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THE BERKSHIRE OBSERVER

SPECIAL REPORT

US Economy, RIP?

Over the past twelve to eighteen months, we have heard a very common question. "Should we still be investing in U.S. equities?"

The concern is two parts. Of course, clients wish to maximize return and want to be in the best-performing markets, but we also sense there is a high emotional content backing the question. Many are genuinely concerned there are structural problems facing America and fear the rise of emerging countries like China and India. They ask, "What type of America will our children inherit?" "Will America still be a super power?" "Will there still be opportunity here?" "Will America still be financially solvent given ballooning deficits, entitlements, wars and a deteriorating financial system?" ***"Should we ever buy a U.S. stock again"?*** These are certainly valid questions particularly against the current economic backdrop.

Clearly, there is no shortage of challenges facing America. There is also no shortage of editorialists, authors, economists and television personalities ready to take a half empty view and write off America. Negativity and crisis sells better than tranquility and status quo, particularly in a 24/7 news world. This amplification mechanism is powerful.

Many books and editorials by very credible authors spell impending doom and loss of competitiveness versus the rest of the world. Patrick J. Buchanan's ***"Day of Reckoning"*** likens the United States to an outstretched military empire with unprecedented military assets, but also with greater military liabilities.[1] He predicts that the very social fabric of our nation is going to disintegrate through a flood of illegal immigrants, runaway spending and jobs flocking to China and emerging nations.

Fareed Zakaria's ***The Post American World*** projects a somewhat more optimistic view, but still portrays a declining and marginal United States, saying it is inevitable.[2]

But much of the logic is cursory or ignores the real reasons these new nations have risen so dramatically. For example, in Zakaria's opening argument, he laments "The tallest building is in Taipei and it will be overtaken by one in Dubai. The world's richest man is Mexican. The world's largest Ferris wheel is in Singapore and the largest casino is in Macao."[3]

These symbols don't exactly make the U.S. irrelevant and are not indicative of true economic power. It is also quite likely that much of the sensationalism was rooted in a false notion: if foreign markets were rising rapidly relative to the US (to even bubble proportions) their economies must be rising to preeminence while the United States is declining to a marginal power.

The United States is far from being marginalized in absolute or relative terms. Despite impressive growth from rising nations, America has the world's largest economy with total output of $13.7 trillion.[4] To put this in perspective, this is about two times the size of China's, 7 times that of India and 12 times that of both Russia and Brazil. The entire European Union isn't as large.

On a per capita basis, the United States generates about $47,000 per worker, which ranks us 10th in the world behind small service-oriented countries such as Singapore and Bermuda. China ranks 132nd with a per capita output of about $4,700.[5]

If you count the entire European Union as one, America still has the world's fourth largest labor force. On a per-employee basis, America ranks second only to Norway in terms of GDP per hour.[6]

Despite having "only" five percent of the world's population, America accounts for a staggering 25% of the entire world's GDP. Our relative influence is not shrinking, either. This percentage of world output has actually stayed relatively stable over the past 100 years.[7]

Many have lamented the lack of manufacturing prowess in the United States. It is true the service component of our economy accounts for $5 trillion of our total output of $13.5 trillion.[8] But, despite being known as a "service-oriented economy," our annual factory output still topples over **$1.5 trillion dollars per year**, making it greater than the entire economies of Canada, South Korea, Brazil and even India.[9] We have individual states which out-produce many countries of the world. For example, the GDP of Texas is about as large as all of Canada and the output from California is about the same as all of France.[10]

Even the U.S. auto employment has shown signs of life – providing you are talking about the Southern United States. Many of the jobs lost in Ohio or Michigan did not go to China, India and Mexico but to more business-friendly states like Texas. Texas has been a huge beneficiary of free trade and exports nearly $7 billion dollars worth of cars to Mexico and Canada. Free trade in Texas has generated thousands of manufacturing jobs in that state and billions of dollars in new revenue.[11]

Many worry about our growing trade deficit and how much we import from other countries. True, we import a great deal but, despite all the rhetoric, America still ranks third in total world exports (narrowly) behind Germany and China. Most of the goods we import from China tend to be low-end commodity type goods, with little value added or engineering content.

China's rise can be beneficial for America if managed correctly. China's low-cost labor force saves Americans over $70 billion a year. Despite all of the "lost" manufacturing jobs to China, our national income over the last decade rose faster than the rapid 1990's expansion.[12]

America still leads in high margin, complex industries such as aerospace, advanced computing, biotechnology, medical imaging and nanotechnology. These industries barely exist in China. They produce America's most profitable products and are demonstrating growth. It is not likely the Chinese can catch up any time soon. On average, many goods made in China require seventeen fragmented and inefficient factors of production such as: middle-men, haulers, and wholesalers who add little value to the product whereas the United States requires only three.[13]

Every import can also mean exports for the U.S. Apparel finished in China is made from American cotton, house wares from American steel and computers from American technologies. As Chinese imports surge it is likely our exports do too. It is a more symbiotic relationship than a winner-take-all situation.

A product like Apple's iPod is a great example. Apple uses dirt cheap manufacturing and parts from China, yet all of the highest-value creating activities are created in America. The bulk of the gross margin comes from engineering (American), marketing (American) and distribution (American). The least important and least value creating activity is where it is made (China).[14] China's biggest asset is its large low-cost labor force. If another country could make it cheaper, the jobs would flock there. That in itself does not constitute a long-term competitive advantage. As long as we continue to maintain our leadership in these important industries, we need not worry that many low end products are made overseas. In fact, our industries benefit. So let China make low end DVD players, while our factories continue to crank out 747's and advanced imaging systems. World output is maximized that way.

China's rise has created a huge market opportunity for the U.S. Our exports have been growing rapidly and China is one of our fastest-growing export destinations. Thirty-two percent of the growth of American exports have come from a rising middle class in China.[14]

Can the U.S. maintain its lead in science and engineering? Many have lamented the decline in the U.S. education system versus the rest of the world. On this topic, Zakaria's book makes an interesting point. His statistics show that on ***average***, Americans students rank poorly on many standardized tests. However, our elite students do not. The top twenty percent of American students matches anyone's top 20%. Many of our universities remain the envy of the world.

Zakaria also dispels the fear that China and India are producing so many scientists and engineers versus America. Some of these statistics can be very misleading. The educational standards and technical certifications required in engineering can vary widely. If the statistics are normalized, America is churning out more engineers per capita than India and China with arguably better standards.[15]

On the financial side of things, America's deficits are no doubt troubling, but there are some silver linings. The annual cost of the Afghanistan and Iraq wars equals about 1.24% of current GDP, which is less than Vietnam.

National debts of other countries as a percentage of GDP such as Japan and many countries in Western Europe are actually higher.[16]

The Federal Reserve is rapidly expanding its balance sheet and the taxpayer is now essentially "long" billions of potentially toxic mortgages and debt issued by Fannie Mae and Freddie Mac. There are actually credit default swaps that trade on U.S. Treasuries which implies some investors are betting the United States will either default on its debt, or that its perceived credit worthiness will deteriorate rapidly.

But during the latest economic crisis, the world flocked to the relative safety of dollar-dominated assets. So much so that creditors are willing to lend the U.S. funds for 10 years at 2.4%, which is a record low rate, and which is not consistent with a loss of confidence. Provided the U.S. does not go into a prolonged deflationary cycle (which punishes borrowers), these low rates provide some justification for a larger debt load, particularly if it unfreezes credit and generates meaningful stimulus.

Other nations such as Russia, Brazil and the Middle East have also been getting more attention. The U.S. economy is 38 times the size of Russia's and 86 times that of Brazil's. Russia and Brazil's oil and gas revenues account for almost 70% of their revenues.[17]

There are really only two industries in the Middle East - oil and oil related financial services, both of which prospered greatly as oil reached $145 a barrel.

Oil has declined over 70% and the U.S., which is in a bad recession, represents nearly 26% of the of world consumption. This pull back in demand and price has already hurt these Middle East industries greatly.

The World 2030 and Beyond

Peter Drucker once said: "Demography is the future that already happened."[18] America recently reached the 300,000,000 person mark. Demographers have drawn some interesting conclusions from the trends. Many of the population trends are somewhat positive for America, particularly against much of the developed world.

Recent age-based studies raise some interesting policy questions. These studies may have long lasting implications, particularly as to how Americans will transfer wealth from one generation to the next, and how it will service Social Security as well as other growing entitlement programs.

In 1950, the United States had **seven** workers for every retiree. There were plenty of workers growing their own wealth and buying assets from retiring workers. Importantly, there were seven workers paying taxes for each retiree. Most people retired at 65 and, on average, lived until 67.[19] This made it pretty easy for the financial planning industry, not to mention the sponsors of pension plans.

By 2005, that number had fallen to **five** workers per retiree. But by 2030, the U.S. is expected to have only **three** workers for every retiree. Life expectancy is increasing and retirement age is decreasing.[19] For retirees, this mandates a long-term allocation to equities and growth oriented vehicles. For workers it means a higher tax burden as social promises will be borne on a fewer number of workers. Runaway growth of entitlement programs is clearly a long-term secular threat.

The U.S. actually stacks up fairly well against most of the developed world, however.

Japan's population will be ancient as it will have less than two workers for every retiree by 2030. The country has made massive social promises. The story is very similar throughout most of Europe. India fares better with a younger, more dynamic and well-educated workforce and will have about four workers per retiree in 2030.[20] South America also appears to have demographics on its side, but its economies are currently far less relevant.

By 2050, one third of Germans, Japanese, South Koreans and Italians will be over 65, compared to one fifth in the United States.[21]

How does China compare? One would think China's huge raw numbers would allow it to sport a massive workforce now and into the future. However, it is entirely possible that by 2030 it will have fewer workers than it has today. It will have one of the worst worker-to- retiree ratios in the developed world. By far its largest age group will be citizens over the age of sixty-five.[22]

What is the reason for this? Much of the blame is the social engineering by the Communist party and the "One Child Policy." In 1979, the Communist party mandated that Chinese couples were only allowed to have one child (to cure runaway population growth). If a family had more than one child, that child was not recognized by the state. Violations of this were met with children not receiving any government services, and parental sterilizations.[23] Having boys was viewed as being much more advantageous as they have greater utility in the Chinese family (earning power, labor etc). Under normal probabilities, about 103 to 105 boys should be born for every 100 girls. China is currently reporting birth rates of 123 baby boys for every 100 girls.[22] The reader is left to draw his own humanitarian conclusion as to why the large discrepancies exist. Yet the demographic and economic implications are relatively self evident: in twenty to thirty years, there will be a relative lack of 20-50 year olds to replenish the work force. A huge percentage of China's population will be over 60 years old which is not good for its long-term competitiveness.[24]

What are the investment implications, especially when the world has seen such a meltdown?

Before we draw a conclusion, we have to do an analysis of the world's most influential economic super power: the U.S. consumer. If it were a country unto itself, the U.S. consumer would comprise nearly 18% of the entire world's output. What's more, its share of world output has actually been rising, not falling. (Source Merrill Lynch)

Over the past five years, this already mighty super power was armed with powerful new weapons: home equity, rising real estate values and copious amounts of credit. This meant a giant consumption binge as it fed commodities from the Middle East, Russia and Latin America. These were recycled and assembled through a low-cost labor force and supply chain centered in the Pacific Rim.

So the commodities the Chinese were allegedly "devouring" were really just being imported and recycled into finished products for the U.S. consumer. Now the consumer is facing a big slump which we now see causing serious negative repercussions around the rest of the world. We have argued for some time that the entire Pacific Rim in many ways acts like a big supply chain to the U.S. consumer. So the notion that the world has "decoupled" (the world grows while the U.S. slumps) was highly spurious.

This is not to say that emerging markets have ascended solely as a result of U.S. consumerism, but ***The Post American World*** and other books like it never really considered the impact or made the linkage of a credit led commodity bubble that lifted these nations. They never considered that so much of the emerging market miracle was led by good old fashioned American consumerism.

We are not saying that the U.S. will automatically stay on top or that these other nations will not continue to become more relevant. Problems abound. The U.S. is not the only investment opportunity set on the globe. Looking beyond the popular headlines and latest dooms-day book reveals another story.

What we are saying is the U.S. has certain ***structural*** advantages relative to the rest of the world that should not be overlooked: its sheer size, wealth, economic diversity, relative productivity of work force, social stability, low cost of capital, strong technology leadership, and high economic freedom. It is still one of the best places for entrepreneurship. Even if U.S. growth does remain slow it may not matter to investors. There have been plenty of times when the world's fast growing economies produce poor stock market returns and vice versa. Valuation always matters.

It has been fashionable (and easy) to point to all the problems, but it may be unwise to sell America short….especially at these prices.

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Notes:

[1] Patrick J. Buchanan, *"Day of Reckoning: How Hubris, Ideology, and Greed Are Tearing America Apart"* (New York St. Martin's Press, 2007).

[2] Fareed Zakaria, *"The Post American World,"* (New York W.W. Norton Company 2008), 1-2.

[3] Ibid.

[4] CIA World Fact Book, 2008 https://www.cia.gov/library/publications/the-world-factbook/.html

[5] Ibid.

[6] Ibid.

[2] Fareed Zakaria, *"The Post American World,"* (New York W.W. Norton Company 2008), p.180.

[8] Patrick Toomey, *"The Greatest Story Never Told": Today's Economy In Perspective* (Impimis, Hillsdale College 2008), Volume 37, Number 5.

[9] Knight Kiplinger, *"Our Mighty Factories"*, Kiplinger's Personal Finance, January 2008.

[10] Mark J. Perry's Blog for Economics and Finance "Size of U.S. State Economies vs. Foreign Countries" (Carpe Diem), http://mjperry.blogspot.com/.

[11] Mary Anastasia O'Grady, *"Texas vs. Ohio,"* The Wall Street Journal, March 3, 2008.

[12] Jeremy Haft, *"The China Trade"* The Wall Street Journal, May 27, 2007.

[13] Jeremy Haft, *"The China Syndrome"* The Wall Street Journal, July 16, 2007.

[14] Greg Linden, *"Who Captures Value in a Global Innovation System? The Case of Apple's iPod,"* Personal Computing Industry Center June 2007.

[15] Fareed Zakaria, *"The Post American World,"* (New York W.W. Norton Company 2008), p.188.

[16] CIA World Fact Book, 2008 https://www.cia.gov/library/publications/the-world-factbook/.html.

[17] Jeremy J. Siegel, *"Impact of an Aging Population on the Global Economy"* CFA Institute Conference Proceedings Quarterly, Volume 24, Number 3.

[18] Ibid.

[19] Ibid.

[20] Ibid.

[21] Joel Plotkin, *"400,000,000,"* The Wall Street Journal, October 16, 2006.

[22] Nicholas Eberstadt, *"China's One Child Mistake,"* The Wall Street Journal, September 17, 2007.

[23] Steven Mosher *"China's One Child Policy: Twenty Five Years Later,"* The Human Life Review, Winter 2006.

[24] Nicholas Eberstadt *"China's One Child Mistake"* The Wall Street Journal, September 17, 2007.