

January 3, 2005**INVESTMENT POLICY MEMO**

Apparently the majority of voters who re-elected George Bush believe it is necessary to engage in violent destruction and torture overseas and to restrict our rights at home in order to protect ourselves from the dangers that lurk in the poor and angry majority of the world, or perhaps in order to secure control for America of the world's scarce oil and gas reserves.

In his wonderful recent book, Blood and Oil, Michael Klare shows how our invasion of Iraq has been focused on the oil and how this is merely a continuation of a singularly focused American policy over more than the past sixty years. And if you were wondering why the U.S. government has shown more concern for the genocide in Sudan than it has over any of numerous previous genocides around the globe, the answer might be in the curious fact that Sudan is one of the few countries in the world with oil resources where all the oil companies are Chinese, French or Russian – not American. These are pretty much the same countries and companies whose claims to develop Iraqi oil were incinerated by the American invasion.

In any case the stock market has celebrated Bush's second term with great enthusiasm. As mentioned in our last Memo, this is not because investors welcome the government's efforts to control oil or its abandonment of numerous international alliances and conventions; rather it is simply a celebration of the prospect that the next four years will bring as many new handouts from the government to corporations as did the last four years. Handouts can be in the form of tax cuts, elimination of obligations (those pesky pension funds), regulatory relief or juicy, non-competitive contracts. It is astounding, if unsurprising upon reflection, that three industry groups increased in value by over 5%, or roughly seventy billion dollars in the first two days of stock market trading after the election: military contractors, tobacco companies and drug companies.

The stock market signaled an impending Bush victory by climbing for more than a month before the election. The dollar anticipated the president's success by resuming its fall before the election and falling faster still after the election. Foreign exchange markets think Bush is bad news for the dollar, and they are right. Bush has already engineered the biggest swing from government surplus to government deficit in all of U.S. history. On top of massive tax cuts the administration has added immense amounts to military spending and even some smaller amounts to domestic spending. Both the tax cuts and the spending increases are set to grow over the next four years.

Meanwhile America's other deficit, the imbalance between what we spend or give overseas and what comes back has grown from an already troublesome minus 4.5% of national income in 2000 to minus 5.5% on the most recent report which translates into an annual outflow equal to roughly 633 billion dollars or nearly \$6,000 for every family. To keep the global trade system running smoothly foreigners would need to add this much every year to their holdings of U.S. dollars, securities, real estate or businesses. Some of the accepted methods for dealing with this problem are raising taxes, reducing imperial expenditures, experiencing a recession or depreciating the dollar. If you weren't able to guess which option the Bush administration

favors, don't worry, the White House has made its choice of a declining dollar entirely clear in numerous statements over the course of its first four years. We continue to believe that the dollar will decline by an average of 5% to 10% a year for each of the next three or four years.

If at some point in this process the falling dollar causes central banks and other foreign holders of U.S. bonds and stocks to decide to shift more of their holdings into other currencies, the direct result would likely be lower bond prices which is the same thing as higher interest rates. Federal Reserve Policy is already set on a course of raising short-term interest rates. Growing federal deficits mean more government bonds for sale, just as continued economic growth will mean more corporate bonds for sale. There is also a good possibility that the inflation which has so far been limited to commodities might become more general just as it did at the end of the 1960s under the pressure of expanding government and international deficits and growing overseas military spending. The falling dollar might cause increased inflation, at least in the U.S., by putting upward pressure on the prices of our enormous quantity of imports. Higher inflation will in turn become yet another force leading to higher interest rates.

Attentive readers of these Memos will recognize the foregoing as a repetition of things we have been saying and incorrectly predicting for the past three or four years. The only differences are that we now say "could" or "might be" where previously we had said "will," and "good possibility" where we had implied certainty. There are many reasons that might explain why we have been wrong so far (about stocks, interest rates and inflation; but not the dollar) and many of them might make us wrong for the next four years as well. We discuss three of them below: the self-interest of foreign owners of American debt; the world hegemony of the United States; and the deflationary impact of abundant global production of most goods and services.

China and Japan between them own one fifth of all the U.S. government bonds in the world that are available for purchase or sale. If there are only three or four significant players in a market, it will behave quite differently than if there were thousands or millions. China and Japan can see clearly that by buying their exports we support their economies. By returning the money to us with the purchase of our bonds, they are enabling us to continue buying their exports. It is not in their interest to see either the dollar or the bond market decline. Indeed ending the U.S. foreign trade deficit by any method would be quite painful for both countries.

So the dollar may not fall as soon or as far as we predict and U.S. interest rates may not rise as much. But, this buffer is diminishing as the dollar declines. At some point the cost of holding trillions of dollars that are declining and paying low interest rates will no longer be tolerable for China and Japan, especially as the falling dollar begins to reduce the amount America buys from them and thus their motivation to continue playing this game.

A second support for the dollar is the straightforward fact that the United States is the world's only superpower, a global hegemon unprecedented in history. U.S. imports and exports are the largest factor in global commerce. Many important commodities, such as oil, are traded all over the world in dollar prices. There may be no precedent for the money of such a predominant economic and military power to fall dramatically from favor. Again this is a comfort that should prove limited in duration if current circumstances persist. America is now hemorrhaging its financial assets to the rest of the world at a rate comparable to the United

Kingdom's in World Wars I and II. After World War II, the British pound declined precipitously against the dollar in value and preeminence.

Our forecast of higher inflation could be wrong because of the abundance of things people produce in the networked and globalized world. Perhaps productivity has increased so much that there is a global glut of cars and cell phones, food and clothing. Perhaps productivity is now so high that everyone in the world could enjoy abundance and the only scarce thing would be a job. (Of course the finite earth itself and the substances we extract from it can only grow scarcer.) While there is much truth in this argument, it does not address inflation as it occurs under actual conditions in the world. As Amartya Sen has demonstrated in his Nobel Prize winning books, famine has usually occurred in the midst of abundance. Only in Europe -- much maligned in America for its welfare state, low consumption and high unemployment -- and in parts of India like Kerala has abundance been reasonably shared with all including the unemployed. Because of the injustices, inequalities and inefficiencies of governments, markets and other economic systems, inflation is already high in rapidly growing countries like Brazil and China.

On balance we stick to the same beliefs about the most likely course of future events: rising interest rates, inflation and twin deficits coupled with a falling dollar. Because of the three arguments just reviewed we are less confident that all of them are imminent, or will be as large as we suppose, or that they will happen at all. Consequently we increased common stock holdings in most accounts, especially after the election. We maintain a variety of common stock investments that we expect to benefit from a declining dollar and/or from rising prices for energy and other commodities. In addition to foreign and domestic energy companies, these include foreign companies with stable businesses concentrated in non-U.S. markets, and American companies that compete against imports for American consumers.

We continue to avoid all parts of the bond market that would be hurt by rising interest rates. We have concentrated instead on: inflation-protected bonds in the belief that they will do well even as the bond market does poorly in an environment of rising inflation; adjustable rate bonds; and high-yield real estate and energy securities. Also, we are exploring investments in short-term bonds that are denominated in other currencies.

Although, in retrospect, we again have been unduly cautious for the past year, most clients still will find that investment performance has been positive absolutely and versus appropriate comparisons.

We hope every reader of this Memo can find it in her or his heart to be happy and hopeful in this ominous New Year.