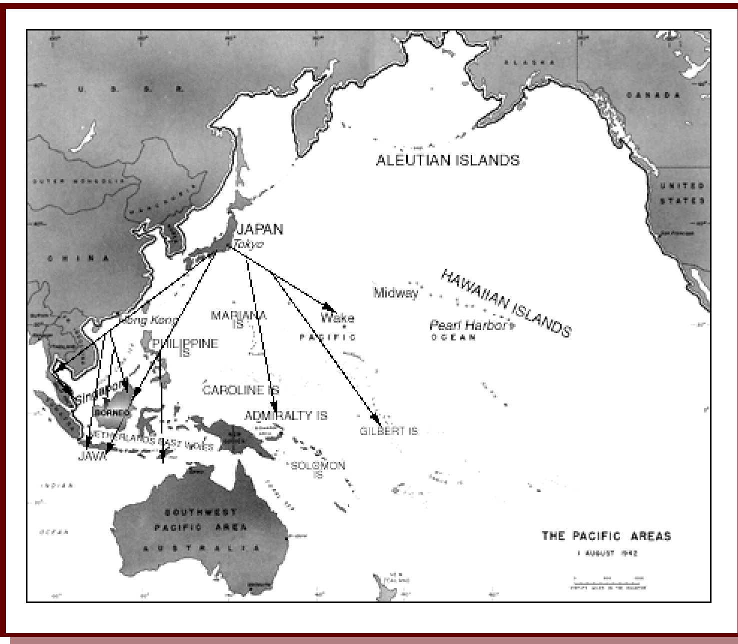
Angeles
INVESTMENT ADVISORS

THIRD QUARTER 2004

OCTOBER 2004

Sea Change



Joseph Rochefort had a perfectly uninspiring career. He enlisted in the navy in 1918, earned an ensign's commission, and was known principally as a lover of crossword puzzles. Stationed on the *USS Arizona* in 1925, he shared this love of crosswords with his CO, Commander Chester Jersey. Later that year, when the navy decided to double its cryptanalysis department (to two), Jersey remembered and recommended Rochefort on the grounds that skill in crossword puzzles qualified one for cryptanalysis. Along the way, Rochefort picked up Japanese, and in 1941 was the obvious choice to head Station Hypo, the navy's communications center at Pearl Harbor. Who could have imagined that a crossword puzzle interest would put this otherwise undistinguished career officer in a position to change the course of history? But that is exactly what Commander Rochefort did.

The five months following the attack on Pearl Harbor were an especially depressing time for the free world. Nazi Germany controlled virtually all of Europe and North Africa, and Japan controlled all of the western Pacific and East Asia. Malaysia, Singapore, the Dutch East Indies, Papua New Guinea, and the Philippines fell quickly to the Japanese onslaught (see map). Neutralizing Australia and India were the next official Imperial war objectives, to be followed by attacks on Alaska and the west coast of the United States. In conquering this immense area, Japanese forces lost not a single battle, and their sureness of divine invincibility appeared justified.

Before Imperial Japan could be defeated, it had to be stopped. Perhaps that sounds obvious, but before a trend can reverse, it needs to be stopped in the first place. It is only in hindsight that we

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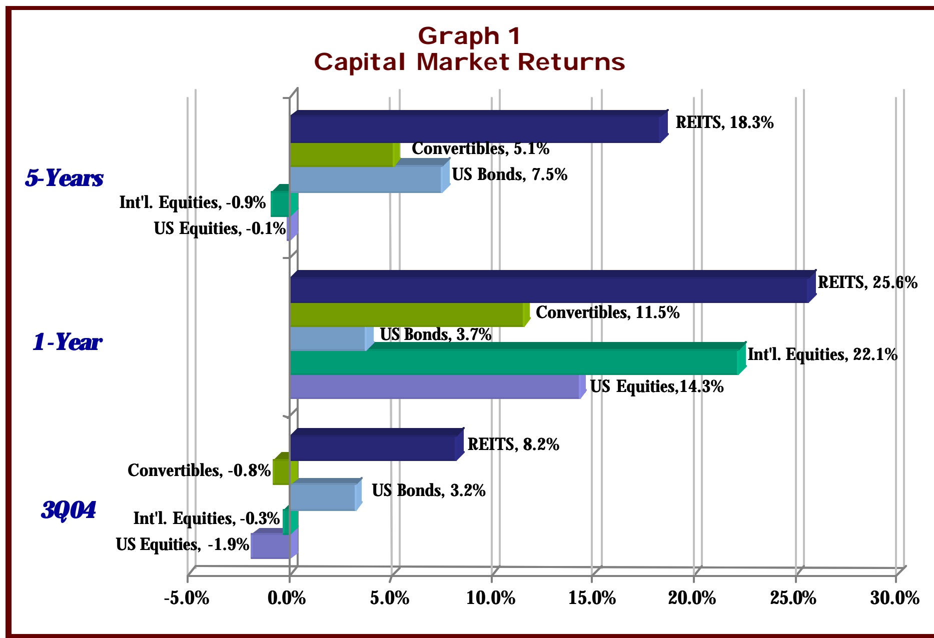


confidently identify a turning point, as much as in battles or wars as in financial markets and economies. But *turning point* is a poor description for how events unfold; rarely do trends just turn and go the other way. This was true in the Pacific War in 1942, and has been so in financial markets throughout time. And we think this is where we are today: a transitional period between very different investment regimes.

It's been a seesaw year in most of the capital markets. In the first three quarters of 2004, stocks were up/up/down while bonds were up/down/up, with little overall progress made. Following a gangbuster 2003, stocks now trail bonds year-to-date, which would make four out of the past five years that bonds trumped stocks, if the trend continues a few more months. Of course, a lot can happen in a few months.

Real estate securities had a bear market (down 20%) the first few weeks of April, and have been on a tear ever since, posting the best return of all major asset classes, not just last quarter, but now over each of the past 1-, 3-, 5-, 7- and 10-years. The most curious result for the quarter just past was that the best stock market in the world was Egypt, up nearly 50%, while the worst performer was Israel, down 17% in these three months. We draw no political conclusions from these data.

Contributing to the modest rebound in bonds last quarter is evidence of a slowing economy. Nothing dramatic here, as the economy is still chugging along, but most of the recent indicators have taken a dip, from retail sales to employment growth. Oil over $50/barrel may be partly to blame for this slowdown, but two other factors are probably much more important. Tax cuts provided a big stimulus to the economy in 2003, but the effects are now fading. The biggest retardant to growth is probably the large decline in mortgage equity withdrawals (see Graph 2). These stimuli kept spending (and economic growth) higher than would have otherwise been. In the four years prior to 2001, real spending kept pace with real pre-tax income, both grew at 5% p.a. In the subsequent four years, real income growth fell to just 1.5% p.a., but spending only fell to 3% p.a. So spending was boosted by 1.5% p.a. relative to income, or about $150 billion. But these economic tailwinds are fading, and near-term drivers of growth are not clearly visible. The concern is that slower economic growth with modest hiring will lower productivity

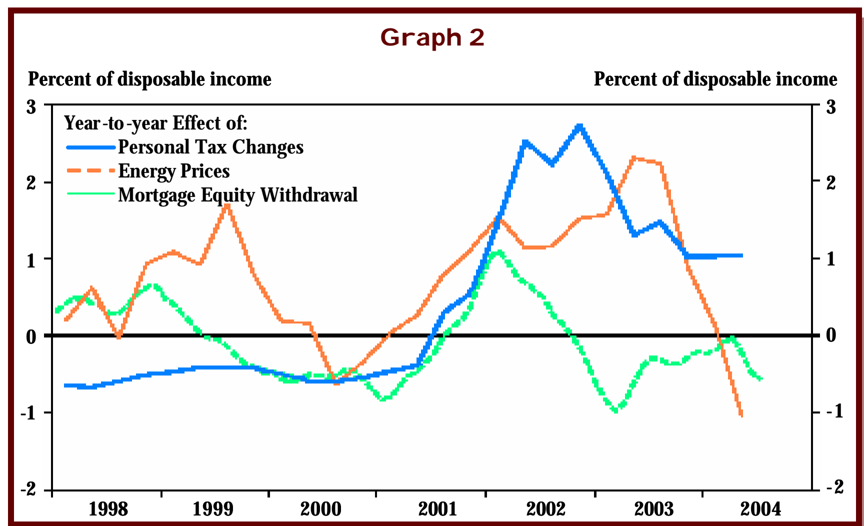
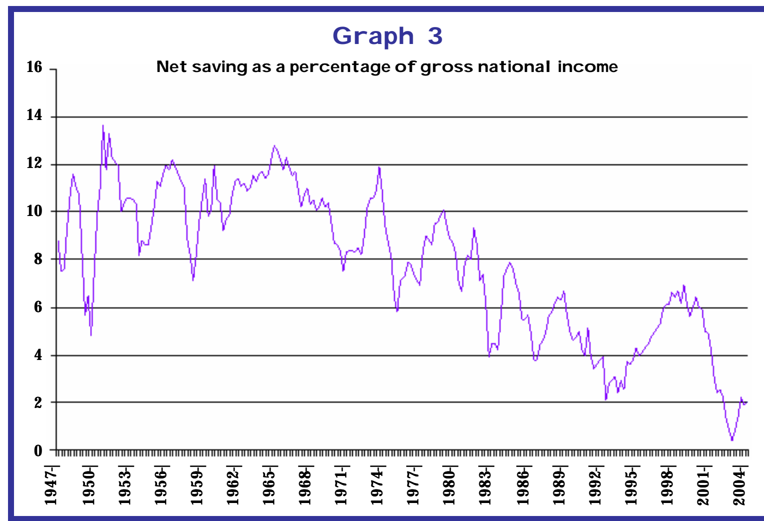


Chart courtesy Goldman Sachs

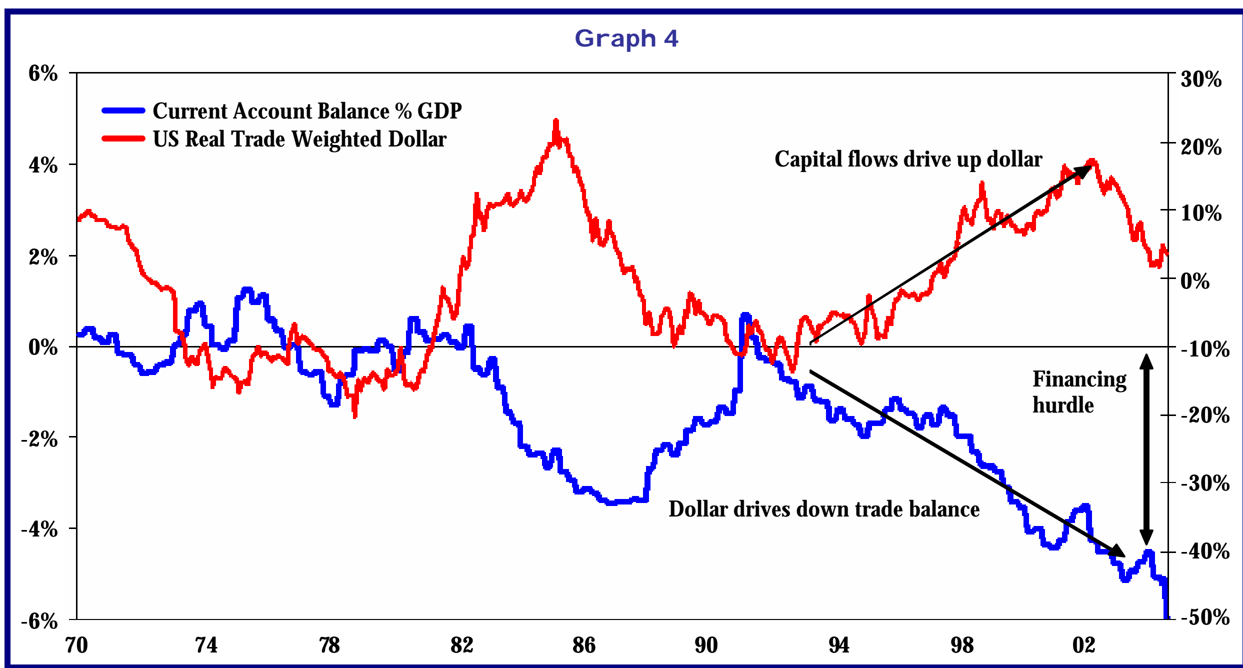


Source Bureau of Economic Analysis

growth and push up labor costs, resulting in lower profits and/or higher prices.

Growth drivers for the economy are obscured because of a large structural imbalance in savings. This applies worldwide, but we'll address the US side first. The savings rate has been in a structural decline (see Graph 3), but it can't get much lower. It's possible that savings out of income declined over the past twenty years as outsized capital gains were available for spending, but this era has ended. The private savings-to-investment balance plus the public sector's balance combine to form the current account balance, the difference between domestic savings and investment that must be financed with foreign capital. This is not a choice; it is an accounting truth. The US current account deficit is now over 5% of GDP (see Graph 4), so we need foreigners to send us about $2 billion more each day than the previous day. Of course, they do (because they have to—remember, this is just accounting), but the question is, at what price? Currently, the price (Treasury yields) is pretty low, but private foreign capital flows (presumably somewhat rational investors) have slowed to a trickle, and the slack has been picked by foreign central banks, who are generally guided more by politics than by economics, and are now buying half of each Treasury auction. So, for the moment, it's good politics, but questionable economics, to buy our debt at current prices. That may continue for some time, but then again, maybe it won't.

Our point is not that we are at that turning point; we won't know that till after the fact. Incomes are growing, productivity is still high, and it is certainly possible that we resolve our savings deficit through a combination of rising exports relative to imports and maintaining our high productivity. But the risks are clearly shifting: the tax stimulus and mortgage equity withdrawals are ending and debt levels are high. It seems more



Graphs Courtesy Bridgewater Associates

likely that savings rates will rise, tax rates will rise and foreign capital flows will slow, all implying that the economy will face some strong headwinds.

Our savings imbalance is mirrored with the opposite problem in the rest of the world, especially in Asia. If Americans don't save enough, Asians save too much. Historically, there have been good reasons for excess savings. Economic boom-and-bust is a frequent pattern in Asia, and over time, returns on capital have been paltry. Lack of attractive investment opportunities, central planning that distorts the economies, the threat of government confiscation, all have promoted high savings. But in the past few years, the savings imbalances on both sides of the Pacific have grown substantially with linkages that have been mutually reinforcing.

Without sufficient domestic demand, Asian economies are dependent on exports for economic growth, especially to the biggest consumer market by far, America. In order to maintain price competitiveness, undervalued currencies are defended by recycling export earnings back to their currencies of origin (i.e., US dollars). This has the added benefit, in addition to lowering the value of their own currencies, of keeping interest rates lower in the US, thus helping to stimulate further demand for Asian exports. This virtuous cycle grows ever bigger and bigger: Americans buy goods from Asia in exchange for dollars, those dollars are spent buying US Treasuries, lowering interest rates, which stimulate consumer demand, and so on.

Of course, all virtuous cycles end eventually. Asian central banks now hold $2.2 trillion of foreign reserves, 80% of the world's total, 70% of which is in dollars. China's exports represent one-third of that country's GDP. Record low interest rates is spurring a housing boom in Shanghai that makes Los Angeles look depressed.

Herbert Stein, a leading economist a generation ago, observed that "things that cannot go on forever, don't" (who said economists weren't clever?). But the real message here is not that these trends cannot go on forever, but that all of these observations are interrelated. The savings deficit in the US is directly linked to the savings surplus in Asia. If Americans shudder at the idea of slower growth in the years ahead, Asians (should) tremble at that prospect too. Not only would the principal driver of export, and therefore their economic, growth diminish, the value of all prior earnings now invested in Treasuries at negative real yields will fall with the value of the dollar, which in turn will diminish demand for Asian exports, which in turn will reduce the demand for recycled dollars, ad infinitum. The virtuous cycle can turn vicious, affecting (infecting?) everyone on both sides of the Pacific.

Of course, there's a more palatable resolution to these imbalances. Asians can develop domestic demand by adopting consumer- and investor-friendly policies, Americans can save more, the dollar can adjust downward gradually and the path between stagflation and deflation can be navigated.

And this is exactly where we are, trying to rebalance these imbalances. If it all feels uncertain, it should. These past few years have witnessed the confluence of a number of momentous changes. The integration of the world's most populous country into the global economy, and the spread of technological innovation worldwide have caused global productivity to rise, but also serious dislocations as people, industries and countries adjust. The investment regime of the past twenty-odd years has disintegrated, asset class by asset class, and the new directions are unclear.

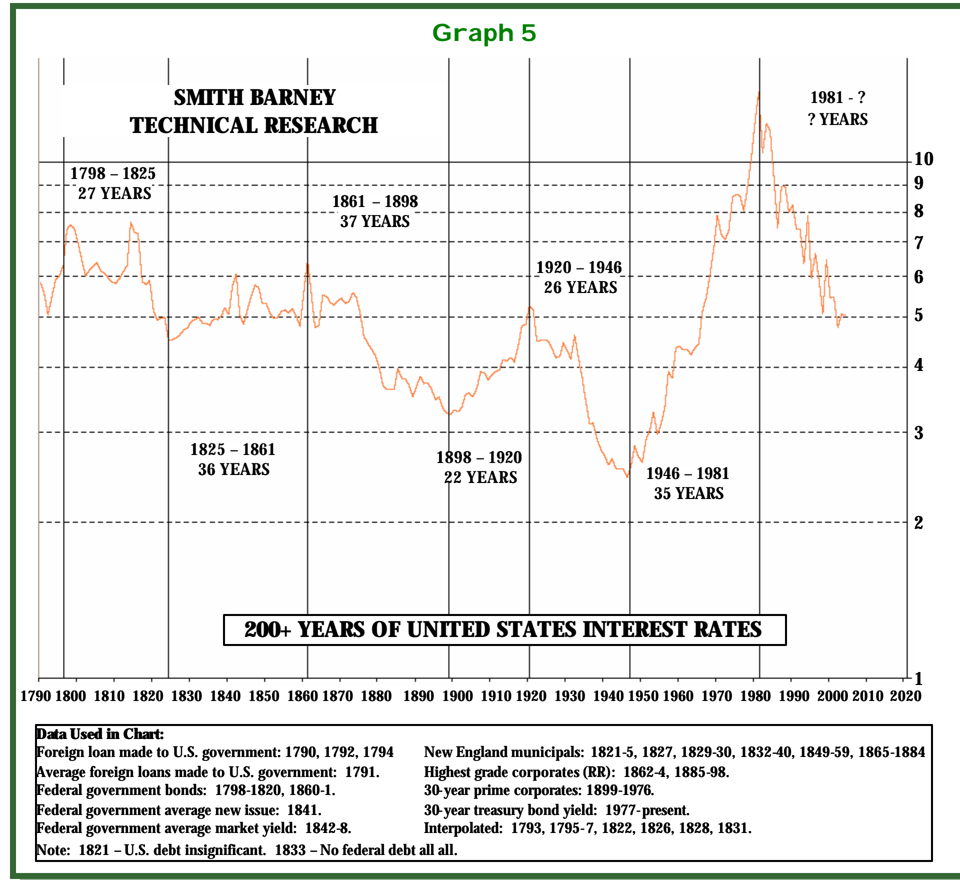
In 1981-82, in the depths of economic ruin, financial assets began major, new long-term projections. Stocks and bonds ascended, while gold, oil and commodities declined, all reversing the environment of the prior decade. Those long-term, structural trends have all now reversed, with the possible exception of bonds. Stocks broke an 18-year uptrend in 2000, gold reversed a 20-year bear market, commodities reversed a 22-year downtrend, and oil has broken through a 24-year plateau. The 24-year bull market in bonds is the last remaining structural trend to reverse decisively.

Historically, the transition from falling to rising rates has been a gradual one (see Graph 5, pg 5 for a 200+ year perspective). This is probably because a low interest rate environment is likely deflationary or near-deflationary, and the risk of falling into deflation takes time to diminish. Thus, a period of yields moving in a low range is required before deflation worries abate, and yields move higher. We think this describes today's environment: the bull market in bonds has probably ended, but we are range-bound for a time, till the next rise in rates begins.

History can also offer some guidance for equities, although the pattern has differed from bonds. With bonds, we see bull markets fade into a period of consolidation, or transition, from one structural environment to the other. With stocks, we see bull markets end abruptly (1906, 1929, 1966, 2000), followed by a bear market, where prices decline to a trough, and then a period of years climbing back before the next bull market begins. Graph 6 on page 6 is the DJIA from 1896 to today, with bull market peaks clearly visible, followed by troughs,

and then a period of transition before the next bull market. The Dow peaked at about 100 in 1906, and took 16 years to recover before breaking out to a great bull market. That ended in 1929, the dramatic fall through 1932, and then ten more years before the next bull market, which ended in 1966. The Dow peaked at about 1,000 that year, made a low in 1974, then broke above 1,000 in 1982, beginning the next bull market, that finally peaked in 2000.

We acknowledge that many would say that these observations about history are bunk: there are too few data points and we are fitting a story to the facts. We agree; these observations are statistically spurious. But we always have imperfect data, and even less perfect vision. But that shouldn't stop us from trying to make sense of the events around us, and past patterns of market behavior seem to have some descriptive applicability to the current environment. Bonds have probably (though not certainly) seen their lowest yields (last year) for this long-term bull market, and rates will likely trade in a range before moving decisively higher. Stocks may have seen their bear market lows in 2002, but it could be a number of years before a new bull market begins. Choppy seas, then, for bonds and stocks.



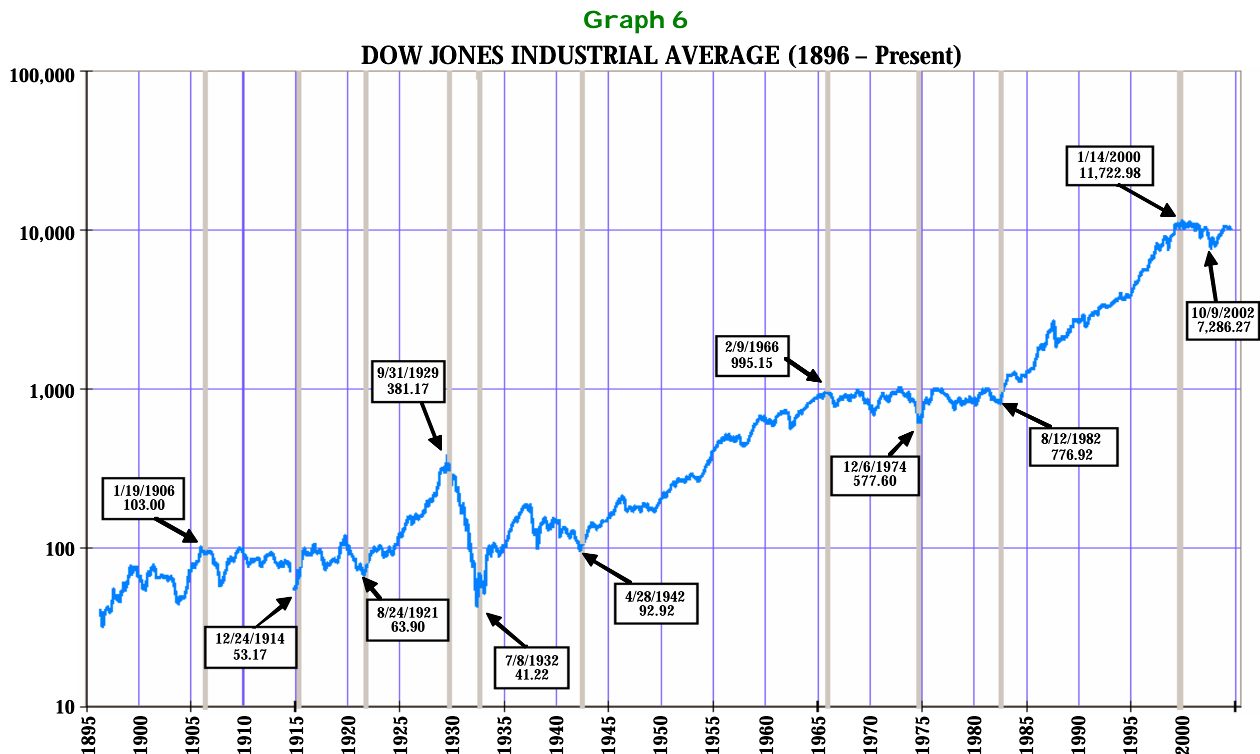
Graph Courtesy Smith Barney

Between Papua New Guinea and the Solomon Islands lies a body of water called the Coral Sea, adjacent to the northeast shore of Australia. Two Japanese carrier groups were assigned to clear the way for the invasion of Australia, a preliminary step to Admiral Yamamoto's grand plan of taking Midway and the Aleutians. The daring raid on Tokyo on 18 April 1942 led by Jimmy Doolittle and 18 B-25 Mitchell bombers caused little physical damage, but shook Japanese confidence, and their invasion plans were accelerated.

On 7-8 May 1942, the first carrier battle of the war was fought in the Coral Sea between the US and Japanese navies. Carrier-based aircraft sank a carrier on each side, and the Battle of Coral Sea was the first naval battle in history in which ships did not actually fire a shot. The Japanese inflicted more damage than they received, so it was a tactical victory, but it turned out to be a strategic disaster, as proven a month later when their damaged ships would be much-needed. The Japanese advance was stopped for the first time at the Battle of Coral Sea, and much of the credit belongs to Commander Rochefort's cryptanalyst team for providing crucial intelligence.

Rochefort noticed a very high level of urgent traffic following the battle, and sensed that something big was being planned. He could read only about 10% of the intercepts, but was able to identify a place code-named "AF" as the target of a huge Japanese operation. Suspecting it might be Midway Island, he called the US base there via an underwater telephone cable, and asked that they send him an uncoded message that their desalination plant had broken. Sure enough, a few days later, Rochefort intercepted a Japanese message that the de-

Graph 6



Graph Courtesy Smith Barney

salination plant on "AF" was broken. He was able to identify positively Midway as the target of attack by the entire Imperial Fleet, and with this information, Admiral Chester Nimitz was able to move every available ship out of Pearl and onto Midway.

At the Battle of Midway, the Americans lost a carrier and a destroyer. But Admiral Yamamoto's Grand Fleet was destroyed: four carriers, 3,400 sailors and 100 experienced pilots were lost, along with the secrets of the Zero fighter, which crashed in the Aleutians and was recovered by the Americans. Control of the seas and of the skies shifted thereafter to the Americans. Midway was the most important naval battle in over 2,400 years, when the Athenians routed the Persians in the straits of Salamis, preserving Greek (and European) civilization. We remember June 6th as D-Day, but the Normandy invasion would not have occurred on that date if, two years before, the Battle of Midway had gone the other way. It's a mystery (to me, anyway) why Midway is not celebrated as a national holiday, and Joseph Rochefort, the unassuming lover of crossword puzzles, isn't lauded as a national hero.

In hindsight, we can identify Midway as the turning point in the Pacific war, although it took another three difficult years to end. But before the tide turned, it was stopped, at the Battle of Coral Sea. For most of the past two decades, investors have seen markets move in one direction. That directional movement has stopped; investors have been through their own Battle of Coral Sea. In hindsight, we'll be able to identify clearly the markets' turning point, their own Battle of Midway. What is clear is that the new environment will be unlike the old, and investors will, as Shakespeare penned in *The Tempest*, "suffer a sea-change into something rich and strange."

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