Global Financial Markets Perspective
Second Quarter 2008

Risks of Global Growth

Investors have become concerned about the economy and their investments since the beginning of 2008 due both to high energy/commodity prices and weak equity markets. As a result of these concerns, we have focused our perspective on analyzing the current global economic environment to provide some insight into the problems as well as the solutions.

For the past five years we have written about the evolving world economy, the spread of capitalism and the associated increase in global standards of living. Unfortunately a negative side to this positive story has unfolded—an imbalance between rising demand from an increasingly affluent world population and the ability of the world "output" mechanism to meet those needs. This time around inflation is not due to excess money creation, the traditional culprit, but is caused by too much growth. Rapidly rising demand for food and energy has driven up prices resulting in inflation. Moreover, numerous natural disasters have complicated the picture. However, current inflation isn't all bad news. For every consumer who has to pay higher prices, there is a producer who receives those revenues. Many American businesses benefit from the spending of wealthy foreigners. The risk to the global economy is that demand-pull inflation (in Tom's lingo) becomes so strong that the wealth transfer stops due to economic conditions and global growth evaporates.

An issue of greater importance is the lack of understanding of these phenomena by the financial and political communities. Wall Street is demanding that the Federal Reserve raise interest rates to curtail inflation—a monetary solution—yet raising interest rates is like adding gasoline to the fire. Higher interest rates in a weakening economy will only accelerate the decline. Oil prices are acting as the brake on economic growth—a role that interest rates usually performs. We don't need another roller-coaster interest rate ride that emanates from a nervous Federal Reserve Board that reacts to either inflation or recession. Moreover, we don't need increased regulations. What we do need is a fiscal response that will provide the incentives to produce more goods and services.

The recent substantial market decline in the face of $140+ per barrel oil should be a wake-up call for Congress to move swiftly to add to the supply of oil or at least to begin the process of relieving the pressures that push oil prices higher.

Solutions that penalize production via a windfall profits tax on oil companies or new regulations on so-called energy speculators only make the problem worse. The solution has to be supply-based whether through releasing oil from the strategic petroleum reserve, lifting any and all restrictions on oil production in the U.S. or offering substantial tax incentives to produce more oil. Any or all of these actions could turn the global economic outlook positive.

Producers of large, gas-guzzling cars like Ford and General Motors are suffering with analysts predicting that 2008 will be the worst year the U.S. car market has seen since 1991. Shares of these stocks are selling for $5 and $11, respectively, providing some perspective of investor's response to grim news. Sales of luxury four-wheel drives have nearly halved in France and Spain this year. Airlines are not far behind as fuel costs have forced 24 airlines to go under in the past six months, despite a steady streamlining in the years since 2001. A look at the housing industry is probably the most grim as homebuilding stocks have lost on average about 20 per cent of their value in the past two weeks alone! Without a reasonably quick reaction to current high oil prices, many consumer-oriented companies could cease to exist.

Inflation is now the dominant global economic risk. Not since the start of the 1980s have signs of rising inflation been so ubiquitious or so intense. Inflation exceeds 10% in fifty economies, mostly emerging markets, and more seem likely to join the "Double-Digit Inflation Club" (DDIC) soon. Morgan Stanley, the well-known Wall Street broker, invented the DDIC last week based on the fact that the number of countries with double-digit rates of consumer price inflation in their coverage universe had more than doubled from only three to seven within the last couple of months. Russia, Ukraine and Vietnam, which have had double-digit inflation for a while, were recently joined by South Africa, Turkey, Indonesia and India – yet another illustration of the rising global inflation pressures that we have been highlighting. In the industrial economies, inflation is above target for most of the inflation-targeting central banks, and concerns about inflation have either taken equal billing with or supplanted recession worries. Higher commodity prices-primarily oil that has risen 697% since November 2001 - are the culprit. This mix of rising inflationary pressures and downside risk to growth poses a difficult set of challenges to policymakers and investors.

Investors continue to worry about the impact of economic stagnation and rising inflation, lifted higher by oil and agricultural commodities' prices. But comparing today's environment to that of the great inflation highlights some important differences. Back in 1973, quarterly GDP growth plunged from +10.6% to –2.1% from May to September as the Fed hiked rates a whopping 525 basis points from January to August. The Fed was forced to respond to the change in inflation which went from 2.7% (annualized) at the end of the second quarter of

1972 to 6% (annualized) by the end of the first quarter of 1973. More recently, annualized consumer price inflation has risen from 2% in August 2007 to 4.2% last month while the quarterly change in GDP (annualized) has decelerated from 4.9% to 1% quite abruptly. The difference today is that inflation is being caused by too much demand. In the Seventies, inflation was caused by a combination of the abandonment of the gold standard and the Arab oil embargo—not global growth. The high level of inflation in the Seventies took years to drive down and created mass unemployment. Today, politicians and central bankers are struggling to find the right policy mix to avoid a rerun of the 1970s crisis - as rising fuel prices stretch household budgets and squeeze business profits.

The delicate balance between too much growth or recession has shifted to greater concerns about inflation forcing the Federal Reserve and the European Central Bank to make hawkish comments two weeks ago that were effectively a verbal tightening. The recent run-up in oil prices to new highs in the face of slowing global demand and possible increases in supply suggests rising risks to the economy. Yet, further shortfalls in energy supply could push prices higher still. This uncertainty is of great consequence to the global economic and financial outlook.

Robust economic growth since 2001 has ultimately increased inflationary pressures around the globe. Additionally, the supply-demand balance plays out differently from one county to another. The United States, the United Kingdom and Euroland are most vulnerable due to the ongoing housing sector adjustment and commodity price increases in general. Countries that peg their currency to the U.S. dollar find themselves suffering from similar inflationary pressures. Wealthy Mid-East countries have considered de-linking from the dollar adding further risk to international financial markets.

Given the uncertainty associated with rising global inflation, we consider two scenarios based upon two different paths for oil prices. Scenario #1 projects that oil prices will continue to rise into the fourth quarter of this year and stay there until there is an economic event to reverse the price rise. If restrictions on oil supply drive up oil prices, inflation will rise further and central banks would likely respond with tightening. The net effect would be a further slowing of growth in 2009. Scenario #2 assumes that oil prices fall dramatically by the fourth quarter of this year because of an unexpected economic downturn and stay there or fall further throughout 2009. A sharp decline in oil prices would ease inflationary pressures and a major headwind would be eliminated. The problem is that an economic cure of a downturn may not be acceptable to relieving high oil prices.

So what does all of this mean for equity markets?

The ebbing of confidence on the part of both consumers and businesses is creating significant headwinds in the financial markets. Until that shifts, it will be hard for the markets to cease drifting down and sideways. Though we believe that the fundamentals of many companies and select areas of the economy remain quite sound, we recognize that current psychology of the markets in and of itself is a problem.

The first quarter drop in the S&P 500 was one of the worst in years and the first half won't end much better. Since 2004, the market's volatility has been narrow relative to its longer-term history -- recent markets have been trading in an annual band of 14% from high to low versus the historical 25% range. With the Dow Jones Industrials Average in bear market territory and the S&P 500 not far off, our view is that we are returning to the more normal trading band and that we will see continued volatility going forward. To the extend that this broad sell-off in equities in the first half of 2008 has been indiscriminate between companies that are improving their competitive edge -- whether though pricing power, market expansion or the ability to maintain long-term value of their franchise -- then the current environment is becoming increasingly attractive in terms of risk-and-reward. Companies on the price-setting end should continue to see sharper profits while companies in the catbird's seat are providing essentials to the global industrial build-out and others are supplying goods and services that are irreplaceable.

We may be in the eye of the hurricane as this market correction may have more to go near-term. With the pervasive anxiety about the place of America in the world, the presidential campaign that is rife with talk of such decline and the changing status of America today, many lose focus of the smaller picture and those companies that are not susceptible to those trends. The bigger picture can be resolved if leaders respond with a supply-side led initiative that will result in improved investor psychology and stabilizing equity markets. Without a big dose of American ingenuity like that characterized by victory in WWII, the U.S. will find itself falling behind those new economies that are forging ahead as the new capitalists of the Twenty-first century.

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