



# INVESTMENT STRATEGY UPDATE

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## GLOBAL CHALLENGES

It seems like it was not so long ago that the great majority of U.S. investors focused almost exclusively on the domestic economy and stock market. After all, ours was the largest, most dynamic economy in the world. And, it was a commonly held belief that this great nation was largely in control of its own financial destiny. But while our economic future never was fully isolated from outside influences, it is undoubtedly much less so today. Currently, we outsource a major portion of our manufacturing and production overseas. And in turn, we import increasing amounts of goods, services, and capital. Furthermore, a substantial number of large U.S. companies have evolved into multinational enterprises, buying, selling, and providing their products and services all over the world. Today's economy is global and, for today's investors, it truly is an international arena.

The world economy is awash in liquidity – a result of both the extremely stimulative monetary policy that followed the bursting of the technology bubble, and the excessive current level of global savings. The effects of excess liquidity can be seen in the relatively loose bank- and mortgage-lending standards (recently addressed by federal bank regulators) and in the extraordinarily low current level of long-term interest rates. In addition, the U.S. corporate sector is flush with cash. Abundant liquidity has also helped to fuel a new speculative boom, but this time in residential real estate rather than technology stocks.

Over the last several months, the Federal Reserve Board has shifted its focus from stimulating the economy toward lessening the potential inflation risk and dampening the speculative rise in housing prices. As such, the Fed has been reigning in excess liquidity by raising short-term interest rates and restricting monetary growth. But recently that task has become more difficult. Economic growth has slowed around the globe. Our economy has softened as well, in what appears to be normal mid-cycle slowdown. If that is so, we should soon begin to regain strength. However, there is a risk. Today's global economy is overly dependent on the U.S. consumer. And if this nation catches a cold, the effect might be felt worldwide. So the Fed must walk a tightrope – continuing to restrict monetary growth while, at the same time, making sure it does not overtighten and turn a temporary slowdown into something much larger. Unfortunately, the question of how much of an interest rate rise is too much, can only be answered after the fact.

## **Wither the Dollar**

The U.S. dollar has spent much of the past four years trending lower. Consider its fluctuations against the euro. Back in June 2001, it cost just 85 cents to purchase one euro. Today, even after this year's dollar rally against the euro, that cost is still \$1.20.

Economic pundits proclaim the dollar's trend of weakness to be well deserved. After all, the U.S. has a very large trade deficit, and currency adjustment is the normal way that trade imbalances are resolved. In addition, they point out, ours is a nation of excess consumption, with a populace that spends too much and saves far too little. And the same can be said for our federal government. Following a brief flirtation with fiscal responsibility under the previous administration, the federal budget has plunged back into a deep deficit position.

But from our perspective, the dollar has been weak against the wrong currencies. The growing U.S. trade imbalance is with the nations of emerging Asia. Yet many of those nations' currencies are either pegged against the dollar or otherwise artificially constrained from rising. So instead, the dollar has been weak against other currencies such as the euro and the yen. But think about it. Our economy is stronger than those of either Europe or Japan. And, as a percentage of GDP, we import less and have a lower budget deficit. The facts are clear: over the past year, U.S. economic growth was 3.7%, as compared to France's 2.3%, Germany's 1.1%, and Japan's 1.2%. The unemployment rate in the E.U. is a whopping 8.9%. Imports amount to 15% of U.S. GDP, compared to 33% in Germany and 28% in the U.K. And Japan's budget deficit, as a percentage of GDP, is more than twice that of the U.S.

So what about this nation's seeming addiction to excess consumption? There is little doubt that in the long run we do need to save more. But were it not for the U.S. consumer, the global economy would be quite a bit weaker than it is today, with rather significant excess productive capacity. The scarcity in today's world is spending, not production. Foreign savings rates are too high, relative to internal consumption. In fact, we think the long-term health of the global economy will depend upon our primary trading partners' success in encouraging their own consumers to spend more.

## **Long, Long-Term**

This is an interesting time in history. China and India are each in the early stages of re-emerging as global industrial powers. Yes re-emerging, for back in the early 1700s, China and India combined for more than 50% of world industrial activity. So why is it that the more established industrial nations are finding it so difficult to compete with those countries that are on their way up? One obvious reason is that the cost of labor is much lower in the emerging nations. But there is a lot more to it than that. Recently, we ran across a rather disturbing passage from *Decline and Fall of the Athenian Republic*, a book by one Alexander Tytler published, ironically, in 1776

A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising them the most benefits from the public treasury, with the result that a democracy always collapses over a loss of fiscal responsibility, always followed by a dictatorship. The average of the world's great civilizations before they decline has been 200 years. These nations have progressed in this sequence: from bondage to spiritual faith; from spiritual faith to great courage; from courage to liberty; from liberty to abundance; from abundance to selfishness; from selfishness to complacency; from complacency to apathy; from apathy to dependency; from dependency back again to bondage.

While we don't agree with Tytler's conclusion that democracy must necessarily be followed by dictatorship and bondage, his writings do help to explain the competitive advantages and disadvantages of the various stages of industrialization. Among the emerging industrial nations, the primary emphasis is on growth and competitive success. Little thought or capital is given to subjects like fair competition, the environment, or workers' rights such as healthcare, retirement benefits, and occupational safety. Our nation wasn't much different in the early days of its industrial awakening (remember the robber barons). But as a society gains in prosperity, its populace gives more consideration to doing the right thing. And inevitably, its workers become empowered (i.e. unions) and more capable of looking after their own interests.

Consider the European Union. In the introductory stages of the E.U., the governments of the potential participants were able to promote the benefits of a common market in broad terms. Clearly, the European nations needed to improve their competitive position in the world marketplace. And while the necessary steps toward meeting the lower inflation rate and budget deficit criteria, as stipulated under the Maastricht Treaty of 1992, would no doubt cause some short-term pain, that pain could not be blamed on any particular nation's government. Rather, it was "those guys" who constructed the E.U.

In our July 1998 *Investment Strategy Update* we wrote that, despite the early success of the E.U., we couldn't help but wonder how long it would be before the nationalistic tendencies of the individual member countries resurfaced. And for how long, we asked, would the European labor unions remain quiescent? After all, had labor not earned its right to generous government-sponsored healthcare and retirement benefits? And why should one assume that E.U. workers would agree to work longer hours, with fewer breaks, and fewer vacation days? An exit poll analysis of the recent French vote against the new European constitution showed a strong division by economic class. More than 70% of those in the highest-income brackets voted in favor of the new constitution, while some 65% of those in the lower-income brackets voted against it. Do more E.U. troubles lie ahead? We wouldn't be surprised.

## **Risk or Opportunity?**

At any rate, here in the U.S. the greater question is, “How well will our nation be able to compete in this rapidly changing world economy?” Certainly we have an advantage over the Western Europeans and Japanese, in that we have stayed with a low-tax, high-growth economic model. Furthermore, as ongoing benefits of immigration and a higher birth rate, our dependency ratio is far lower – defined as the number of people over the age of 65, as a percentage of the number of people 20 to 64 years old. In addition, our nation has far fewer entrenched impediments to entrepreneurship and innovation. And, we have a history of allowing our aging and obsolete industries to fail, so that new technologies may more easily rise in their place. That willingness to move on does not exist in much of the rest of the industrialized world.

But even considering the prospect of a probable Chinese currency revaluation, we would still be unable to compete on a pure labor-cost basis. The gap is just too large. Yet, we think that by exercising our collective will, this nation can successfully improve its competitive position by emphasizing our educational infrastructure, reforming our tort system, and continuing to promote an environment of innovation and entrepreneurship.

From an investor point of view, there are a large number of U.S. companies prospering from their foreign activities. In fact, collectively, domestic companies’ overseas earnings grew by 26% last year, accounting for a full 40% of the profit growth of all U.S. companies. General Electric, for one, says it expects 60% of its revenue growth to come from emerging markets over the next decade. And the consulting firm McKinsey & Co. has even suggested that, at least in part, our large trade deficit is due to our own companies producing overseas and shipping the goods and services back to the U.S. Indeed, our world is changing. And, as there always is with change, there are risks. However change also creates opportunity. We remain optimistic about the opportunities and prospects for our nation, and for U.S. companies in particular, to successfully compete in an open global arena.

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