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Trusted Advisor

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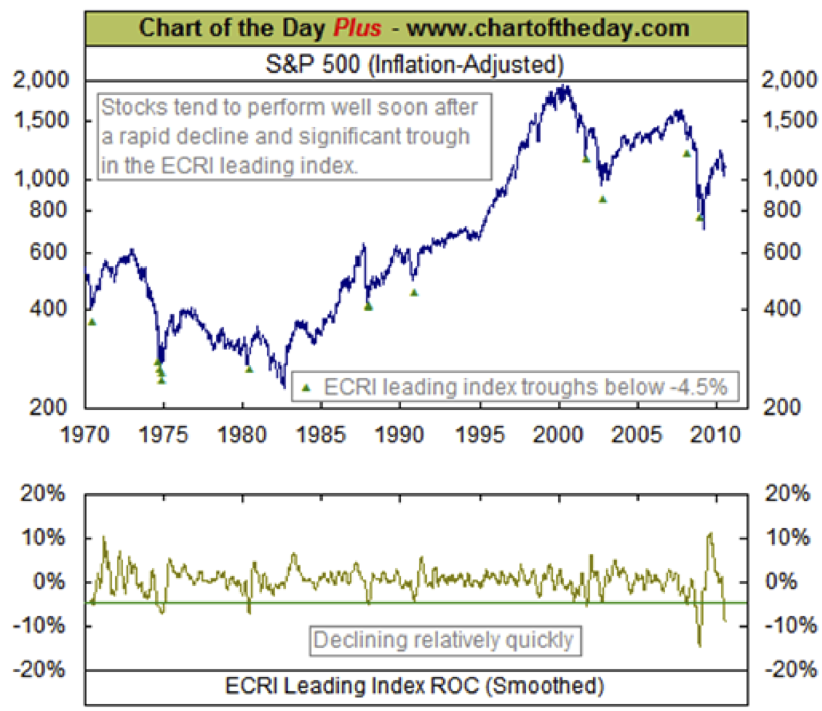
SLOWING ECONOMY

Is a Double Dip upon us?

With the US economy sputtering, according to a release from the Federal Open Market Committee on August 10, I thought it was prudent to reduce client exposure to stocks in the event we are heading into a double dip recession/ depression. Long-term clients know I have never claimed to be a big picture economist. However, a macro view of the world is certainly a factor in my choice of portfolio design and specific holdings. The fact that this is not a healthy economic recovery is, I suspect, due to a confluence of economically depressing forces that have been gathering for decades.



Certified Financial Planner™

Gary Miller is in his 36th year of providing financial guidance to individuals and pension plans. He is a Registered Investment Advisor and a Certified Financial Planner ™ Practitioner. Gary holds a Certificate in Personal Financial Planning from the University of California, Irvine and has served as a Board member of the Financial Planning Association, Orange County Chapter.

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Capitalism rewards those who are most efficient, most productive and most competitive. While aspects of the US economy remain competitive on the global stage such as software and energy development, agricultural production, banking and finance, heavy industry and manufacturing are challenged by the expense of our workforce.

A client was kind enough to alert me to an article that appeared in BusinessWeek recently. Authored by Intel's legendary former chairman, Andy Grove, it explained that while Americans still excel at conceiving new products and processes, they often cannot afford to build an enterprise around them here at home. To quote Grove:

"Today, manufacturing employment in the U.S. computer industry is about 166,000, lower than it was before the first PC, the MITS Altair 2800, was assembled in 1975. Meanwhile, a very effective computer manufacturing industry has emerged in Asia, employing about 1.5 million workers - factory employees, engineers, and managers."

New green technologies are unlikely to result in new employment. Grove observes that although photovoltaics for solar electricity production were perfected here, and likewise the lithium ion battery to power electric cars, they are primarily being manufactured in Asia. His observations explain, in part, why unemployment remains stubbornly high after about 16 months of economic recovery.

A century ago, the United States was the China of the world, stealing business from Europe, particularly England, because of our cheap labor, plentiful resources and the willingness of our people to work 12 hour days, 6 days a week. These same people worked in dangerous, unsanitary conditions, and their families breathed polluted air and drank water of marginal quality. They had no medical insurance, no guarantee of security in retirement, and little protection if hard times hit. Few could afford to own a home or even a decent horse, let alone an automobile. Life was pretty tough, but Americans, especially recent immigrants, seized the chance to better themselves.

Today, it is places like China, Indonesia and India that offer a workforce willing to sacrifice in this way. Further, the cost of initiating and sustaining a business in the United States is often challenged by environmental and consumer protection regulations. Without these restrictions, I believe that many Americans would likely be living much as people do in third world manufacturing nations like China. Yet these citizen protections allow a powerful industry of lawyers to harass American companies with a chronic series of lawsuits, many of them little more than an attempt at extortion.

There are other disincentives to manufacturing in America: a comparatively high corporate tax burden as well as a relatively high minimum wage, conspire to place the USA at a competitive disadvantage in many situations. Seemingly pristine US companies, like Apple, enjoy strong profit margins partially because the components of their products are manufactured in nations that turn a blind eye to environmental and human destruction. I'm not opposed to environmental protection, but tend to side with Andy Grove's idea of some sort of import tax. I'd limit this to products manufactured in nations who care little about the environment.

Americans have come to expect a roof over their heads, cheap food and affordable consumer goods. Televisions, Xbox consoles, smart phones and inexpensive clothing are key to a middle class life. A new, often inefficient, car is expected to appear in the driveway every few years. I note that most of my employed contemporaries value free time over a 40 hour work week. In a global economy, this spells trouble for much of America. We are the world's most voracious consumers, and individually and collectively have borrowed vast sums from outside the United States to pay for this lifestyle.

Beginning in the 1980s, the Reagan administration embraced the concepts of free trade under the theory that as things get sorted out, each nation will focus on those tasks for which they are best suited. This is the notion of “Competitive Advantage” articulated at the time in “Free to Choose”, a book by economists Milton and Rose Friedman, and popularized as a series on PBS television; nations with cheap work forces will do the heavy work of manufacturing while nations with educated and or creative work forces will conceive, create and direct enterprises. Perhaps the world is on its way to such a lovely, balanced future, but boy, the transition is painful for many. Take an auto worker or someone working in a specialized parts manufacturing operation. Let’s not kid ourselves that people with this sort of background will, with a little education, become software developers. Even if many were to make the transition, they must compete with a growing elite and educated white collar population of India who offer their services for a fraction of the cost of a US based worker.

The common wisdom making the rounds of many economists is that once the US housing market turns around, many white collar jobs as well as blue collar construction jobs will come back, and people will begin borrowing and buying once again. I would not hold my breath waiting. First, there is no huge demographically driven demand for new homes as there was with household formations in the 1950’s and again in the 1970’s. Second, with high unemployment, first time home buyers and move-up home buyers will continue to be sparse. There is no clear sign that the housing market has bottomed out. We may be on the verge of another down-leg for the economy because government props to powerful sectors appear to have lost political support, and corporate America is nervous about committing their large hoard of cash to new capital investment at home. While there may be validity in the blame assigned to new entitlement requirements (universal medical insurance), I suspect a more powerful element is fear of a double dip recession. Warren Buffet extracted significant profits in the early 1950’s by buying shares of corporations who were hoarding cash, paying less than the cash value for these companies. These entities were often managed by people who had lived through fifteen years of financial uncertainty (The Great Depression and World War II). They had a high degree of comfort in keeping a lot of powder dry. Buffet, in his ‘20’s, did not share this historical paranoia and was quite successful in taking profits away from the Old Fogies. I have to believe this same hoarding mentality is at work today throughout industry, as executives wonder whether it is too soon to commit to hiring, building additional plants or upgrading their technology.

Some people cling to the belief that our central bank can still come to the rescue by keeping interest rates low. About that notion, Mohammed El Erian, a brilliant economist at PIMCO, put it more simply: *“Expecting the Fed to save the economy is like sending out a quarterback to act as a wide receiver”*. The Wall Street Journal had this to say about the Fed’s possible future actions:

> *“With interest rates as low as they can go, the Fed has few attractive options to resist deflation. The main one is to print money electronically to resume large-scale purchases of securities.”*
>
> *“That option is now waiting in the wings should the recovery show clear signs of faltering and core inflation continue to trend lower.”*
>
> *“The bottom line is that this Fed is now clearly more concerned about downside risks to the economy and deflation...”*

What’s wrong with deflation? Haven’t we been told, for a generation, that inflation eats into our buying power and is bad for the economy? Those who believe the government must do everything possible to avoid deflation fear that a reduction in the general price level will lead to a depression, a repeat of the 1930's experience. Here's one example playing out right now: if you and your spouse purchased a $600,000 California home in 2005, with a $480,000 mortgage, the house is likely worth about $350,000 to $400,000 today. Since the mortgage is larger than the value of the home, you might ask yourselves, "Why should we continue paying a mortgage at all? Maybe life would be easier if we just walk away?" In a generalized deflation, debtors of all sorts, homeowners, motor home buyers, businesses, etc. begin to walk away from their debt. This could cause another financial crisis as lenders must again mark down the value of their loans, as they did in 2007-2009. Those who put their faith in *laissez-faire* capitalism would suggest that falling prices should allow markets to clear, bringing in bargain hunters (likely foreigners flush with US dollars). Meanwhile, the result could be sky high unemployment, more commercial property vacancies, and an unwillingness of entrepreneurs to move forward on their ideas. Still, I suspect we are going to see deflation in wages. I know quite a few middle class people who have been holding out for a job that will pay them like the last one. They are unemployed or underemployed and, barring an unexpected boom in the economy, they will eventually have to take low paying work.

As my outlook shifted more to the worried side, I made the decision to exit three good companies in mid-August: Colgate Palmolive, Wal- Mart and General Electric. Colgate was a stock I'd assumed we would hold for many years, as it is a classic defensive holding, purchased in late 2008 when the economy was falling off a cliff. But Colgate has lost some consumers for its relatively high priced tooth care products. After an unimpressive quarterly earnings conference call, the stock fell apart on my charts, and having learned to be disciplined, this bad boy had to be taken to the woodshed. The sale of Wal-Mart and GE was a result of the Fed's admission that the US economy is again slowing. As yet, these positions have not been replaced. I'm finding few compelling bargains among equities, and fixed income deals are few and far between right now. As a result, most clients will see an increased cash position.

Of course, we have held on to stock in those companies whose technical performance appears to be confirming their more recession resistant properties. Above all, I am most happy to have clients enjoying their largest ever allocation to fixed income vehicles, guaranteed to pay regular interest payments with yields far above those available on certificates of deposit or current bond offerings. There could be a threat to their prices if interest rates were to suddenly and steadily begin rising. Just last week, however, respected bond guru Bill Gross opined that he does not worry about interest rates rising for two or three more years. This is good news for our bond and preferred stocks, but has ominous implications for the stock market. Be assured I am watching things closely.

Sincerely,

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