

THE FALL OF EMPIRES

(Part 1)

Since January this past year (2009), I have been having strikingly similar conversations with many clients and non-clients. Everyone (pretty much unanimously) is cynical and skeptical of the effects of Obama's bailout plan, healthcare reform, and George Bush's bailout plan before that. There seems to be a deeply ingrained belief that politicians of both parties are untrustworthy and equally likely to sell out to deep-pocketed corporate interests. As someone once said, the definition of an honest politician is one that when bought, stays bought. Most of the conversations then digress to the "fat-cat" bankers on Wall Street pocketing enormous profits while enjoying the full backing of the U.S. government, insider trading scandals seemingly popping up every week and Madoff-like Ponzi scheme frauds occurring in our backyards. Some of them point to Tiger Woods, Jonathan Edwards and Mark Sanford (Governor of South Carolina) as examples of the weakening "moral fiber" of this country where the measure of a man seems to be how wealthy and powerful he is. Indeed it often seems that the U.S. is crumbling all fronts: political, economic and social. Combine that with seemingly unstoppable economic growth from developing countries such as China and India and many people are implicitly asking, whether they realize it or not, **"Is the U.S. the prudent place to invest my money for the next 30 years?"**

The first part of the answer to that question, lies in the answer to a similar question: "Is the U.S. economic 'empire' in decline?" By this I mean to ask whether the U.S. economy will continue to drive growth around the world or will it take a "backseat" to other developing and developed countries. Empires in decline* share a number of traits, some of the most common are:

1. Loss of territory and influence

Although the U.S. has not lost any territory over the last 30 years, it is hard to argue that U.S. global influence has not diminished. Most casual observers would tell you that U.S. influence reached its peak under President Clinton and they would be correct when looking at U.S. influence relative to other countries at the time. The unprecedented levels of international cooperation (regardless of whether it was willing or unwilling at the time) for the Bosnian and Kosovo conflicts would seem to mark a high point for U.S. influence. In the Kosovo conflict, both Greece and Russia who had opposed military intervention were involved in "peacekeeping" operations under NATO command. China, whose embassy was hit by a cruise missile, protested but took no other action. Out of 50,000 NATO ground troops, the U.S. supplied only 7,000. This is in comparison to the war in Afghanistan where the vast majority of troops have been supplied by the U.S. (~35,000), and the U.K. (9,000) with other European countries and Canada supplying most of the remainder of the 73,000 total troops. The war in Iraq has been even more lopsided with ~80% of the initial 250,000 troops that invaded Iraq provided by the United States. Currently the U.S. is the only foreign country with troops in Iraq (the U.K. and Australia withdrew the last of their troops in July 2009).

* For an interesting read on the rise and fall of an empire I highly recommend [Lost to the West: The Forgotten Byzantine Empire That Rescued Western Civilization](#) by Lars Brownworth

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2. Redistribution of wealth from poor to rich and oppression of the poor

Besides the moral implications of an increasing gap between the rich and the poor, common sense tells us that excessive income gaps lead to increased social instability – something that no one wants except those with nothing to lose. Over the last 30 years the incomes of the top 3% of Americans have increased by 300% while the remaining population’s incomes have only increased by about 50%. The disparity between the “haves” and the “have-nots” has widened considerably in the past 30 years. As shown in the table below, as incomes have grown, the wealthiest have received a disproportionate share.

Percentage of Total U.S. Income

	1979	2008
Poorest 20%	4.1%	3.4%
Richest 20%	44.2%	50.0%

Since 1979 average wages have increased by ~30% after inflation (1% per year) but worker productivity has increased by 60%. As the nation’s economic pie has grown, corporations have increasingly held back from giving their workers a bigger piece – keeping much of it for their executives and shareholders.

3. Devaluation of its currency

U.S. Dollar vs Basket of Major Currencies (Jan. 1979 = 100)



Since January 1979, the U.S. dollar has lost 22% of its value. Since the “dot com bubble” burst in 2001 and the U.S. government lowered interest rates to stimulate the economy by printing dollars, the dollar has declined in value by almost 35%. If the U.S. continues to devalue its currency, foreigners will be more reluctant to buy U.S. government bonds, pushing up the cost we pay to support the debt that we have borrowed from the rest of the world. In many ways, the value of the dollar is the ultimate gauge of the confidence that foreigners have in strength and stability of our economic and political systems. These systems operate in a world in where perception often matters more than reality and the breakdown of which can easily result from self-fulfilling prophecies.

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4. Protectionism / breakdown of well-functioning markets

Whether as a result of the recent financial crisis, or as a reaction to its diminished role in the world economy, the U.S. has increasingly taken a protectionist stance when discussing global trade. Some examples of this are:

- the U.S. government's "Buy American" provision in the fiscal stimulus package
- Restrictions on Mexican trucks operating in the U.S.
- Potentially imposing tariffs on countries that do not place a price on carbon emissions
- The U.S. International Trade Commission's decision to place import duties on Chinese steep pipe

Even more concerning, however, has been the breakdown in previously well-functioning markets. Right now, government sponsored entities like Fannie Mae and Freddie Mac own or guarantee almost half of the \$11.8 trillion of residential mortgages and in 2009 those 2 entities accounted for 75% of new mortgages given out. While we can speculate whether or not the mortgage market would be even be working right now without their assistance, it is hard not to believe that the outrageous lending behavior that drove the mortgage markets to the brink of collapse earlier this year was not driven in part by the willingness of these quasi-governmental agencies to guarantee almost any questionable mortgage. Some of the more colorful descriptions of the types of loans they had purchased or guaranteed: "Liar's Loans" (where the borrower only had to state his/her income without providing documentation), "Teaser Loans" (which qualified the borrower for a loan based on an artificially low interest rate without having sufficient income to make the monthly payment when the interest rate would be reset to the higher level) and my personal favorite "NINJA Loans" (No Income, No Job).

The U.S. is currently playing a gigantic game of musical chairs, shuffling around the bad loans – effectively buying them from the banks and guaranteeing them via the U.S. government (a.k.a. our tax dollars). If the banks had kept the bad loans then the "poor" stockholders and bondholders would have been forced to take the losses for the bad mortgages. Instead, the stockholders and bondholders have been able to recover 100 cents on their dollars while the U.S. taxpayer will be ultimately holding the bag for any losses. This type of massive government intervention and reallocation of wealth (most owners of stocks and bonds are relatively well off while the majority of working class Americans have a minimum of investments) does not bode well for either the social or the economic stability of the U.S. in the future.

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(Part 2)

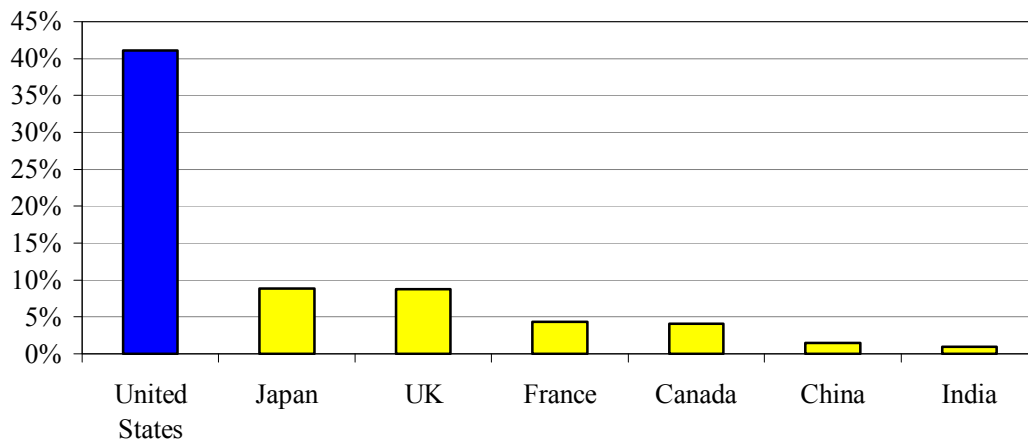
"Amateurs talk about tactics, but professionals study logistics."

- Gen. Robert H. Barrow, USMC (Commandant of the Marine Corps)

The second part of the answer to our original question, **"Is the U.S. the prudent place to invest my money for the next 30 years?"**, is related to the situation in the world as it stands today. While it may be theoretically preferable to invest all or a sizable amount of one's portfolio in countries outside of the U.S., there are a number of reasons why American investors should not invest all of their dollars abroad.

1. The U.S. has the largest and best-functioning markets in the world

Local Stock Market as % of World Total



While the many emerging markets stock markets have had a phenomenal year in 2009 (China and India up over 80%, Russia up over 120%), the size of their markets is still miniscule in comparison to the U.S.. Smaller (i.e. less "liquid") markets are generally more volatile, more easily manipulated and more sensitive to government actions. Adding up all of the 22 emerging markets countries' stock market values together and they comprise only 24% of the world stock market value, but over 80% of the world's population.

2. Developing countries have a large share of their population in poverty

Increasing their share of the world economy while dragging a majority of their citizens out of absolute poverty continues to be the major challenge for developing countries. Although many of these countries such as China have made enormous strides in increasing standards of living, there is still much work to be done. In 2008 approximately 35% of Chinese (~460 million) and 81% of Indians (~925 million) lived on less than \$2 per day, the benchmark for "absolute poverty" as defined by the United Nations.

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3. Undemocratic countries generally have higher political and economic risks

While China's state-run economy has been spitting out 8-10% growth every year for the past decade (including a very suspicious 9.6% in 2008) and reporting record low unemployment (4.3% as of early 2009), other conflicting data make it hard to tell what the true reality is. Alan Greenspan, when asked what he thought about a soon-to-be-released Chinese economic report, replied to the effect of "Don't you think it's strange that it takes us a month or two to collect all of the data but the Chinese have figured out a way to get it out in a few days?" Unofficial estimates of unemployment in China are around 20% - that would make the ~260 million Chinese unemployed the 4th largest nation in the world.

China and other countries in the same dilemma absolutely require growth to keep their population employed and content. This idea of "growth at any cost" makes some otherwise nonsensical actions make sense. The famous "empty city" of Ordos in China – was completed in 2009 to house 1 million residents but is currently entirely deserted. The city was built with government stimulus money which the local government eagerly spent to keep the economy humming regardless of future losses. Even China's own politicians have warned of the shenanigans that are occurring as one Communist Party member criticized the common scheme of tearing down newly built bridges just to have something to spend government stimulus money to rebuild.

4. The U.S. dollar is still the preferred currency for international transactions

There are many factors that determine if a currency will be the international "standard" for transactions and these have to do primarily with how one country is viewed vs. the rest of the world. Many of these factors currently favor the U.S. dollar over other currencies:

- How necessary is the currency to its users? (as the largest consuming economy in the world, U.S. dollars are extremely necessary)
- How liquid is the currency? (the dollar is also the most abundant currency)
- Is it readily available? (there are no limitations on dollar exchange or purchases by the government)
- How safe is it? (it is backed by the full faith of the U.S. government)

5. The U.S. economic and social systems are among the best for rewarding innovation and entrepreneurship

In 2006 U.S. resident foreign nationals were listed as inventors or co-inventors on 24% of the patent applications in that year which is a huge increase from the 7% they comprised in 1998. The majority of the applicants were from China & Taiwan (27%) and India (21%). Meanwhile an extremely high percentage of immigrants continue to establish high-tech businesses in the U.S. (almost 40% of all technology and engineering startups from 1995 to 2005). As the largest and one of the most open global economies, many of the best and brightest around the world choose the U.S. as the place to make their mark on the world.

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6. U.S. social mobility and relative wealth are substantial

Adjusting for cost-of-living between different countries, the U.S. ranks 4th (World Bank 2008) for average income per person at ~\$47,000 with China coming in at 89th (\$6,000) and India at 113th (\$3,000).

While developing countries struggle to deal with a population that survives on less than \$2/day, the poverty line in the U.S. is currently set at \$30/day and only 13% of Americans are below that level. Put another way, it would take 28 years for a worker earning \$2/day to get to \$30/day if his wages grew at 10% per year.

What we are doing at Nauticos Investment Advisors to take advantage of these conclusions:

- Actively looking to invest in growing economies but being careful of overly stretched valuations for many emerging markets stocks.

Translation: We like growth but aren't willing to pay nose-bleed prices for it

- We prefer to invest in countries with mature local economies and an established legal business environment with the potential for significant growth from emerging markets.

Translation: We like countries that can have their cake and eat it too! One example would be Australia – a Western economy that supplies much of the raw materials China requires to keep growing.

- Reducing the size of our emerging markets positions commensurate with the political, legal and economic uncertainty that might exist

Translation: If we're not 100% comfortable with the country risk we will take smaller positions so that we won't jeopardize the whole portfolio

- Investing in U.S. multinationals with exposure to emerging markets

Translation: We like to buy U.S. companies that can generate much of their growth in the faster-growing countries

- Stay nimble

Translation: Stay nimble! The markets are always creating opportunities