

What Happened to Profits?

(Global Risk and Reward Revisited)

2004 MACA Annual Meeting

Schaumburg, IL

September 9th, 2004

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Agenda

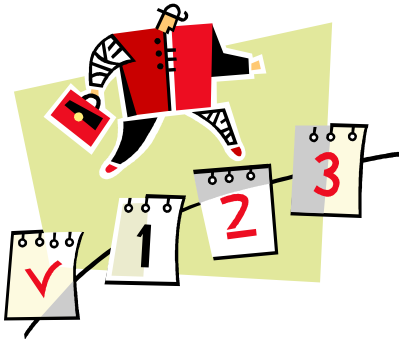


1. Global Economic Imbalances

2. Profit Drivers



3. Recommendations



Legacy of Globalization

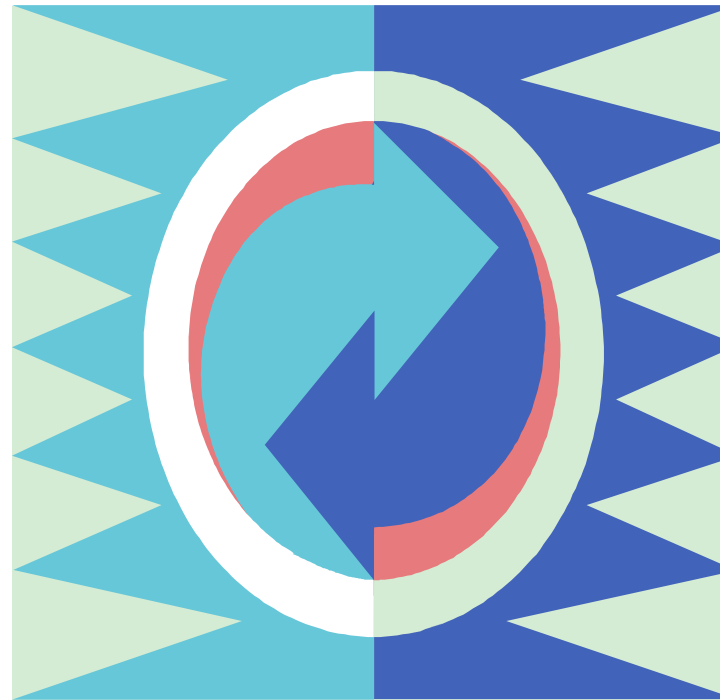
American Industry's Great Divide

Virtuous Cycle

- Steady **Domestic Market Growth**
- **Booming Exports** and **International Expansion**
- **Minimal Foreign Competition**
- **Market Growth Driving Capacity Expansion**
- **Synergistic Acquisitions**

1940's to
Late 1990's

Late 1990's to
?



Vicious Cycle

- **Flat Market Growth**
- **Slowing Profits**
- **Exports Flat**
- **Extensive Foreign Competition**
- **Slow Growth Results in Overcapacity**
 - Downsizing
 - Cost Cutting Focus
 - Wars of Attrition

*Significant Growth
and Profits*

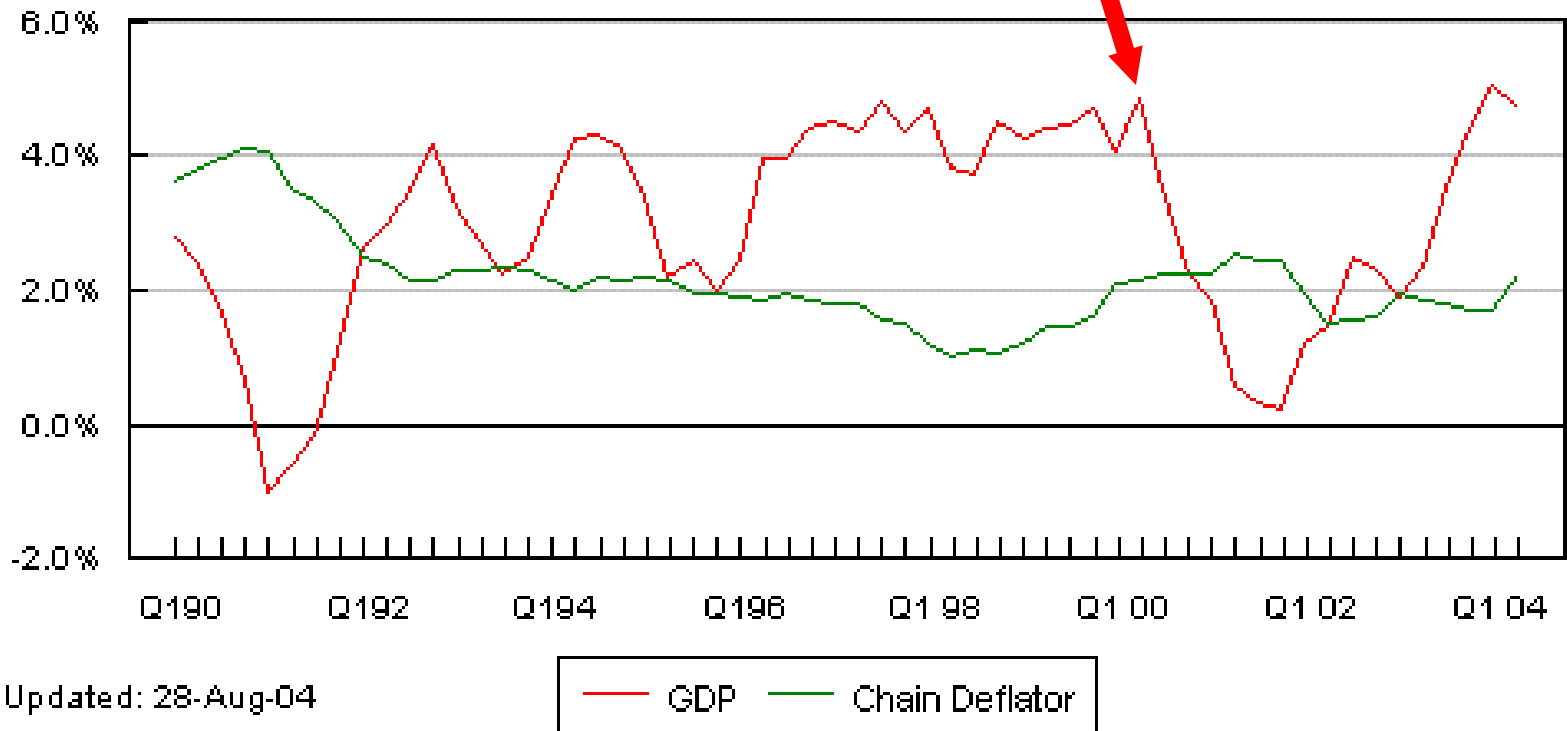
**Great
Divide**

Tailwinds Headwinds

*Limited Growth
and Meager Profits*

U.S. Economy 1990-2004

After Eight Years of Growth, the Internet "Bubble" Pops in 2000



U.S. Lowers Interest Rates to Stimulate Consumer Spending

Effective Federal Funds Rate
(Percent)

Source: Board of Governors of the Federal Reserve System



U.S. Government Lowers Interest Rates to 46 Year Lows on Order to:

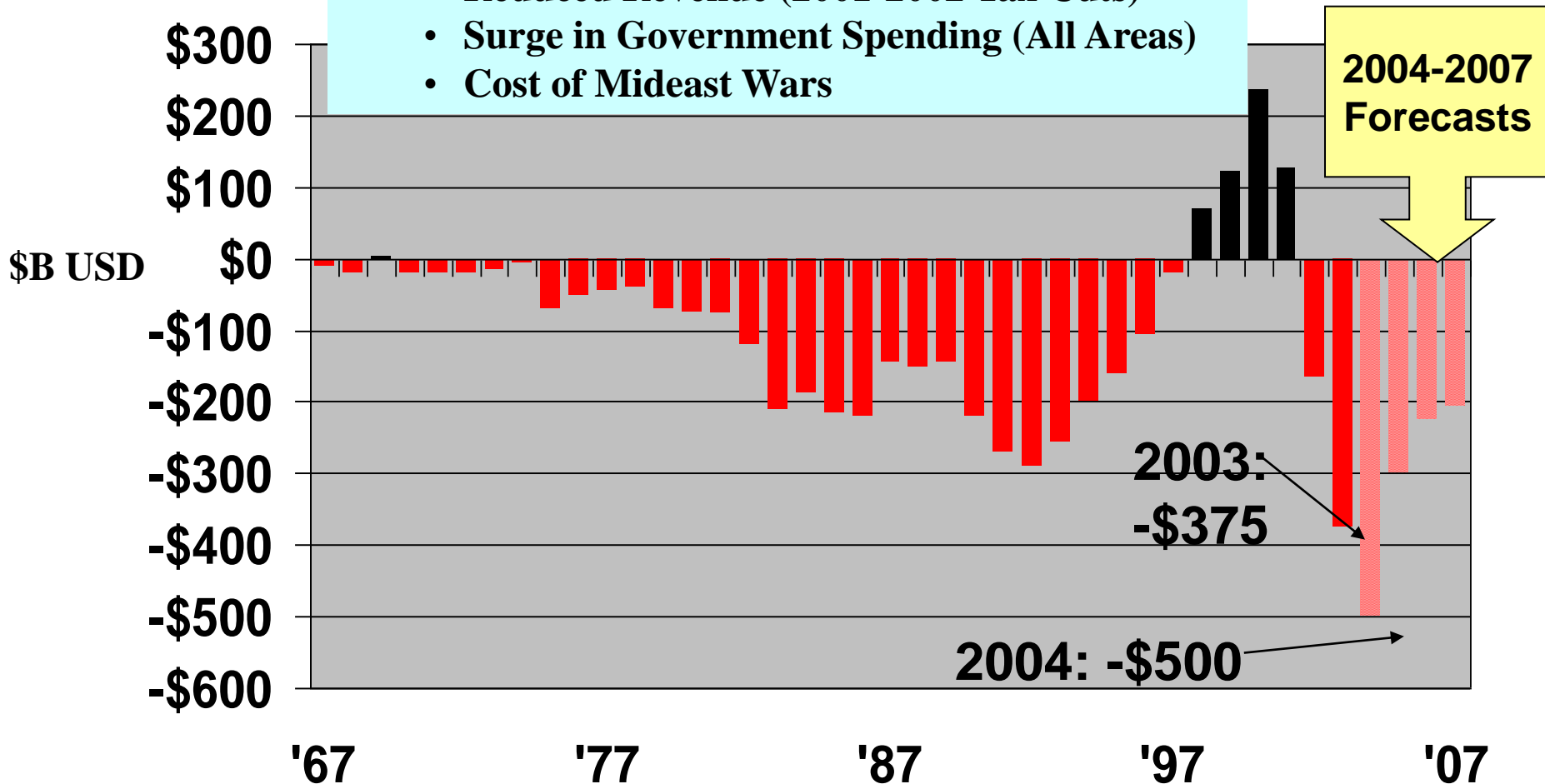
- Exit Dot-Com Recession
- Avoid Deflation
- Stimulate the Economy (2004 Elections)

2004 Federal Reserve Bank of St. Louis
research.stlouisfed.org

U.S. Runs Budget Deficit to Stimulate Economy

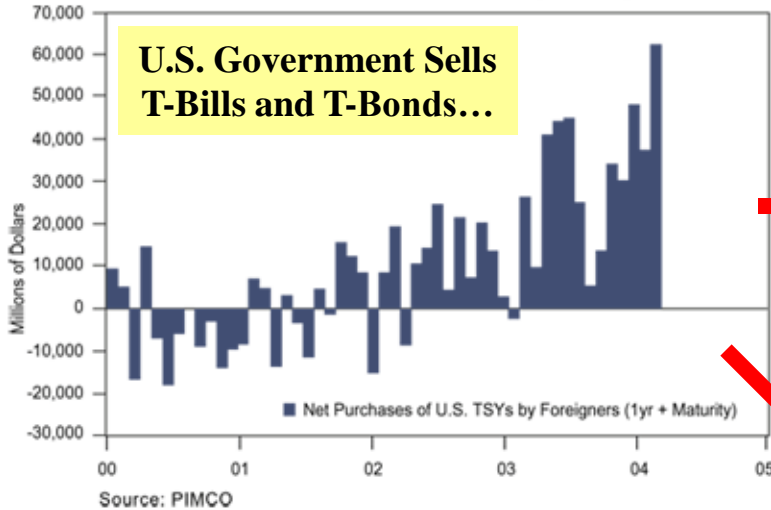
U.S. **Budget Deficit Explodes** Due to:

- Reduced Revenue (2001-2002 Tax Cuts)
- Surge in Government Spending (All Areas)
- Cost of Mideast Wars

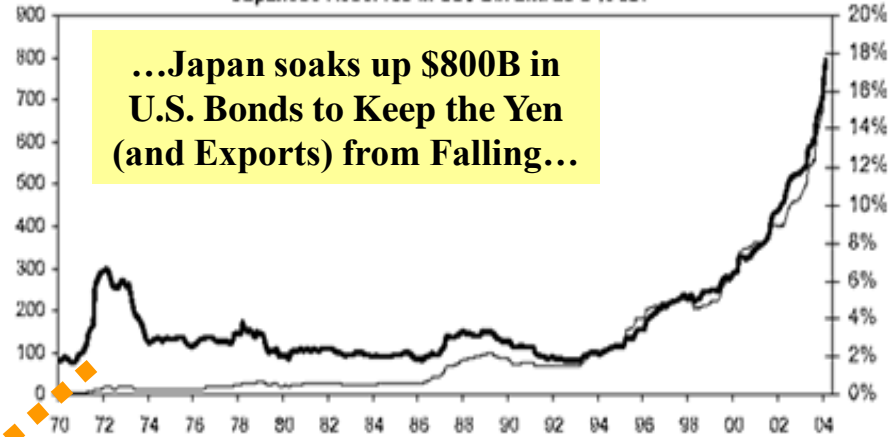


Where is the U.S. government getting all the money to spend more?

Net Purchases of U.S. TSY's by Foreigners



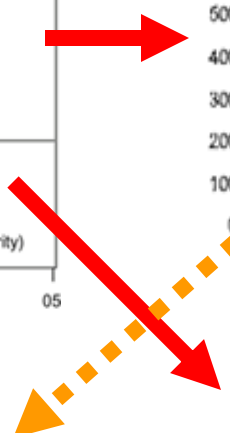
Japanese Reserves in US\$ Bln and as a % GDP



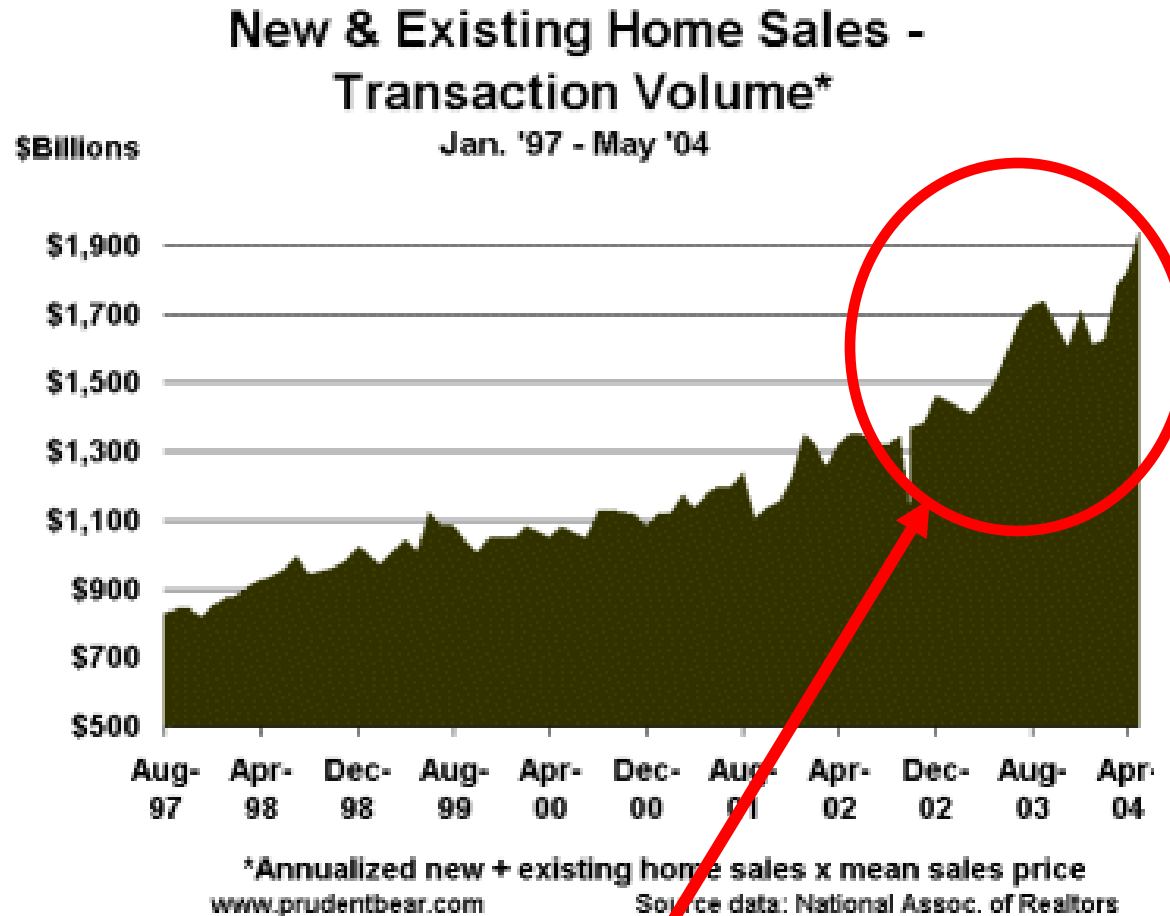
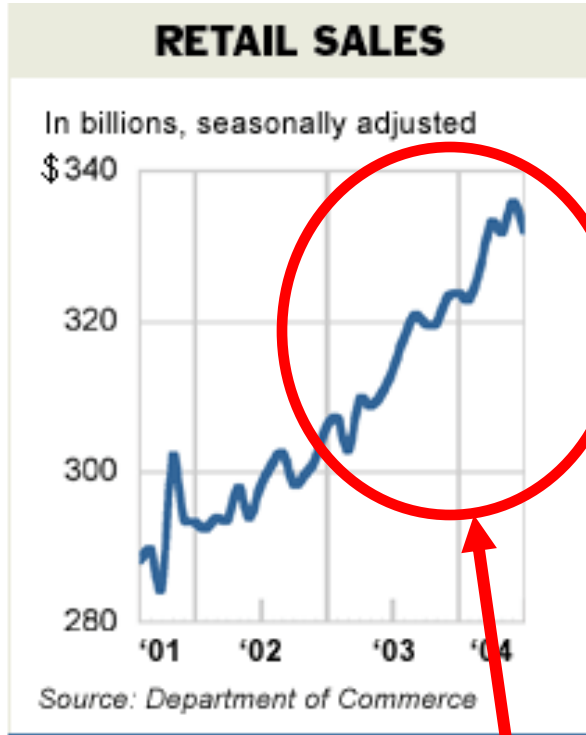
Money Supply (M3)
April '03 - June 14, '04



China Foreign Exchange Reserves

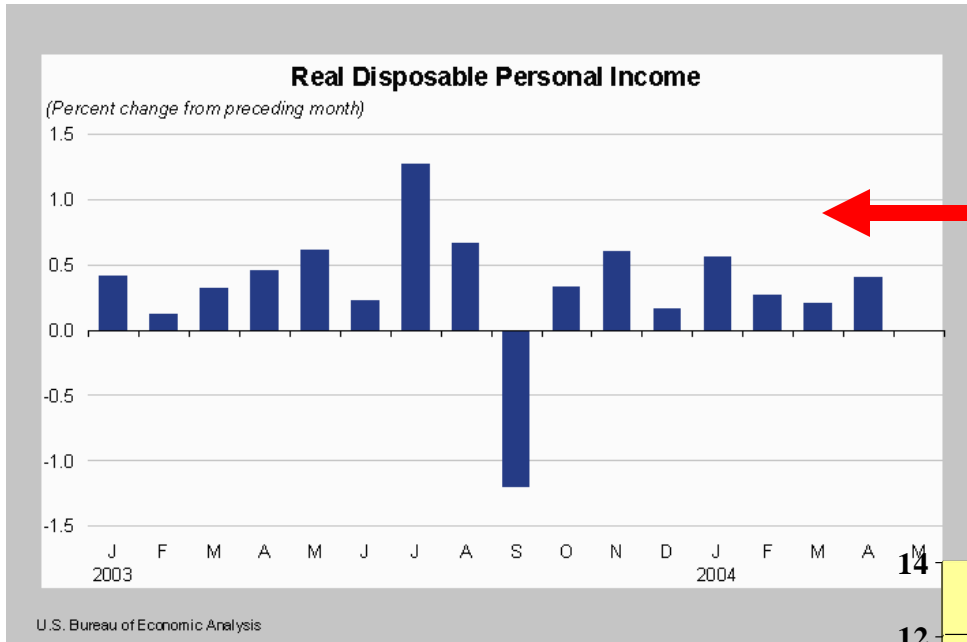


U.S. Domestic Impact: Skyrocketing Retail and Home Sales



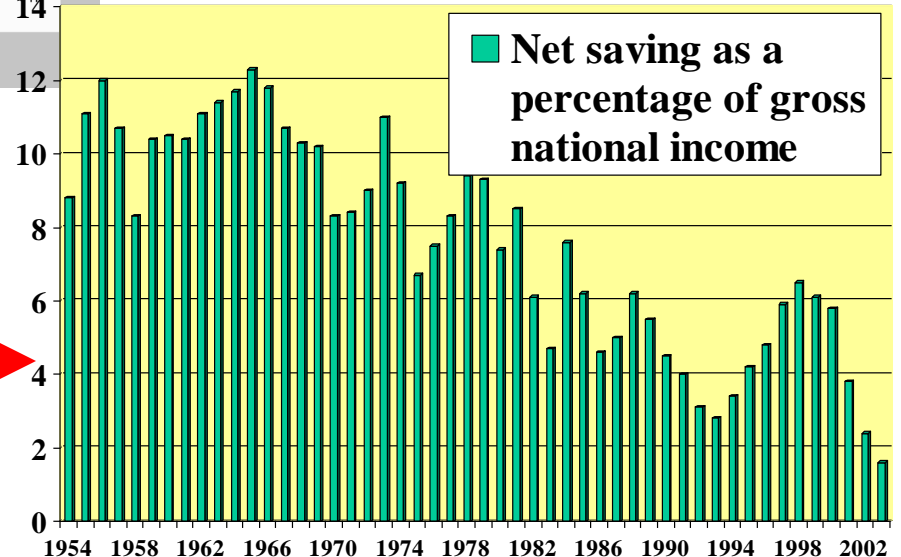
U.S. "Recovery" Fueled By Consumer Spending!

Where are consumers getting all the money to spend more?



Not Personal Income Growth – Only 2.7% for 2003 and Negative for 2004!

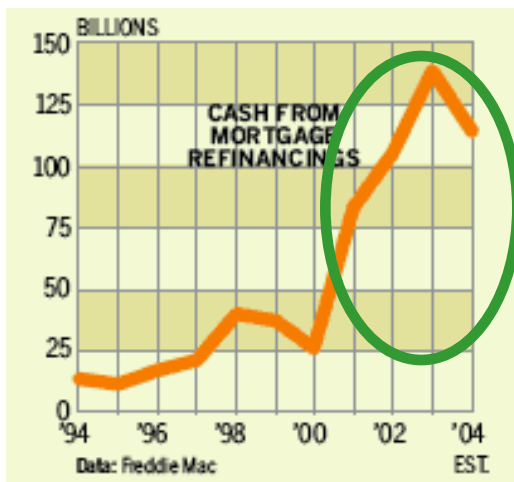
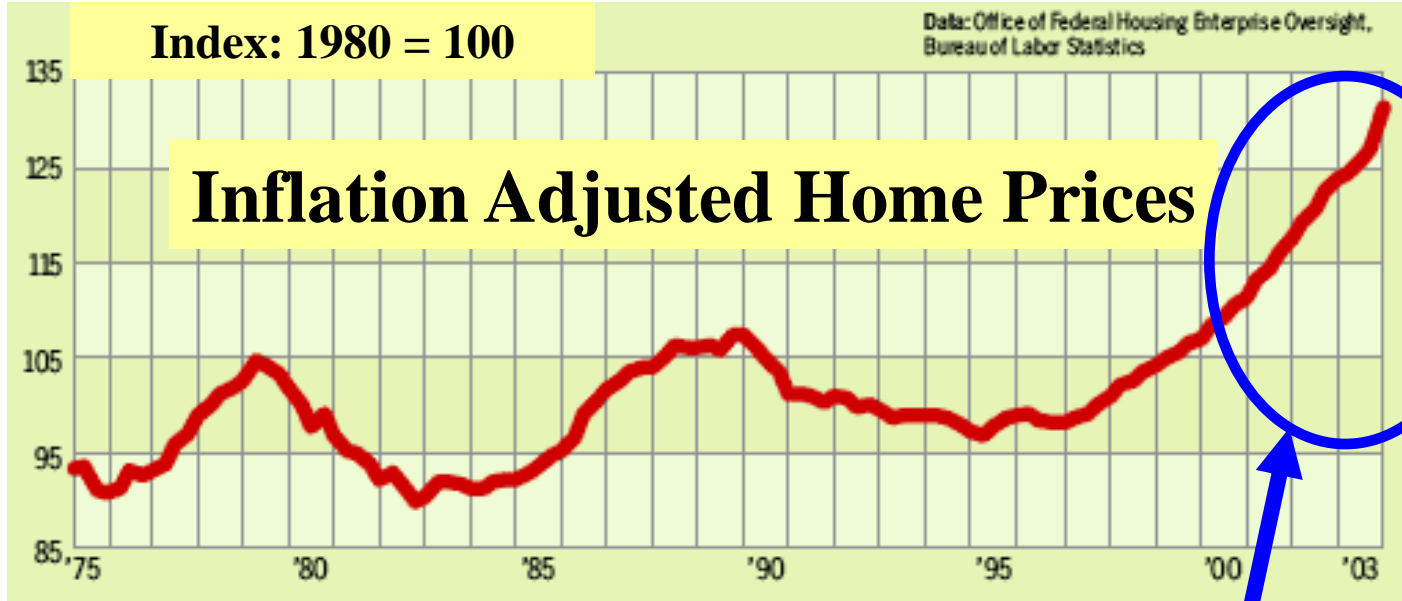
Not Savings – Savings Rates Are at 50 Year Low!





BrightPath Cashing Out on Inflating Housing Prices!

STRATEGIES

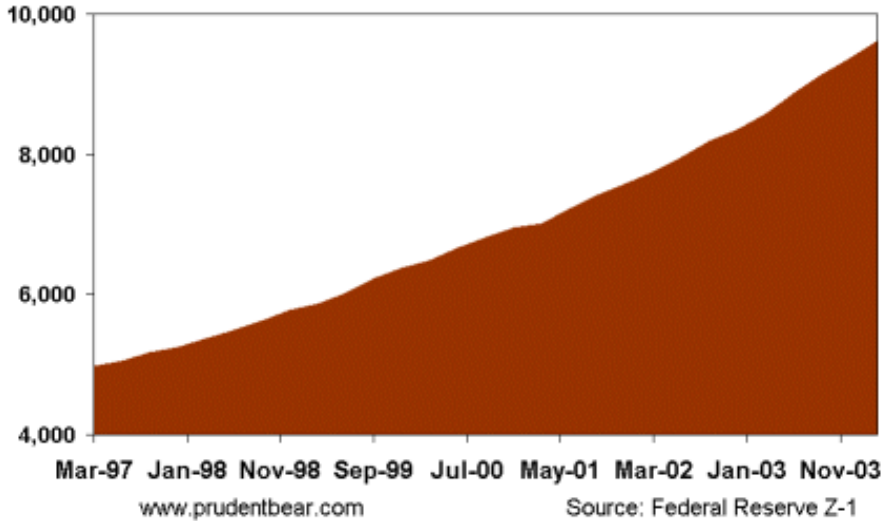


Home Prices Are Exploding...

...and U.S. Consumers Have Extracted \$400B in Home Equity via Refinancing in Three Years!

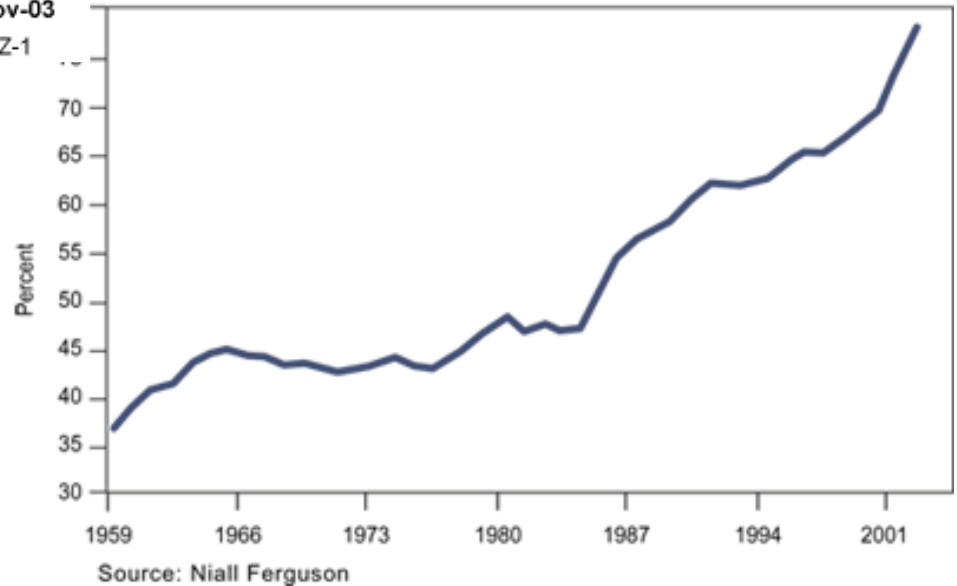
Overextended U.S. Consumers

Total Mortgage Debt
1997 - Q1 2004 (\$Billions)



U.S. Consumers Have Piled on a Huge Amount of Mortgage Debt...

U.S. Household Sector Credit Market Debt as a Percentage of GDP

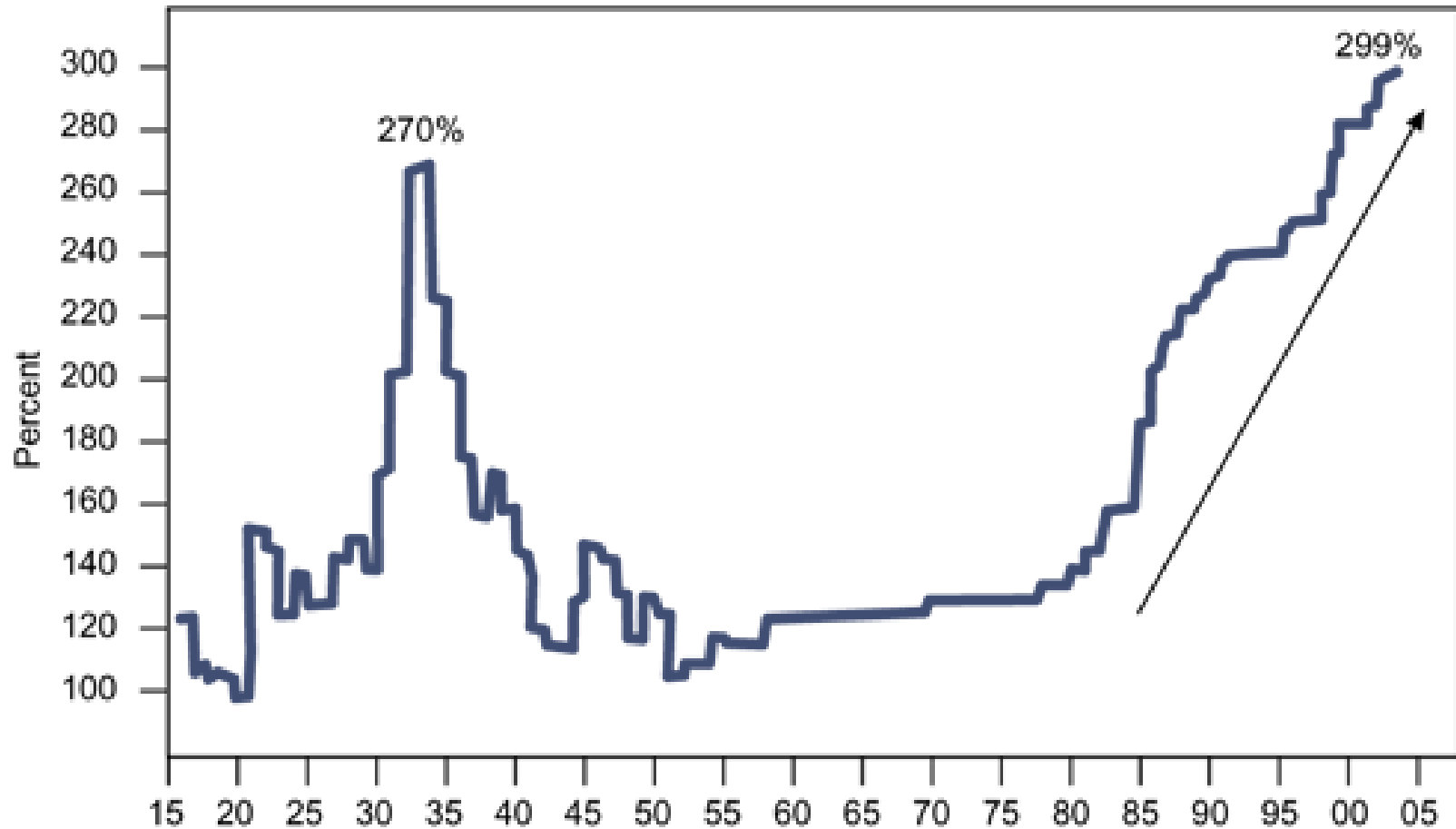


...Resulting in the Highest Debt Levels in 50 Years!



High Government and Business Debt Combined with Overextended Consumers

Total Credit Market Debt (all sectors) as % of U.S. GDP



Source: Gabelli

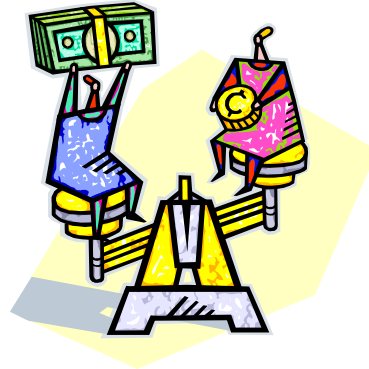
Global Economic Drivers

Change Underway

Historically a **generalized phenomenon** within an economy for an extended period of time...

Inflation:

A rise in the general price level.



Deflation:

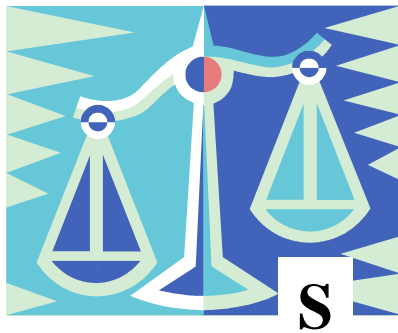
A decline in the general price level.

...but today they often **co-exist** in real time within a single economy.

Simultaneous Inflation-Deflation

Inflation:

Demand > Supply



D

S

Education
Medical Care

Price Up >2%/yr

Price Stability:

Demand = Supply



D

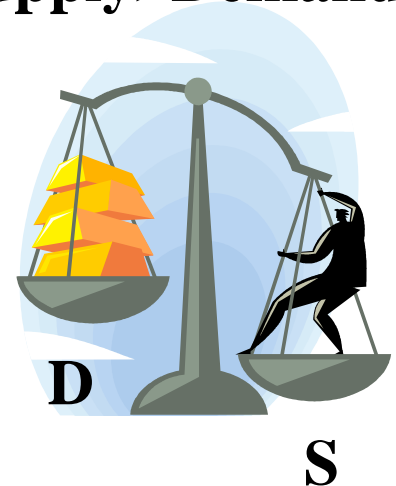
S

Food!?!?

Price + or - 2%

Deflation:

Supply > Demand



D

S

Electronics
Computers

Price Down >2%/yr

The Rise of Structural Deflation



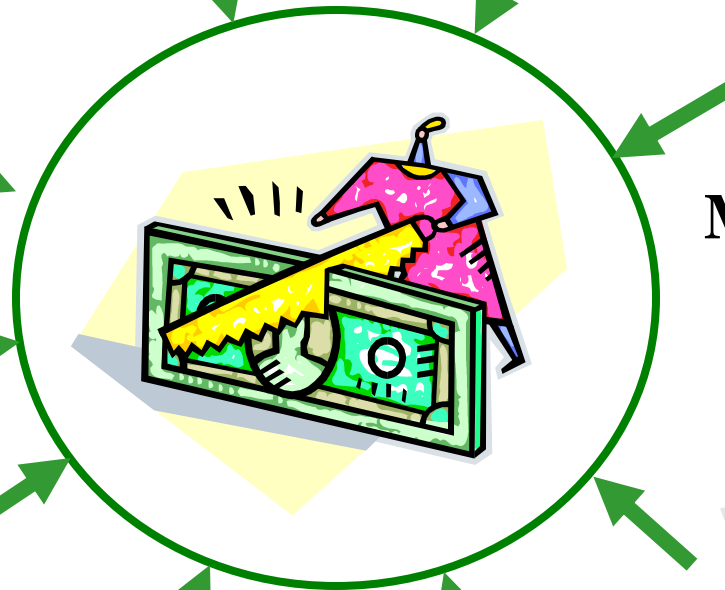
Discount Retailing

Weak IP Enforcement



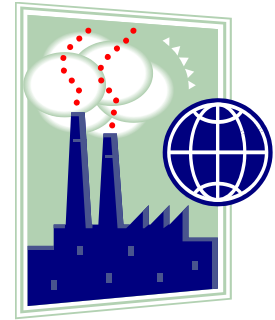
Internet Shopping

Growth of Capitalism



Free Trade

Lax Antitrust



Offshore Manufacturing

Deregulation



Service Outsourcing

Rise of Invisible Inflation



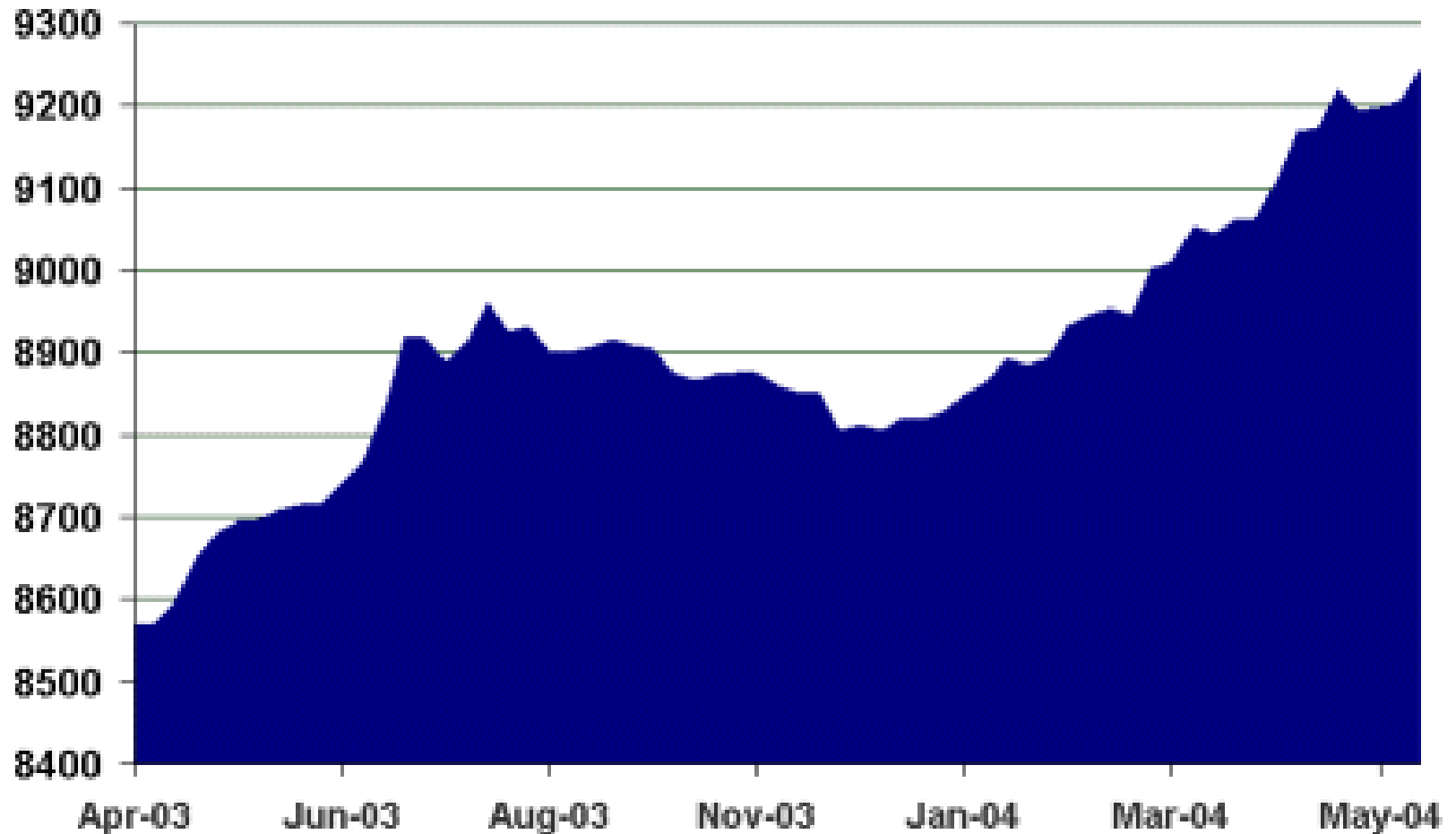
Fiat Currency and Inflation

*“... U.S. dollars have value only to the extent that they are strictly limited in supply... the U.S. government has a technology—called a printing press - that allows it to **produce as many U.S. dollars as it wishes at essentially no cost**...by increasing the number of U.S. dollars in circulation... a **determined government can always generate higher spending and hence positive inflation.**”*



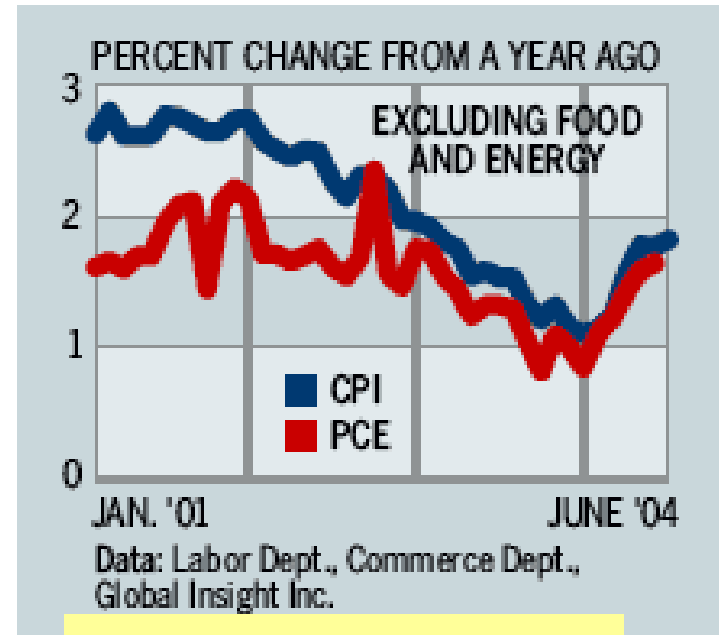
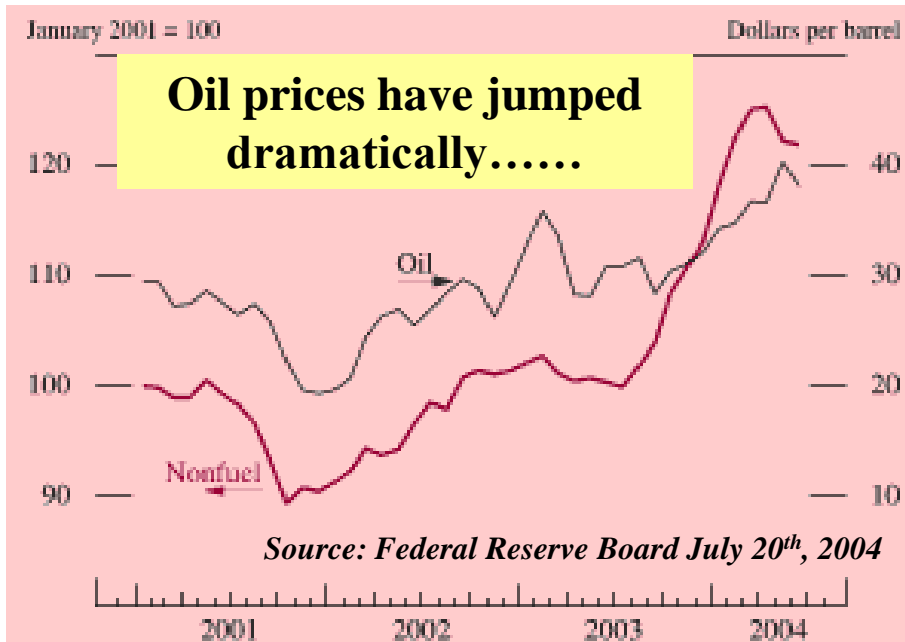
Fed Governor Ben S. Bernanke
National Economists Club November 2002
Deflation: Making Sure It Doesn't Happen Here

Money Supply (M3) April '03 - June 14, '04



Signs of U.S. Inflation Surge

Oil and Other Commodities



...as have general consumer prices!

Should Inflation Increase, Higher Interest Rates Will Be Needed...Which Consumers and Businesses Couldn't Handle!

Inflation-Deflation Challenge

“A man with one foot in boiling water and one foot in ice on average is quite comfortable.”



Airline Profit Squeeze

Inflation

- Fuel
- Employee Benefits



Deflation

- Ticket Prices



The U.S. Dilemma

Why The Fed is Stuck

Action

- U.S. Government Raises Interest Rates Too Quickly
- Government Maintains Low Interest Rates Too Long

Deflation



Inflation



Risk

- Economic Growth Stops as Leveraged Consumer Spending Collapses
- Inflation Grows Very Rapidly, Undermining Real Growth But Inflating Away Debts