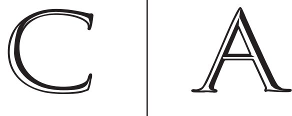

CAMBRIDGE ASSOCIATES LLC

CUTTING STRATEGIC ALLOCATIONS TO U.S. EQUITY

2006

Ian Kennedy

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ABSTRACT

1. In all developed markets, investors' bias in favor of domestic equities is irrational and sub-optimal. In the specific case of U.S. investors, even a market cap-weighted portfolio (i.e., 48% allocated to U.S. equities) is theoretically less efficient than one more evenly balanced among the world's major regions.

2. However, our recommendation to overweight Asia and underweight the United States is predicated primarily on our perception that although Asia's rise benefits the global economy as a whole, relative wealth will accrue faster in the east than in the west (albeit from a much lower base), resulting in and assisted by the rapid development of capital markets and private investment opportunities.

3. Meanwhile, the United States is intensely vulnerable to any diminution in the global appetite for US$-denominated assets, which currently sustain the huge current account and fiscal deficits. Correction of unsustainable global imbalances—in which U.S. borrowing and consumption are financed by Asian savings—must include some combination of a depreciating dollar, reduced U.S. consumption, and increased U.S. savings, all of which point to weaker U.S. growth during the adjustment period.

4. Whether such an adjustment occurs gradually over a period of years (the benign scenario) or abruptly as a result of a dollar crash (the malign scenario), the process also requires that the prospective returns of US$-denominated assets be sufficiently attractive to continue attracting inflows equivalent to the current account deficit. Even if that deficit gradually shrinks, in the context of dollar depreciation (or even the *expectation* of dollar depreciation) this might well imply a lower multiple for U.S. equities and higher yields for U.S. bonds.

5. Although these risks are widely recognized and discussed, this does not mean they are necessarily priced into the market. Studies have shown that systemic risks with indeterminate maturities are not discounted—resulting in violent price adjustments when they do in fact occur.

6. At lower prices and more attractive relative valuations, we might well institute a tactical recommendation in favor of U.S. equities. However, we are unlikely to change our strategic recommendation to underweight unless and until we find our reasoning to be false, or global economic relationships evolve in ways that significantly alter the competitive landscape.

SUMMARY

> For years I thought what was good for our country was good for General Motors, and vice versa. The difference did not exist. Our company is too big. It goes with the welfare of the country.
>
> —*Charles Wilson*
> *President of General Motors, 1953*

> The cities that were formerly great, have most of them become insignificant; and such as are at present powerful, were weak in olden time. I shall therefore discourse equally of both, convinced that human happiness never continues long in one stay.
>
> —*Herodotus*

Introduction

We recently recommended that investors' strategic equity allocation should be equally divided between the Americas, Europe, and Asia, and subsequently elaborated on the question of how best to structure and implement the Asian portion of such an allocation.[1] Since this recommendation constitutes an implicit derogation of the relative attraction of the world's richest economy and largest equity market (U.S. equities currently constitute 48% of the MSCI All Country World Index), it seems logical to ask: what's the basis for a strategic bet against the United States?

We use the term "strategic" to indicate a longer time horizon than would be implied by "tactical;" however, this binary distinction oversimplifies. At one end of the spectrum lie relatively short-term, clearly tactical portfolio decisions; for example, overweighting growth and underweighting value on the basis of relative valuations, or investing in high-yield bonds because credit spreads seem inordinately wide. Such tactical bets have a limited life expectancy—perhaps three years at most. Less obviously tactical are decisions that may take longer to play out, but are nevertheless based also on current market conditions. For example, an investor might decide that a combination of stimulative monetary policies and rising oil prices implies higher global inflation somewhere down the road and consequently warrants increased allocations to inflation-sensitive assets for an indeterminate period until this expectation plays out or is proven wrong by changing circumstances. Is this decision tactical or strategic? In these instances the distinction is not very useful since although the implicit time horizon is clearly less than decades, it may prove longer than three years. At the far end of the spectrum lie *totally* strategic decisions expected to persist indefinitely, regardless of changing conditions. Decisions expected to pay off over a decade or longer are less pure, but still clearly strategic.

Our recommendation to underweight U.S. equities and overweight Asian equities is *primarily* strategic, based on the view that Asian markets will benefit from reasonably persistent tailwinds over the next decade or so, while U.S. markets have not discounted the probability of some challenging headwinds.

[1] Global Market Comment: *Increasing Strategic Equity Allocations to Asia* (November 2005) and *Investing in Asia* (March 2006).

We currently also have a *tactical* recommendation to underweight the United States and overweight Asia on the basis of relative valuations, and this dovetails with the strategic case, the reasons for which have varying time horizons, from quasi-tactical to completely strategic, as indicated below.[2]

I. Strategic Asset Allocation: Global Investing in a Global Economy

Most investors in every developed nation have sub-optimal, inefficient, strategic overweights to domestic equities. For example, a recent paper from Alliance Bernstein[3] cites a study indicating that the equity holdings of pension plans in the United States, United Kingdom, Japan, and Australia were weighted 85%, 64%, 60%, and 73% in their respective domestic markets. Such local favoritism results in higher risk, an irrational constraint on the opportunity set for returns, and lower alpha potential. As we noted in our November comment, equity investors should first make a strategic commitment to invest globally, since this will improve the risk-return profile of their portfolio, and secondly, should recognize that a cap-weighted global equity allocation is still sub-optimal since current market capitalization is unrelated to the prospective risks, returns, and correlations among markets—which are the data one needs to construct an "optimal" allocation. Regardless of the current outlook, therefore, a strategic allocation of one-third to the Americas, one-third to Europe, and one-third to Asia constitutes a theoretically more efficient portfolio than one invested according to current market-cap weightings.

However, investors do not invest in countries but in companies, and the evolution of the world's largest companies in an era of increased globalization also argues for a global orientation. Of course, multi-national corporations are among the favorite targets of anti-globalization protesters, being accused of displacing local businesses (the Wal-Mart effect), destroying indigenous cultures (the McDonald's effect) exploiting cheap labor (Nike sweat shops), and precipitating a race to the bottom in environmental standards and tax rebates from host countries (bloodsucking capitalists in general). All largely untrue—but the outgrowth of an accurate perception that multinationals seem increasingly detached from their traditional ties to nation states. Indeed, the term multi-national is increasingly anachronistic as these global companies become supra-national; that is, unaffiliated with any particular nation. What is an American company? Probably the best answer, today, is: "one that is incorporated and has its headquarters in the U.S. and its primary listing on the New York Stock Exchange or Nasdaq." For now, this holds. But as cross-border mergers among stock exchanges moves us inexorably toward a truly global bourse, with major companies'

[2] Since our focus is on those areas where we perceive the United States to be at a comparative disadvantage, we have omitted discussion of several long-term themes where the United States is either better off than other nations or at least no worse off. Among these, for example, are demographic trends, where the United States—despite its seeming inability to find politically palatable solutions to social security and medicare liabilities—is probably better off than Europe or Japan. (However, the impact of demographic trends on investment risk and opportunity is a matter of some debate.) The economic effects of global warming, a deadly pandemic, or terrorist attacks are additional issues where there seems no compelling reason to regard the United States as more or less vulnerable than other nations; moreover, the *investment* impact of disasters—whether man-made or natural—is very difficult to anticipate and generally overstated.

[3] Seth J. Masters, Christopher Nikolich, and Dokyoung Lee, "Home-Country Bias: Where Traditional Asset Allocation Falls Short," March 2006.

shares held by global investors domiciled in many countries and traded around the clock on global electronic exchanges, the notion of a major company being loyal in some way to a particular nation state may come to seem quaint.

Already, the relationship between corporate profitability and national income is unraveling. As a recent article in *The Economist* observes, "Firms in Europe are delivering handsome profits that are more in line with the performance of the robust global economy than with that of their sclerotic homelands." And as for jobs: "The world's 40 biggest multinationals now employ, on average, 55% of their workforces in foreign countries and earn 59% of their revenues abroad . . . Only 43% of all the jobs at companies in France's CAC 40 are in France."[4] Cisco's CEO John Chambers, believing that China will become the global leader in information technology within several decades "is trying to develop a strategy for becoming a Chinese company."[5] How's that for loyalty to the nation state? However, Chambers may be short-sighted; after all, what is a Chinese company? Already over 55% of China's exports are made in China by foreign enterprises (79% of industrial machinery, 92% of computer equipment, and 74% of electronics and telecoms).[6] In other words, the ubiquitous label "Made in China" does *not* mean "Made by a Chinese company."

These are *structural* reasons why equity investors' long-term asset allocation should be global rather than domestic + world ex domestic and allocated more efficiently than a global market-capitalization construct provides. If implemented, they would result in a significant reduction in the allocation to U.S. equities, but without any indication of whether this might be desirable from the perspective of relative valuations or economic prospects.

II. Globalization: Who Wins If It Keeps Rolling? Who Loses If It Reverses?

Who Wins If It Keeps Rolling?

Assuming, for the moment, that global economic integration persists in the coming decades, how should we expect the United States to fare relative to other countries? There are many reasons for optimism: compared to other developed nations, the United States has a relatively flexible labor market, an entrepreneurial culture, a history of technological innovation, a dynamic financial infrastructure, reasonable demographics, the ability to attract and absorb immigrants, and a stable political system. When one looks at looming problems, like massively underfunded pension and health care liabilities, the United States can at least take Job's comfort by comparison with Europe and Japan.

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[4] "Decoupled," *The Economist,* February 25, 2006. This is, of course, a consequence of the commoditization of unskilled and semi-skilled labor resulting from the participation of China, India, and other formerly closed systems in the global economy. It is related, therefore, to the issues of globalization and the potential for protectionist backlash discussed below. At the least, as FX Concept's John Taylor noted in his March 23, 2006 "Market Insight Report," "This worldwide division between an increasingly global economic system and localizing political systems is sure to cause some monumental problems in the years ahead."

[5] Cited by Clyde Prestowitz, *Three Billion New Capitalists: The Great Shift of Wealth and Power to the East*, p. 148.

[6] George Gilboy, "The Myth Behind China's Miracle," *Foreign Affairs,* July/August, 2004.

On the other hand, we are constantly reminded that tomorrow's winners in the global economy will be those with highly educated workers, the foresight to develop and exploit comparative advantages, and receptivity to technological innovation. Given how quickly emerging technologies are now transferred from advanced to developing countries, it is a stretch to assume the United States is likely to enjoy a continuing edge in this area.[7] As regards education, U.S. high school students consistently rank near the bottom in various international comparisons and fewer and fewer scientists and engineers graduate each year from U.S. colleges and universities, while the numbers graduating in Europe and Asia keep rising. And there are those, like Clyde Prestowitz, who argue that the United States no longer possesses any sort of coherent industrial or commercial policy beyond the simple mantra of free trade and is thereby ceding vast areas of potential development to others who *do* have a clear game plan for the future.[8]

Who Loses If It Reverses?

Whether precipitated by higher energy prices or some other catalyst, the next U.S. recession may well turn the current murmurs of protectionist sentiment into full-throated roars. Notwithstanding the extraordinary contribution of trade liberalization to advancing global prosperity in the past several decades, the governments of the developed world have failed abysmally to educate voters as to benefits of globalization, and have done little of consequence to alleviate the damage done to those who have borne the costs.[9] The result is widespread voter indifference to and/or active antagonism toward free trade initiatives, as the majority that stands to gain cedes the debate to the minority that stands to lose. Similarly, developing countries, which should profit the most from greater integration into the global economy, have often failed to reap the potential benefits because of weak governance, ineffective institutions, poor policies, and inadequate financial infrastructure. Here the result is a tragic shift in public opinion—most conspicuously in Latin America—back to economic nationalism—back toward the empty rhetoric and failed policies of the past. Among others, Harold James and Jeffry Frieden have written eloquently about how and why and with what

[7] "The view that the uniquely inventive U.S. economy will always maintain economic leadership by doing the next new thing no longer necessarily holds. U.S. spending on research and development has declined in critical areas, and its technology infrastructure is deteriorating...Most important, the leading U.S. venture capitalists and technology firms are taking R&D and new start-up company development to Asia as fast as possible." Prestowitz, p. 19. See also Thomas Bleha's analysis of the economic impact of U.S. failure to deploy broadband and next-generation mobile phone technology: "Down to the Wire," *Foreign Affairs,* May/June 2005. Also Adam Segal, "Is America Losing Its Edge: Innovation in a Globalized World," *Foreign Affairs,* November/December 2004.

[8] "…the U.S. government proclaims its devotion to laissez faire and retains no mechanism for considering industry structure issues. The irony is that this in itself is an industry structure decision. Other governments do have industrial policies. The financial incentives offered by China attract investment that might otherwise have been made in the U.S. market. In this case the absence of U.S. policy amounts to a policy to put the plants in China. Because we so hate having U.S. bureaucrats pick winners and losers, we outsource the job to Chinese bureaucrats, all the while reminding ourselves of the glories of the free market and complaining when the Chinese don't comply with our wishes." Prestowitz, p. 211.

[9] Recent literature on globalization is vast and growing. However, the main lines of debate and some invaluable historical perspective may be found in two collections of essays: from the National Bureau of Economic Research, *Globalization in Historical Perspective*, ed. Michael D. Bordo, Alan M. Taylor, and Jeffrey G. Williamson; and from the Council on Foreign Relations, *Globalization: what's new?* ed. Michael M. Weinstein.

terrible consequences the lights went out on the last great era of globalization—warning us, in effect, that we should not assume, as our predecessors did in 1914, that the global economy must inevitably proceed along its current course (see Herodotus, above!).[10]

If growth hits the skids, politicians will find the allure of populist economic rhetoric well nigh irresistible and the protectionist bandwagon could easily gain rapid momentum. Already, economic patriotism (a term coined by a French politician and adopted by Prime Minister Dominique de Villepin) is on the rise. Witness the recent electoral successes of populists and socialists in Latin America, the measures taken by Japanese and Korean authorities to ward off foreign buyouts, and even China's new go-slow policy as regards foreign ownership of financial service and industrial companies. All this during a period of robust economic expansion.

But is not this a *global* issue, likely to affect Europe, Asia, and Latin America every bit as much as North America? It is. Indeed, by and large the distributional coalitions[11] that oppose globalization appear stronger in Europe than in the United States, while the United States is not nearly as open to the global economy as, say, China. In the long run, therefore, the United States might well emerge from a multi-decade retreat into economic nationalism in better shape than most of Europe or the more developed Asian economies like Korea or Japan. In the short run, however, the US$ and the U.S. current account deficit come into play—as discussed below. Since the US$ is the world's currency, the United States is the world's banker. Any restriction on capital flows, any retreat from currency convertibility—in short, any diminution in global financial activity would strike most immediately at the world's primary financial intermediary and weaken the dollar. At the same time, any shrinking of global trade would impede U.S. efforts to step up exports which a weaker US$ would render more competitive in world markets.

In most developed countries with a free press, socioeconomic observers are prone to overstate the problems at home and understate those abroad. Moreover, gloom sells—even in optimistic America—and it is all too easy to swallow gloomy prognoses wholesale, especially when they are liberally sprinkled with some telling facts and figures. This is by way of admitting we are just not sure how to assess America's economic odds in a future of continuing global integration. In absolute terms, we have no doubt the U.S. economy would benefit from further globalization; our best guess is that it would do so to a greater extent than Europe, but a lesser extent than Asia. On the other hand, a protectionist backlash that raised barriers to the free movement of capital, goods, and services would damage all nations' economic growth, but in the long run probably prove most detrimental to Europe, Japan, and China, and less so to the United States.[12]

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[10] Harold James, *The End of Globalization: Lessons from the Great Depression;* Jeffry A. Frieden, *Global Capitalism: Its Fall and Rise in the Twentieth Century*. See also, Niall Ferguson, "Sinking Globalization," *Foreign Affairs*, March/April 2005.

[11] The term is Mancur Olson's, from his brilliant 1982 book, *The Rise and Decline of Nations.* "Stable societies with unchanged boundaries tend to accumulate more...organizations for collective action over time…[These] distributional coalitions slow down a society's capacity to adopt new technologies and to reallocate resources in response to changing conditions, and thereby reduce the rate of economic growth," p.74.

[12] The comparative advantage of the United States in this regard is due in part to the fact that despite the global orientation of the largest American companies, about 85% of the goods and services consumed in the United States are produced domestically.

III. Oil

Oil ranks high among the potential catalysts for a crisis involving the US$ and current account deficit. The persistence of higher oil prices since 2004 has surprised those who assumed increased supply would emerge to meet rising demand—even allowing for temporary disruptions caused by Hurricanes Katrina and Rita. Despite dramatic reductions in recent decades in energy consumed per unit of GDP, the U.S. economy is still highly dependent on oil even as it bumps into rising constraints on its ability to bring new supplies to market. This does not turn on China's voracious appetite for energy—although that demand does exert a significant influence on global prices—nor on Hugo Chavez's desire to stop selling Venezuelan oil to the United States (most oil is fungible), but on stricter environmental regulation and under-investment in refining capacity.[13] While *any* predictions regarding oil prices should be treated with a hefty sack of salt (the track record of oil prognosticators rivaling those of interest-rate forecasters for inaccuracy), nevertheless the U.S. economy is undeniably vulnerable to persistently high oil prices: more expensive oil → weaker economy → lower dollar → higher dollar price of oil (so that the global price of oil remains constant in real dollar terms) → rising inflation → lower appetite for dollar assets among foreign investors → higher interest rates → even weaker economy. Any clear-thinking, anti-American anarcho-terrorist should be targeting pipelines rather than subways or airports.

IV. Global Imbalances

Among the headwinds facing the United States, the most pressing and immediate is an inter-related series of vulnerabilities most visibly represented by the U.S. current account and fiscal deficits. There is, as usual, much heated debate among economists on the nature, extent, and severity of the enormous U.S. current account deficit, but with only a few exceptions[14] reasonably broad agreement that the global imbalances in which this deficit plays such a prominent role are unsustainable. Moreover, almost everyone agrees that resolution of these imbalances will require some combination of a considerably weaker US$,

[13] See "Hundred Dollar Oil, Five Percent Inflation, and the *Coming Recession,*" by Philip K. Verleger, Jr., *The International Economy*, Winter 2006. And, by the same author, "Energy: A Gathering Storm?" in *The United States and the World Economy,* ed. C. Fred Bergsten. Also, Charles T. Maxwell, "The Gathering Storm," *Barron's*, November 14, 2004.

[14] Most notably Ricardo Hausman and Federico Sturzenegger, who argue that their analysis of the nation's financial income flows indicates there is no current account deficit. A useful summary of the points of debate can be found in the online discussion hosted by the *Financial Times*' Martin Wolf.

especially *vis-à-vis* Asian currencies, reduced U.S. consumption, and higher U.S. domestic savings.[15] The universal hope is for a gradual adjustment, spread over many years; the universal fear is of a rapid adjustment in the form of a run on the dollar and consequent global recession.

All this is old hat—and widely discussed old hat too. Presumably, therefore, the attendant risks are appropriately discounted in global asset prices? Unfortunately not. As several commentators have noted, markets do not in fact discount this kind of risk until the house of cards actually collapses.[16] The probable reason is the impossibility of handicapping both *when* such a macroeconomic adjustment might take place and the subsequent chain of unforeseen consequences as the affected parties react to changing circumstances. And although almost everyone agrees that the United States cannot continue to attract an ever-larger share of global savings (already estimated at 80% or so), to fund an ever-larger current account deficit (already around 7% of GDP), almost no one agrees on whether this can go on for another one, three, five, or ten years (hence our inability to clearly label the issue as tactical or strategic—could be either/or). The market's response to such uncertainty is: let me know when you have decided; meanwhile, I have got next quarter's earnings to worry about.

But aren't the imbalances a global as opposed to a U.S. problem? Yes...but. The United States is most vulnerable because its continued economic health is more heavily dependent on the continuation of these unsustainable trends than are the economies of other countries. Certainly, the Japanese, Chinese, and European economies would be adversely affected by a sharp sell-off in the dollar that forced U.S. interest rates higher and equity prices lower, in response to the imperative to attract foreign money into US$-denominated assets to fund the current account deficit. Depending on the catalyst for such a sell-off, a U.S. recession might either accompany such a development or be triggered by the higher interest rates that ensued,[17] and shrinking U.S. consumer demand would certainly be detrimental to global growth, even if domestic demand in Japan, China, and Europe remained reasonably robust. Nor would a cheaper dollar prove

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[15] Effectively summarized by Michael Mussa in "Sustaining Global Growth While Reducing External Imbalances," *The United States and the World Economy,* ed. Bergsten, p. 176:

> *Sooner or later, one way or another, a substantial downward correction of these imbalances will come. Whenever and however it comes, the correction will necessarily involve three broad and interrelated macroeconomic developments: (1) The US dollar will need to depreciate substantially in real terms . . . (2) In the United States, domestic demand will need to grow more slowly than domestic output in order to make room for an expansion of US net exports; and as logically necessary counterparts of this downward adjustment of US demand relative to output, there must be a corresponding improvement in the US national savings/investment balance and an equivalent reduction in the net use of foreign savings by the United States. (3) In the rest of the world, domestic demand will need to grow more rapidly than domestic output in order to allow for the reduction of net exports that corresponds to the improvement of US net exports; and as logically necessary counterparts of this upward adjustment of demand relative to output, there must be a corresponding deterioration in the savings/investment balance and equivalent reduction in the net outflow of capital to the United States from the rest of the world .*

[16] See, for example, Niall Ferguson, "Sinking Globalization," *Foreign Affairs*, March/April 2005. Also, Barry Eichengreen's comments on a paper by Michael Dooley and Peter Garber in *Brookings Papers on Economic Activity,* 2005:1, in which he identifies "a substantial number of previous episodes where major imbalances leading to sharp changes in exchange rates were not obviously factored into financial markets until immediately before the event," p. 189.

[17] "The dollar could fall sharply, as it has about once per decade over the past 40 years (in 1971-73, 1978-79, 1985-87, 1994-95). Market interest rates would rise immediately and the Federal Reserve would probably have to push them higher to limit the escalation of inflation." Bergsten, "A New Foreign Economic Policy for the United States," *The United States and the World Economy,* p. 11.

a panacea by making U.S. goods and services more competitive overseas, allowing the United States to export its way out of trouble. Manufacturing now accounts for only 12% or so of U.S. GDP, while 40% of manufactured goods are already being exported and there is little excess capacity. Although exports would certainly rise, therefore, they can't be conjured in huge quantities from thin air (agriculture and mining, which also have export potential, account for only another 7% of GDP). In 2004, the United States exported $620 billion of manufactured goods and $320 billion in services; implausible multiples of both would be required to eliminate—or even half—the current account deficit. Consequently, reduced consumption is a necessary component of the inevitable adjustment. In short, when the time comes, others might catch a cold, but the United States would be down with the flu.

The *fiscal* deficit is also part of this equation, for several reasons. First, a massive fiscal deficit—especially if tied to growing disillusionment with the Pax Americana—should make foreign holders of U.S. Treasury securities increasingly nervous. And, of course, any reduction in the rate of purchase of US$ assets by foreign investors (whether public or private) would probably push U.S. interest rates higher, raising the cost of capital to U.S. businesses and exacerbating the U.S. government's liabilities. In short, a monetary policy designed to stimulate a weak economy could be undermined by the constraining effects of a massive fiscal deficit funded to a significant extent by foreign money.

Optimists note that the so-called global imbalances in fact serve everyone's best interests, so why should anyone tip over the apple cart? In addition, several commentators have pointed out that foreign capital has not been, in effect, drawn into US$ assets by the lure of high interest rates or cheap equities, but has been invested voluntarily because the U.S. economy remains stronger, more flexible, more entrepreneurial, and more productive than those of Europe or Japan. Very true. U.S. workers are not rioting in the streets against provisions designed to relieve high unemployment among young people, and all the projections for next year's GDP growth among the major developed economies put the United States substantially ahead of Europe and Japan. Nevertheless, it seems cavalier to assume that the foreign capital recently attracted to the United States must necessarily remain indefinitely and, indeed, be continuously supplemented by additional inflows. When foreign capital perceives that its interests may be better served by going elsewhere, it will go elsewhere. No one can say for sure when and to what extent and under what circumstances this might occur, but it *will* happen at some point, in some way, with consequences more or less malign.

Summary

Although gloom sells and there is some allure to wallowing in lamentation, this is not a polemic on the decline of the west. Moreover, what *could* happen is by no means what *will* happen, and history demonstrates that all prophetic utterances should be cast in the conditional tense. The United States has many lasting strengths and structural advantages over other nations and there is no question that Europe and Asia face a litany of problems at least as diverse and problematic as those outlined here. Japan, for example, must deal with a shrinking population, rising competition from China and other low-cost manufacturing centers across Asia, and entrenched special interests more likely to impede than contribute to economic progress.

The contrast with the United States, however, is that Japan, having gone through the wringer since 1995, is gradually putting its house in order and coming to terms with what must be done to restore economic health, while the United States' major problems seem to lie ahead.

Our strategic perspective is unlikely to change unless and until we find our reasoning to be false, or global economic relationships evolve in ways that significantly alter the competitive landscape. Our *tactical* views, however, are more subject to change on the basis of relative valuation. At some price, U.S. assets will become a compelling value play, both in absolute and in relative terms, with prospective returns high enough to keep attracting the foreign capital needed to fund our deficits despite the continuing threat of a depreciating dollar. Unfortunately, getting from here to there might well require lower equity multiples and higher bond yields—a possibility inadequately reflected in current valuations because, as noted above, the timing is too uncertain. Meanwhile, corporate earnings are strong, consumer spending robust, real interest rates low, and liquidity plentiful, allowing investors to feel reasonably comfortable in the here and now. What worries us more is the there and then, when the headwinds start to blow in earnest and the U.S. economy is subjected to forces substantially beyond its control.