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Ptolemy versus Copernicus

Claudius Ptolemy's *Almagest* circa 150 A.D. used brilliant, creative Euclidian geometry to explain the motion of the planets and Sun. Only the finest mathematical minds could grasp the intricacies of cycles, epicycles, and deferents. As the intellectual bulwark for the commonsense observation that the Sun and planets revolved around the unmoving Earth, Ptolemy's geocentric astronomy held sway for 1400 years. Then in 1543 Nicolaus Copernicus's *On the Revolutions of the Heavenly Spheres* posited the Sun, not the Earth, as the center of the planetary system. That book shook the foundations of astronomy, although several generations elapsed before the Copernican view became popularly accepted.

Sometimes the conventional, established wisdom is vulnerable to a rival interpretation of the facts – one that leads to different predictions and behavior. Today much economic and investment "wisdom" perhaps has a Ptolemaic quality: widely accepted, intellectually respectable, and probably wrong. Or, if not wrong, at least subject to strong reservations. Let's consider two:

1. Low Interest Rates Are Good for the Economy

To hear politicians, Wall Street strategists, and the financial media talk about interest rates, you'd think lower interest rates are always better. Lower interest rates make servicing debt easier for companies and individuals, not to mention government. Sophisticated econometric models predict that low rates spur capital spending and stimulate the economy. Therefore Keynesians, Monetarists, and Supply-siders all generally agree that low interest rates are a good thing. We also agree – up to a point.

Historically, low interest rates have been associated with well balanced economies. National savings (personal savings +retained business savings + government savings) supported net borrowing. The international current account surplus/deficit hovered around zero. Goods and services inflation was minimal. These conditions characterized the healthy 1950's expansion and bull market. Contrast data from a typical year, 1959, with today:

Savings & Borrowing 1959 vs. Today[1]
($ billions)

	Personal Savings	+ Business Savings	+ Gov't Savings	= Total Savings	Total Borrowing	GDP
1959	$26.7	$17.5	$21.0	$65.02	$56.8	$506.6
% of GDP	5.3%	3.5%	4.1%	**12.9%**	11.2%	
Today	$189.0	$153.5	$(424.7)	$(82.2)	$1,288.5	$10,846.7
% of GDP	1.7%	1.4%	**(3.9%)**	**(0.8%)**	11.9%	

[1] Source: Bureau of Economic Analysis and Federal Reserve. "Today" data thru 2Q2003.

In both years total borrowing was 11-12% of Gross Domestic Product. The crucial difference was the collapse in total savings from about 13% of GDP to **negative** .80%. Personal savings and business savings (retained earnings) both fell sharply in percentage terms while the government went from a surplus to a large deficit (dissavings). Foreigners and the printing press have made up the gap between domestic savings and total borrowings.

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In our opinion, the Federal Reserve has driven short term rates below equilibrium levels. At 1% Fed Funds are well below any reasonable estimate of inflation. (Comparable foreign rates are 2% for the Euro and 3.75% for the Pound Sterling). Artificially low interest rates amount to a huge subsidy for borrowers at the expense of savers. So it's no surprise that credit growth remains excessive. Since the beginning of 2001 when the Fed began reducing rates, total non-financial debt has grown by $2,894 Billion!

The purchasing power provided by that massive debt increase has driven up the price of housing and, as in the 1990's, financial assets such as stocks. It has fostered continued over consumption by Americans and has postponed the adjustments needed to return the U.S. economy to some semblance of balance.

2. A Weaker Dollar is Good for the Economy

An estimated 90% of Americans do not have a passport which might explain the average investor's bewilderment about currencies, exchange rates, and international finance in general. Americans just don't have to think very much about such matters. After all, the most important import, oil, is priced in dollars as are over 70% of the most widely traded commodities.

So, most U.S. investors have not noticed that the dollar exchange rate has been weakening since 2002. For example, at the end of 2003 a dollar bought 15.8% fewer Euros (.80 versus .95) than it did on December 31, 2002. Most U.S. commentators say this is good for the economy since it makes our export industries more competitive. (A $100 item which cost 95 Euros a year ago now costs only 80 Euros). We don't dispute the impact on exports, but we think other important impacts get overlooked.

A declining dollar reduces the incentive for foreigners to hold dollar denominated assets. Look at the Dow Jones Industrial Average from the viewpoint of a Euro investor.

The Dow – Dollars versus Euros

	DJIA	*Euros per Dollar*	*DJIA in Euros*
12/31/2002	8,342	0.95	7,925
12/31/2003	10,454	0.80	8,363
% Change	+25.3%	-15.8%	+5.5%

From a European perspective, the decline in the dollar largely diluted the great 2003 rally in the Dow Industrials. Worse still, overseas investors in the U.S. bond market suffered **negative** returns because the nominal dollar return on bonds was considerably less than their currency exchange losses. Private foreign demand for U.S. financial assets has declined sharply and were it not for massive foreign Central Bank buying of Treasuries and Agencies, the dollar undoubtedly would have fallen even further. Since foreigners hold over $3.5 trillion of our debt and since we are adding to our debt at a $1 trillion annual rate, there could be a problem looming down the road. Due to the imbalances in our economy, we are dependent on the goodwill of foreigners for our economic recovery.

Some Investment Implications for 2004

Low money market rates will keep us alert for alternatives such as cash merger arbitrage investments. The lack of retrenchment in consumer spending means the usual boost to the economy from pent up demand will be weak. We do not expect a "normal" recovery. Stocks in the housing and consumer durables (autos, furniture, appliances etc.) sectors look vulnerable. Laggards from 2003 such as pharmaceuticals might fare relatively well and so might the energy and raw materials sectors.

Foreign bonds should outperform domestic bonds again in 2004. We think until the Fed changes its "easy money" monetary policy the path of least resistance for the dollar is down. U.S. companies with substantial foreign sales should benefit as should companies in export sectors. Opportunities might develop in overseas markets with improving fundamentals such as Australia, India, and Southeast Asia. In addition precious metals stocks historically do well during times of dollar weakness as do commodities in general.

As a footnote, Copernicus delayed the publication of his manuscript for 20 years out of fear for the controversy it might cause. We trust you find our speedier release worthwhile, even if some of our observations are a tad controversial.