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INVESTMENT POLICY MEMO

Hurricanes Katrina and Rita have devastated lives, homes, a whole city, and significant portions of the American oil economy and transportation network. Still, as has been true of almost all previous natural disasters, the overall impact on the nation's current and future economic well-being is likely to be very small. As is also true of many previous disasters, the impact on people's perceptions has been profound. For the time being, at least, hurricane winds have blown the cover off many previously unchallenged myths and unseen realities.

Now there is room to say that the increased severity and frequency of hurricanes is tied to global warming to which the United States is a major, stubborn contributor. Suddenly it became apparent to a vast television audience that the Department of Homeland Security, patched together to serve a political agenda and staffed with wealthy ideologues and campaign supporters, had not kept us even as safe as we had been before it was created. The same audience could also see – some for the first time – how blatantly the Bush administration substituted lies and video illusions for the truth. Not in 35 years have so many been made so sharply aware of the huge disparities in this country between rich and poor, white and people of color, especially in the most important outcomes affecting life and death.

As the President's poll ratings dropped, his credibility decreased on many issues less obviously connected to the hurricanes and their aftermath. Sentiment had been turning against the wars in Iraq and Afghanistan slowly as casualties mounted and turmoil persisted in both countries. Cindy Sheehan's efforts along with Military Families Speak Out and fledgling groups of recent veterans had already accelerated the shift of opinion against these wars. Katrina yielded another hard shove and it is now the case that most Americans think the wars are wrong and should be stopped with some urgency. Of course in Congress only a handful of Democrats and Republicans are willing to say what a majority of their constituents believe. These are wars to establish permanent military bases and control of oil along the whole southern border of Russia. So arguments to end the wars because they were based on lies or have produced many new terrorists while capturing few, or even because they are machines of continuing death and destruction and a very direct drain on the strength and resources of the United States, all fall on deaf ears in the highest echelons of Washington or corporate America.

Remarkably, a large block of fiscally conservative Republicans, previously believed to be an extinct species, reappeared in the post-Katrina world to halt the extension of tax cuts on dividends and capital gains and the elimination of the estate tax. Meanwhile the President's gang of thieves went merrily along stealing from everyone else to benefit the super rich in ways that do not require help from a Congress unexpectedly lapsed from its larcenous ways. Federal spending on reconstruction of New Orleans and the Gulf Coast will cost as much over the next few years as the war on Iraq has cost so far.

The first \$60 billion installment has already been authorized and much of it already awarded by the Bush team under the now familiar no-bid contracts to the same list of now familiar Iraq contractors plus a handful of much smaller and even more disreputable Texas firms which presumably have ties to the likes of Bush, DeLay and Cheney. Also, by executive order, this money will be spent without regard for the long-standing, prevailing wage standard that the Congress has insisted on keeping even in recent years. As for the mostly black and poor residents of the flooded lowlands of New Orleans, the President's mother has already cheerfully announced that they were better off in the Houston Astrodome than they had been in their former homes, while a prominent Republican Congressman from Louisiana allowed himself to be overheard saying that Katrina had fixed the problem of public housing in New Orleans that he and his colleagues had been unable to fix for many decades. Apparently it has already been decided in high places that the flooded homes and neighborhoods of poor people will not be rebuilt.

Since the hurricanes, it is now also generally accepted that the world's proven reserves of conventional petroleum have probably peaked and that a peak in petroleum production will not be far behind. Alternatives, such as oil from shale and tar sands, liquefied natural gas, liquefied coal and ethanol are all more expensive than today's price of petroleum and are all extremely inefficient in the sense that they require almost as much energy to produce as they provide when used. All this is not to say that the price of oil and natural gas may not drop precipitously at some point because of unseasonal weather or a global economic decline. However, we remain convinced that the scarcities that are driving prices higher will persist indefinitely into the future. So despite any temporary fluctuations, the secular trend in oil and natural gas prices is inevitably up.

The rising prices of petroleum and petroleum products might themselves be the cause of a recession that could temporarily push energy prices back down. We concur with recent Wall Street analyses that the prices likely to produce such an effect would be at or above \$100 a barrel of oil compared to today's \$65, or \$4 to \$5 a gallon of gasoline compared to the present \$2.75.

Meanwhile recent evidence shows the American economy growing less rapidly, a slowdown of profit growth and rising inflation. The Federal Reserve Bank's uninterrupted string of increases in short-term interest rates is particularly focused on rising inflation. Driven primarily, but not entirely, by energy prices U.S. inflation has continued to accelerate during 2005 along with expected future inflation revealed in surveys. Slowing economic growth and decreasing productivity growth suggest that companies will increasingly cover their rising costs by increasing the prices they charge their customers, thus further increasing inflation. If they are unable to do this, the incredible string of profit increases in recent years will end with poor consequences for the stock market.

The list of obstacles confronting the economy and the stock market is formidable: rising inflation, slowing growth of profits, rising interest rates, a rising government deficit and a rising overseas deficit tied to America's collective failure to save any part of its income despite our being the largest and one of the wealthiest economies in the world. It is inescapable that rising short-term interest rates will eventually produce rising long-term rates and rising mortgage rates.

Many have argued that the Chinese and Japanese central banks are committed to reinvesting their international surpluses in the U.S. government bond market and that this has kept U.S. interest rates low. However, when risk-free, short-term U.S. Treasury bills start to yield more than longer-term U.S. Treasury bonds there is no imaginable reason why foreign central banks would not start to buy Treasury bills, with little interest rate risk and higher yields than Treasury bonds. In that case, the yield on Treasury bonds would move up to be more competitive with short-term rates. This is exactly what the Fed is seeking to accomplish. This in turn will bring higher mortgage rates, which will probably bring a halt to the giddy rise in house prices that has fueled an overwhelming portion of recent economic growth. Our list of threats to financial markets is still not complete without mentioning the ever-present prospect of a severe decline in the dollar.

Our conclusions from all of this are as follows. The stock market is very generously priced for this dangerous environment. For the most part it is better to be in cash than in stocks or bonds. However there are two exceptions. Companies that will benefit from the scarcity of hydrocarbons and energy infrastructure are well worth owning for the indefinite future. Also companies that have a good chance of growing their earnings even as economic growth and profit growth decelerate or disappear, are also well worth owning. Most of the companies we have identified that satisfy this last criterion are in the health care sector; a few are producers of consumer staples.

We continue to concentrate portfolios that we manage in healthcare, energy and cash or cash equivalents. This approach has produced consistently good results over the past two years, and particularly in the last three months. We see no reason to change it. In fact we have sold additional holdings in other areas to add to these three primary components of client portfolios.