



## Global Financial Markets Perspective Second Quarter 2006

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### Confidence Conundrum

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As regular readers of our quarterly review know, our optimistic outlook for financial markets is predicated on global economic expansion. Despite a tug-of-war between the “inflationistas” and the “slowgrowers” on Wall Street, we continue to believe that the rapidly developing economies of the E-7 will stimulate increased investment, improved productivity and higher profits for multinational companies that embrace these opportunities. Moreover, the implementation of capitalist policies around the globe will provide additional fuel for economic growth. There will always be periods of uncertainty producing a lack of confidence on the part of investors. Today’s financial market environment is one of those times. Given the well-known positive long-term rewards of investing in financial assets, it is likely that short-term factors are causing the current confidence conundrum.

To summarize, persistently high commodity prices, rising interest rates, slower economic growth, a decline in the housing market, slowing profit growth, and heightened geopolitical risks are the market’s current concerns. However, the key question to ask is whether or not these factors will persist or change the direction of the world economy.

U.S. Global Investors recently wrote an article called “The Rise of the Chinese Consumer” that discusses the demand for commodities relative to economic cycles. Given the expectation that global commodity demand will come from China, India and Latin America on the back of infrastructure development, the authors argue that commodities prices will stay elevated for some time.

As for rising interest rates and slowing economic growth, some perspective is in order. The Fed appears to be preparing the markets for at least one more interest rate hike. Judging by his recent testimony, Fed Chairman Ben Bernanke is predisposed toward fighting inflation at this juncture based upon the most recent core CPI reading of 0.3% for a third straight month. Admittedly, the Fed’s latest beige book assessment of the economy suggests that the expected slowdown from the first quarter’s inordinately strong 5.6% advance has begun. And the high interest rate policy already implemented by the Fed could relieve some of today’s inflation pressures over the coming year -- but that relief might be stymied by continued high oil prices. Nevertheless, the credibility of Bernanke and company is now being challenged in the bond market and to a lesser extent in the currency market on fears that they will overshoot. With some luck, the Fed will preempt a slowdown before the economy passes the tipping point at which acceptable slowdown turns into outright recession. The operating premise of our economic forecast is that the Fed will successfully engineer a soft landing along the lines of the 1995-96 slowdown that actually extended the economic expansion.

An extraordinary fact is that just over the past 11 quarters dating back to the June 2003 Bush tax rate cuts, America has increased the size of its economy by 20 percent. In less than three years, the U.S. economic pie has expanded by \$2.2 trillion, an output add-on that is roughly the same size as the total Chinese economy, and much larger than the total economic size of nations like India, Mexico, Ireland and Belgium. Since 2003, tax revenue collections from the expanding economy have been surging at double-digit rates while the deficit is constantly being revised downward. Bush and his team correctly targeted investment in order to slash the after-tax cost of capital and rejuvenate investment incentives. The move

paid off by the fact that investors now keep nearly 50 percent more of their after-tax capital returns – an enormous increase that has resulted in a remarkably profitable and highly productive business sector. While the overall economy has grown by 20% since mid-2003, private business investment has expanded by 37 percent. Record low tax rates on capital are leading to continued job and income gains as businesses continue to expand.

The characteristics of this expansion are encouraging and presage a different type of business economy. According to the U.S. Small Business Administration, firms with less than 500 employees created 88 percent of the net new jobs in the U.S. between 1990 and 2003 (the last year for data). During this fourteen-year period, the share of total jobs created by small businesses was never less than 50 percent and was sometimes double the employment total. The pessimists may also be in error in assuming that real incomes are falling because of data on payroll employment. As many of these smaller companies are structured tax efficiently vs. their big brethren, employees who are also owners do not rely solely on taxable earnings to enhance their standard of living.

These data points hardly suggest a slumping domestic economy. Instead they reveal a low-tax, durable, resilient, and flexible market system that easily shifts from one sector to another. This American economic dynamism is being embraced by emerging nations to transform overregulated and overtaxed systems into prosperous free-market economies. Ironically these emerging capitalist economies are not burdened with the legal and regulatory environment that stifles American business. In the end, the American capitalist dynamo may be undermined by the very forces that should be providing the framework for success.

Will the corporate profit engine run out of gas? The fact is that the extraordinary U.S. profit expansion continues into a fifth year, but with less exuberance from investors. In the business cycle expansion to date, S&P 500 operating profits have nearly doubled with share prices only increasing around 14% over the same period. Moreover, profits have grown at a double-digit pace in nine of ten economic sectors in the first quarter of this year, belying talk of a very narrow base of profit gains. It seems very likely that seven or eight of ten sectors will post double-digit earnings per share gains in the coming second quarter earnings season. Obviously the energy sector is the greatest contributor to these gains but data suggest that profit growth is strong across the board.

To put these profit gains into perspective, one must keep in mind that globalization and the Internet altered supply-chain systems allowing multi-national corporations to better manage their just-in-time inventory logistics. Furthermore, the decline in trade friction through the World Trade Association, the North American Free Trade Association, and similar treaties opened up global sourcing and created a large supply of cheaper labor pools in countries like China, Vietnam, and India. As a consequence, productivity improvements flowed straight through to the bottom line and investors were rewarded.

### **Conclusions:**

From an economic perspective, global stock markets are positioned to benefit from continued global growth and expected stability in the U.S. dollar – the world's "business" currency. Furthermore, the S&P 500 has reached reasonable valuation levels. The stock market currently is trading at 15 times estimated earnings in an interest rate environment that is healthier and an inflation environment that is more positive. Earnings may decelerate from the double-digit rates of the past 16 quarters to approximately 7 to 9 percent by yearend 2006.

As businesses report record profitability and excellent cash flows, stock market values have yet to completely reflect these positive factors. Corporations are on track to distribute record-breaking dividend payments and to buy back more than \$400 billion worth of shares. These activities may inject more than

\$600 billion into the stock market in 2006. In addition to the fundamentals driving the market, these shareholder-friendly activities could enhance the stock market's attractiveness especially for smaller companies that are viable acquisition targets for both domestic and international behemoths.

Risks to this favorable scenario are an increase in price fluctuations on the back of increasing geopolitical concerns. Geopolitical risks have always been a threat to investing in the financial markets. Until recently, these risks were largely in the background and fairly understood by market participants. Within the last week, efforts to bring North Korea back to disarmament talks failed, Israel launched attacks on Lebanon after the killing of Israeli soldiers by Hezbollah and a war appeared imminent in the Middle East. The heightened risks associated with these geopolitical events will increase short-term volatility and further test investors' confidence in the financial markets.

The baby boom generation has experienced all manner of financial market volatility since 1950, none worse than the stagflation of the 1970s. By comparison with that period's double-digit inflation and unemployment rates nearly as high, today's global economic prospects look a whole lot brighter. As such, we remain bullish on global equity markets due to attractive valuations, robust corporate profits, corporate margin power and the fact that we are entering a typically powerful 15-month seasonal period for stocks in the four-year presidential cycle. This force has produced positive returns in 21 out of 23 periods since 1913. Granted, past performance is no guarantee of future returns. However, if this historic relationship holds, the financial markets should rebound after these geopolitical issues subside.

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