More Corporate Accounting Deceptions
Retained Earnings are a Drag
Retirement Blues
Soft Landing or Over the Cliff?
The Teddy Bear Market
Warren Buffett and Bear Markets
Weightless in New York

By John Mauldin

Every week, as I sit down to write, I think about the scores of research reports and articles I have read in the past few weeks. Is there a new theme? What trend is developing? What is the picture coming into view from the pieces of the puzzle at which I get to look? What have I seen that I should bring to your attention?

Usually one or two things jump out, and this week is no exception. A number of articles, all about the dollar, and when taken in concert, are beginning to concern me. The developments in the dollar are the most serious threat to my view of a Muddle Through Economy and Market. This is important for you to understand, as it could have a profound affect upon your investments. We will look at these in depth.

But first, I want to briefly give you the highlights of the keynote address at the Hedge Fund Forum this last week. I think it will give you food for serious thought.

Rob Arnott of First Quadrant presented a sobering picture of the future of investments and retirement. A well-known writer, researcher and hedge fund manager, Arnott impressed a rather jaded audience of hedge fund managers with his first rate analysis.

I wrote about a research paper he did on risk premiums in my May 3rd e-letter. You can go to the archives at www.2000wave.com and read it. Basically, he demonstrates that the risk premium of stocks vs. bonds has gone to zero, which implies that bonds are extremely likely to outperform stocks over the next decade or longer. At this conference, he began to go into the reasons why stocks are likely to under perform and some very interesting implications.

More Corporate Accounting Deceptions

In 2000, Arnott showed how companies in the S&P 500 hid about $62 billion in unfunded pension expenses by assuming they would make an average of 9.5% on their portfolios, or an average of $6 per share, or over 12% of total earnings. Not only did these earnings not appear, but in the future the losses must be made up as actuaries are going to force companies to start lowering their estimated returns of the pension portfolios. Instead of adding 12%, it will start subtracting. By the way, that $6 would represent about 25% of current earnings.

In that recent e-letter, I wrote about how dividends were the main source of appreciation of stocks over the last 200 years: “First, the largest component of stock market return, up until 1982, was inflation. From 1802 to present, $100 would have grown to $700 million if you assumed all dividends re-invested. However, if you take out inflation, we are left with a still impressive $37 million. If you take out dividends, however, you find that your $100 is only worth $2,099!

Here's the kicker: in 1982, the stock portfolio would have been worth only $400. The bulk of the growth, over 80% of current value, came in the last 20 years.

This data simply means that conventional wisdom which says equities get most of their value from capital appreciation is false. It is based upon recent experience, and a bubble mentality."

Retained Earnings are a Drag

The current counter argument is that retained earnings are now the way you receive growth. You are better off if a company does not pay you dividends, and thus subject your money to taxes. They can then use the retained earnings to grow the company, and you get compounded growth.

Arnott exploded that myth. Analysis shows that on average and over time companies with the highest dividends actually show the highest growth. Retained earnings seem to be a drag on long term growth.

"How can that be?" he asked. The answer is that companies are not very good at investing capital. If a company pays out most of its earning in dividends, it only gets to fund its very best ideas. Evidently, when it can fund its 10 best ideas, or pay rich multiples to purchase other companies (as Cisco, Tyco and WorldCom did), then many of those ideas do not work, and result in losses. It says something about the arrogance of today's CEO's when they think their 10th best idea is better than their shareholders first best idea.

The current environment of low dividends will prove to be a significant drag on growth of investment portfolios in the coming decade.

Retirement Blues

But this lower growth environment is not only a problem for pension plans. It is also a problem for individuals. Many financial planners have made assumptions of very high returns for the portfolios of their clients. Many planners assume real returns on investment portfolios of 6-7-8% or more. By real returns, I mean returns after inflation. A dollar saved today, even in today's low inflation environment, will only buy $.75 worth of bread in 10 years.

Arnott shows that average REAL returns will probably only be about 3.5% (portfolio returns after inflation) in the future. Many boomers and those in the 40-50 age range are not going to be able to retire comfortably on the portfolios they are likely to have.

First of all, in 2030, with normal 65 age retirement, there will be only 1.5 workers per retiree. Forget the implications to Social Security, as enormous as they would be. Think about the logistics of such an environment. Who is going to do all the work? Provide the health care? Deliver the pizza? Work the farms? Produce products? Yes, we will be more productive, and immigration will rise to offset the problems. But think about what would happen if 60% of the work force today decided to retire this year. How in the name of rising productivity could all the goods and services get produced?

What is the critical moment when things become untenable? 10% more retirees? 25% more? 100% more? No one knows, and I would not hazard a guess. But we will have Japan and Italy to learn from, as they are much further down this road than we are. One of the reasons that Japan is in such dire straits is that their aging population is not consuming enough to keep the economy growing. This is a direct reason for their deflation.

Arnott argues from a seemingly backward position, but it is one I will ponder for the next few months. He notes that under the current normal investment portfolio growth assumptions, nearly everyone would be able to retire at 65. However, society cannot function under those circumstances, so that the economy/market will not provide the conditions for such an event to happen.

The very fact of large numbers of workers retiring will slow the economy, thus slow down the growth in stocks, and thus slow down the growth in investment portfolios. We will have to work longer to amass the investment portfolios we need to retire comfortably. The difference between a portfolio compounding in real terms at 3.5% and 7% is HUGE.

Now, I am not endorsing a Malthusian end of the world scenario. I can think of several solutions to the problem. For instance, we could simply open the border with Mexico. There are millions of high quality hard working employees looking to be productive. Production could become more international, but then we will pay more for certain items. Maybe millions of Americans will move to other countries where costs are lower.

Maybe we will reverse the current trend. Instead of our kids leaving home and then coming back to live with us, maybe we surprise them and move in with them. We will adjust, as we always have. I am not worried about some doom and gloom life.

However, the implication is that the future world of 2030, however we adjust, is not going to look like our world today. Further, hoping to get 7% or 10% (forget the old 15-20%) growth in your total portfolio, and betting your future lifestyle on it, is not going to work. You need to take a hard look at your portfolio and retirement planning. You may need to start saving more.

Arnott gives us a few examples: if you are 40 today, and are just starting to save for your retirement, this is what you face: assume you now make $45,000 per year, that your salary will grow at 2% per year plus inflation, and that you save 9% of your salary per year in your 401K. If you get real, inflation adjusted returns of 3.5%, you will need to work until you are 76 in order to retire at 2/3's of your pay. The only way to retire earlier is to save more or live on less. If you wanted to retire at 65, you would only get $14,180 per year (in current dollars) plus Social Security (which of course will not kick in at age 65 in 25 years).

If you are 30, the difference in a lower assumption and today's "I can make an easy 10% in my portfolio" means you will have to work until you are 73 to retire on the same amount.

Encourage your kids to start saving. If you are not saving enough to retire, then I would be nicer to your kids.

By the way, the implications of this model was not lost on the hedge fund audience. For the most part, these are managers who think they can deliver 10% returns. And many of them probably can. The longer we continue in this long term secular bear/slow growth environment, the more likely the explosive growth in hedge fund investing will continue. That was what they liked to hear.

The second implication was not as pleasant to contemplate. The problem for most investors is that there is not enough room in the hedge fund life boat for everyone to get a seat. But more and more will try to crowd into the dory. The implication many of us discussed was what would happen to hedge fund returns as the pie got bigger? The clear concern is that in some styles of hedge fund the returns would begin to suffer at some time in the future, as there would be too many funds chasing the same deal.

No one ever said it would be easy.

Soft Landing or Over the Cliff?

Let's look at what good things are happening. Today we learn employment may be starting to turn. The U.S. service economy expanded during May at the fastest pace in almost two years, as the recovery from recession gains momentum. U.S. manufacturing expanded in May at the fastest pace in more than two years, as production and new orders increased. Retail sales were essentially flat in May, but that is better than dropping.

In short, America is doing what it has always done, and that is to adjust and grow. The core business of America is still in pretty good shape, with a little fraying around the technology edges.

Greenspan tells us, "The underlying, remarkably quiescent inflation outlook to me, in my judgment, is a positive factor, and I suspect the American economy is in an upswing," Greenspan told a group of banking chief executives at a conference yesterday in Montreal. "It's not going to be a dramatic upswing. But events look increasingly positive."

Hmmm. Not dramatic, but positive. That seems to be a description of my prediction for a Muddle Through Economy. Right now, that prediction for this year is still looking good, but there are things which are bumping around in my worry closet at nights which are causing me some concern.

Quite simply, the US dollar is dropping faster than I would like it to. It recently touched .95 euros and 124 yen. This is a drop of about 9% from the peak, and against a "trade-weighted" index of currencies, the dollar is down about 3%.

These levels do not concern me. I expect the dollar to drop further. What causes me concern is the rate of the drop. I thought it might take a year for the dollar to drop to parity with the euro. Now it looks like it could happen quite soon. The Japanese government has told us repeatedly they want a weaker yen, and are selling yen to try and make their currency weaker, but so far it is not having much effect. What does it say about the competency of a government when they cannot even figure out how to destroy a currency? Maybe they should consider hiring Arthur Anderson executives as consultants. Those guys are expert at destroying paper.

The Teddy Bear Market

A gradual drop of the dollar will not negatively affect the world economy all that much, will not cause a return of inflation and will actually help many US companies. It will help our trade deficit. On balance, a gradual drop in the dollar is not something to lose sleep over. Call it a Teddy Bear Market.

But a steep and rapid drop is another type of bear altogether. It could be a rogue grizzly, tearing up everything in its path.

In 1985 and 1986, as the dollar gradually weakened, we actually saw the stock market rise, and the economy grow. The dollar dropped almost 13% in 1996, and the economy and the stock market rose.

It is not a dollar dropping per se that bothers me, but the climate surrounding the drop in the dollar. In 1987, the dollar crashed, and against a back-drop of higher inflation expectations, rising interest rates and conflicting central bank policies, that led to the stock market crash.

Today, could we have the makings of a perfect storm, or just another summer squall? Let’s look and see.

In 1987, central bankers around the world pursued policies that took advantage of a falling dollar, making the decline much worse than it should have been. If international monetary policy was a football game, they would have been flagged for unnecessary roughness.

Many of you remember how expensive it was to travel internationally, and how cheap American products were for the rest of the world. That drop actually helped set up part of the base for the bull market of the 90’s.

Now, we have a world-wide consensus that the dollar is dropping. Will these same central bankers once again pile on a weakening dollar?

I think that is not likely. Morgan Stanley estimates that a rapid drop of 20% in the dollar would cut European GDP by 1%. Japan really wants to halt the rise of the yen. Other countries want to keep their currency competitive with Europe and Japan. This argues for a soft landing, as in theory central bankers should coordinate to allow the dollar to drop gradually.

On balance, relative productivity in the world economies and our economic growth, among other factors, would argue for a gradual drop, and a soft landing.

But as I have previously shown, central bankers are not the powerful controlling factor they once were. They have limits to their available capital.

There are other factors involved. Foreign investors shied away from the U.S. in 2001, as direct foreign investment fell by 60.4% from 2000, the Commerce Department said. That trend is accelerating. Foreign investment has been a major reason the dollar has been so strong.

Andrew Kashdan of Apogee tells us, "…the current account deficit remains gargantuan, even though everyone knows it. That means foreign capital will still be needed to plug the gap. And with markets underperforming and foreigners realizing currency losses on top of investment losses, it may dampen, even douse, their enthusiasm for U.S. assets. In the event, the dollar will have nowhere to go but down."

Enthusiasm for American policy abroad is waning. The recent wave of protectionism of steel and agricultural subsidies, and difficulties with foreign policy do not play well. Foreigners look at a tidal wave of ugly disclosures about corporate malfeasance and wonder who is running the asylum?

The noise in my closet is foreign investment in the US turning significantly negative. They are looking at a dropping stock market, a bond market that is not showing any strength when it should be and on top of that they are watching the dollar fall. At what point do they decide enough is enough?

Normally, this would not be a problem, except that these times are not normal. As I said last week, foreigners own over $8.2 trillion of US assets, while we own only $5.6 trillion of assets in the rest of the world. For whatever naive reason, I always assumed that we owned more of their stuff than they did of ours. To put it in perspective, that $2.6 trillion difference is 26% of GDP.

Foreigners hold 24% of corporate bonds, 13% of the equity market and 22% of US corporations. Foreign ownership has risen from 33% of US GDP in 1990 to 78% today.

If even 10-15% of foreign investors decided to rapidly leave the US markets, it would cause a serious problem. A rapid drop of 20% in the value of the dollar would mean their stocks and bonds would lose 20%. Would that cause 20% of foreign investors to head for the exits? No one knows, but a lot of people worry about it.

We need foreign investment to maintain the value of the dollar. The current climate is not one which is going to attract a lot of enthusiastic new investors.

When I also add in the fact that the Fed is playing with one hand tied behind its back, I get more nervous. Normally, to attract capital, you would want to raise interest rates. As an example, look at Canada, and how their currency is actually appreciating. (There are other positive factors as well.)

But Greenspan cannot raise rates, at least not yet. To do so would cause a serious hiccup in the stock market, given the tenuous nature of the market and a very low inflation outlook. Raising rates too much and too fast could hurt housing as well. IN an election year, raising rates prior to the election would be politically difficult.

Treasury Secretary O'Neill has made it plain that the government does not want to intervene in this market by supporting the dollar.

So we are at the not so tender mercies of foreign central bankers and investors in a way that we have not been for many years, and that gives me cause for concern.

What would happen in a dollar crash? Stephen Roach gives us this picture: "In my view, a dollar crash would have a devastating impact on US financial markets that could well be amplified in other capital markets around the world. Foreign investors would continue to reduce their exposure to dollar-denominated assets and US investors would undoubtedly rebalance their portfolios in an effort to seek greater exposure to non-dollar-denominated assets. The result would be lower prices for equities and bonds, alike. This could have significant negative consequences for a wealth-dependent US economy. It would undoubtedly deal a devastating blow to consumer confidence, finally sealing the fate of the long-awaited consolidation of the American consumer. The negative asset effects would also result in a higher cost of capital that would most likely impede business capital spending."

Morgan Stanley has raised their projection of the probability of a dollar crash to 10-15%. When Stephen Roach, that erstwhile bear, subscribes to such a view I am not surprised. The interesting thing is that his colleague Richard Berner agrees with him. "I stand shoulder to shoulder with Roach," he says. Berner is no bear, and has not agreed with Roaches view of a double dip recession.

Berner believes that policy makers will work together to bring us to a soft landing. But his description of what would happen if they fail is not pleasant reading.

I agree that we should not see a dollar crash. I still continue to think we Muddle Through. But that growling sound in my worry closet just doesn't go away. We need to have our eyes fixed on the value of the dollar, and hope this slide slows down soon.

Warren Buffett and Bear Markets

Unless you are involved in the arcane trivia of the markets, you may not have noticed that Warren Buffett just sold a remarkable piece of paper. Dennis Gartman (of the exceptionally well-written Gartman Letter) tells us: "It is a convertible debt issue, carrying a 3% coupon, with an attached warrant that will allow the buyer to "call" from Berkshire shares at approximately 12.5$ above the level that Berkshire "A" shares sold at two weeks ago. In order to keep the warrant alive, however, the buyer will pay to Berkshire an annual fee of 3.75%. In other words, Berkshire has sold debt with an annual negative interest rate of .75%...retaining the right to sell shares at a substantive premium to today's price! We can only recall the Swiss government having been able to make such a grand debt issue, doing so back sometime in the late 70's or early 80's to the best of our knowledge, when money was flowing to Switzerland as a safe haven and the Swiss tried to stem that tide by offering a negative coupon."

Think about that. Supposedly sane institutional investors are going to pay Buffett for the right to take their money. Berkshire is such a proxy for the stock market that you have to be a major bull to enter into such a transaction.

I for one cannot figure out why anyone in their right mind would do this. There are certain rules in life: you don't play poker with guys called Blackie, you don't shoot pool with fat guys called Slim, and you don't take the opposite bet against Buffett.

Berkshire has all the money it needs. Why would Buffet risk serious dilution of his shares by selling these relatively cheap options if he really thought his stock was going to rise? I think he decided to take advantage of a few optimists and add to his bank account. He has got to be chuckling to himself late at night over this one.

The obvious implication is that he thinks we are in for a prolonged bear market.

Weightless in New York

I am thankful I do not live in New York. I would weigh 300 pounds. This week's trip to New York was a culinary delight. The hedge fund conference was in the conference rooms of the newly re-decorated Russian Tea Room -- a little over the top on glitz, but interesting.

My daughter Tiffani, who works with me, went to this conference, and I must say that it was a delight. Those of you who have the privilege of watching one of your children do well, and to have the double pleasure of having them work with you, know what I mean.

She attended her first Power Breakfast at the Regency, across from Larry King (glancing at the prices I am glad we were the guests) and then lunch at the Russian Tea Room. It was quite a difference from my first low budget trip to the Big Apple many years ago.

This weekend will be interesting, as the Texas GOP convention is in town, and I will spend a few hours attending sessions and meeting old friends. I was on the Texas GOP Executive Committee when Bush was merely governor, and made a lot of good friends. It will be nice to see them again. Have a great week, and hit 'em straight.

Your glad to be back home with his bride analyst,

John Mauldin