



# INVESTMENT STRATEGY UPDATE

April 1, 2005

## **“THE TIMES THEY ARE A-CHANGIN’”**

Bob Dylan

The recognition and analysis of change are among the more challenging activities of those who study the investment arena. Since the environment within which we invest is in a constant state of flux, the assumptions upon which we base our investment decisions must remain flexible as well. Change creates dislocation, and dislocation in turn creates opportunity. It is our ability to adapt to change that sets us apart.

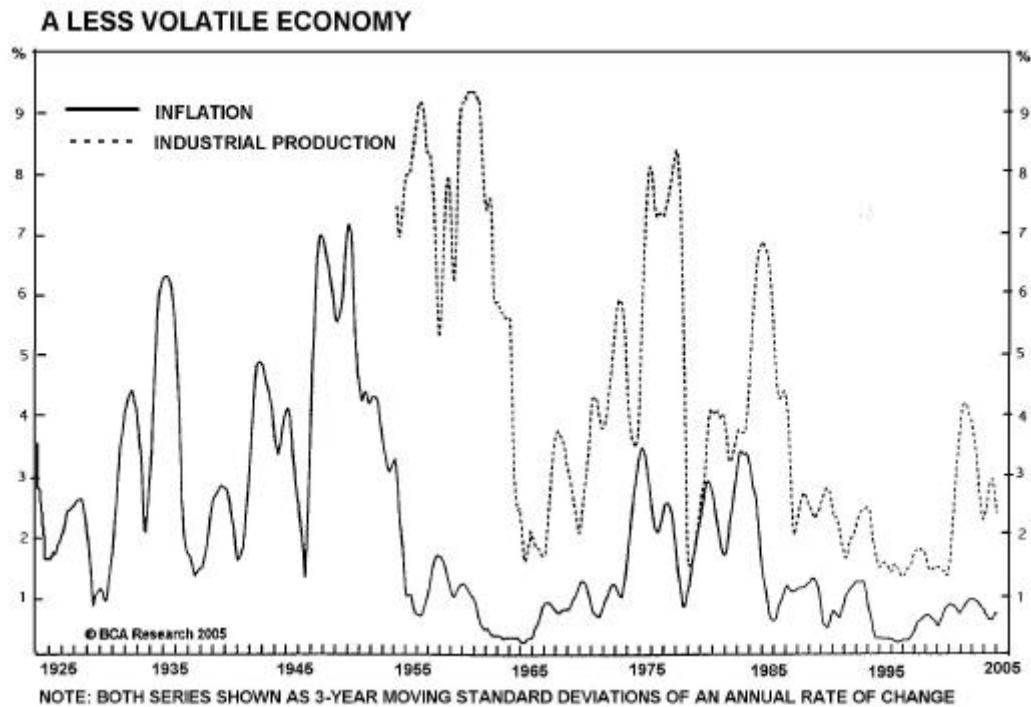
### **The Question of Interest Rates**

Recently, we have been considering some of the data that have diverged from our previous assumptions. One question that continues to arise is, why have long-term interest rates remained so low, in light of our strong domestic economy and the Federal Reserve Board's persistent steps to raise short-term interest rates? While bond yields have risen in recent weeks, long-term interest rates are still well below their historical average. For example, the ten-year U.S. Treasury bond currently yields about 4.5%. But over the last fifty years or so, the median yield on that bond is nearly two percentage points higher.

With economic globalization, doing business in the U.S. and the rest of the industrialized world has undergone vast change. Most major companies are no longer integrated manufacturers. Rather, collectively, they design, market, and sometimes assemble the products they sell. For the most part, these companies now outsource their basic manufacturing to the lower-cost, less-industrialized parts of the world.

There are many consequences of this trend. One is that the basic nature of U.S. domestic employment has changed. With fewer of the more volatile manufacturing jobs here, U.S. employees in general now have greater job security. And with increased job security, workers and their families can spend more confidently. And although the data shows the U.S. consumer to be very heavily indebted, a significant portion of that debt is in the form of fixed-rate mortgages at historically-low interest rates. (As a simplistic framework for the discussion that follows, interest rates are a function of the supply of funds, the demand for funds, inflationary expectations, and risk.)

Another consequence of the shift toward outsourced manufacturing is that a significant portion of our economic volatility has also been exported. Indeed, as shown below, U.S. economic volatility has been trending lower in recent decades. As an aside, less economic volatility can be translated to mean lower investment risk, which in turn provides some justification for higher stock-market valuations.



COURTESY: The Bank Credit Analyst

From a corporate point of view, the new U.S. economy requires less spending on plant and equipment. So one reason interest rates have remained low is that companies now have less reason to borrow (the demand for funds). In fact, U.S. corporate cash hoards are at record levels, leaving one to wonder what will be done with all that liquidity. Rising dividends and an increasing level of acquisition activity seem most likely. Also, with favorable balance sheets, the probability of corporate defaults is relatively low (risk).

From a supply of funds standpoint, there is a substantial amount of liquidity in the financial system, both domestically and abroad. We have heard it said that the financial infrastructure of the Western world is organized to facilitate the provision of capital to the more-industrialized nations. However, by outsourcing manufacturing to the less-developed parts of the world, we have also outsourced at least some of that need for capital.

On a side note, we have been questioned as to whether we think the U.S. can survive as a major economic power when, in essence, it is morphing into a service economy. We believe the answer is yes, even though there has been no such world power in the past. With a global economy, the U.S. now imports a large variety of products, ranging from microwave ovens to running shoes. But our exports are expanding as well, in categories such as agricultural technologies, medical technologies, financial and insurance services, media and intellectual property, information, and innovation.

Economic globalization has also served to reduce inflationary pressures and contain inflationary expectations. While there is no question about the influence of rising commodities prices, globalization has resulted in tremendous competitive pressure to keep

prices down. In the current age of information and mobility, businesses respond quite rapidly to new trends. As a result, there are few truly unique products or services that allow for long-term pricing power. So in order for companies to prosper without something unique (i.e., a coveted brand or patent), they must constantly strive to be a low-cost provider. Manufacturers and service-oriented companies are continually seeking lower-cost sources of labor and manufacturing, as well as more efficient methods to produce and distribute their products. It is hard to imagine meaningful, sustainable inflationary pressure in this type of environment.

But not all of the current influences favor low interest rates. In addition to rising raw materials prices, there are the cyclical inflationary pressures of dwindling available capacity, slowing productivity growth, and a tighter but still accommodative monetary policy. Furthermore, we have a growing federal budget deficit and a government that shows little sign of reducing its excessive rate of spending. In fact, as a society, we consume too much and save too little. Taken as a whole, the current U.S. balance sheet is too heavily laden with debt. Thus, the dollar could weaken further and the foreign investors upon which we are so heavily dependent may choose to eschew additional holdings of U.S. bonds.

It has been more than a year since we first expressed our belief that longer-term interest rates would rise to more normal historical levels. For now we still hold that belief, but much has changed. So, we continue to wonder...

### **Commodities Prices – Secular Trend or Cyclical Anomaly?**

Raw materials prices have continued on their upward march despite the fact that world growth is now slowing. So another question we have been pondering is whether the continuing commodities price rise is a sustainable secular trend that will persist into the future. Or, is it instead, simply a stronger-than-normal cyclical upswing, augmented by increased speculation? Previous episodes of rapidly rising raw materials prices have always resulted in reduced demand for those materials, and likewise, always stimulated increased production. Thus, commodities prices have been highly cyclical, historically.

But we believe the current trend is more sustainable than in the past. The industrialization of emerging Asia is a very powerful evolutionary force that is still in a relatively early stage of development, in our opinion. We are talking huge numbers, as China alone has a population of 1.3 billion people. And, measured on a per capita basis, Chinese commodities consumption is just a small portion of that in the more industrialized nations. China, for example, consumed only 1.7 barrels of oil per person during 2003, versus 17.5 barrels per person in South Korea, and 25.2 in the U.S. For aluminum, the numbers were 4 kilograms per person in China, compared to 21 kilograms in the U.S. And the amount of copper consumed per capita was 4.7 pounds in China, versus 15.8 pounds in the U.S., and a whopping 37.6 pounds in Korea.

In a February 2005 basic materials report, Morgan Stanley analysts predicted that China's share of global consumption will increase by 50% between now and the year 2010. If that occurs, they conclude, China could then account for an astounding 34% of global copper consumption and 37% of global aluminum consumption. In yet another research report, Oakmark Associates, Ltd. investment strategist Ed Yardeni wrote that he is expecting China's energy needs to double by the year 2020.

Those are staggering projections, and if they prove anywhere close to reality there will need to be a substantial global supply-side response. But for a number of commodities, it will be several years before production can be increased sufficiently to catch up with the projected rise in demand. And while high commodities prices will certainly act to reduce world demand growth, we do not expect that reduction to be enough to hold prices down.

Having said that, commodities prices and the related common stocks have risen significantly in recent months. And, at today's levels both the prices and stocks appear to be well ahead of the currently existing fundamentals. In addition, as we are well aware, the economies of emerging Asia have a history of periodic cyclical blowoffs and meltdowns. Those economies are likely to remain volatile. So we would not be at all surprised to witness a rather sharp retrenchment. But we believe the underlying secular growth trend to be quite powerful, and we strongly expect that any pullback will eventually be measured as a correction within a rising trend.

There are, of course, a number of crosscurrents. Take, for example, the growing popularity of hybrid automobiles. It is indisputable that these vehicles provide rather substantial fuel savings. But less recognized is the effect that increased hybrid automobile production will have on other commodities. Industry sources suggest that it takes 50 pounds of copper (electric motors and wiring) and 40 pounds of nickel (very large batteries) to produce the average hybrid automobile. Those numbers represent large increases in the usage of those materials, as compared to the amounts required to produce a standard gasoline-powered automobile. In addition, because hybrid cars are typically made lighter for added fuel economy, a substantial amount of aluminum is substituted for the much heavier steel. Hybrid engine technologies will not be restricted to automobiles. General Electric is even working on a hybrid engine for locomotives. The bottom line is we believe that commodities prices are likely to move higher in coming years, and perhaps even a lot higher.

## **Conclusion**

To date, 2005 is fulfilling our expectation that it will be a trying year for investors. We continue to expect a sideways-to-modestly higher stock market, with periodic opportunities to add value through stock selection, sector concentration, and flexible asset allocation. Buy on weakness, lighten on strength.

In summary, this is an exciting time to be in the investment management business. It is also quite challenging. There are a number of significant current trends to analyze for change: Technology marches on, our population is aging, and healthcare costs are rising exponentially, to name but a few. So we must remain ever diligent and continually question our assumptions, "for the times they are a-changin'." Opportunity abounds.

*Previous Investment Strategy Updates are available online - [www.btrcap.com](http://www.btrcap.com)*

---

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST. The information contained herein is based on sources which we believe reliable but is not guaranteed by us and is not to be construed as an offer or the solicitation of an offer to sell or buy the securities herein mentioned. Opinions expressed herein are subject to change without notice. This firm and/or its individuals and/or members of their families may have a position in the securities mentioned and may make purchases and/or sales of these securities from time to time in the open market or otherwise.