In Your Interest

2005 INVESTMENT OUTLOOK

In 1905, George Santayana wrote: “Those who cannot remember the past are condemned to repeat it.”

Humans are creatures of habit that typically evolve into patterns. Where there is uncertainty, the patterns become most pronounced; probably because comfort is more likely to be welcomed than is boldness.

Keeping history in mind, last year at this time I suggested that markets in North America were likely to be positive because of the Presidential election in the United States. As I write this letter in late December, that prophecy is likely to be correct.

Our future begs the question “What is the most likely course for stock and bond markets in 2005?” My feeling at this point is this: Most likely down and, quite probably, significantly.

Before we run for our historical dose of ‘comfort’, let’s keep in mind that not everything is gloomy. Let me give you four fine examples:

~ Markets continue to benefit from the lowest interest rates in five decades.

~ The stock and bond markets are not overvalued. In fact, a case can be made that both are undervalued. Stocks are trading at less than twenty times reported earnings and long bonds are two and one-half percentage points higher than short rates.

~ Corporations have the lowest debt to equity and debt to cash flow ratios in several business cycles.

~There is still ample cash sitting on the sidelines waiting to be invested.

These conditions would normally present a positive outlook for the markets. The wild card perspective enters in that these are not ordinary times.

The American economy has been the driver for the rest of the world for a long while but especially so in the past fifteen years. That economy accomplished a remarkable number of things.

~ exposed as a house of cards, the economic system of the European Communist bloc and caused that political system to collapse;

~ brought the Japanese economy out of its most serious and prolonged downturn since the end of the Second World War;

~ helped transform the Chinese economy;

~ made the market economy the model of choice for most of the world.

These prodigious feats have, in turn, left their mark on the United States economy. It has created huge monetary and fiscal distortions approaching levels that, if the U.S. were a lesser-developed country, the International Monetary Fund, and the World Bank would be encouraged to intervene to induce stability. Moreover, the American consumer has reached levels of indebtedness that will probably cause record numbers of personal bankruptcies if long-term rates rise even two percentage points.

Foreign governments, most especially Japan and China, have financed the spending spree. This has led to speculation that the U.S. currency could collapse when the creditor nations refuse to continue their financing program. The speculation has been given credence by the serious decline in the greenback against the Euro, the British Pound and commodity producing nations such as Canada.

The concern about a collapsing dollar has gained such credit that it is now approaching conventional wisdom. Therefore it is likely that the dollar will begin to stabilize. This could happen if the creditors buy Treasury Bills as they exit their long bond positions and convert some of their dollar holdings to gold.

Sixty percent of money managers are bullish with only twenty percent negative on the markets. This is relevant because these investors are notoriously wrong at the turns in the markets. The worst bear market in the Twentieth Century was the crash that ushered in the Great Depression. The second worse market began in 1973. The only time that institutional investors were more positive than they are now was in 1973.

The stock market is a discounting mechanism. Generally, it begins to decline six months prior to an economic downturn. One event that will begin in about six months is the mandated requirement by the Financial Accounting Standards Board in the U.S. that all stock options issued by corporations must be expensed. This will tend to increase Price/Earnings ratios and affect the relevant view of the market as cheap/expensive.

But, in my view, the most important influence on the market will be the level of interest rates. Both short and long rates will likely need to rise in the U.S this year. Over time this rise will make stocks less attractive than fixed income. It should also influence rates worldwide and the money on the sidelines is more likely to move towards fixed income.

Returning to Santayana's sage comment in 1905, it is worthwhile noting that the first two years of a four year Presidential term have the worst performance statistics.

So what will be our investment strategy? We will carry high levels of cash. The companies that we own will have secure cash flow and will pay decent dividends. We will be over weighted in petroleum securities because we believe that there will be a genuine shortage of this commodity in the future. We will disregard the conventional wisdom that financial companies will be bad investments because of slower earnings growth and higher interest rates. When (if) equities decline we will look for opportune prices in great companies and put the cash to work in convertible securities.

But, above all, we will try to earn a positive return on our capital as opposed to trying to "beat the market."

Best wishes for the New Year.

Wayne D. Armitstead December 28, 2004