

Winter 2005

Kites rise against, not with, the wind. No man ever worked his passage anywhere in a dead calm.

— ROBERT HERRICK, 1591-1674

December 31, 2004, marked the end of a year of many significant accomplishments. The U.S. successfully transitioned through what appears to be a sustained economic revival, and the equities markets correspondingly reacted and delivered especially handsome rewards to opportunistic investors. The elections of 2004 are now behind us, commodity prices have backed off their overheated boils (oil prices closed the year up 33%, but are down from their peak of up 71%), and some initial progress has begun with respect to the much needed enhancement of hedge fund oversight and regulation. While the Middle East is in the throes of major change, it has been a mixed year for Islamic terrorists. The greatest events of civilian carnage were the savage attacks in Madrid and in Beslan, Russia. Yet, Osama Bin Laden and his devilish minions have been unable to wage an attack in the U.S. with anything stronger than an infomercial. Saddam Hussein, who had a long history of terrorist involvement, is now out of the terror business. In fact, not only have there been no additional terror attacks on U.S. soil in spite of several big target opportunities (the political conventions, the election, etc.), neither have there been any large scale successful terror attacks on non-military U.S. citizens abroad. More progress on the containment of terrorism is coming. If the U.S. and other nations take bold

steps to eradicate the purveyors of terror, there could be short-term economic pain (such as periodic oil shocks), but the gains long-term could be stunning for the world economy and world stability.

At first glance, the overall picture for equities in 2005 appears mixed, at best. On the positive side, we seem to be in an environment with solid economic growth, contained inflation, strong balance sheets (which should bolster M&A activity), and a Fed which seems committed to slow but steady interest rate hikes. On the other hand, the U.S. is entangled in a war in which there seems no easy exit. The insurgents are implacable and fighting an unconventional conflict which could drag on for some time. The cost of the war to the U.S. is a major contributor to the U.S. budget deficit. Oil prices have escalated and the dollar has declined, creating a realignment in the world financial system which is designed to address the imbalances that have developed. Interestingly, while this is the scene President Bush faces today, it is a scenario similar to what President Richard Nixon was facing in 1973-74.

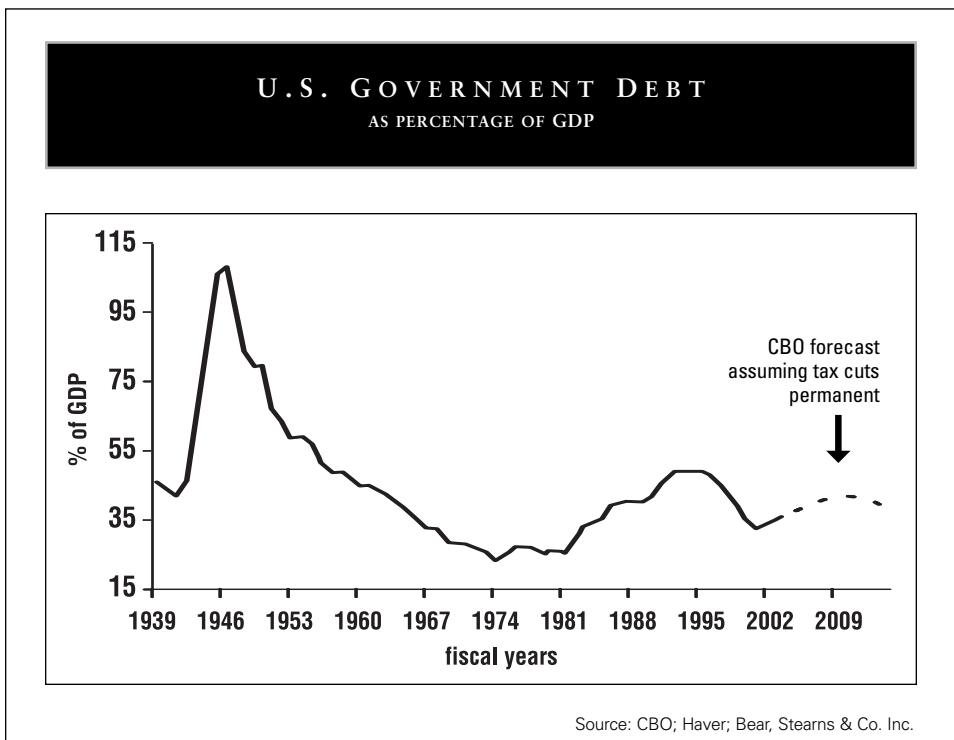
The U.S. is presently running a large imbalance in its trade and current accounts. The cumulative U.S. trade deficit set an annual record during

2003 of \$489.4 billion, or 4.5% of GDP. As the U.S. economy has picked up steam, the deficit has continued to grow, driven by higher oil prices and strong demand for foreign goods. On an annual basis, the current account appears headed for a deficit of approximately \$650 billion in 2004 (or nearly 6% of GDP). The problem with running trade deficits of this magnitude is that the U.S. must attract capital inflows to finance them. Normally, to attract foreign capital to finance a deficit, interest rates must be equal to (or greater than) comparable rates in other countries. Fortunately, over the past few years, the U.S. has been able to maintain interest rates at or near 45-year lows—below comparable rates in other countries except for Japan—and still attract the foreign capital necessary to finance its deficits. In particular, Japan and China have been willing to provide this financing by accumulating large amounts of dollar reserves. While this appetite may be sustained a while longer, it will not last indefinitely. At some point in the future, the U.S. will have to see the trade and current account deficits decline to a more manageable level, which is likely in the vicinity of 3% of GDP.

In order for the U.S. to continue to service its mounting debt, it needs to leverage up its balance sheet. Asia, with a massive pool of savings, a growing propensity to spend, and a consumer who is not overly leveraged, fits the bill. The U.S. has two financial partners in Asia, Japan and South Korea. Japan has operated the Bank

of Japan in close concert with the Fed since the end of World War II, and South Korea tends to cooperate with U.S. requests on economic/monetary policy because the country would not exist had it not been for U.S. military support over the past 50 years. Both Japan and South Korea are not raising interest rates and have easy monetary policies, which is beneficial to the U.S. The country that is not reflating, however, is China. In fact, Beijing is moving in the opposite direction. Its first interest rate hike in years, formal government guidance to restrict bank lending, and multiple refusals to revalue its currency have placed Chinese economic policy squarely at odds with the United States. China is not acting like a financial partner to the U.S., and we should not presume that it will do so in the future.

To get China to “cooperate,” the U.S. has an interest in flexing its financial muscle to cool China’s economy, forcing a currency revaluation and a reduction—not further increases—in Chinese



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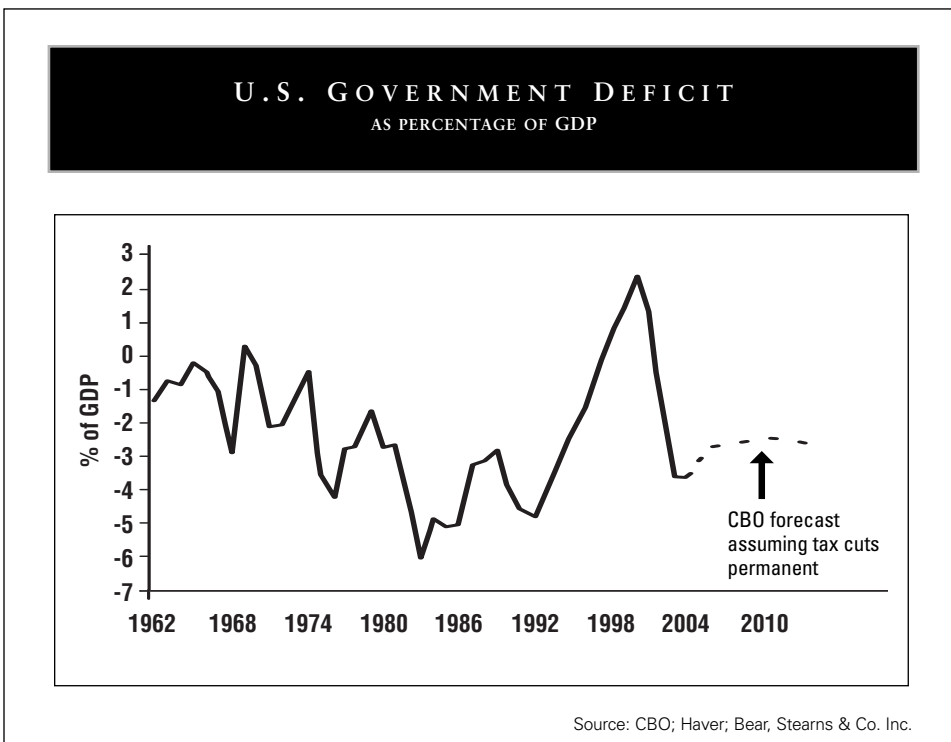
interest rates. For instance, the U.S. in reality does not mind higher oil prices (within reason) because

elevated crude prices put a tremendous amount of pressure on the Chinese. A higher Renminbi (which is what the U.S. wants) would help alleviate China's oil bill. Higher oil prices also pressure China and the Asian economies to reduce interest rates, and to reflate, which will eventually help the global economy and of course the U.S. economy. The bottom line is that if Asia reflates, its appetite for U.S. debt should also increase. In addition, an increased amount of Asian liquidity should also find its way into the U.S. and European equity markets, bolstering stock prices as well.

Importantly, the slowing of the Chinese economy must be done delicately, as China has been the new global growth engine for several years now. Too sharp of a downturn would pose great risks to the Chinese banking system which sits with sizeable, non-performing loans. Many Chinese businesses, which are indebted to the banks, are faced with the problems of excessive expansion. For example, Chinese inventories have been

on the rise for some time and are becoming problematic in some areas. A case in point is the explosion in the inventory of cell phones which is currently approaching 70 million units! The cooling of China's very rapid growth rate must be handled in a well-thought-out manner in order to not create too much spillover onto the Chinese banking system and the rest of the world, especially Asia.

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U.S. dollar may wane, the Fed argues that the capital markets are so deep that there is much more money available to borrow and that the U.S. should have no trouble finding lenders to finance the large U.S. deficit. In addition, many argue that China and Japan will continue to buy U.S. debt in order to maintain their high level of exports to the States. Finally, the IMF is concerned about the stability of the U.S. dollar, as a collapse would likely cause a ripple effect throughout the world economy.

Of course, the mounting U.S. trade deficit is a major cause of the depreciation of the U.S. dollar against other currencies, which in turn is causing some concern in the U.S. equity and fixed income markets. While the value of the dollar has certainly declined dramatically, it is difficult to compare its value to other currencies because over periods of time currencies have a tendency to move together (they are all on the decline or all on the rise). A better way to measure the deterioration is by comparing it to a commodity such as gold. When comparing the dollar to gold, the dollar's value has been weakened by 40% since 2001.

However, approximately half of that decline reversed previous dollar strength. The other half, however, is actual dollar weakness, which causes upward pressure on inflation and invites capital flight. As previously mentioned, since 2002, interest rates have been very low relative to inflation, which helps explain part of the weakness in the dollar.

There is a silver lining to the weakness in our currency. A lower dollar is not necessarily a bad thing for many U.S. companies. A weaker dollar results in an improvement in U.S. competitiveness in the world markets and helps boost global demand for U.S. exports of goods and services. Imports should also decline or grow more slowly if importers boost their prices in response to the dollar's fall. Also, earnings of U.S. multinationals in overseas markets would translate into more U.S. dollars. Over the past five years, foreign earnings have constituted approximately 35% of total corporate profits. Companies that will benefit from these developments include U.S. exporters (which should see their demand and revenues rise), industries facing import competition (should see it lessen), and U.S. multinationals (which should see their profits improve).

In addition, as the dollar falls, it makes U.S. services and assets at home cheaper and more attractive to other nations than they were previously. A major beneficiary of a lower dollar would be the tourism industry. As an example, tourism was up significantly in New York City in 2004. Approximately 39 million visitors—many of whom are foreigners—were forecasted to have visited the city in 2004—1.8 million more than 2003's record. In fact, demand was so strong that the director of the Waldorf-Astoria Hotel indicated that only six days in December were not sellouts. Citing the international traveler as the linchpin, he pointed out that bookings by tourists from every major country (except for France) were up at least 25%

from 2003. Correspondingly, room rates are also on the rise.

U.S. assets are also cheaper, making U.S. companies more vulnerable to acquisition offers from international competitors. Many European companies, in particular, appear to have their financial houses in order, and their currencies are now worth substantially more than a year ago. Many will view American companies as an easy access to a lucrative market—again, byproducts which are positive for the U.S. equity markets.

While the dollar's decline should be monitored closely, it will stabilize at some level as eventually there will be a bottom to the dollar's value that will attract foreign investors back to dollar assets. We may be nearing this point, as the value of the dollar historically has been very responsive to U.S. interest rate expectations, which have in turn responded to the Fed's comments and actions. If the Fed were to sound less dovish, interest rate expectations would rise and the dollar weakness would likely stop.

The bottom line is that deficits and dollar weakness tend to move in cycles, depending on the economy and the geopolitical environment. Today the U.S. has very large trade and current account deficits and a dollar on the decline. A tighter control on spending will have a positive impact on the budget deficit and the trade deficit will eventually start to reverse itself as the falling dollar reaches a level that starts to attract foreign capital.

In addition, while the budget and trade deficits are a concern, their respective levels must be put into some sort of historical perspective. Currently, the U.S. debt/GDP ratio stands at 37.5%—the lower side of its historical range. Assuming the tax cuts are made permanent, that ratio could possibly peak at 40.5% in 2010, still well below historic highs.

Finally, while a significant dollar decline will cause some increase in inflation, it should not be as much as some fear given the excess capacity around the world. For example, the dollar has been in decline since 2002, dropping approximately 15% on a trade-weighted basis and approximately 50% against the Euro. Yet U.S. inflation remains low. There was a similar effect when the dollar declined in the late 1980s.

While concerns do exist and challenges will present themselves, overall we are cautiously optimistic about 2005. Despite the Fed raising interest rates, liquidity still remains in the U.S. system. For instance, M3, one measure of money supply, is rising at a rate of 4.8% annually, meaning monetary policy is not that tight, which is good news for stocks. It is true that the equity calendar is also beginning to grow, with more IPOs coming to market than at anytime in the past two years. Yet, importantly, equity fund flows have been more than sufficient to offset the new equity supply thus far. Corporations also have plenty of cash—net debt to cash is currently at a seven-year low. This cash horde provides ample ammunition for shareholder-friendly actions such as increased dividends, accelerated share repurchases, and increased merger and acquisition activity. In fact, during 2004, M&A activity jumped to \$1.95 trillion, a 41% increase from its level in 2003. During the fourth quarter alone, approximately \$600 billion was spent on takeovers, the most since the second quarter of 2000 when \$671 billion of acquisitions were made. There is no doubt about the stability of the capital markets and that the recovery in the M&A market is gathering momentum. The potential for tort reform and the chance of some sort of personal account in social security should also be major positives for the economy and the equity markets in 2005.

On October 22, 2004, the President signed the Homeland Investment Act. This action may lead

to a significant repatriation of funds to the States, possibly propping up the dollar. The new Act will allow U.S. companies that have accumulated profits abroad to repatriate those earnings for one year at a 5.25% tax rate instead of a 35% tax rate. Corporations are limited in their use of these funds, but are expected to use the money to pay down debt, to make capital expenditures, and to pursue acquisitions; all of these actions are obviously positives for the equity markets.

Another interesting development is the high correlation between stock market performance and insider buying and selling within the brokerage industry. A recent study concluded that in all but one year from 1990 to 2004, the overall stock market rose when brokerage and investment bank insiders were consistently buying their own firms' stock in the prior year. The only year this analysis did not pan out was in 1993, when the stock market was flat. Interestingly, in 2004 insiders have been buying their firms' stock with

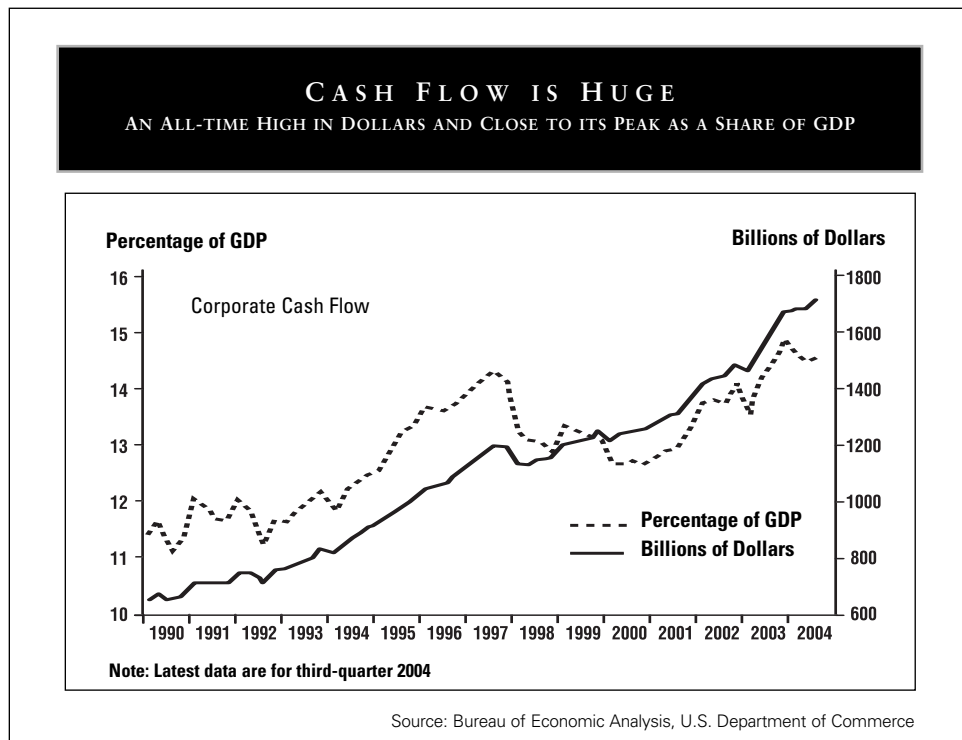


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a consistency not seen in seven years. In addition, the pace of selling by insiders is the slowest it has been in ten years.

This business cycle differs substantially from previous ones because the recession was deflation-related rather than inflation-related. The result has been steadier growth in consumption, but a longer than usual delay in business spending on equipment, inventory, and new hires. When the improvement in corporate confidence spreads into inventory and/or hiring decisions, it should have particularly



positive implications on GDP and on equity prices. Calendar year 2005 should mark the start of a multi-year process of inventory rebuilding and above-trend increases in demand for commodities, with correspondingly strong profits.

Finally, despite concerns about consumer debt, recent signs have been positive. Personal bankruptcies declined 2.6% in the 12-month period ended September 30, 2004. Personal bankruptcies seldom decline, and in fact have been climbing since 1984. In addition, both consumer and business loan delinquencies are down. Indeed, one has to return to 1995 to find a time when credit cardholders have been this current on their payments. Another factor that is different today about leveraged U.S. consumers is the composition of their debt. Importantly, while absolute debt levels continue to rise, much of the increase has been spurred by the number of people trading up into a house rather than renting an apartment. The impetus for this phenomenon has been the

historically low interest rates of the last several years. Thus the quality of consumer debt is higher than it might otherwise appear, as houses are a collateralized obligation.

In summary, while many challenges confront investors in 2005, we are cautiously optimistic about the underlying fundamentals of the economy. We also remain confident that the Business Valuation Approach will continue to prove fruitful in uncovering rewarding opportunities for our clients.

Lastly, our thoughts are with all of those affected by the tsunami disaster in Asia. The power of Mother Nature and the wrath that she can bring can never be underestimated. We are hopeful that 2005 will bring a period of recovery for that area of the world as well as a year of prosperity to all.

Leah R. Friday, CFA
Senior Vice President



"Then it's agreed. Until the dollar firms up, we let the clamshell float."

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Over the past twenty-four years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

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We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

Sources: TIS Group, Inc., Prudential Equity Group, Bear Stearns, *The Wall Street Journal*, Bloomberg L.P.

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