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INVESTMENT POLICY MEMO

It's Spring and Democracy is breaking out all over, or so it seems, especially in American media and political orations. In just a few months there have been elections in Afghanistan and in Iraq during which significant numbers of voters turned out in the face of deadly threats and actual violence. The scenes from the Iraqi elections were reminiscent of the first post-apartheid elections in South Africa. Meanwhile protest movements professing their commitments to democracy have ousted authoritarian regimes in Lebanon, Ukraine, Georgia and Kyrgyzstan.

President Bush and the press have portrayed this string of events as a contagion similar to the collapse of one pro-Soviet regime after another in Eastern Europe followed by the disintegration of the Soviet Union itself. This time, however, the not so invisible hand of American intervention is apparent in every event. Afghanistan and Iraq after all are countries under American military occupation. And while some reporters claimed that American troops were nowhere to be seen during the elections in Iraq, others have reported a massive show of force and the most intense security since the occupation began.

Protected by this shield the Shia majority turned out to vote with great enthusiasm after generations of oppression. And the Americans did not interfere with the election of candidates committed to Islamic fundamentalism and close to the Shia fundamentalists who rule Iran. So after arming and supporting Saddam Hussein as a bulwark against Iran and these very same Shiite Iraqis, America is now supporting its former enemies, having destroyed its former ally. (Ironically, Dick Cheney and Donald Rumsfeld were among the principal bearers of arms and money from the Ford and Reagan administrations to Saddam.) In any case the new Shia government could not have been elected and could not stay in place without continuous American military protection. So it is unlikely to veer in any direction distasteful to its new protectors.

The withdrawal of Syrian soldiers and secret police from Lebanon is even less deserving of its image as an unambiguous triumph for democracy, although it was certainly a triumph for national independence. Whatever their many faults, the Syrians did shield Lebanon from Israeli incursions, maintained a genuine democratic process and maintained the constitutional arrangement for sharing government power between Christians and Muslims. It is far from certain that this will continue to be the case in their absence. The demonstrations that led to a change in Lebanon's government and the withdrawal of Syria's forces were undeniably massive and were undeniably supported and encouraged by the American government.

The same can be said for the demonstrations in Kiev that effectively invalidated the announced results of the Ukraine presidential election. Not to mention the capital city demonstrations in Georgia and Kyrgyzstan. They were large, popular and advised, supported and influenced by the United States. So the question becomes whether these revived democratic processes will thrive under the watching eye of their American Big Brother and whether the new elected governments will be free to pursue policies responsive to the wishes of the citizens who elected them.

While the new government of Lebanon is unlikely to invite the Syrians back in, it is simply unimaginable that the new governments of Afghanistan or Iraq will invite the Americans to go home. In the near future Ukraine is likely to welcome American military bases and seek membership in the EU and NATO. Kyrgyzstan had an American base even before its democratic revolution and Georgia is surely not far behind in the move to welcome U.S. armed forces. All three countries will now permit the oil and gas pipelines the Americans favor and cooperate in every other way with the American desire for an increased flow of hydrocarbons in a westward direction.

However Machiavellian American motives may have been in these events, one still has to admire the emergence of democratic processes and to be somewhat cheered by America's rediscovered fondness for democracy. Once established, democracy takes on a life of its own. Then it often heads in a direction opposed by powerful opponents and, at least sometimes, overcomes military might with the strength of a popular movement, as Jonathan Schell has demonstrated with a long series of important examples in his wonderfully hopeful book, The Unconquerable World.

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Meanwhile back at the ranch, inflation in the U.S.A. has been rising persistently from 1% two years ago to 3% or more today. While this is a greater acceleration than was expected two years ago by Alan Greenspan or the consensus of economic forecasters, it is close to what we have been predicting for the last four years. Large and growing government deficits, a large and growing international balance of payments deficit and the resulting decline in the dollar are leading to more rapid price increases. The economic distortions created by a wartime economy accelerate these trends, as do rising interest rates and high oil prices.

The stock market was up from the election until the end of the year and has been mostly down since January. Now it is essentially unchanged from its high levels shortly after the election. At first glance this seems an atypically serene response to the dramatic acceleration in inflation and a parallel, but even more rapid acceleration in short-term interest rates. The Federal Funds rate has increased from 1% to 3% in only one year and an additional increase to 4% and perhaps 5% is virtually guaranteed. One reason the stock market has held up so well is that the bond market has also responded with atypical equanimity to rising inflation and short-term interest rates. While the former has risen by one percentage point and the latter by two, the yield on a ten-year U.S. government bond has fallen slightly over the last year.

Another prop for stock market optimism has been the recovery of the dollar in foreign exchange markets during 2005. Yet another is the very spread of democratic movements or American power and influence with which we began this memo. Even the president's emerging defeats on capitol hill around privatizing Social Security, repealing the estate tax, spending more on new nuclear weapons, etc. can all be seen as reducing the growth of future government deficits.

The financial markets also continue to take comfort from the idea that the high level of oil prices is only a temporary spike. Once they retreat to more "normal" levels (as they always have in the past), the inflation problem would disappear. In this instance we think the reliance on past history may be wrong. As mentioned in earlier memos, there is a good chance that we have arrived at a point where continued production of oil and gas at current global levels, or more, will inevitably lead to higher prices because of increasing scarcity or inaccessibility.

We still think that America's government deficit and overseas deficit will keep increasing; that the dollar will keep declining by about ten percent a year, that inflation will rise in part because of the deficits and the dollar, in part because of high petroleum prices, and in part because of the growing share of military and security activities in the total economy. It seems almost inevitable in these circumstances that stock prices and bond prices will respond far more negatively than they have so far and more the way they have in the past, as these traditional demons of financial destruction continue to breathe fire.

Since January we have moved more of the portfolios we invest into cash, inflation-protected bonds, health care stocks and energy stocks. Health care, apart from the old-line pharmaceutical companies, could show sustained or increased growth while many other areas decelerate with the already aging economic expansion. We believe energy stocks will benefit for many years from the rising prices of oil and gas. We raised the money to add to these areas primarily by reducing holdings in cyclical and financial industries. We also continue to reduce investments in developing countries, since they are likely to be particularly hard hit by the ongoing increase in U.S. interest rates, a slowdown in U.S. growth and a resumption of the decline of the dollar. We continue to believe that bonds should be avoided like the plague, as the saying goes, with the exception of very short maturities or interest payments that vary with inflation or with another interest rate. This has been our view for most of the past five years, and more often than not over that period of time it has been bad advice. However, as the Federal Reserve continues to relentlessly increase short-term rates, time is running out for long-maturity interest rates, which are extremely unlikely to stay the same, let alone decline, as short rates grow to equal or exceed long-term rates.

So far our eccentric mix of oil, healthcare and cash has performed well in up and down markets. However, in the currently perilous circumstances of financial markets, these small victories could be wiped out quickly by a variety of possible sudden market turns. Cash, short-term bonds and inflation-protected bonds are attractive because they will retain most of their value through any storm in financial markets.