Economic recovery: Are we there yet?

Earl L. Wright, Thomas Shane, Peter Swinburn

There are encouraging signs for an economic turnaround on the horizon, but are they credible or too optimistic? Three top-level executives with domestic and global experience led a panel discussion on the short- and long-term outlook for investments, real estate and the economy in general: Earl L. Wright, President/CEO AMG Guaranty Trust, N.A.; Thomas Shane, Chairman of the Board, Western Stone and Metal Corporation; Peter Swinburg, President, Coors Brewing Worldwide.

Saved by the consumer
Earl L. Wright

Earl Wright is president/chief executive officer of AMG Guaranty Trust, N.A., a nationally chartered, non-depository trust bank headquarted in Denver with regional banks in Chicago, New York and Philadelphia. He is currently an officer and/or member of the board of trustees/directors for several corporations and institutions including the Denver Area Boy Scouts of America, Alliance for Choice and Education, Denver Rotary and the Hershey School of Dance. The author of articles for Trusts & Estates and Personal Financial Planning, Wright holds an MBA from The Wharton School, University of Pennsylvania.

The economy is picking up strength and is well on the road to recovery, according to Earl Wright and research by his company AMG Guaranty Trust. AMG's clients are predominately high-net-worth individuals and institutions. The firm manages $2.4 billion in client assets and serves as an advisor for another $6 billion.

While many economists are jumping on the recovery bandwagon now, "we have felt since the fourth quarter of 2001 that we were in an economic recovery."

Why wasn't it apparent at that time?

"People were confusing an economic recovery with the plummeting stock market, which did not behave in a way it normally would have during an economic upturn. The Iraq war had a lot to do with the market's decline and masked what was happening in the economy.

"This is an unusual period. We have been saved, to a large extent, by the consumer who, thanks to a tax stimulus and low interest rates, has more disposable income and is spreading it around."

However, Wright emphasized, there is no correlation between consumer confidence and consumer spending. "The correlation is that if personal income goes up consumers spend money, and 67 percent of our economy is the consumer.

Credit the consumer, he said, for taking us through "a weak first quarter this past year, a little stronger second quarter and a phenomenal third quarter.

"We still have a lot more money from the tax stimulus that's going to filter in through 2004, particularly in the first half of the year.

"This economy is going to support very strong corporate profit increases through the first half of next year.

But where in this rosy picture are the jobs?
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“There's no correlation between jobs and leading indicators. Job improvement will start to occur as we get into the economic recovery. We fully expect that the unemployment rate will be in the 5.5-5.7 range by the time of the election. The trend in unemployment certainly works in the favor of the Bush administration.

“That's the good news about the economy.

“The bad news is that we expect interest rates to go up. They'll go up 100 to 150 basis points between now and the end of next year. The one concern we have 18-24 months out is inflation. That's an unknown.

“There's a huge amount of cash in the economy. It's the highest proportion of cash available for the stock market that we've had in the last 20 years. And even though significant sums are being invested each week, there's still an awful lot on the sidelines that the general populace is waiting to put in.

“The stock market, relatively speaking, is between 10-15 percent undervalued.

“The consensus is that growth next year will be around 3 1/2 percent. We're saying it could be 4 to 4 1/2 percent, stronger than people are anticipating. We could very easily have S&P earnings in the low double digit range, and that would be an even stronger argument that the markets still have room for improvement.

“Bottom line for the U.S., we're pretty optimistic about the equity markets, pessimistic about the bond markets. There are some real problems in the economy outside of the financial markets and that's in the hard asset area. Denver, for example, has six years of office space available with the current vacancy rate.

“Contrary to what I've just said, real estate prices are holding up very high. We would have expected that real estate prices would have started cratering a bit but it has not occurred. Our theory on that is there's a lot of money on the sidelines wanting to own real estate.”

Shortage of product
Thomas Shane

Tom Shane is chairman of the board of Western Stone and Metal Corp., direct diamond importers with stores in 11 states. His business memberships include: Diamond Bourse, Antwerp, Belgium; Diamond Club, Antwerp; Colorado Harvard Business Club; Leadership Council Member Bard Center for Entrepreneurship Development, plus others. He is the recipient of many awards: 1999 Alumni of the Year Award, CU Boulder; 1996 Dean’s Entrepreneurial Excellence Award, CU Boulder; 1996 Knight in the Order of Leopold II, King of Belgium. He holds a BSBA from CU’s School of Business Administration.

Diamonds have become a commodity, said Tom Shane, offering his perspective on what he calls “a very small industry" but one that is perhaps a microcosm of what is happening in the global economy.

“During the last three years, the wholesale industry worldwide has been down in volume. The U.S. has been relatively flat, and we're the biggest market in the world. The second biggest market in the world for jewelry is Japan. It has been dead. The third biggest is Europe. It has been dead.
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"Southeast Asia has been going gangbusters. It's the strongest market in the world today but it's a relatively small market. So overall, the market has been down."

As both an importer and retailer, Shane has seen a change in the diamond market. "In the last five years or so, diamonds have become quite commoditized, which means that it's much harder to maintain an advantage. Competitors and consumers are much more knowledgeable, at least they believe they are, because they are taking decisions based on certificates that may or may not be valid."

As a result, Shane's company has been focusing on rubies and sapphires, which are mined in places like Thailand, Laos, Cambodia, Miramar, Vietnam and Madagascar among others. "I'm in Bangkok four times a year buying stones. Each one has to be negotiated, each one is different.

"When I make a purchase, I receive an invoice and I write a check. Worldwide, these transactions are quoted in U.S. dollars. It's very clean and simple."

It's not so clean and simple on the other end, said Shane, describing the typical ruby and sapphire mine as very small, run by a man who sells magazine and tobacco from a stand in the front, and digs up stones from a hole in the ground that's a few hundred feet deep.

"This is true in much of the world. The 'miners' own this small piece of land, a quarter of an acre at the most."

In order for these stones to get to market in Bangkok, they have to cross numerous borders. "They might go on the back of a donkey, in a saddle bag. The people that are in the business of transporting high value product across borders operate a service not much different from Brinks. Frequently, the people carrying the goods are also carrying all kinds of contraband and dope in the other saddle bags on these same donkeys.

"The borders are porous and things get out. Contrary to the beliefs of government leaders and some experts, most of these countries are very loosely governed in terms of their day-to-day activities. People are very clever and they figure out a way to eke out a living."

Shane requires that vendors produce an invoice for his purchases. "Typically, the goods are not recorded or reported until an invoice is necessary, which means until they are sold. So what's in the pipeline and what exists isn't often known to a lot of people. And this is a cash business."

Availability of goods has been a problem in the last six months, not because of price but because the dollar has crashed in value and caused a huge loss on inventories, Shane said.

"The vendors are in a bind. They can raise the price in dollars in order to break even in their local currencies, but then they risk killing the U.S. market. They can continue to sell in U.S. dollars at the same price, which will net them less in local currencies. Or they can hold onto their goods and continue to suffer a loss in asset value.

"No one wants to build inventory under these circumstances, so they've elected not to mine the stones. Consequently, there's a shortage of product on the market, particularly nice quality goods."
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"Globally, my business provides a good opportunity to see into the future, what markets are picking up and where things are taking place. In the U.S., the last six months have been strong for our retail stores, and we feel very positive about the U.S. economy."

Brand-savvy
Peter Swinburn

Peter Swinburn is president of Coors Brewing Worldwide, a position he has held since May 2003. Previously, he served as chief operating officer as well as sales director at Coors Trade in charge of marketing Coors Brewers Limited beer brands in the United Kingdom. He also focused on retail management and development of strategic plans for Coors Brewers Limited and was a chairman of Tradeteam (a logistics company jointly owned by Coors Brewers Limited and Ocean Group) and a director of Grolsch UK (a joint venture between Coors Brewers Limited and Grolsch). Swinburn holds a bachelors of science honors degree in economics from the University of Wales.

Coors trades in about 20 countries outside the U.S., in both the developed and developing markets, said Peter Swinburn. "In the U.S. it's a consumer land and we're all very brand-savvy. Alcohol, believe it or not, is a discretionary spend. So we suffer all the things you would expect us to suffer when people don't have enough money in their pockets.

"That doesn't mean that people drink less beer or less alcohol overall. The main impact is what we call down-trading; people come down to lower value brands, lower price brands. That hits your margins so your product mix is affected."

The beer industry has heavy fixed costs, with breweries that are "very expensive to run and difficult to change in the short term. What happens is that brewers trade down into their lower margin brands and the margins come down.

"The beer industry is very protected and structured in the U.S. Therefore, if people have money, it tends to flow right through the whole system. I would be less optimistic in terms of the consumer benefit flowing through in the established markets in Europe."

"Unfortunately, beer is susceptible to taxes, regulation and dislocation. In Puerto Rico last year, the local governor decided to increase tariffs on imported beers by 25 percent, so retail beer prices went up by 25 percent. That's a dislocation that is really difficult to manage."

"In our industry, what we are looking for in developing markets are a number of criteria. We need a certain market size, a disproportionately large population under the age of 29. We're looking for countries where people aspire to own U.S. goods and indulge in the U.S. lifestyle."

"Most important, we're looking for markets where there is a sufficient amount of money within the under-29 demographic to sustain a super-premium sector. Because in all the new markets we go into we are effectively the super premium priced beer."

"There is a massive difference in terms of pricing among the brands in the various countries so you do need a sufficiently large youth population with sufficient disposable income."
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"Globally, the two main development markets for beer are China and Russia. They have accounted for something like 150 percent of the beer growth in the world over the last five years. It's an area of high competition for the major international brewers.

"China alone accounts for some 3 million hectoliters and has grown at a compound aggregate of 7 1/2 percent over the last five years. The premium sector has grown at 10 1/2 percent. So although the premium sector is only 22 percent of the Chinese beer market, that is still something like 8 million hectoliters. (1 hectoliter=211 pints or 3,381 ounces.)

"If the U.S. starts to turn around and do better, China will do better. It will increase the number of breweries that can come into the super premium beer range and increase the number of cities that can actually sustain the presence of a company like Coors. Because each city in China is in effect a market. The more successful the city, the bigger the premium sector.

"On the other hand, China is an extremely difficult market in which to operate; it has driven off different nationalities.

"In Russia, culture plays a big part in beer consumption. Alcohol, in particular Vodka, is very much a part of the social fabric. Beer is accepted and there's actually a huge cultural push to move people into beer.

"Russia is a massive market and it's growing. The premium sector is now 40 percent because there are a lot of people in St. Petersburg and Moscow who have a large amount of disposable income and want to show it. And Coors Light, Budweiser and a Mercedes are some of the ways of showing it."

Q. Economists are saying that this is the poorest managed economy since at least Herbert Hoover. They cite profligate spending and the fact that the president has not vetoed a single item.

Wright: There's a 7 percent increase in federal expenditures this year, right. And entitlement.

Q. The feeling is that all of the factors combined are going to lead to a second term disaster if Bush is reelected. How do you see that, Earl?

Wright: We looked at the federal government's fiscal deficit of $350 billion to $425 billion and considered what that might add to interest rates. We came up with 50 basis points. That's not a disaster. We don't think the deficit will stay at that level. It is probably going to halve itself in the second term because there's going to be growth in the economy itself. Most of the deficit increase is going to occur primarily because of military spending, not entitlement. If you keep the same 7 percent growth in entitlement spending, the economists are absolutely correct. It could be a real problem.

I think a fascinating thing is that 43 percent of U.S. debt is owned by the Japanese and Chinese. You could scare yourself with that, but where else do you put the money? The capital markets aren't large enough to handle that. So we fully expect that there will be about a 20 percent devaluation of the U.S. dollar over the next 18-36 months.

Q. Regarding the euro, I don't think we were expecting it to go quite this high and this fast. I know it's good for us exporting, but how is that going to affect Europe's recovery?
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**Wright:** Most of Europe’s economy is self-contained or in the area of contiguous countries. So even though the U.S. dollar might devalue, it won't have a huge impact on Europe. The euro is going to go up, possibly to $1.35, $1.40.

Q. _Should the Chinese decide that they don't like trade restrictions imposed on them by the U.S. and choose to put their money into the euro and not into the dollar, will that be a problem?_

**Wright:** I'm a firm believer that the Chinese are trying to keep their economy as stimulated as possible. It doesn't work in their favor to get on the wrong side of the U.S. because we are a huge, huge buyer of their goods.

Q. _Tom, between the guy that digs the stone out of the mine till it finds its way to market in Bangkok, how many people on average are involved in the transaction?_

**Shane:** You might think that the more people that touch it, the more commissions, the more profits, the higher the price is going to be. But it's just the opposite. There's a market price of what it sold for at wholesale and, working backwards, everybody that's going to have to touch it is going to know what they can afford to pay. The further downstream this poor little guy is the less he's going to get.

Q. _Tom, you say the purchase is official when you get an invoice, but it's an invoice between you and some anonymous seller. So from a seller's perspective, how does that invoice matter?_

**Shane:** Because that invoice gets officially recorded. So those sellers have to account for the sales of those goods. If somebody has a thousand carats and I'm buying 40, they have to officially own those 40 carats before they can sell them to my office. Then I can officially pay for the 40 carats. The other 960, I have no idea about.

In the diamond business in Antwerp and Tel Aviv and Bombay, our vendors there know that a requirement that we impose on them is that every stone that we buy must have an invoice and will be paid for officially and at the legitimate price. And if they have to go out and spend between a half and three-quarters of one percent to buy an invoice, they will figure that into my cost of goods.

Q. _Peter, we keep hearing that China is the biggest economic threat to the U.S. because of their capability in terms of manufacturing. What are your thoughts from what you've seen there?_

**Swinburn:** China is effective and it will continue to be effective because it's got an awful lot of people to put to work. And if those people become too expensive, they'll be replaced with other people. I don't see China as a threat at the moment.

**Shane:** I find in Southeast Asia that the Chinese work force is a terrible threat to the Thais and to the Malaysians and to the Indonesians. They are the ones that had the cheap labor and a little bit of technology, and the Chinese are killing them with that. Even the Koreans are suffering terribly at the hands of the Chinese, more so than from the U.S. in my experience.

Q. _Earl, What effect do you think the mutual fund scandals will have on the stock market?_

**Wright:** I think there will be a washout. One of the great ironies of this is Invesco. They are going out of business on Jan. 1 anyway, merging with another company. But there's a lot of very interesting things going on. I think some mutual funds will be harmed; the credibility of some of the funds will be hurt. But
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where does the investor go with his $15,000? He doesn't go to hedge funds or to a private manager. And 80 percent of the money out there is, to a large extent, coming from consumers who have $15,000, $20,000, $25,000 floating around in the 401K programs.

Will there be some legislation? Sure. Will there be some legislation on front-end loading and legislation with regards to timing? Yes, there will be. The mutual fund industry is going to come through this, but I think there will be some people that will be sorted out.

It's typical what happens here in the United States. The big firms will survive and do very well. Small firms will be hurt because new regulations will drive them out of business.