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INVESTMENT POLICY MEMO

Now that an instantaneously famous victory has been won by the United States, even before the war was quite finished, it is appropriate to ask exactly what it is that has been won. And what has been lost. America now sits firmly astride the oil production facilities of Iraq, which covers the world's second largest reservoir of proven petroleum reserves. This could prove a bounty to the fortunes of American oil companies, just as the expansion of American influence in Saudi Arabia aided them in the past. It could also initiate a period in which low oil prices contribute to economic growth and prosperity throughout the world. Alternatively, as some of the darker voices in the Bush Administration have previously indicated, it could provide the United States with a "stranglehold" over the vital flow of oil to Europe as well as China and Japan.

Donald Rumsfeld has won his argument with the generals in the Pentagon, who were shown once again to be busy winning the last war. And those of us who opposed the war have learned how precarious it is to enlist the doubts of military commanders as a way of adding weight to our own misgivings. Halliburton, of which Dick Cheney was CEO before becoming Vice President, will win a cornucopia of contracts along with similarly situated U.S. firms who will not have to suffer the inconveniences of competitive bidding or foreign competition. And George Bush, whose serious political opponents could already be counted on one finger, has perhaps won the ability to obtain even more tax cuts for the wealthy and to pursue even more imperialist adventures in the world with the costs to be borne in some future time under some different president.

The Iraqi people have won, or at any rate they have been granted, the right to live under the dominance of American military might rather than the terror of the Baath Party regime. Israel has won the right to move more boldly in pursuit of its hard line on the Palestinians under the implicit protection of its American ally.

Space prohibits listing even the most important things that have been lost. For a start, all of the multinational institutions that were built since the end of World War II under American leadership have been seriously, perhaps fatally wounded. The intent and effect of these institutions, from NATO to the IMF to the United Nations, has been to protect the structure of capitalism and the property of capitalists. The interests of a particular group in a particular country are being asserted against the global interests of capitalism and capitalists, not unlike the transition from the Roman Republic to the Roman Empire at the time of Julius Caesar or from the merchant city states of Europe to monarchical nation states during the time of Machiavelli. Consequently, the U.S. is more in danger of losing what remains of its civil rights and liberties, its commitments to economic justice and effective democracy.

Iraq has lost most of what remained of its infrastructure after the Gulf War and the subsequent twelve years of American and British bombing. It will take a lot of money to restore schools and roads, hospitals and public safety. And, because of the course America took into the war, it appears that no one else will help America pay for these costs of getting back out.

The world has lost even more of its dwindling ability to feel safe. Iran, Syria, Venezuela and countless other countries must now live in greater fear of regime change through the agency of American force. Oh yes, and all of Iraq's weapons of mass destruction have been lost, although American intelligence was supposed to know exactly where they were unlike the U.N. weapons inspectors who also couldn't find them. Consequently America's credibility has been severely damaged everywhere in the world except here in the good old U.S.A.

The negative consequences of all of this for peace and justice in the world are horribly large. It seems disrespectful to pass over them too quickly and move on to the bad, but ultimately less important, consequences for the economy, for stocks and for bonds. But here goes.

In Bill Clinton's last year as president the Federal government surplus was \$236 billion, the largest surplus ever in dollars and the largest as a proportion of GDP since 1948 when Harry Truman was the successfully re-elected president. In his first two years in office George Bush helped turn this surplus into a deficit of \$157 billion. This year's deficit is likely to be close to \$400 billion, eclipsing the previous record established in the first Bush Administration, and next year is heading toward \$550 billion. In the last six months the prospective size of the deficits this year and next have grown substantially because of a continued tepid economic recovery and because of the enormous costs the United States is shouldering in its nearly unilateral occupation of Iraq and its continuing preparations for military action elsewhere. As a result, the prospective swing of nearly \$800 billion in four years in the government's fiscal position, or approximately eight percent of GDP, is even more unprecedented than the shifts described in previous memos.

The deficits are comprised primarily of tax cuts for the rich and increased spending on war and "anti-terrorism". These uses may be ethically deplorable and economically inefficient; but they are nevertheless serving as a stimulus to an economy in need of stimuli. However, a rise of more than one trillion dollars in outstanding Federal debt from 2002 through 2004 will almost certainly cause interest rates to rise. This will especially be the case if the deficit stimulus combines with other factors to produce a stronger economic recovery.

Rising interest rates will get an additional boost from the decline in the foreign exchange value of the dollar. The dollar resumed its recent downtrend as soon as it became clear that the U.S. was going to abandon all of its international alliances and obligations to pursue a war against Iraq. Growing government deficits and current account deficits with the rest of the world also put downward pressure on the dollar. If foreigners are less interested in buying or holding American debt, this alone will cause interest rates to rise and the dollar to fall further. It could also have a negative effect on the prices of stocks, real estate and other investment assets.

A falling dollar raises the dollar price for Americans of imported goods, which are now a significant portion of U.S. consumption. In this way a falling dollar leads directly to increased inflation in the United States. So far the only inflation we have seen over the past several years has been in commodity and raw material prices. Explanations for low inflation include a weak global economy, global excess capacity, continued strong growth in labor productivity, the erosion of business pricing power from the Internet and similar developments, and increasing inexpensive exports from low labor cost countries, especially China. There is probably merit and durability to most of these explanations. However it is possible that a weak dollar and the ultimate consequences of current U.S. fiscal and military policies will be enough to start inflation climbing again after more than twenty years of decline.

A weak economy in the U.S. and the world has been far more durable than we expected even three months ago. Americans may love their president and support the troops overseas; but at the same time they, especially businesses, have grown more cautious about spending and investing. If oil prices or general inflation or interest rates were to rise sharply in response to some new foreign misadventure, the U.S. and much of the global economy could be pushed back into recession. In the best of cases profit growth will be weak (although helped by a falling dollar). Profits are still declining from their extraordinary percentage of sales reached in the late 1990's. Declining stock prices have led to larger required pension contributions (although there is now legislation pending to undermine the Federal requirement that corporations fully fund their pension obligations), commodities purchased by businesses are going up in price while products sold are not. Similarly security costs and insurance costs, especially for health, are rising dramatically.

The list of things that could stay as bad as they are or get worse is long. The potential for anything getting significantly better in the next six months or so is small. Stocks are selling at the high end of their range for the past nine months. Accordingly, this seems like a good time to move some money from stocks to cash or cash equivalents. The amount of money that could be lost owning longer maturity bonds seems vast in comparison to the amount that might still be made. Among stocks the best prospects continue to be for companies with high dividend yields, low prices compared to earnings and assets, a potential to gain from inflation or a better than average ability to increase prices; and a focus on low and middle income consumer markets.

These kinds of stocks should be least vulnerable if the stock market resumes its descent. At the same time, they may be up significantly if the market rises further. This remains a time for caution and the protection of existing asset values.