



Fear of Globalization, Fear of Sheep

The recent French election, won by center-right candidate Nicolas Sarkozy, was notable for the abject fear of globalization, sharpened economic competition, and declining French economic standards that both candidates, left and right, openly tried to placate. Being politicians, neither side addressed issues such as how to reverse France's rapid decline in percentage of global exports, but they did have an interesting, if unusual, debate on whether pedophilia and teenage suicide rates were due to genetics or a lack of social workers.

The Japanese, living in a society that reveres understatement, handled the same economic issues and fears in a much more subtle, insidious manner. First, Toho Manufacturing, a maker of elaborate toilets with water features and air dryers, recalled thousands of units that had been shipped to Europe. According to the company, due to faulty wiring by a Chinese subcontractor, the toilets had seats which first warmed, then melted. Which was bad, of course, but even worse was the news that the melting was merely the signal that the unit was about to burst into flames.

The motto was subtle but clear, I believe. It was: Use Chinese subcontractors in your product, but don't blame us if in the future you walk slowly, hunched over, and never smile again.

A similar signal was sent to Japanese consumers. Hundreds of women paid a great deal of money to import what was sold as an exotic breed of toy poodle. Weirdly, they were apparently not confused by the fact that the animals did not bark or eat dog food. The reason was fairly simple — they were artfully barbered lambs. Again a clear motto: Import anything you want but don't blame us if your living rooms start filling up with sheep. You've been warned.

Can There Be "Irrational Non-Exuberance"?

Watching the current corporate earnings season, which in much of the world is coming in quite a bit better than expected, has led markets higher across the world. But somewhat weirdly, the better than expected numbers seems to have actually *depressed* sentiment among corporate managers and market players. Outlook statements from companies, in particular, have been muted to the point of bi-polar disorder, even when there is no apparent discernable reason for the caution.

My favorite example, so far, is a Swiss company (which, out of mercy, I'll leave unnamed) where the Chief Investment Officer was defending his muted outlook. When I pointed out that his output was sold at fixed prices and

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that his raw material costs were 100% hedged, he agreed. When I pointed out that he was working at 98% capacity, and that he had sold everything he could produce for the next 18 months, he corrected me by saying that it was now 23 months. So why such a subdued outlook for 2007? "I don't exactly know," he told me. "I just feel bad and that something is wrong."

Which, despite a global economic outlook that appears to be on track, seems to be a fairly widespread feeling. Does it make sense? Are genetically optimistic souls such as myself simply out to lunch? Is there a horrific meltdown on the horizon as forecast by everyone from Marc Faber to Jeremy Grantham?

Reasons to be Fearful

The issues of concern that the market has focused on have ranged from the ludicrous (a meltdown sparked by U.S. sub-prime loans) to the tedious (a negative U.S. savings rate that, as I've written about before, is merely a reflection of the bizarre method by which the statistics are calculated) to the abstruse and never-ending (the meaning of a sharply negative U.S. current account deficit). None of these issues strike me as serious.

But there is clearly, if you take a step back, a massive anomaly in the system: The rising and ever-increasing amount of leverage. Is this good news or bad news? Will it inevitably unwind and take the economy as we know it with it? There is evidence on both sides, and I don't know how anyone lacking ESP can be definitive on the subject.

The simple *fact* of leverage is inarguable. The face value of existing derivatives is estimated to be 8.3 times the GNP of *the entire world*. Many of these instruments, of course, are written in opposing directions and would cancel each other out in a forced liquidation, but no one even remotely tracks the size of the amount outstanding that would essentially not be offset by other financial instruments.

There is also an oddity in the surge in private equity, which is taking on some of the characteristics of an unstoppable train. I have no idea whether this is good or bad, but again it is clearly a phenomenon caused by leverage. Profits in the area come more and more from radically increasing the debt a target acquisition carries rather than a multi-year restructuring of a badly run business.

What is curious about this process? The fact that the earnings yield (profits divided by market capitalization) is higher than the cost of financing a takeover creates the impetus for deals, but the wall of money available for

leveraged transactions is the entirety of the fuel. What is the anomaly? The fact that earnings as a percentage of GNP is at an all-time high, and that the ability to pay back the debt taken on to finance these highly leveraged transactions is premised on that phenomena continuing. (Which for all I know, it might. Again, I'm not a critic, merely a curious bystander).

What seems slightly bizarre to me is that rising levels of debts at acquired companies assumes that the average corporation can successfully manage its affairs at much higher levels of indebtedness than they have historically maintained. So there appears to be an obvious question. Have the average corporate board and management, responsible for an enterprise *through entire economic cycles* been far too cautious in aggressively managing their company's balance sheets? Have they been too cautious in the level of debt they were willing to shoulder? After all, debt levels of public companies sorted by sector have been fairly stable for decades. In short, are corporate managers overly conservative wimps or are private equity funds insane pirates? Who is in the best position to judge?

The Lenders Get to Decide . . . Oh No!

The strict capitalist call would be to say that lenders providing liquidity are in the best position to monitor their exposure and the rest of us should simply shut up, stay out of their way, and butt out. I can't help but wonder if history confirms this sort of invisible hand mysticism.

In the early 1980s, U.S. banks were lending hand over fist to developed economies prostrated by the post-Shah of Iran rise in oil prices. The deeply vile David Rockefeller, of Chase Manhattan Bank, went so far as to praise the Argentine government, known at the time for kidnapping citizens, torturing them, and then dropping them alive out of helicopters into the ocean, as being a particularly good credit. The subsequent losses and write downs by 1982 exceeded in value the entire profits of the financial industry since the country was founded in 1776.

But we learned our lesson, right? Lenders should actually use some caution and not act like someone at 3 a.m. trying to roll a '7' at a casino. Well, not exactly. In 1992, the \$500 Billion government-funded bailout of the financial industry during the Savings and Loan crisis exceeded the previous decade of profits for *the entire financial industry*.

History would suggest that lenders should be given tranquilizers not money to lend. It's simple human nature. The down side of bad lending is in the future and the profits on such lending is in the present — hope will



always triumph over caution, especially right before bonus season. I wouldn't take the availability of money as a sign that everything is OK.

It is clearly causing something of a malaise among financial players and an inchoate feeling that maybe we are going too far, too fast. But who knows? Maybe the growth and financial deepening of the emerging markets (which will, in the next several months, account for an astonishing 50% of world GNP on a purchasing power parity basis) means that volatility is permanently muted, and a New Order has arisen that private equity has been the first to grasp. Certainly the existing arguments of the mega-bears seem somewhat feeble. If there is about to be a nightmare reversal in the cards I can't, surveying the financial world as it stands, identify the proximate cause. Which doesn't mean, of course, that it doesn't exist, but at least for the moment I don't feel like hiding under the bed.

Current Condition: Good Numbers, Tepid Enthusiasm

We are only partially through earnings season, of course, but it is already clear that earnings in the U.S. and Europe will easily beat expectations, though to be fair, analyst forecasts in both markets had been lowered sharply since the beginning of the year. So it's more a case of "business as usual" rather than "new turning point." Numbers in Japan are also better than expected, but only slightly.

It's always difficult to parse Japanese corporate outlooks at this stage of the year, which follows the close of the fiscal year in March. In good times and bad, if I was to release a composite forecast from Japanese managements at this time of year, it would read something like, "Here are the numbers. Yes, they are OK. Next year may not be so good, but does it matter anyway since we will all eventually die?" See what I mean? There is zero tendency to be perky.

There is probably, to be fair, some reason for caution. Industrial production is declining slightly, inventories are a bit too high, core machinery orders are sagging, and recent inflation numbers are causing some pundits to worry that Japanese deflation has not been comprehensively and definitively broken. Additionally, the consumer led boom seems to be on semi-permanent hold, as consumer confidence fell in the IQ and wages stagnated. Offsetting that, China (which is growing at a still-shocking rate) replaced the U.S. as Japan's leading trading partner, and the integration of the Chinese and Japanese economies continues to progress. The opportunity set for investment in Japan is narrowing, but at the same time it is just as clearly not disappearing.

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Is that White Noise or Faint Cracks At the Margin?

As mentioned, earnings in the U.S. and Europe have generally, so far at least, been fairly solid. Both regions, however, have perhaps given a faint whiff of potential stress in the benign outlook that has dominated markets for the past couple of months. One of the areas, in both the U.S. and Europe, that has positively surprised the market, has been branded consumer goods. To a certain extent this reflects higher than anticipated consumption in emerging markets and a clear recovery in spending by consumers in Europe.

But I've also been struck by the nature of the forecasts by any number of such companies that reflect both an anticipated continued increase in raw material costs (from packaging to milk to commodities) and extremely firm guidance that it will be possible to pass on the entirety of such costs via price increases. The numbers released indicate that such a pattern, in a period of modestly rising demand, is already happening, and margins in the sector are clearly rising. It's not an immediate concern, but it does indicate the existence of inflationary expectations that simply didn't exist in the recent past. And if anything out there is likely to call the current party off it would be a rise in interest rates above market expectations.

The other area of concern is more medium term and hard to define, and almost entirely political. One of the striking continued areas of global growth is in luxury goods virtually everywhere. This season, I've been forced to ponder such new themes as the sustainability of a massive rise in cognac sales in Southeast Asia and why Yves St. Laurent is a hot brand in Russia but DOA in China. And what does it mean that someone has created the first \$150,000 handbag?

Clearly there are global mega-brands forming at nosebleed price points, and they appear to be growing in terms of where they are distributed. This had led to the theoretical evolution of a new sub-luxury category, which Pinault Printemps Redoute (which is bidding for sneaker maker Puma) calls "aspirational luxury" and clearly believes will be a massive global trend. Essentially this is things like shoes and sunglasses that are associated with luxury marques but retail for between \$100-150. Put baldly, it means that consumers in emerging markets will buy the "luxury" item they can afford, as long as it clearly sets them apart from the consumer down the street.

At the same time, a new phrase has appeared in broker reports which unconsciously suggests something at least sociologically which we might want to ponder: The "need-based shopper." This pathetic creature apparently goes to low-end stores and only buys thing that he or she needs. No quarter

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million dollar watches for this bozo. The phrase seems to reek of contempt for people who don't have the means to show their excess income on their wrists or by their jackets. It's medium-term, of course, but it fills me with a sense of unease that I can't seem to shake.

Should We, For Once, Consider Some Circuit Breakers?

French elections, of course, are not a global indicator of anything in particular, but as mentioned above, the French are clearly petrified in the face of globalization. But everywhere the range of wealth distribution is widening sharply and popular support for globalization is declining. If there is a bomb in the road ahead, it is the exacerbation of these trends and a rise in protectionist sentiment that arrests global growth. That outcome would be a genuine disaster.

In the 1960s, Andy Warhol celebrated mass consumer culture and items such as Campbell's Soup and Coca-Cola in part because it was radically democratic. We all consumed the same products and no matter how rich you were there was no way to get a better or different Coca-Cola. The luxury trend is the exact opposite. Disparity in income is harsh but far more tolerable if it is private. However, once it is reflected in what you wear on your body, and clearly observable to everyone, it is a far different dynamic and likely to lead to a far different political stress level.

Is there any way to lower the stress without resorting to panaceas such a protectionism that will simply take everyone's house down? I would go back to leverage. The way to slow down the train is obvious — raise the financing bar. Whether it's a company rushing to translate jobs and production abroad or a massively leveraged corporate buyout the cost of credit is the single greatest determinant in whether the process happens at a speed that is greater than most people's ability to absorb it.

One obvious approach would be to lower corporate tax rates enormously but reduce or eliminate tax deductions for corporate debt. Obviously you would want to phase it in (and it could easily be made revenue neutral so no new sources of tax are created) but you could do with little or no strain. And maybe, just maybe, the short and medium outlook, which looks very good indeed I have to admit, could be extended significantly. But either way the near-term prognosis is the same — high global growth, intact earnings scenario and distant (if more distinct) clouds on the horizon.