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HOPE IS NOT AN INVESTMENT PLAN

By the time World War II ended, the American consumer had considerable pent-up demand for most everything. Years of rationing met the savings created by a generation of G. I.s home with a few dollars and Rosie, finally off the line, with her savings.

You can make a case that personal consumption also went on hold from the deep years of the Depression ('30-'33) until the war; demand prevailed, but money was non-existent.

A time period covering a war and a depression, with and without money, certainly did nothing to destroy inherent demand. Recall that the car, the radio, air travel, electric appliances and mass-produced consumer goods, from pots and pans to dinette sets, became broadly available in this era. When we could buy, we surely did. As that generation arrived home and began to build homes, roads, malls and the like, a great consumer-driven business cycle began. It had periodic recessions as excesses crept in from both demand and supply, but in general a great cycle, reaching over 60 years, was born.

One fuel for that massive, consumer-driven cycle was the credit card, as we all know. (I smile when I hear folks say ". . . Well, in my day we paid cash . . ." – of course you did – the credit card is a recent event and no bank would lend you money to buy your wife dinner.) It is a myth, however, to conclude, as I did, that personal consumption as a percent of income skyrocketed. Much of the "increase" was imputed to consumers by government statisticians and was, in fact, medical expenditures. (Logical – who else would you impute employer healthcare programs to?) We have born the cost of employer health care through lower wage growth, as many have pointed out. Nonetheless, through it all we were bombarded by TV and radio to buy – NOW. It was a subtle addiction: an employer buys health policies for 100 people as a package and deducts that expense from corporate revenue. The package is "given" to employees who see it as a boost to their benefit package – and they don't have to pay for it. The package, of course, is a policy which is far cheaper than raises to the same 100. Further, the employee has a credit card and can work around the low wage growth barrier to increased consumption. Government accounting imputes the cost of that health care to them – unknown to them, of course – and an implied higher consumption level results.

So even though this boom of 60 years of consumption is currently on life support, I think it is very important to note that the share of Gross Domestic Product (GDP) attributable to the consumer is virtually flat since 1950 (between 56% and 61%) until you add back medical care and then it rises – to 72% of late. . . and that demand for goods and services is still there albeit shifting in priority.

The swing variable, obviously, was consumer debt. We bought all that "stuff" in spite of very low wage growth, but now have to pay for it – with fewer jobs and the same (or lower) wage growth. No wonder folks are saving and trying to de-lever. They may not have seen it as I have presented it, but they sure act like they do. In any case, the TV ads continue.

There are at least three points, I think, to be made:

1) The case for very moderate to low consumer spending for years to come, both because they have to and it's now socially "acceptable," is for real. The medical component, one way or another, to one degree or another, is about to be handed back to us for real and not as "imputed." It will negatively impact re-hiring as it likely loses the tax deduction for employers and the reality is that 1/6 of the economy is out of control . . . and yes, tort reform and waste control are huge – but do you really think that will happen?
2) The spending that the credit card allowed isn't gone, but now resides in fewer hands. The marginal poor will be a long time recovering from their debt overload, the middle- and

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upper middle-class less so. In any case, credit card-driven consumption will be significantly diminished and altered.
3) Last, we are now biased to an older population – the boomers are 65 and spend differently with now-diminished savings; they are not in the growth mode.

Of interest to me, however, and to my clients, is what new areas of investment will evolve and which old ones will persist? In the '50s and '60s, two major changes occurred in the stock market that reflected those times:

1) Stocks yielded more than bonds, but greater earnings growth became more noticeable – and more attractive, especially as dividends rose. More and more individuals, bank trust departments and brokers began to focus on "growth." For example, in the late '50s and early '60s, utilities were a massive growth industry as the suburbs grew with returning vets, the newly prosperous and the far-sighted. Growth stocks ruled.
2) Stock ownership became, as my old boss used to say ". . . the appropriate thing . . ." to this new generation. Legal code changed, the Prudent Investor concept evolved, ordinary folks saw the way to riches in owning the stocks of the products they bought. It was quite a list: Georgia Pacific, Detroit Edison, Kresge, Burroughs, Coca Cola, Procter & Gamble, General Motors.

The ownership of stock has ebbed and flowed over the decades and you would think after a loss of somewhere around $12 to $13 trillion – correct that – we just made back almost $1 trillion in this "rally" – so a loss of only $11 trillion, folks would think twice. But no, it's game on, same stocks, same ideas. I, for one, doubt it.

The issue for me is not whether or not to own stocks – of course we will. What we have to get right is what sea change has taken place, like the '50s and '60s, that has spawned entirely different investing avenues; what, in fact, do these new normal times require? Is growth dead or did it leave town?

I digressed to the '50s and '60s because the magnitude of that investing change, to my mind, was equal to the present, only then it played out longer. Then, investors went from bonds (nearly always) to stocks – nearly always. Today we are at the reverse point.

As I see it, a return to basics, however defined, will be forced on us if we don't elect it voluntarily. Population growth globally and much longer lives here (children born in the next decade are expected to live to 100, routinely) argue for massive expenditures in health care, crop efficiency, water access (and cleanliness) and power. These, to me, are domestic growth industries. I see the logic of these needs not as a starry-eyed tree hugger, but as a realist who sees long-term needs exceeding long-term supply. Taxing the rich for health care, carbon taxes, etc. is a political, not economic, idea that, at best, transfer decision making to elected officials who, as I see it, have less sense of reality than the guy next door. Underneath, however, is a badly fractured governmental system at the very time that economic growth – more precisely, increased productivity, is critical . . . and it's in the hands of 400+ people, few of whom have ever met a payroll. So, with all that venting as prelude, wither from here?

Government schemes will likely continue – cash for clunkers will be labeled a success in Washington. Most of America's manufacturing world is now focused on cars, housing and commercial building. The current rebound in manufacturing is substantially a ramp up in auto production – and, believe it or not, housing starts. Their hope is that with a now cheap dollar – <u>some</u> of those manufacturers (cars, appliances) can export, but the rest . . . ? The weak dollar is making our goods attractive to the world, but much is priced in dollars. Those who hold dollars

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will see a slow loss of value and, therefore, be eager to trade them for Euros, the Australian dollar – whatever currency appears to be stronger, relative. This can and does snowball. We will continue to stimulate housing and cars, neither of which is in any kind of short supply or a growth industry, so we will see a loss of capital to other countries.

If you are still with me, I am painting a picture of weak domestic growth fueled by the much-discussed need to de-lever here while, outside the U. S., still low standards of living are increasingly improving as commodity-rich nations see internal investment and stimulating internal demand as at least as critical as exporting or investing here . . . to wit, Brazil, China, Korea, Argentina, Chile, some of Eastern Europe, etc. Even Germany has come to see that internal demand is at least as important as exporting well-made cars, tools, optics, et al.

It will still be all about growth – here and abroad. To our case, the odds for growth (a la the '60s) are slim, especially as taxes rise. We have a Federal Reserve that thinks recessions and excess capacity and labor keeps inflation under control – while growth causes it. They can't be more wrong and even a casual survey will illustrate that a shortage of supply and an excess of demand raises prices. Demand is returning . . . in aggregate, and when demand is weak, as now, producers cut prices to move goods – and cut labor and production to control cost. (Lowering prices is usually, by the way, the last of those steps). When all suppliers do this, goods become scarce for a given amount of money in circulation. If money is increasing (as now) and goods grow scarcer (as now), you have upward pressure on prices . . . in money terms – inflation.)

To be fair, we are now running, year over year, a low 1% or so inflation. It is the direction moved, however, that matters far sooner than the level. When we begin to move to 2% or 3%, that alone will have the folks on FOX, CNN, et al, preaching doom and gloom. In fact, I see a worst case around 4%. (What is underestimated is the recovery speed of our economy . . . and all that labor on a 33-hour week.) I suspect a 4% peak rate is the 80% probability. I have to acknowledge the real threat of it spiking beyond that if even bigger tax increases, still lower consumption and still higher deficits put businessmen – well, out of business – and supply falls even further. Some of the basic influences on economic recovery, therefore, may include:

OIL

This can be brief: Oil prices correlate very well with prior-year demand. Global growth this year is negative almost 2%, so oil should be lower next year. Real demand for oil follows along with real global growth – the rest (i.e., $145) is a bubble. Spare capacity in OPEC alone is 6+ million barrels per day . . . almost 1/5 of overall capacity. It likely won't happen, but the "logical" price of oil is more like $30-$35, not the current $70-$80. The only good news is that at current levels, the economics to find, develop (or re-work) fields is present. My personal concern is that lower oil prices will likely fuel behaviors in Russia, Venezuela, Nigeria, etc. that keep their dictators in power when they can no longer buy votes. For now, let's work with the idea that oil is topped out at $70-$80 and the commodity funds/traders are being watched . . . if oil goes much higher, plan on a new recession.

THE INNOVATORS

In the October 3 issue of the *Economist*, reference is made to companies that pick times like these to invest, heavily, in themselves. The companies that grew during the depression include Revlon, Hewlett Packard, Pepperidge Farm, DuPont and Procter & Gamble. Procter, in fact, "invested so heavily in radio advertising that it created . . . soap operas." DuPont hired out-of-work scientists so that by the late '50s, 40% of its products were less than a decade old. In more current times, I note the decline of Dell, the rise of Apple, the "always investing" Intel . . . so I am seeking innovative firms – firms spending heavily on research and development, new equipment

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biotech, eldercare, etc. These will be the employers of the unemployed. Technology is there to assist – I just don't see it as key to future needs. Technology is, as Larry Ellison noted recently, now about consolidation and merger – not innovation, so I don't see that industry doing much for the unemployed.

GOLD

I hate to admit we own it – it's, well, pedestrian. You know why and for a bit longer we stay. I don't see $2,000 unless we slide into a real depression – now hard to see given the tons of money in circulation. By the way, many think tight money caused the Great Depression, forgetting we were on the gold standard and the money supply was virtually an unmanageable constant. No, it was tariffs on trade (Smoot-Hawley) and huge tax increases. Seemed the topic of gold was the place to mention that . . . what with Chinese tires and all. I see the likelihood of further tariffs as a disaster – whether we like it or not, we have to do business with China . . .

WATER

Earth's water is a closed system in motion – some 1.1+ trillion acre-feet* is the estimated finite volume – be it snow, ice, salt water, clouds, lakes, etc. Globally about 86 billion acre-feet (10 times the volume of Lake Superior) is rain – not necessarily where it's needed. Some 96% of all water is in oceans, seas and bays. Icecaps, snow and glaciers (fresh water) are only 1.7% of the total. Swamps, lakes, rivers, etc. are the so-called fresh surface water – and it adds 0.3% to the total. In short, most is salt-laced. Global water consumption doubles every 20 years or, put another way, two times faster than population growth. Here in the U. S. A., we 305 million people have tripled our demand in the last 30 years, but population only grew 50%. (All the above, courtesy of San Jose Water Company.)

To me, this is a demand function looking for a supply curve – ideally vertical, or water will soon be viewed as a luxury good. We have, of course, an infinite supply of salt water and as it is a closed system, two drivers come to mind: Clean it and desalinate it.

As the globe in total moves the quality of life forward, as I see it, not much can happen without addressing this growing need. Thus, I believe my clients need to be invested in a global manner and for a long haul. Note, too, that we all (would) like to live near coasts – which means interior lands have an unique issue – transporting water inland. Pumps, pipes, filters, etc? Why? Because 70% of fresh water is used for agriculture. Demand from Africa, Asia and the Middle East will be huge as lifestyle (or just survival) evolves. Even China has acknowledged its filthy water . . . and social cost. We will be involved, and U. S. manufacturing could be – but so far it's minor.

THE UNINSURED (Data from Cato Institute)

Just a quick note that the 45-47 million number of "uninsured Americans" is off by a bunch. Here is some data:

- 12 million of the total are eligible for Medicaid and Children's Health Insurance, but have not enrolled. That covers 64% of uninsured children, by the way. As Cato puts it, if they went to a hospital they would be automatically enrolled.
- About 10 million more are illegals (5.6 million) and legal but not citizens – well, he said "Americans."
- The Congressional Budget Office found 43% of the uninsured have income over $55,000 for a family of four – and a third over $66,000. About 3/4 of the uninsured can afford it, but elect not to . . . 65% are under 35 and, as we all know, immortal for a few more years.

*one acre of water, one foot deep

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- Last, only about 30% remain uninsured for more than a year and less than 3% for 3 or more years.

So, again, the cure is worse than the disease. Heck, just allowing selling insurance across state lines . . . but a growth industry or two can come from this.

UNEMPLOYED

Education. For profit. Simple. A growth industry. Second cure: Accept that over 1/2 the population is not university material and train (and respect) the trades . . . and quit producing college grads with near-useless degrees. I leave it to you to name them and start the uproar with . . . economics majors . . . clearly they are of no use of late.

Some 65% of companies are still cutting staff such that manufacturing employment is now at 1941 levels. Washington, as I write this, is struggling to explain away "a maximum of 8% unemployed and over 1 million jobs saved" – and find some answers beyond extending benefits. When households are surveyed (not businesses – that's the usual), the households reported August new unemployed at over 600,000. Figure, too, that the labor force itself welcomes near 200,000 new members each month. When you add in those who start their own business and "avoid" being unemployed (few are profitable), 1 million a month in dislocations is in sight. Now add 9 million involuntarily working part time. Keep picking at it – workers off benefits, frustrated workers just stopping their job search, well, all up we get unemployment at over 16%. (*Source: Haver Analytics*) Folks not on temporary layoff, i.e. the job is gone for good – 8.1 million. Long-term unemployed are now 1/3 of the total jobless (long-term is over 6 months). All up? 26 million.

Can you see the quandary? Induce us to spend – say with cash for clunkers or abnormally low mortgage rates - as if we were short either of those items . . . then raise taxes, directly and indirectly.

So, this is the somewhat longer case for weak demand – and again, not no demand, just very weak. Kind of explains the absence of meaningful top-line growth for consumer goods and sets the stage for a new kind of consumer spending.

MICHIGAN, MY MICHIGAN

Some months back, the Wall Street Journal did a piece on natural gas found in shale formations. It noted this gas was shallow, abundant, located where it was needed (U. S.) and new technology made it economical to extract. Gas (not gasoline) is in surplus at the moment and so much is around it could stay that way for some time. But it is needed, burns cleaner than coal, needs little refining, is easily transported – a true "green" fuel. Three states have 90%+ of all the shale gas in the U. S. One state has it under the entire area of its lower peninsula – Michigan. Then there is all that fresh water in the (now) highly protected Great Lakes. We like the folks in Ontario, Illinois, Indiana, Wisconsin – they are like us. We have cheap housing, skilled labor, infrastructure (even 94 looks great) universities of world caliber, manufacturing skills and scars, entrepreneurial spirit . . . what are we missing? The folks in Alaska have done a deal such that anyone who is a resident for more than a year (I think) receives an oil royalty check every year – and Alaska itself has a goodly income from the rest of us for that oil. It seems to me that what we lack is creative, courageous leaders . . . the rest is in place. Michigan could be a growth state.

KICKING THE CAN DOWN THE ROAD

All are fully aware that the Fed has truly painted itself into a corner: turn off the money spigot too soon and the nascent recovery stumbles back into recession – leave it on too long and inflation

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becomes embedded. Desperate for renewed growth, they flirt with strangling the goose instead. The recovery, such that it is, is masking a still severe fall in inventories. Small business, the bulk of this country, is having serious problems finding financing. One sees proof, of sorts, by looking at store shelves – a minimum seems to be the case.

The level of manufacturing is very low. What upticks are occurring – and they are – are likely restocking the pipeline. Put another way, I doubt it's going on retail shelves save for specific seasonals like Halloween or back-to-school.

So we have a sluggish recovery for some time to come. It is occurring against a backdrop of Fed attempts to walk a tightrope with money. Rebuilding inventories has begun and is the only source of current growth. Remember: consumption is fairly stable quarter in – quarter out. Inventory building and exports are far more volatile and can easily distort GDP each quarter and easily mislead us. For now, we await stronger consumer spending, hope commercial real estate does not further hurt banks and cause yet another financial crisis and that banks start lending. Against this, emerging economies, growing 3 to 5 times faster than ours, remain the place to invest. Key to their recovery is they did not have over-levered households. By now I hope you see that the rest of the world is where we were in the '50s and '60s and we have a mature economy to deal with here – a lot like England after the war.

The stock and bond markets, as I have commented in my weeklies, are assuming the recovery is for real and that meaningful demand will return. Further driving those markets are too much money, "rising" earnings (from absurdly low estimates), flight from the dollar – frankly many things other than real top-line growth. I'll give it to them, it's a real recovery – on life support.

Until the Fed and Washington step up and lay out a clear, vocal plan to address our massive deficit, however, and cuts – in taxes and spending – I see Pelosi, Reid, et al, just kicking the deficit can down the road to the next Administration, leaving us with higher inflation, slower growth, massive unemployment and trillions in new debt. The solutions take courage, not brains. So let's invest elsewhere.

Stupid is a condition, ignorant is a choice.

October 2009

P. S. Five years ago, when I opened my own firm, I made the decision that categories, created by and for consultants, would not influence how I achieved diversity for my clients. Thus, I am neither a value nor a growth investor, do not differentiate between small, mid or large cap, and prefer to think that macroeconomic trends dictate the countries and industries of investment. This paper had a goal of establishing some of those global trends.

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