

Fall 2005

The public... demands certainties... But there are no certainties.

— HENRY LOUIS MENCKEN

There's only one place where inflation is made: that's in Washington... in response to pressures from the people at large... The voting public... ask their Congressmen to enact goodies in the form of spending, but they are unhappy about having taxes raised to pay for those goodies.

— MILTON FRIEDMAN

The Bad News Bears are back. The Federal Reserve is going to cause a recession as it pushes up interest rates to combat growing inflation. We will soon be faced with a housing bust and a corresponding collapse in real estate prices. Major credit defaults are looming on the horizon, with a surge in bankruptcies to follow. Energy prices will go through the roof, with some prognosticators predicting \$100 to \$200 for a barrel of crude oil. The rise in energy prices is driving up costs for consumers and businesses. Corporate profits are going to take a major downturn. Northwest Airlines, Delta Airlines, and Delphi Corp. have filed for bankruptcy, and GM is on the ropes. Iraq continues to impose significant human and financial costs on the U.S., and the Bush Administration and its agenda seem to be in disarray. Oh yes, not to be omitted, Is there going to be enough vaccine to protect us against the pandemic of "bird flu" that may be winging its way around the globe?

Good news does not make great copy for selling print or visual media to the public. Yet, the grist of personal and corporate pursuits is frequently filled with far more positive events than negative. True, there are periods when

the balance of the scales in the economic world may exert a greater drag on the material progress of man more so than is the case in less troublesome times. Such may be the case today, as exemplified by the behavior of the U.S. securities markets. But although the near-term outlook has become more clouded in recent weeks, the view of the future in coming quarters is likely to be more promising. However, many of today's "investors," and Wall Street in particular, tend to obsess over a time horizon of a few weeks, as opposed to having the foresight to view the world in terms of a year or more.

The mood of investors has taken a decidedly negative turn in the past few weeks. Stocks headed south to start the fourth quarter amid concerns about energy costs, inflation, and renewed uncertainty about when the Federal Reserve will stop raising interest rates. The S&P 500 registered its worst quarterly start, in terms of performance, since 2000. A confluence of factors is behind the negative tone. There is obvious frustration with the failure of equity prices to advance in the face of tremendous profit growth. Returns on both

stocks and bonds have been subpar compared to more ebullient periods over the past two decades. Investor confidence has probably also been undermined by the continuing conflict in Iraq. And there is growing unease with the Bush Administration and Republican Congress which have been beset with not only exogenous factors with which they have had to deal, but from a string of self-inflicted wounds as well, only a year after sweeping into office. But the downward spike in equity prices that ushered in October primarily reflects a shift in investor attitudes based on events that seem to have crystallized after Katrina and Rita swept in on the Gulf Coast.

First, the hurricanes underscored the impact of higher energy prices. The long upward march of energy prices has finally begun to have an impact on both consumer and business expectations. Recent measures of consumer confidence show it is at its lowest point in eight years. The plunge in SUV sales may be an early barometer of the change in consumer psychology. Natural gas prices have soared to record highs, and will inevitably drain consumer pocketbooks this coming winter. While retail sales have remained reasonably resilient following the storms, there are growing doubts about the health, or lack thereof, of consumer spending. Housing, a major positive for the economy over the past several quarters, is also showing signs of softening.

Recent economic reports have revealed the impact of the rising price of energy on a host of both consumer goods and raw materials as higher costs are passed through to the end user. Fuel surcharges are starting to appear in a number of industries. A recent Institute of Supply Management survey highlighted a divergent trend between manufacturing and

services industries. Manufacturing has benefited from a post-hurricane bounce, whereas services appear to be flagging. The real growth of the economy is probably somewhere in between. Importantly, as far as the Federal Reserve is concerned, the economy is still cooking, and the Fed is prepared to turn down the heat.

The Federal Reserve's surprisingly hawkish posture in the aftermath of the hurricanes has been the second major factor that has unnerved investors in the past few weeks. The Fed seems determined to rein in perceived froth in the real estate market, boost personal savings rates, and narrow the trade deficit, all of which it deems achievable through higher interest rates. The Fed has the consumer in its crosshairs, not just inflation. Typical of the Fed's sharpened talons are the comments of Richard Fisher, President of the Federal Reserve Bank of Dallas, who warned that inflation shows "little inclination" to slow and is near the "upper end" of the Fed's target range. Fisher stated that, "We cannot let the equivalent of sclerosis block the arteries and disrupt the workings of the circulatory system." He added, "Nor can we let the inflation virus infect the blood supply and poison the system."

The sharper rhetoric is clearly aimed at lenders and the housing market, and reflects the Fed's concern about inflation and its desire to slow down consumption growth. The spike in input prices experienced by manufacturing and services industries will keep the Fed on inflation alert. A rise in inflation expectations has pushed up Treasury yields at the same time equity prices have fallen and growth has slowed. But the Fed's concern and its vigilance are already sowing the seeds for a dampening of inflation.

Reports of declining real estate prices are already cropping up in a number of cities around the country, most notably in The Big Apple. The sizable drop in consumer confidence should be felt in weaker spending extending past the hurricane-induced slowdown. Should demand fail to revive, businesses will slow down their investment and hiring plans. The recent correction in energy prices in the face of supply disruptions reflects a slowdown in demand. Short-term rates that are higher than those of many of our foreign counterparts have made investments in Treasuries attractive. This has created a demand for the U.S. dollar to fund these purchases. Consequently, the dollar has continued to rise throughout the year, contrary to widespread expectations for its decline at the beginning of the year. A strong dollar helps to keep import prices contained. The excess global capacity for a large array of consumer and manufactured goods forces businesses to be competitive in their pricing.

There is another development that will help to restrain inflation from racing through the economy as it did when energy prices spiked in the '70s and '80s. The recent bankruptcy filings by two major airlines and Delphi underscore the death of corporate welfare. In 1948, GM, which formerly owned Delphi, a major auto-parts supplier, and the UAW ratified a contract that instituted cost of living adjustments (COLA) and an annual improvement factor (AIF) based on increased efficiency through technology. These provisions, along with a failure to develop competitive auto models, were key factors in eroding the profitability of GM and the other auto manufacturers who were forced to follow suit. Manufacturers in other industries adopted similar positions in their labor agreements. As a result of COLA, labor costs stayed elevated for



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a number of years after the spike in inflation. Thus, the labor costs of the auto industry soared in the '70s and '80s along with energy and inflation, while productivity lagged the AIF. The Japanese, with lower labor costs and more efficient plants, gained significant market share. With a slowdown in inflation in the '90s, COLA was less burdensome. Productivity improved during this period and SUVs added to the bottom line. But the lingering effects of corporate largesse were manifested in GM's generous health care and retirement benefits paid to current and retired employees. Delphi, spun off from GM in 1998, patterned much of its compensation practices after GM. For the Big Three, Delphi and other auto-parts manufacturers, as well as those manufacturers that are still populated by private sector unions, the Delphi chapter is the beginning of the end for labor unions and collective bargaining in their current form. Delphi CEO Steve Miller, who helped lead Bethlehem Steel and United Airlines' parent,

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UAL through Chapter 11 restructurings, observed, "There is now such a critical mass with non-traditional automakers in North America. The Big Three no longer have the pricing power, and the pricing power is being set by the low-cost producers. This is what happened in steel and airlines and what is happening now before your eyes in the automotive industry."

Today, U.S. corporations operate in a global economy in which the lowest cost producers offer stiff competition. The U.S. has been in the forefront of fostering the flexibility that enabled businesses to restructure in order to reduce costs. Now they are being joined by Germany and Japan. Following the fall of the Iron Curtain and the breakup of the Soviet Empire, along with the entry of China into the World Trade Organization, combined with the major inroads made by technology, communications, and the Internet, the dynamics of the world economy have given rise to thousands of new businesses and millions of new laborers and consumers. There has been a massive sea change in the ratio of invested

business capital-to-labor. The global workforce has doubled since 1990, while invested business capital has remained fairly stable. As global economic activity expanded dramatically over the past fifteen years, the glut of the world labor force of unskilled and skilled workers has kept wages and salaries low. The ratio of capital-to-labor and the growth in economic activity have resulted in very high returns on invested capital. This development is a key reason corporate profits and cash flows in the U.S. have been going up so dramatically for the past ten quarters, far beyond what most analysts had been expecting. And the pressure on wages and benefits and pricing power will persist. As Delphi demonstrates, companies which cannot or do not adjust to the forces of a global economy will no longer be competitive or profitable. For a long time, the global marketplace will serve to keep inflation from running away. Witness recent developments in China.

Discussions of burgeoning growth and the tremendous demands made on the world economy by China are a frequent feature of media reports. Yet, China is in many respects also a source of deflation, not only in labor markets, but also in the development of excess capacity. China is also subject to the cyclical forces that affect demand as prices for raw materials rise. Over the past year, Chinese demand for oil is up only 2%. Demand for cement has been flat, and demand for aluminum has actually decreased by 5%. While the expansion boom in China has increased steel demand by 20% over the past year, China's production of steel has mushroomed by over 30% over the same period. By 2006 China will have a trade surplus in steel of nine million tons, and it is forecasted to grow to 13 million tons by 2007. Not only will China

be a net exporter of steel, but its exports of aluminum and cement are rising at a brisk pace. Thus, in these and other basic industrial materials and consumer goods, China has and is developing excess capacity. Similar developments are occurring in India and throughout Asia and Latin America as well. This excess capacity and heightened global competition is deflationary and should help to keep prices reasonably well contained.

In addition to introducing a glut of labor and excess capacity to the marketplace, globalization has fostered greater demand for energy, resulting in attendant price increases. But is the fallout of higher energy demand a precursor of a continuation of spiraling energy prices? The odds of a return to the low energy prices of \$20 a barrel are long indeed. But are we doomed to \$100 to \$200 a barrel as some are predicting in the not too distant future? It is hard to pick up a newspaper without being reminded of the high price of gasoline, heating oil, or natural gas. And is there anyone who does not know the price is headed higher? The Bullish Consensus (which tracks the buy/sell recommendations of commodity advisers) spiked to a 96% bullish reading recently, higher than any previous reading. Of course, we hear that, "This time it's different." Perhaps the real truth lies somewhere between the respective views of the pessimists and the optimists.

Certainly the global economy has propelled a higher level of energy demand that should continue to grow. It is also likely that prices will be maintained at a higher average plateau than in the past. However, there are tangible signs of a slowing of demand for oil around the globe. There are some other straws in the wind as well

that would seem to signal the need to balance the fear and speculation that have been driving prices higher with a little bit of caution.

Quite often, the projection of a trend into the future fails to take into account the potential for a change in dynamics or countervailing forces. Could that be the case with oil today? In late September, the Saudi Arabian Oil Minister and Rex Tillerson, the President of Exxon Mobil, in separate statements, made some interesting comments about the supply of oil. The Saudi Minister indicated that his country is on the verge of almost doubling their oil reserve estimates. Tillerson said that his geologists estimated that there are still seven trillion barrels of oil yet to be discovered. True, there is much discussion about the actual situation in Saudi Arabia and the nature of world reserves, but should these comments be totally dismissed? Closer to home, in recent months, exploration by French and Canadian interests for oil and gas has picked up just offshore of Cuba, which has been a net importer of oil from Venezuela. Indications are that Cuba could be a net exporter of oil in the not too distant future. Much of the U.S. continental shelf near California and Florida remains available for offshore exploration and development.

It would also be beneficial to bear in mind that oil is still a commodity. The high price of oil makes alternatives look more attractive and is changing the way consumers and businesses use energy. The vast tar sands of western Canada are much more economical at \$40 a barrel oil. There is growing discussion around the world about developing more nuclear power. China is ramping up to produce its largest nuclear plant in history. It is also planning a \$24 billion

coal-to-oil program that could reduce its oil consumption by one million barrels a day from its present seven million barrels. Coal and liquefied natural gas are much more competitive with oil at \$50 or \$60 a barrel. In Thailand, a unit of Exxon Mobil plans to install gasohol pumps in all of its 650 stations by 2006. Gasohol, like ethanol, is a mixture of gasoline and fuels from agricultural crops. Proctor & Gamble recently announced that it will replace 20% of its petroleum input with palm oil. The search for new sources and the replacement of petroleum with alternatives has entered a new chapter. The impact on supply and demand could prove significant.

Changes in demand on the margin can have meaningful changes in the price of a commodity. The price of oil can go higher, and the oil business can produce significant profits and cash flow. But oil is a commodity and it is subject to cyclical swings. At present, it has gone a long way on the upside. The immediate question is, Are oil prices north of \$60 a barrel sustainable? If they are, Has much of the positive impact on the prices of oil related stocks already factored it in? If not, Will the hedge funds and momentum buyers that have rushed into energy stocks wait for a downward adjustment to occur or head for the exits? The action of energy stocks in the first several days of October is a sign that, for the near term at least, their upward movement has stalled. Should energy prices decline dramatically, some of the more speculative energy securities could see a little air let out of their balloons.

In any event, the focus on energy, inflation, and interest rates roiled the bond and stock markets as the fourth quarter began. Markets around the globe have swooned during the first two weeks of October. The U.S. economy has given mixed

signals recently, with some barometers signaling strength while others are registering weakness. The key issue for investors is whether the economy is going to lose enough momentum to put further Fed hikes on hold before rates eventually go much higher. As inflation fears have accelerated in recent weeks, the Fed has grown more hawkish, particularly because of its concern about the impact of energy costs and what it perceives as an overheated housing market and overly accommodative mortgage financing.

Investors should watch what the Fed does and not get too carried away with what it says. The Fed often drives while focused on the rearview mirror. The higher decibels cascading from the Federal Open Market Committee appear to be sparked by developments in housing, housing finance, and the spike in energy prices. In both housing and energy, there are already signs that things are cooling. The precipitous drop in consumer confidence also heralds a consumer who is more cautious. Faced with higher energy



prices, rising borrowing costs, and falling housing affordability, consumers will doubtless slow their pace of expenditures and borrowing. Businesses will factor a consumer slowdown into their plans and be less aggressive in hiring, investing, and in raising prices. Any slowdown in growth and hiring coupled with inflation that is constrained by the forces of global competition should also keep wage gains in check. The deflationary impact from Asian goods prices should continue along with the pressure on U.S. labor costs arising from the global glut of skilled and unskilled labor. These forces will play a major role in restraining long-term inflation expectations. The challenge for Alan Greenspan and his successor will be to quell the recent rise in short-term inflation expectations before they become entrenched. In coming weeks, it is quite likely that the worst fears regarding inflation will have diminished. The risk to the markets is that the Fed, as it has in the past, will overshoot in its attempts to slow the economy.

Even if the Fed continues to talk tough and push rates up another notch or so, the equity market is probably getting close to adjusting for much of the bad news with which it has been bombarded in recent months. The real risk of significantly higher inflation over the next twelve months is lower than the "Chicken Little" media would have us believe, the Fed's rhetoric notwithstanding. After eleven rate hikes since June 2004, we are certainly much closer to the end of a tight money policy. The markets will begin to anticipate a neutral and then easier monetary policy. A neutral or easier monetary policy would also occur at the same time there is an expansive government fiscal policy. The equity market will begin to discount that possibility. The drag from higher energy costs and interest rates may slow economic growth, but the underlying economy

is quite strong. For the most part, corporate balance sheets are also solid. As for valuation levels, the price-earnings ratio for the S&P 500 on forward twelve months operating earnings guesstimates is less than 15 times, its lowest since the fall of 2002. The 10-year U.S. Treasury yield of 4.5% has a comparable reciprocal of 22.2 times. Stocks are as cheap today as bonds were at the peak of the equity market bubble in 1999-2000, and bonds are as expensive as stocks were in early 2000.

The major equity averages have been going sideways for 21 months and investors are frustrated. There is an old expression that "bull markets climb a wall of worry." The wall looks very high right now, and investors may stay cowed for a little while longer. However, as the domestic and global forces of supply and demand combine with a vigilant Fed to exert their influence on inflation, fears of inflation should lessen. While the growth of the economy may slow, it will remain on its long-term upward trajectory. As the economy slows, the Fed will no longer be viewed as the House of Grinch, but a potential ally to stimulate growth. Corporate profits, which are at record levels, will remain decidedly positive. As investors start peeking through the cracks and evaluating the relative attractiveness of equities and bonds, they will begin to scale the wall to pursue the rewards that await them.

Roger E. King, CFA
Chairman and President

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