



## **Outlook for Financial Markets in 2005**

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As is often the case, a clear consensus has emerged, at least about the broad domestic outlook. Most strategists believe that equity markets will be up; that the economy will expand 3% to 4%; that corporate earnings growth will slow from the torrid pace of 2004 and dip into the high single digits; that inflation will be modest; and that global equity markets will continue to look attractive. In other areas, there is less agreement: strategists are divided about how much more the Fed will raise interest rates; how low the dollar will fall; and where energy and commodity prices will go. There is also little consensus about what sectors will lead the markets, how much consumer spending will increase versus how much corporate spending will increase, and whether the trade balance and the budget deficit will narrow or grow.

Conventional wisdom on Wall Street is that conventional wisdom is wrong. Because we agree with that sentiment, we know that it can also be right. Our view on these big-picture themes shouldn't be a surprise to those who've been reading our quarterly commentaries year after year. Yes, we too think the economy will grow 3% to 4%; that the equity markets will end 2005 higher, and will surprise on the upside; and that corporate earnings growth on the whole will slow from its 20% pace in 2004, but that many individual companies will continue to deliver both double-digit earnings growth and multiple expansion for their stocks. We also believe that job growth will disappoint those who look to past patterns of job creation, and that productivity will continue to surprise the skeptics by maintaining a historically high level of around 3%. We think the Fed will stop tightening sooner than most expect, that short-term rates will be no more than 3% a year from now, and that the 10-year U.S. Treasury note will be between 4.25% and 4.50% by the end of the year. And we think that the consumer could bend but not break, and increase spending at least by 3%.

These year-end predictions, however, are often more fun than meaningful. As bottom-up stock pickers, we know that you can find good companies in mediocre sectors, and mediocre investments in great sectors, and that factors like interest rates, the value of the dollar, and rising energy prices don't point in one direction or another for long-term investment decisions. For instance, we believe that we're in a cyclical trend of rising energy and commodity prices. But that doesn't mean that it would be prudent for investors to buy energy and commodity stocks willy-nilly. Prices will zig and zag and not all companies will benefit at the same time. Higher crude prices, for instance, hurt some refiners, and rising ore prices hurt some steel manufacturers. The devil, as always, is in the details.

At the big picture level, in past commentaries we've discussed energy policy, information technology (superhighway), and productivity as major factors affecting the equity markets. We've also pointed to the China effect, which can hardly be overstated. The China story, for all the press it's received, is still misunderstood. China represents a dramatic change in the global economic landscape because it is becoming an avid consumer of commodities, goods and services, not because it is a low-cost producer. There is nothing new about business migrating to where labor or capital is the cheapest. In that respect, China today is no different than Mexico in the 1980s and early 1990s; or, for that matter, the United States relative to Europe in the 1890s or early part of the 20th century.

The United States now has approximately 14 million manufacturing jobs out of a labor force of approximately 140 million. More than 2 million manufacturing jobs disappeared in the past three years. Just as there are now only 2 million farmers who produce more food than 290 million Americans can

consume, as few as 10-12 million factory workers in the United States should be able to manufacture more goods than two to three times the manufacturing workforce produced decades ago. Though it is small comfort to those who have lost manufacturing jobs, most of those were lost in the 1970s, 1980s, and 1990s either to more cost-effective machines and technologies or to low-cost labor countries like Malaysia, the Philippines, and Mexico. Those are the countries currently suffering the most from China's low-cost competitiveness. The United States clearly benefits, on the whole, from low-cost goods. This benefit makes it possible for discount and chain stores to sell products that are affordable to the vast majority of American consumers. So, the 'sacrifice' of American manufacturing jobs improves the quality of life for the 275 million Americans not employed in manufacturing.

As a recent report by Credit Suisse/First Boston emphasizes, what's new is the sudden and rapid emergence of China as a consumer. We heard recently that someone bought Hanukkah candles made in China -- that is a sign of globalization if ever there was one. Someone else bought American flags made in China! But China as a buyer in its own right is more important going forward. The Chinese consumer is a dynamic change factor in the global economy. Already, it's estimated that by 2015, China will surpass the United States as the driver of global growth. That doesn't mean that China will spend more than the United States, but rather that the combination of absolute consumer spending in China plus the rate of annual growth will contribute more to the global economic expansion than U.S. spending. 2015 is still a decade away, but since 1945, U.S. spending has been the primary driver of the global economy. By 2015, the number of Chinese consumers will approach 150 million, each with a purchasing-power equivalent of a \$40,000 annual income. The result: China will become the world's shopper.

Unlike Japan in the 1980s and 1990s, China has a culture of consumerism. What does that mean? In essence, the Chinese are like Americans in that they have a seemingly endless appetite for "stuff". They also have an extremely large internal market, which is only starting to be developed. There is still a very high savings rate in China (above 40%), but not because of an inherent conservatism about money, rather because there have been so few appealing outlets to spend — until now. The surge in real estate, in low-end electronic goods, in gambling in Macau, in clothing and entertainment in the burgeoning cities (and there are more than 100 cities in China with more than 1 million people) has only begun. This is not a prediction of the seamless emergence of China, but the one risk that we rarely hear on Wall Street or Main Street is that China will surprise us by moving more quickly and with fewer disruptions than people expect – that there won't be a hard landing, or a soft landing, but rather no landing. That growth will continue at a torrid pace with inflation in check because China's internal market is nowhere near saturation and because the non-convertibility of the currency insulates China from global capital flows.

Already China as a buyer is shaping global energy and commodity prices, and more than a few of the Fortune 500 companies look to China as their best opportunity for growth. Those companies are defining their businesses as global, and while the United States is a bulwark, it is not necessarily the focus of future growth. Investors in U.S. traded securities have to be sensitive to the global nature of prices and markets. In short, the China effect is a variable that investors can't ignore. It is a significant factor for most of the companies currently listed in the United States, because it will influence everything from interest rates to the sale of U.S. Treasury notes (China currently holds about \$180 billion of the U.S. debt), to the cost of goods and the opening of new markets. We've been looking for areas of dynamic change for 20 years, and today, all roads lead to China.

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