

INVESTMENT UPDATE

On November 12, the 2002 Index of Economic Freedom, jointly produced by the Heritage Foundation and *The Wall Street Journal*, was released. In its eighth year, this study analyzes countries based on such factors as taxes, trade policies, regulation, monetary policy, property rights and the size of each country's black market. Countries are then ranked and classified as "free", "mostly free", "mostly unfree" and "repressed".

It came as no surprise that the findings continued to point to a direct correlation between economic freedom and economic prosperity. Countries listed as those with the highest degree of freedom, including Hong Kong, Luxembourg, the United States and the Netherlands are far wealthier than those at the bottom of the rankings, which include Cuba, Libya, and North Korea.

With economic freedom also comes a more humane way of life. As the authors point out, "Economically free countries exhibit greater tolerance and civility than economically repressed ones, where hopelessness and isolation foment fanaticism and terrorism".

The mention of terrorism triggers the question on the minds of most Americans who might see this survey: Where does Afghanistan rank?

In fact, Afghanistan is nowhere on the list. Why? Because, again quoting from the authors, "Afghanistan [and four other countries] are all so void of a rule of law that they are impossible to analyze". In other words, the Taliban regime in Afghanistan has driven the country into a state of anarchy. The absence of a proper governing structure is not a result of the US-led bombing campaign; the damage was done years ago.

It is our strong belief that countries like Afghanistan are swimming against the tides of time and the economic realities of the modern world. The Taliban regime, along with other totalitarian regimes, cannot long survive in a world where the subju-

gated can learn how much better the free world lives. "You can fool some of the people some of the time..." as the adage goes, and a despot can keep some of his people down for an extended period of time, but eventually, the oppressed become desperate enough to do almost anything to find a better way of life. It wasn't that long ago that freedom-seeking people were shot trying to get over the Berlin Wall.

The Afghan people have more than enough reason to wish for a better life. After countless years of oppression and civil war, the populace is in a pitiful state. Life expectancy is barely 45 years, two-thirds of the population (including an estimated 85% of women) cannot read, per-capita annual income is only \$800, and more than 10% of their population live in foreign refugee camps. They don't need to look far to find people with better lives; they are far and away the poorest, most oppressed people in the region.

Francis Fukuyama of Johns Hopkins University penned the expression "The End of History" in his controversial 1989 essay in reference to the global movement toward embracing the modern institution of Western liberal democracy. In Dr. Fukuyama's opinion, after thousands of years of social and economic experimentation, the world finally settled on a winning formula for economic prosperity. In his words, we had reached "the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government".

Dr. Fukuyama's opinions, once deemed radical, now appear to be supported by the findings of the Index of Economic Freedom. This year's study showed that of the 156 countries ranked, 73 received better scores for economic freedom than last year, while 53 received worse scores and 27 countries' scores remained unchanged. To a greater or lesser extent, the entire world is moving toward free markets and greater personal liberties. In what was unthinkable a decade ago, traditional communist



powers such as China and the former Soviet republics are either fully embracing capitalism or are trying to add capitalistic elements to their system. Even the people of Iran, after more than 20 years of radical Islam, are pushing for more personal freedoms. While many countries are still receiving poor scores, the trend of increasing freedom is solidly in place.

Few regimes have so completely rejected the Western institutions of free markets and liberal democracy than the Taliban. Even though they have been driven out of power by the US-led military campaign, we believe their hold on the Afghan people was slipping even before September 11. Ultimately, they would have failed not because of their insistence on a radical, oppressive form of Islam, the Taliban was destined to fall because they offered no real economic plan, and thus offered no hope for a better life for their people.

With the Taliban seemingly removed from power, the new leaders of Afghanistan must now agree on how much social and economic freedom they will allow. The alternatives seem clear: to continue to rule guided by a radical and oppressive form of Islamic law or to embrace freedom and offer their people the promise of long-term prosperity. To remain in the dark ages or to move the country ahead and begin to embrace the modern world. There is no easy path: even under the most optimistic scenarios, the people of Afghanistan are years (if not decades) away from enjoying what we would call prosperity.

We need to recognize that the challenges confronting the progress of freedom are not limited to Afghanistan or even Central Asia. Practically the entire African continent is ruled (where there is rule) by oppressive regimes. For every developing country that has put in place modern Western economies like Singapore and South Korea, there is a Laos or Cuba, falling ever further behind the modern world.

Even Dr. Fukuyama, with all his optimism for the future of global democracy, recognizes that resistance will continue to come “from societies whose traditional existence is threatened by modernization”. While we may take comfort knowing that the world is moving in the right direction, we can be sure that progress will not take place linearly, nor will free countries be immune from attacks by tyrants still clinging to power.

Meanwhile, optimism regarding the rapid progress against al Qaeda in Afghanistan is showing up in the prices of US stocks and bonds. While it seems premature, apparently consumers believe that the sooner the US effort in Afghanistan is over, the quicker we can get back to “normal” here at home. With consumer confidence on the rebound, investors are easing back into stocks and lightening up on less-risky assets like bonds. Since the post-terrorist “flight-to-quality” of mid-September, the S&P 500 has gained 15% while 10-year Treasuries’ prices have fallen 5%.

As always, our markets are anticipating what the future may hold. While we continue to believe that economic growth will resume next year, we do not believe that the US economy can so easily get back to “normal” (we’ll save that discussion for another day). Measures of consumer confidence are important, but we are looking for more concrete evidence of a pickup in the real economy before implementing significant changes in our clients’ portfolios. These changes are likely to include a move towards a more “barbelled” yield curve strategy, an increase to our overall corporate allocation, and a rotation out of defensive corporate names into more cyclical credits. These moves would all be designed to take advantage of a flattening of the yield curve and anticipated improvements in the credit profiles of economically-sensitive companies that are likely to occur in an economic recovery.

