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Market Commentary by William W. Priest, CEO

As informed investors, it is impossible to ignore the symptoms of the global economy's failing health reflecting the ongoing deleveraging of the global economy. Especially with the doubling of oil prices in the span of a single year, there is ample evidence that global demand will falter, global growth will be seriously threatened, and a U.S. recession will almost certainly be in the cards. But the point of this paper is not to simply rehash this grim diagnosis. Rather, it is to offer a perspective on both the nature of the illness and its potential cures, all of which can be found both at home and abroad.

The contagion in our midst had been spread and amplified by the reality of global trade. Nearly one third of the world's production of goods and services is now traded, with the U.S. consumer accounting for 72% of domestic GDP and the global consumer accounting for 60% of global GDP. The linking of our international economies via trade, therefore, will mean a worldwide slowdown will manifest itself most severely within the U.S. as the American consumer continues to feel the squeeze from the deleveraging process of a decline in housing prices, tighter lending standards, and the effect of a doubling of energy prices on an already stretched budget. And with Trichet having led Europe into an ill-fated policy of tight money, the outlook is probably worse in Europe than many pundits want to acknowledge. The BRIC countries are fighting inflation internally and the policies of their central banks remain behind the curve, indicating the eventuality of interest rate increases. In China, as an example, wage growth rates are growing seven times faster than export growth rates.

One of the most obvious symptoms of this global economic malaise is the weakness in the U.S. financial sector which is closely linked to the bursting of the housing bubble. Although the fallout of this financial crisis is ongoing, it is now possible to get a clearer view of its potential dimensions, which are specified in the spread between \$500 billion already written off to the \$1.6 trillion estimated by Bridgewater Associates. (Nouriel Roubini, the NYU Professor recently profiled in Barron's has a \$2 trillion number.) If one wanted to hazard a guess at the real-time spread, one could say that it is now between \$900 billion and \$1 trillion (about the same estimate recently made by the IMF): an indication that we are about half way through this storm. The storm will not abate, however, until housing prices hit bottom, which is still a year away. However, there are signposts that can be used to forecast the storm's end: purchase mortgage applications, mortgage rates, home sales, home inventories, and home affordability measures. So long as employment does not decline sharply (which is a big "if"), one can envision better conditions by late 2009.

To observe the beginning of the end of the ailments outlined above, we must start with the dollar. The “trade” of going “long” commodities and “short” the dollar is ending. In this instance, oil is the lynchpin, which should fall below \$100/barrel. The dollar will rally on that basis alone. Global demand destruction has been severe from the combination of the surge in energy prices and the tightening of credit as bank balance sheets have witnessed a contraction of equity. As a result, this “trade” will come under severe pressure in our view.

At the same time, U.S. companies continue to be on sale for investors who can pay in the Canadian Dollar, the Pound, or the Euro. Granted, there are many ways to look at relative currency values; but, from the standpoint of purchasing power parity, the Euro could fall a quarter and the pound even further from their recent highs. This could signal the onset of real overseas interest in U.S. assets. Foreign investors will not start investing in the U.S. until they see the dollar start to rise and their own currencies heading lower.

As for the bond market, foreign investors know that, based on historical precedent, buying U.S. bonds at a yield below inflation makes no sense. Conversely, an investment in equities will ultimately protect the investor from inflation and allow the investor to participate in the benefits of productivity from both capital and labor. In our view, foreign savings will find their way into high-quality global equity companies – many of which are domiciled in the U.S. – either directly (through acquisition) or indirectly (through the capital markets). Our guess is that one will see lots of cross border investing by non U.S. companies, particularly after the election. Hopefully, once the new administration is in place, Congress will be less likely to react to deals with the equivalent response of capital controls, thus tripping the wire for a global depression and a new version of Smoot Hawley. On a positive note, it is a good sign that InBev was permitted to buy Anheuser-Busch. This provided the important signal that capital can move globally. “Buy America” will become a theme.

In many respects, the world economy seems to be in its most trying state since the 1930’s. But it is nowhere near as serious today as it was back then. When Roosevelt took office in 1933, one quarter of working age males were unemployed. Banks, on the brink of failure, were closed in order to enact legislation to protect depositors. Today, we are nowhere near that state of crisis. Other than a few radicals in the Middle East, no sovereign nation has a vested interest in seeing our capitalistic “system” fail. That was not true in the 1930’s, when many “isms” competed for attention, power, and supremacy over the allocation of economic resources.

In conclusion, here are some general points to keep in mind:

1. The world generates about \$7 trillion a year in savings. This sum will get invested one way or another, sooner or later.
2. Globalization, through the application of the Law of Comparative Advantage, has been good for every nation in the broad sense that living standards have risen, capital productivity has risen, and inflation has been less than it otherwise would have been given the growth rate of global GDP over the past 20 years.

3. At present, deflation is a bigger threat than inflation reflecting the consequences of the deleveraging process now going on.
4. Until inflation gets into the wage system, it is not a problem.
5. The global financial system is threatened, but the dimensions of the problem are beginning to be quantified, regulators are starting to regulate, and a glimmer of hope is beginning to emerge.
6. The dollar will appreciate, if for no other reason than other currencies must fall. Trichet will have to relent and loosen interest rates late in 2008, commodity currencies will fall (the A\$ and the C\$) and the U.S. dollar will, therefore, effectively rise.
7. The theme of “Buy America,” both literally and figuratively, may well begin after the election. The present political regime will be over, and regardless of which party wins, there will be a perception of a long-awaited new dawn in U.S. politics.

As a final caveat, it should be noted that there are two potential impediments to the realization of the scenario detailed above: 1) if the real economy proves to be worse than imagined and employment in the U.S. declines abruptly, and/or 2) if Congress places capital controls on cross border deals. But if we manage to sidestep these dangers, the U.S. economy – and, for that matter, the global one – should regain its health and emerge even stronger and more stable than before.