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## Global Risks, Global Opportunities

### Investment Commentary, Q3 2006

The global population participating in world markets has risen from about 500 million to about 5 billion since the end of the cold war. This *10-fold* increase in the number of workers and consumers is the dominant force in the world economy, underlying many major trends such as:

- ❑ The boom in outsourcing and world trade
- ❑ The falling “real” cost of low-skilled labor
- ❑ Deflationary pressure
- ❑ The de-industrialization of the United States
- ❑ Overwhelming demand for natural resources

The political response from developed nations has been to embrace free trade, promote global growth, and fight deflation by increasing the money supply.

***Expanding world trade is the dominant force in the world economy***

As the world adjusts to the new labor force and production capacity, we expect these trends will evolve naturally. Outsourcing will continue and broaden as technology continues to make distance and language less of an impediment. The real (inflation adjusted) wages of low-skilled labor will continue to lag. Deflationary pressure from expanding trade and improving productivity will be offset by an expanding capital base. The de-industrialization of the United States will slow as energy and commodity prices rise because U.S. industry is more energy-efficient than most competitors. The overwhelming demand for natural resources will continue to drive up prices, as demand continues to grow faster than supply.

There are still major unanswered questions that will guide global growth. For example:

- ❑ How quickly will emerging markets raise their consumption toward levels that are common in the developed world?
- ❑ Will the deflationary pressures of trade and productivity be offset by rising asset prices and an expanding monetary base, such that inflation can remain low and stable?
- ❑ As limited natural resources are bid up by new global demand, will market forces be able to restrain governments from nationalizing resources?
- ❑ Will developed nations be able to retain labor standards and a social safety net while competing freely with nations that do not?

Investors might consider the following strategies against this backdrop of trends and risks.

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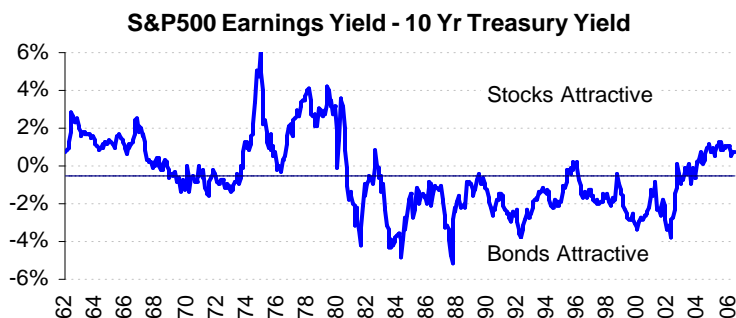
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## Overweight U.S. Stocks

We believe U.S. equities are generally cheap, with prices already anticipating a broad economic slowdown coupled with higher interest rates. While earnings have been growing very well, prices have lagged, leading to an earnings yield premium that looks more like the average of the 70s than any period in the 80s or 90s.



If the economic slowdown is less than expected, prices may rise substantially from these levels. If the slowdown is greater than expected, clearly there is risk to the downside, but the equity markets appear more attractive, on balance, than fixed income securities.

*While U.S. Stock earnings have been growing, prices have lagged*

Within the U.S. equity markets, macroeconomic trends point us toward nimble multinationals and commodity producers. It might be wise to avoid owning companies that depend on the U.S. middle-class consumer. U.S. consumer spending has some structural disadvantages because of rising mortgage rates and an interruption of the rising real estate market, so is unlikely to continue growing in line with recent history. The deceleration in consumer spending may be gradual or dramatic, but it is very likely.

## Underweight U.S. Bonds

The U.S. bond market may not be attractive at this time compared with equities. After a prolonged bull market in long-term bonds, the risk/reward balance, compared with stocks, appears unfavorable.

Foreign governments are buying U.S. bonds to stabilize the value of their currencies. Insurance companies and pension funds are buying bonds to offset predictable liabilities. These sources of demand are driving up bond prices independently from other investments, making bonds less attractive.

Demand from foreign governments may diminish because they may decide that holding a global portfolio of bonds is better than concentrating in U.S. bonds. Demand from insurance and pension funds may diminish because managers are migrating toward efficient asset allocation, as opposed to strictly offsetting their liabilities.

*The U.S. Bond market may be in a bubble*

Any one of these changes could cause a drop in the price of U.S. bonds. For example, if Japan privatizes its postal saving system as planned, it would mean that more than ¥224 trillion (\$2.1 trillion) in savings and ¥126 trillion (\$1.2 trillion) in life insurance would no longer be invested by the Japanese government. Japanese citizens may be less eager to buy US bonds than the Japanese government has been. Indeed, they may redirect some of those assets into Japanese equities.

Investors who must hold bonds should restrict ownership to only the highest quality, short-term bonds. Even investors seeking tax-advantaged municipal bonds are cautioned that avoiding the

inflation tax, which stealthily confiscates principal, is more important than avoiding taxes on mere income.

### **Lock in Your Mortgage**

For the same reasons that long-term bonds are in a bubble, long-term mortgages are artificially cheap. The boom in adjustable rate mortgages was the result of a very accommodating Federal Reserve, and that time is past. Now that the yield curve is flat, locking in long-term financing within 1.25% of the overnight lending rate is a rare opportunity.

### **Diversify U.S. Dollar Exposure**

Conservative investors should hold some investments that are linked to assets or are diversified among a variety of currencies.

The stability of the U.S. dollar is tenuous. The large trade deficit and large foreign ownership of U.S. debt and investments are a tribute to the strength of the US economy; however, they also represent a risk to the U.S. dollar. Interest payments to service these debts already exceed the budgets for the U.S. Department of Homeland Security, Department of Education, Department of Justice, Department of Transportation, the entire Legislative Branch, and NASA, combined. Then, at some point, foreign debts will have to be repaid. A more immediate risk is that foreign investors will sell their U.S. investments if they believe they can achieve better returns elsewhere.

A similar dynamic came to crisis in dozens of countries in Asia and Latin America in the last 20 years. The increased risk of U.S. dollar weakness justifies diversification. Even a gradual long-term resolution to this imbalance would richly reward asset-based and foreign currency investments.

### **Heavily Overweight Commodities**

The risk to the value of the U.S. dollar is enough to justify an overweight position in commodities. The additional trends in global demand growth also suggest an overweight position. Also, many individual and institutional investors have long ignored this asset class, so increased interest from the investor community may provide additional upside potential.

For fundamental reasons, commodity prices may trend higher for a long time. Previously, there had been a sustained stagnation in real commodity spot prices from 1972 through the turn of the millennium. This stagnation was partly due to the collapse of the Soviet economy, and led to a slowdown in investment in new commodity production capacity. Global demand growth was widely overlooked as producers concentrated on meeting U.S. consumption patterns. This oversight was largely because emerging market commodity consumption had historically represented such a small fraction of the total market demand.

The 4.5 billion new members of the global economy are, on average, increasing consumption at a rate far exceeding that in the U.S. Per-capita demand for commodities in emerging markets is only about 10% that in the U.S., so total commodity demand could grow at an accelerated rate until they catch up. If emerging market demand rises to 20% of the per-capita consumption in the U.S., even while the U.S. does not grow at all, total commodity demand would increase by 47%. There is simply not enough production capacity to meet that demand.

*The strength of the U.S. dollar is tenuous*

*For fundamental reasons, commodity prices may generally rise for a long time*

*Per-capita demand for commodities in emerging markets is only about 10% that in the U.S.*

How long will it take global per-capita commodity demand to rise to half that of the U.S.? If that happens, global commodity demand will have almost tripled (even assuming the U.S. does not grow at all). Commodity producers (and investors), take notice.

### **Overweight Select Foreign Stocks**

In many cases foreign stock valuations are low, yields are high, and prospects for growth are favorable. In addition, they are less dependent on U.S. consumer spending, and can be a good way to diversify currency exposure.

### **Neutral Position in Foreign Bonds**

Foreign bonds offer the benefit of currency diversification, and may benefit from global central banks moving away from strictly using U.S. Treasuries. Long-term bonds issued in major currencies such as the Euro, Yen, and British Pound may benefit from flattening yield curves. However with rising global interest rates and inflation, shorter maturities may be preferable for bonds in other currencies.

## **“Freakonomics” [A postscript inspired by the book of the same name]**

The key investment in the “green revolution” may be land. Wind farms require land, solar panels require land, bio-fuels grow on land, etc. Let’s inspect one specific use: using solar panels to generate hydrogen for fuel-cell cars:

As of last year, 700 sqft of Honda’s roadside solar generators produce enough hydrogen in one week to fuel one car for 175 miles. Clearly this is not enough, but it could be if you use more land.

$$\begin{aligned} (700 \text{ sqft of solar arrays}) \times (7 \text{ days}) &= 175 \text{ miles} \\ &\text{equivalent to} \\ (1 \text{ acre of solar arrays}) \times (1 \text{ day}) &= 1556 \text{ miles} \end{aligned}$$

If we assume that cars get about 25 mi/gallon of gas, then each acre produces the equivalent of about 62 gallons of gas per day. If gas costs \$3/gallon, and hydrogen is priced to drive the same distance for the same cost, then each acre produces about \$187/day in sales. That’s \$68,140/year. Maintaining solar arrays is pretty cheap, let’s assume \$5000/year/acre. If we discount the implied cash flow using a real rate of 5%, the value is \$1.26m/acre. Obviously, an acre of solar arrays is expensive. Today, the cost would be about \$1.5m, and exceed the net present value. But not for long!

Technology is progressing at a rapid rate. Today’s 6% efficiency may improve to 30% within 10 years. If the efficiency rises to 30%, the negative net present value of producing hydrogen turns positive. Very positive: \$5 million per acre.

And don’t forget, for added upside you can install a wind farm over your solar arrays, and produce with both. Own some land.

*If you enjoyed this postscript, please let me know. I added it for fun, but I don’t want to detract from the message of the commentary.*