to complete.

The mood of the growth phase is one of accumulation and the desire for new product manufacture. Accompanying growth is a shift in social demands. As wealth is accumulated and new innovation introduced, great upheavals and displacements take place.

## Summer – Stagflation (Recession)

Eventually, the continuation of exponential growth reaches its limit. Excess capital produces a shortage of key resources and the economy enters a period where growth creates a shortage of resources. An economy will only support expansion to the limits of its resources, both human and material.

The mood of affluence also brings a change in attitude towards work. As an economy gets closer to its limits, inefficiencies build up. The imbalances of this period have been historically exaggerated by what can be labelled as a 'peak war'. Examples of this are apparently World War I and the Vietnam War, which came at the end of a very affluent period.

These wars produced strains on the economy and increased the impact of inflation. A dramatic drop in output, rapid rise in unemployment and unusually severe recession characterise this period. Although the primary recession is short-lived, lasting only three to five years, it is the

Source: Subtracted from the article entitled 'The Kondratieff Theory.'

economy will still be able to see growth. The pertinent question to investors is, of course: Which are these 'still growing' sectors amidst the winter scenario in the economy?

Some clues could be drawn from the government's plans and thrusts itself. The government has identified sectors such as agriculture, biotechnology and *halal* food as future growth drivers in the economy. The government is also promoting tourism and Islamic finance in a big way with various spending and tax incentives as outlined in the recent budget proposal.

Apart from the sectors that are being promoted by the government, selective sectors such as plantations and oil and gas

should also be resilient. People who are employed in these sectors should be seeing good times even while other people employed in other sectors have been forced to tighten their belts because of increases in expenditure brought about by rising prices.

To quote from a recent Press report: '*In northern Sarawak, the oil and gas capital of Sarawak and the top producer for Malaysia, employees working for oil giants Shell and Petronas here continue to live the good life. Their strong purchasing power has in fact helped to sustain the local economy through the past two years when the price increases of fuel*

*and consumer goods have forced the rest of the citizenry to cut back on spending.*'

In other words, the country and its citizens can still keep 'warm' by identifying the right sectors and thrusts even during a cold 'winter' economy.

### Going global

Some K-Wave experts suggest that markets have a tendency to return to where they started. In other words, gains of the previous period are normally wiped out following a speculative bubble phenomenon. For instance, in the US, some stocks have fallen by more than 95% while other big names such as Enron and WorldCom have collapsed. Some K-Wave winter bears even suspect that the Nasdaq market will ultimately lose at least 90% of its value from the top, or fall to at least 500 points over the next decade. For the Dow Jones Industrial index, in theory, this suggests that it could fall back to around 5,000 points as well.

While the bear camp could be right about the downside risk potential of Nasdaq, they may be less accurate in their predictions for the Dow Jones. In fact, the index is now only about 500 points from its peak of 11,800 points. What does this mean? Well, the bears may have underestimated the power of diversification or globalisation, and Malaysian companies should learn quickly from this phenomenon.

Note that the component stocks of the Dow Jones are totally different animals compared with the other component stocks of the US S&P500 and Nasdaq. In other words, Dow companies are truly 'global' companies.

Even if the K-Wave is right and that US is also potentially now in a winter economy, i.e. with double deficits and high household debts, Dow companies have surprisingly been able to maintain their profitability and growth through globalisation and diversification of their markets. These companies have invested around the world, particularly in the economies that have been labelled 'spring' or 'summer'.

To further substantiate this hypothesis, let's compare the percentage of overseas

key in altering perceptions and the structure of the economy. The economy could then go into consolidation and tight bounds for the next 20-25 years.

### Autumn - Deflationary Growth (Plateau Period)

The change in price structure, along with the mood of a population used to consumption accompanied by the vast accumulation of wealth from the past 30 years, causes the economy to enter a period of relatively flat growth and mild prosperity. Due to structural changes and the limits of the existing paradigm, the economy becomes consumption-oriented.

Coupled with fiscal liberalism, individuals in this period look for stability or normalcy. The plateau period generally lasts seven to ten years and is characterised by selective industry growth, development of new ideas (both technological and social) and strong feelings of affluence, culminating in a feeling of euphoria.

The inflated price structure from the primary recession, along with the desire for consumption, produces a rapid increase in debt. Eventually, wealth consumption expands beyond all practical limits, and the economy slips into a severe and protracted depression.

### Winter - Depression

Excesses of the plateau period lead to a collapse of the price structure. This exhaustion of accumulated wealth forces the economy into a period of sharp retrenchment. Generally, the secondary depression entails a three-year collapse, followed by a 15-year deflationary workout period. Kondratieff viewed depressions as cleansing periods that allowed the economy to readjust from the previous excesses and begin a base for future growth. This is a period of incremental innovation where technologies of the past period of growth are refined, made cheaper and more widely distributed. Also, one will see an incremental increase in the innovation of consolidating industries, which could narrow profits and increase costs - a low profit margin era.

Within this phase, one also sees a consolidation of social values or goals. Often, these social changes are supported by shifts in technology and the period of incremental innovation provides the framework for social integration as well.

Political sense faces changes in this period too. Contrary to the growth period when one witnesses political stability, during the tough times, old alliances become challenged. Through the process, old alliances fail and new alliances are formed. The final stages of the cycle is a period of coalescing or 'quickening' of the alliances that will govern the next period of growth. **mb**

revenue contributions of the Dow component companies with the bottom 30 component stocks of the S&P500 Index. The results (as shown in the table below) reveal that Dow component stocks have a much higher overseas contribution to their business vis-à-vis other smaller local S&P companies.

The following chart also clearly suggests that the Dow Jones index has

been far more resilient than the S&P500 index. Based on the findings, it would seem that going global is definitely one of the most effective ways of mitigating the risk of an economic slowdown in a home country when it is stuck in a winter period.

Interestingly, the government seems to be on the right track by encouraging the local big boys, including Khazanah

Nasional Bhd and Petroliam Nasional Bhd, to invest overseas. More emphasis has also been put on the recent 2007 Budget to promote Malaysian investments abroad. Thus far, among the local banking groups, Bumiputra-Commerce Holdings Bhd, Malayan Banking Bhd and Public Bank Bhd have invested substantially or about 20% of their assets overseas. In fact, in the previous *Malaysian Business* issue on 'Global Malaysians' (Aug 1, 2006 issue), one should note that most of the successful local businessmen and entrepreneurs have taken the initiative to invest overseas.

### ■ Percentage of Overseas Revenue Contribution to Companies (Based on the Latest Information Available From Bloomberg)

Component Stocks of Dow Jones		Bottom-30 Components of S&P500	
Company	% of Overseas Revenue Contribution	Company	% of Overseas Revenue Contribution
Altria Group Inc	56.2%	PMC - Sierra Inc	66.2%
International Business Machines Corp	61.6%	Andrew Corp	52.2%
Boeing Co	28.4%	Navistar International Corp	13.7%
Exxon Mobil Corp	69.2%	ADC Telecommunications Inc	45.3%
3M Co	60.8%	Peoples Energy Corp	0.0%
Caterpillar Inc	52.3%	Hercules Inc	52.6%
Johnson & Johnson	43.8%	Parametric Technology Corp	62.3%
American International Group Inc	45.0%	Unisys Corp	54.0%
Procter & Gamble Co	55.3%	Nicor Inc	0.0%
United Technologies Corp	51.7%	Sanmina-SCI Corp	76.2%
American Express Co	34.0%	Big Lots Inc	0.0%
Citigroup Inc	41.4%	Dillard's Inc	0.0%
JPMorgan Chase & Co	21.4%	Louisiana-Pacific Corp	30.8%
Coca-Cola Co/The	71.0%	Meredith Corp	0.0%
Wal-Mart Stores Inc	20.1%	Dow Jones & Co Inc	8.5%
Merck & Co Inc	42.0%	Goodyear Tire & Rubber Co/The	54.1%
El Du Pont de Nemours & Co	58.2%	Dynegy Inc	0.0%
Honeywell International Inc	35.1%	Ciena Corp	0.0%
McDonald's Corp	66.0%	Novell Inc	50.6%
Hewlett-Packard Co	64.8%	PerkinElmer Inc	61.3%
Verizon Communications Inc	3.2%	RadioShack Corp	0.0%
General Electric Co	44.9%	Tektronix Inc	65.2%
Home Depot Inc	0.0%	Allied Waste Industries Inc	0.0%
AT&T Inc	0.0%	Bausch & Lomb Inc	57.2%
General Motors Corp	33.9%	Snap-On Inc	43.1%
Walt Disney Co	22.3%	Watson Pharmaceuticals Inc	0.0%
Alcoa Inc	40.7%	Brunswick Corp	34.6%
Pfizer Inc	48.0%	Teradyne Inc	77.5%
Microsoft Corp	32.3%	American Power Conversion Corp	54.8%
Intel Corp	80.5%	Autonation Inc	0.0%
<b>AVERAGE</b>	<b>42.8%</b>	<b>AVERAGE</b>	<b>32.0%</b>

Source: Bloomberg

### CONCLUSION

Malaysia and most of the world's big economies like the US may actually be in a long 'winter' economy stretching 10-20 years ahead if one believes in the K-Wave economic theory. Fortunately, its effects can be mitigated by remedial measures. The government and local companies should recognise the potential downside risk of the K-Wave cycle and draw up long-term and contingency plans to deal with its consequences. As for investors, they should recognise by now that companies (either big or small-cap) that have taken the initiative to expand overseas and with profitable track records would probably be safer bets going forward.

In addition, investors should note that even during the autumn or winter seasons, the market can still swing into a counter cyclical rally. Luckily, the timing of such a rally is that it may well occur in the next few years in the local market as highlighted in the earlier part of this article. As such, the current depressed broad market may still actually be an opportunity to accumulate down-beaten stocks for investors despite the longer-term winter effects. **mb**