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Economic Commentary - 3rd Quarter 2004
Finding traction in the oil slick

In a very newsworthy quarter, aside from hurricanes and elections, the primary focus of the markets has been the unrelenting run-up in oil prices. Pressured from continuing unrest by Iraqi insurgents targeting the oil fields and shipping ports, and, from rebel uprisings in Nigeria, the price of oil has passed historic highs and closed above $50 a barrel for the first time 9/27/04. Iraq and Nigeria are only the immediate stimuli to oil prices however. With double digit growth in the economies of Asia the need for oil will continue to climb and many experts see a potential for $60 a barrel oil in the not too distant future. Asia is directly affected. S Korea had its slimmest growth in 9 months and Japan is sputtering with GDP at 1.3% after running at 6.4%. Newly industrialized countries are seeing 4% not 6% growth. This all affects trading capability with the US and our trade deficit.

The psychological effect of the oil run-up over-rides the actual price climb since on an inflation adjusted basis oil is still at 1970 levels. (Compare it to a cappuccino!) However, the ubiquitous nature of oil and its distillate products has been woven into every aspect of economies worldwide. Seemingly, every bad earnings report this quarter was blamed on either the hurricanes or oil, or both. Indeed, the combination had a major impact on oil rigs in the Gulf as well as the ability of tankers to traverse the oceans in the face of storm after storm. On an on-going basis the re-building after the storms will conversely add to growth.

Largely because of political goading, strategic oil reserves were opened in September primarily to aid refineries in hurricane areas, not to address overall shortages. These are considered only short-term loans.

Despite the indisputable impact of oil globally, the US economy has not lost much traction in this oil slick. Greenspan felt that the economy had "regained some traction" from its spring slow-down citing consumer spending and construction. Philadelphia Fed President A. Santomero noted the economy as a whole is "looking beyond" oil prices and when the Federal Open Markets Committee voted to raise the discount rate to 1.75% on September 21st they reflected this same sentiment. The FOMC statement retained all of the other key buzz words hinting at continued hikes: the balance of risks is 'roughly equal'; policy accommodation still can be removed at a 'measured' pace, and underlying inflation is expected to be relatively low, thanks in part to robust productivity.

Undoubtedly, the 'soft patch' in the second quarter was mostly due to oil with supply falling from 303 million barrels a day to 287. Oil held the consumer back from the 4.5% rate of the 1Q. Economists estimate that oil prices will take ½ % from the US GDP this year but estimates still put annual GDP from 3.5 to 4.0%. That will put growth above the 3.2% average of the last 30 years. GDP in the 2Q grew at 3.3% with inventories and exports growing (up 7.3%). This growth matches the average in the 10 years before Bush's election.

Also helping is the lack of inflation. The core rate was only 1.1% (annually) the last 3 months and agricultural prices were down 10% in the quarter after a 20% surge in spring.

Central to growth (and election rhetoric) is employment. Florida led the unemployment gains and layoffs hit a high in September, but, household gains are above trend at 205,000 and self employment surged 122% in the summer. In the last four quarters unemployment fell 1/2 % as GDP expanded 4.7%. This exceeds the traditional rule of thumb which has jobless rates down 1/2% for every 1% growth gain. This 'quiet acceleration' in employment is particularly robust in construction and manufacturing important because of their high salaries. And, overall hourly pay has increased 2.3% above a year ago. Personal income has accelerated from 3% last year up to 4.5% in past year with 4.8% in the last 6 months.

Manufacturing growth means a continued growth in employment. The September ISM non-manufacturing (service) data was weaker at 56.7 than the expected 59 and both are off the peak of April at 68.4. But, even with this deceleration, we remain well above the 50 gauge of growth. Employment in the service area reflects this same steady momentum as traction is once again gained. New orders above the 58 level reflects a backlog of orders and continues to point to growth in business activity in services.

The consumer remains the key and the consumer continues to spend. The hourly pay and employment gains are maintaining a brisk retail pace. A $25billion gain in July consumption spending offset the $10billion loss in June. With no inflation in sight we can assume higher consumption and profits in the 4Q. The consumer continues to refinance and buy new homes. Mortgage applications rose in September to the highest level since May and the mortgage bankers gauge of loan demand is up 4.9% with the still low mortgage rates.

Weather and socio-political forces have kept the quarter interesting and volatile. Hurricane Charley was an $8 billion insurance event and Frances and Jeanne promise to be even higher. Insurance only offset 1/2 of the losses. The half of the loss fell to offshore re-insurers primarily. Terror is still rampant as seen in the increasing car bombs in Pakistan and the slaughter of innocents in Russia.

In the face of all these major forces weighing on the economy perhaps the most important fact lies in its resilience. In the face of hurricanes, terrorists, election style terrorism, oil, higher global competitive economic conditions there remains no inflation. Corporate profits after tax are up 18.5% in the last 12 months. Consumer expenditures (a favorite Fed indicator) are up 1.7% with 2% forecast for the year. The trade deficit has closed to $580.3bb on an annual rate. **All of this with no new fiscal stimuli**. New home sales bounced back in Sept (up 9.4%) after a decline in 3 of the last 4 months. Consumers are spending at a 4% annual rate. Construction outlays are 2.3% higher past 3 months.

The economy's resilience and the Fed's clear intent to reduce their accommodative stance in credit points to a continued, slow upward climb in rates. A strong fourth quarter has the potential to generate two more rate hikes before year end taking us from 1.75% to 2.25% on the overnight funds rate. For investors that means a slow stepping up and out the curve to stay with, but not extend beyond, the rates as they move.

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Some other news to follow that will affect the bond markets as we enter the fourth quarter:

FNMA, the second largest financial organization in the US behind Citigroup, has been targeted by its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) and accused of fraud by the Dept. of Justice for manipulating its earnings. The White House and FRB want limits on its growth and Congress is making calls to make it independent. Any new accounting oversight and higher capital requirements will affect the markets as will talk of independence. The actions could force a recognition of losses on FNMA's derivatives and options in the billions.

China plans to open its currency (the yuan) to market forces. This has been a major criticism by the US. The yuan has always been pegged to the US dollar which kept it undervalued. A higher yuan will mean a perhaps significantly lower US trade deficit.

A final story to watch is the emphasis given by Greenspan to **Medicare and social security** instabilities. Although not a new story, Greenspan's focus on it and assertion that we may "have promised more than our economy has the ability to deliver" will surely raise the question of re-calibration of the systems again to prominence.