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INVESTMENT POLICY MEMO

It's been nearly eight months since we committed to writing our thoughts about world events and the outlook for investment markets. A lot of water has gone over the dam since then. The Bush administration juggernaut has continuously and by now almost completely broken down. Iraq has moved into the civil war that Peter Galbraith has correctly predicted from the beginning. We have lost two great champions of peace and justice, Peter's father, John Kenneth Galbraith, whose wise books and pungent witticisms will be sorely missed in a world where integrity and well-written English are each in precipitous decline, and the Reverend William Sloane Coffin, from a time that now seems fleeting and long ago, when religion was more about peace and love than intolerance and hatred.

And almost as a jester's side show to these serious events, Larry Summers has been deposed as president of Harvard University. The Boston Globe marked the announcement with a front-page story summarizing the accomplishments of his brief tenure, including advocating that the "curriculum should focus more on actual knowledge and quantitative disciplines and less on ways of thinking." These astonishing sixteen words are an apt, if unwitting diagnosis of the current corruption of education from grade school through graduate school and the concomitant decline of thinking and its popularity from the halls of Harvard to the halls of Congress.

There is no point recounting our forecasts that have since been proven fact or folly. It will suffice to say that we were more accurate about global political and social developments than we were about financial markets. Since late last year the U.S. and world economies have gained strength, as have many indicators of their future prospects. In particular, it now seems almost certain that the U.S. housing bubble is unwinding in a gentle and benign fashion. Coupled with the strength in the rest of the economy and the growth of employment, this implies that in all likelihood America will experience a slowdown in growth similar to those that followed the recent ending of housing booms in Great Britain and Australia. We are most likely to have a slowdown in what has been a rapid pace of economic growth, but not a recession.

Consumption has already begun to slow down along with the growth of imports. Meanwhile exports have started to grow faster, partly because of a strengthening global economy relative to the U.S., partly because of growing war demands and partly because of a renewed decline in the dollar. In addition, it appears that investment spending is increasing in response to continued record high levels of profits and increasing scarcities of labor and productive capacity. Without new tax cuts (certainly not to be ruled out in an election year in which many Republican legislators face grim prospects) the government deficit will shrink modestly because of economic growth; but will still be an enormous stimulus. So consumption and gross national product will grow more slowly while investments and exports accelerate.

An American economy that continues to grow at a moderate pace is good news for the rest of the world's economies, particularly in developing nations, and it is good news for stock markets. It is only good news, however, if economic growth does not lead to rising inflation,

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something we have been incorrectly forecasting for about five years. The reasons inflation might now finally flare up include: an acceleration in the already enormous increases in most commodity prices, falling unemployment leading to higher wages, falling excess capacity leading to greater corporate pricing power, a possible acceleration of healthcare costs because of the new Medicare insurance programs, and a decline in the large gains we have experienced in worker productivity for the past ten years to merely normal levels.

However, there is also a formidable list of reasons why our incorrect inflation forecast of the last five years might remain incorrect for the next five years. Oil prices in the range of $70 a barrel or $3 a gallon of gasoline, have already caused a decline in U.S. petroleum consumption and a severe flattening of world consumption growth. A decline in U.S. housing prices and activity will have deflationary effects both directly through housing prices and indirectly through decreased mortgage financing of consumption and increased unemployment among those linked to housing. Higher interest rates in the U.S. and most of the world may begin to be a more serious brake on economic activity. In addition to all of these recent developments, the most important reason that inflation may continue to lie quietly has been with us all along: Globalization.

Recent studies at the Bank for International Settlements and the International Monetary Fund conclude that globalization has changed most of the previous rules about the relation between inflation in one country or region and economic growth, unemployment and currency declines. The developing countries that have been integrated into the global economy only in the past five or ten years, China, Indonesia, India, Brazil, Mexico and many others, contain a vast supply in the billions of often well-educated and sometimes well-equipped workers who are able and eager to do the same work that is done by an American, Japanese or European worker at a small fraction of the compensation. These countries might well be able to continue growing at 5% to 10% a year for another twenty years or more before using up most of their underemployed labor and ceasing to keep a lid on prices and wages in the developed countries.

To the extent that the lid on wages is tighter than the lid on prices, globalization is probably an important reason for the historically high levels of corporate profitability in the U.S. and other advanced economies. All of this is a capitalist's (and a stock market's) dream: a reserve army of the unemployed that is four times bigger than all the people working in all the developed economies, a semi-permanent lid on wages providing a floor under profits. Ironically, if this analysis is correct, the lion's share of the credit for increased profits and a strong stock market goes to Bill Clinton, Robert Rubin and Larry Summers for bashing down the barriers to increased Western penetration of the developing countries, while a much smaller share goes to Bush administration tax cuts, sweetheart deals and anti-labor policies. Among other things, this might explain why the stock market has been remarkably indifferent to the ill winds buffeting the President and his henchmen.

All of this is only a theory, albeit one that others have been advancing for five years or longer and one that is quite consistent with what has actually happened in the opening years of this century. We now believe that it's forecast of continued modest growth and negligible inflation, is the most likely course for the American and world economies over the next year or

more. Any surprises will probably be in the form of higher growth, inflation and interest rates. An economic collapse or a decline in general price levels are each extremely improbable.

The biggest risks continue to be acts of violence by military organizations and by terrorists. Iraq slips deeper into chaos and human misery. Starting within days of electing Hamas to lead them, Palestinians have been terrorized by a series of assassinations and kidnappings by the Israelis and by an economic boycott supported by the U.S. and the European Union as well as Israel. Deprived of mobility, employment, food and medicine, and still subjected to military incursions, the response of the Palestinians and their supportive neighbors will inevitably become more violent and desperate. The U.S. is already reaping a similar whirlwind in response to the reckless evils it has inflicted under the guise of a war on terrorism.

Yet all of this seems small in comparison to the Bush administration's deliberate approach to attacking Iran, perhaps with nuclear weapons. The National Security Policy Strategy released in March identifies Iran as the greatest threat to American security in the world, just as Iraq was so identified in the build up to the American invasion. And it reiterates the right of the United States to use force "pre-emptively" against any perceived foreign threat. A while later, Seymour Hersh, whose New Yorker articles have been infallible thus far, wrote that Bush, Cheney and Rumsfeld were advocating using nuclear weapons to destroy Iran's alleged buried nuclear facilities. It is much to be hoped for the peace, security and survival of the world that our country does not do any of this; but it is much to be feared, based on the history of the attack on Iraq, that our country will attack Iran and perhaps will add to its record as the only country in the world to have ever used a nuclear weapon. This prospect is unimaginably bad in ways that eclipse the responses of financial markets. However, the prospect alone has contributed to the increases in the prices of oil and gold and in inflation expectations.

Even this brief and incomplete survey of the varied prospects for the next year or so, suggests a complex environment. Our adaptation of investment policy to current circumstances must also be complex. We continue to hold large positions in various energy companies that will benefit from economic growth in the near term and from increasing scarcity of petroleum in the long term. We have added to holdings in stocks that will benefit from increased business investment, overseas investment and exports. We have added to stable companies that will do well in any economic disturbance and that will benefit in many cases from a declining dollar. Our investments in overseas companies in select developing countries, Europe and Japan, have been maintained or slightly increased.

These numerous purchases have been financed by reducing but not eliminating cash reserves and by substantially reducing healthcare holdings, which had been the largest portion of most portfolios. The healthcare stocks did extremely well for several years before turning down late last year, in part because strong economic growth made other areas more attractive and in part because even the medical service and biotechnology companies that we had owned, began to encounter new problems. We continue to think that these stocks have superior growth prospects over the next five or ten years, although they may not provide good returns in the near future.

May you all have a rewarding summer and the world a peaceful one.