

## **2005 Mid-Year Commentary**

*“The proclivity to go to excess is a phenomenon of collective psychology that seems to repeat itself again & again”.*

*Robert E. Rubin*

*Former US Treasury Secretary*

About this time last year in my commentary to you, I acknowledged the financial markets as being a bit boring and touched on the potential frustration that many investors might be feeling over the relative stagnation in their investment accounts. Clearly, matters have not improved very much as the various market indices have been fluctuating in a somewhat narrow range and thus far have not advanced much above where they began this year.

As I discussed in my 2004 Mid-Year Commentary, there are fundamental reasons that may account for why the general markets seem to be in neutral. At this year’s mid-point, we can also add rising short-term interest rates, rising oil, gas, energy and natural resource prices, possibly slowing corporate profit growth and still somewhat higher-than-historical price ratios to the mix. To be sure, there are many proponents of some kind of rally just over the hill, but whether or not a one will materialize is anyone’s guess. One of the only sure things we know is there will not be a Presidential election this year, (like last year); to give the financial markets a boost in the 4<sup>th</sup> quarter.

One of the more frequent questions I get nowadays is about the so-called “real estate bubble”. The press and financial media have all gotten into a lottery-like discussion of when this appreciation bubble will burst and of course, friends and acquaintances alike have asked my opinion about the issue. The frank answer is; I don’t know, anymore than I knew such a bubble was about to occur. Speculative frenzies can last longer than imaginable, (dotcoms and tulip bulbs, for example). That said, when I see websites such as CondoFlip.com, (whose homepage header, “Bubbles Are for Bathtubs” essentially pooh-poohs the hard lessons learned by day-trading stocks, oh-not-so-long-ago), to paraphrase a local newspaper columnist, “the end can’t be too far away, Bunky”. It’s fairly clear though, even to the average person, that the catalyst for this real estate scurrying has been the low interest rate environment and the easy credit policies of mortgage lenders and financial institutions. (Our nation’s Total Credit Market is growing faster than GDP and still hovers near 300% of GDP). Even though the Federal Reserve has raised short-term interest rates, longer-term bond and mortgage rates have not responded in-kind all that much, prompting Fed Chairman Alan Greenspan’s “conundrum” quotation. One of the chief reasons for stable longer term rates is the heavy demand for our Treasuries by foreign investors who are buying up our Treasuries with their many-saved US dollars, (accumulated from our country’s near rabid spending on stuff they manufacture and sell to us). In effect then, the cycle has been that we buy their stuff, allowing them to save dollars so they can buy our Treasuries and debt & keep our long-term rates low and we can borrow more to buy more of their stuff. So, it would seem to me that as long as financing policies and longer term interest rates continue as is, real estate could continue to defy the bubble-bursting odds-makers. The underlying concern should be, however, about what could transpire when this monetary stimulus ends? Specifically, what concerns me about the whole real estate affair is not so much of a “bursting” (I envision more of a slow leak), but of the impact on consumers and the financial institutions holding these property titles and mortgages acquired with the easy money when it is no longer available. To me, either rising long rates at some point or investor unease over the amount of lower quality loans on lenders’ books may cause a “credit crunch”, (tightening credit standards and available loans) and a flight to quality out of riskier mortgage-backed securities, leveraged investments, high-yield bonds and the like, to less risky fixed-income securities, such as US Treasuries, (which could lower rates again and set off a new round of refinancing as well, keep in mind). As many money managers and investors are reaching for yield in this low-return investment environment, a broad sell-off of riskier assets and flight to quality could have significant, unforeseen impacts on financial markets and the economy, especially if things like hedged-portfolios and leveraged derivatives are affected as well. In addition, if real estate investors and homeowners start finding their ARM and interest-only loan payments converting to the more expensive level and have trouble making their payments (for loans they possibly couldn’t afford in the first place), we could then see heightened levels of non-performing loans in the portfolios of financing institutions, etc, which is

also not good. Add the notion of a “flattening yield curve” (where short-term rates approach long term rates or worse, an “inverted curve” where short rates exceed long rates), and one might see storm clouds on the horizon for financial companies, which, as financials comprise a large portion of our economy, could spell trouble for the markets in general. The problem then, even if you can clearly envision the endgame, is predicting when such an end will occur. In my mind, it would be prudent to stay conservative and stay tuned. This is not the time for excessive risk-taking.

According to my mortgage broker friends, while real-estate purchase financing is still active, refinancing seems to have tailed off, which could indicate that everyone who wanted to extract equity from their properties to finance their spending has already done so, (or ran out of tap-able equity). If refinancing does stay tame, it will be interesting to see how consumer spending holds up over the near-term. As job growth and capital investment by businesses have been more or less anemic so far into this ‘recovery’, consumer spending has shouldered the majority of the country’s GDP growth. The jobs and investment, by the way, have been shipped over to Asia, where manning a telemarketing phone or assembling computers and jewelry is far cheaper than on our home turf. Based on these two thoughts; consumer (over)spending fueling the economy and the source of that spending (asset appreciation and extraction for spending) tailing off as the real estate boom subsides, the implications for at least a slowdown in economic growth seem apparent. Translated to “investor-speak”, if the economy slows down this year, corporate earnings could suffer which of course, affects already pricey stocks, the financial markets and your investments. As I stated in previous commentaries and this one, many stock investments are not all that appealing (to me) in the first place. This doesn’t necessarily mean we should completely exit US stocks, but instead not jump too far into stocks and not with both feet. There doesn’t seem to be many bargains to be found and more of our favorite investment companies have closed their doors to new investors, as they are also still having trouble finding qualifying companies to invest in with the cash they have on hand. As an aside, one good thought to stagnant stock prices is that earnings for our desired-but-pricey companies may catch up with prices and over time, may present buying opportunities at more appealing price levels. Returning to my pessimistic line of thought, if the economy and stock market do start to skid, the Federal Reserve may not have much room to prime the pump with lowering interest rates as in the past. Greenspan’s impending exit in 2006 aside, with “real yields” (meaning the yield minus inflation) still at very low levels, the Fed may only be able to lower rates to a certain extent, else risk deflation and the problems that accompany it, (like negative compounding of investment returns).

One area of that may offer opportunities is Asia. It’s not much of a secret anymore that many Asian economies, especially China and India, are growing rapidly now that capitalism is embraced. Even the long-suffering Japanese economy is experiencing a revival of sorts via investment in China’s growth, (despite the political tiptoeing around long memories in China of WWII Japanese atrocities). Both China and India, as the centerpieces of Asia, could emerge as the economic engines for Asia, if not the world, within the next decade, much as how the USA became the economic engine for the world in the last century. Accompanying this growth is a lot of trade protectionist saber-rattling from the US Congress over jobs going overseas, but you should realize this protesting has more to do with politics, in my view. The job losses occurring is simply a matter of economics and coping with the fact that our lifestyle and economy has matured as a nation. Yes, people are losing \$45,000/year manufacturing jobs, but would the rational consumer rather pay \$3000 for a couch made in the US rather than \$1000 made in China? You might be patriotic and choose the more expensive US-made couch, but how many of us look for and buy cheaper, foreign-manufactured products on a daily basis? Chances are, all of us, so the loss of low-wage manufacturing and routine service jobs is inevitable. In fact, you might be surprised at what other kinds of jobs have gone overseas. How about tax preparation? According to journalist Thomas L. Freidman, nearly 400,000 state and Federal tax returns were prepared electronically in 2004 by subcontracting to preparation firms in India. Why? Because Indian accounting professionals trained to prepare your state and Federal tax returns cost 1/10<sup>th</sup> the amount that an accountant would here in the US, so major accounting and tax prep firms are subcontracting routine preparation to these firms and concentrating their efforts on client relations, tax planning and the more complicated tax returns, all possible due to Internet technology and the economic differences between here and India. I could spend pages of commentary on this subject, but instead, if you are interested in a glimpse of what our economic future might hold, I highly recommend you pick up a copy of Freidman’s latest book,

*“The World Is Flat”* and give it a studious read. The overriding message is that our global economy is more competitive and will change more rapidly than ever. These two economies have a young, growing educated workforce that is getting their first taste of capitalism in the form of rising wages and opportunities. Whether Chinese, Indian, Muslim, Hindu or Buddhist, these folks want the same lifestyle & benefits that we sometimes take for granted. You can believe they are hungry and ready to compete with our economy to obtain wealth, now that technology and their governments have provided the opportunity. While the US equities market may not be all that appealing for the moment, investing in these economies might provide some future growth to our overall investments.

I also believe natural resources hold some promise for investment returns. Growing economies need raw materials and energy to supply their manufacturing bases and with India and China, we have two additional countries trying to source such materials to feed their economic engines alongside those developed countries, such as the US, that still need such materials as well. Growing demand outpacing limited supplies can have an uplifting effect on prices and perhaps explains why we’re paying more at the gasoline pump these days. As we’ve also seen in the news lately, (and as I indicated in my previous commentaries, btw), China has been aggressively looking to secure future natural resource supplies by attempting to buy natural resource companies (again, with all those dollars they’ve accumulated). Really, there should be no surprise here. The Chinese tend to think long-term, (anything under a decade is historically short-term to them), so it makes perfect sense that they should be buying material they need for their manufacturing base in the future. Along with oil companies in the US and Canada, the Chinese have been looking to acquire mining operations in South America and other areas. Besides needing oil, energy and raw materials for their manufacturing base, the Chinese and Indians will also need oil for all those consumers that may have disposable income in the future and want to spend it, like on a car to drive. With their vast populations wanting to drive their own cars, how much of an additional demand might we expect on oil supplies over the next decade? In my opinion, it could be quite a bit and with the ability of refiners and oil supplies to meet even current demand under question, I think chances are better than average that oil investments (as well as general energy and other natural resources) could be profitable in the future.

This leads to another question you might ask; “What about investing directly in China then?” For now, I might hold off on direct investment for a number of reasons. First, China is still a developing country and economy in many ways. Their banking and financial structure is still somewhat fragile (which is why they should not float their currency for the moment or at the very most, do it in (very) small increments), their financial regulations and accounting procedures are not as sophisticated and their growth may experience a setback or two along the way to prosperity. A better idea might be to broadly diversify in companies or investments that benefit from China and Asia’s growth, such as companies that service or supply their economy. Many of you have investments in mining operations, oil companies and others that supply their products or services to China. As China benefits, so might they. This seems more of a prudent play on the China phenomenon.

The hard aspect of investing in today’s world is balancing our instant information environment against the patience element of long-term perspective. You may be tired of hearing about long-term perspective, investing for the long-term, etc. etc. while your investments do not seem to be growing all that much lately. This is a natural reaction, especially in an environment where we’re able to get instant live, play-by-play news of a baseball game or golf tournament or where real estate prices seem to be increasing week by week. To not get “results” whenever you look can be “boring” in today’s world. (This may be why professional soccer hasn’t taken off just yet in the USA). For many investors, this could be a dangerous time, as the inability to remain patient may cause him or her to try and “push the investment envelope” too hard, investing in riskier securities such as high-yield (junk) bonds, highly-touted technology stocks or even speculating in real estate with the same euphoria as in the dotcom days. Taking a business-like approach to your investments is still the way to go in any investment climate, but especially when there are real risks growing, especially in areas such as real estate. The absence of the anticipated endgame does not mean the risk has gone away; if anything, the absence could indicate the risk has grown and could have more of an impact once the endgame has been reached. The catalyst for this endgame could be anything; China deciding to float its currency(\*), another terrorist attack, a currency crisis in a third-world country, a major financial institution reporting massive

derivative losses, a large private hedge-investment company going under, etc. Most of these examples have happened before and could again. We cannot just keep our money in a mattress, nor can we ignore these risks. What we can do is to be prudent, take our gains where available, (such as income-oriented investments if the climate for stock prices going up is not favorable), and remember that returns on investments are rarely a smooth line. Instead, there are ups, downs and many periods of long-term stagnation (such as from 1964-1982 when the equities markets in general stayed the same for that 17-year period, though there was quite a bit of volatility).

If you have any questions about this letter, your investments, financial planning or other matters I can help you with, as always feel free to call. I appreciate each and every client I have the privilege to serve and hope you find commentaries like this useful to your investment education and understanding. Thank you very much for your business.

(\* I penned this commentary before China's decision to re-peg the yuan to a basket of currencies instead of just the US Dollar. While symbolically noteworthy, (especially in appeasing US trade protectionists), after an initial knee-jerk reaction, the markets seemed to have absorbed this move in stride. The 2.1% revaluation is relatively small and the Chinese government still maintains strict controls on the yuan's valuation, so for the moment, it looks as if there shouldn't be too much fallout from this event, (but ya' never know.....).