# Trusted Advisor

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## Post-Election Commentary:
### *Challenges are Daunting*

Election day creates a special burden for financial writers. Many feel they must tell you how certain stocks or funds will react to the outcome of the voting. However, with so many variables affecting market performance, I find such predictions difficult -if not impossible- to make with any hope of accuracy.

I was tempted to publish this month's edition of Trusted Advisor just before the election, to make the point that whomever won the Presidential race, it would not, in my opinion greatly alter the course of financial history: the economic issues facing our country are daunting - bigger than any one President or Party. Had Kerry won, I believe he would have governed in the mode of a middle–of–the-road Democrat, like Bill Clinton. Leading Dems have learned that obstacles to capital formation and business bashing achieves nothing good for the overall economic wellbeing of the nation. Besides, with control of Congress expected, pre-election, to remain in Republican hands, Kerry would not likely have been able to raise taxes significantly or impose a radical increase in government's burden on the wealthy. Now that the election's results are known and with Republicans solidly in control of all branches of government, pro business types are rejoicing: tax incentives for capital formation such as lowered capital gains rates may be improved further–perhaps stock dividends will become tax free as they are in most other nations. Constraints such as environmental law enforcement and product liability lawsuits may return to levels unseen since the early 1970's, a sad thing for the environment, but great for business profits. Legislation to accelerate the paces of energy development and exploration has become increasingly likely. Supporters of the President's view on the economy may want to temper their enthusiasm by considering that the second Bush administration will face structural problems that threaten the future economic prosperity of this country in a way we have not seen since the late '70's.

First, we are caught in a situation reminiscent of the Johnson years: mired down in an expensive foreign military conflict, the government cannot pay it's bills without massive borrowing. High government debt limits the ability of both Congress and the Federal Reserve to promote further economic expansion or prevent a recession. As Medicare and other "entitlements" demand a ever greater share of tax revenues, there is virtually no hope for a balanced budget in the foreseeable future.

Since Congress, in Republican hands has shown itself more than willing to engage in pork barrel spending, the Federal Reserve is the last line of defense in preventing runaway inflation. But one of the strongest quarterbacks to have ever played for "Team Fed", Alan Greenspan, will likely retire in early 2006, creating uncertainty and perhaps anxiety in the financial markets. The Fed


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Chairmanship is arguably as powerful a position as the Presidency itself. President Bush with the consent of Congress, has some big shoes to fill. The new Fed Chairman must be able to steer a monetary policy that minimizes economic contractions, yet prevents an expansion from becoming an inflationary blow out. Even assuming a capable individual is chosen, The Fed's job is made extremely difficult because national debt is soaring again. Further, the economy is susceptible to a downturn because the sharp rise in oil prices, rising health care costs, and poor job creation are limiting the ability of consumers to spend, and consumer spending has been the backbone of the current expansion. The Fed has limited options: it cannot stimulate the economy, with interest rates already near 50 year lows, so it is possible that the USA faces a prolonged growth recession, like Japan. This growth recession could turn into an outright downturn if the Fed raises interest rates or worse, if foreigners lose interest in buying Treasury bonds and rates rise without Fed action.

And this brings us to China. With a burgeoning population of workers who earn less than $1.00 per hour, receive little in benefits and who are arrested and tortured when they protest, China is a ferocious world competitor, gobbling jobs from throughout the developed world. Even Mexico is becoming worried about losing jobs to China[1]!

What is the Central Bank of China doing with all the tax receipts it collects from booming Chinese enterprises? Supporting America's addiction to debt, that's what! According to analytical firm Bridgewater Associates[2] at the end of 2003, 37.3 percent of U.S. Federal debt was in foreign hands - more than double the 18.2 percent share of ten years earlier. In 2003 the Treasury sold $373 billion of bonds to the public. Foreigners bought $259 billion, or nearly 70 percent.

This week, Bridgewater observed that the current situation is eerily like 1968-1973, with China playing the role of Japan and Germany and buying U.S. Treasuries to prop the dollar up. This policy was unsustainable and, contributed to the dollar's collapse in 1972, runaway inflation and a 28 month bear market in the early '70's.

As a precaution, I have positioned clients to benefit from possibly rising foreign currencies (a falling dollar) in a number of ways: We recently purchased a fund focusing on Asian and Australian bonds, in some cases adding to existing positions. This fund offers a dividend near 7% per year. We re-purchased a fund that invests mostly in European sovereign debt and pays about a 4% dividend. Both holdings should benefit from dollar weakness, in addition to churning out generous monthly pay outs. Even if the dollar holds value, these investments exhibit share price behavior that is quite different from that of U.S. stocks and bonds, making them a great portfolio diversifier.

We also retain significant exposure to strong foreign currencies via such holdings as Prologis, a global warehouse builder and operator with holdings from Poland to Szechuan province. Likewise, Johnson & Johnson, a new portfolio addition, enjoys significant foreign sales that contribute to income. Perhaps the most satisfying investment that has enjoyed foreign currency exposure is the single largest holding for virtually all clients. Investing in foreign value stocks[3], this fund's management has earned Morningstar's highest five star ranking for years, and is up 11.5% (year to date) aided by a weak U.S. dollar.

## Headlines we Love :

*"U.S. Oil Shortages Seem Unavoidable to Many Analysts"* -New York Times, February 17, 1987. Yep, and nothing has changed, has it, in over seventeen years? America's love/hate relationship with black gold dates back well over a century. I am plowing my way through Daniel Yergin's *The Prize*[4] a well written and fascinating history of the oil industry from the first commercial discovery in 1856 through the book's publication in the early 1990's. Historical perspective is useful: for some 150 years, shortages have periodically developed, after low prices have spurred demand, and production dwindled. Then rising prices spurred new discoveries, or improved production methods. Oil again flooded the market, prices plunged and once again, consumers forgot their former thriftiness in dealing with energy. These cycles seem to repeat themselves about every 20 years, with mini cycles along the way. I

believe we are in the midst of a major price upswing for oil and especially for natural gas. Much of this is driven by demand from China where prosperity is growing and motorized alternatives to bicycles are in high demand. But significant price retreats will occur during this secular bull market. Recall it was only two years ago that bottled water was selling for more per gallon than was gasoline! With prices high again (yet below levels of the 1970's when adjusted for inflation), consumers are cutting back, as can be predicted. My little planned community of Siena, in Laguna Niguel is bravely doing it's part, turning off the pool heater for the winter months (shiver). My father-in-law is the happy owner of a new Honda gasoline-electric hybrid. Individual decisions like this add up. I suspect the big story of the next year or two will be a surprise drop in energy demand and prices, but then again, the health of China's economy and it's new-found thirst for oil is a difficult factor to predict.

**Reminder:**

Our annual "Client Appreciation Luncheon and Holiday Party" is scheduled for December 7, Tuesday at 11:45 PM, and will again be held at fabulous Mr. Stox in Anaheim. See you there!

So, energy related investments are likely to continue as a fixture of our clients' diversified portfolios. My clients have benefited from exposure to the energy industry since the low prices of early 2003. I've tried to position clients in a way that does not depend on sustained high oil prices for profit. Our largest exposure is to natural gas and refined product pipelines. These are akin to toll roads: regardless of the price of oil or gas, pipeline owners get paid for carrying traffic. This is a far more secure and predictable source of income than wildly fluctuating energy prices. While pipelines have not earned the headline grabbing returns of more aggressive energy investments, I've heard no complaints. Consider that Kinder Morgan LLC, purchased in January of last year, has grown over 40% (with dividends reinvested). Valero L.P., purchased in July 2003 has grown similarly up 30%, and has thrown off over 10% in additional dividend pay out since purchase. Incidentally, Valero recently announced the purchase of Kaneb Pipeline Partners, a larger competitor. Here is Goldman Sach's analysis of the transaction:

*"We view VLI's $2.8bb acquisition of KPP/KSL positively as it (1) is expected to be ~$0.55 accretive to 2005 Discounted Cash Flow and result in an est'd $0.30-$0.40 2005 distribution increase, (2) improves VLI's organic growth prospects with the vastly increased footprint in pipelines and terminals that occurs from a $1.7 bb company buying a $2.8 bb company, and (3) reduces VLI's dependence on Valero Energy as a customer .. with est'd 3rd-party revenue increasing to 75% from 2%. "*[5]

Investors have initially put their stamp of approval on the transaction, driving VLI's price to record highs on November 3 (although some of this could have been post election euphoria in the oil patch).

(Footnotes)
1 El Tiempo, Managua, October 15, 2004
2 As quoted in CBS Marketwatch November 2 2004
3 Known to clients, this fund will remain nameless for competitive reasons.
4 ©1992 Touchstone/Simon & Schuster
5 Goldman Sach's research commentary as quoted at Schwab Institutional web site, November 1 2004