

The Blue Sheets

A quarterly review of the markets and the economy

February 2004

CHINA

The Major Economic Force of This Decade

At a store near you

Shopping this past Christmas was a more international experience than we had expected. From two very fashionable, ultra American department stores we brought home one evening a quilt, a set of sheets, three wooden toys, two sets of hand painted stemware and a stained-glass candle holder. Everything but the candle holder was from China; and the candle holder was from Japan. From a manufacturing point of view the score for this short shopping spree was China 7, Japan 1, USA zip, zero, nada.

Driving home in our Jeep Liberty (American made by a German-owned enterprise), wearing my new winter jacket (from Vietnam), we talked about the current reality in manufactured consumer goods. Wal-Mart, Mary Liz suggested, gave oriental imports a huge impetus several years ago; since then, the need to remain competitive has forced the other chains to also shop abroad for our apparel and home furnishings. Realizing how thoroughly China has captured the shelf space in American stores (did you know that China supplies 85% of all our Christmas ornaments?), we could understand why US unions have lobbied for protective tariffs. We agreed with each other that, long-term, protectionism is very unhealthy; the Administration just recently backed down on the steel tariffs, so it seems our country is not going down that road... at least for now.

The next day, I spoke with my son-in-law about the Chinese import phenomenon. Mark, a very accomplished computer scientist, is an unabashed free-trade advocate, but his first contribution to the topic was to remind me that products from the world's most populous nation can under-cut any competitor's offerings because they are made with "slave labor"; "You realize, this is a communist country," Mark reminded me. "I am not sure what your definition of slavery is", I said, "but two million of those slaves bought new cars this year. Do you want to exclude their products from our

shores by fiat because you don't agree with their political structure?" "Of course not," Mark replied without hesitation.

Clearly the subject of imports from China (and the other Pacific-rim nations) is emotionally charged and complex. But the reality is that manufacturing in the US is not participating in the current economic recovery because consumers, whose spending accounts for nearly 70% of our GDP, are not willing to pay a premium for a "Made in the USA" label. Unless we go down the protectionist road (which I think would be to our detriment in the long run) we can look forward to shrinking employment opportunities in manufacturing.

Please notice that I said shrinking *employment opportunities*, not necessarily a shrinking share of GDP. I make that distinction because the contest is going to be between the fact that half the world's population would be happy to work for \$5 a day, on the one hand, and the storied productivity of American enterprise on the other hand. Paying very low wages is but one way to reduce the cost of manufactured goods. There are other ways, such as automation, product design and scale. And never forget that US makers have a transportation cost advantage with respect to the domestic market, and that American consumers, the wealthiest in the world, are suckers for innovation...at which American manufacturers should be at least competitive.

But before we start looking forward to a US victory in the consumer goods manufacturing wars, we should mention that the international conflict is not restricted to manufacturing. It is expected that IBM and some other technology giants will approximately double their employment of software engineers in India next year. High-speed communications have accelerated the migration of many kinds of service and professional jobs overseas. In these areas, wages are an even bigger factor than they are in manufacturing, meaning that the competitive challenge to US companies is even greater.

Speaking of jobs

There is no doubt that the economy has picked up speed in the last six months. In the second half of 2003, GDP rose at a 6% pace. Even more surprisingly, productivity (output per hour worked) smashed records with a more than 9% increase in the third quarter (5% for the second half as a whole)! Surveys of manufacturing firms indicate more optimism on the part of managers concerning their order outlook. Consumer sentiment is stronger than it has been in two years. Interestingly, the stock market has stalled in the first 6 weeks of this year, reminding us that markets *anticipate* the future. In other words, these glowing economic figures were already baked into the stock market cake. And the reason that strong results had been widely anticipated is that the government announced it would provide unprecedented stimulus to consumer demand in the form of tax cuts, deficit spending and historically low interest rates to encourage the use of credit.

For better or worse, the borrowing incentives worked; debt has surged. Productivity has surged. Output has surged. The one thing that hasn't surged is employment. The fourth quarter saw about a 65,000 monthly addition to the number of paying jobs, and January of this year gained an estimated 112,000 (less than the 180,000 hoped for by economists.) To put these in perspective, the country needs new jobs on the order of 150,000 each month just to absorb new entrants to our working population, and another 100,000 new jobs a month to bring unemployment down from 5.6% to about

4.9% that some consider a full-employment level. So, while it is nice to see job gains rather than losses, we have a long way to go to before the working class considers this a healthy recovery. Without opportunity for the young and the unemployed, it is hard to picture growing consumption based primarily on increased credit card use by the currently-employed. And perhaps the stock market, by languishing the last six weeks, is reflecting investor concern about this outlook.

In past recoveries, consumers improved their balance sheets. Not so this time as consumer debt rose from 70% of GDP in 2000 to 82% today! This is so because jobs and earned income did not grow while consumer debt did. Instead of the usual correction of imbalances in the nation's financial structure, this time they got even further out of balance. It has been, if you will, an artificial recovery.

And another thing...

Every reader of the financial pages knows that the dollar has weakened recently; to put this in laymen's terms, a dollar is worth fewer yen or euros than it was six months ago. Another way of translating this arcane reality is that Cadillacs costs less overseas and Toyotas cost more here than they used to. Theoretically, this change will help reduce the US balance of payments deficit by helping our exporters (Caterpillar, IBM etc.) and penalizing those who ship us candle holders and bedspreads from the orient. Interestingly, though, the Chinese yuan is tied to the US dollar...it is not allowed to fluctuate against our currency the way the yen and euro do. So, the weaker dollar has not impacted our trade with China.

Besides the relative costs of imports and exports, there is another very significant dimension to the weakening of the dollar. It has to do with the future demand by overseas investors for US securities. The reason that our nation has been able to enjoy low interest rates even while we are running a half-trillion annual trade deficit and a federal budget deficit approaching that level, is that foreign investors have been willing to buy our stocks and bonds with the dollars we gave them in exchange for coats and cell phones.

The Japanese and European investors in dollar-denominated US securities have, in six months, lost 15- 20% in terms of their own currency (the one *they* use to buy groceries and gasoline). One has to wonder how long an investor will endure that sort of pain in return for a 4% yield on a 10-year US Treasury bond. Shouldn't we ask ourselves whether that investor will feel warm and fuzzy about his dollar-denominated stocks if shares of WalMart and P&G should stall?

Outlook for the stock market?

The US economy is strong and stock prices are rising. What's not to love?

The economic stimulus provided by the federal budget and the central bank this year has been effective in boosting consumer demand; and there has even been a little follow through in corporate spending for computers and software. The S&P 500 gained 28% for 2003, the first positive return since 1999, and Wall Street is expecting a double digit increase in corporate earnings this year and further gains for stocks.

Mutual funds are still experiencing strong cash flows into equities, and one widely-followed index of investor sentiment reads an extraordinarily high 81% bullish (optimistic). Sure looks like we've entered a new era of prosperity, doesn't it? Say good riddance to that nasty bear market, and move on! Please, no more gloom. At least that's the consensus outlook; most forecasters expect good economic and corporate news at least through the elections, and conclude that with the wind at our backs, stocks should post at least 10% gains.

Nobody is happier than we at Financial Advantage to have a rising stock market, especially since our trusty bonds are running out of gas. (*For new readers*, Financial Advantage was able to realize positive returns in our portfolios during the three-year bear market in stocks because we established hefty positions in long-term treasury bonds, which rose in value as interest rates declined. Earlier this year, we shifted some treasury money to corporate bonds, which has been a profitable move. But now that rates are historically low and the spread between corporates and treasuries has shrunk back to normal, we do not see a lot of appreciation potential in bonds.) But there are some imbalances in the economy which suggest that the recent economic improvement may not be sustainable. Furthermore, there are troubling signs that the stock market has entered another speculative boom...also ultimately unsustainable. So, we think it's a good time to be a little extra careful.

As to economic imbalances, there are three we deem especially significant: the jobless recovery, the unprecedented level of debt in the US, and the swelling trade deficit with low wage countries. Together, we believe these are likely to constrain GDP growth in the US, prevent a resurgence of inflationary fears and probably also provide an excuse to keep US monetary and fiscal policy loose.

As usual, we will stop short of forecasting stock prices for 2004 because 40 years in this business have taught us that anything can happen in the short run, so this is not a fruitful exercise. That having been said, and said sincerely, it is our conviction that stock valuations as measured by the S&P 500 are extremely high by historical measures (30X actual earnings) and appear to leave little room for disappointment. Disappointment could come in the form of below-consensus GDP growth, weaker than expected corporate profits due to rising energy costs or extremely competitive retail pricing etc., rising interest rates, a change of heart on the part of foreign investors in US securities, or a rise in geo-political stress someplace on the planet... just to name a few. But risk and reward go hand in hand, so just what sort of risks look like they are worth taking?

Our "view from 10,000 feet" leads us to several convictions about the likely flow of capital in the foreseeable future. Before listing them, we want to note that conviction is not the same as knowledge! That's why we must always diversify our portfolios.

We believe China, India and other low-wage countries will continue to grow faster than the already-industrialized nations for a long time. Their billions of people are discovering the power of free markets, even though they don't currently look the same as the free markets we are used to. There is an enormous gap between their standard of living and the one we enjoy, and they will close the gap by providing the products and services we want at a lower cost than we can provide them for ourselves. Real, inflation-adjusted GDP growth in these two huge countries could well be sustained at twice or even three-times the rate the aging west is capable of (6% to 9% versus about 3%).

Several important consequences flow from this unstoppable reality:

- Young, rapidly-growing countries will need capital, and the rich, aging populations of the west will provide that capital. (Capital flows to its most productive use.)
- India, China and their economic satellites will need larger and larger supplies of energy and other natural resources; a supply-demand imbalance will raise commodity prices high enough for long enough to stimulate the supply of those essential materials.
- Economic competition between rich and poor countries will heighten political stress. Possible consequences include sword rattling (think Taiwan, Korea), terrorist activity, protectionism and currency strife.
- Beggar-thy-neighbor currency policies will prevail around the world, as nations try to defend their competitive positions.
- With domestic demand sluggish, western corporations will focus on improving productivity to enhance their competitive positions, and they will try to further penetrate developing-nation markets.

In this environment we see:

- Historically high prices for oil, gas and coal. We own Exxon and Apache, and our research efforts are focused on other investment opportunities related to persistently strong commodity prices.
- Slower-than-expected GDP growth in the US and Europe. It will be hard for investors to earn a decent return in broad stock indexes like the S&P 500 which anticipate strong, sustainable earnings growth. We are researching the possibility of hedging our market exposure by owning a *short* fund such as Rydex Ursa.
- Low US inflation in CPI terms. Too much capacity in manufacturing and retail businesses, slow growth in end demand due to demographics and debt burdens, and competition from low-wage countries mean that corporations will experience severe price competition for their wares.
- A steep yield curve as the Fed keeps short rates low. We see opportunities in financial services businesses, especially those that borrow short and lend long such as mortgage lenders and leveraged fixed-income funds. We own Washington Mutual, Thornburg Mortgage, Allied Capital and Hancock Patriot Premium Dividend II.
- Slow wage growth because employers will not have to bid up for employees. With a weak wage background, the Federal Reserve Bank will not succeed in rekindling broad inflation, so debt burdens will continue to weigh consumers down. Some of the best opportunities will be for businesses that enhance productivity, such as IBM and Cerner.
- Lower-than-expected interest rates in developed countries. The principal risk in longer-dated high quality bonds may be less than the consensus believes. The junk bond universe, however, may see spreads widen again, making this an asset class with significant principal risk.

The following was first published in Michael Martin's column in the December '03 issue of Financial Advisor Magazine.

Surf's Up...Someplace

There is always opportunity, even in overheated markets

The movie theater near you probably didn't even exist in 1967 when the film, "Endless Summer" was making the rounds of American neighborhoods. As I was thinking about the topic for this month's column, images from that movie flickered in my imagination; scenes of lithe and beautiful young people astride their surf boards, chatting idly as they paddled about in calm ocean waters, straining their eyes toward the horizon in earnest anticipation of the perfect wave.

I was musing on waves and surfing on a recent Friday afternoon at the office as I watched the slow trading activity on the NYSE wind down to a quiet close of what had been a hectic week. I was all alone; our staff had been dismissed a little early as a thank-you for managing an extraordinary volume of new client activity during the past few days. Suddenly, my reverie was shattered by a vigorous "Hello; anybody here?" from the reception area.

The voice was vaguely familiar. Sitting upright, I put my feet back on the floor. Leaning toward my office door so I could see into the lobby, I was thrilled to behold, replete with an unfamiliar shock of silver hair, a friend and fellow analyst from my Wall Street days whom I hadn't actually seen in twenty years. "Bob, you old rascal, I can't believe it! What in the world are you doing in Maryland? It's so great to see you!" "Nancy and I are in town for a family wedding and I couldn't resist the chance to look you up. Got time for a glass of wine with an old buddy?" "Your timing couldn't be better; Mary Liz is having dinner with her sister tonight. I've got just the place for us to have a long visit."

Amid a flurry of catching-up chatter, I shut down the computers, threw some weekend reading into my Land's End tote, locked the front door and guided Bob across the mall to the Iron Bridge Wine Bar and Restaurant where I knew we would enjoy some memories and swap investment ideas for a couple of hours.

Facing Our Elephant

We arrived in time to get the last table. In no time we were pouring from a chilled bottle of Kanu Chenin Blanc (South Africa) and sampling the restaurant's signature brochetta. "Mike," Bob began, "I've been reading your column in Financial Advisor, and I must say you are starting to get to me with the concerns you have been writing about; especially the acceleration of credit and the high valuation levels of both stocks and bonds."

“That’s a pretty succinct summary of the key issues, Bob. Loose money, a bunch of exciting new technologies and a classic dose of speculative fever spawned a spectacular stock market boom; and the cheap equity capital funded enormous mal-investment at the turn of the millennium. On top of that, reduced credit standards and falling interest rates ushered in a surge in housing price that fostered a credit-based consumption boom. When the stock bubble finally burst in 2000, and jobs started disappearing, the Fed and Congress poured on the monetary and fiscal fuel to “save us” from a natural correction. Corporate debt, consumer debt and government debt all rose at the same time.

“I have a chart in the office that I call ‘the elephant in the living room’. It shows total debt in the US as a percentage of GDP zooming in 15 years from a normal 125% to an unprecedented 310%!”

“Yeah, I think I saw the chart in Barron’s. But what do you mean by ‘elephant in the living room?’” “It’s an expression from AA, referring to a family member’s drinking problem. Everyone in the family knows it’s a problem except the person, but nobody wants to talk about it. It’s like having an elephant in your living room and everyone is trying to ignore it. It’s not going to go away and if you don’t do something there’s going to be some damage. As professionals responsible for clients’ nest eggs, I don’t think we can safely ignore the potential consequences of huge debt.”

“Yeah,” my friend agreed again, “the mediocre growth we have been able to generate has come at a high price. At some point the cost of carrying all this debt has to start pulling down consumption, doesn’t it?”

“Well, I suppose rising carrying costs will slow consumer spending, especially if rate rise, and possibly precipitate more defaults, which would cause credit to tighten up and rates to rise more. Not pretty”, I added unnecessarily. The waitress was just placing the broiled crab cake special in front of us. “Not pretty? What are you thinking, hon’, that’s a beautiful crab cake!” I tried to explain that I didn’t mean the crab cake, and I poured two more glasses of Kanu and asked if they still served that delicious raspberry iced tea; I had to drive home later.

Those were the days!

“Bob, do you remember seeing ‘Endless Summer’?” “Sure. Bunch of young surfers circling the globe in search of the perfect wave or something like that?” “Yeah, that’s the one,” I said. “I’ve been thinking about it and I believe there’s an investment lesson in it.”

“Something in your iced tea?” Bob wisecracked.

“No, really. It’s made me think that there are always waves; the trick is to wait for them, stand up and ride them while they last, then get off and watch for the next one. Like the

oceans, markets are always moving; there are always waves you can ride. Or you can sit on your board and let them pass you by because they're not good enough, and wait for that elusive perfect wave, the next twenty-year bull market."

"Mike," Bob licked the last crumb of backfin from the corner of his mouth and drained his glass, "You and I are old enough to know that 1982-2000 *was* the perfect wave, probably a once in a generation thing of beauty. Ignore the dips, hang on and never look back! We may not see that again in our careers even if we work as long as John Templeton and Roy Neuberger."

"I'm sure you're right, Bob. It was the longest, most powerful wave in modern financial history. Almost twenty years of rising P/Es and falling interest rates. Do you remember when the Dow sold at less than 7 times earnings in 1979?" "Sure I do. And those were peak earnings, too; corporate profits didn't get that high again for about ten years!"

"And a couple years later long treasuries sold at a 15% yield and nobody wanted them, remember?" "Sure I remember. But now look what we've got, 30 times earnings and 4% on the ten-year bond. Is this a wave we can ride?"

Everything's Expensive

"Well, I don't know. Maybe it is," I suggested to Bob's amazement. "Yeah", he rolled his eyes, " P/Es will go to 60? Or maybe we'll squeeze 15% earnings growth out of a 3% GDP trend? Or maybe the 2013s will trade at 2%? Where's the wave?"

Well, I agree with you that everything is expensive; stocks, treasuries and even junk. But remember, there are two sides to every trade.

In the days of the great bull market, if you thought prices were getting ahead of themselves, you might take a breather, take some profits and wait for a dip to get back in; like 1984 and 1987. But you were always long. Today, on the other hand, when *everything* is so expensive, it could take years to get back down to normal valuations...or, you gotta agree it's possible, a correction could happen suddenly! I don't know about your clients, but half of mine are retired and making withdrawals from their portfolios. If I try to hide from the overvaluation of stocks and bonds, what am I going to earn hunkered down in cash and short-term bonds? 1%? 3%? That's not enough; I have to shoot for 7% average returns. If I don't believe that being long the market cannot provide that, I have to think, 'How can I make money even if the market is choppy, flat or falling.'"

"Whoa, brother!" a frightening realization had apparently fallen upon Bob, "Are you talking about selling short? Naw, you're not; right?. Tell me you're not."

“The idea is as foreign to me as it is to you, Bob. I’m just thinking out loud about ways we might make money for our clients in the capital markets when we don’t have the wind to our backs like we did when P/Es were rising and interest rates were falling.”

“The most fundamental rule of portfolio management keeps coming back to me; DIVERSIFY. We all agree you never bet the farm on any one concept, right?” Bob nodded but his arms were folded across his chest and his face was a mask of skepticism. “That used to mean you put 60% or 70% in a basket of small cap, large cap and foreign stocks, something like that, and you mixed in 30% or 40% of short-to-medium term bonds to dampen volatility, right. That was diversified.

“But we both know that stock returns in the US and Euroland are no longer uncorrelated. In both places we’re looking at historically high valuations, sluggish demographics and high debt loads that strongly imply slow growth and at least the *risk* of a financial disaster of some kind. And the gap between value and growth stocks has largely closed; ditto for small and large caps. So if we have 70% of our money in developed market stocks, are we diversified or have we bet the farm on a single delusion?

“I have to wonder, just wonder mind you, if perhaps I should consider making an investment in the possibility that valuations will come down to match the slower growth realities of the mature economies. It would certainly provide some diversification, right? And it would give me a vehicle for rebalancing. In the last ten years I used long-term treasuries for this purpose, but that game seems largely played out.”

The next wave

“Would you short stocks, or what?” “No, not individual stocks; but I could go long the Rydex Ursa fund, or maybe buy index put options. I haven’t gotten that far yet. But a long market slide would not be a surprise, so that’s one possible wave I’d like to be prepared to ride.” “What are some other waves?” Bob asked.

“Well, the Fed and most other central banks seem increasingly locked into what looks to me like a currency war. Every host country wants its currency to be cheaper than the other guy’s to help their trade balance. But obviously this is a zero-sum game. If the game goes on, it seems pretty obvious that the price of globally-traded raw materials like energy, metals and maybe food will rise in currency terms. There’s a wave we could ride. It would help offset damage to the principal value of our fixed-income portfolios. It would be like overweighting energy and mining equipment in the 1970s.”

Bob was really getting uncomfortable, “Next thing you know you’ll be long gold!” “Well, actually...” “No, I don’t want to hear about it,” Bob insisted. “OK,” I said, “We’ll skip gold for now.”

But speaking of gold, I’ve been reading a very interesting and provocative book by Marc Faber called *Tomorrow’s Gold; Asia’s Age of Discovery*. He’s recorded tons of financial history from the early 19th century through the 1990’s New Era. Reviewing all

those cycles helps you realize that human nature doesn't change. Our cycles of greed and fear, optimism and pessimism, always exaggerate quantifiable business realities like profit and loss. Global capital keeps sloshing away from over-priced assets toward overlooked ones. If we think of the securities markets as rational we'll never master them. The average modern portfolio manager accepts current pricing as "efficient" and spends his time trying to be sure he is diversified across all asset classes. In the 1990s this manager looked good whether he owned US stocks or long-term bonds, because whether he knew it or not he was riding a wave of enthusiasm manifest in ever-rising P/Es and ever-falling interest rates.

Today those waves are washing up on the shore. Capital is starting to flow away. We can keep standing on our surfboards wondering why we're not going anywhere, or we can paddle out into the deep in search of, if not the perfect wave, at least some very good rides.

Bob and I tussled playfully over the check, vowed to meet soon in New York, and I drove my friend back to his hotel to rest up for tomorrow's wedding... and the next wave!

February 11, 2004

DJIA	10,738
S&P 500	1,158
Nasdaq	2,090

J. Michael Martin, J.D., CFP