October 17, 2011

Times had changed considerably. The terrible panic of 1873 had struck, worse than any ever before. The country had still not recovered from it and would not for some time. Incredibly, Jay Cooke & Company, the most famous banking firm of the day, had gone bankrupt. In no time one Wall Street firm after another had gone under. Thousands of businesses, mostly small ones, had been wiped out and thousands upon thousands of working people lost their jobs. The streets of New York had been filled with drifters and unemployed ever since.

From *The Great Bridge (The Epic Story of the Building of the Brooklyn Bridge)*
By David McCullough

I recently saw historian David McCullough interviewed on Fareed Zacharia's "Global Public Square" (GPS) Sunday morning TV show. Mr. McCullough referenced his book about the building of the Brooklyn Bridge. The US had just come out of the Civil War and then we entered our first "Great Depression" and yet during that period one of the greatest monuments in the United States' history was built. I highly recommend the book, not only to learn about the amazing feat of building the bridge, but also to get a flavor and perspective of another time – so different and yet so similar to today.

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The U.S. economy and political landscape are currently experiencing a trajectory altering transition. It has been in progress for many years and will last for many years to come. It is a combination of many cycles and trends, including debt cycles, demographics, technology/productivity and globalization. The current phase is a period of economic sluggishness and for some individuals and families a time of struggle. Like most transitions, there is a noticeable change of beat as well worn sequences sputter or break down, as some of the tried and true strategies in business and public policy become less effective or just don't work. And, as in any transition, there are winners and losers, new opportunities and dead ends. The post World War II era is over and the 21st century is here to stay, at least for awhile. Here are a few brief notes on some of the key factors in the transition:

1) The real estate/debt bubble and subsequent implosion: As I have written before, this is the largest factor weighing down the U.S. economy in our current business cycle recovery. A good portion of the economy was brutally injured in 2008. While many people avoided getting caught up in the mania, there was no shortage of participants in this shortsighted folly, including politicians of all stripes (from those promoting home ownership through government guarantees to those promoting aggressive financial deregulation and feckless regulators), the Federal Reserve, investment bankers, mortgage bankers, insurers, rating agencies, investors, builders, speculators and consumers. There was a confluence of narrowly focused self-interest over common sense. Now the economic activity created by the bubble is gone. If fact, because the bubble created such distortions to the upside, we are now suffering through a resulting distortion to the downside. At some point, the housing industry will normalize and resume its role as a cyclical engine of economic growth. Meanwhile, in terms of jobs, economic demand and middle class wealth, there is an economic hole that will take time to fill.

2) Demographics: This is a dominant, long-term transitional factor in our economic and political landscape. Here are some statistics that frame the changes in our demographic mix: in 1950, 16 workers paid into Social Security for each retiree receiving benefits. Today that number is 3 workers for each retiree. By 2030 it is estimated that there will be 2 workers for each retiree. People are living longer. This demographic shift affects not only consumer demand, it also overwhelms the current financing/benefits construction of our Social Security/Medicare senior safety net.

3) Improving technology/productivity: This is simultaneously the most enabling and disruptive global trend. Over the last 10 years, U.S. manufacturing has increased 30% while shrinking its work force by 5.5 million people. Whole industries such as publishing and film-based photography have been dismantled by new technologies. Improvements in technology and productivity are increasing overall standards of living (think communication availability, information access and medicine) even as they put specific individuals, businesses and communities out of work. The trend is not new, but the pace of change is increasing and the impact of staying on the right side of the trend versus ignoring it is growing more dramatic.

4) Increased globalization: Like the technology/productivity trend, globalization is both an enabling and disruptive force. It is a huge and fascinating topic, but I only have room here to make a few critical points: First, the U.S. remains a relatively closed economy. Total imports from all countries are about 16% of U.S. consumption (that includes finished goods, intermediate goods and services). Surprisingly, given the political and media hyperbole, total imports from China account for only 2.5% of U.S. consumption. Our exports account for about 12% of our economy (with the majority of the trade deficit, imports minus exports, coming from our oil imports). Second, U.S. corporations continue to be aggressive in pursuing global opportunities. As measured by a percentage of total revenues, S&P 500 companies have grown foreign revenue from 32% to 46% since 2000. Third, the growth of communication and internet technologies have helped develop and unleash human capital from around the globe. Fourth, for the first time in history emerging markets have been the driver of global economic growth as the developed economies struggle. And fifth, China's global impact continues to grow!

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Europe is going through its own transition. The ongoing Euro zone sovereign debt/bank capital crisis was the driving force behind the stock market's aggressive selloff in the 3rd quarter (the S&P 500 index was down -13.87% on the quarter, leaving it down -8.68% so far this year, while the Russell 2000 small cap index was down -21.47% on the quarter, leaving it down -17.02% so far this year). The primary fear is that we will see some kind of replay of our 2008 financial crisis in Europe that will lead to a new global recession. To date, the European governments involved have failed to stanch the negative feedback in the financial markets. It is in everyone's interest for a speedy and equitable solution to be reached, but the Euro is still in its infancy and there are huge hurdles ahead. Assuming a continuation of the Euro zone's incremental progress, the U.S. will likely continue our uneven economic recovery (and based on the earnings of the companies that we follow, excluding those related to real estate, U.S. businesses are doing remarkably well in this environment). From Peak's perspective, how the U.S addresses the 4 factors outlined above will have a much bigger impact on the underlying value of our stock market than the Euro zone's painful transition. Individuals, businesses and politicians all need to focus on positioning themselves (us!) to minimize the negative effects and maximize the benefits of the big cycles and trends. As we enter the Presidential election cycle, it would help if the candidates would take a moment to consider the advice that David McCullough concluded his *GPS* interview with, on an appropriate perspective for our President: "Not only must he or she have an appreciation and understanding of what happened before we came along, but a realization that we too are a part of history. That today's polls and tomorrow's headlines are not what is going to matter, but how this will look in time to come. What cathedrals are we going to build?"

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John McCorvie, CFA