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Investment Perspective
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Changes and Challenges

Introduction

Much has happened in the world since 2000. Americans think immediately of September 11, 2001, and of the wars in Iraq and Afghanistan. We also remember the crash in technology stocks in 2001-2. In the face of those events, not even the best economic prognosticators would have predicted the breadth and strength of the worldwide recovery which started in late 2002. Two momentous developments—the almost universal adoption of, first, market based economic systems, and, second, remarkably conservative balance sheet policies—have combined to overcome geo-political uncertainty and low market visibility.

This paper will concentrate on six points of economic and market interest, all of which stem from the two momentous developments referred to above. These six points are:

- US corporate profits at a record high percentage of National Income
- Many emerging countries with impregnable balance sheets
- Low interest rates (real and nominal)
- US dollar only marginally weaker since 2001, despite a doubling of our trade deficit
- Low inflation in goods and services despite accelerating growth in demand
- Rapid rises in prices of world real estate, commodities and financial assets.

These positive points are inter-related, and form the principal reason why we continue to focus on broad global diversification while concentrating on equity and equity-like investments.

I. It may be difficult to remember that in 2000 we were principally concerned by currency crises abroad (Russia had defaulted in 1998, much of Asia—led by Thailand in 1997—had been through devaluations, and Brazil and Argentina were about to suffer major runs on their currencies). The US government, under considerable fiscal restraint endorsed by both political parties, was about to report a budget surplus. The US stock market was very high, both in absolute terms and in relation to earnings, while foreign markets suffered from fears of inflation or poor governmental economic policies.

   Today, if we turn away from the US (which has experienced some self-inflicted wounds), we see massive change for the better. What has happened?

The first development was the adoption or maturation of mostly market-based economic systems in much of the world. While state control, which was prevalent in much of the non-Western world, began to be replaced or reduced in scope by various forms of private enterprise in China and a few other countries in the 1980s and 1990s, this trend spread rapidly in the past six or seven years. Many emerging countries have shown above-average real growth spurred initially by exports to the developed world and then by their own consumer markets. In each case, private enterprise has led the way, although checked by firm governmental controls.

The second development was the adoption of responsible and conservative balance sheet strategies by virtually all those countries which had currency trouble in the late 1990s. Today, there are very few countries with potentially dangerous deficits. Instead, countries have hoarded their earnings from higher commodity prices or from exports of goods and services. We see China with foreign exchange reserves of over $1 trillion, the rest of Asia with correspondingly strong balance sheets, the Persian Gulf countries with fat annual surpluses, and Russia with reserves approaching $300 billion. Ironically, it is the US which has changed for the worse, turning a budget surplus into a large deficit.

II. While the US has undertaken very rapid rises in government spending, both for foreign affairs (the wars in Afghanistan and Iraq have so far cost over $400 billion) and for domestic consumption (led by a very generous Congress and Administration), our currency has only gradually weakened. Past economic experience would have indicated that by now the dollar should have been under major pressure, perhaps enough to force a change in policy. Partly responsible is the excellent performance of our economy led by housing, until very recently, and fostered by low real and nominal interest rates. Even more important has been the huge surpluses run by the rest of the world. In March of 2005, shortly before he assumed the chairmanship of the Federal Reserve, Ben Bernanke stated that the global savings glut was a key reason why interest rates remained low, inflation seemed under control, and the US dollar was protected. Because foreign countries remember all too well the currency crises of 1998-2000 and the accompanying toll on growth, they have preferred to invest in a safe haven, the US dollar.

In effect, the US has lucked out. Just as we reduced revenues through tax cuts and substantially increased government spending at the same time, we were able to finance these policies with little if any cost. However, it is not altruism that has persuaded foreigners to buy dollars, it is self-interest. Countries abroad are undergoing vast changes similar to what we went through in the first half of the 20th century; people are moving off the farm and into cities, seeking jobs. Asia, Eastern Europe, South America and (finally) Africa are creating jobs through exporting to the US and to other developed countries. Then, as they grow, their trade with each other grows rapidly in importance, and a self-reinforcing cycle takes over. In contrast to formerly accepted economic wisdom, which maintained that developing countries would always have to borrow from the developed world so as to invest in growth, now the developing countries are investing their enormous budget and trade surpluses in the securities and currencies of the developed world. This change comes with mixed blessings. Certainly, the improvement in living standards in much of the developing world is welcome. Yet environmental standards have suffered, and cronyism and corruption have been sadly present.

III. The effect of these changes on profits and on equity markets world-wide has been profound. In the US, corporate profits are now at a record high percentage of national income (14% vs. 6% a few years ago), as wage rates have been held in check by the global over-supply of labor and as corporations have experienced superb gains in productivity, through use of technology. Earnings in Europe and Asia have also exploded, both in the developed and developing worlds.

  As price inflation has been held in check by rapid growth in both foreign manufacturing and service industry competition, the big surge in global savings had to find an outlet. As a result, real estate, commodities and financial assets have all risen steadily in price.

  In effect, the world has reached an advantageous economic bargain: if the US in particular will buy from Asia and the rest of the world, those countries will finance our resulting deficits. In return for US access to cheaply priced goods and services which our consumers and companies demand, the developing countries receive opportunities for jobs creation which their populations demand.

Summary

The six major economic shifts described in the introduction are all inter-related. They all stem from two crucial policy changes instituted by the developing world: a switch to primarily market-based systems, and a correspondingly conservative balance sheet strategy. What could change?

Apart from events impossible to predict, such as a horrendous act of terrorism or a major natural disaster, a world dollar crisis or a major rise in inflation would certainly alter everything. Yet it is difficult to envision how any country could benefit from a dollar crisis. Therefore, we expect that foreigners will only very gradually diversify their reserves and savings away from dollar-denominated assets. However, the US must expect that a greater portion of our Treasury debt, as well as our real estate and financial assets, will come under foreign ownership. A major rise in inflation would tip this virtuous cycle out of balance; yet with most emerging countries following a policy of maintaining low prices for goods, and with productivity high in the developed world, inflation does not appear to be a near-term problem.

As long as this implicit world bargain continues, it seems reasonable to suppose that real and financial assets will remain the principal financial beneficiary. We therefore still plan to focus our clients' assets on those areas, diversifying throughout the globe and especially emphasizing equities and equity-like instruments.