



## Economic Commentary - 2nd Quarter 2004

*Stepping out with my money! Maybe not ahead of the curve but definitely on it...*

At the end of the first quarter we talked about *shifting out of neutral* and shift we did as the economy has quickly gone through at least three forward gears in 2004. Despite hurdles that still exist in the economy such as energy costs, OPEC manipulations, rising consumer debt, higher mortgage rates, terrorists, and geopolitical uncertainty the economy continues surges forward in fits and starts. The anticipation of change - especially at times of direction changes in interest rates - often moves the markets more than the actual events. As a result, investors have to be careful not to assume that projections will all go as planned. There will always be unforeseen variables to blast our expectations but a total sit-and-wait attitude rarely serves portfolios well. Instead, we have to understand the current dynamics and how they will affect our portfolios. There are no easy choices at this point but small steps out the curve can help.

Portfolio decisions must be made on major current drivers and this past quarter a few major themes have monopolized the markets attention. Naturally, the central story has been the Federal Reserve's Open Market Committee (the FOMC) raising interest rates for the first time in four years from 1.0% to 1.25%. This is the Fed's first step towards unwinding their accommodative stance to liquidity. The increase had been telegraphed by just about every Fed Governor. Earlier in the quarter Greenspan, speaking to the International Monetary Conference, had spooked bonds by indicating that "restoration of a significant degree of pricing power" and therefore inflation, was in the equation. He said "the FOMC is prepared to do what is required to fulfill our obligations to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth." I.e. control that inflation. But, at his confirmation hearings, Greenspan painted the rosiest of pictures of the economy. Obviously the truth lies somewhere in between and as various factors vie for front page space, the markets will continue to trade in a well established range. All indications are that the Fed's primary concern is inflation (and not drags on the economy).

The market wants to know just how "measured" the FOMC will be in fighting inflation. The committee's addition of a *just-in-case* clause to "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability" clearly gives the Fed wiggle room to act more or less aggressively as they detect inflationary pressures.

The risks for a move against inflation are relatively evenly balanced. Growth will have to stay over 4% to sustain the FOMC tightening rate cycle but employment increases are promising that growth. This quarter put jobless claims at four-year lows and in 2004 over 1.2million jobs have been added-all but erasing the 2 million jobs lost over the previous 3 years. (Even the media hype on outsourced jobs has been hushed by the facts.) The heady pace of job growth was halted in July and the market panicked. The June employment data showed growth of 112K jobs and maintained the 5.6% unemployment rate but the market had *expected more* so the negative reaction was substantial as money flowed back to bonds and lowered rates temporarily. Overall there has been a sharp acceleration on hours worked and the rise in earnings should fuel wage lead income. We will see such fits and starts in the coming months but the trend is clear.

Inflation will continue to be the focus because it also is gearing up. Month over month the CPI rate appears tame with the core up a benign 0.2% but the year-over-year increase is 1.7%. In the first five months of 2004, the rate rose by 5.1% which is double the pace in the same period of 2003. Most of these increases are in basic necessities like food and energy (oil). Housing costs have risen only 0.2%.

GDP is our broadest measure of inflation. The fixed weight deflator which weights all the GDP components on inflation has been in a steady climb. Inflation is not anywhere near menacing levels however. It may fuel speculative fires but we are still benefiting from technological changes which

although slowed from prior overdrive levels still increased 4.5% over 3 years. This means profits. These heightened profit margins appear big enough to absorb cost increases without price increases at this point.

An interesting and understated portion of the FOMC message noted that the inflation has "been due to transitory factors" a theme that will be fleshed out surely in this month's Humphrey Hawkins testimony. This might have been a simple attempt to deflect some of the criticism that an overly accommodative Fed caused the inflation but it is curious that it was cited instead of a *contained* inflation. Greenspan knows that the market always reacts to temporary shocks and sexy news items but that policy can not be made in reaction to those shocks or situations - anymore than portfolios can be managed reactively.

The changing bets on inflation and possible Fed moves are mirrored in most areas all of which adds volatility and makes the markets jumpy. On the positive side, confidence is at its highest level in 2 years due primarily to job gains. Chicago Purchasing Managers saw a slight decrease but their indicator in June was the highest since 1988. The Institute of Supply Management, a very reliable indicator, has been showing solid growth as companies rebuild inventories and expand employment. Even with a percentage point rise in mortgage rates YOY mortgage applications are soaring and new home sales remain high with annual volume at a healthy 1.369 million. Of course the potential downside of the housing trend is troubling. A rising number of mortgage defaults are popping up. Another troubling statistic is the decline in the sale of durable goods although this is an extremely unreliable and volatile indicator.

With the short term volatility the markets are range bound waiting for more information - perhaps on a geopolitical bent. In the first half of 2004, the Dow averaged 10,376 with a high of 10,737 in Feb. and a low of 9,906 in May (currently 10,171). The more accurate equity measure, the S&P 500 shows the same range tendency with an average of 1,127 and highs of 1,157 and lows of 1,084 (currently 1,108). The Reagen funeral this quarter slowed consumers who stayed glued to their TVs. The Iraq turnover had tensions running high and only partially moderated with the early turnover. Policy actions in China threaten to slow global trade with that 900 pound gorilla and inflation fears in Europe have brought growth down from the first quarter. The geopolitical factors will continue to fuel fears of changes in economic policies such as protectionism or the weaker dollar, both of which could raise costs of capital and slow business spending.

Globally however it is impossible to ignore the unprecedented two year coordinated monetary stimulus package in which every central bank participated to some degree. Monetary stimulus historically has required 2-3 years to kick in and it certainly did in the first half of 2004. Now the *multiplier* and *accelerator* effects have to be seen to be believed, i.e. spending, hiring and investing.

Incorporating this ebb and flow into portfolio decisions can be difficult. It is tempting to think that rates will rise so quickly that we need only sit and wait for the magic entry point. A recent study by Citigroup of 200 plus years of interest rates concluded two important basic points. (1) *Major* reversals in rates can take multiple years to accomplish and (2) the reversal process is slow and gradual. The current reversal is in its fourth year! The ten-year has been in a 3.5-5.5% range for that whole period. In large part, this gradual pace is impacted by conflicting information and data - a condition analogous to our current situation. Plus, getting all the momentum directed from so many myriad factors simply takes time.

We have long advocated a gradual "stepping into and up the rates." By staying within a short term horizon (approximately one year) a portfolio can improve over current liquidity rates, earn extra yield for the same period and have funds available to continue up and out the curve as rates come to you. This will involve reporting *unrealized losses* for short periods of time but if funds are targeted to specific liabilities and not extended over-aggressively they will always remain *unrealized*. This is the nature of bear markets. To wait for the plateau in higher rates only creates true opportunity *costs*. For example, a \$2 million investment that sits in a pool or fund at expected rate increases until March 2005 (up to 1.80%) will earn \$5,500 *less* than investing that same \$2million to March now at 1.80%. As the rates increase the security will have an unrealized loss but that is simply a feature of price movement. Then the funds are reinvested.

Investors need to be pro-active in any scenario but especially as rate changes create volatile markets. Our disappearing long flat front end curve required a liquid position because it did not offer any inducement to extend but slight extensions are now necessary to stay ahead of the curve. We have to step out the curve.