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# Political, Economic and Capital Markets Review and Outlook for 2004


*Summary*

- Bush Administration likely to be reelected, along with Republican majorities in both houses of Congress. Republican Party will have ability to implement their policies at least until after the Congressional elections in 2006.

- U.S. and foreign equity markets likely to hold up well in 2004, despite some volatility in response to political events. Rising inflation and interest rates will be less favorable for fixed income investments. U.S. economic growth for 2004 (GDP) estimated at 3.2%.

- After 2004, widening imbalances and tensions in U.S. domestic fiscal policy as well as in global political and economic policies create increasing risk of a major global crisis.

- In 2005-2006, investment markets will be turbulent, especially in the event of a crisis. Investors with a shorter time horizon may choose to hedge their portfolios.

- Longer term, the superior investment strategy is in global growth.


## Domestic U.S. Political Commentary

In our Review and Outlook for 2003, we sketched a preliminary outlook for 2004 as follows:

> "…we anticipate that global political tensions and a rancorous domestic presidential election will result in a highly contentious atmosphere, with renewed economic stress, and volatile, uncertain investment markets."

Now, at the start of 2004, though no primaries have yet taken place, presidential election activities in both major parties are well underway. At present, the overriding factor is the commitment of the Bush Administration to be reelected. Barring some unforeseen circumstance, Bush will be the Republican candidate. Bush has been actively speaking around the country and the Republicans have been aggressively raising unprecedented sums in anticipation of the campaign. Policies, appearances, speeches—all look to be primarily crafted with the goal of Bush's reelection.

On the side of the Democrats, the picture is fragmented. Amongst the large field of candidates, Howard Dean, a populist, has risen to an unexpected position of prominence through skillful use of the internet. As an outsider, he is untarnished by Washington politics. However, despite his independent attitudes, he has an argumentative streak that has hindered support for him within the Democratic Party. Furthermore, he has some left-leaning positions that make it questionable if he would prevail in a general election. Amongst the other contenders, none yet stand out.

Behind the weakness of the Democrats is a lack of vision, while clarity of purpose strengthens the Republicans. Whether or not misguided—or even popular—the Republicans have a strong ideological and practical agenda to which they are dedicated. In addition to their accumulated financial resources and early campaigning, their drive to remain in power and move forward with their agenda underlies the strength of their campaign. On the other hand, the rivalry amongst the Democrats and lack of clear program—other than simply criticizing that of the Bush Administration—in fact strengthen Bush's candidacy.

Therefore, as we launch into the New Year, while the political debate may be rancorous, we believe it will become increasingly apparent that Bush will be reelected. The result of the election, of course, will not be known until November, but the economy and the markets will likely move well in advance of the election. We expect that they will initially react favorably.

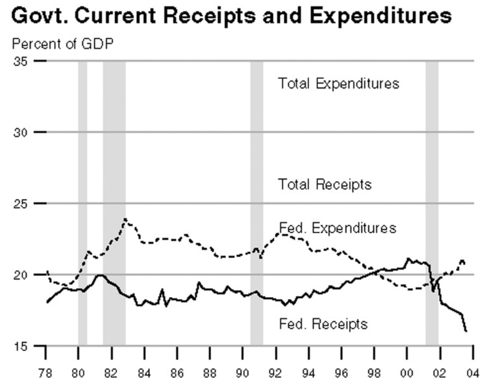
In addition, it appears that the Republicans will retain majorities in both houses of Congress, and that effective domestic political opposition to the Bush Administration will not arise at least until after the Congressional election in 2006. This indicates that the Bush Administration and Republican Party will have the political clout to implement many of their policies.

In general, based on a traditional view of the Republican Party, those policies might be characterized as conservative, supportive of business, and in favor of less government and regulation. But this is rhetoric. Instead, we see actions that conflict with that traditional view.

To begin with, the Administration's fiscal policy stands out. We note that the Administration, working with Congress, has successfully implemented significant tax cuts. What is surprising, however, is that many of these cuts, such as reduced taxes on dividends, capital gains and estates, are not truly stimulative to the economy.

Even more surprising, is the Administration's approach towards the size of government and level of spending. Despite stated goals regarding smaller government, the size of government continues to expand and the amount of regulation proliferates. Nor has our current government displayed the political will to impose fiscal discipline and restrain spending.

As a result, the Administration has pursued a combination of tax cuts and spending initiatives that have resulted in rapidly widening budget deficits, to the amount of approximately $500 billion for fiscal 2003. While these deficits may moderate some in 2004, thereafter they are slated to get worse. Furthermore, these imbalances have serious negative repercussions for our economy and the investment markets in the years that follow.




Another striking disparity between stated policies and actual actions concerns foreign policy. While the Bush Administration started out with an isolationist stance, it quickly became embroiled in international military activities. Following the terrorist events of 9/11, the U.S. launched a bombing campaign in Afghanistan to oust the Taliban. In 2003 we conducted an invasion in Iraq to depose Saddam Hussein. The Administration has also spoken belligerently with regard to Iran and North Korea (the "Axis of Evil"). Whether or not justified, these military involvements are creating increasing expenditures and exacerbating global political tensions.

In summary, it appears that the Bush Administration will remain in power and that the Republicans will maintain majorities in both houses of Congress. This will give them the political control to implement their policies for the next several years. In 2004, the economy and the markets may initially react favorably to this political climate. We note, however, the underlying trends, particularly with regard to fiscal policy and foreign policy (discussed separately below). These policies are creating serious tensions and imbalances around the world. In 2005-2006, as those tensions and imbalances become more evident, we believe that they will undermine our economy and investment markets. As a result, they may lead to a political or economic crisis of global proportions.

## Domestic U.S. Economic Review

Preliminary year-end data for 2003 shows that real Gross Domestic Product (GDP) growth came close to 4% for the year. This slightly exceeds our previous expectations, due to a higher level of consumer spending than we anticipated. Looking into 2004, consumer spending will continue to play a critical role in the U.S. economy. A modest re-build of inventories, some decrease in the current account deficit, and information technology equipment and software spending will also make important contributions to GDP. For the year we estimate GDP growth at 3.2%. Following is a look at each component of that estimate.

(1) *Consumption.* There are few clear explanations for the decisions of consumers. Yet consumer purchases in the past have accounted for roughly two-thirds of GDP. Low interest rates, the recent stock market rebound, government incentives in an election year, and indications of a stronger U.S. economy will give consumers reason to stay confident in 2004. Tensions in Iraq, terrorist attacks, high levels of consumer debt, and a highly valued housing and stock market are pressures that could slow consumption growth. We estimate nominal aggregate consumption will grow 4%, adding about 140 basis points to real GDP growth.

(2) *Fixed Investment.* In 2003 fixed investment contributed about 100 basis points to real GDP growth, largely due to growth in computers and peripheral equipment and, to a lesser extent, growth in single-family homes and other residential structures.

In 2004 we expect further growth in computers and peripheral equipment driven by corporate tax incentives, low interest rates, and replacement of deteriorated equipment purchased in advance of Y2K. We anticipate software will continue to make a significant contribution to GDP in 2004 as security, server applications, new office applications, and voice-over-IP play an important role at the corporate and individual level. We estimate equipment and software spending will grow again at a nominal 7% rate, contributing 40 basis points to real GDP growth.

Demand for residential housing is largely driven by demographics, interest rates and vacancy rates. 64% of first time homebuyers are under the age of 35. U.S. Census Bureau data shows that as a group, total households in the 25-34 age range are estimated to decline slightly in 2004-2005, though overall household growth is estimated at just over 1% in the same time frame. Residential vacancy rates are at 9.9% for rentals and 1.9% for owner structures, a record high since 1960. These high vacancy levels will tend to slow new residential constuction. Rising interest rates likely in 2004-2005 will also make investment in residential structures less attractive. We estimate contribution of residential structures to economic growth will be in line with inflation and not add to real GDP.

Investment in nonresidential structures declined by 16% in 2002, and then stabilized in 2003. We expect a modest pick-up in this investment due to low interest rates, tax incentives and increased federal funding for programs such as in the renewed U.S. highway construction bill. Overall we estimate nonresidential structures will grow by a nominal 6%, adding 10 basis points to real GDP growth.

(3) *Inventories.* Decline in inventory levels slowed economic activity by 30 basis points in 2003. Some of this inventory loss may be permanent due to increased shipping efficiency and new inventory management technologies. Given the low level of inventory to sales, we estimate inventory levels will rise about $60 billion in 2004 adding 50 basis points to real economic growth.

(4) *Net Exports.* Net exports (exports less imports) currently account for a deficit of $488 billion, effectively slowing real GDP by over 400 basis points in 2003. In late 2003 the weakening U.S. dollar helped to decrease the current account deficit making a positive contribution to real GDP. Policy makers are looking for solutions to the current account imbalance, and are considering further actions to weaken the U.S. dollar and re-work trade policies. For 2004 we estimate U.S. imports will increase with inflation at 2% and exports will increase at about 3% leading to a 10 basis point contribution to real GDP growth.

(5) *Government Consumption.* The budget of the U.S. Government states fiscal year 2004 government spending should not grow faster than the income of the American family (4%). We believe the federal government will spend beyond its budget in 2004 and state and local spending will be constrained. A 5% nominal growth rate to federal government spending and a 3% nominal growth rate to state and local government spending will add 70 basis points to real GDP growth.

(6) *Inflation, Unemployment & Interest Rates.* Money supply is a key variable that impacts inflation. After peaking in August, money supply has decreased by almost 2%. Policy makers will have difficulty further reducing money supply in 2004 due to concerns about economic recovery. The large increases in the money supply made over the last several years and increased federal budget deficits will likely lead to higher inflation. We estimate inflation at over 2% in 2004, rising to over 3% in 2005.

In addition to our above estimates for 2%+ inflation and 3.2% growth in real GDP, we make the following projections for 2004: unemployment will remain over 5.5%, short term treasury rates will increase slightly to around 2%, while interest rates on ten-year treasuries will rise to 5.5% to 6.0% by year end 2004.

In the 2005-2006 time frame, job growth will be key to economic activity. If unemployment remains in the current 5.5% to 6% range, consumption will likely slow. Furthermore, corporate tax incentives are slated to expire, interest rates and the dollar will most likely head higher, and pressure on current account deficit will continue. All of these factors will tend to restrain U.S. economic growth, and renewed economic stress is likely.

## Global Political Review

We believe that the most important trend in the world today is globalization. Some may think that globalization is a recent concern. In fact, a global consciousness was in place at the time of the Roman Empire. In more recent times, however, particularly since the beginning of the $20^{th}$ Century, it has become much more critical. Due to issues of environmental threats, terrorism, global trade, nuclear and biologic weapons, even disease, we are being forced to figure out how we will all get along together, to the point where globalization is a necessity.

Over the past 100 years, driven particularly by the two major world wars, the world witnessed the decline of the major colonial powers and the formation of independent nationalist states. Following the close of World War I, the United States had risen to the leading position amongst countries around the world. That position was solidified at the close of World War II. For the next fifty years, a cold war stood between the U.S. and the U.S.S.R., but other than a quasi balance in military power, the United States, together with the support of its Western allies, was by far the dominant power. Towards the close of the $20^{th}$ Century, socialist regimes in Eastern Europe and Russia collapsed. At the turn of the Millennium the United States stood alone as the preeminent world power.

Yet that preeminence was not unchallenged. Other European powers had successfully rebuilt themselves following the devastation of World War II. Central and South American countries were struggling to change from oligarchic structures to more democratic ones. China had established itself as a rapidly growing political economic and military power. With the breakdown of the Cold War, and the growth of global trade and global interests, imbalances around the world had become more apparent, and foreign interests had greater resources with which to challenge the predominance of the United States.

In addition, during the $20^{th}$ Century, we witnessed the first attempts at democratic global authorities. First, in the aftermath of World War I, came the League of Nations. It floundered, due in part to structural flaws, but also because it received inadequate support. The failure of the League is one factor that led to World War II. The devastation caused by that war subsequently resulted in a much stronger commitment to world order – the United Nations.

We also witnessed the creation of other global authorities besides the U.N., such as the World Trade Organization (WTO), the International Monetary Fund (IMF) and several others. But these organizations are in their adolescent stages. Overriding power still remains with governments of individual countries.

In the 1990s, the world became enamored with the fall of Communist regimes and the spread of capitalism and democracy. There were some disruptions along the way: for example, the meltdown in Asian economies in 1997. Nevertheless, it was a time of rapid increase in global trade, rapidly rising stock markets, and expansion of democratic ideals.

In the enthusiasm, we failed to heed the darker aspects of globalization: the economic chaos that free markets can engender, the growth of terrorist networks, as well as the threat of development to our global environment.

The wake up calls came primarily in the form of the 9/11 terrorist incident and the bursting of the bubble in the U.S. equity markets in 2000 to 2002. It has been a sobering time. In addition to these events, we have also seen other breakdowns and failures: in World Trade Organization talks and fights over tariffs and trade policies, in proliferation of weapons, in failure of the United States to sign on to the Kyoto protocol of global environmental regulation.

As a result, the trend of the latter 1990s toward enthusiastic globalization has taken a decidedly different turn. People and countries are now more fearful and belligerent. Terrorist incidents are on the rise. Political states are asserting their sovereignty and fighting against each other.

Along with these sobering times, has come the change in the U.S. from Democratic to Republican leadership. In this new climate, under this new leadership, the United States in particular has taken a markedly different approach. This is demonstrated by our recent history since the 9/11 terrorist incident. Initially, our response was to work cooperatively through the United Nations. We forged an alliance to attack Afghanistan and unseat the Taliban.

Subsequently, however, we have chosen to act unilaterally. We have sought to assert our supremacy and reduce our vulnerability to foreign powers. For example, with regard to Iraq, rather than working with the United Nations, the U.S. chose instead to proceed on its own.

This does not mean that the trend towards globalization is reversing itself. Rather, that we have entered a new phase: where we are less enamored with it, where its “dark side” is more apparent, and where issues are more visible and difficult to resolve. We see that globalization requires compromise and sacrifice. The process continues, but it has become much more arduous and tempestuous.

Over time we believe the necessity of powerful global institutions will become apparent, and that they will come about. Indeed, we are constantly at work struggling to build them. But we also see the current countervailing forces, where people and governments are resisting these trends and retreating from them. Rather than working towards these inevitable outcomes (such as a powerful U.N.), we are currently working against them, creating increased tensions, disparities and imbalances.

We believe that the current approach of the United States government reflects this. In our view, this will not work. The United States cannot maintain its status of extraordinary preeminence. As we seek to maintain our “hegemony,” we hasten its demise. The manner in which this plays out could be through a catastrophic event, such as another 9/11-like incident, a biologic terrorist attack, or even a nuclear confrontation. Or, rather than a political breakdown, such an event could be a cataclysmic economic one: collapse of the U.S. dollar, a stock market crash, or a global trade war.

Note, however, that such a catastrophe is not inevitable. The upshot of these tensions and imbalances could be simply a reversal – a swing back in the other direction to where people around the world simply change their thinking and move towards increased cooperation.

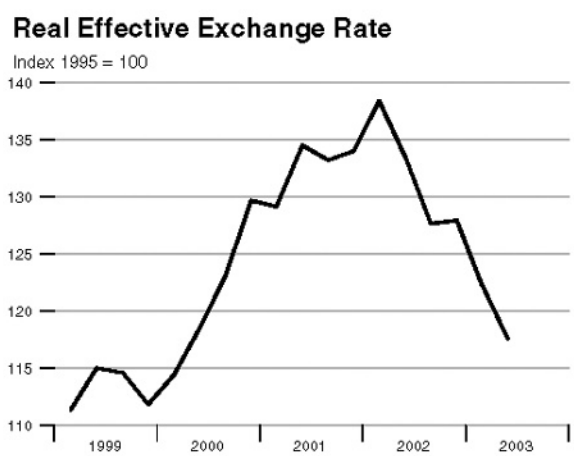
Nor do we view these trends as necessarily negative, but more as growing pains as we seek to attain a higher world order. We see peoples around the world who want to share in the prosperity of the U.S. We see vibrant growth in the world economy, particularly in specific emerging markets. We see persistent ongoing efforts to establish stronger global authorities.

Nevertheless, based on the tracks we are now on: nationalism, turning away from global cooperation, unwillingness to compromise, insistence on U.S. supremacy – some sort of crisis appears to be the direction in which the world is currently headed, and that it will take a global crisis to serve as a catalyst to achieve those higher levels.

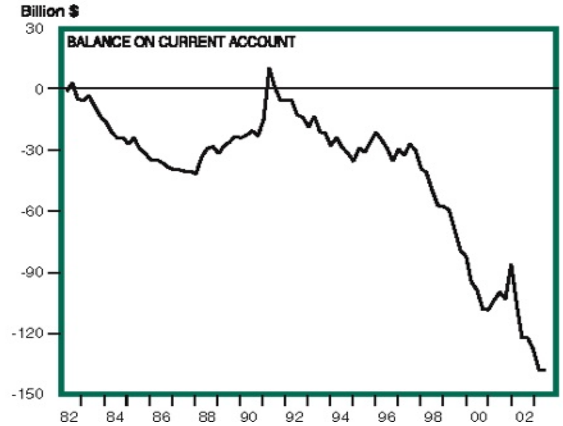
## Global Economic Review

Alongside growing global political tensions, the following additional economic imbalances and disparities give further weight to our conclusions.

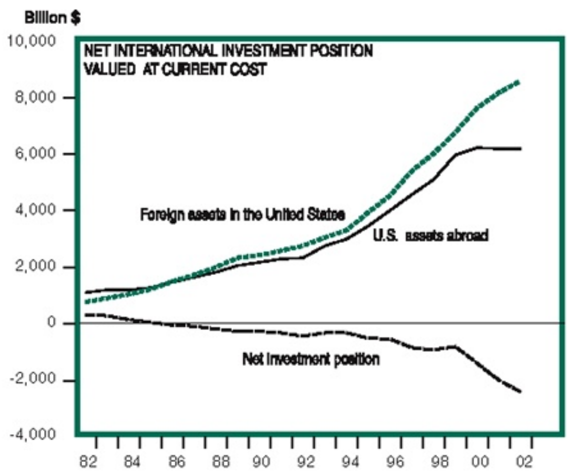
(1) *U.S. Dollar.* The U.S. dollar is currently serving as the functional global monetary standard. Recently we have noted reports about a prospective crash in the dollar. Due to the interests of so many parties around the world who hold assets and transact business in U.S. dollars, we don't believe such a crash will occur. Nevertheless, the recent slide in the value of the dollar will likely continue, creating additional global economic instability. Over the longer term, rather than a U.S. dollar crash, we suspect global currency devaluation (inflation) is the more likely outcome.




(2) *U.S. Current Account Balance.* The current account balance represents total U.S. exports less imports. Over the past ten years, the U.S. current account has been negative and has widened dramatically to record deficits. In 2004 the weak dollar may provide some temporary relief to this deficit, but longer term the wide disparity between U.S. and foreign costs of production will continue to weigh on it.

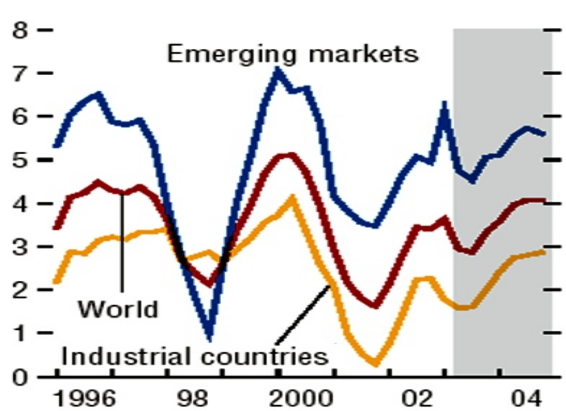



(3) *International Investment Position.* Perhaps less visually dramatic, but of even greater concern is the international investment position. In 1986 the U.S. turned from a net creditor to debtor nation. Over the past several years, U.S. ownership of foreign assets has flattened out, while foreign ownership of U.S. assets has continued to climb in response to global growth. This net balance, therefore, has steadily declined to approximately a $3 trillion debit level at present, and continues to deteriorate.




(4) *Emerging Markets Growth.* As counterpoint to the above dramatically negative trends of weakening in the economic relationship between the U.S. and the rest of the world, we note the tremendous growth and strengthening that is taking place in many Third World countries.

GLOBAL OUTLOOK
*Real GDP; percent change from four quarters earlier*



The meaning of the four above trends is telling. Over the past 50 years, the U.S. has held the preeminent position with regard to global economics, currency, and markets. Now, however, other people and economies around the world are becoming more prosperous relative to the United States. Over time, as they experience ongoing growth in their own markets, and become increasingly disenchanted with their dependence on the U.S. markets and dollar, they will seek more diversification in trade, in their ownership of foreign currency and assets, and increasing investment in their home and other emerging markets.

## Capital Markets Outlook

Given this world of rancorous politics, growing global political tensions and economic imbalances – yet vibrant economic growth in many emerging markets around the world – what do we believe is the outlook for the investment markets in 2004, and what do we think is the appropriate strategy to pursue as we head into the New Year?

With regard to the domestic U.S. equity markets, we expect that during the course of 2004 they will hold on to the gains of 2003 and likely continue to rise, albeit at a more modest pace. While we could witness another major terrorist incident or a military flare up, we don't believe that such an event would be so severe as to seriously undermine the markets. In addition, in 2004 the Bush Administration will take a restrained approach, intended to support the economy and markets to facilitate their reelection. They will seek to defer any destabilizing measures (such as a military confrontation with North Korea) at least until after November. Therefore, if any catastrophic event is in the works, we do not expect it to occur in 2004. We expect that the U.S. and foreign equity markets will continue to rise in this relatively benign environment, perhaps on the order of 5% to 10% over the course of this year.

In the 2005-2006 timeframe, however, we believe that the climate will be more turbulent for investors, in both the equity and fixed income markets, foreign and domestic, and that a destabilizing scenario, if any, would then be much more likely.

## Investment Strategy

Despite the current climate of growing tensions and imbalances, we believe that the optimal investment approach is to look beyond these troubles and anchor one's perspective in the global world of the future. Indeed, the largest and most successful businesses in the world, such as IBM, Microsoft, Nestle, General Electric, Toyota and many others, are already structuring themselves and operating on this basis. Large global-oriented companies like these will be the key participants in creating and prospering in the global world of the future, and investment in broadly diversified common stock holdings in companies like these should form the core of any longer-term investor's portfolio.

Owning stock in these companies provides investors with the benefits of global diversification. Most pay dividends that are modest, but that will grow over time. These global companies also give investors the opportunity to tap into the more rapidly growing economies around the world, such as China, India, Mexico and Brazil.

For investors who seek to enhance longer term returns, and can undertake higher risk, funds that invest in stocks and bonds in those emerging markets should enhance portfolio returns.

With regard to fixed income investments, some diversification in this area nearly always makes sense. Nevertheless, in light of the likelihood of rising interest rates and inflation, as well as the potential risks of currency devaluation, we are currently underweighting bonds, particularly those with longer maturities. The significant exception to this is investment in U.S. Treasury Inflation Protected Securities (“TIPS”). TIPS are AAA-rated direct obligations of the U.S. Government, and are fully protected against inflation. Due to the extraordinarily low risk of these securities, and their guaranteed real return, we believe they make sense for any U.S.-based investor, except in situations where they create onerous tax liabilities.

For investors with a lower risk tolerance, or shorter time horizon, who are not positioned to ride through a potential global crisis in the next several years, some “hedged” positions are appropriate. TIPS holdings should work well for this purpose. Ownership of utility stocks, or resource based assets, such as real estate or oil stocks, may help. We would also recommend elimination of any variable rate debt.

Over the last few years, we have focused on real estate investment trusts (REITs), high yield bonds and convertible securities, for both their favorable returns and properties of diversification. We continue to favor investment in these securities, but we do not currently emphasize them.

## SUMMARY

We believe that globalization is the wave of the future. Under our current political leadership, the counter trends towards nationalism, unilateralism, trade protectionism and military conflicts are taking us in a different direction and are increasing the likelihood of a major global crisis. Nevertheless, such a crisis is not inevitable. Furthermore, even in the event of such a crisis, though devastating for many, the world would endure. Such an event could serve as a catalyst towards resolving problems that confront us today, and in strengthening the global institutions that will enable us to handle them more successfully in the future. This might entail significant global political and economic structural changes. Nevertheless, we expect that people around the world will still work with money and savings, trade and investment.

We believe the successful investment strategy today is to invest on the basis of that global future.

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16 January 2004

*Sources for Charts: Federal Reserve Bank and International Monetary Fund*