

## INTERVIEW

# Making Sense of the World's Symptoms

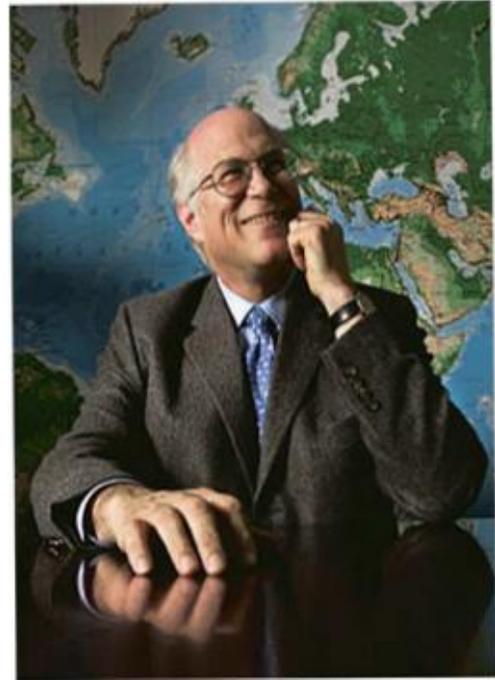
By Sandra Ward April 30, 2007 12:01 am ET

**IF CHANGE IS AFOOT SOMEWHERE** in the world, it's likely that Hess and his associates at Inferential Focus in Manhattan have detected it. Started nearly 30 years ago with co-founder Bennett Goodspeed, author of *The Tao Jones Averages*, Inferential Focus is committed to detecting subtle shifts in behavior and trends across a broad spectrum of disciplines that often result in major investment and marketing themes. Its client list is an elite group of financial institutions and hedge funds and multinational corporations eager to gain a strategic advantage from the intelligence gathered by Inferential Focus. The firm's latest work suggests opportunities in satellites and telecommunications; energy, and Web advertising.

**Barron's:** What exactly does Inferential Focus do?

**Hess:** We do with the world what good doctors do in diagnosing their patients. They objectively look at symptoms and clues that are often anomalous, suspend judgment and allow for multiple indicators, and then put it all together for a diagnosis. We read a lot: about 350 trade journals and newspapers and now online material from around the world, and we exclude as evidence over 99% of what's written because in the discipline of diagnostics, opinion doesn't matter. We are looking for events. The inferences are a matter of picking up the clues and putting them together in the right way to get the right picture of what has happened already. We started writing about terrorism a year before 9/11 because we were piecing together clues that were already being manifested. We are not trying to forecast or predict what is going to happen, but we will infer from what has already happened and hopefully our clients will be better off at dealing with new situations.

*How did you help investors prepare for 9/11?*



A year before we issued a report on what we called World War III, our phrase for a new area of conflict that we defined as a new world of permeable borders, and it included threats ranging from the piracy of copyright material to diseases like SARS and West Nile virus and all kinds of cross-border movement, including terrorists and immigrants, financial transactions and trade and commerce.

*Does your permeable-borders thesis remain relevant?*

Yes. It's a pervasive change. In a world of permeable borders, Saudi Arabia is building a wall on the border with Iraq. China is building a wall on the border of North Korea. We are building a wall on our border with Mexico. There are big attempts to try to recreate and protect borders.

*And then what? Do you make recommendations?*

Our role is to diagnose the new dynamic or change and try and figure out what it means and what its impact might be. The implications of the changes that we identify are both suggested by us and developed in dialogue with clients. As part of our World War III thesis we saw a whole series of reactions by individuals trying to maintain control and security in their lives, and we called it the "sustainability" response. It involved physical security, employment security, financial security and emotional security. There has been a big movement, especially after 9/11, toward redecorating homes, practicing crafts and owning pets. We saw people looking to gain some control in a world where things change suddenly. How do you maintain your sanity when a company takes your health insurance away or when the border between weekends and holidays and workdays is lost? We suggested that part of the solution involved sleep, and we have since seen hotels and individuals spending a lot of money on replacing mattresses.

*Were you able to diagnose the current housing situation and the implications for the economy?*

We've been talking about housing for 2½ years. The anomaly of the 2001-2002 recession following the dot-com blowup was that consumer spending never slowed down and personal debt never slowed down. At the same time, real incomes were not increasing. It was the first time in decades where there were five years straight in which real incomes did not increase. Cash-out refinancing and home equity loans filled the gap. This is the first time in the postwar period that the housing market has fueled the economy. It has regularly gone through the cycles with the economy, but it hasn't ever fueled the economy and supported consumer spending. A lot can ripple out from the housing market. We're seeing the first wave. We are suggesting to clients that corporate reactions to protecting earnings might be a hidden factor that could lead to other shock waves involving housing.

Corporate managements have been so well-trained to cut back on expenses to protect earnings that it might be the catalyst that trips the next wave. There's been a huge increase in housing supply on the market, turnover is way down, but prices have plateaued after going down a slight amount. That's because we haven't had any forced sales. If there are

corporate layoffs, there will be forced sales. There has been a lot of leverage created in the housing market and it could lead to a significant decline. About 40% of the new jobs in the last four years are housing-related. Housing is 23% of the overall economy. While there are offsets -- commercial real estate is doing well and the government is hiring -- this has the potential to tip the scales. It could lead to the Fed lowering rates, and if we've got to lower interest rates to stimulate the economy, it takes the incentive out of owning dollars. That becomes tricky when you consider it's important for the Chinese to help support our economy by continuing to buy dollars.

*Let's talk about a change occurring that hasn't registered on radar screens.*

The military is increasingly dependent on satellite communications. In this World War III world, space is another permeable border and we need to protect our communications, something that is not only important for the military but also has implications for financial institutions because of ATMs, and public communications because of cell- phones. The military is getting very anxious about the vulnerability of our satellites and has set up a couple of separate departments to focus on it. It became more urgent since China knocked one of our satellites out of the air in October, which created debris in the area below the satellite-orbit range and caused disruption. Lasers can be used to knock satellites from orbit as the Chinese did, but it is also possible to simply jam the command data between spacecraft and ground stations. The U.S. spends all this money on missiles and aircraft carriers and apparently any country with a ground station can jam our satellites.

The Department of Defense has begun to embark on building a whole new global-networking system similar to the Internet called the GIG, or Global Information Grid. About \$34 billion is committed to this secure- communications system. Some companies that are benefiting are Globecom Systems [ticker: GCOM], SAIC [SAI] and Radvision [RVSN].

*How about another dynamic underfoot?*

The price of oil is very contingent on whether the Iranians are cooperating with the Saudi Arabians to try and create stability in the Middle East.

*So politics is alive and well in the oil-price dynamic?*

Right. There seems to be a whole other strategy beyond supply and demand and weather that is influencing the price, where the political actions in the Middle East have been interestingly correlated with the price of oil.

Saudi Arabia's King Abdullah has now galvanized this strategy of using oil as a weapon to ease tensions in the region. The Saudis have forged serious connections with the Russians in the last few years. They are the two biggest oil producers in the world, and now they coordinate their actions. The Saudis are buying arms from the Russians for the first time. Putin paid the first visit ever by ahead of Russia to Saudi Arabia. King Abdullah also visited Moscow, a rare event for a Saudi king.

Interestingly, in the last couple of months the Russians told Iran they were not going to supply equipment for their nuclear plant and they said the Iranians needed to respond to the U.N. sanctions. The Russians were big supporters of Iran. They sell them a lot of goods. They have an important energy coalition with them. But it's clear the Saudis were using their ties to Russia to put pressure on Iran. We are very interested in what happens in Iran because if they don't cooperate and they create more instability in the Middle East, the Saudis are likely to respond by bringing down the price of oil. If Iran cooperates, they get higher oil prices.

*Do you have a recent example where the price change appeared to be linked to the Saudis putting pressure on Iran?*

Last fall, when the price plummeted from \$75 to \$40 a barrel. The Russians could have cut back production to get prices up but they did not. It recalls 1997, when the Saudis engineered an increase in OPEC production by half a million barrels a day, driving the price of oil to \$8. The price was already weak, and they put more oil on the market. At the time, the Caspian Sea was purported to be another Middle East in terms of reserves, and there were multibillion-dollar projects being assigned right and left to develop it. The lower prices effectively knocked out those oil projects. It turned out that the Caspian wasn't as good a source as it was supposed to be. But the anomaly of increasing production while prices were weak indicated to us that there was a different strategy going on.

*Where are you suggesting the price ends?*

There is optimal pricing the Saudis can live with, where you don't kill economies and you maximize revenues. In the past, that price was in a range from \$22 to \$28 [a barrel], and they managed it within there. Now the new range is probably \$50 to \$60. But Europe and North America can expect to see gasoline prices at the upper end of their recent range as a result of greater cooperation between Saudi Arabia and Iran. That could become a problem for consumers, especially as the housing market continues to weaken.

*How about another theme?*

We call it the New Necessity: Collaboration. The ability to collaborate at a distance is becoming a necessity for big business. There has been a significant increase in telecommunicating just in the last five or six years, facilitated by technology. Think of it: We know of one micro-multinational with 25 employees who live across five time zones, four nations and two continents. This has facilitated the need for collaboration tools.

*Such as?*

Online video and teleconferencing capabilities and collaboration software. Cisco [CSCO] just bought WebEx, which provides Web and video conferencing. Citrix [CRXS] is another. Polycom [PLCM] plays in it. Optelecom [OPTC] and iLinc [ILC] are other companies. People

are working more distantly from corporate offices, and there's a greater need for collaboration.

*You have also mentioned targeted advertising as a theme.*

As technology has changed and individuals control more of their technological destiny, selecting from the Internet what they want to see or hear and when they want to see and hear it, it has brought about big changes in how people interact with their media. Advertisers are increasingly trying to reach these audiences in what can be very small markets in some amazing ways. For example, the Web-TV series and podcast, DiggNation, features two guys sitting with laptops and talking about technology. But they attract 250,000 viewers and have 15 sponsors paying \$10,000 each per episode to place products like beer and tea on the show. Adagio Teas sold \$100,000 of tea after the two hosts plugged the tea on the show.

Digital technology helps ad firms measure what they are getting and who they are targeting. Digital billboards are popping up where advertisers can target a certain demographic of commuters in the morning and change the ads as the day goes on. Owners of BMW's Mini Cooper can register to receive personalized messages on billboards which recognize the drivers, thanks to a radio chip in the key.

*Thanks, Charlie.*

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