



Economic Commentary - 3rd Quarter 2002

A myriad of conflicting forces batters the market.

With a backdrop of public outrage at corporate scandals creating market reports that read like police blotters, with stocks sagging and volatility in the hundreds of points on the Dow each day, and with the specter of war looming with Iraq, what is the economy likely to do?

There are so many forces and variables pushing against one another in the marketplace, analysis is difficult enough let alone the art of forecasting. There are several major areas which have taken center stage during the quarter to consider and present a puzzle rather than a pattern. The equity markets in September hit lows not seen since August of 1998 when Russia was in default. The blue chips in the third quarter fell 12.4% which created the worst September since 1937! The Japanese even found out what it was like to hold a government bond auction and no one came. As is normal when such difficulties arise investors head for safety: the US Treasury market. The enormity of the move to bonds in this cycle has been viewed as a bond bubble. The question is whether it will bust or simply deflate in its time.

All in all, this has been a quarter of economic body blows and the battering has been from all directions and often two directions at once from the same source. We have to take a look at the major forces to determine whether optimism is called for and/or where we can look for relief.

Consumers have been holding the economy together by seeing enough to keep confidence higher than expected by economists. In September confidence hit 93.3 a reasonably positive statement against the 92.1 expected, but, though it stays in the 90th percentile this month was the third consecutive decline. Since January of 1998 this has averaged 123 and as recently as June been over 100 but the slide since then is most troubling if the consumer stops the long running retail binge.

Oil is another good news/bad news scenario. Oil prices have risen dramatically since the Administration began public warnings of the possibility of war with Iraq. Now at \$29.3/barrel crude started the year as low as \$19/barrel and averaged \$25 until August when it spiked at \$30. Naturally this type increase will impact prices across many industries which is not welcomed by consumers or producers (who can't raise prices because of competition) however even the oil question has more facets. A successful war with Iraq would open one of the world's largest oil fields not open for over 20 years and (theoretically) reduce the long-term cost of oil. More immediately, an increase in oil prices will bring some inflation which is needed. Without some inflation in the system, the economy runs the risk of deflation. Deflation is a persistent decrease in consumer prices (or persistent increase in the purchasing power of money) from a reduction in available currency or credit. As the general opposite of inflation, it has historically affected both output and employment negatively. If imports decline in price and our manufacturing continues to stagnate, consumers and industries will delay purchases in the anticipation of lower prices. This will further slow the overall economy in a dangerous spiral.

Much of confidence and growth depends, of course, on employment trends. The unemployment rate peaked at 6.0% in April but has decreased fairly steadily to 5.6% in September. While this has understandably decreased household income personal income has increased. The increase is largely due to increases in productivity. As workers become more productive, their wages tend to increase. In addition, after the tech boom employers who found it hard to find talent may be more inclined to hold onto talent even during the downturn. Employment will

ultimately define consumer spending patterns which ultimately define our national income (GDP). Two-thirds of GDP comes from consumer spending (and half of that on spending on their houses). The 3.6% increase year-over-year on consumer spending bodes well for Christmas if it can be sustained.

The Federal Reserve has many detractors now who feel that it could have or should have done more to kick-start the economy lead by our newly knighted Chairman Sir Allen. However, it has moved to historically low interest rates to encourage business borrowing and keep consumers spending. They have also added significantly to the liquidity in the system. The most interest rate sensitive portions of our economy – housing and automobiles – have been booming for two plus years on zero percent loans and refinancings. Further lowering the interest rates when the veritable bottom is in sight may speak more to desperate measures than to confidence building. It could also lead to a more widespread look-out for deflationary prices. There was little direction given at its September FOMC meeting. The FOMC stated that “the current accommodative stance of monetary policy, coupled with still robust underlying growth in productivity, should be sufficient to foster an improving business climate” which suggests no need for rate moves, but, the Committee left room for changes if necessary by saying that “against the background of its long run goals of price stability and sustainable economic growth...the risks are weighed mainly toward conditions that may generate economic weakness.” The fact that two Committee members went against the final action to leave rates unchanged at the August meeting indicate the span of thought even among the Committee members.

What might be termed “serial refinancers” have been taking advantage of the lowering rates but have also added considerably to the volatility in the markets. Not so long ago the bureaucracies of the mortgage lenders and S&Ls made refinancing harder but increased competition has added speed and from there volatility. This has exasperated a asset-liability mismatch at our two largest agencies FNMA and FHLMC. Mortgages held by these two giants at 7.5% have been refinanced to 6% but they remain liable at 7.5%. To hedge this risk means they or others holding insurance for them buys long US Treasuries which has brought our long-end down. If rates suddenly stabilize bond rates may literally soar on longer end.

One decidedly negative factor in the economy that can not be tamed without constraint on the part of the consumer or higher rates is the level of debt both personal and overall. For the first time ever we have reached over \$20,000,000,000 (that is Trillion) in debt which leaves the economy very vulnerable and could keep interest rates low. Household debt has climbed to \$810 billion in the second quarter only \$110 billion of which is commercial. This compares to a \$500 billion level in a booming 1998! Overall debt has been growing at a 9.1% annual rate which is higher than the growth period 1997 through 1999. Such extremely high levels of debt robs the future. It is this debt level that may convince the consumer to take a breather. But, we see no indication of a slowing here on the consumer side. We need the consumer to continue to spend but we also need that same consumer to start paying off their debt.

One of the primary culprits in this slowing economy is business and not just because of the unearthing of numerous frauds and accounting scams which have deteriorated confidence in our business leaders. Business has increased its output which tells us that the economy does have a foundation from which to grow. But, business has also been too focused internally on governance issues, arrests, insider trading exposures, and accounting issues. In general, they have been preoccupied with their own Sarbanes Oxley issues to hire new people or invest in new capital. Until the risk-takers of business change this focus and re-direct their efforts it will be difficult to turn the economy around.

Add to this brew the saber rattling of the United States and the difficult and, more importantly, timely process of coalition building before any military action is taken. All the factors tend to point to a bottom forming slowly and tentatively. We came from a period of major excesses and those excesses require a longer period of purging and re-direction. But the curve is still steep indicating that once the factors align that rates will increase. The timing of that action is the most difficult forecast of all. If that process begins and the interdependent forces domino we will undoubtedly see not only an increase but a very fast one indeed.