April 16, 2007

INVESTMENT POLICY MEMO

As we write this, the U.S. stock market is setting a new, post-911 high, and markets in the rest of the world have mostly done the same in the past couple of weeks. In our view the U.S. market is now quite fully priced and will probably provide disappointing returns to investors over the next year or so. The stock market could keep going right to the moon. But we believe it has now encountered a menacing meteor shower: rising interest rates in much of the world, rising food prices driven by the growth of emerging economies and of ethanol production, an unexpectedly serious assault by the Democratic Congress on the White House and its policies, a dramatic slowdown in U.S. profit growth, a halt, for more than half a year, in the growth of business spending on new equipment, buildings and software, declines in business and consumer confidence and a wave of defaults on recent mortgage loans to low-income home buyers.

The slowdown in profits and capital spending along with the belated tightening of mortgage lending standards at just the wrong time, all suggest that a severe drop in the U.S. rate of growth or an outright recession have become more probable. The most likely outcomes remain a continuation of moderate growth around 2% or a resumption of slightly more rapid growth at or over 3%. Nevertheless, consistent with our primary focus on avoiding losses even at the expense of reduced gains in good markets, we have decreased equity holdings in our accounts. We have also reinvested some of the proceeds in bonds rather than money markets, since bonds might be the only asset that actually does well in a recession.

A recession is not the only risk or catastrophe that looks more possible. The U.S. is now moving a third aircraft carrier and battle group into the Persian Gulf close to Iran. Wildly implausible and unproven charges about Iran's role in Iraq continue to pour out of the White House and the Pentagon. The U.S. also is engaged in the same song and dance with the U.N. as preceded the invasion of Iraq. Perhaps no other government in the world has proved so eager to use force without regard to international law or public opinion as America under George Bush. So we take quite seriously the small possibility of a U.S. air assault and covert land attack on Iran. The ultimate effects of such an attack are unpredictable but almost certainly extremely bad.

In the immediate aftermath, we would confront ominous political, military and economic uncertainty. The global proliferation of nuclear arms would receive yet another boost from America. Energy supplies would be severely disrupted and prices would soar. Other Middle Eastern and Muslim states would perhaps be threatened with overthrow. At a minimum, Iraq and Afghanistan would go from their present horrific circumstances to something even worse. In the rest of the world economic growth would be interrupted, especially in newly emerging countries like India, China, Brazil and Indonesia, where the consequences might be sharp changes in political direction or economic policies. In sum, the sequel to a U.S. attack on Iran, or any other military or terrorist attack on an oil producing country, is likely to be very bad for the United States and far worse for the rest of the world -- bad for everyone, with the possible exception of Osama Bin Laden.

Suite 1000, 84 State Street, Boston, MA 02109
Phone: (617) 742-6666 fax: (617) 742-6660 email: robert@rbza.org

An economic recession, on the other hand, is likely to start in the United States and would have unusually small consequences for the rest of the world, particularly Europe and to a lesser extent, Japan. Most countries in Europe, along with Japan and Australia, have already finished their real estate price corrections. While economic growth has been declining in the U.S. for the last three or four years, it has been increasing in Europe and Japan, and holding to a very high level in the largest emerging economies. At the same time, Europe and Japan have had more success than the U.S. with exports to the emerging economies of both investment goods and consumer goods responding to the rapidly expanding incomes of households. A U.S. recession would be cushioned by the fall in our demand for goods imported from China and other emerging countries. However, Europe and Japan would likely have an even bigger offset to the decline in their exports to the U.S. through the growth of exports to these faster growing countries. On balance, we find European and Japanese stocks more reasonably priced than the American market.

Meanwhile back home the signs of distress and excess continue to multiply. Consistent with what we have seen of the huge effects of top-income bonuses on the average wage of the entire labor force, a recent study tells us that in 2005 the top 1% of all income earners, received over one-fifth of all the income and the top 10% received nearly one-half of all income. These are the highest percentages of income at the top since, well, 1928. And all of the evidence suggests that the percentages have continued to increase rapidly in 2006 and 2007. While reported personal income has been growing at a moderate pace, these figures, based on tax return data, make clear that the vast majority of Americans have had slightly declining inflation-adjusted incomes in the past six years, and basically since 1973, while incomes at the very top of the pyramid have grown rapidly. These income figures understate the size of the shift to the super rich from everybody else. The percentage of people with no health care insurance has been rising along with the costs borne by those who do have coverage. Similarly, retirement benefits have been severely cut or eliminated for well over ten million people. The public transportation, safety and education available to most Americans have declined substantially and persistently. And taxes for the rich have been cut, while taxes for everybody else, including Social Security and Medicare, have been rising.

Of course, if these inequities could be sustained and increased without limit and the destruction in Iraq could be pursued until there was no real opposition left to an American military presence and control of the oil, these results in our peculiar world might be positive for the stock market. History and recent shifts in the wind suggest that this unconditional victory for plutocratic imperialism will not occur. While we are not predicting Armageddon, a day of some sort of reckoning appears to be close by. So, at the risk of being too conservative yet again, we are moving to protect our clients against a growing chance of bad outcomes.

In addition to increasing cash and bonds, we have reallocated equity investments away from America and developing economies toward Europe and Japan. Developing economies retain the highest probable growth for the foreseeable future, but their stock markets will do quite poorly in either a U.S. recession or a forceful disruption of the flow of oil from the Persian Gulf. To the extent possible we have also increased the portion of equity holdings in client accounts that is invested in consumer staples, information technology and other producers of investment goods for markets that are still growing. We retain sizeable holdings of alternative and conventional energy stocks because of their superior long-term prospects as the world runs out of inexpensive oil and their prospective strong gains in the event of a Middle Eastern war or terrorist attack, which would be a poor environment for almost all other investments.

If you have succeeded, dear reader, in convincing yourself that the world was in a happy state we apologize for dwelling so long on its dark underside. We would rather tell the truth than huckster comforting illusions as Senator John McCain has recently attempted. On a recent visit to Iraq with another pro-war Senator and two pro-war Representatives, he famously declared after "visiting" a market in Baghdad that he had chatted and bargained with some rug vendors in a completely normal and safe way, thus verifying the success of the American surge to pacify Baghdad. But the New York Times reported that one hundred U.S. troops accompanied the Congressional delegation to the market, that attack helicopters circled overhead, sharpshooters manned every rooftop and additional troops directed all would be visitors away from the market. And of course McCain and the rest of his delegation were wearing bulletproof vests for their ordinary visit to an ordinary market, which is standard operating procedure for all Washingtonians visiting Iraq.

We live in a sorry time of brazen deceit and escalating violence.