

Unsettled Times

After an outstanding year 2003 and a positive first quarter 2004 the political and economic outlook has worsened. Not that it was an unexpected development. We have been more surprised by the strength of the surging market, than by the present slowdown and uncertainty. Like other investors, we have well profited from the pleasant rise in emerging country debt, but it was almost too good to last. Stocks and bonds, in particular the riskier ones, had rallied back to optimistic levels.

The political situation has taken a turn for the worse with the failure of the US and allied operations to gain acceptance by the local population in Iraq and the Middle East. Local mistrust of the US plans for this region is widespread and opposition to it seems to be insurmountable as long as the US are not seen proposing and implementing a more balanced peace plan for Palestine and the Iraq. With this widespread Arab and Islamic opposition and hostility, a military solution is unlikely and would require too high costs. A bloody and expensive stalemate, which satisfies nobody, is the result. This malaise has let oil prices surge, an important inflationary factor in the developed world.

The economic situation is improving after the setback of the stock market crash. Profit margins and earnings are going up again. Sentiment indexes improved. A strong real estate market in the US has helped to lift consumer spending. Most middle class families probably gained more in net wealth from increased housing prices than they lost by falling stock prices.

The Fed under Greenspan has done a wonderful job in extending favorable economic conditions. But it has also created a climate in which, due to the very low interest rates, debt expansion has gone to extremes. High debt exposure can always get higher, if circumstances remain benign, but the margin of safety gets smaller and smaller. The US consumer has record high debt and also his mortgages are at all time highs. If now mortgage refinancing gets more expensive, it may very well lead to declines in house prices, which in turn will squeeze the debtor. Since also corporate and government debt are at or close to record levels it is only fair to say that we face growing uncertainty. There is possibly more weakness to the dollar, if foreign nations or individuals tire of holding additional dollars. The phenomenal growth of hedge funds with their speed and opportunistic turnover is an additional cause for instability. The consequence for prudent investors is that he should become more defensive and watch credit risks closely.

We are not worried, but we are cautious and will look for value. Volatile, fast growing concept stocks of lower quality, that promise rapid wealth, have never been our favorites. For us, the best investment strategy is to buy good quality cheap, the cheaper the better. Investors will move from enthusiasm to worry and even pessimism and they will get rid of good or even great quality stocks just because they will fear a further decline. This will be the time to pick them up at favorable levels and build a prosperous portfolio as contrarians always should do. Our emphasis will be on companies with good, sustainable profitability, firms which will grow over time and will not be rendered obsolete by inexpensive Asian competition. Emerging country and some corporate debt may also come under pressure from time to time and will give us a chance to buy bonds with high returns.