



Economic Commentary - 1st Quarter 2004

Shifting from neutral... the economy takes off.

Although in this election year so far the candidates and especially the news media have tended to focus on the negative employment growth and the outsourcing of American jobs, that story and the basis for it are fading quickly. The economic information and statistics from the first quarter of the year shows considerable strength in many critical areas of the economy. Not only does the lagging job growth seem to have been overstated but what lag there is does not seem to be hampering the consumer or business.

The March payroll report woke both the equity and bond markets up to strength building for several months in the employment arena. Not only were payrolls up 308,000 for the month, but both January and February were revised upwards (159,000 and 49,000 respectively) indicating over a half million jobs created in the quarter. The unemployment rate itself, which measures the slack in the economy increased from 5.6% to 5.7% again indicating positive movement. In fact this is the largest gain in job growth since April 2000 and the growth was noted in both the service sector and the manufacturing sector. Over the quarter payroll growth has been measured in all the working categories which bodes well for the economy. In addition, despite the talk of outsourcing of jobs, the facts show an increased "in-sourcing" of jobs as foreign companies chose to build plants in the US. And, rather than blaming the lag in employment on only outsourcing the real culprit – if one can call it that – is productivity which has allowed businesses and government to maintain or increase output without adding people. This will of course begin to create its own cycle of employment needs as technology needs grow and older technology has to be replaced.

Along with employment growth, we have seen a tremendous strength in retail sales which was forecast as slow from a moderate Christmas season. January retail sales jumped .9% however as consumers waited to buy on after-Christmas sales in expectation of lower prices. With a new present of choice increasingly focused on gift cards, January sales could have been expected to be high. (This shows why retail year end is January not December to capture the after season sales.) February sales jumped again .6% and year-over-year retail sales are surging at a rate of 7.3%.

Although the consumer clearly continues to spend wildly, the technological gains made over the past ten years have allowed this to occur without inflationary pressure. A strong domestic demand has been met often by cheap imports. In 1994, China represented 6% of US imports. This has now grown to 12% in 2004 feeling the hungry consumer.

But, not only imports have been selling. Factory orders have been stronger than any period since December of 2000. The March factory index from the Institute for Supply Management (previously National Purchasing Managers) showed an extremely strong growth in manufacturing also. For the fifth straight month the index has stayed above the lofty 60 level (at 62.5) and above 50 for the past eleven months. The ISM national survey has also supplemented the employment report figures by reporting its employment index above 57 which is the highest since December 1987. The growth in manufacturing should have increased supplies of goods in the economy but the strong demand has actually decreased inventories from 49.4 to 48.3. This will lead to a need for higher production which will in turn create a higher need for jobs.

Against such a rosy picture looms three major negatives: the election and the unrelenting rhetoric attached to it, the US budget deficit, and the continuing terrorist actions throughout the world and primarily in the Middle East.

The deficit weakens the US dollar and we have seen the dollar sink throughout the last two quarters against world currencies. The dollar has been allowed to sink in some measure to decrease costs of US exports thereby helping US manufacturing worldwide. The weakness of the dollar also contributes to lessened international demand for our debt. The Bank of Japan however has had an aggressive program of buying US debt (treasuries and agencies) to strengthen the dollar and therefore lower the yen to protect their own exports to the US. This is critical to Japan since the US accounts for one-third of all Japanese exports. The Bank of Japan has announced that this artificial support program will end at the end of March 2004. If that does occur, the dollar could fall further and quite quickly and subsequently raise US debt rates. The market has not been focusing on this possibility but with the clear growth in employment and overall strength in the economy this might be hard to ignore much longer.

The Federal Reserve has clearly been monitoring this strength but remains focused on job growth. The FOMC has kept rates at the historically low 1% level citing a "balanced" economy and growth. They are emphasizing their ability to remain patient and they can afford to ignore inflation threats to this point. Although many see a continuing accommodative stance by the Fed as tantamount to encouraging inflationary pressures, the monetary pressure can mount for many more months before the FOMC has to move. Although a low interest rate does create money it will take quite a while to move through the normal process of inflationary pressure building. The money growth has to spur overspending by consumers but the overspending limits have been raised by the sizeable refinancing gains in consumer pockets (with 30 year mortgages still at 5.41% close to the record 5.21%) in combination with tax incentives and tax stimulus programs in place. In addition, the overspending, when it does come, has to push the limits of domestic resources and cause serious shortages in production. These shortages will then eventually increase inflation. According to most economists this could take up to two or three years. Although February CPI grew by .3%, the core only inched higher at 0.2% neither of which presents any inflationary pressure on the system.

We have also seen a continuing disconnect between expected higher stock prices and higher bond rates. The flat front end yield curve, the excess capacity, strong corporate profits and earnings, the lack of inflation, and growing productivity without parallel labor costs have all allowed stocks to gain in price without the normal rise in interest rates. However, this scenario is also beginning to change. Bonds and the economy have diverged over the past year. The reluctance of the Fed to act in raising rates has convinced some traders to retain positions in bonds and push prices higher (rates lower). They believe, as normally do most bulls, that they will be able to escape a sudden rise in rates. However, this is rarely the case.

The FOMC does not have to move to increase rates. We have already seen a significant move with the two year bounding forward from 1.49% to 1.89%. As general confidence grows in the stock markets and investors move into the stocks they will remove their funds from their safe harbor in the bond market money market funds and a very basic supply and demand reaction will dominate. Prices will fall and rates will rise and this rise may be exacerbated by the Japanese withdrawal from the US debt market. As the economy moves forward the talk of deficits may also abate which will also fuel a rise in rates.

No doubt this expansion, like the recession which bore it will be slightly different and may be slower than many in the past. However, it is as clear that the economy is moving out of neutral and will continue to grow unless a totally unexpected shock to the system occurs. Fixed market investors will have to move with the rates as they increase to take advantage of the curve steepening especially in the short end. It is a time for short steps out the curve in pace with the growing strength in the economy itself.