

## **ECONOMIC AND INVESTMENT OUTLOOK**

### **APRIL 2008**

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As everyone knows from the evening news, the U.S. economy is wrestling with some of the largest challenges that it has experienced in a long time. The 'perfect storm' created by excesses in the credit markets (a combination of excessive borrowing and sloppy, irresponsible lending) and euphoric home buying by consumers has strained parts of the economy to a degree not seen in decades. Inevitably, the trauma associated with these problems has produced sharp sell-offs in the U.S. equity markets; but, to the surprise of many, it has produced comparable or worse declines in many of the world's other important equity markets. The crisis has also pushed the dollar down and many commodities sharply higher. It's our opinion that some of these asset price moves are substantially overdone, creating both new risks and, equally important, compelling new opportunities. In this discussion we will attempt to explain, as concisely as possible, what has happened and how it bears on helping you to achieve your investment goals.

### **THE EVOLUTION OF A PROBLEM**

The unraveling of U.S. credit markets began in earnest last fall. Much of what has transpired in housing and money center bank problems since then has been amply covered in the media, so some brevity here is appropriate. But, for those readers who would like a quick recap, here's what happened:

The twenty-two year bull market in bonds (lower interest rates) created the opportunity for the American public to finance ever larger mortgages which were used to buy bigger houses, additional houses, or more consumer goods. This was spending that was overlaid on top of what most consumers could otherwise afford with their wages. One of the results was that the U.S. economy expanded faster than if consumers had only spent their available incomes. Another effect was the inflation in home prices that evolved because of the ease with which consumers could borrow ever larger amounts, while keeping their monthly payments the same. Yet another was that demand for big ticket consumer goods grew faster than what one would expect based on their income growth. Unfortunately, all of these trends were being supported by excessively escalating (and unsupportable) borrowing. It was inevitable that these trends had to end—and they have, more and more painfully over the last couple of years.

The U.S. economy has remarkable strengths. So much so, that if the aforementioned excesses were the only ones, the U.S. wouldn't be in its current fix. Unfortunately, there were other excesses concentrated in that bastion of American capitalism, the big money center and investment banks. A combination of greed, poor supervision and occasionally poor ethics fostered the environment for the creation of a toxic combination of actions that spawned all of the new, highly theoretical financial instruments; the very same financial instruments that are now unraveling and causing the crisis for all of the threatened financial institutions. The creation of these instruments and the subsequent unraveling are inextricably tied to the housing market boom and bust.

### **THE REPAIR JOB**

Much work has already been done to patch up the problems and initial steps are also underway to create more permanent fundamental solutions. But, these steps will take time and those players who have exploited the weaknesses in the system will resist changes that threaten their 'golden



goose.’ Nonetheless, we remain confident that the problems will get fixed through a combination of public and private actions.

The immediate essential requirement of the current repair job is to preserve the liquidity of the banking system. And the essential ingredient to preserving that liquidity is unconditional confidence in our financial institutions. The Federal Reserve and U.S. Treasury, working in tandem, have acted very decisively in recent weeks to feed extra liquidity to the institutions that were most at risk. It’s our belief that they have been successful. Each week that passes without further crises increases the likelihood that the authorities have been successful.

The second phase of the financial system repair job will take decidedly longer. It will involve the Treasury, Fed, Congress and the new President. Free market capitalism has an inherent tendency to over-run its regulatory constraints and from time-to-time regulation has to catch up. This is one of those times. Regulatory restraint will evolve. It always has, but it will take time. The self-interested will resist as they always do, but we’ve always managed to come up with a reasonable set of solutions. This is unlikely to be any different. Timing, on the other hand, is impossible to predict.

One final thought about the ‘repair job,’ though, that is important to understand. The repairs that we’ve been talking about are to the financial system. Some of the changes to the economy that must evolve are more fundamental and they will take more time — years, but they will likely evolve as needed also. These changes are the next topic for discussion.

## **THE ECONOMY’S SECULAR CHALLENGE**

In past commentaries we have described the previous problem as a mechanical one; more than just a distraction, but not acutely tied to the fundamental long term issues of the economy (provided that the mechanical challenges are resolved in reasonable fashion). Everything that has evolved since last quarter continues to support that argument. The larger challenge facing the U.S. will be how it restarts growth with an economy that has become far too dependent on debt to grow.

The U.S. economy has been extraordinarily dependent on consumer spending since the last consumer recession in the early 1990’s. By 2006, it drove our trade deficit to unheard of post World War II levels as a percentage of GDP; and it has left the U.S. with a consumer, who is on average, more in debt than at any time since WWII. It is impossible to build an economy around constantly escalating amounts of debt. Ultimately, not even the U.S. has sufficient wealth to indiscriminately spend without saving somewhere in the economy. Fortunately, American companies have been good savers in recent years with the result that the non-financial portion of Corporate America’s balance sheet is generally in quite good shape. This will be one of the keys critical to future growth.

Rebuilding the consumer balance sheet, on the other hand, is a much bigger task. Most American wage earners have seen little or no real (inflation adjusted) wage increases in a half dozen years. They have supplemented their spending by indulging in the borrowing binge that was mentioned earlier. The problem is that when consumers adjust their spending at the end of a borrowing binge, their spending must be reduced to less than their income as they pay down some of their accumulated debt and rebuild their balance sheets. This would put a considerable drag on the

economy all by itself, even without the potential decline in one of their most important assets, their homes.

So, housing values become the crux of the problem. Further declines in home prices would undermine the collateral that has supported their borrowing. Too great a decline and some homeowners would have the incentive to walk away from their mortgage loans. The challenge, therefore, for the various federal agencies is to take the necessary steps to mitigate the risk of an escalating rate of decline in housing prices. Some of these steps have already been initiated. Federal agencies like Fannie Mae and Freddie Mac have already been given expanded loan authority and the Federal Reserve has pushed interest rates lower to enhance the buying power of prospective home owners. It's essential that federal actions continue to escalate efforts to get ahead of the home value problem in order for the economy to recover. At present, home prices are still eroding, but we believe efforts by various federal agencies and Congress will be successful in stabilizing prices.

### **SIZING UP U.S. ECONOMIC POTENTIAL**

As we have mentioned in previous letters, approximately 70% of the U.S. economy has been driven by the American consumer. Dependence on an impaired portion of the economy, that is this large, raises serious questions about what it will take to move the economy forward. The addition of all that debt by consumers is variously estimated to have added as much as 1.5% to annual GDP growth in recent years. Without this added leverage, the economy must depend on growth from either corporate or government spending.

Government spending appears to be an unlikely solution. Current estimates for the federal deficit in the fiscal year ending this coming September 30 are approaching \$400 billion or almost 3% of GDP. At this level it is not practical to advocate still bigger deficits if one is in Congress. On the other hand, with this being a Presidential election year, lots of promises will be made that could push subsequent federal deficits higher. Weakness in the job markets will exacerbate the deficit by reducing tax collections further. State budgets are also deteriorating as sales tax collections and taxes on home sales decline.

So, if the consumer is no help and federal and state governments aren't really in a position to help, either, where does the U.S. economy get its stimulus from? Two sources of demand will be important – foreign demand and capital spending by domestic and foreign companies alike. Increased foreign demand is likely to be incrementally the greatest net contributor to our economy.

Over the last year or so, the dollar's decline has been substantial against the other currencies of the developed world (particularly Japan and the European Union) making many of our industries much more competitive. As of March 31<sup>st</sup>, the declines for the dollar from its high of the last 12 months have been almost 20% compared to the Japanese yen and Euro, and in the low teens compared to the Canadian and Australian dollars. Declines of these magnitudes make many American manufacturers and farmers much more competitive and allow them the luxury of seeking either larger volumes or better profit margins. This will then lead to the second positive trend; these manufacturers and farmers will be bigger buyers of new capital goods as a result of their improved prosperity. Farm prices have already escalated sharply, but an even more remarkable demonstration of this phenomenon was the recent Wall Street Journal article discussing how the Big Three U.S. auto makers expect to substantially increase their exports.



There is one other aspect of current trends in the U.S. economy and foreign trade that is very positive for the future. It's the favorable effect on the U.S. trade deficit that will result from the 'financially burned-out' consumer and the dollar's decline. Consumers will likely spend much less on many of the consumer products which they have purchased during their debt binge. Most of these products (electronics, autos, bicycles, cameras, etc.) are manufactured outside of the United States. Reduced demand will therefore lead to an improvement in the U.S. trade deficit and hopefully stabilize the exchange value of the dollar. Unfortunately, this beneficial trend will be somewhat offset by the large amount of crude oil and related energy products that we are importing at considerably higher prices. But, we believe that the improvement will be considerable nonetheless. Estimates of the impact of excessive consumer borrowing and the consequent spending were that this behavior added as much as 1.5 % to GDP annually. That's about \$200 billion in extra impetus. If the trade deficit declines by as much as \$200 billion by the end of next year as some economists suggest, it's possible to visualize a direct offset.

### **TALLYING THE SUM OF THE PARTS**

How does this all add up? We see it like this:

1. The financial crisis which was building has been averted thanks to decisive action by the Federal authorities. Money center banks and brokers have already begun to de-leverage their balance sheets through a combination of capital raising and asset sales.
2. The next stage of solving the economic problems will take longer (years rather than months). Housing prices will be the key to how severe the economy suffers in the next couple of years. House prices need to stabilize near current levels to avert further difficulties. Federal authorities must continue to be proactive to accomplish this.
3. The economy will struggle to find broad positive momentum for several years, but very importantly, there are whole segments of the U.S. economy that will do very well thanks to the decline of the dollar and their improved competitive position.
4. Short term interest rates, which have declined due to Fed intervention, may go still lower in the near term as the Fed continues its encouragement. Longer term rates seem unlikely to go much lower as world demand keeps pressure on commodities and as de-leveraging of the U.S. financial system widens the quality spreads for poorer quality borrowers.
5. World economic growth will slow; partly as a result of the pronounced slowdown by the American consumer and partly as a result of efforts by China and some other emerging countries to restrain inflationary tendencies in their own countries.
6. Inflation is not likely to be a significant concern. The 'financialization' of commodities as a result of hedge funds, pension funds, foreign central banks and an increasing number of individuals investing in commodities has temporarily

changed natural supply/demand patterns for raw materials. But, except for the types of supply disruptions caused by weather or political shocks, most commodities will experience improving supply and better balance as 2008 progresses.

7. The rout of the U.S. dollar will pass. The dollar is experiencing an inevitable secular decline as the world diversifies away from it, initially as the world's only reserve currency and more recently as their primary currency. This has been destined to happen for years. The rate with which it would happen was going to be a function of how well the U.S. ran its international financial affairs. We haven't done a particularly good job of this, so foreigners are diversifying faster. Big trade deficits and excessive borrowing from the rest of the world to fund our consumption have been the problems.
8. Future U.S. economic growth and investor success will be highly correlated with the ability of the country and individual American companies to capitalize on the needs of a faster growing world population outside of the U.S.

## **INVESTMENT IMPLICATIONS**

With all of the economic moving parts, it's easy for investors to lose their sense of direction. So, here are some closing thoughts on the core assumptions that should guide investors in the foreseeable future:

1. The trend in interest rates or the cost of capital generally dictates the framework around which the outlook for other asset classes is built. So taking it first, our expectations are that interest rates, except for the very short end, will not decline much from here. The Federal Reserve will probably push the fed funds rate lower in the next several months, but longer rates will not come down easily.

Two countervailing forces will push against that possibility. One is the inflationary trend in commodities and a number of emerging market economies. The other is the tightening trend in banks and other lenders as a result of their shrinking balance sheets. This will continue to make them more reluctant lenders who demand higher quality standards and wider credit spreads.

As a result of these factors we would expect longer rates to have an upward bias for everything but treasuries in the near term and probably treasury rates, as well, as the economy stabilizes. The weakening economy will also put upward pressure on credit spreads as credit quality concerns grow. Junk bond spreads have already widened dramatically in the last nine months and medium grade credits have widened as well.

2. When it comes to commodities we think several observations are timely. First, the commodity boom has already had a good run. The last commodity boom in the seventies was predicated, among other things, on predictions of a permanent and inevitable shortage of all sorts of commodities. The commodity

trading boom predicated on this assumption ultimately came to a painful end as supplies caught up with demand. This will almost certainly happen again.

Second, the earlier mentioned financialization (the accumulation and trading of commodities for profit) probably has more to room to run. But the 'old' core reality remains. Higher prices drive conservation and ultimately lower consumption. Higher prices also drive new production from previously marginal suppliers. Both trends *always* converge. Each commodity is unique in the time frame necessary to adjust, but adjust they do.

Commodities may remain a good asset class for talented traders but universal commodity inflation is not likely around the corner. Equity asset classes still have a future.

3. Finally, when it comes to equities we think that the future prospects are better than the gloom would suggest. Companies, large and small, that are positioned to serve a growing world will benefit. Those classically high profit multinationals that can exploit their global footprint will continue to grow, even if it's a little slower. But it's also important not to overlook small companies that are similarly positioned. The U.S. equity markets are full of small companies that have taken steps just like the multinationals to capture their share of global growth. Those who have missed earnings expectations in the last year have seen their stocks crushed by the combined effects of typical bear market anxieties and the unrelenting short selling of their shares as a result of the elimination of the old 'uptick rule' that the SEC phased out a couple of years ago. Many of these stocks are extraordinary values. The 'busted' small value sector presents the best risk/reward opportunity in years.

## FINAL THOUGHTS

This has turned out to be a much longer treatise on the vagaries of the investment realm than our readers are customarily obliged to experience, but these truly are unusual times. Our hope is that in offering more detail, clients will come to understand that investing is not now, nor never will be, a singularly monolithic process. There are risks in this environment, but there are also, presently, exceptional opportunities. With many of these opportunities the prices already amply discount the broader economic risks. We like the risk reward trade-off. Your asset class specific letters follow.

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