

BIG PICTURE QUESTIONS AND ANSWERS 11/06/06

The march toward a weaker economy continues. Always at turning point, we have mixed news. Some give comfort to the bulls who permeate Wall Street, and others seem to validate the bear case. In most cases those indicators that lead the economy are projecting a downturn in business while those that lag reflect continued strength.

Examples of strength are the recent positive reports from the service sector plus a very good unemployment number of 4.4%. On the other hand, housing permits and a negative yield curve indicate weakness ahead. As we have in the past, we vote with the leading indicators.

On another matter we recently made a presentation to one of our institutional clients. It is a “big picture” item that represents the overall economic fundamentals. Included in the piece are five different questions which require an answer if one wants to have investment success. The following are those answers.

Consequences for the U.S.

C. 2. Yes, today as well as the 1930's

C. 3. Yes, maybe 60/40 bad

The World in a Nutshell

B. 1. The same people but will spend much less.

C. Yes, but not as well as in the past.

D. We have to say no, but the financial industry is very innovative.

THE ECONOMICS OF GLOBALIZATION

- A. Asian countries have adopted *capitalism* as their economic model.
- B. Other countries will need to conform in order to survive.
- C. Capitalism is inherently deflationary.
- D. Long-term results—a rising tide lifts all ships.

CONSEQUENCES FOR THE U.S.

- A. In the short term, a reduction in GDP growth.
- B. Our concern—consumer debt.
- C. There are two types of deflation:
 - 1. Good: few debt problems—late 1800's
 - 2. Bad: many debt problems—1930's and today?
 - 3. Chances: 50/50?

THE WORLD IN A NUTSHELL

- A. 2001-06 U.S. and China—43% of world growth.
 - 1. U.S. Slowdown—Housing Bubble
 - 2. China Slowdown—Capital Spending Bubble
- B. Wall Street says above slowdowns no problem, but:
 - 1. Who will the buyers be?
 - a. Germany and Japan—very low consumption
 - b. Asia—no middle class as of yet
 - 2. U.S. has the only consumption model
 - a. $\frac{1}{5}$ more than Europe
 - b. $3\frac{1}{2}$ x Japan
 - c. 9 x China
 - d. 17 x India
- C. Can public policy help?
 - 1. Fiscal deficits everywhere
 - 2. Monetary excess
 - 3. U.S. in the best shape
- D. Can we blow another bubble?