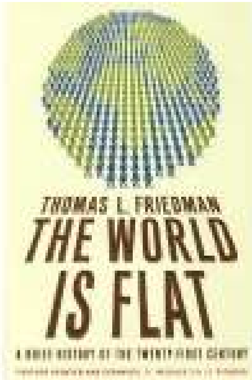
The World is Flat



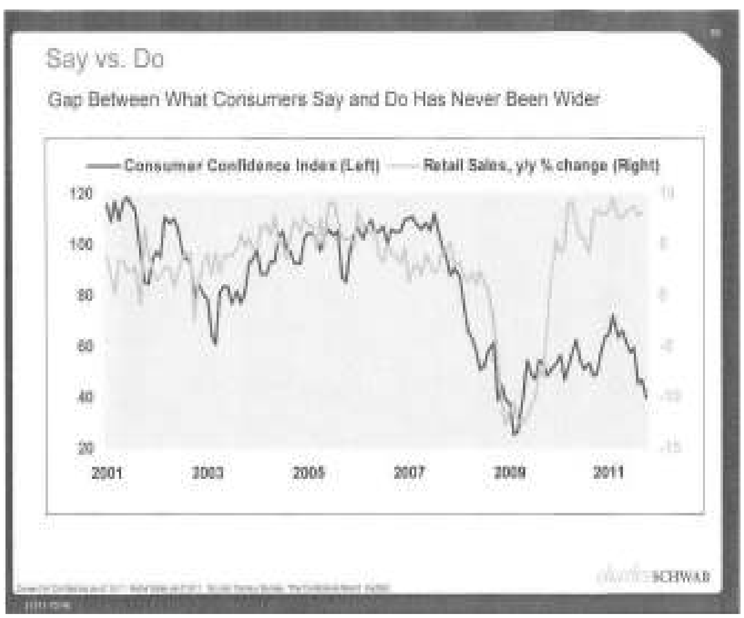
In 2005 Pulitzer Prize winning author Thomas Friedman came out with a book entitled *The World is Flat*. It was a book describing a theme with which we are all familiar – increasing globalization of our modern world at an increasing pace.

Webster defines globalization as “the development of an increasingly integrated global economy marked especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets.” I would add the free and rapid flow of information.

The free and rapid flow of information is one of the reasons that the process of globalization is speeding up so much. It also provides much of the angst associated with this process.

For example, because of constant exposure to the reporting of crimes on the news and the preference of the media for sensationalism people believe that crime is much more prevalent than it is and that they are much more likely to be a victim than is actually true. A study found that the more television people watch the more this is the case.

In the same way, economic problems of other countries may be exaggerated in their effect on investor and consumer psyches. Consider the following chart from Charles Schwab Chief Investment Strategist Liz Sonders’ recent market commentary:



Consumer confidence is the dark line and it has been low and dropping again. However, consumer spending measured by retail sales is back up to and even above pre-recession levels and staying there.

The actions do not match the reported mindset. Might it be that consumers just can’t break the spending habit or is it that declining housing expenses are freeing up money for other things? How is it that retail sales are near record levels for the last ten years even with the current 9% rate of unemployment?

The point is that how bad people feel about the state of the world is not always a reliable indicator of actual economic behavior. In fact, the correlation between confidence and spending is rarely as tight as financial reporters make it sound.

<u>How Flat is It?</u>

There is no denying that economic developments in one major portion of the world affects the others. For example, the growth in China has greatly affected stocks, commodities and bonds across the world.

Here’s my question(s) – what is the limit to globalization and can its effects be exaggerated? To what extent should our investing be affected by the news in Europe, Asia and Latin America?

Let’s start with Asia. China, India and others have been restricting credit for months, partially by increasing interest rates and partly by restrictions on bank lending in the case of China. Their worry is inflation in the high single digits or higher. It was due partly to the flood of money Ben Bernanke unleashed on the world and partly to other factors such as over-heated Asian economies and the increase in speculation, especially in Hong Kong property.

Asian economies are slowing down and it could be that rates will be coming down before long, a good thing for both stock and bond investors. Latin America is pretty much the same story. *Barron’s,* a weekly magazine that I hold in high esteem recently had a cover story encouraging investing in Brazil.

However, both areas rely on exports to Europe and North America for a good part of their economic growth. In fact, Europe is China’s top trading partner, then the U.S. America has been barely growing and Europe barely came out of recession and is going back into it.

<u>Europe</u>

It won’t surprise you if I say Europe is *in hospital*, as the Brits say. People have wondered for a good while if the troubles in Ireland, Portugal and Greece would spread to the rest of Europe. That appears to be the case.

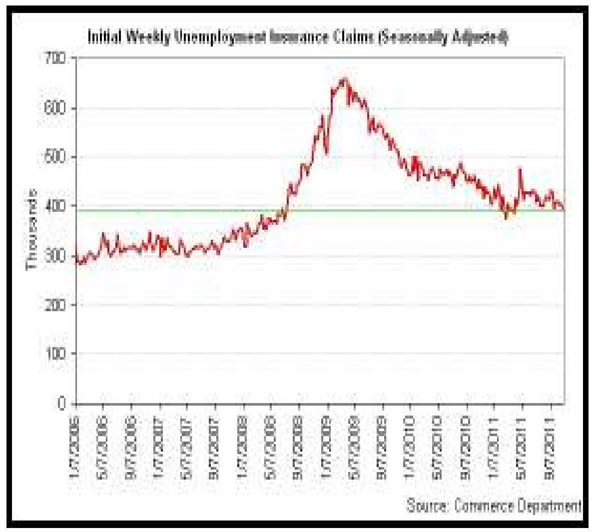
When rates on 10-year government bonds went above 7% all three of the afore-mentioned peripheral European countries had to ask for bailouts. Well, this week Spain, the fourth largest economy in the Eurozone auctioned off 10-year bonds at a rate of 6.9%. Last week, rates on similar Italian bonds went over 7% before falling back to 6.4%. Even France, with a AAA rating has seen rates move up significantly the last year, though not nearly as high as Italy and Spain.

What’s going on is that investors worldwide are selling the bonds of European countries other than Germany. Even though the European Central Bank is buying the bonds, this selling is overwhelming those efforts, leading to higher interest rates than what Spain and Italy can afford and raising the cost of deficit spending for other countries like France. How long will this go on? I don’t know but I do know that banks everywhere, including Europe are getting rid of many

European bonds. As long as this lasts deficits will be pressured upward and European stock and bond markets will head lower.

This is not a problem that can be solved by Germany, the IMF, the EFSF or anyone else investing in Europe. The scope is just too large. This will likely lead to a shrinking of the Eurozone and a deeper European recession and is something we need to keep an eye on.

The U.S.



In the United States things are not as bad. Recent economic news has been improving. Unemployment claims are dropping and manufacturing is still growing. Consumer spending, as I highlighted above is at a good level.

We still have a serious debt problem that is worsening. We have a few years yet before our debt becomes crippling but we have a president who it seems weekly trots out new spending proposals. The Super-Committee is hamstrung and trying to use good ole DC accounting gimmickry to try and give the mistaken perception of real cuts. Meanwhile voters relay the message that touching Medicare and Social Security will get one voted out of office.

Investment Strategy

How much should we worry about Europe when our market is priced fairly low and the economy here is slowly improving? Consider the following 5 year chart:

It used to be that the US and Europe traded very closely. In the last two years though, while the movements are highly correlated the magnitude is not. Since late 2009 the 5 year price return for the European market has gone from -24% to -40% while the US has gone from -24% to -14%.

While neither return is anything to aspire to the US has done much better than Europe. But, it seems that if the European market continues to fall, it will have a lowering effect on the US.

So what's an investor to do? Buy income, my friend. That's why I bought HDV recently. HDV has high dividend blue chip stocks. That means less volatility and a 4% income that increases.

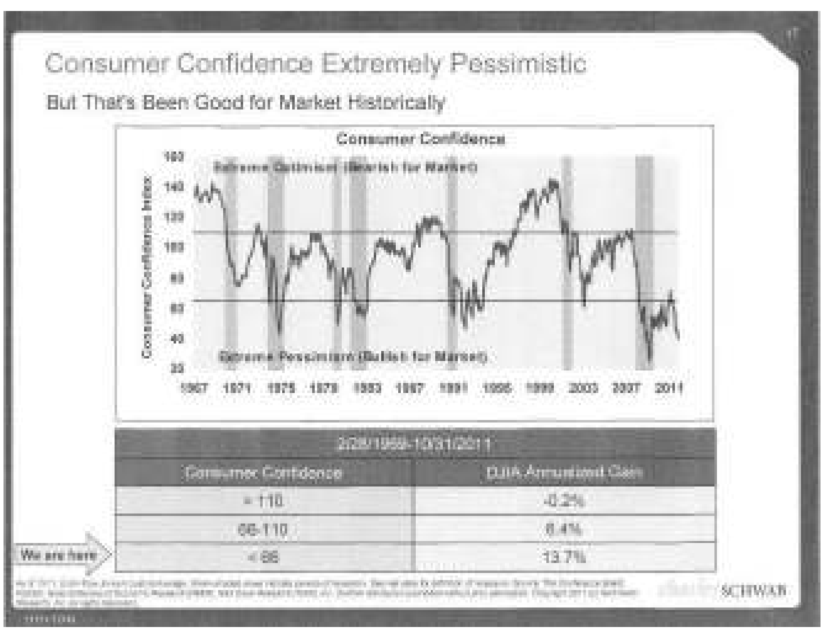
Here are some other income ideas that are not closely tied to European debt woes:

Name	**Symbol**	**Yield**	**Federal Tax-Free**
DWS Managed Municipal Bonds S	SCMBX	4.90%	Y
Nuveen Dividend Advantage Municipal Fund 3	NZF	6.90%	Y
Scott's REIT (Diversified Canadian REIT)	SOREF	15.00%	N
American Capital Agency Corp. (Mortgage REIT)	AGNC	20.00%	N
SteelPath MLP Select 40 A (energy MLPs)	MLPFX	6.70%	N
TCW Emerging Markets Income N (local currency)	TGINX	6.80%	N
	Average	**10.05%**	

Talk to me about any of these before you buy. Some have low volume and some are more stable than others. They are not all suitable for every investor and some may be paying year-end dividends shortly that are worth avoiding. This is not a set of recommendations but a place to start an individual conversation with you or your clients.

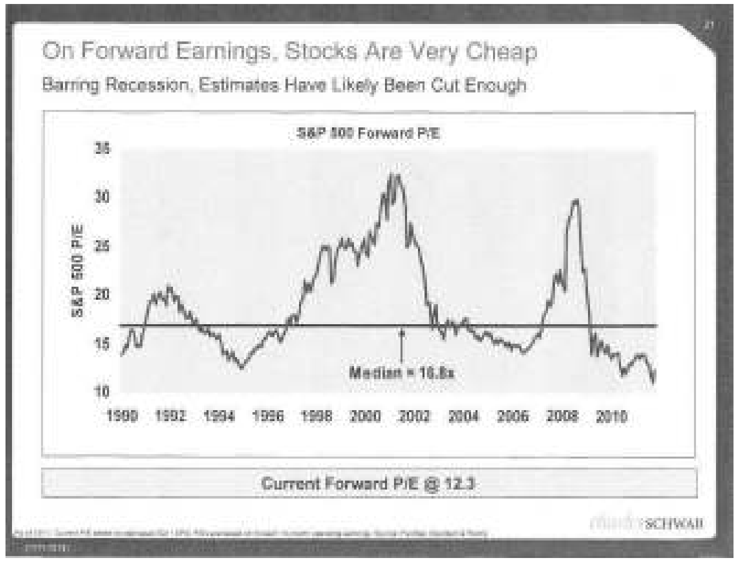
I also have some money in US stocks or stock mutual funds because the US market is fairly cheap. Again, here are a couple charts courtesy of Liz Ann Sonders at Schwab.

If one had bought stocks every time consumer sentiment dropped below 65 they would have done extremely well. It's very hard emotionally because the world seems lousy but it has paid off.



Personally, I can say that on average my worst buys were the ones in which I had the most confidence. That's not to say I'm a moron but that if you buy when the world is pretty good or buy a stock when people love it you will be buying expensively. It is best to have mixed emotions – to buy things that objectively makes sense but that emotionally you feel nervous about buying.

Right now the market is fairly cheap based on estimates for next year's earnings, which should not be too far off. I wouldn't say as Liz does that they are very cheap but they are 25% cheaper than average.



Buy stocks with good dividends and good valuations and your total return should be higher and volatility lower than average. Over time, value investing in good companies, large or small is still the best strategy. That's one reason why so many mutual funds investing with a value style in small companies are closed to new investors.

I hope that helps. I would like to hear from you and talk about your investments. Give me a call or pass along the name of a friend that might appreciate what I do.

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