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December 30, 2004

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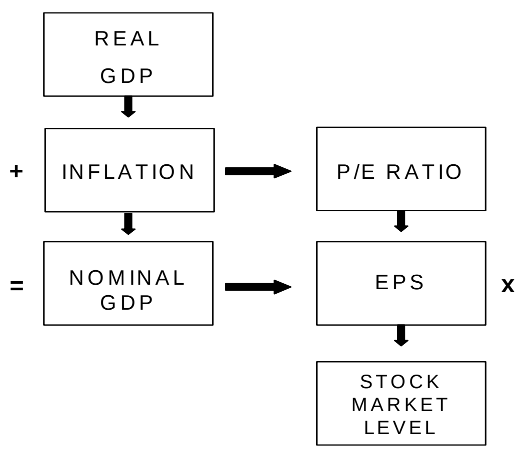
Silver Linings

Our valuation model indicates that the stock markets of the world are valued at current levels but the outlook for real growth in the world's economy is better than most pundits believe. There are a number of "worry points" but when have there ever been none?

Let us start with a valuation model and the reader can place in the boxes his or her views of each variable. The real economy and the financial economy are two sides of the same coin. The values of the capital market are "linked to" and "driven by" the events in the real economy. Below is a model that reflects this linkage. As simple as it is, it is also a very powerful model due to its all inclusive nature[1].

Measurements of:

Real Economy — Financial Economy



[1] For the U.S. real GDP should reach 3.5% with inflation around 3% thereby giving a growth rate for nominal GDP of about 6.5%. Earnings for U.S. companies should mirror that number and a reasonable P/E would be in the area of 18 at a 4% level for long term interest rates. This would give the S&P500 a value of 1260 compared to its year end level of 1212.

The most volatile variable for financial markets is the P/E ratio. Whereas earnings almost always rise, P/E ratios fluctuate, rising in some years and falling in others. P/E ratios are determined largely by interest rates which in turn are driven by inflation expectations.

To illustrate the sensitivity of the P/E variable to interest rates, it has been estimated that a 50 basis point change in long term interest rates translates into roughly a one point change in the S&P's fair value multiple. Put another way, a 6% bond yield would trim about four points from the S&P's forward P/E versus that number in a four percent interest rate environment. With this degree of sensitivity, one can see how a rise in bond yields provides a headwind for equities unless overcome by earnings growth from a robust economy.

The silver lining here is the evidence of the application of the Law of Comparative Advantage. This Law states that every nation should specialize in making what it does well then trade those goods for other goods and services it desires. This idea is at the heart of the steady increase in the world's GNP numbers provided by the International Monetary Fund. The rise of five percent in the world's GNP this year, the fastest growth rate in 20 years, is attributable to this Law at work. Barring the institution of tariffs and import quotas, this phenomenon will continue into the future, benefiting the living standards of all of us.

For perspective, if the world's productivity rises just two percent per annum, that would constitute a doubling of income per capita every 36 years or in about two generations. When one looks at historical productivity tables, such an expectation is not unrealistic and is a large improvement from that of the last century. Should global productivity reach three percent, world living standards in aggregate would double in just over one generation.

The integration of over two billion people from developing countries into the world's economy is a powerful stimulant to this rise in productivity. China is the epicenter of this integration phenomenon. China's population is 1.3 billion of which around 900 million may be assumed to be of working age. If we assume a labor participation rate of 65% and, given that an industrializing economy normally requires 20 percent of its workforce to be employed in manufacturing, this raises the prospect of manufacturing employment in China amounting to 120 million workers – a staggering total when viewed against the 80 million for all the OECD (Organization for Economic Co-operation and Development) countries combined.

China has attracted over $500 billion in foreign direct investment over the past fifteen years. China's exports have grown more than eightfold since 1990 and its share of global exports exceeds seven percent compared to less than four percent in 2000. China accounts for nearly 20 percent of the incremental growth in the world's economy ranking second only to the U.S. Output from China's private sector now approaches 50% of the country's GNP with the output of the SOE's (State Owned Enterprises) shrinking to one third.

There are also constraints on China's growth that include not only global shortages of industrial commodities but also the limits of its own natural and human resources. In the first nine months of 2004, for example, Chinese imports of oil rose one third year after year. In the long run Chinese oil consumption will increase year-in-year-out, but it is very doubtful that China's oil consumption will rise at more than 30% annually for long. At the very best one would expect

Asian consumption, including Chinese oil consumption, to rise by about 8% per annum (which would still call for Asian oil consumption to double from 20 million barrels daily to 40 million barrels daily in less than ten years – note that total global oil production presently averages 80 million barrels per day).

Water contamination is becoming a huge problem. Agricultural land is shrinking in size and the Chinese are eating more meat based products, which as a means of obtaining nutrition from the land is many times less efficient than eating rice, grain, and vegetables.

China's population is both aging and shrinking, and the effects of the one child policy are just beginning to be felt. The biggest problem, however, is that China's boom is not underpinned by consumption, rather the underpinning is an investment boom illustrated by the fact that over 40% of GNP is comprised of investment spending. Growth below 7% per annum leads to rising unemployment and causes corporate profitability to plummet. China needs to create 20 million new jobs per year to absorb the job losses occurring within the state-owned enterprises, which are estimated to equal 8 million per year. We are reaching the point where if China catches a cold, the rest of the world gets pneumonia. China really matters to investors and events within China affect almost all investment decisions.

A de Facto-dollar zone – China and the U.S. as its leaders

Much has been made of the twin deficits of the United States. If it is such a problem, why have countries not abandoned dollar assets and why are our interest rates relatively low? Perhaps the answer lies in a different application of the Law of Comparative Advantage. Through the pegging of currencies to the dollar, perhaps a broader nation concept is unfolding – one not based on geography.

Presently, Asia is sending far more capital to the U.S. than is needed to finance the U.S. trade deficit. Based on net capital inflows in 2003 and 2004, this number is in fact about one third more than necessary. These capital inflows and their corresponding shifts in trade patterns occurring under nearly uniform monetary conditions are the mirror images of resource reallocation or shifting divisions of labor within a single currency system. Hence, one has the emerging perspective of a dollar zone encompassing those countries.

Members of this zone include China, Hong Kong, Taiwan, Malaysia, Singapore, Thailand, South Korea, Japan and, of course the U.S. The combined GDP of this group is $18.5 trillion with a 4½% growth rate. This group's exports account for 45% of the world's exports and 50% of its imports.

The dollar zone's trade deficit with the rest of the world is $325 billion with the U.S. accounting for about $300 billion and the remaining $25 billion attributed to the Asian members of the zone. This deficit is 1.7% of the dollar zone's GDP. If NAFTA (North American Free Trade Agreement) and OPEC (Organization of the Petroleum Exporting Countries) are included in a somewhat looser definition of a dollar zone, then these deficits disappear.

Recall the arguments from the Reagan Administration about the deficit. The idea was that the deficit was not a problem because we owed the money to ourselves. The debt of the Federal government was owned by its citizens and therefore it did not matter to us – sort of like having the left hand pocket of our pants empty of money but the right pocket full[2]. If we extend that concept to the dollar zone members, it leads one to the view that these deficits of ours matter much less than many pundits believe.

If this argument has validity, interest rates will remain lower than people believe, productivity will be better than expected, and so will corporate profits. To make it all work requires a rule of law accepted by all parties. Progress has been made but we still have a long way to go.

<u>Broad Investment Drivers – The 50,000 Feet View</u>

Four events have altered the traditional indicators many investors rely upon to make investment judgments.

1) The enormous productivity in the U.S. economy – Recently at 50-year highs, productivity is just beginning to hit the service sector. (The average annual productivity growth of 4.4% in 2002-2003 is the fastest two-year period in non-farm productivity since data was first compiled in the late 1940's). The "new economy" is thriving.
2) Five billion people are entering the global economy and they all want a better life and a higher living standard. CNN trumpets Western values virtually everywhere and reinforces their desires.
3) The wiring and interconnection of the world through the Internet only happens once and it is happening now at phenomenal speed. Consider this example, the DNA for SARS was discovered almost immediately versus the years it took for AIDS in a pre-Internet world.
4) There is a global contagion of economic wisdom – an understanding by leaders the world over that economic growth is necessary for political survival, and they are instituting policies of lower taxes, less regulation, increased technological innovation, expanded credit availability, improved educational opportunities, institutionalization of property rights, deregulation, luring foreign direct investment and wider distribution of wealth. Put another way, in the short run politics determine economics, but in the long run economics determine politics.

Reflecting these observations, the world is currently in the most synchronized expansion since the late 1980's, with over 60% of global GDP increasing at a faster rate than that of the U.S. World industrial production is rising at 5% year-over-year, nearly double last year's rate. The International Monetary Fund and World Trade Organization have once again increased their forecast for world trade growth to 8.8% and 8%, respectively.

The Economist reports that world GDP growth is tracking at its fastest rate in nearly 30 years. For the first time since at least 1980, all 55 countries that *The Economist* follows are growing. Some 60% of monitored emerging markets are expanding at 6% or more.

Corporate balance sheets may be in the best shape in history and rising corporate profits and cash flows have always closely correlated with capital investment. We believe that the application of

[2] There was a "crowding out" argument at the time dealing with the deficit's impact on interest rates but it could never be proven satisfactorily.

free cash flow into capital investment may be slower in happening this time around but the outlook for dividend increases and share buybacks becomes better than ever in that case.

Investment Themes for the Future

China Plays

One can profit from selling to China and buying from China but not competing with China. All investment possibilities must take this maxim into account.

Energy

Commodities may enter a pause in their multi-year positive outlook in 2005 as growth slows in China and inventories are at high levels. Nevertheless, the outlook for energy is very positive. It has been our argument for the past three years that the world is running out of oil and the marginal buyer, the countries of the developing world, would be radically increasing their per capita consumption levels. For example, the U.S. consumes 22 barrels of oil per capita; for the Chinese, that number is just over 1.5 barrels per person. This gap will narrow with time.

As expressed in a recent article in the quarterly magazine, *The International Economy,* six reasons can be cited for the rapidly changing view regarding the global energy situation.

- First, China and India have emerged on the global energy scene as major buyers just as they have begun to make a mark on the global economic scene. Increased industrial output and a more affluent citizenry in these countries have boosted energy demand, particularly for petroleum, at record rates in both countries.

- Second, the key players in the global energy industry – both OPEC nationals and the large multinational companies – did not anticipate the demand growth that has occurred and they have failed to expand capacity at an adequate rate. Investment slowed or stopped following the price collapse at the end of last century and companies have been reluctant to accelerate programs since, despite four years of prices that would clearly justify a higher rate of expansion.

- Third, political circumstances in a number of key oil exporting countries are precarious. There is widespread concern over internally or externally led political disruptions that could result in a significant loss of oil supply or the supply of some other energy source for a prolonged period.

- Fourth, investment in processing and transportation capacity – particularly refineries – has been neglected in the United States and Europe. Decisions by competition regulators on both sides of the Atlantic have caused key assets to be transferred from large multinational corporations to smaller firms that lack the financial resources to expand rapidly.

- Fifth, environmental regulations adopted in the United States and Europe has reduced capacity to manufacture key transportation fuels such as gasoline, diesel fuel, and jet fuel.

Limited supplies of these products have led to large product price increases, which have pulled up crude prices.

- Sixth, consumers have been led to believe that the price increases experienced over the last few years are due not to the natural forces of supply and demand but rather to the actions of the energy industry. This mistaken belief has discouraged conservation, particularly in the automobile sector, and created the foundation for a very large price increase to come.

China and India have emerged as the principal players on the global energy scene. In 1990, consumption in these two countries amounted to no more than 3.5 million barrels per day, approximately 5 percent of global petroleum use. In 2003, thirteen years later, use in the two countries had more than doubled and now accounts for more than 10 percent of global oil consumption.

The impact of the two countries on world markets is illustrated in Table 1. The top row of this table shows total use by these two countries in 1990 and 2003, as well as the annual rate of growth, which is 7 percent. The second row shows total global use, which grew at the far more sedate rate of 1.3 percent per year. Row three of Table 1 shows the growth rate for global consumption excluding India and China. As noted within the Table, global consumption without India and China increased at a rate of only 0.8 percent per year.

Table 1

Sources of growth in world oil consumption, 1990 to 2003
(thousand barrels per day)

	1990	2003	Annual Growth Rate (%)
China and India	3,595	8,679	7.0
Total World	66,227	78,112	1.3
World less China and India	62,632	69,433	0.8

Source: BP Statistical Review of World Energy Markets, 2004.

Dollar Devaluation Beneficiaries

Dollar devaluation is likely to continue perhaps by another 20%. Only then can an industrial renaissance begin in the U.S. which will be modest in our view given the erosion of manufacturing capacity that has already occurred. When currencies change, financial power shifts to countries whose stockholders' equity is dominated in the strengthening currencies. In takeover terms, these countries cease being the hunted and become the hunters. Foreign based manufacturers may well become the acquirers in the reindustrialization of America once the dollar has fallen an appropriate amount.

Healthcare System Beneficiaries

The U.S. has a unique health care system for active workers and retirees and its costs are priced into the selling costs for U.S. goods and services. Whereas most competing nations have these costs borne by the government and hence, the tax system, in the U.S. healthcare system it is the private industry that bears much of the healthcare costs. Short of taking over the private system, tremendous pressure exists to get these costs down so U.S. firms can compete more effectively in the world at large. Companies that facilitate that end will be attractive investments.

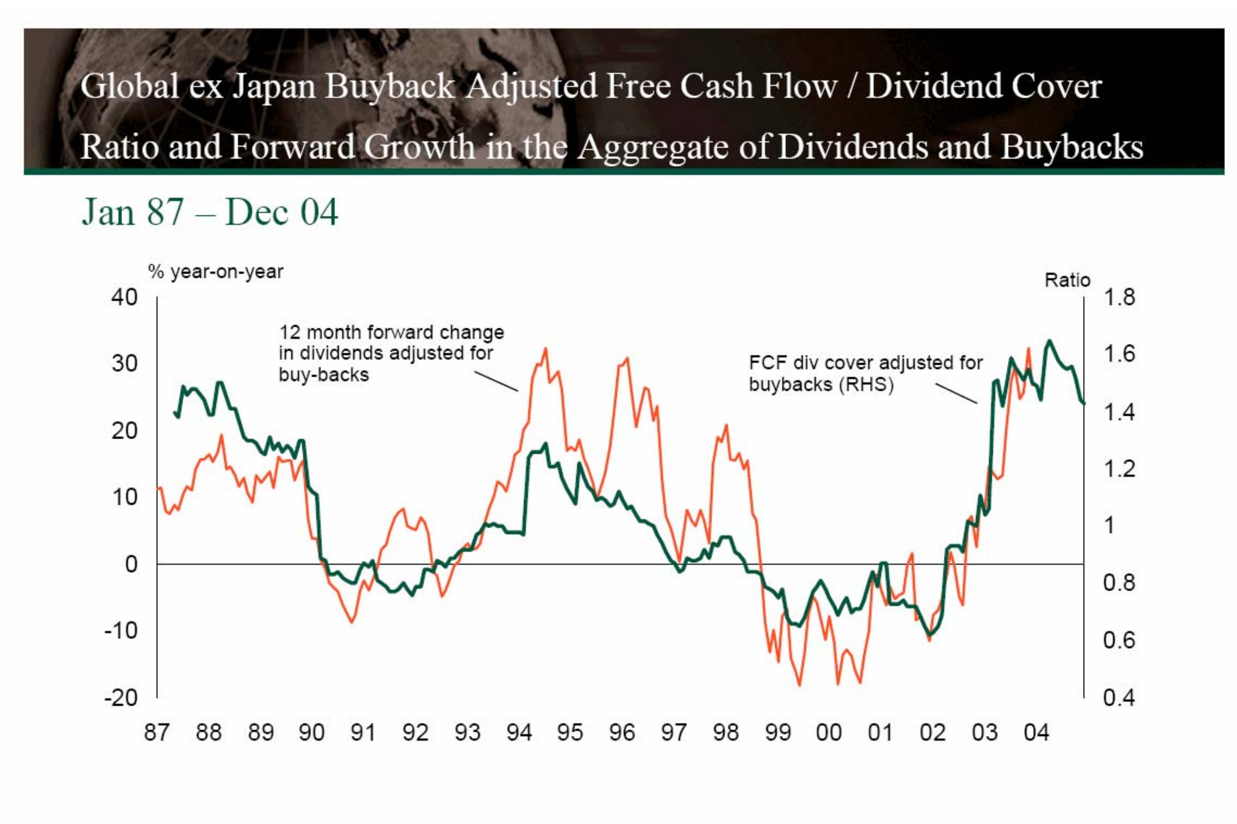
Tort Reform Beneficiaries

It has been estimated by Towers-Perrin that the tort system costs the U.S. in excess of 2.3% of our GNP; i.e. over $230 billion. This is a huge unproductive tax placed on our economic system hindering our manufacturing companies competing with those of other countries. The size of the wealth transfer to tort lawyers exceeds the GNP of scores of countries in the world. If Bush does nothing else, ridding our system of these expenses will be a huge national plus.

Dividend Payers

The prospects for dividend and share buyback growth in 2005 are the best since the start of the mid-1990's bull market. With plentiful free cash flow, and a generous free cash flow to dividend cover ratio, forward dividend growth could be quite large.

Figure 1

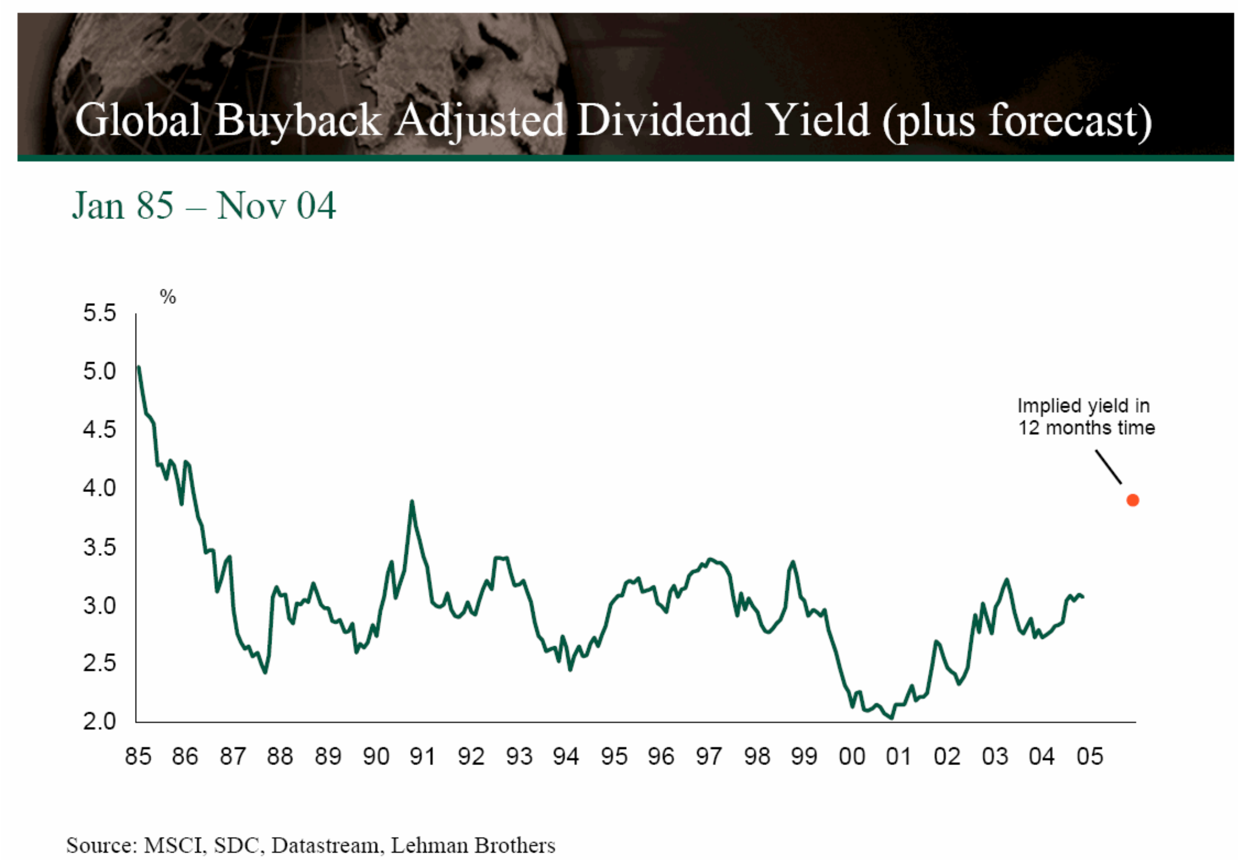


Source: Worldscope, Datastream,, IFR Securities, Bondware, Lehman Brothers

Figure 1 shows the ratio of free cash flow divided by dividends plus buybacks (currently 1.4x) and then the forward 12-month growth rate, again for the combination of dividends and buybacks. According to Lehman Brothers, the currently high cover ratio implies future growth continuing at around 25% or, put another way, $900 billion of dividends and buybacks in 2005 are a possibility.

In yield terms, Lehman Brothers estimates the market is currently trading on (trailing) buyback adjusted dividend yield of 3.1% (Figure 2). If we then factor in 25% growth in the combination of dividends and buybacks, on unchanged stock prices, the yield would rise to 3.9% in 12 months' time. According to Lehman, that would send the yield to its best levels since the mid-1980's.

Figure 2



Summary

We expect the real economy to do well around the world provided China does not catch a cold. Compared to the 1990's, during this decade faster global growth should occur. This increase is enhanced by the reflation process, freer trade, globalization, increasingly flexible economies, and a surge in developing country growth and investment. The U.S. economy will probably pass through a period of moderate inflation and slower growth over the near term. We think core consumer price inflation, now 2%, may rise above 3% year-over-year in 2005 or 2006, while the U.S. GDP growth rate may slow somewhat later in 2005.

This business cycle is substantially different from previous ones because the recent recession was deflation-related rather than inflation-related. The result has been steadier growth in consumption, but a longer-than-usual delay in business spending on equipment, inventory and new hires. If and when an improvement in corporate confidence spreads into inventory or hiring decisions, it will have particularly positive GDP implications.

The biggest risks to our expectations are unanticipated events in China, dollar weakness, and the situation in Iraq. Dollar weakness causes higher inflation and furthers uncertainty about interest rates. Worse, it could cause an outflow of capital from the U.S., reducing investment and forcing a spike in interest rates. Moreover, the Fed has put investors on notice that it intends to keep raising rates at the short end of the curve. Rising bond yields has been consistent with our investment strategy for some time as we believe we have entered a period where rates have begun a long but irregular rise. Our hope is that this occurs at a moderate and relatively benign pace.

Iraq is a quagmire and an expensive one. We cannot leave and no exit strategy seems plausible at the moment. It is a drain on the nation's Treasury and, eventually its morale, unless a solution manifests itself.

The financial economy, as reflected in the value of the capital markets, should experience a bit of a headwind from rising interest rates, which in turn place downward pressure on P/E ratios. Offsetting this factor will be solid earnings gains, above average increases in dividends, and share buybacks.

The dark clouds in the distance are China, the U.S. dollar, and Iraq. Still, silver linings seem to be abundant and there are plenty of investment themes to capture.

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