



## “Bad News Sells”

July 8, 2005

The U.S. economy has entered the second half of the fourth year of post-bubble expansion. This expansion has been strong and steady despite warnings of fragility, repeated claims of a slowdown, and fears of China reminiscent of those toward Japan in the 1980s. Despite negative headline news stories, analysis of the actual data shows a very different reality – an upwardly mobile society in which households are benefiting from large gains from rising incomes, flexible jobs, low unemployment, low mortgage rates and more assets than debt. The so-called housing bubble is producing enormous wealth for homeowners who are finding various uses for the increased equity in their homes. For those worried about global imbalances and the minority’s perception of a decline of America, stay tuned – media headlines may continue to accentuate the negative view even as the economy keeps thriving. Haven’t you heard that “Bad News Sells”?

As acclaimed investor Ian McAvity notes:

*“When the talking heads of CNBC start explaining that a 0.1% number is above or below ‘expectations’ and THAT is why the market is doing something, they are basically acting as microbiologists in drag...talking about the biological makeup of a leaf, on a tree, that happens to be in a forest. Their business is to try and attach historical significance to every moment of the day, while any serious student of history realizes that it typically is the next generation or later than can best put the present into an historical context. But they have a lot of ads to sell, and an apparently willing audience who seem to believe that THE answer to all is out there somewhere, and they hang on every word from the visiting experts.”*

Reinforcing McAvity’s interpretation of business news is the latest CNBC attempt at attracting viewers. The popularity of Mad Man Cramer and his daily diatribe for or against individual common stocks has prompted media moguls to run the program twice each evening. Little attention is paid to the fact that Mr. Cramer’s ranting bears no resemblance to making sound investment decisions.

Finding pessimism attractive is a sad human trait, but if people look for things to be unhappy about, they will certainly find them. We believe that negativity has characterized the investment environment during the first half of this year. Coming off a low base in 2003, earnings for the S&P 500 grew nearly 25% in 2004. These stellar results led to widespread predictions of 6-7% growth in earnings for 2005. Already, companies have surprised on the upside with more than 13% growth in the first quarter. Corporate profit growth is at a record high and profit forecasts for the rest of 2005 and 2006 are set to grow in the high single digits. Moreover, equity valuations as measured by the P/E (pessimism/euphoria) ratio are at record lows. It’s time for investors to focus on the positive things!

### **The U.S. Economy**

The 229 year-old U.S. economy based on free market flexibility is unmatched by major foreign economies and continues to grow as a result of the implementation of expansive fiscal and monetary policies after a technology sector implosion. During the second quarter, gross domestic product was revised upward to 3.8% -- the ninth consecutive quarter of above-3% growth and the fifteenth consecutive quarterly gain of any size. At the same time, a key measure of inflation in the report was revised lower. The Conference

Board's consumer confidence index in June rose to the highest level in three years. Initial jobless claims fell to the lowest level since mid-April and the unemployment rate was 5.1%. The Institute of Supply Management's manufacturing index for June rose to 53.8, better than the 51.5 reading in the prior period. These are good times!

While the bigger bite of energy costs has taken something off economic growth, it appears to have had little impact on the overall economy. Nor has it generated crushing inflation. The impact of oil prices hitting the \$60 level is more psychological than real, since it only barely takes us to a new magnitude of pricing. Crude oil futures were running above \$55 for most of this year. In inflation-adjusted terms, today's price is a third lower than at the price spike of 1980; in fact, it's lower than it was during much of the early 1980s. However, prices have gotten higher than we expected and some corporations are feeling the pinch. For example, FedEx cited higher fuel costs as it recently reported earnings that were slightly below Wall Street's expectations. Despite the fuel cost issues, the company's profits rose 9%. The company's average daily shipping volume, which is something of an indicator of general economic activity, was up a healthy 6%. Some economists have suggested recently that it would take oil prices as high as \$85 a barrel to do serious damage to the economy – in other words, prices closer to the 1980s' real-dollar peak than to today's level.

One variable that has changed in the supply/demand equation is the rapid, energy-consuming growth in developing economies, particularly India and China. Their expanding use of resources is a permanent situation that has to be remedied by long-term solutions. For energy, this includes new and alternative sources, increased refining capacity and continuing efforts at improving energy efficiency in order to reduce costs and conserve existing supplies.

An important aspect of economic growth has been monetary policy. The Federal Reserve Bank determines the level of short-term interest rates in an attempt to control inflation. The Fed has to keep Congress aware of where inflation is going so later this month Federal Reserve Chairman Alan Greenspan will testify before both houses and present the mid-year report on monetary policy. Investors will scour his testimony for hints to how much more Fed tightening lies ahead. Twelve months ago, at the beginning of the Fed's latest tightening cycle, the credit and securities markets anticipated at least a year of tightening and a fed funds rate of roughly 3% one year hence. In fact, the Fed has gone somewhat faster, pushing the fed funds rate up another 25 basis points to 3.25% in late June. The Fed has raised rates 200 basis points in the last twelve months. While there has been little surprise in the actual Fed rate hikes of the past 12 months, year-ago expectations for longer-term interest rates were not as prescient, particularly the further one goes out on the Treasury yield curve. The 12-month forward curve for Treasuries at mid-year 2004 was pricing in a yield of 3.80% for two-year Treasuries at the middle of 2005 (not bad – they are 3.75% today); but 10-year Treasuries were expected to get to 5.17% (vs 4.04% actual); and 20-year Treasuries were expected to be 5.68% (vs 4.38% actual).

Chairman Greenspan addressed this interest rate “conundrum” five months ago in testimony on monetary policy to Congress. At the time, the mysterious market behavior Greenspan was alluding to was the following: after six 25 basis-point hikes in short-term interest rates, yields on Treasury bonds with maturities beyond five years were lower by 18 bps (for 5-year Treasuries) to 87 bps (for 30-year Treasuries). As Greenspan pointed out, such market action was unusual in a period of Fed rate increases.

Despite the rise in both short-and long-term rates, mortgage rates have fallen further contributing to additional borrowing by consumers and negative headlines touting an imminent real estate bubble. The last national real estate collapse occurred during the Great Depression when more than 5,000 banks failed leaving depositors with vast losses of savings and no FDIC insurance. Farm income fell by 50% due to the Dust Bowl, real interest rates hit 15%, world trade shriveled by about 65% in dollar terms in just four years under misguided protectionist acts, and there was an average 18.2% unemployment rate during the 1930s.

Those conditions are thankfully not in place today. Regional “bubblottes” have arisen in the past 30 years, and we could see similar examples in varied hot spots.

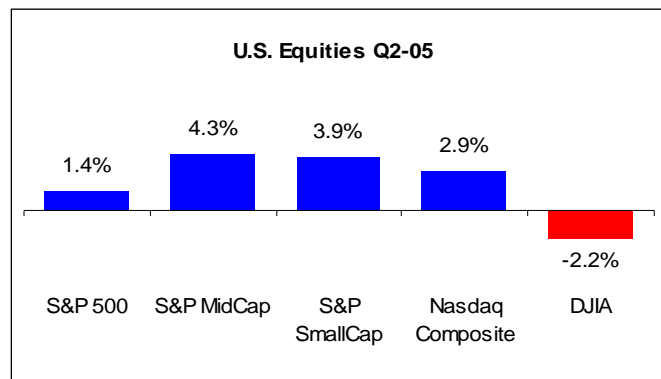
Short-term rates have risen more in the U.S. than in any developed nation in the world over the past year, and long-term U.S. rates, despite falling, have risen to their highest levels relative to other developed markets in recorded history. Not surprisingly, foreigners’ net acquisitions of U.S. financial assets hit the third highest total on record, at an annual rate of \$1.17 trillion in the quarter. Moreover, the bid by China National Offshore Oil Corporation (CNOOC) for Unocal highlights foreigners’ interest in acquiring U.S. real assets in addition to U.S. financial assets. Indeed, Lenovo’s pending purchase of IBM’s PC business shows a new penchant for buying companies rather than paper as a means to re-circulate the vast amounts of American dollars flowing into China for goods exported into the U.S.

While such Chinese acquisitions cause investor and political angst, there were similar protests when Japanese companies made acquisitions in the 1980s. Japan subsequently build up its investment base in the U.S., resulting in auto plants employing thousands of American workers – a positive outcome overall. Despite these positive developments, various media representative continue to implement their mantra of “if it bleeds, it leads” and have painted China as the evil aggressor. The fact is that the flood of cheap products from China has actually improved America’s standard of living – and also allowed American companies to sell more product into China. Joint ventures with Chinese companies are also generating profit opportunities for many U.S. multinationals.

### U.S. Financial Markets

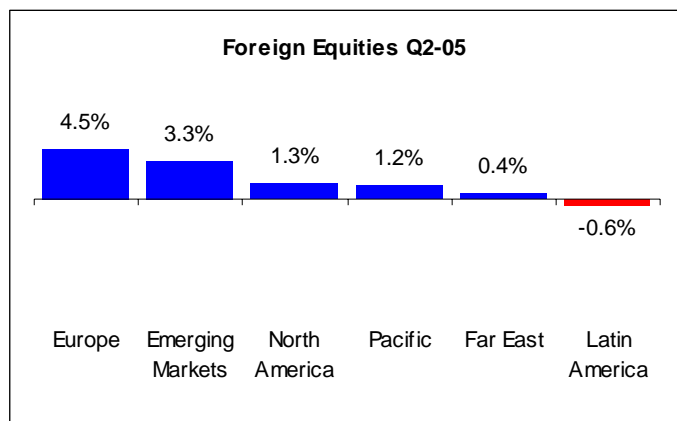
After suffering broad losses during the first quarter, U.S. stocks rebounded over the last three months, as widespread fears about inflation abated and the economy continued to show signs of healthy growth. These and other factors led stocks to almost recoup their first-quarter losses, though they did give up some of these gains near the very end of the quarter.

Most indices finished up by the end of June with the exception of the Dow Jones industrial average that fell a little more than 2% on fears of a global slowdown. Mid-cap stocks posted a gain of more than 4% while small-cap stocks gained nearly 4% as investors sought out attractively valued defensive plays with strong one-year price performance. Energy finally took a back seat as yield-hungry investors continued to bid up utilities that gained more than 10%. Energy still finished strong posting a better than 9% gain. After recent periods in the doldrums, the hardware and health-care sectors enjoyed a rebound gaining nearly 5% and 7%, respectively. Only industrial materials had negative returns, as commodity-sensitive businesses suffered in light of a slowing global economic recovery. Lastly, in June, for the first time in seven months, large and small-cap value stocks outperformed their growth counterparts.



Bonds also enjoyed a surprising rally during the quarter. There was one spot of weakness: high yield bonds that finished about flat for the quarter as downgrades of automakers' debt roiled the market. During the quarter, debt of General Motors, the nearly century-old automaker, was downgraded to "junk" status by Standard & Poor's and Moody's. The stumbling industrial also endured Kirk Kerkorian taking a large stake in its shares -- a move that sent the company's stock higher.

## Foreign Financial Markets



European stock markets just completed a third successive quarter of positive returns. For the first six months of this year, these markets collectively have bested their U.S. and Asian counterparts, while also outperforming many emerging stock markets. The MSCI Europe index rose more than 8% in the first six months of 2005. At the end of June, equities in the Netherlands had rallied nearly 13%, French stocks gained nearly 11% and German and British equities advanced 6%, as measured in local currencies. Despite a late quarter rally, Latin American equities closed down 0.6%.

Europe's run can be attributed to attractive valuations, low interest rates and bond yields, and corporate profits buoyed by restructuring and cost-cutting efforts. In Germany, for example, the country's nominal gross domestic product has increased a meager 4% in the past three years, while profits of the 30 largest companies that comprise the Xetra-DAX index have ballooned 47% in the same period. Economic figures in the United Kingdom were weak over the last quarter, particularly consumer related data. However, the latest Purchasing Managers' Index showed a slight recovery in manufacturing. In addition, market sentiment has improved due to speculation that the Monetary Policy Committee may cut interest rates sooner than anticipated.

Unlike their European counterparts, developed Asian and Far Eastern equities continued the first quarter's sluggish performance as political risk took center stage. Protests swept China following Japan's bid to become a permanent member of the United Nations' Security Council. In the Philippines, a tussle over tax legislation and allegations of election fraud against President Gloria Macapagal Arroyo led the markets down. Developed Asian markets rose slightly better than 1% during the quarter. Japanese stocks fell as exports slowed sharply, oil prices hit imports and political worries related to China mounted.

Not all was negative in Asia. India was one of the better performers over the last quarter primarily driven by inflows from foreign investors. India also has the advantage of playing the domestic consumption theme as the economy is less dependent on the global market. Indian equities rose more than 10% during the quarter. Positive returns were also posted by Hong Kong's Hang Seng index that recouped most of its first-quarter losses, ending the past three months up more than 5%, as property prices rose and investors guessed that a potential Chinese currency revaluation would boost prices in the territory. Moreover, a spate of Chinese initial public stock offerings boosted market sentiment.

Within the emerging markets, Eastern Europe continued to shine with Hungarian equities gaining 25% and publicly-traded companies in the Czech Republic rising 22% in local currency terms. The implementation of capitalist measures to include lower tax rates for corporations and individuals have spawned economic growth and development throughout the region.

Latin America's biggest stock markets, Brazil and Mexico, surged late in the quarter after earlier declines, as more U.S. investors headed south and wound up getting an extra bang from strengthening local currencies. Brazil's Bovespa index of most traded stocks rose more than 6%, led by the state oil company and banking stocks. Meanwhile, Mexico's IPC index of heavily traded stocks gained more than 10% as service-sector stocks rose on the back of strong consumer demand.

## Conclusion

The world today is roughly divided into three areas: the mature economies of Western Europe, Japan, and the United States; the emerging economies led by China, India, Russia, Eastern Europe and Brazil; and the stagnant economies of sub-Saharan Africa and part of the Middle East. Of the mature economies, only the United States offers prospects of consistent growth.

Publicly traded companies must find ways to remain competitive and to grow – that’s what shareholders and investors reward them for. Competitive, dynamic companies have to go where the growth is, and today, most of that growth is in the emerging world.

One common assumption today is that the spread between corporate revenue and earnings growth on the one hand, and national and global GDP growth on the other is wide by historical standards and therefore must narrow. Most people seem to believe that GDP growth in the United States is about as strong as it can get. That means that corporate growth must slow, right? WRONG.

Continued productivity gains (at a 3% annual rate) coupled with the fact that the global nature of many companies has not been factored into earnings growth rates indicate that global growth may level off at around 4% for the next couple of years. But in many regions and across many industries, the growth rate will be much faster. Not only will coastal China – a region of close to 200 million people – grow between 15% and 20% in the coming years, but parts of India, Eastern Europe, Asia and Latin America appear to be expanding rapidly as well.

The new age of capital (a term first used to describe the later part of the 19<sup>th</sup> century in the United States and England where a few dominant companies and financial institutions did well) is here. Many corporations, from large multinationals to nimble companies with global supply chains and sales, are finding that their best markets are in the developing world. Thousands of smaller and mid-sized companies that can use information technologies and low trade barriers to compete internationally will continue to have double-digit growth.

The general picture is crystal clear: the gap between how companies are doing and how national economies are doing will remain large. While there will likely be a relative slowdown in earnings growth this year compared to last year, we do not see that gap narrowing nearly as much as Wall Street expects. The S&P 500 is trading at a multiple of 16.5x on this year’s earnings and 15.5x on very low estimates of next year’s earnings. That is cheap, cheap, cheap when the 10-year Treasury is yielding 4% and inflation is below 2.5%.

In general, risks to financial markets are government policy mistakes – protectionism, tax increases, the inability to restrain spending growth and inattention to political problems. Today, terrorism is back on the front burner after yesterday’s attacks in London. Heightened geopolitical risks will dominate the landscape in the short-term, but history demonstrates that the impact of events on U.S. soil is short-lived.

**A Summer Thought:** “Every man dies. Not every man really lives.” *Braveheart*

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