



next year. Although Stern is not a current voting member of the FOMC he is the longest standing member of the FOMC and a close observer of the economy. Noting that productivity grew at an annual rate of 6.8% April –June which tripled the first quarter rate, and, CPI grew only 1.3% in the past 12 months, Stern sees little fear of inflation or deflation. With rates low and stimulus high he projects continued growth and sees the “wiggles” (as he calls them) in the underlying rate of dest in either direction” over the next months.

With financial conditions good and continued rate stimulus from a super-accommodative Fed the picture does suggests growth. Many economists expect a 5.5% growth in the fourth quarter. Durables were up 3% in August – the strongest since third quarter 2001 when we were recovering from a recession. Inventories are not yet building. When business perceives a need to build those inventories it may produce another boost in spending. The consumer meanwhile continues to spend in stores and on automobiles – up 1.7% in the past two months. The income in households from \$330 billion in tax cuts and mortgage refinancings pushed disposable income up 1.5% in August and .9% in September and income before taxes is up .2%. The income facts point to employers hanging on to workers but waiting to hire again until the economy grows on a sustained basis. The cost of capital should remain low which helps business spend.

The elusive productivity factor has persisted throughout the slowdown period and as the economy picks up this huge boost in productivity could very well mean a robust and ongoing growth trend. If productivity stays in the 4-4.5% range it tends to keep a lid on inflation. Productivity averaged 4% in the 1960s and 3.5% in the 1970s followed by large and long rate increases.

The last hurdle is **employment**. In response to the August decrease in payrolls, the FOMC changed its assessment of employment growth from mixed to weakening. Although earnings are increasing for businesses they remain skeptical about adding new positions. The employment rate fell in August from 6.2% to 6.1% but that figure actually reflects workers who are no longer actively seeking employment. The 93,000 jobs lost in August represented industries and businesses across the board and was the seventh straight month in declines. The big three auto makers are considering large layoffs in October. The employment data shows that hours worked are soft but the workweek is steady with increased earnings. Clearly this indicates that business will again add to payrolls if they see a sustained growth pattern. Many economists are looking at no movement in jobs until yearend largely because business needs the prerequisite which comes from a strong profit upturn. Profitability could be in the 20-25% range for all of 2003 which would make it consistent with job growth. It is important to note that employment *always* lags

a recovery. However, with the boisterous beginnings of the election season it makes a handy 30 second sound bite which will undoubtedly be used for many months.

A perceived hurdle is the budget deficit, but, the deficits may be appropriate now because the economy needs the boost it gets from government spending.

A more significant and far reaching hurdle may be in the currencies. The dollar has weakened against 14 of the 16 major currencies since the G-7 meeting 9/20/03. It has lost value significantly against the yen and the euro in September. (The euro had been dictated in large part by economic news in the US and perhaps by large hedge fund buying). In September Treasury Secretary Snow got agreement at the G-7 meeting for flexible, global exchange rates. This can be translated into a realization that the US can not be the only engine driving the worlds' economies and that currencies should trade without governmental intervention. Tying currencies and therefore hinging economic movements on one economy create too much unhealthy volatility. Japan has limited the value of the yen since 2000 by buying US dollars to stop their own deflation and to make Japanese goods more attractive in the US. A strong yen could stop the recovery which has taken hold in Japan. China has pegged the yuan to the dollar for a decade for basically the same reason. The US wants a weaker dollar to improve exports and to create jobs, but, a weaker dollar could also kill the treasury market because of the fear of inflation and result in the selling of US debt by Japan and China among others. The US relies on foreign investment to buy our debt and finance the deficit. But because of these massive dollar transactions US bonds could be seen as substantially over-valued which means the freer floating dollar will act to increase rates over the long haul. No currency impact will be immediate however nor will it be a quick fix to the economy.

In interpreting what all these forward and backward steps mean for rates and the fixed income investor a new study by Joe Carson economist at Alliance Capital Management sheds an interesting light. Carson looks at the gap between Fed Funds and the nation's nominal output to forecast long term rate movements. If we view Fed Funds as a type of *risk free return on cash* and GDP as a "*crude proxy for return on holding capital*" then when Fed Funds stays significantly below GDP it is stimulative to the economy. Over the past 40 years we have had either short and shallow rises in rates (for example 1980-2000 lasting 13 months and rising only 2%) or long and large interest rate moves (for example 1960-1980 lasting three years and rising 4%). With Fed Funds nearly guaranteed to stay in the 1% area for an extended time (to stimulate the economy) and GDP expected to grow at the rate of 5.25% YOY this would forecast a long and large interest rate trend for the next years. Another economist (James Bianco of Bianco Research) comes to the same conclusion using an asset valuation model. Bianco uses the 5-year Treasury Note in a parallel to Fed Funds as his counter-party to the GDP. When the GDP growth is higher than the 5-year, it makes economic sense to borrow which puts pressure up on rates. (If in the inverse if the cost of borrowing exceeded the return on GDP borrowing would be unprofitable and rates would fall.)

Such is the dilemma of the fixed income investor. Between very low rates, a steep curve which promises some value out in the 2-3 year area, and a super-accommodative Fed, investors can be lulled into a sense of false comfort (for continuing lower rates) and tempted to extend. Both treasuries and agencies will face directional market risk with extensions. Building ladders to *roll up* the curve will better insure portfolios from continued swings on this dance floor!

Some of the other news items during the quarter which will undoubtedly play out over the next quarter include (a) continued scrutiny of FHLMC and FNMA as new regulators from the SEC and Treasury step into place but major changes in their credit is not expected, (b) continued readjustments of global currencies to ever so gently affect trade balances, and the(c) continuous finger pointing as we move into the prime election campaigns.