

BARRON'S

The Dow Jones Business and Financial Weekly

www.barrons.com

December 25, 2006

\$4.00

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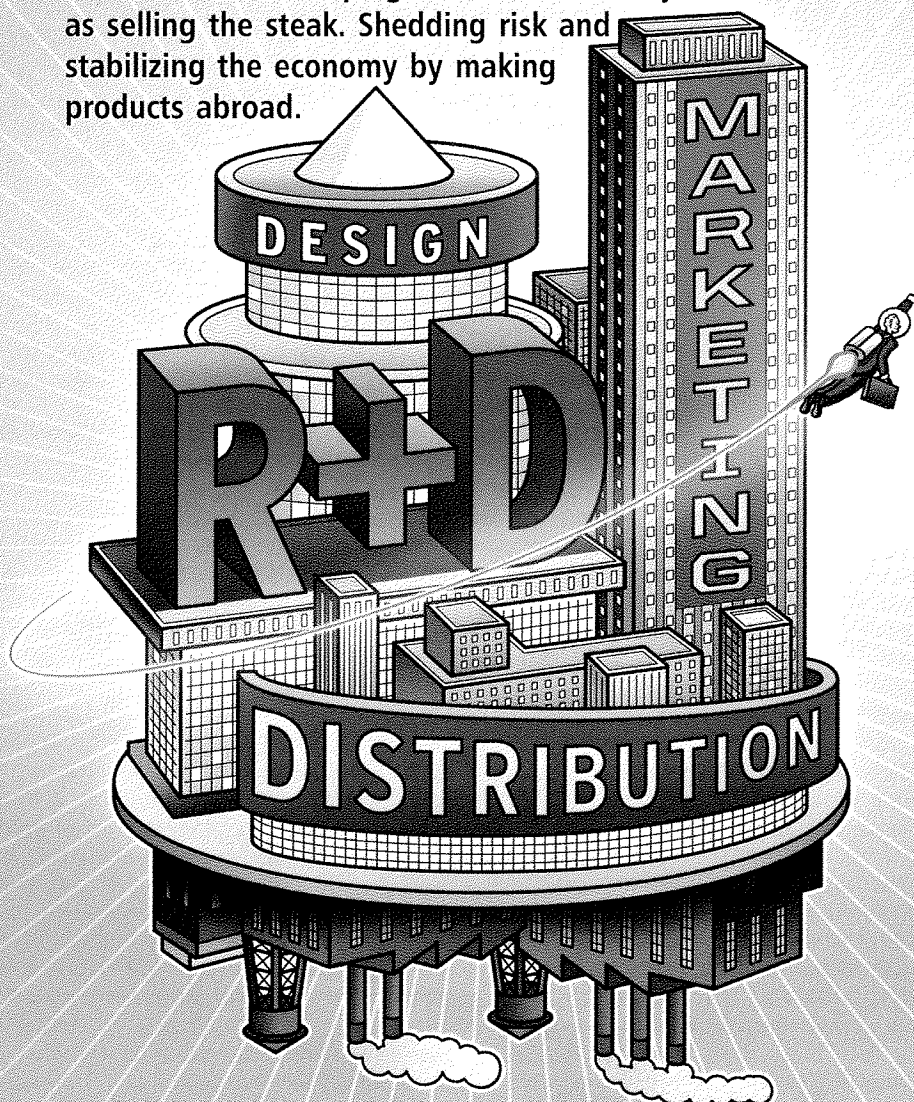
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SIZZLE INC!

For the U.S., developing the sizzle is now just as crucial as selling the steak. Shedding risk and stabilizing the economy by making products abroad.



DOWJONES

Display Until December 29, 2006

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DOWJONES

Welcome To Sizzle Inc.

by Jonathan R. Laing A cloud hangs over the U.S. economy and stock market, even though both have enjoyed a spirited recovery since 2003. ● Bears worry that a serious recession lies ahead, spurred by over-leveraged consumers cutting their spending in response to a collapse in home prices. Longer term, gloomsters bemoan the U.S.' huge current-account deficit, a reflection, they insist, of America's lust for consuming more than it produces and spending more than it saves. Only the kindness of strangers (mostly Chinese and other Asian central bankers buying U.S. debt securities) lets Uncle Sam continue his profligate ways. ● Inevitably, all this will end in a vale of tears, the pessimists argue. They foresee an economic ice age. First, foreigners will withdraw their largess, sending the dollar plummeting and interest rates soaring. Meanwhile, all the good manufacturing jobs will have been outsourced overseas, leaving the average Joe in Dallas, Dubuque or Denver bereft of economic opportunity. Grim stuff, indeed. ● But such opinions aren't shared by everyone. In fact, an international research boutique called GaveKal views these forebodings as poppycock. To the firm, the much-ballyhooed U.S. current-account deficit is largely a product of antiquated statistical measures that mainly miss the favorable impact of surging U.S. corporate cash flow and profitability. Likewise, no housing bust impends, according to GaveKal, a respected strategic adviser to some of the globe's largest financial concerns, including some of Wall Street's largest mutual funds. In fact, third-quarter federal data indicate, the consumer has never been more flush on a net-worth basis, with stock gains more than offsetting the flattening of homeowners' equity.

Nor is Wall Street poised on a precipice. Stocks actually are cheap by many measures, says GaveKal. And shares of a certain type of nimble and tech-minded U.S. multinational could rise the most in coming years.

GaveKal asserts that the global economy is on the cusp of a decades-long deflationary boom that will lift America and much of the emerging world to unprecedented prosperity. In a book entitled *Our Brave New World*, the research outfit even invites derision by asserting that, these days, "things are indeed different."

The optimism arises from a clutch of profound economic changes that GaveKal's founders, Frenchman Charles Gave, his Hong Kong-based son, Louis-Vincent, and British financial writer Anatole Kaletsky (the firm's name is a contraction of the prin-

cipals' last names) argue have been largely ignored by most commentators. GaveKal's central aperçu revolves around a business model that has evolved in advanced nations, such as the U.S., Sweden and Great Britain. They call it the "platform company."

These corporations concentrate on high-value-adding functions in which knowledge and technology are paramount. The platform company farms out to low-cost manufacturers at home and, increasingly, abroad low-return, volatile portions of its operations, including manufacturing. In essence, they are focused as much on the sizzle as the old multinationals were on the steak. "Instead of producing everywhere to sell products around the world, the platform company harnesses endemic global overcapacity and cheap information transmission to produce almost nothing directly, but sell everywhere," Charles Gave says in an interview at his loft apartment in Manhattan's trendy Soho district.

Although privately held Ikea, for example, has a worldwide presence, it largely consists of a bunch of furniture designers in Gothenburg, Sweden. Then there's **Apple** (ticker: AAPL), which is minting money from the development and distribution of its iPod line, while relying on Asian manufacturers to produce it. **Motorola** (MOT), **Hewlett-Packard** (HPQ), **Dell** (DELL) and tool and appliance maker **Black & Decker** (BDK) are among the companies that have embraced the model with signal success. Software outfits, likewise, are increasingly using low-wage Indian programmers to write codes for routine, nonproprietary portions of new programs. And **IBM** (IBM) is relying heavily on India to boost its outsourcing presence.

The implications of this trend are vast, according to GaveKal. For one thing, platform companies trim risk by fobbing off the most cyclical parts of their business. If sales hit an air pocket, the platform firm merely reduces its orders to, say, a Chinese supplier, rather than shoulder the financial burden of liquidating inventories, laying off workers and perhaps having to take a punishing restructuring charge on idle plants and equipment.

GaveKal partner Steven Vannelli says that companies are reluctant to discuss the scope of their platforming for public-relations and competitive reasons. Yet their financials often afford telltale indications of their embrace of the strategy. Most tend to generate more cash than they did in the past. Likewise, revenue per employee surges as plant, property and equipment on the asset side, and debt on the liability side, dwindle on corporate balance sheets.

Capital instead is poured into research and development and worker training. Working-capital requirements swoon, as the need to finance inventories disappears, and platform companies pressure their foreign suppliers to accept slower payment for goods.

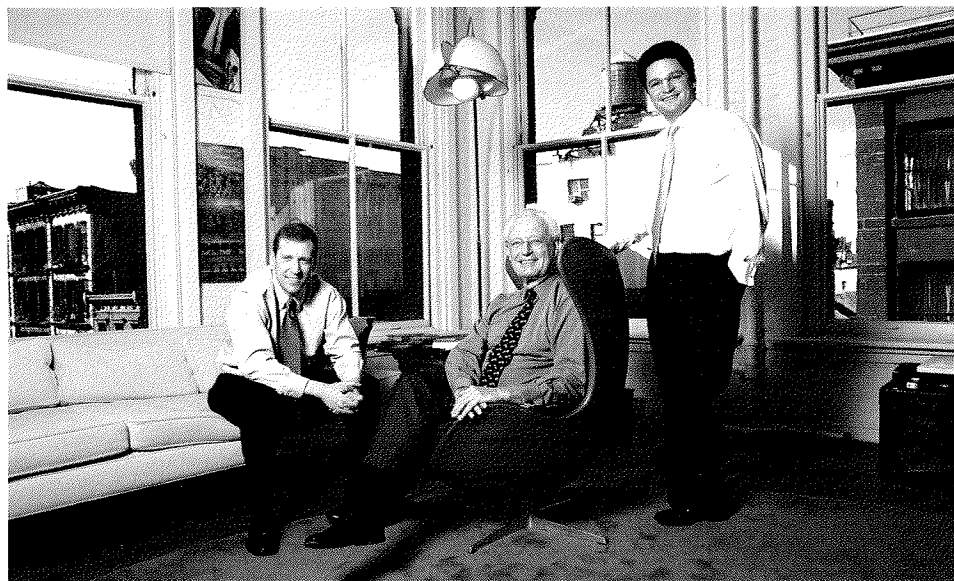
The platform model seems to be behind the surge in U.S. corporate profitability in recent years, whether measured by net income or cash-flow margins. For one thing, platform companies have reduced capital-spending needs, thus slashing their debt-service burdens. Motorola has seen its capital spending fall from 80% of its cash flow in 2001 to just 12% this year. In the past decade, its net investment in property, plants and equipment has dropped from more than 30% of its assets to 5%.

At the same time, research and development spending has soared in the platform economy. It's crucial, of course, for companies outsourcing in China to stay one step ahead of the local manufacturers because theft of intellectual property is rife in the Middle Kingdom. This year, the U.S. will spend some \$330 billion on research and development, versus No. 2 China's \$136 billion. And the Chinese number is inflated mightily by U.S. and European multinationals, which have shifted some less critical research operations there.

For many platform companies, R&D now dwarfs capital spending. At **Danaher** (DHR), a maker of tools, sensors and testing equipment, research spending jumped from an amount equal to 150% of capital outlays in 2001 to one equivalent to more than 300% last year. And the ratio of R&D to capex has zoomed in the high-tech arena. At semiconductor company **Analog Devices** (ADI), it's now about 6-to-1, versus 1.5-to-1 in 2001.

The advent of China and other developing nations as the modern world's workshop is a Faustian bargain. In return for their new prominence, these countries are willingly importing much of the risk and cyclicity from platform economies like the U.S. Reliance on manufacturing is eminently preferable to that most risky of activities—agriculture. Indeed, millions of unneeded farm workers are streaming into Asian cities, seeking better jobs. "In effect, China is trading job growth for the profits flowing to U.S. and other platform economies," Louis-Vincent Gave notes of a phenomenon that he has closely tracked from GaveKal's office in Hong Kong.

And this trend is in its early stages. More than 300 million agricultural workers figure to move to industrial areas on China's



From left: GaveKal's Steven Vannelli, Charles Gave and Louis-Vincent Gave argue that Corporate America and the U.S. economy in general are far healthier than many pundits believe.

eastern and southern coasts over the next two decades. Similar migration patterns are evident in India, Vietnam, the Philippines, Indonesia and Malaysia.

Thus, there's little indication that Beijing will slow its prodigious spending on manufacturing and logistical infrastructure like roads, ports and industrial parks, despite huge overcapacity in many of its domestic industries. China may have more than 300 car makers and 3,000 ball-bearing outfits, but each local entrepreneur is eager to accept cheap government financing and continue to grow, regardless of profitability. Perversely, each figures he will survive the Chinese economy's inevitable shakeout only by being deemed "too big to fail," Louis-Vincent asserts. Such operators become easy pickings for the West's platform companies.

The massive reordering of the global economy engendered by the platform model is an unalloyed good, according to GaveKal. Productivity is enhanced. And intellectual property and knowledge is harnessed to garner the higher returns that accrue to breakthrough products and technologies.

GaveKal developed the platform concept after noting global economic developments that seemed inexplicable on their face. Perhaps most important was a quite noticeable drop in economic volatility or swings in growth in many post-industrial Western economies. Annual swings in industrial production or non-farm employment since the 1950s have traced a telling pattern. Beginning in the early-'90s, jagged peaks and valleys begin to flatten at relatively favorable levels.

U.S. consumer delinquency rates on mortgages, credit cards and auto debt plunged from over 6% of the totals outstanding at the beginning of the '90s to 1.5% to 2.5% over the past decade, even as con-

sumers leveraged their household balance sheets to unprecedented levels and "sub-prime" transactions became common.

Meanwhile, corporate earnings went on a tear. After-tax profits and cash flow as a percentage of gross domestic product are at record levels, exceeding 8.5% and 15%, respectively, according to the Bureau of Economic Analysis. "The platform model seemed to offer the clearest explanation as to what was happening," says Charles Gave. "We first noticed these economic changes in Sweden in the mid-'90s, but now the U.S. has embraced the change full-hilt."

High on every pessimist's list is America's yawning and growing current-account deficit, which represents mostly our negative balance of trade with the rest of the globe, supplemented by the difference in income that U.S. and other nations earn on investments in each other. The nation's current-account shortfall, which has steadily worsened since the early '90s, is expected to equal about 7% of GDP this year—a banana-republic level.

The conventional wisdom holds that foreign central banks eventually will tire of sopping up the sea of excess dollars generated by chronic U.S. trade deficits and stop buying debt from Uncle Sam. If this happened, interest rates would soar, and the dollar would tumble. Or foreigners recycling excess dollars into American stocks and bonds would end up controlling most of the U.S. economy. Warren Buffett, for one, argues that America is well on its way to becoming a sharecropper society—hocking its family jewels to finance insensate consumption.

To GaveKal, such doomsday prophecies are silly. For starters, even if one assumes that the current-account deficit will stay at its current level for some time, this would pose no particular peril, in the firm's view.

U.S. household net worth, including stock and bond holdings, the value of private businesses and homeowner equity, stands at \$54 trillion, according to the latest Federal Reserve data. This is far larger and is growing far faster than the \$2.5 trillion we owe the rest of the world (in excess of U.S. asset holdings abroad).

So instead of saying that this year's expected current-account deficit of \$800 billion is 7% of GDP, it's more to the point to say that it's slightly less than 1.5% of national wealth. U.S. net national wealth has risen over the past 50 years at a steady 5% to 6% per annum in nominal terms. At a current national net-wealth growth rate of about \$3 trillion a year, the U.S. generates more than enough assets to cover the \$800 billion it must borrow abroad. The current U.S. ratio of net foreign debt to national net worth is 4.6%. That hardly bespeaks impending doom.

According to GaveKal, quirks in international trade accounting paint a misleadingly melancholy picture. Trade measurements do a much better job of capturing the flow of physical products, which can be precisely measured by shipping manifests, than that of services, America's strong suit. Much of the latter involve the dark matter of intellectual property, such as consulting, training and financial-management services that often move electronically and are unvoiced.

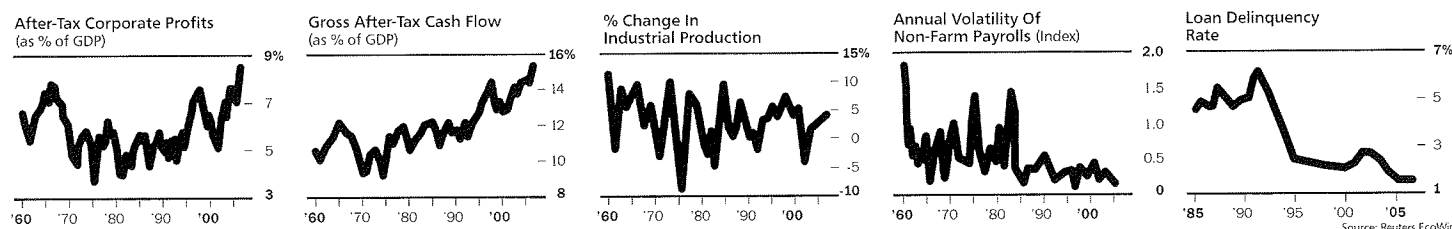
Of even greater moment is the fact that trade statistics measure dollars per sale, rather than the profits derived from sales, according to GaveKal. The sale in the U.S. of a \$700 Dell computer might generate a negative trade balance of \$450, representing the purchase from Asian companies of various components shipped for assembly in the U.S. Yet that same transaction might generate only a \$30 profit for the Asian vendors working on slender margins, while the American companies—Dell for its mark-up, Microsoft for its software and Intel for its microprocessor—might realize a profit of about \$250. The U.S. comes out a big winner, even though, through the prism of the trade balance, it appears to be sucking wind.

Pessimists also worry that the foreign capital flowing into the U.S. is being squandered on consumption, rather than being spent on the productive capacity necessary to make the nation competitive on the trade front. America is deemed to be eating its seed corn by wasting recycled trade surpluses from China and the like on cheap mortgages, flat-screen TVs and lids of cocaine.

GaveKal vigorously disputes this notion. In fact, much U.S. consumption goes toward health care (an investment in human capital, according to the firm) and education. "Who can calculate in a knowledge economy the importance of the U.S.' superior university system, for example?" asks Charles Gave.

The Telltale Charts

Over the past few decades, U.S. corporate profitability and cash flow have risen sharply, while gyrations in industrial output have moderated and swings in non-farm payrolls have plunged. Meanwhile, the credit-delinquency rate has plummeted, despite a rise in subprime loans. The cause, according to the GaveKal research firm: the rise of a new kind of business model that bodes well for the future.



“Not when you realize that important global enterprises like Google, Cisco and Sun Microsystems literally emerged from the dormitories and labs at Stanford University.”

Likewise, Corporate America’s world-leading spending on research and development—the aforementioned \$330 billion a year—counts as consumption, not investment, under generally accepted accounting principles. R&D is treated as an intermediate cost and expensed annually, rather than as a capital item to be written down over several years. Yet research can yield revenue for years to come.

There’s little wonder why foreign nations are willing to finance the U.S. trade deficit. America boasts cutting-edge technology, high-margin companies and enviable productivity growth, plus liquid financial markets, political stability and strong private-property protection.

A platform economy is inherently less volatile than a developing one like China’s, which is high in both growth and risk. That’s a big plus for wealthy investors. Only severe capital controls in nations like China, which force businessmen to remit their excess trade dollars to central banks, keep even more private investment capital from streaming into the U.S.

“The big risk is not that foreigners will lose their appetite for U.S. assets, but that Americans will refuse to sell assets to foreigners,” Charles Gave notes acidly. The greenback was pummeled this year after Congress wouldn’t permit Dubai to keep a controlling stake in a company managing key U.S. seaports and when a Vietnam trade-normalization bill was delayed. Currency markets abhor impediments to the free flow of investment capital.

Yet GaveKal foresees no impending collapse for the buck. In fact, it expects the dollar to strengthen over the next year or so. The greenback, after all, is the basic medium of exchange and font of liquidity for the global economy, and promises to remain so for years because of Washington’s political, military and economic might.

In fact, it was the large U.S. current-account deficits of the past decade or so that permitted the global economy to emerge relatively unscathed despite the 1995 Mexican peso collapse, the 1997 Asian financial meltdown, the 1998 Russian ruble crisis, the

2001 tech meltdown and the recent surge in commodity prices.

As GaveKal’s Anatole Kaletsky has observed, while U.S. trade deficits have consistently grown over the past 20 years, the global economy has enjoyed unprecedented stability and growth. And the U.S., Britain and other chronic trade-deficit lands have significantly outpaced Japan, Germany, Saudi Arabia and some other nations with surpluses.

The research house also thinks that U.S. stocks are still dramatically underpriced, despite their recovery since the 2000-2002 bear market. A key to this is the stability that platform companies have injected into the economy and which shows up in corporate earnings and the financial markets themselves. An indication is seen in the collapse in yield spreads between low- and high-risk bonds. Or take a gander at the Chicago Board Options Exchange Volatility Index. The VIX closed around 10 Thursday—less than half its level three years ago.

This new stability alone would argue for a jump in price-to-earnings ratios from the current level around 16 for the S&P 500. When risk premiums fall, stocks rise. GaveKal also contends that the recent jump in corporate profit margins and returns on invested capital isn’t yet fully reflected in stock prices. And, the firm argues, the growing adoption of platform strategies in the U.S. argue against a serious reversion to the mean.

In addition, the supply of common stock in the U.S. is beginning to shrink as a result of heavy corporate share buybacks and a frenzy of leveraged buyouts. This development is hardly surprising to GaveKal. Platform companies require far less capital because they concentrate on product development and sales, leaving to parties abroad the heavy financial lifting entailed by manufacturing.

Meanwhile, a huge global pool of capital has developed from rising corporate cash generation and the prodigious savings rates in China and elsewhere in the developing world. “It’s thus no mystery,” Charles Gave maintains, “why buyouts are escalating when folks can borrow at 6% and buy S&P companies that earn an average of around 9% on their cash flow divided by their mar-

ket price. That’s a 50% return on your money. That alone argues for a melt-up in U.S. stock prices.”

A meltdown in U.S. housing prices could play hob with such a scenario by crushing consumer demand. GaveKal doubts that housing prices will fall much, however.

For one thing, the U.S. consumer is no more levered with mortgage debt than households in, say, Great Britain, Australia and the Netherlands. For another, over the past eight years, real housing price growth in Ireland, the U.K., Spain, Sweden, France, Australia and the Netherlands have all outpaced that of the U.S. Nor has the housing markets in Britain or Australia suffered any major ills, even though the central banks in both countries tightened earlier and more aggressively than the Fed, causing more of an economic slowdown than the U.S. has yet experienced.

Housing bears tend to ignore the favorable impact of the increased stability that platform economics have brought to the U.S. True, America has lost manufacturing jobs as a result of outsourcing abroad. But blue-collar workers—the employees most at risk in an economic downturn—now make up just 9% of the workforce.

U.S. jobs are still increasing nicely, particularly in higher-paying managerial, administrative and professional categories. More workers now are ensconced in the recession-resistant service economy and have the additional security of a working spouse and the prospect of parental financial assistance in a pinch. This, perhaps, explains why consumer delinquencies have dropped so drastically.

Charles Gave doesn’t deny that his Brave New World platform economy could come a cropper. The biggest risk is protectionism, fanned by demagogic politicians bemoaning the U.S. loss of jobs to China and other countries. A large tax boost or monetary-policy mistake could threaten GaveKal’s scenario, too. And, of course, a major war could imperil the huge U.S. global asset base so painfully accumulated since World War II.

Optimism is often a tougher sell than bearishness. But, based on the trends of the past half-century, GaveKal’s argument looks like one worth buying. ■