June 2009: Identifying the Tides

As we've often said in our past newsletters, the vast majority of investors regard investments the same way they view a body of water: they look at the surface and just see the ripples. A few will see the waves, but those who identify the moving tides will prosper mightily.

At present, the big tide is the decline in dominance of the American economy and the rise of the rest of the world. While it won't happen overnight, this shift will have a profound impact on the relative returns of investment portfolios going forward.

This is not to say that the United States isn't still the most advanced economy with a tremendous amount of global influence, or that its people aren't the most innovative and productive. It's simply to say that the United States' *share* of global GDP is on the wane.

Why this is important

The U.S. economy is experiencing a significant deleveraging after years of excessive borrowing and the misuse of cheap credit. Due to prior excesses, aspects of free market capitalism are currently being challenged (see April Market Commentary). The U.S. government is now heavily involved in numerous key industries and increased regulation is likely coming.

To combat the financial crisis, the U.S. government and Federal Reserve have implemented a policy response of near zero interest rates to lower the cost of credit once again. In our view, this time the policy will lead to inflation because the disinflationary factors that existed leading up to the year 2000 – low geopolitical tension, technology and productivity advancements, explosive global labor force growth, and low money supply – are no longer present.

Because of the widespread damage to personal and corporate balance sheets, an aging population and pervasive risk aversion, Americans will be loath to speculate once again in an oversupplied residential housing market or in a stock market that has proven itself treacherous. This time around – because of the financial health and economic growth within developing countries – we expect cheap credit and a skyrocketing money supply to translate into price increases of scarce commodities due to the lack of investment in their development, increased global demand, and a general migration of capital to investments that hold their value in real terms.

Animal spirits of capitalism are thriving elsewhere

Despite what's happening in the U.S., China's and India's economies are performing just fine (for example, India just reported first quarter GDP growth of 5.8% and they elected a pro-industry economist as Prime Minister). They are not likely to go into recession, despite exports to the U.S. having declined. China and India will continue to devote their massive reserves and trade surpluses to healthcare, education and infrastructure – the building blocks of future economic activity, productivity growth and consumerism.

Our concern: A weaker U.S. dollar

The paradigm shift we are outlining will result in the future weakness in the purchasing power of the dollar. The dollar has no choice but to decline in real value. Starting with the abysmal condition of the fiscal situation in the U.S., the reasons continue well beyond that in the form of loss of military hegemony, anti-competitive policies of the U.S. government, and structural economic headwinds.

This is more than a windy breeze disturbing the water on a sunny day; it likely won't die down by sunset.

Recent market movements highlight the shift

In looking at market action during the month of May, our concerns about a weaker U.S. dollar have been increasingly confirmed. Despite the Fed telling market participants that it would be *buying* long-dated Treasurys, the bond market has called its bluff and *sold* Treasurys because it knows that the Fed can only buy them with newly printed dollars, not future tax revenue. Oil has traded from $50 to $65 and gold stocks have skyrocketed. The dollar index has declined significantly, losing the most value relative to the currencies of countries that are similar to the U.S. (in terms of secure property rights and advanced economies), but who are developing the energy and mining resources that the rest of the world (including the U.S.) needs to grow. Canada and Australia are examples.

It is interesting to note that this commentary is being posted the day after the bankruptcy filing of General Motors, which symbolizes the winding down of the era of American industrial might. The U.S. taxpayer is now the largest stakeholder in GM – providing debtor-in-possession financing while the company figures out how to restructure itself for an entirely new market going forward. Meanwhile, the stocks of resource producers and inflation hedges are outperforming to the upside, signaling that the rest of the world is just fine.

Remember: Focus on the tides

Most average investors are worried about whether "sell in May and go away" is an axiom that will hold true this year, or whether Wall Street analysts are too optimist or too pessimistic on S&P earnings. This focus loses its relevance entirely when considering how to position one's portfolio for what is happening around the world – not just this summer, but for years to come.

It's a challenging time to be an investor because of the unconventional types of risks. Therefore, a cautious but unconventional investment strategy makes the best sense. We at Obermeyer Asset Management continue to be vigilant about what's happening globally and how it might impact investment markets. We expect to continue to see moments of heightened anxiety among investors going forward; however, there remain many fantastic long-term opportunities and those positioned for tides should do just fine.