Sauberan & Co. LTD.

Volume 10 Issue 3

January 28, 2005

ECONOMIC OUTLOOK

"2005 Economic Forecast"

Overview

The US economy grew 4.4% in 2004, the fastest pace in 5 years. Much of the global economy benefited as exports increased to meet the growing demand in the US. However, data indicates the US economy has been slowing in recent months as the largest fiscal stimulus in history dissipates. US economic growth in 2005 will likely slow to 3%, the average growth rate for the past 10 years. In that the US is more than 30% of the global economy, Europe, Canada, Mexico and most of Southeast Asia depend heavily on US consumption to support their economies.

The slower growth rate will cause some "economic pain" around the globe. Several key issues face the global economy heading into 2005.

Global Economy

Europe and Japan combined also represent about 30% of the global economy. European and Japanese GDP growth projections for 2005 are well below their 10 year GDP averages. These two regions continue to struggle with economic and social structures that inhibit growth. Government debt equal to 150% of Japan's annual GDP and significant bad debt in the banking sector have combined to stymie growth for almost 15 years. Even with interest rates near zero the Japanese economy remains in a deflationary spiral. Real wages have been declining for the past 5 years.

Germany, the world's third largest economy, has an unemployment rate of almost 10% with over 50% of the unemployed out of work for at least a year. Germany recently passed legislation reducing holidays, vacation time and unemployment benefits in exchange for a longer work week at the same wage. Ouch!!! These social changes are necessary to compete globally. Gov't debt in Germany and France exceed the European Unions fiscal policy of 60% total debt to GDP and 4% annual deficits to GDP. Italian gov't debt is 150% of GDP and UK consumer debt is 100% of GDP, higher than consumer debt to GDP in the US.

China on the other hand has seen a decade of annual GDP growth rates near 10% and is expected to become the worlds largest economy by 2030. However, China faces tremendous challenges to becoming a global economic power. China's economy is still relatively small with GDP at $1.6 trillion, which is less than the GDP of Canada, Italy and even California, but with 4 times the population of the US. China has 50 million unemployed, the US has 8 million. China has "bad" bank debt of $500 billion, which as a percent of their GDP, would be the equivalent of the total US treasury market being worthless. The per capita income in China is about $1,200 per year vs. $40,000 in the US.

Weak economies in Japan and Europe and a small consumer market in China have contributed to a significant trade imbalance in the US.

US Economy

The economy is running on a credit cycle, not a traditional business cycle. GDP growth has been funded by increased debt rather than increased wages. In the last 5 years total debt has increased $10.5 trillion or 42%. During the same period, consumer debt increased $3.5 trillion or 54%. More importantly personal incomes have risen less than 24%. The data shows the influence of the lowest interest rates in 40 years and the weakest job recovery on record.

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Since the economy peaked in 1999 the US labor force has grown by 8.8 million, yet jobs have increase only 3.4 million. Interestingly unemployment numbers don't count most of the 5.4 million people not working, since they haven't looked for work in the past 4 weeks they are considered "not in the labor force." If we compare the number of new jobs created since the beginning of the "recovery" in 2001 to other similar periods, this "recovery" period trails the 1991 "recovery" by 6.4 million jobs and the 1982 "recovery" by 13.2 million jobs. The "participation rate", that is the number of eligible workers compared to actual workers, is the lowest since 1988. This is significant because until 2001, the participation rate, other than for short periods during recessions, experienced a steady increase all the way back to 1970. Since 2001 the "participation rate" has steadily declined. Most important to the over health of the economy is wage growth, wage growth adjusted for inflation over the past 4 years is zero.

The weak job market is a result of globalization and a changing economy. In addition to weak job numbers, the quality of today's jobs are different from previous "recoveries". The vast majority of new jobs in this "recovery" are service sector and part-time jobs, lower paying jobs without benefits.

The lack of wage growth combined with increasing debt will be "reconciled" at some point in the future.

Interest Rates

When the "Fed" lowered the "Fed funds rate" to 1% in 2002 there were a few unintended results. Shortly thereafter the US dollar began a 30% decline that would extend 2 1/2 years. In turn, the dollars decline sparked inflation fears as commodity prices rebounded from their lows of 2001. As most commodity prices are set in dollars, any country "tying" their currency to the US dollar experienced an increase in raw material prices. Much of the inflation fear driven by a falling dollar has been unfounded as inflation remains below historic averages around the world. Inflation in most of the developed world remains at or below 2%, except Japan which has experienced deflation for 5 years. Rising raw material prices haven't resulted in rising inflation because material is only about 10% of finished products. For the most part globalization has forced businesses to absorb the increased costs. Historically inflation is driven by increased wages as labor costs represent 65% of finished goods. From the earlier discussion on wages and the downward pressure applied by globalization, real wages are declining making deflation the larger risk.

The other unintended consequence of a 1% "Fed Funds Rate" is asset inflation driven by too much liquidity. In the past few years nearly every asset class has increased in value, stocks, bonds, real estate, gold and commodities. Asset appreciation in so many categories at the same time is very uncommon and reflects a lack of risk premium between asset classes. This is an extremely dangerous consequence of excess liquidity and usually ends badly. Real Estate in the US, UK, Canada and Australia has appreciated upwards of 50% in the past 4 years, 10 times faster than normal.

In the past 7 months the "Fed" has raised the "Fed Funds Rate" to 2.5% this has been positive for the dollar. However, the "Fed" continues to add liquidity to the banking system through sophisticated techniques which does little to correct over valued assets.

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Stock Market

Corporate earnings as a percent of GDP are at an all-time high. Earnings growth is expected to slow to about 10% in 2005, much slower than the "torrid" 25% rate in 2004. As we found out in 2000, slowing earnings growth and rising interest rates are a worrisome combination for stocks. Even though the S&P 500 is still down about 30% from it's high reach in 2000, stock prices remain expensive. Much of the gains in the S&P 500 the past two years are in small and mid size stocks as investors show a willingness to assume more risk in hopes of better returns. "Bullish investors" have reached 62%, a higher percent than early 2000.

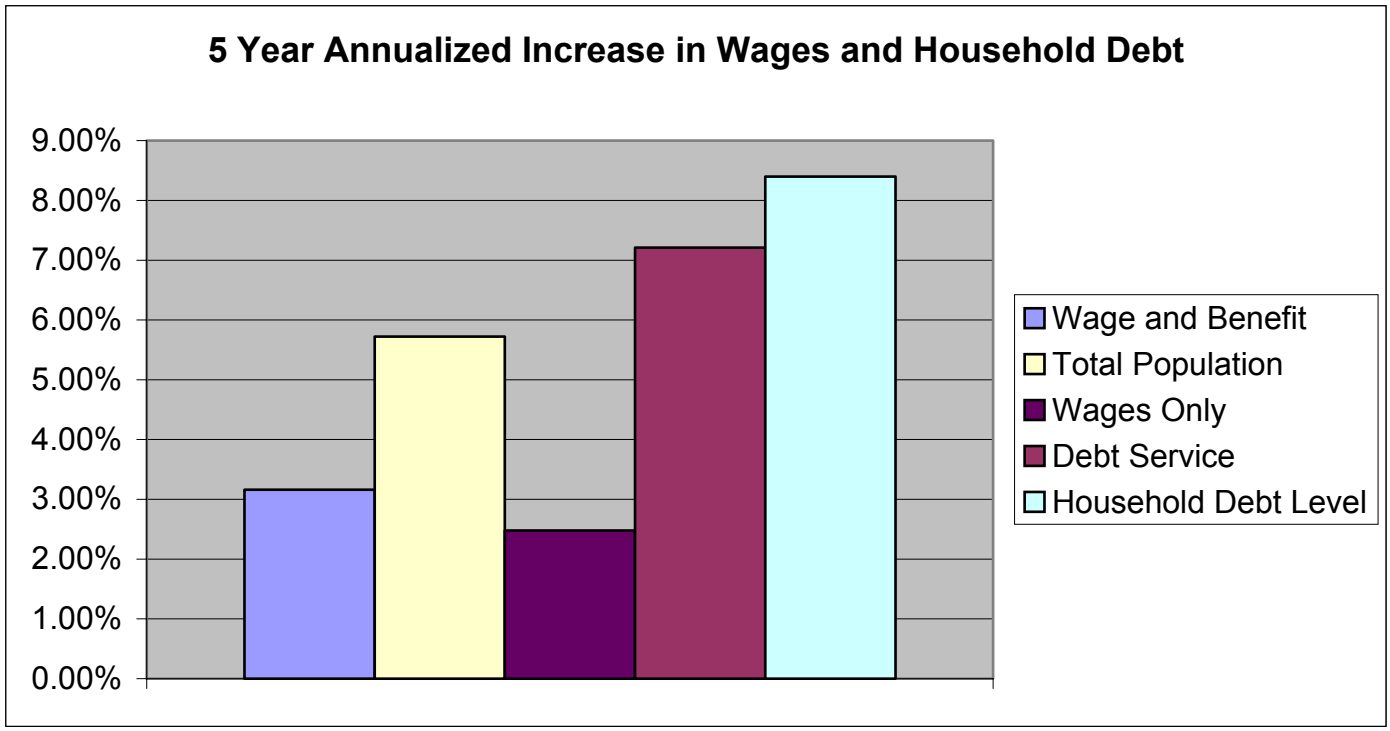
Rising interest rates tend to erode profits in financial institutions. With the S&P 500 40% comprised of "financial companies" it looks to be a "down" year for stocks.

Summary

The US dollar will rebound slightly on rising short term rates and better fiscal responsibility. Short term interest rates in Europe, Canada, the UK and Australia will decline slightly to "spur" economic growth. Japanese interest rates remain at zero as they continue to struggle with deflationary pressures. Global competition, excess capacity, technology and high debt levels continue to drive down prices, spreading deflation and thus slower growth through the world economies. Long term rates continue to fall as investors recognize the threat of deflation.

Conclusion

Our general investment strategy will be to hold long treasuries, some cash and short stocks with covered calls.



World Growth Rates
From the OECD

	10 Year GDP Growth	2002 GDP	2003 GDP	2004 GDP 3 qtr Ann
Australia	**3.5%**	2.8%	2.4%	**1.2%**
Canada	**3.6%**	3.3%	1.8%	**3.2%**
France	**2.1%**	1.2%	0.5%	**0.4%**
Germany	**1.4%**	0.2%	-0.1%	**0.4%**
Japan	**1.3%**	-0.4%	2.7%	**0.4%**
Korea	**5.2%**	6.3%	2.7%	**2.4%**
UK	**2.9%**	1.6%	2.2%	**1.6%**
US	**3.2%**	2.4%	2.9%	**4.0%**
G7	**2.4%**	1.4%	2.2%	
EU-15	**2.1%**	0.9%	0.5%	
Euro Land	**2.3%**	1.1%	0.9%	1.2%
OECD	**2.6%**	1.6%	2.1%	

Performance of World
Market Indices

	London FTSE	^FTSE	Germany Dax	^SDAXI	Japan Nikkei	^n225	Australia	^AORD	Hong Kon Hang Sang	^HIS
1999	6930.2		2889.39		18934.34		3152.5		16962.1	
2000	6222.2	-10.22%	3073.23	6.36%	13785.69	-27.19%	3154.7	0.07%	15095.53	-11.00%
2001	5217.4	-16.15%	2365.18	-23.04%	10542.62	-23.52%	3359.9	6.50%	11397.21	-24.50%
2002	3940.4	-24.48%	1709.28	-27.73%	8578.95	-18.63%	2975.5	-11.44%	9321.29	-18.21%
2003	4476.9	13.62%	2586.07	51.30%	10676.64	24.45%	3306	11.11%	12575.94	34.92%
2004	4814.3	7.54%	3143.69	21.56%	11488.76	7.61%	4053.1	22.60%	14230.14	13.15%
2 Year		10.53%		35.62%		15.72%		16.71%		23.56%
3 Year		-2.64%		9.95%		2.91%		6.45%		7.68%
4 Year		-6.21%		0.57%		-4.45%		6.47%		-1.47%
5 Year		-7.03%		1.70%		-9.51%		5.15%		-3.45%

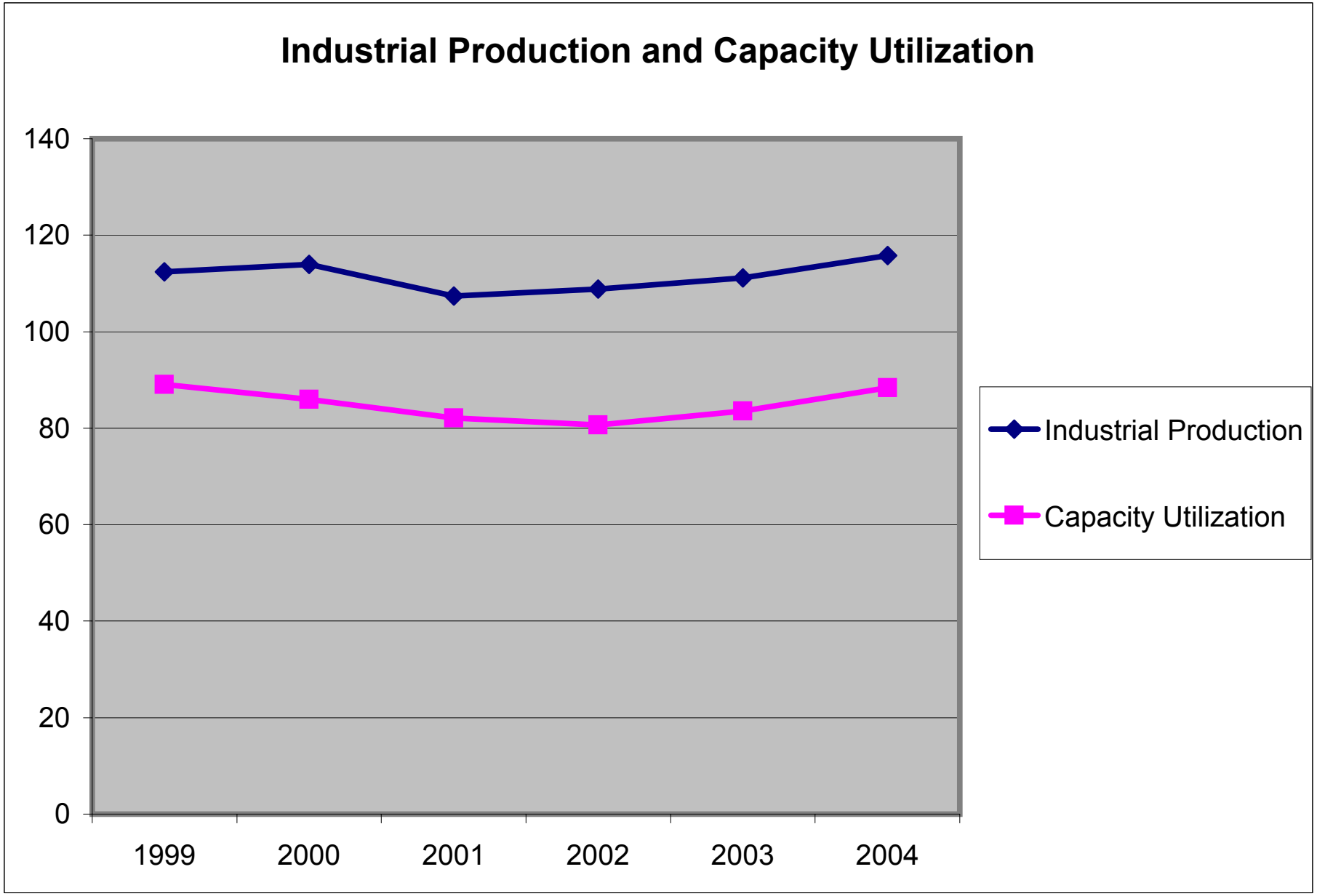
	China Shanghai	^SSEL	India	^BSESN	S. Korea	^KSII	Paris	^FCHI	Toronto	^GSPTSE
1999	1366.58		5005.82		1028.7		5958.32		8413.8	
2000	2073.48	51.73%	3972.12	-20.65%	504.62	-50.95%	5926.42	-0.54%	8933.7	6.18%
2001	1645.97	-20.62%	3262.33	-17.87%	693.7	37.47%	4624.58	-21.97%	7688.4	-13.94%
2002	1357.65	-17.52%	3377.28	3.52%	627.55	-9.54%	3063.91	-33.75%	6614.5	-13.97%
2003	1497.04	10.27%	5838.96	72.89%	810.71	29.19%	3557.9	16.12%	8220.9	24.29%
2004	1266.5	-15.40%	6602.69	13.08%	895.92	10.51%	3821.16	7.40%	9246.7	12.48%
2 Year		-3.42%		39.82%		19.48%		11.68%		18.23%
3 Year		-8.37%		26.49%		8.90%		-6.16%		6.34%
4 Year		-11.60%		13.55%		15.43%		-10.39%		0.86%
5 Year		-1.51%		5.69%		-2.73%		-8.50%		1.91%

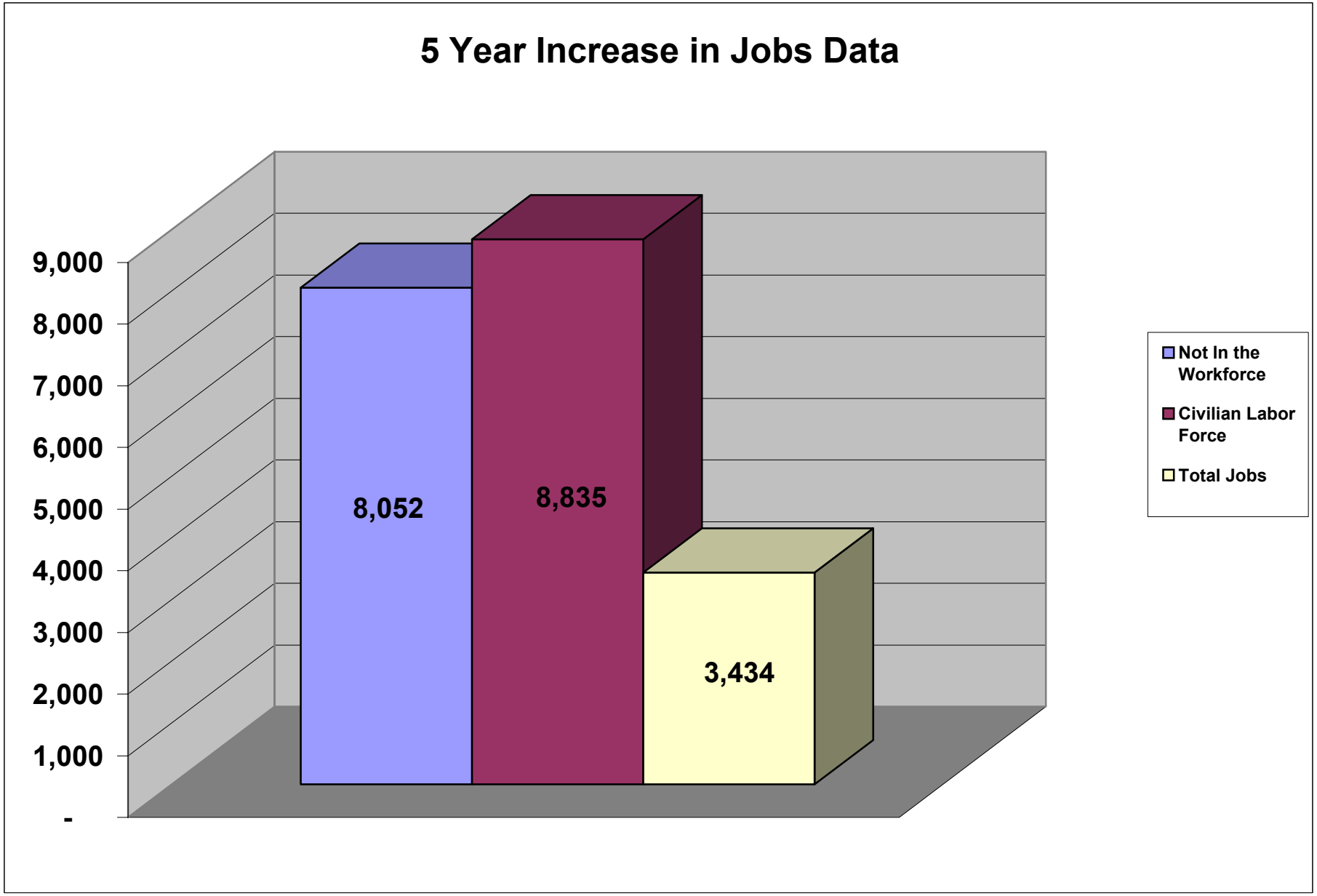
Performance of World
Market Indices

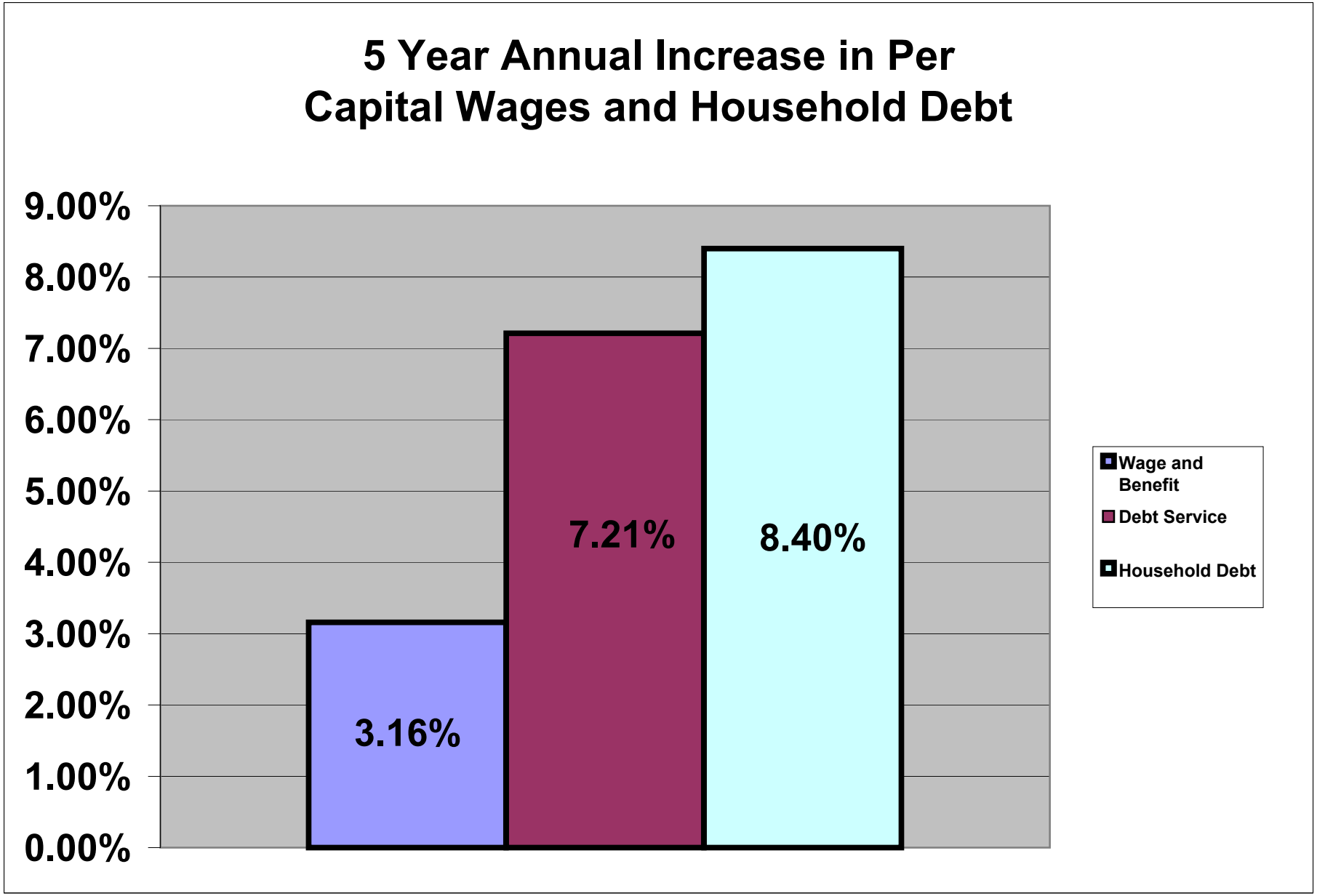
	S&P 500 ^GSPC		S&P 400 Mid Cap		S&P 600 Small Cap ^SML		Nasdaq ^IXIC		Lehman Long Bond	
1999	1469.25				197.9		4069.31		7921.23	
2000	1320.28	-10.14%			219.59	10.96%	2470.5	-39.29%	9514.28	20.11%
2001	1148.08	-13.04%			232.18	5.73%	1950.4	-21.05%	9948.1	4.56%
2002	879.82	-23.37%			196.62	-15.32%	1335.51	-31.53%	11656.57	17.17%
2003	1111.92	26.38%			270.42	37.53%	2003.37	50.01%	11900.16	2.09%
2004	1211.92	8.99%			328.8	21.59%	2175.44	8.59%	12773.57	7.34%
2 Year		17.37%				29.32%		27.63%		4.68%
3 Year		1.82%				12.30%		3.71%		8.69%
4 Year		-2.12%				10.62%		-3.13%		7.64%
5 Year		-3.78%				10.69%		-11.77%		10.03%

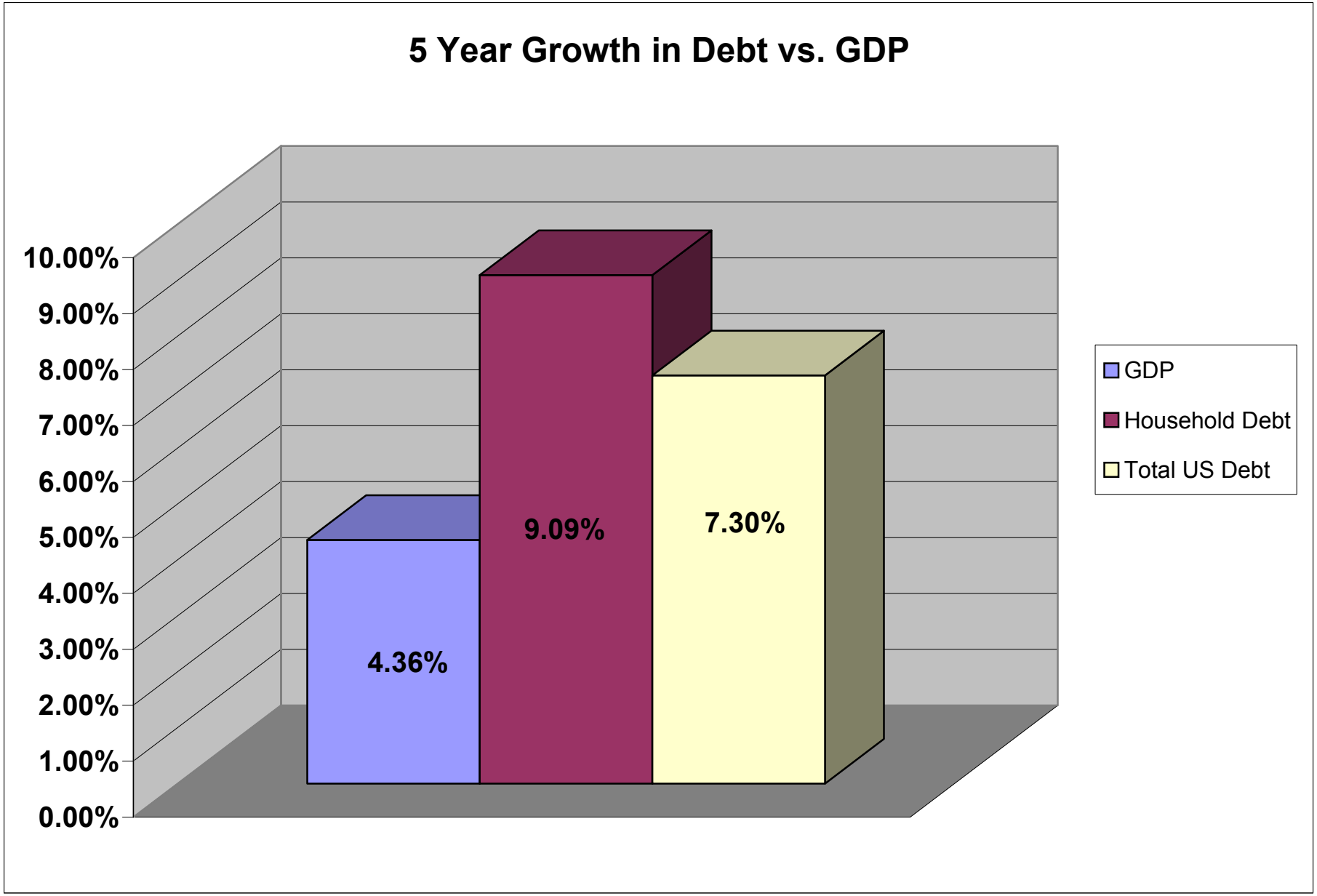
	Russell 1000 ^RUI		Russell 2000 ^RUT		Russell 3000 ^RUA	
1999	767.97		504.75		793.31	
2000	700.09	-8.84%	483.53	-4.20%	725.75	-8.52%
2001	604.94	-13.59%	488.5	1.03%	634.16	-12.62%
2002	466.18	-22.94%	383.09	-21.58%	489.49	-22.81%
2003	594.56	27.54%	556.91	45.37%	630.13	28.73%
2004	650.99	9.49%	651.57	17.00%	693.63	10.08%
2 Year		18.17%		30.42%		19.04%
3 Year		2.48%		10.08%		3.03%
4 Year		-1.80%		7.74%		-1.13%
5 Year		-3.25%		5.24%		-2.65%

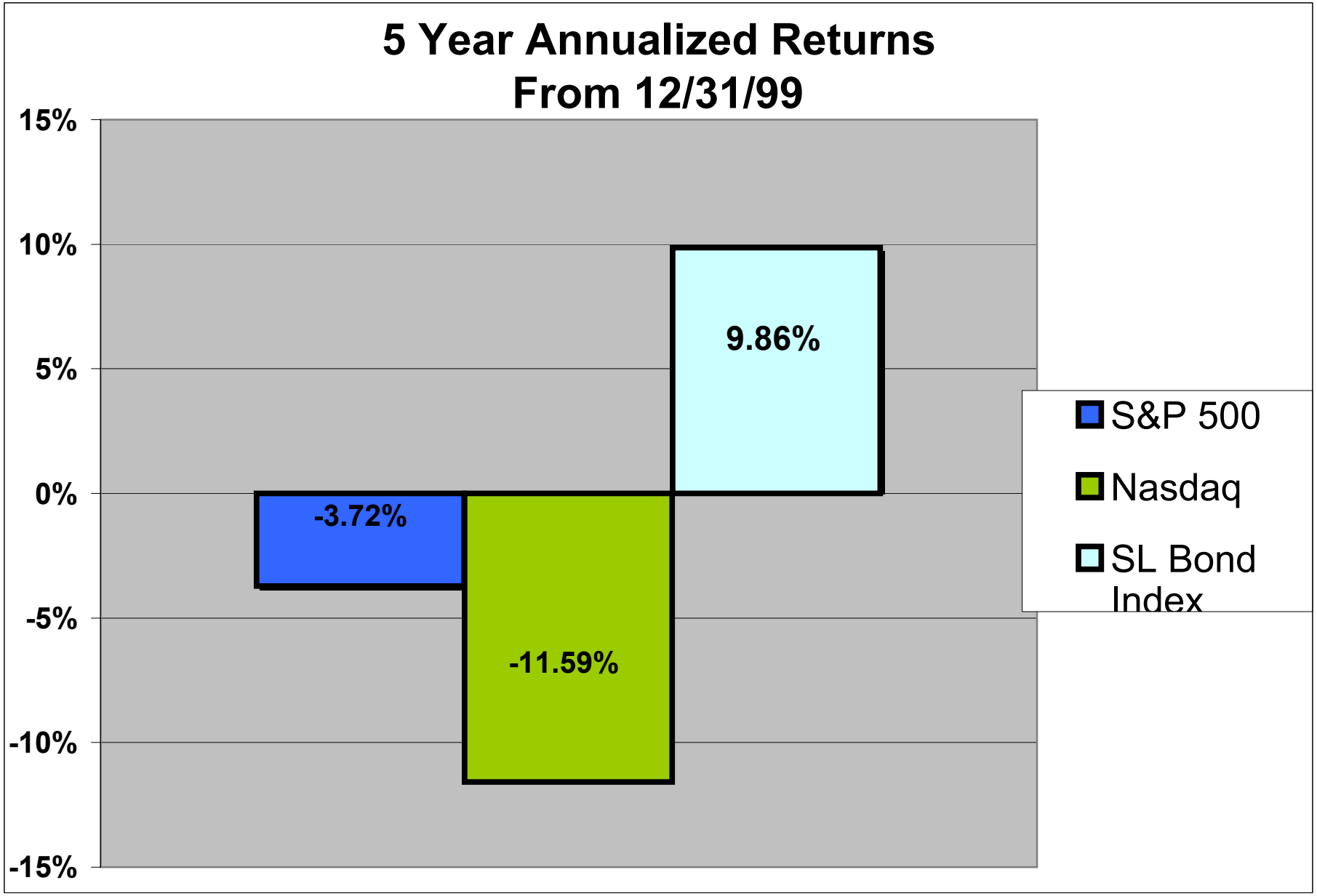
Russell 1000 = 1000 largest companies
Russell 2000= Next 2000 largest companies
Russell 3000 = Largest 1000 plus the next 2000


Industrial Production and Capacity Utilization
140
120
100
80
60
40
20
0
1999
2000
2001
2002
2003
2004
Industrial Production
Capacity Utilization


5 Year Increase in Jobs Data
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
-
8,052
8,835
3,434
Not In the Workforce
Civilian Labor Force
Total Jobs


5 Year Annual Increase in Per Capital Wages and Household Debt
9.00%
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
3.16%
7.21%
8.40%
Wage and Benefit
Debt Service
Household Debt


5 Year Growth in Debt vs. GDP
10.00%
9.00%
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
4.36%
9.09%
7.30%
GDP
Household Debt
Total US Debt


5 Year Annualized Returns
From 12/31/99
15%
10%
5%
0%
-5%
-10%
-15%
-3.72%
-11.59%
9.86%
S&P 500
Nasdaq
SL Bond Index