



## Global Financial Markets Perspective Second Quarter 2007

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### The Challenges of Global Expansion

In 1987, the year of “Black Monday”, I was a newcomer to the investment business. After completing an MBA in London, I was faced with two career hurdles: (1) I was a female and, (2) I was a “Yank”. How could I possibly succeed in this investment world of gentlemen-only clubs? I quickly learned that success required I master and practice understanding “all sides of the story” – a philosophy not condoned by my employers who wanted to indoctrinate me into their way of thinking. Nevertheless, I became a regular reader of works by economists and investment professionals with diverging views.

Having served my time in London (I worked at UBS and Philips and Drew), I returned to the United States after five years where I was faced with a new set of local challenges: (1) I spoke and wrote in English (not American) and, (2) I was still a female but had experience in foreign investing. Perhaps the other reality was that I returned to Santa Barbara, a small southern California town where I grew up, which is light years away from my former offices in Knightsbridge and my frequently visited establishments in Belfair and Chelsea. Despite, the “do-it-our-way” demands of my employers, I continued to practice my philosophy of understanding all sides of the story.

My experience tells me that one of the more valued traits in the investment business is recognizing past mistakes and being modest about achievements. Unfortunately, current Wall Street gurus don’t seem to have mastered the latter. As an avid reader of one of the most well-known economists on Wall Street for many years, I was pleased to hear that Stephen Roach of Morgan Stanley was appointed as Asia Chairman (Mr. Roach, who served as Chief Economist of Morgan Stanley since 1982 relinquished this responsibility and assumed his new role in June). Incidentally Mr. Roach, whose work was intriguing, was mostly wrong as an economic forecaster and market observer. As a bear in a bull market, he is one of those gurus who failed to admit his mistakes – until recently. At the same time, I am disappointed that I won’t be able to read his weekly (formerly daily) articles that challenged many economic beliefs that I have and sometimes made my blood boil. So when he wrote his final commentary on June 15<sup>th</sup>, I paid particular attention to his perspective about the effects of globalization. He said:

*“Globalization is certainly on a par with the other two milestones of the past 25 years. In this case, the comparison between 1982 and 2007 is like day and night. I walked into this job when global trade stood at just 18% of world GDP; this year, that ratio is likely to hit a record 32%. The problem with globalization is that we have done a lousy job in understanding and explaining it. And by “we” I mean my fellow economists, policy makers, politicians, business leaders, and other pundits. Far from the nirvana promised by the imagery of a “flat world” and the ecstasy of the “win-win” mantra, the road to globalization has led to saving and current-account imbalances, income disparities, and trade tensions – all having the*

*potential to spark a very destabilizing backlash. The threat of just such a backlash remains a clear risk in today's environment.*

*Notwithstanding those concerns, globalization has been a huge success – at least on one level. Despite persistent and devastating poverty in many poor countries, there has been a doubling of per capita GDP growth in the developing world over the past decade. What is still missing in this newfound prosperity is a key element of sustainability – the emergence of consumer-driven growth models in these still largely export- and investment-led economies. At the same time, in the rich countries of the developed world, the benefits of globalization have accrued far more to the owners of capital than to the providers of labor; labor shares of national income in the major developed economies are at record lows, whereas the shares going to capital are at record highs. Moreover, the distribution of gains within the labor share of the developed economies has become increasingly skewed toward the very few at the upper end of the income distribution – at the expense of those in the middle and at the lower end. Therein lie the seeds for a potentially powerful backlash: As the pendulum of economic power has swung from labor to capital, the pendulum of political power is now in the process of swinging back from a pro-capital stance to that which provides support for labor. The case for trade protectionism – especially in the United States – is alarmingly high as a result. Sadly, this is antithetical to the global stewardship that is so desperately needed in today's world.”*

A few days later, I was reading the transcript from Dr. Arthur Laffer's May 23<sup>rd</sup> conference call. (As you know my partner Tom has written extensively for Dr. Laffer in addition to being in his employ for several years thus making me indirectly subject to the professor's views). Dr. Laffer discussed the effects of globalization, and in his usual fashion, was much more optimistic than Mr. Roach. However, he raised the same warning flags:

*“Everything begins with politics. Going back to the late 1970s there was a huge change in the way we looked at economics and politics in America. Within the period of a few years, we got Proposition 13 in California, the Steiger-Hansen tax rate reduction on capital, Paul Volcker was appointed as head of the Federal Reserve, and Ronald Reagan was elected as president. These developments were a colossal sea change.*

*When Reagan took office the prime interest rate was 21.5%, inflation was running above 10%, unemployment was rampant, and the highest capital gains tax rate was almost 50%! Since that time, inflation has come under control as Volcker, Greenspan and Bernanke have run monetary policy well. Tax rates have been cut dramatically on income as well as on the ownership of capital. Union membership has decreased substantially and tariffs are at their lowest levels in years.*

*We have witnessed one of the greatest quarter-century performances in history! Compare the past quarter century to the period following Kennedy's assassination. The Dow went from an intraday high of 1,000 in February 1966 to a low of 777 in July 1982, and that doesn't count the trebling of the price level. That is a secular depression of ungodly proportions. Over that period, the average annual compound real rate of return on U.S. equities was -8% per year for 16 years. Yet we were able to turn that incredible bear market around and experience a 25-year bull market of unprecedented proportions.*

*As I look at politics today, I do not like the way things are unfolding. There are all sorts of issues out there that are starting to worry me...energy independence is about as stupid an issue as you can find. We use oil really well, and other countries produce oil really well. It's a natural comparative advantage. Having energy independence would hurt us and the rest of the world. And there are a lot of people talking about*

*protectionism, particularly in relation to China. Of all the things, trying to get China to revalue the Yuan just makes no sense."*

The divergence in these professional perspectives is clear. More importantly, one cannot help but notice the similarity in the concerns of these scholars. As an investment advisor in today's volatile markets, I have to assess the validity of research since there are few knowledgeable academics and younger counterparts don't seem to have the wisdom or experience to evaluate new circumstances. But in reading the words of two of my favorite economic professionals with normally divergent views, I find myself at a crossroads since they both show concern about the SAME THING – the prospect for a backlash against capitalism and free trade that would negatively affect the global economy.

Even the best professionals in the same business can disagree. Recently I had the opportunity to enjoy "A Chorus Line" for the umpteenth time. When the play opened in New York, critics reviewed it as a *musical*. The play won the Pulitzer Prize as a *drama* and our local director considers the play a *tragedy*! Consider three different interpretations of a growing world economy. The capitalist entrepreneur sees the world as an opportunity to create wealth. The redistributionist sees wealth creation as an opportunity to enhance the egalitarian state. The isolationist sees growing world trade as a threat to economic independence.

This consensus is cause for a wake-up call! Maybe we have become too complacent. Times are just too good. We take our rising standards of living as a given. We ignore the developing political consensus that America needs more wealth redistribution through higher taxes. Obviously, politics is very important to our market and world markets too – and even more so over the next two years given the disagreement among politicians about appropriate economic policy. The major risk is that the body politic opts for a change that takes us backward.

CNBC economist Larry Kudlow also warns about the risks of a war on capitalism: "*Tax rate hikes will curtail capital formation and could constitute the biggest attack on capital since the 1930s. Job creation could also be adversely affected if Democrats get their way. You can't create new jobs in the private sector unless there is a new or expanding business that needs those jobs. And since new and expanding businesses require more capital for investment funding, if you tax that capital more, you get less investment and fewer jobs.*"

As regular readers know, we were proponents of investing in developing markets because we believed in a coming global economic expansion driven by a rebirth of capitalism. Yet, our optimism is challenged for the first time in many years by these economists' concerns. In Edward Gibbons' History of the Roman Empire, he concluded that the Romans wanted to take more and to give less and in his historical judgment, they lost everything. As Dr. Laffer (affectionately known as Dr. Boom in the 1980s) lauded the progress of the U.S. economy over the past twenty-something years, his optimism must be challenged by both the echoes of Gibbons' perspective on the Roman Empire and the similarities rising from the halls of the political elite. By "George" (that's a little English humor) we'll help the middle class if we have to emasculate the rich to do it. Unfortunately, the bottom line is that you can't have capitalism without capital – and guess where capital comes from? Yes, free markets.

The explosion of global capitalism is good in that it will challenge our ability to compete in a new capitalist world. Yet, the concept of wealth redistribution is appealing to the masses. Fortunately the presidential election isn't until next year and any backward legislation won't be passed until 2010 at the earliest. In the meantime, American voters will have the opportunity to stick with capitalism or go for the big enchilada – the middle American Midas touch. Wow, what a time to be around and to be given the opportunity to experience the collision of economic philosophies and the winner's impact on financial markets. Oh, and by the way, we'll do our best to make sure you are ahead of the investment curve on this one. Stay tuned...

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