

# The Blue Sheets®

The Financial Advantage, Inc. Ongoing Commentary On the Global Economy and Securities Markets

MARCH 2010

## Freedom, Capitalism and the Role of Government

Oh, East is East  
& West is West  
and never the  
twain shall meet.

–Rudyard Kipling

Our mission at Financial Advantage is to promote the prosperity and, thereby, the economic freedom of our clients and their families by thoughtfully investing their savings; to pursue opportunity wherever we find it, while diversifying the risks that attend even the most promising enterprises.

As the door swings open to a fresh new decade of opportunity, and as we survey the exciting array of businesses in which private capital might be invested, we are conscious of three large-scale risks that have the potential to overwhelm ordinary investment considerations. These risks have to do with how governments respond to

- a) The exhaustion of the post-WWII credit expansion in the developed economies;
- b) The increase in terrorism, mass demonstrations and geo-political tensions around the world; and
- c) Intensified global competition for markets, capital and natural resources.

In this edition of the Blue Sheets®, we have elected to focus on one very complex and surprisingly contentious issue that could, of itself, largely determine whether and how these three risks can be managed. That single critical variable on which so much depends is the **condition of personal freedom**, which is always and everywhere the sine qua non of economic progress.

1775



Lexington Green, American Minutemen confront the King's army; 15 months later... The Declaration of our right to life, liberty and the pursuit of happiness!

1989



"Tank Man" confronts the modernist Marxist state at Tiananmen Square; 3,000 protestors died there. Today, it's still forbidden to even write about the incident.

# A society's standard of living improves when its individual members are free to reap the rewards of their own efforts.

## THE ENIGMA

A foundational principle of classical economics is that a society's standard of living (per capita GDP) improves when its individual members are free to pursue a better life for themselves and their families *by working hard, saving, taking economic risks* and reaping the rewards of their efforts. A corollary to this principle is that when the motivation for hard work, saving and risk-taking is diminished by outside force (usually some form of government control or taxation) then the whole economy languishes.

In the United States of America, personal economic freedom has been secured by a democratic form of government and a rule of law designed to protect the rights of workers and investors against violence and fraud. This combination of economic and political freedom is widely credited with the unprecedented prosperity achieved in America and in nations that have adopted a similar construct. More repressive social models have never produced a steadily rising standard of living for the general population... think Cuba, much of Africa and the Middle East, No. Korea, Venezuela, the USSR, and communist China. But, wait a minute...

In 2009, the economy of the **United States**, the guardian of western democracy, that champion of free-market capitalism, the home of the free and the brave, *shrank by a record -2.6%* despite massive credit injections by the federal government! In that same year, **China's** avowedly Marxist economy, despite contraction of its major export customer, *grew by a solid +8.7%*, continuing its *25-year growth* which has averaged over 9% a year, a pace unheard of in the modern free-market West! This surprising disparity suggests the following enigma:

- Is personal freedom on the wane in America?

- Is China experiencing an expansion of personal freedom?
- Or is the freedom-growth principle an inadequate explanation of economic progress?

History, especially 20th century history, showcases the inexhaustible creativity of the human spirit. Unconstrained by cultural and institutional prohibitions, and free to enjoy the fruits of their efforts, human beings have multiplied the productivity of their farms, made air travel commonplace, practically eradicated polio and malaria, and distributed a billion 2-inch screens with access to the libraries of the world! The extent to which societies remain or become free and motivated to realize their potential will have enormous implications not only for investment opportunities in the decade ahead, but as well for the quality of life for the planet's 6 billion residents.

Because personal freedom is so critical to the exercise of our inherent creativity and powers of adaptation, we think it is consistent with our obligations to our clients to maintain an informed understanding about the condition of personal freedom around the world in the second decade of the twenty-first century. In this issue we look at the situation in the United States as a proxy for the so-called developed economies, and at The People's Republic of China as a proxy for the developing or emerging-market economies.

**Along with our broad-brush conclusions about the condition of freedom, we will describe the investment posture we think is most appropriate in light of the present uncertainties.**

**Pressed for time, dear reader? Our investment conclusions begin on page 8.**

## FREEDOM AND GROWTH IN AMERICA

Jamestown and Plymouth Colony were settled in the early 1600s by small numbers of people, mostly English, seeking economic opportunity and religious freedom; their expenses were underwritten by investors (two Kings, in the case of Jamestown!) hoping to profit by developing trade with the New World. The Mayflower Compact (1621), the first constitution written in North America, established the foundations of self governance based on the principle of majority rule.

By the 18th century, life in the Colonies had matured and prospered considerably. Britain had overwhelmed the French in the North American theatre of the Seven Years' War and emerged as the dominant colonial power. In 1765, George III imposed a tax on paper documents, magazines and newspapers printed in America. This "Stamp Act" proved so unpopular with merchants and landowners that it spawned a loose coalition of independence-minded colonists all along the Atlantic coast! Demonstrations against British attempts to control affairs often turned violent, leading to a growing British military presence to maintain the peace. King George eventually backed down on the Stamp Act, but struck back with a formal declaration that England alone had the right to establish laws in America; not well received here!

In Parliament's 1773 Tea Act colonists saw a power grab and violation of what they believed was their right to be taxed only by their own representatives. The ensuing destruction of tea cargoes in Boston Harbor, and other organized protests coalesced in the First Continental Congress in Philadelphia (1774) which organized an economic boycott of Great Britain. In response to the growing numbers of British soldiers, colonial militias were accumulating weapons. A company of 700 "Redcoats", sent to destroy their cache, was confronted by a line of "Minutemen" on Lexington Green at dawn on April 19, 1775; the famous "shot heard 'round the world" launched the American Revolution, and the birth of the most free country in the history of the world. Today, America's 5% of world population accounts for nearly a quarter of global GDP. The

## The American Revolution launched the freest and most productive society in the history of the world.

annual output of goods and services in modern America is 6 times the current GDP of that island Empire which once taxed her tea at gunpoint!

### WHAT ABOUT AMERICA'S FUTURE?

But past is not always prologue, is it? A lot has changed in the United States, even since its armies and navies returned home to well-deserved honors after leading the world's defeat of the Axis powers in 1945. The national pride that unified the hearts of citizens in the early postwar years now seems to have blurred into a polarizing disunity concerning the American Dream and the role of government. Another significant change: our savings instinct has all but disappeared. Since 1965, total savings in the US has steadily declined from 12.5% of GDP each year, to *negative 2.5%*; it's been replaced by an eagerness to maintain consumption by increased borrowing.

Even as we saved less, we borrowed more. Total debt in the US (all outstanding credit obligations) equals 370% of GDP;

as recently as 1985 it was half that!

Society has long understood that debt is a constraint on freedom; see Proverbs 22:7, "The borrower is the slave of the lender" (ESV©2001). Our mountain of debt must be either properly serviced by the borrowers or eventually written off by the lenders as uncollectible. A soaring debt service cost necessarily impairs our collective ability to lend, spend and save (savings is essential to growth).

Unmanageable personal debts mean less personal freedom; unmanageable government debts, which ultimately can only be serviced by taxpayers, also constrain the citizens. When you realize that **total US debt** in the last decade (public and private) has been **growing six times faster than GDP**, you quickly see that even the modest pace of GDP growth we have been putting on the books overstates our prosperity because the pace of borrowing that supported it is clearly unsustainable!

There exists a vigorous debate in the US as to the influence of public debt and

deficits on our freedom and prosperity, and the proper role of government in coping with the situation. Not surprisingly, much of the polemic is politically charged (cf. modern Tea Parties). In the last few years, it has been a matter of US public policy to artificially depress interest rates in an effort to minimize the debt service burden, AND it has been the policy to substitute new government obligations for worthless private commitments to forestall a bad-debt contagion. Do such policies represent a fix, a postponement or a worsening of the problem?

## We've stopped being a nation of savers...

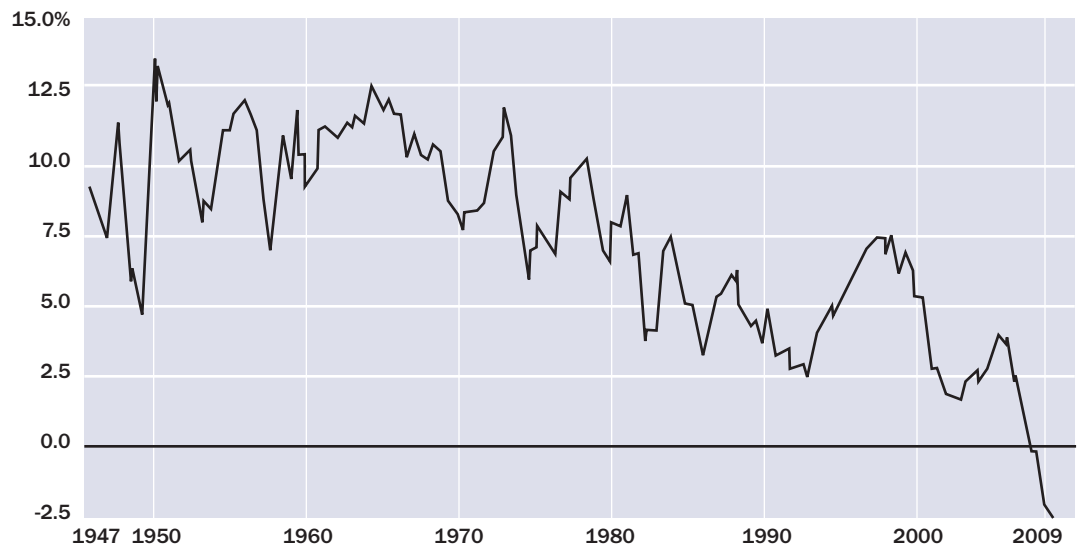
Most analysts see *three possible roads back to financial equilibrium* in the western world.

- 1) **A long period of restrained growth** and gradual reduction of our loan obligations by timely payments. While by far the most desirable of alternatives, from a policy perspective this might require a more delicate crafting of fiscal and monetary policy than a democracy can realistically expect from its government.

## SAVINGS RATE IN U.S. DIPS EVEN LOWER IN 2009 (BLOOMBERG)

Personal, corporate and government savings as a percentage of U.S. gross income, quarterly\*

In 2008, government deficits caused the first annual shortfall in U.S. savings since the Great Depression. Personal, corporate and government savings as a percentage of gross income turned even more negative in the first three quarters of 2009, reaching the lowest level since the Commerce Department started tracking quarterly data in 1947.



Source: Commerce Department

## Proverbs 22:7, “The borrower is the slave of the lender”



### 2) Let defaults take their course.

Freeze or even reduce government spending, match monetary expansion to actual GDP growth, eschew protectionism and let the markets set interest rates. This is the textbook free-market solution, but it might involve more discomfort in the short run than a free electorate is willing to endorse. We'll see.

3) **Debase the domestic currency** by fostering higher inflation, making it easier for debtors to meet nominal dollar obligations. While inflation is the cruelest of “taxes”, especially on our lowest-income population, and an intentional robbing from lenders and savers, it may be the most politically expedient and, therefore, the most probable outcome of the current policy debate. (A recent IMF report urges central banks toward a 4% long-term inflation target!) But, unless currency debasement is accompanied by increased savings, it will only kick the can down the road.

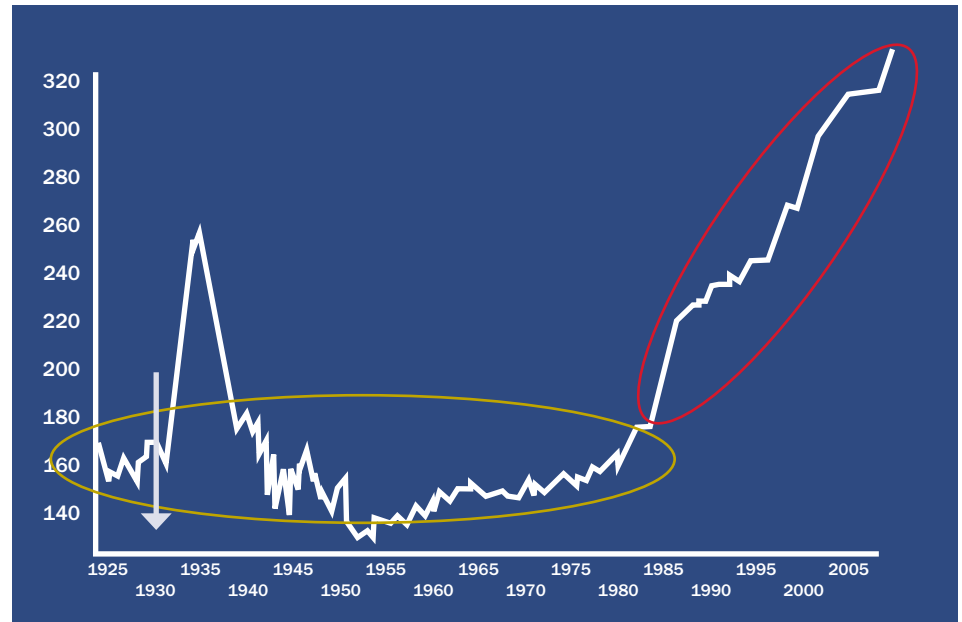
Widespread defaults are arguably the most unattractive of these paths, probably leading to a debt-deflation global depression à la 1929. That is why the two recent Administrations have vigorously sponsored all manner of government interventions such as deficit spending and quantitative easing (“printing” money) to prevent a forest fire of defaults. It's pretty clear that our representatives are deliberately choosing

Since 2000, U.S.  
debt has been  
growing six times  
faster than our GDP.



## A HISTORIC LEVEL OF DEBT

This chart shows total debt (or “credit”) in the U.S. as a percentage of GDP



the path of inflation (aka currency debasement) as the preferred solution to a problem of our own making. The risk in this approach is that they may succeed in expanding our already enormous federal debt obligation, seriously restricting the economic freedom of future generations, yet fail to ignite wage and price inflation that would gradually ease the burden on current debtors.

Under any of the three possible policy directions, it is inescapable that heavy debt payments will limit our economic opportunities and restrict our real growth until we correct the imbalance. (Keep in mind that consumer spending accounts for 70% of our GDP.) We are still free to work hard, and most of us do. But economic stagnation is putting the saving and investing parts of the growth formula out of reach for more and more of our citizens.

Oh, and let's not forget that we can still vote! In America we are still only taxed by representatives of our own choosing. Of course, our debt problem is not lost on those seeking public office; that is why they seem prone to sponsor national policies favoring borrowers

(mortgage resets, cash for clunkers, low-rate government-guaranteed mortgages) more than savers (Treasury bonds and CDs pay less than inflation) or investors (more progressive tax rates and more regulatory bureaucracies). And, to a much greater extent than 25 years ago, federal policy is unabashedly redistributionist. Again, there is a vigorous public debate about whether a Robin Hood fiscal policy is compassionate & generous or whether it is naive and corrosive of our long-term ability to generate a rising standard of living to the benefit of all.

On balance, our judgment as managers of the accumulated savings of hard working investors is that annual federal deficits on the order of 10% of GDP, and the tax policies necessary to support government spending that grows twice as fast as GDP, ultimately diminish the sort of personal economic freedom that produced our legendary private charity and a standard of living that is the envy of the world.

## It is inescapable: heavy debt payments will limit our economic opportunities and restrict our real growth until we correct the imbalance.

Annual *government spending* (federal, state and local) recently clocked in at *45% of GDP*, twice its share in the early 1950s. Government policy is not, and has not been for some time, supportive of the hard work, saving and risk-taking that built our storied prosperity. A high-cost government clearly restricts the economic options of our tax-paying citizens, and probably limits the country's investment opportunities in the process.

However the policy debate unfolds, this is about our *economic* freedom, not about our political freedom. And this is a distinction with merit. As long as our culture supports the idea promoted by the Mayflower Compact and the First Continental Congress that we can only be taxed by our own representatives, and as long as we have the secret ballot and freedom of political speech, *our citizens themselves have the power to determine the direction of government policy*; we can still replace the policy makers at the ballot box when we think it is appropriate; and that is not true of the society which we will consider next.

But before we get too sanguine about our prospects for electing pro-growth policy makers, it's a good idea to recall the observation of Alexis de Tocqueville in *Democracy in America* (1835). He said that, "this great experiment in self governing which we call the United States will survive only until the American people discover they can vote themselves largess from the public purse." Persons who have saved rather than taking loans for consumption... persons who would like to invest their savings in the plethora of new breakthroughs in medicine, science, and the industrial arts of which free men and women are capable... persons who would like to grow prosperous enough to support life-changing charitable activities and the arts... such persons may want to consider using their priceless franchise as American citizens to promote a government that encourages *hard work, savings and risk taking*.

### FREEDOM AND GROWTH IN CHINA

*(This writer's mind has been a wasteland with respect to Chinese ancient history; I've extracted many of the following nuggets from Wikipedia's History of China.)* The written history of China dates to 1700 B.C., but Chinese culture, literature and philosophy seem to have sprung from the *feudal* Zhou Dynasty (1045-256 B.C.). That dynasty ultimately fractured into warring city-states until they were re-assembled in the first Chinese Empire around 221 B.C. Over the years, the Emperors developed *sprawling bureaucratic systems* that allowed them to directly control the vast territories whose populations sprang from a number of different Asian peoples.

Slavery was not abolished in China until 1910. The last (Qing) Dynasty was overthrown the following year by a military uprising that formed the Republic of China in 1912, led initially by Sun Yat-sen. Sun had evolved a political philosophy known as the Three Principles of the People (concerning a strong national defense and personal responsibility of the citizens). The Three Principles are embedded in the National Anthem. Today that anthem is sung in Taiwan, sometimes in Hong Kong and Macau, but is banned in mainland China.

Following a brief, uneasy alliance with the fledgling Communist Party of China, first Sun Yat-sen and then his successor Chiang Kai-shek unsuccessfully battled the CPC. And after WWII, Chiang and his forces were defeated by the Communists and fled to Taiwan in 1949, naming that island the Republic of China (ROC), which

it is still called today, a matter of much consternation on the mainland which is officially named The Peoples' Republic of China (PRC). No peace treaty has ever been signed between these opposing parties, yet today ROC businesses employ hundreds of thousands of PRC citizens on the mainland!

To supplement my uninspiring 250-word summary of 3,650 years of colorful history of the largest nation on the face of the earth, I offer a few more facts from the latest 60 years that may help us in our effort to understand the condition of personal freedom in modern China (admittedly from a Westerner's perspective).

October 1, 1949 Mao Zedong proclaimed the PRC from atop **Tiananmen** ("gate of heavenly peace"). He believed that socialism would triumph over all other ideologies, and began his rule with a redistribution of land to peasants. In the 1950s some of the larger landlords were executed, foreign investors driven out and many buildings and public artifacts destroyed because they were reminders of China's feudal past. I think it is important to understand that Mao was avowedly Marxist in his belief that workers, and not owners of land or capital, were entitled to "surplus labor" or what capitalists would ordinarily refer to as "profits". (Though compromises were made in subsequent regimes, this important Communist principle has never been disavowed. More on this later.)

In 1958 Mao Zedong launched the *Great Leap Forward*, a collectivist movement in rural China that ushered

De Tocqueville (1835): "This great experiment in self governance which we call the United States will survive only until the American people discover they can vote themselves largess from the public purse."

## All the inventions and advances of the last 200 years are China's for the asking.

in 3 years of massive famines. Some 30 million are said to have starved to death. His *Cultural Revolution*, beginning in 1966, was what most westerners would consider a very heavy-handed attempt to impose socialist orthodoxy and purge the country of any capitalist concepts. In 1971, the PRC replaced the ROC (Taiwan) as a member of the UN and the UN Security Council. Mao's death in 1976 opened up a new struggle for political power. Four years later Deng Xiaoping had emerged as the new leader.

As he assumed control of the party and the government in 1980, Deng was convinced that the country needed a new emphasis, Marxist but less hostile to the country's traditions; he promoted what became known as *Socialism with Chinese Characteristics*. He brought all state apparatuses back under Communist Party control. In an effort to jump-start the economy he re-opened China to foreign investment and to global markets and permitted limited private competition. China developed Special Economic Zones (SEZs) which were allowed to run basically as a capitalist system within the communist state. Standards of living, at least in the SEZs, improved considerably in the 1980s under this arrangement. Supporters of the economic reforms maintain that the average citizen has also come to experience a wider range of personal rights and freedoms.

Political tensions continued between the "conservatives" who were unhappy with Deng's accommodation of western materialism, on the one hand, and the "liberals" who continued to protest the party's totalitarian leadership (one example is the one-child policy initiated in 1979). In 1989, a year that saw the collapse of a number of other Communist governments around the world, there were weeks of demonstrations against Deng's regime by students, intellectuals

and other supporters of democratic reform, in Tiananmen Square in the heart of Beijing. Deng sided with the Party leaders that called for a strong response to the "counter-revolutionary uprising", and by Red Cross accounts several thousands were gunned down by the army in the shadow of Chairman Mao's mausoleum. Arrests and other crackdowns on protesters followed, including banning the foreign press from the country, a purge from the Party of protest sympathizers, and strictly controlled coverage of the events in the PRC press. Deng soon retired from public view; he was succeeded as Chairman by Jiang Zemin, and died in 1997.

**Economic liberalization expanded under Jiang and China's growth rate picked up by the mid 1990's.** Inefficient State-Owned Enterprises (SOEs) experienced massive layoffs, stressing the country's minimal social safety net, so not everyone was happy with the arrangements. Hong Kong and Macau were voluntarily returned to China by Britain and Portugal, respectively. Jiang and President Clinton exchanged visits, and China gained membership in the World Trade Organization. Between 2003 and 2004 Jiang ceded his leadership roles to Hu Jintao. And in 2008 China hosted the Summer Olympics, considered a tribute to, if not an endorsement of, the nation's progress toward integration with the western world.

### WHAT ABOUT CHINA'S FUTURE?

Whatever one may think of communist China's compromises with capitalism, this country of 1.3 billion mostly poor, ill-educated people **has already become a major economic force in the world.** Last year, more cars were sold in China than in America! Last month they surpassed Germany as the world's largest exporter, and this year they're expected to displace Japan as the world's second largest national economy.

If China's eco-political model were more like our own, it would be easy for us to postulate that they would sustain

or even accelerate their amazing growth pace. After all, unlike the industrial history of the US, the Chinese need not patiently await the development of the internal combustion engine, telephony, plastics, robotic assembly lines, fertilizers, air and space travel, modern banking, nuclear power, globalization of commerce, the microchip and miracle drugs that have enhanced modern life during the past 200 years... all that and more is available every morning right on China's well-guarded doorstep.

But their model is *not* like ours; much more Hobbesian than Jeffersonian.

**In pondering where things may be headed in the Middle Kingdom, a lot of questions come to mind.**

- Is China firmly entrenched as an integral part of the world economy?
- Are its citizens increasingly free to work, save and invest?
- Is its impressive GDP growth sustainable?
- Can Western companies confidently commit billions to their business infrastructure in a communist country?
- Is it prudent for US retailers and US electronics corporations to become dependent on Chinese manufacturers?
- Can America and Europe even compete with Chinese manufacturers?
- Has the United States Government unwittingly become hostage to the Chinese Politburo because they are the largest single buyer of our Treasury bonds?
- Can investors from Japan, Europe and the US confidently own publicly-traded shares of Chinese companies that exist at the whim of the Party?
- Is the Party now so dependent on cash flow from these profit-making enterprises that they could not withdraw support even if they wanted to?

In 2010, China is expected to become the second largest national economy in the world.

# The American experience will never be duplicated, but... Might another people with a different history and a different model also succeed?



- With 15% of Chinese now considered middle class, are Party leaders more or less worried about the possibility of a revolution? How will that possibility influence their political and economic decisions?
- Can a centrally-planned economy peacefully morph into a capitalistic one?
- Or does it even need to?

The actual American experience of political and economic freedom will never be duplicated, because there remains on Earth no sparsely- populated 3000-mile expanse of fertile land and abundant natural resources that can be organized de novo “of the people, by the people and for the people”. But the Chinese experience does cause one to ask whether another people with a different history and a different model might evolve in such a way as to liberate the creativity and decency of the human spirit while protecting the citizenry against man’s darker instincts. This observer believes that these are the optimal or perhaps even essential conditions for a society to experience a steadily rising standard of living.

Here it may be helpful to distinguish between political freedom and economic freedom. There is certainly no evidence of democracy in China’s long and colorful political history; and there is no credible movement toward granting the franchise to its 21st century citizens. The Communist Party is sovereign (Party membership is only about 5% of the population), and leadership succession is determined by the insiders as it has been since The Revolution. The Party adheres to the Marxist concept that all “profits” from industrial or agricultural production belong to the working class; but the modern **Chinese State**, while it does not technically “own” all means of production, **controls the distribution** of those fruits of labor as it sees fit;

often this takes the form of massive, unproductive infrastructure projects just to create jobs.

To be fair, it needs to be mentioned that this concentration of power, like other examples in history, presents the possibility of abuse by those who wield it. Reality in other centrally-planned economies has tended to be as George Orwell (*Animal Farm*, 1945) famously observed, “All animals are equal, but some are *more equal* than others.” On the positive side, a concentration of power can provide institutional stability, and stability can be a benefit to private enterprise. But Google has recently discovered firsthand what the protesters at Tiananmen learned the hard way: there is a dark side to absolute power.

## Political freedom and economic freedom seem equally important.



The Politburo most assuredly remains concerned about controlling the message and minimizing dissent. In the eyes of the Party, the Tiananmen Massacre never happened. Discordant political speech remains unacceptable to the point that it can merit imprisonment or even execution. *There is no political freedom*, and this remains a grave distinction between China and the capitalist West. Yet, China has certainly enjoyed increased prosperity in the past 20 or so years; to the degree that individual citizens actually benefit from these economic gains, one would think that many of them have a greater range of lifestyle choices, an increase in economic freedom. Do they? One person’s story may be instructive...

This story of one Chinese worker was recently published by a non-governmental watchdog group; it does not sensationalize the young man’s situation, which I think enhances its credibility. Yao Ming (not his real name) is 20 years old. He comes from a subsistence farm a few hundred miles from the electronics factory. He went to work to help his older brother pay for college to improve his opportunities. He spends 28 days a month at the factory from 7:30 am until 8:30 pm. There is a dorm room he can share with eight other guys and there is one toilet and sink to serve several such rooms; he opted to spend about 20% of his wages to share a somewhat better off-campus room a half hour away with another worker. After rent and transportation costs, Mr. Yao earns about \$180 a month, the bulk of which he sends home. His major complaint: “I am too tired to even think, almost all the time. When my brother finishes school I will quit.”

## Chinese factory worker earning 80 cents an hour: “I am too tired to think, almost all the time.” Yet, there is a line around the block for low-paying jobs.



This worker is paid about 80 cents an hour plus 3 sketchy meals a day. I’ve read many stories of even lower pay and worse working conditions. It is interesting, though, that it must be more attractive than subsistence farming, since there is a line around the block for Yao’s job, and he plans to stick it out for his family’s sake.

**Is this economic freedom? I guess I’ll have to give it a very grudging “yes”** because by his freely-offered labor the young man is improving life for his family. But, insofar as he is working for about 3% of what a factory worker is paid in

## China's accounting is different. Transparency seems to be an issue.

the country where his output is sold, *is he being taken advantage of? Again, I have to answer in the affirmative.* I don't know where the blame for this sort of exploitation falls... on the Chinese employer? On the western electronics distributors who put their brands on the finished product? On their shareholders? On the Communist Party that would jail him if he tried to organize his bench fellows to seek better wages?

For years, traditional economists have forecast the implosion of China's centrally-planned economy because it ignores "market signals" such as price, consumer demand, and interest rates that help allocate capital to its most productive uses. Yet the country's steady growth persists! The outside world does not know by what complex process China's economic decisions are actually made, and that should probably bother us as investors. I am reminded of an immigrant friend of mine who told me years ago, "Mike, don't forget ... where there's secrecy there's deceit."

We do know that China's accounting is different. For example, when they authorize \$100 billion for an infrastructure project, it immediately becomes part of reported GDP though not a brick has been purchased nor a shovel of dirt turned! This might help explain how they can report GDP growth of 8% in a year when their exports (40% of their economy) are down 25%. For this writer, transparency is definitely an issue when it comes to evaluating information released by the Party. The State controls banking, and articles abound speculating on the enormity of worthless loans to money-losing state enterprises that are still carried on the books at face value.

And we know for sure that some of their capital allocations have been what Capitalists would deem enormously wasteful... South China Mall, the largest in the world at 7 million square feet, was completed in 2005 and remains 99% vacant today. Another one, Ordos is a brand new, upscale city built in Inner Mongolia to accommodate a million residents... 5 years after completion

it remains almost deserted! But for a few years these massive undertakings provided a lot of jobs. Is that a good use of Mr. Yao's "surplus labor"? Investors who are attracted by China's economic growth will want to know whether cash flows are being reinvested in such a way as to generate future growth. Spectacularly wasteful construction projects are not very encouraging in that regard, but with an estimated 150,000,000 farmers expected to seek urban jobs in the next ten years, central planners need a way to create 17 million jobs a year! If the jobs aren't there, then what?

## Huge capital allocations are enormously wasteful... empty cities and malls.

Here are a few important questions concerning China's future:

- Is China's governmental power so fragile that it can only be maintained as a police state?

- If that's the case, how sustainable a model is it?
- What forces might upset the balance, and what are the implications for outside investors?
- Will hundreds of millions of Yao Mings with internet access be forever content to work so hard that they cannot think?
- Is civil war a potential Black Swan?
- But if current circumstances can be maintained, will Chinese workers eventually manufacture everything in the world?
- How long before its western customers push back with protectionist measures?

**These are complex, currently unanswerable questions with profound implications for all the world's inter-related economies, and for wage**

prospects and economic freedom everywhere. Following is our effort to distill a rational investment response to these uncertainties concerning freedom, growth and the role of government in the developed and developing parts of the world.

## Investment Implications



### RISKS AND OPPORTUNITIES IN AMERICA

Economic growth, innovation and commercial vibrancy are so well established in

the United States that we take them for granted. But the outlook for growth is currently encumbered by two prominent realities... 1) Continual growth in the size of government relative to the private sector, and 2) Unprecedented indebtedness (public and private) relative to our GDP.

Because the cost of government must ultimately be funded by taxes on the private sector, a growing government increases the cost of doing business here, diminishes profits, drains motivation and reduces the amount of capital available for innovation and growth. This writer believes that most tax-paying American voters do not want to "vote themselves largess from the public purse" in the form of bailouts and redistributions because they know that their wallet is the public purse! If limited government becomes more popular at the ballot box, our nation may soon rise to the task of putting our financial house back in order, right-sizing our governments in keeping with our founding principles, and going about our business of *hard work, saving and investing* in a better life for all of us. But until there is some evidence of a turn in that direction, this remains a hope and not an assumption on which we can build our investment policy.

As far as our enormous burden of debt is concerned, *there is evidence that the private sector is reducing its obligations*; for about a year, household debt has been declining for the first time since we began keeping records in the 1950s! Credit card debt fell at an 18%

## There are financially strong, well-managed, innovative U.S. companies capable of growing in a stagnant economy.

annual clip in November! But total US debt has only dipped recently from the peak 375% of GDP to 370%; we've a long way to go.

Propelled by political pressures, more realistic credit standards and voluntary temperance, **we think that the US economy has entered a multi-year process of de-leveraging** which will be healthy for us in the long run, but disruptive in the short run. The optimal, if not most probable scenario, is **5 or even 10 years of very slow real growth in our economy (0% to 2%)** accompanied by a steady reduction in the size of the debt millstone that is weighing us down.

On the bright side, while overall debt is way too high, not every citizen and not every company is in hock; not by a long shot! For example, half the homes in America are debt-free! While odds indicate a sluggish US economy in the aggregate, we are convinced that most Americans remain optimistic, hard working and eager to build a better future! Our research is uncovering many opportunities to invest in well-financed, innovative businesses that promise to handsomely outperform the economy as a whole. That is why you'll hear us say so often that we do not invest in the broad stock indexes; we want to be shareholders in healthy businesses that can adapt to the economic and political environment and grow by gaining market share in a flat economy. We think stocks of well-managed American companies represent the best Growth Opportunities for our clients' portfolios.

**Bond investments** are a little more challenging, because government shenanigans here and in other developed countries have artificially suppressed interest rates in recent years. The G7 meeting in Canada last month offered no encouragement that western governments will withdraw from the stimulus game any time soon, especially since the myopic stock markets seem to love every new government initiative! We think prices of bonds are actually in a little bit of a bubble. However, we expect that when interest rates do start to rise, decreasing the market prices and raising the yields on existing bonds of strong companies, our fixed-income opportunities will mushroom. In the meantime we are *defensive, emphasizing high credit quality and short duration in the Income portion of our portfolios.*

We've talked a lot about the economic risks posed by government growth and unprecedented debt levels in the US. But in comparison with the *rest of the developed world*, we are convinced that America remains the freest, most resilient economy in the world, and the most capable of slowing down government spending; and we're in the best position to innovate, to adapt and to grow our way out of our credit problems. *For several years Financial Advantage has minimized our investment exposure to Europe and Japan, where the debts, the political culture and the demographics are far less promising, and that remains our current posture.*

Now to the question of whether the "emerging economies" offer better opportunity for investors. Because it is by far the largest, we have made China the focus of our brief inquiry.



### RISKS AND OPPORTUNITIES IN CHINA

We live in very different worlds, the Chinese and we Americans.

- We, of course, are a representative democracy where capital allocation decisions are widely dispersed; they are organized as a communist state where major economic decisions are handed down from the top.
- Our GDP per capita is (roughly) \$47,000 versus their \$6,000!
- 3% of our workforce produces enough food for all of us with a surplus for export; over 50% of their folks work the land and they still have to import food.
- We could reach "full employment" by adding 10 million jobs; they need 15 million new jobs every year to keep their population from starving! **HOWEVER:**
- Their government has \$2.4 trillion dollars in currency reserves including \$755 billion in US Treasuries; the US has only \$83 billion of reserves.
- Their public government debt at 15% of GDP recently compared with ours at 60%.
- Most of their workforce lives hand to mouth; just 15% are considered middle class, and they have very few credit cards. We, on the other hand, with our comparatively lavish lifestyle, are in hock up to our collective eyebrows!
- They are motivated to make a better life even if it means working long days for 80 cents an hour; Americans, some say, are too well-fed and perhaps a little bit spoiled.
- What infrastructure China has is new, its factories are modern and their wage costs give them an enormous competitive advantage. America is very developed, but our labor is expensive, a lot of our factories and power plants are obsolete, and many of our bridges, highways and water pipes are ill-maintained.

America is in much better shape than the rest of the developed world.

All these comparisons could suggest that China, not America, is the new land of opportunity. China's promise lies in its potential for almost unbelievable leaps in productivity as its workers move from subsistence farming where they produce barely enough to feed and clothe themselves, into productive roles in modern factories. China has modest debts, cash flow from an enormous trade surplus, and the potential to develop a self-generating consumer economy as their population progresses along the path from poverty toward a Western standard of living. The world's investors have enthusiastically embraced China's possibilities, driving the Shanghai Composite stock index up by 80% in the past year alone!

China's big risk lies in the possible failure of its unorthodox experiment in harnessing capitalism in the service of a Marxist State. Party leaders are keenly aware of their country's history of rebellion and civil war, a legacy that keeps the power elite at risk.

Here are six things which suggest that the centrally-planned economy is a risky venture:

- 1) the massacre at Tiananmen,
- 2) the waste of enormous sums on unproductive infrastructure projects,
- 3) secrecy about bank balance sheets,
- 4) wages that are only slightly above subsistence levels,
- 5) signs of increasing protectionism in the West,
- 6) aggressive efforts to control their citizens' access to the internet.

China's leaders seem threatened by the spread of Western ideas, especially democracy, and fret openly that the internet poses a risk to national security and political stability. After

## China's growth potential is enormous, but... It depends on the Communist Party's ability to keep order as 15 million people a year flee their subsistence farms for commercial jobs.

seeing how Iranian protesters used new communication tools to organize their challenge to Mahmoud Ahmadinejad, the Chinese Communist Party has been cracking down on the use of personal email, Twitter, Facebook and YouTube, and is developing homegrown alternatives that can be better controlled.

China's international relations seem to be fraying a bit, as well. US Secretary of State Hilary Clinton recently lectured PRC leaders for internet censorship, and there has been a bit of saber-rattling over America's potential arms sales to Taiwan. In negotiations about international sanctions against uranium-enriching Iran, Europe and the US seem to be treating China with kid gloves, hoping they will abstain rather than veto sanctions in the UN Security Council. Some experienced China-watchers think that China's decision makers now believe the US needs them more than the other way 'round, and they're starting to flex their muscles. And some believe that the Party's concern for political and social stability (control?) could now trump economic factors. How this might affect foreign investors in China is a big uncertainty.

China's almost limitless pool of low-cost labor and its ready access to global capital are setting the stage for an unprecedented dominance of global manufacturing. But Europe and the US, desperate to protect domestic jobs, are

starting to increase protectionist trade policies and push their argument that the Yuan's tie to the US Dollar gives an unfair advantage to Chinese exporters. The United States has a trade deficit with China of \$227 billion a year, up from just \$30 billion in 1995. Import tariffs and "Buy American" policies, if they get traction, could seriously dampen expectations for Chinese export growth.

In summary, our concerns about transparency, the rising international tensions related to the Chinese export juggernaut, and our discomfort with the Marxist/Capitalist hybrid, as successful as it seems to have been so far, make us shy away from direct investment in Chinese shares. If China does keep growing, our portfolios can still benefit, with less risk, by investing in the consequences of their success such as soaring demand for energy, metals and agricultural products. Our preferred China play is to invest in non-Chinese companies which develop energy and other natural resources in politically stable areas of the world. For direct exposure to the growth potential of emerging economies we would rather emphasize countries where the citizens have more influence over the direction of government policy, countries like Brazil, India, Indonesia, Mexico and Singapore, as well as natural resource-rich developed countries like Australia and Canada.

### FOR THE INVESTMENT COMMITTEE:

J. Michael Martin, J.D., CFP

MARCH 10, 2010

DJIA 10,564 | S&P 500 1140 | NASDAQ 2340 | 30-yr Treasury 4.70%