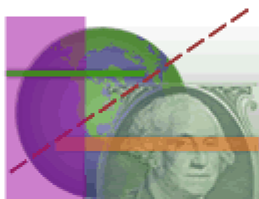


FINANCIAL SENSE ONLINE

Newshour's Ask The Expert

TRANSCRIPTION OF INTERVIEW

August 20, 2005
Barry B. Bannister, CFA
Managing Director, Equity Research, Legg Mason Wood Walker Inc.
Topic: Commodity Cycles

Editor's Note: We have edited the interview in this transcription for clarity and readability. The original real audio interview may be heard on our Ask The Expert page.

Barry B. Bannister, CFA

JIM PUPLAVA: Joining me on the program this week is Barry Bannister, CFA. He's an investment analyst and investment strategist at Legg Mason Wood Walker in Baltimore, Maryland.

Barry, I want to start our discussion with some macro issues that could impact the markets and commodities. We have a couple of scenarios: scenario one, the US economy continues to grow strongly, the Fed raises interest rates, oil prices start to rise – that's one scenario; another scenario is, as a result of these, we get a weak economy and a hard landing. Let's talk about that.

BARRY B. BANNISTER, CFA: You're hitting it on the head. I think there's the 'darned if we do, darned if we don't' scenario: that if we have a strong economy oil will rise, and the only reason oil would fall is if it reached a clearing price that slowed the economy, and that's not a very good outcome either. But oil is already rising, and that's because we have strong demand and fairly tight supply from years of under investment. [3:17]

JIM: What about some of the implications – I remember when oil prices hit $40, they said that would slow down the economy, then the figure was $50, and now we're looking at over $60, and we're still going strong?

BARRY: If you go back to the peak, around 1980 oil was around $95, inflation-adjusted. It would be a long way from the prior peak. Also, consider that the US and Western Europe are less oil intensive than they used to be. But on the other hand, we have large trade deficits from countries that use a great deal of oil to make manufactured goods that we import, so we essentially import a lot of our oil in finished products, not just in raw form.

Another factor to consider, Jim, is that oil demand is now largely inelastic, which means that as the price goes up that doesn't mean that the demand goes down. You have no other choice, to fly a jet, or to drive a car, than to buy oil, as opposed to 50, 40, 30 years ago, when you could cease using industrial boilers, and quit burning oil to heat homes, and so forth. [4:24]

JIM: If we look at the last two centuries we find that commodities sort of inflate and deflate in unison, with

energy leading that. In terms of patterns where we are now, where are we?

BARRY: Energy doesn't always lead. Sometimes, such as during wars, you might have U-boats, so agricultural prices may be very strong because it's pretty hard to get the trade done, or you have to divert some metals to other uses in wars, and so metal prices have to be price controlled and rationed. But energy is the core. It is the life blood of economies. It prevents devolution to disorder; it holds everything together; it courses through the veins of the industrial economy; and without energy you simply wouldn't have anything. You wouldn't have any activity, except maybe brain power, and that may only last as long as your food supply, which again is derived from energy: used to make food, fertilizers – is driven by energy prices, nitrogen fertilizer requires natural gas and so forth – also, you have to feed the animals and process the food. And so nothing happens without energy.

Now we're at the bottom of one of these cycles, I believe. They've averaged about 18 years in each direction, up and down, so that's 36 years point to point; we've had 6 or 7 upturns and downturns in the last 2 centuries; and we seem to be in one of those upturns, the last one having been in the late 60s, and we're doing it again. [5:50]

JIM: In your opinion, we're only at the bottom, so if we look at energy prices, lead, copper, zinc, agricultural prices, this would imply that we've got much further to go.

BARRY: Yes, usually what happens, Jim, is that the more supply-inelastic things – that's things that just can't be turned on overnight, such as real estate prices, energy, agricultural and metals prices – are the commodities; they tend to go up first. And it's partially demand, partially a lack of supply, partially the devaluation of the currency that you are denominating those items in. So, it's not so much that real estate is going up in price, it's the value of the dollar, versus real estate, is going down. [6:33]

JIM: Now, in past rising commodity cycles, prices foreshadowed a rise in consumer inflation. In fact, price peaks only occurred when you saw, for example, towards the end of the 70s, new supplies were developed, economies were weakened, we had the recession of 80-81, and reflation devolved into stagflation. We're nowhere near any of those right now, in my opinion, are we?

BARRY: No, and that's part of your earlier point which is correct: we haven't reached a clearing price yet. We are way, far away from stagflation; we can absorb much higher energy prices and eventually we will have to try to monetize the costs. You can't monetize oil because it's denominated in dollars, but you can print more money to keep people employed, or at least keep the economy over juiced, over gunned. And that may be the outcome here, but eventually stagflation is the result. That probably is 10 years away. As far as the near term though, it's not a consumer price inflation problem, on a widespread basis, but it is a problem on a standard of living basis, if you are trying to afford a home, to afford these prices, and if you're trying to afford gasoline and starting to pay prices for things that are not oil related like tuition, medical care. We are seeing some inflation in the cost of living, or I should say, the standard of living of the country. [7:57]

JIM: There's an argument that is often made on inflation, that is rising productivity, and especially an increased import supply coming from Asia, will keep the overall CPI rise in check.

BARRY: Well, there is a lot of new labor coming on stream, and that's part of why oil prices are high. You have China and India entering the workforce and world trade, and as such they increase the demand for commodities and price us out of the market. At the same time, they have a vested interest in keeping our interest rates low, so we'll keep consuming from them so they can employ their labor forces. I mean it's a virtuous circle in a sense, but it also leads to increased indebtedness, which raises the risk profile of both our economies. It also does prop up commodity prices for a very long period of time, and that will seep through to cost of living. [8:49]

JIM: You hear, as we do today so many times, when the price of oil is over $60 or various other commodities have risen, we've got complaints coming from builders here, in terms of lumber costs, steel costs, rebar costs. But from a fundamental viewpoint, bear markets generally lead to weak pricing, which is certainly what we saw in the 80s and 90s; you saw the industry consolidate, as you did in oil and also in the mining sector; it contracts and investment diminishes. The only way I see to rebuild this, and increase supply, is repricing.

BARRY: Yes, there is an argument that it's paper versus hard assets, stocks and bonds and paper money being a paper asset, rising and falling in value *vis-à-vis* something hard, like gold, real estate, oil, agricultural commodities, or land. That's definitely something that has already begun. It began 5 years ago; it's been masked by the fact that the broader market, such as the S&P500 or the Dow Industrials – if you want to use that index, the more recognized index – those markets, those indexes may have been stagnant for a better part of 5 years but underneath them, smaller capitalization companies, small companies, have rallied quite a bit. So most mutual funds that could pick and choose beyond the top 100 have done pretty well. But even that rally looks a bit exhausted, and I think investors have to turn to continued natural resources hedges, which I've argued for for 3 years now. Also, they need to turn to international investing, which is best done through mutual funds. [10:26]

JIM: Let's talk about some of the political factors that could impact commodity prices. One, obviously, is war, which has an impact on commodity prices, as you mentioned, sometimes strategic materials have to be rationed or controlled, and then also the influence of social programs. Right now, we have a war on terror; and with an aging population, we've got a new drug prescription program; we have social security issues facing the government, so there's greater demand for social programs. What about those impacts on commodities?

BARRY: The aging of the workforce has helped contribute to the kind of productivity that you referenced earlier, which has helped keep inflation down, but the maximum positive effect of the aging workforce – you know, it's like you and me, we reach an age where we're at the peak of our productivity but then our attention, our health, our priorities, start to shift and maybe some of our productivity diminishes as we age; but when we were very young we were less productive and when we're very old we might be less productive on average, I mean, I'm just talking nationally, in aggregate – so the peak in productivity, in the early 40s, mid 40s, of the baby boom generation is reaching that crest and that could cause upward pressure on prices. So the combination of war, legacy debt, social costs and the productivity effects of demographics could all contribute to a rising general price level. And if we don't have the price level, and we continue to have low rates and we continue to build asset bubbles in real estate, that jeopardize the financial system, we only create more hazard and risk in the system, and ultimately that could lead to financial problems. [12:03]

JIM: You've been calling for commodity inflation since 2001; you wrote a major piece back in April of that year called *The Inflation Cycle of 2002 to 2015*; you believe this will be a 15 year price trend. However, we now have a Fed rate cycle that should eventually impact economic growth. Does that argue for a near term consolidation, or perhaps a soft patch in prices?

BARRY: Even if the Fed is hiking rates, it looks like China may be reaccelerating their money supply growth, which correlates with their bank credit, which correlates with the growth of their economy. It has shifted up and down for the last 6 years or so: it went down from 1999 to 2000, up sharply from 2001-2003, down sharply in 2004, and is now reaccelerating from 05 into 06. So China could reaccelerate, and that's partially why oil hit record high prices last week. The demand for commodities is a global phenomenon, it's not just driven by the US economy. And Europe even looks like it's trying to perk up a little bit, Japan as well, and that'll increase energy demand as time goes by. [13:14]

JIM: You know, it seems like anytime we see a nice run up in either energy prices or commodities, they bring out what I call the 'China card'. I remember April 2004, there were big stories that China was going to slow down, their economic growth was going to get down to 5 or 6%, and therefore less demand for commodities, but we found out by the time we got to the third and fourth quarter of last year, China's growth rates were above 9%, as they are today.

BARRY: China's also got some non-official economy – and they're fairly industrious people, and I suspect they are growing pretty well below the radar, not black market but unofficial economy – which is growing pretty nicely. And India, of course, is waiting in the wings. They've had a legacy of bureaucracy, but in the information technology and financial industries it looks like they have a great deal of potential to grow; they are the world's largest democracy; they largely speak English, thanks to the legacy of the British Empire; and India has a younger population, which will steadily reach its most productive years in the next 20 years. So India's oil demand is going to skyrocket as well. So it's all back-to-back. [14:25]

JIM: Well, speaking of energy demand, looking at the individual sectors, energy companies in particular, they've done very well, when do you think we'll see the surge in CAPEX spending. Even though companies are spending money, I don't think we've seen a great surge in CAPEX spending from the majors yet, have

we?

BARRY: Not much, you're just starting to see backlogs rise, and companies that service these sectors and build their capacity, and you're starting to see the oil service rig count up sharply, since the 99 bottom it's about doubled, but it was down for so many years. Your first wave of performance is the commodity, and then the second wave would be the commodity producers, and the third wave of performance is the people who serve the commodity producers: the service companies. And so you're starting to see some of that, not as much as you saw already, but because they're fairly light on assets and they have the ability to magnify their return on capital, those industries that serve these cash intensive, cash using, capital intensive, reserve purchasing commodity producers, these serving companies may be attractive right now. So, look for funds that consist of those kinds of companies. [15:48]

JIM: Does the same also hold true for the mining sector, whether you're looking at gold mining, copper or any of the others?

BARRY: Yes, the mining sector has had a great move, and they're growing very rapidly on the return on capital volume, and so the next most logical conclusion is they would capital spend at rapid rates. So you've started to see good performance out of the mining equipment makers shares, and it will just continue to grow. You look for industries where there's been a sharp reduction of capacity to produce the type of goods, services, equipment, or whatever, that are needed by these producers and commodities. You look for where the commodity is difficult to substitute, where there's strong demand. And it leads you to pretty good investments. [16:35]

JIM: What about agriculture, Barry, it seems very vulnerable with rising energy prices in terms of direct costs – the diesel fuel to run the tractors and combines and also fertilizer – and indirect costs, such as even processing the commodities, and transport.

BARRY: Well, the historian Will Durant, I think he said that, "technology is a parasite on the man with a hoe." So the problem with farming is that it becomes productive, and productive farming is going to deflate its own primary commodity, and leading to their own output being devalued constantly. It's a race to the bottom. But what's happening now is that the demand for agricultural products, such as the rising meat consumption that comes from wealth, is causing agricultural prices to firm. The other thing that's driving it is the inputs to farming, which are, as I said before, the fertilizer – that uses natural gas to make nitrogen fertilizer – the diesel fuel, the processing cost, the power for the refrigeration, are all driving up costs for agriculture. And the other thing that's happening is energy in agriculture – to turn farm products into fuel such as biodiesel and ethanol – which is an arbitrage method: it is arbitraging people away from eating food, rather to burning it as a better alternative. All these things are contributing to rising commodity prices, and since it is the lagging group, it seems to point to the fact that that commodity group – agriculture – may be the next to turn. [18:13]

JIM: Assuming we hit a soft patch, or even a hard landing – if the Fed continues to raise rates – that may slow down demand in the short term, to some extent. What about the long term catalyst that makes this a long term trend?

BARRY: Well, I've said there's been many years of low returns on capital. Only a fool would have put new money into oil field technology in the late 90s, when obviously the best money should have been spent on Internet. But the good thing as an investor is your interests are not aligned with the general consensus of the public: I don't think like the public; I don't act like them; I think in terms of what could be, or what's going to be, not what should be. So when I looked at investment in the late 90s in energy, mining and new mines, we purposefully reduced the capacity through underinvestment. All we needed was a demand catalyst, which was the Chinese and Indians, to help tighten up the market. And then we had the ingredients present for a supply and demand driven bull market for the hard assets, which are very difficult to produce, it takes years and years to bring fields on stream, to make them productive. And so I'm fairly pleased the investment is just beginning, which means that the peak is probably not till 2010-2012 for the investment rate, and so the new supply will not be an issue for probably 5 more years, as far as I'm concerned. [19:44]

JIM: One thing that stands out as we take a look all across the spectrum, whether you're looking at energy; we haven't built a refinery in this country, I think since 1976; we need more pipelines to carry natural gas; we need more power plants; and we also need to be finding more natural gas and oil. Do you think there's been enough incentives to keep these drills running, for example, in the energy and mining sector?

BARRY: The US has no spare production capacity; it imports more than it actually produces in oil and gas, same with the Canadians and US combined. And so, we are net importers, as is Europe, as is Japan, and China is increasingly importing. What's going to happen is that we'll be trading dollars for other people's products; we'll be hoping that the spread of capitalism and democracy leads to an increase in supply through sheer investment and efficiency, instead of the rife corruption you have like in some West African oil producers; you'll have more accountable governments and countries, and people whose lives could be positively affected by the flow of oil money, will actually enjoy some of those benefits. So I mean, President Bush's philosophy is very much a humanitarian view, in that sense, that the world becoming capitalist democracy, is one that will be accountable to the people and the wealth that has been squandered in West Africa, Mexico and other places, will then be put to use for the people's benefit. So state-owned oil companies are anathema to that, as are dictatorships, and theocratic dictatorships as well, so we have a real problem with a lack of the sort of capitalist democracy infrastructure that will promote higher oil supply. And until that is fixed, I don't think the market is going to be that loose, it's just going to be tight for years to come. [21:41]

JIM: That brings up another issue as it concerns energy, and that's the world's oil supply is located in probably some of the most unstable parts of the world – if you look at the Middle East and the Caspian – I mean it's just hard to see democracy, at least at the moment, coming to those areas.

BARRY: Yes, I believe there are only a couple of countries, including the US, in the world where the people can own the mineral rights. So the state has its fingers in it. When was the last time the government really ran anything other than a war well? So the problem we run into is that these inefficient, state-owned, poorly capitalized, poorly managed, poorly executed companies in some cases – or they get greedy and corrupt and they chase off the kind of talent the US or European majors can bring to the table, by inviting them in, using them, and then taxing them out of existence, as Venezuela is trying to do right now. Russia has tried it as well. So we need accountable oil companies. Americans don't want to own the oil companies, we want the oil companies to be efficient so that they can produce ample quantities and relieve the tightness of supply. There's plenty of oil, the problem is getting the capital and people motivated, and mobilized, to get it out. [23:04]

JIM: Let's talk about China and India for a moment. If we look at the last bull market in commodities, in the mid '60s and mid '70s, it was mainly perhaps a Western oriented commodity cycle. Now we've got China and India, that are almost half the world's population, that's a major factor this time around, don't you believe?

BARRY: The fastest growing parts of the world are the most commodity poor. I like to look at history a lot – in fact, I just had a debate with somebody about whether the devaluation of the dollar would follow the path of Emperor Justinian of Rome, and I said no, because we haven't even declared we're an empire let alone try to reconstruct it as he did. So I don't believe history can be used willy-nilly, and certainly not carelessly. But in terms of why this cycle is very different from past cycles, is that it is very much a factor that the fastest growth is coming from South and Eastern Asia, and they just don't have adequate commodity supplies to feed many of their needs. They do have a lot of coal, which is actually bullish for coal and coal related equities. But they don't have a lot of oil and gas. [24:15]

JIM: Also in the developing parts of the world, with Asia and Latin America, you have younger populations, if you compare that to Europe or the United States.

BARRY: Younger populations are good in that they are willing to take entry-level jobs and they work pretty hard; they're not as productive at the very younger end, but they become more productive as they age. The Europeans opened up themselves to immigration from North Africa, the Middle East, and Eastern Europe, and there have been cultural frictions, obviously, due to that, but on balance they benefit from the 'youthening' of their population. We have opened up parts of our economy to Central and South Americans, who've helped keep our labor costs down, have worked hard, and as they assimilate into society – pass one generation into another – become middle-aged and highly productive and part of the fabric of the economy. We just get stronger for it. If you go back to the early 20th Century, we did it with immigrants from Italy and other parts of Europe. So, when you think about it, it's one of the things that made the US strongest – is that we've obtained a free flow of capital, with finance and a floating dollar; we've obtained the free flow of labor with immigration; and we had the land, we had the US West, which we kept pushing West and obtaining more and more land, more commodities. So we had everything: land, labor and capital, which made us very, very powerful. And countries that have all three are going to be powerful; and countries that don't have all three, they'll have to struggle, but they have a chance of maximizing their strengths like Japan did on its front. [26:01]

JIM: Looking at some of the larger macro issues as it applies to the US, we've got rising trade deficits – the budget deficit is going down, with the increased tax revenue and the economy doing well – but debt is rising exponentially; some argue the result could be deflation, others say inflation. What say you?

BARRY: Almost all of the debt is directly or indirectly backed by the people who own the printing press. There's 'too big to fail' as a doctrine. So you have a handful of very, very large banks and financial institutions; you have Federal guarantees of a lot of mortgages and of course guarantees of some of the banks – some of the banks are viewed as too big to fail for there to be an FDIC loss event – so there is a moral hazard: people willing to take the risk because they feel they will be bailed out. And having the power of the vote, a great deal of people are going into debt on the consumer level, because asset values are rising due to ever lower rates, partially due to this recycling with Asia of our trade deficit – they buy our Treasury debt and keep our rates low so we can buy from them – but the risk is you create this moral hazard calamity one day that causes the people who do control the printing press to say a) of the people who loaned me money, those who are foreigners, which is about 45%, I believe, of all of our debt is owned by foreigners, they don't vote, so they don't matter as much; and b) the people who do vote here are in debt and they want easy money. Easy money would hurt Wall Street, it would hurt people who own long term bonds, and those people would be on the losing end if that ever happened. So I don't fear deflation, I would actually fear, if we had a deflationary event, more of a strong reflation as a political response. [27:49]

JIM: I wonder if you might contrast where we are today compared with the 30s. In the 30s we had probably a lot more GDP compared to debt, and today we've got a lot more debt compared to GDP, I would say that argues for different outcomes.

BARRY: If you look at debt, excluding what's called 'financial debt', which may be double counted – double counting of debt which in the financial sector means if you issue a mortgage it is a debt of a consumer, but if the debt is turned around and bundled as an asset backed security by Fannie Mae, then it becomes debt twice – so if you exclude that twice counted debt, debt-to-GDP is about where it was in 1928-29. The deflationary calamity of 29-32 caused the debt in nominal terms to stay flat, but the GDP to just sink, to fall away, and there was a deficiency of GDP. We don't have a deficiency of US GDP now, we probably have a deficiency of world GDP because of all the underutilized people in the world. So there will be a push to grow the world at a high nominal rate. So, as far as debt is concerned, it would become difficult to compete with those people for capital and resources; so it may be we're seeing the bottom of interest rates, but arguments that we're going to have a calamity are probably premature. [29:08]

JIM: We've seen the dollar rally since the beginning of the year, but we've embarked on what I call a 'guns and butter' policy: we've got the War on Terror going; we've got social programs coming into play, so we've got higher debt. Do you see the dollar remaining strong?

BARRY: I think the dollar is in a long term weakening mode. As long as the US retains a very, very large, manifold military superiority, I think the dollar will be strong, because in a historical sense, countries that had tremendous military leadership – the US is unrivalled in history in terms of its leadership – tended to maintain a fairly strong currency because people saw them as a safe haven or a place to store value. One risk is that the new era of warfare is asymmetric, with small non-state groups, and individuals who are empowered by technology, so it increases the urgency to spread the benefits of capitalist democracy and the wealth around the world. Now, if that requires that Americans have to pay more for gasoline so we can make the Middle Easterners richer through the sale of their oil so they stop blowing up buildings, then that's what it's going to take. And if it requires that we have to actually pay a higher rate because the world's supply of capital were to tighten up – it's not tight now, but if it did – so that we could keep the Chinese happy, then so be it, we pay a higher mortgage rate. But we all benefit in the end, just through peace, capitalism and democracy. And as far as being the sole high standard of living, the sole superpower with an absolute, unrivalled standard of living, that's probably going to be peaking in our very lifetimes. [30:50]

JIM: Given the fact that we're going to be embarking on a rate raising cycle right now, with the Fed raising rates, what options does it have in terms of reflation? Let's say if the economy does slow down, maybe we get a hard landing, soft landing, whichever one it is, what does the Fed do, lower interest rates again, pump money in, and if that's the case, do we get another bubble somewhere?

BARRY: Let's just say we rolled from a bond bubble in the Greenspan era in the late 80s, early 90s, to a stock bubble in the late 90s, to a real estate bubble in the early 00s, so rolling asset bubbles are creating their

own little dislocations. Very few people owned bonds, more people owned stocks, and everybody seems to own real estate, so the bubbles have become more democratic, but in so doing they just become larger. The only good thing you can say is people aren't going to sell their house for a gain if they don't have some place else to live, so there is a certain illiquidity to the most recent asset bubble. Affordability could become an issue and I do think that is one problem as these securities reprice. We either devalue the dollar substantially versus real estate, which is inflation, or we are going to create some real problems on repricing for a number of mortgages, especially the interest-only ones. Now, as far as Greenspan, when he leaves office, in theoretically January of 06, my personal guess, and this is not a firm guess, is Bush is going to want someone who is a strong advocate of Social Security reform and entitlement reform, because the entitlement system in the country is the ticking time bomb. All the money we owe the retirees from Medicare, Social Security in the future is just huge. So he's going to want somebody at the Fed – assuming the next President may even be a Democrat –who's a strong, conservative hand, and wishes to achieve entitlement reform. And the only person I know of who fits that bill is Professor Feldstein at Harvard, and so that would be my guess as to the next Fed Chairman. And I don't think he's going to come in and just start cutting rates. I think we are going to actually invert the yield curve or come close to a flat yield curve in the 10 year versus the Fed Funds – 10 year Treasury versus Fed Funds – and that will probably succeed in slowing some parts of the industrial economy down, which has been my bet for the most recent few months. [33:13]

JIM: Now, if we get this rise in interest rates and perhaps if inflation ticks up, doesn't this also argue for a significant change in market leadership – if you take a look at this cyclical bull market that we've been in, in stocks it's been led by the technology stocks which have done well, the financial stocks have done well, but I would assume in this next round, whatever emerges, there's going to be another asset class or group that rises to the forefront.

BARRY: True, but I think some of that has already begun. If you go back to 2002 most of the markets were bottoming, including the small caps, everything was bottoming around October 2002. Some of the very strongest performers, such as large copper producers that have more than quadrupled in price, oil E&P, oil services companies have begun to rally. These companies have already begun to move, the question is how long will it last, how strong could it be, and could there be a pregnant pause, an interruption caused by the Fed realizing that they have prompted a slowdown, and therefore can't afford to be tight, and so let it go. And that happened in the 70s, Chairman Art Burns, I think, after some bank problems in the early 70s, and the oil shock, kind of realized that negative real rates were going to be pretty much the norm, and his successors were more in tune to that thinking, and it took Volcker actually, to jack up rates in the early 80s, and whip inflation. But prior to that we'd had to suffer through inflation, and unless you happen to be on the receiving end of pricing power, which you should want as an investor, you did pretty well – so one man's sushi is another man's bait. And what we call inflation, the Arab Oil sheiks called a good pricing environment. [35:02]

JIM: I guess also looking at the demand for commodities, now that we've got India and China growing, how do we resolve these competing demands for scarce resources, and do so without resorting to war?

BARRY: That's what I hope. Somebody always gets greedy it seems, or somebody tries to secure their supplies forcefully, but I don't think the US has been engaged in that. I think we've definitely tried to promote accountability and democratic governance around the world. It's going to take a long time though, and certainly far beyond this Administration's tenure, and I don't frankly see anyone in the wings with enough vision to promote the agenda. So I am a little pessimistic that what you describe could occur. [35:52]

JIM: Given this environment, Barry, in terms of where we are in the cycle, where would you be investing?

BARRY: You should have a healthy dose of these natural resources funds, basic materials funds, in your portfolio. I thought, where other people, 3 or 4 years ago thought 10%, I was thinking 25-35% of your funds should be invested in basic materials, natural resources and the like. I wouldn't waver from that, certainly about a third of it should be in that. The other third should be in international funds: not just Europe, but Japan is coming out of its long slumber; the emerging market funds – while not cheap have a lot of growth ahead of them and their return on personal capital there should improve. So if they improve their utilization of the upfront costs of development, they'll generate higher and higher returns, and therefore the stocks will be rewarded; the PE valuations will become higher as they become less volatile – the South Americans and Asians and such. So a good third of it should be international. And then the other third should be domestic. Now we're talking pure equity. I'm not going to talk bonds because that's just not my area, but on the pure equity side, the other third would be domestic but with very much of an emphasis not on closet indexers – and

you know, big, boring funds with 150 stocks – but I would be interested in somebody who's got a reputation for stock picking, who is willing to go at all cap sizes; if you can afford it, one of the long-short hedge funds, but if you can't, then somebody who's got a reputation for bottom up stock selection – if you're going to be in the domestic portion. [37:37]

JIM: In looking forward from what you see on the horizon, what comes next in your opinion?

BARRY: Well, outgoing Chairman Greenspan's next few moves will be very interesting, very telling, as the job market picks up, and the capacity tightens up a little bit in manufacturing, these import prices flow through the system and you get your kind of later cycle spike in the price indices. I'm actually fairly bearish personally on the stock market outlook for the US in the next year, I wouldn't be surprised to see the Fed overdo it, push up rates a little too high on the short end, slow the economy and disappoint GDP expectations in the first part of 2006. So, a little bit of cash is not a bad strategy, if you're waiting for good prices. The worst mistake in investing is the tendency to want to do something, rather than wait for the soft pitches to come to you, and to run out there and try to swing at everything, because you just strike out, and so I'm fairly concerned about what the Fed's going to do in the next few months and what it'll mean for GDP several months later – there's always a lag. [42:01]

JIM: And then I guess a couple of final questions – in your years analyzing the financial markets what would you say is the most important thing you've learned?

BARRY: The best lesson was by an investor who said you should treat investing as if you had a card where you could, in your entire career, punch out only, let's say, 25 purchases, and that you were very careful where you put money, and took reasonable investment steps based on ideas you felt had really come to you, where you had a unique insight, or you had come up with a thesis, as I did, when oil was a little over $20 that it would go to $60, where I realized there was this supply-demand and dollar devaluation brew, mixing for the commodities markets that would lead to value added – things like that.

You should really just save your powder, if I had to guess as to what the most important thing I ever heard was. And it would be to be careful and only invest sparingly in ideas where you feel it's going to win, where you feel good. And likewise, when you invest, usually the best ideas give you a lump in your stomach, you're buying something that's highly out of favor such as – I bought gold mining shares back in 01 when it felt very, very bad to do so, and then very recently when they dipped, and even now I bought more. So gold mining shares feel like a very difficult thing to do. But when you find a really well managed company, and you want to invest in it and you think it's going to be a thesis, that's going to work, which is this devaluation of the dollar slowly grindingly happening, then you take that leap and you do it. [40:35]

JIM: Then I guess a final question, if you were to leave our listeners with one thought, what would that be?

BARRY: I would be careful to seek out advice, and to listen to a large variety of people. By the time something is being touted in the mass media it's probably well underway. So be careful of hype, charlatans and hucksters; be careful about listening to just one person; seek out advice from as many people as you can; and then have one financial advisor that you work with, that you trust, that you can talk to; and then place orders sparingly, and carefully and sometimes with a lump in your throat; and invest for the long term, because that's generally the only way to make money. This frenetic, crazed desire to move in and out of stocks, day-trade, and float from idea to idea, and cocktail party idea to cocktail party idea is just insane. And it's the quickest ticket to losing your money in the stock market. [41:41]

JIM: Very well said. And I want to thank you for being so generous and giving up part of your evening to join us here on the Financial Sense Newshour. I appreciate it very much!

BARRY: Alright, take care and thanks a lot! [41:51]

Mr. Bannister's Expert Page

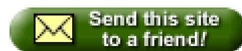
© 2005 Financial Sense™ is a Registered Trademark

NOTICE: This transcription may NOT be reproduced without the expressed, written permission of

Financial Sense Online. Email FSO Selective quotations are permissible as long as this web site is acknowledged through hyperlink to: www.financialsense.com

BACK TO TOP

Home | Broadcast | WrapUp | Storm Watch | Perspectives | Sitemap | About Us | Contact Us



Copyright © James J. Puplava Financial Sense™ is a Registered Trademark
P. O. Box 503147 San Diego, CA 92150-3147 USA 858.487.3939 disclaimer