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Thoughts Galore

In the euphoria of the stock market bubble, laymen and economists alike peddled terms like "new economy" and "technological revolution" without much reserve. In fact it was a faux pas, a social disgrace, to suggest otherwise. Currently, such terms are at the end of the proverbial stick, as the recent worldwide recession has instilled caution above optimism. Free trade, however, is but one of a few terms that have remained intact – albeit in somewhat of a weaker form.

That's not to say that the stock market bubble has engendered free trade. On the contrary, free trade is as old a concept as commerce. Moreover, I am not implying that free trade is a bad policy; in fact I am pro-free trade to a certain *degree*. Rather the point to be made is that the prior bull market has rendered us myopic to certain free trade flaws that need to be addressed and redressed.

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At this juncture, the distinction between theoretical free trade and implemented free trade is needed. Theoretical free trade is highly desirable. Its benefits are well known and widely accepted; its rationale too has been accepted to be valid. The rationale goes as follow: Society will witness higher productivity as a result of better resource allocation. This productivity in turn leads to increased production, and as a result, everyone experiences a higher standard of living. Not to mention that since goods are produced more efficiently, inflation would be lower than norm.

As with most economic principle, free trade theory and its practical implementation diverges markedly. The divergence has never been more pronounced than it does now. As note before, the unprecedented run up in the equity market has blindsided us from this divergence. So dense was this myopia, that the pertinent focus at that time was no longer the economic merits of free trade but rather its social implications. Do emerging countries embrace globalization as readily as its counterparts? Are corporation wielding too much influence on their social infrastructure? And who gains more form globalization?

But recent across-the-board recessions and markedly that of the United States have pushed such social questions aside. Now the economic validity of free trade is being questioned.

At this moment, you're probably asking: where's the proof of this divergence? To this inquiry, I answer: Simple, if free trade works as the underlying theory dictates, current account deficits for all participatory countries should be zero or at the very least show some significant mean-reversion towards zero.

Current state of international affairs, however, shows otherwise – attesting to the fact that free trade reality diverges from theory. Current account deficits on the contrary have historically exhibited momentum rather than reversion. Although current efforts are centered on U.S. current account deficit being reduced, the resulting deficit will be nowhere near the zero benchmark. In fact, the focal of the efforts is for the reversion to be *temporary*.

This temporary (non-permanent) reversion actually carries merit. If US current

account deficit were to reach zero in the intermediate future, global depression would ensue. Zero U.S. current account deficit is a no-no. This dependency further highlights that free trade might not be really free trade.

This global dependency on the strength of the United States economy is worth noting. During the prior bull market, foreign countries (especially emerging countries) economies piggybacked essentially on the back of US import demand. It came as no surprise that the recent tapering of US import demand has caused a global recession

What this means in essence is that the prior U.S. bull market, through the wealth effect, fueled other countries economic growth. Free trade had relatively little to do with the higher global standard of living, as free trade proponents would want you to believe.

What we observe is not truly free trade, but rather hyper consumption via equity-financed. In a theoretical framework, free trade should be a two way street, as the United States should be exporting as much as it's importing, at least in the long run. What we observe in reality, however, is a one-way street.

What's more problematic for the global economy is that this poor implemented free trade hurts all parties in the long run. This is most apparent, as of this writing. We'll look at the United States and the emerging countries to see why this is the case.

The topic of free trade and employment will be a hot topic in the upcoming presidential election. Free trade has become a nightmare to Americans to say the least. The painful outsourcing of jobs has hit American from coast to coast, and the date of a trend reversal is uncertain. Intermediately, the trend will continue as firms are stuck in a forced imbroglio. Firms that outsource are gaining an advantage over its non-outsourcing rivals, as labor cost would boost bottom line figures. Firms can ill-afford not to do otherwise.

An unappreciated corollary of this will be the reduction in small businesses. Small businesses are less likely to outsource than their behemoth counterparts. Thus their cost structure cannot keep pace with that of larger firms, and logically a reduction of small businesses is in order. The hard part to swallow is that small businesses account for two-third of employment in the United States.

Proponents of free trade, however, contend that jobs would not be cut but instead increase down the line. To argue their point, they point back to the 1980s, citing that manufacturing sector and its corresponding wages grew despite foreign competition. What they fail to recognize is the problem of historical correlation. The conditions that permeate twenty years back are dissimilar to what we have today. In the prior two decades, what we saw was an emerging service sectors that made up the slack. In other words, the emerging service jobs were pushing up more demand for manufacturing products. Not only did this weather the impact of foreign competition but it also boost the manufacturing sector. (The emergence of the service sector is an amazingly feat in U.S. history – one that U.S. will be hard pressed to duplicate.)

Currently firms, however, are outsourcing b*oth* manufacturing and service jobs. There is no third sector popping up to fill in the gap – like the service sector did in the previous two decades. This is a gloomy prospect and one that looks intact. The wage discrepancy between foreign manufacturing jobs and US manufacturing job is enormous. The wage discrepancy between foreign service jobs and US service jobs are even more eye popping.

What we ultimately will observe if outsourcing continues is the erosion of U.S. consumer demand. This will serve to activate a vicious cycle. With our economy (and the world economy) dependent on US consumer spending, job losses will eventually hurt firms and their profits, as the consumer demand falters. In responds, firms have to cut cost even *further*. Considering

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that labor cost usually amounts to two-third of production cost, further outsourcing would be expected. A vicious cycle indeed.

Moreover, outsourcing engenders a deeper ingrained problem: structural changes of employment. Service jobs for the most part entail educational cost, which is a sunken cost. Thus logically, people are less likely to be trained if outsourcing continues. Why get trained, when future salary does not justify the cost? A high school senior might be less receptive to getting a college degree when her projected future income doesn't look too promising. Hence, we would expect the level of education to become persistently lower as training (college, graduate school, etc) will become too expensive and not justified on the grounds of future benefits.

This ultimately leads to a structural change from a service-composed employment into manufacturing-composed employment. Why is this the case? Because manufacturing jobs does not require the sunken cost of training. The sunken cost of education and training would deter people from seeking service-composed employment.

But hold on you might inject, isn't that extending it too much? I disagree. Notice the huge discrepancy between service labor costs in United States compared to that of other countries, it is hard not to imagine firms forced to go the outsourcing route. U.S. service job wages will eventually go down to a point where the sudden cost of education would not make sense to explore. Factor Price Equalization Theory says that the service wages of U.S. should be equalize to that of other countries. I rest my case.

So overall, in the long run no one benefits from this poorly implemented free trade. Now the question becomes: how do you fix it?

Furthermore, if the shift from US service-composed employment to US manufacturing-composed employment does occur, there will little upward pressure on wages of manufacturing. This is due to the fact that firms can still outsource manufacturing jobs if manufacturing wage level in US is too high.

So do foreign countries benefit as the result of this outsourcing? Actually the answer is No. In the short run, yes. But more importantly, in the long run, no. It's true that outsourcing will benefit workers in the short run, but the demand of goods still rest on the other party – the U.S. consumers. Outsourcing forces U.S. consumer demand to fall in the long run as no job means no money to spend. Higher consumer demand from other countries as a result of higher wages would *not* compensate for this slack in U.S. consumer demand. In totality, the global demand would shrink and the average living standard would fall as a result. Logically foreign wages have to drop further than previous level if demand is missing.

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So what do I advocate? The abolishment of free trade, as we know it? Hardly, I think free trade is inevitable and a good thing. But the problems associated with this currently poor implemented free trade will only cause more headaches in the not-so-far future.

What I hope to see is a consortium of countries whereby the chief agenda is to push the United States current account deficit closer to zero through the means of a heavily depreciated dollar. A one time charge or correction, if you will. Of course, export-oriented countries would suffer in the short run. But this is the only solution that in the long run helps both parties. A whiff of pain now and none later. Moreover, this one time charge would deter other countries from being too export-oriented, and start them gearing future plans for domestic-orientation. Boosting domestic demand instead of catering to the whims of US consumer would dislodge some of the international contagion that have been the cause of some of the worse crises (Asian crisis, South American Crisis, etc).

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Weekly Harbor

It wasn't too long ago that the weakening of the dollar was the focal point on Wall Street. Economists and analysts alike predicted that a weak dollar would not only jumpstart but also strengthen the ensuing recovery.

The jumpstarting aspect has worked like a charm, but the strengthening aspect looks unlikely in the current context of an appreciating dollar.

The dollar is gaining considerable strength as of late, and the trend looks to continue. Despite Eurostocks being on the upswing, economic prospects from Euro countries look more morbid than bullish. German economy, the largest economy in the Eurozone, contracted 0.1% in the second quarter, citing a drop in export as the main culprit. (Actually, the weak dollar is the true culprit.) The Dutch and Italian economies also followed suit.

The weakening of Euro economies provides the strongest case for the dollar to continue to appreciate. On the horizon, fiscal and monetary stimuli in Europe look to become more pronounced. Moreover, inflexible structural problems would logically force monetary stimuli to become more extreme than normal – causing the Euro currency to depreciate even further if otherwise. Coupled with the recent increase in U.S. Treasury yield, the dollar is looking very attractive even on its already high perch.

The strong dollar, however, hurts the U.S. economy in two forms – one is pretty obvious, and the other is equally pernicious but subtle. A strong dollar would obviously dampen abroad revenues, as market share will be pared from U.S. hands into those of Euro and Asia. The ramifications to our recovery are obvious: weak corporate profits means more risk aversion, ultimately leading to further job loss and weakening of consumer spending.

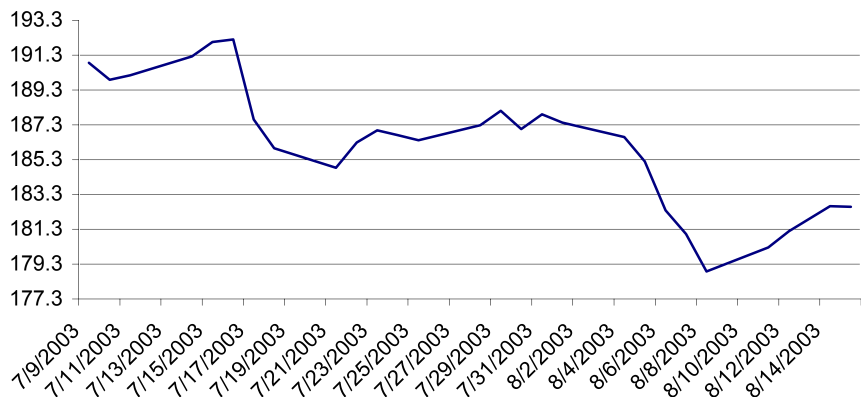
The other effect is equally detrimental to our recovery. A strong dollar would further weaken the U.S. job market, as jobs in the United States will shift to those in foreign countries. A strong dollar gives firms more incentive to hire abroad as labor become even cheaper than before. In others words, a strong dollar provides more purchasing power in terms of not only goods but also human capital. Unfortunately, this effect has been too subtle to be widely acknowledged. Nevertheless, we’re bound to witness lower consumer spending. Outsourcing can only hurt American consumer spending.

As we can see, a strong dollar is a double whammy – taking a toll out of business profits and the labor force. Logically, consumer spending has to falter and quite possibly the recovery as well. This, of course, assumes that other aspects of the United States economy would not improve *enough* to weather this loss of consumer spending. For starter, further strengthening of the housing market might weather some of the aforementioned loss of consumer spending.

But the housing market currently looks more like a sprained ankle than as a backbone to lean on. The MBA Refinance Index dropped 20% last week to the lowest level since July of last year. Although calling the end of the housing boom is premature, the significant tapering off is a ponderous harbinger of a slack in house-linked consumer spending. Not wanting to beat a dead horse, but consumer spending is the game on Wall Street.

What about capital expenditure? Would that buffer some of the loss of consumer spending? The blind spot to this suggestion is that consumer spending comprises roughly 70% of the economy whereas capital spending accounts for only 17%. Thus a 2% loss in consumer spending would require capital expenditure of more than 8%. This is asking too much in my opinion.

Thus we see that neither capital expenditure nor the housing market look posed to weather the effect of a strong dollar. What this all translate into is a weaken economy in the next six to eighteen months if the dollar

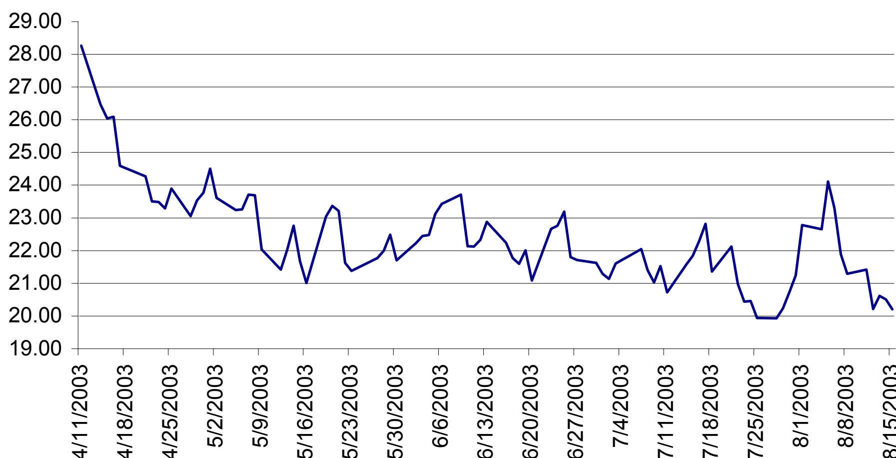


keeps appreciating. The equity market correspondingly will look weak. Unless the Fed and congress do something about this appreciating dollar, this view will hold true.

The important question next becomes one of timing. Timing after all is the crux of finance. I see the market start recognizing and discounting the effect of a strong dollar, one to six months from now. I think we'll start to see signs of this in the next two weeks.

Looking towards next week, the topic of consumer spending will continue to be at the frontline. University of Michigan consumer sentiment is due out Monday, and its outlook calls for a bullish start. Earnings of retailers are due out early in the week as well. With the plethora of good retail numbers, retailers' earning should be inline with or better than projections. The market would clearly benefit if this were the case. Overall during the early part of next week, I expect the equity market to continue the upward march.

Towards the end of the week, however, I see more selling than buying pressure. The August effect should start enforcing itself – snowballing daily declines that cumulatively should push both Nasdaq and Dow into the red for the week. The Dow should do relatively much better than Nasdaq albeit in negative territory. Furthermore, I am anticipating a volatile bond market that would also contribute to a poor week for equity. Lastly, I think VIX has hit a local minimum and is posed shoot up next week.



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Cash City

The concept of buying out-of-favor stocks is one of those hackneyed advices that investing pundits have perpetually peddled and harped on. All too often, however, it is the same pundits who do otherwise. Buying out-of-favor securities is much harder than it seems, namely because the pitch-sale are not enticing enough. The lure of finding the next Wal-Mart is a better pitch than finding the next turnaround.

In this week Cash City, I am going to make the case for Blockbuster Inc. (NYSE: BBI) as a good "boring" candidate. Blockbuster recent troubles, however, might coerce average investors into shuffling towards the exit. The astute investors, however, can profit from this extremity.

A little more than eight months ago, Blockbuster shocked the market when it announced that it would not meet its previous earnings guidance for 2002 fourth quarter. Even more troublesome was the eventual scoop that insiders were dumping personally held common stocks before the announcement was made, prompting several lawsuits in the ensuing months. The stock correspondingly dropped in the aftermath.

On top of that and arguably more important, fierce competition from the likes of Netflix, Wal-Mart, and TiVo has drawn concerns from the investing community. Netflix has already caught considerable amount of attention from Wall Street with its innovative business plan. Its plan in a nutshell is to allow customers to rent DVD via mail through a subscription-based enrollment. This attention, however, has prodded both Wal-Mart and Blockbuster to recently roll out similar plans to Netflix's. Some have argued that Netflix's first mover advantage puts Blockbuster (and Wal-Mart) behind the eight ball.

TiVo's threat to Blockbuster is more subtle. The basic premise of TiVo's business model is to allow consumers the ability to "freeze" their television sets at their convenience. This innovation might spur consumer-viewing time from movie rentals to television shows – in other

words, a substitute of television in place of movie rental.

All in all, shadows are being cast on Blockbuster's future prospect. Despite recording net income increase of 47% and revenue growth of 9.5% in the second quarter, Blockbuster is still viewed with extreme caution. Blockbuster's roadblocks are the aforementioned legal and competition issues. But theses roadblocks, in my opinion, have engendered too much pessimism. For starter: the legal aspect has not really been an issue; the likely scenario is that of a reasonable settlement. Moreover, the market has already discounted this into the pricing of the common stock.

With regards to competition, Blockbuster's market share will decline as logic dictates (more competition, less to go around), but nominal revenue growth can be sustained at a reasonable level. This is due to higher demand. The emergence of Netflix and its concept serves to introduce *more* demand for DVD rental. The share of the pie might be getting smaller, but the pie itself is getting *larger*. The overall net result would still be higher revenue. With regards to TiVo's threats, the prospect of such substitution on a grand level is a good several years down the line, if at all. Nothing in the immediate future suggests otherwise.

Moreover, the market has already discounted some if not most of the pessimism regarding competition.

To further strengthen the argument, we'll look at its cash flow. Assuming a five-year horizon, cash flow analysis dictates a favorable evaluation of Blockbuster.

Lets assume a conservative revenue growth rate of 3% along with a profit margin of 3% as well. Note that the extrapolation starts from 2002 and not from recent quarter. Thus the better than expected second quarter we just witness has not been accounted for. In other words, we're pricing it rather conservatively. Let the cash tax rate chime in at 40%. Fixed capital rate, as a percentage of additional revenue, will be tagged at a hefty 32.46%. Also, working capital rate, as a percentage of additional revenue, will be earmarked at 23.13%.

With regards to the all-important cost of capital, we'll assume 4%. Forecast for stock market return in the next five to seven years ranges between 6% and 12%. Blockbuster's cost of capital would logically be much lower as its debt to equity ratio is a respectable 0.13. And more important, its beta is –0.29. I expect the beta to range around 0.30 in the next five or so year, thus the 4% cost of capital estimate is pretty reasonable and conservative. Inflation rate is assumed to be 2%, roughly the consensus number among

	2002	2003	2004	2005	2006	2007
Revenue	$5,565.9	$5,732.9	$5,904.9	$6,082.0	$6,264.5	$6,452.4
Operating Profit	$167.0	$172.0	$177.1	$182.5	$187.9	$193.6
Less: Cash Taxes on Profit		$68.8	$70.9	$73.0	$75.2	$77.4
Net Operating Profit After Tax		$103.2	$106.3	$109.5	$112.8	$116.1
Fixed-capital investment		$54.2	$55.8	$57.5	$59.2	$61.0
Working-capital investment		$38.6	$39.8	$41.0	$42.2	$43.5
		$92.8	$95.6	$98.5	$101.4	$104.5
Free Cash Flow		$10.4	$10.7	$11.0	$11.3	$11.7
Present Value of Free Cash Flow		$10.0	$9.9	$9.8	$9.7	$9.6
Cumulative Value of Residual Value		$10.0	$19.8	$29.6	$39.3	$48.9
Present Value of Residual Value		$5,060.4	$5,011.7	$4,963.5	$4,915.8	$4,868.5
Corporate Value		$5,070.3	$5,031.6	$4,993.1	$4,955.1	$4,917.4
Add: Nonoperating Assets		$0.0	$0.0	$0.0	$0.0	$0.0
Less: Debt and other Liabilities		-$507.0	-$503.2	-$499.3	-$495.5	-$491.7
Shareholder Value		$4,563	$4,528	$4,494	$4,460	$4,426
Shareholder Value Per Share		$25.51	$25.31	$25.12	$24.93	$24.74

Figures in million

economists.

And lastly we'll assume no nonoperating asset with nonoperating debt to be 10% of corporate value.

Adding all these assumptions up leads to a fair value of $24.74. As of Friday's close, the stock is quoted at $19.16 – a 29.12% undervaluation.

Author's Note

Only one pertinent excel file is in store this week. BBI.xls is stored in the download section.