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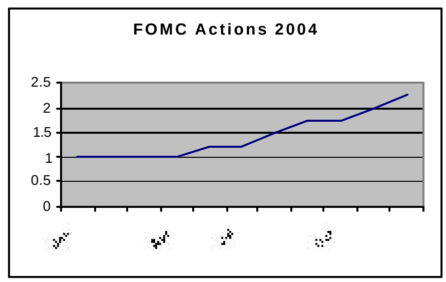
INVESTMENT PROFESSIONALS

Economic Commentary - 4th Quarter 2004
It's a New Year! And the prospects look darn good!

New years inspire us look ahead and forecast the future - although we *know* it is impossible and *should* remember our past, dubious crystal ball gazing records. Before looking ahead however we have to look behind and perhaps this year we ought to just be glad we got down the road at all! In spite of a grinding and negative election campaign and faced with war and terrorists and record breaking natural disasters, 2004 was a year of stuttering growth which probably established an even smoother path for 2005.

In economic terms we had five major stories which vied for the headlines month after month and these same five will undoubtedly continue to push to the forefront in 2005. The first broadly encompasses a troubled socio-political landscape. The wars in Iraq and Afghanistan, the over-hanging threat of global terrorism, hurricanes and tsunamis all created a sense of unrest and uncertainty not only for people but entire economies. For many, the year's profile was painted by 60-second sound-bites, most of them negative, as Republicans and Democrats fought a media battle for votes. The discussions of the election process on social security, deficit, and health care will continue for many years. The next two years, before Bush becomes a lame-duck, will see considerable effort and discussion on these fronts. But another theme - the relative health of the economy - began to clear as soon as the rhetoric slowed.

FOMC AND RATES

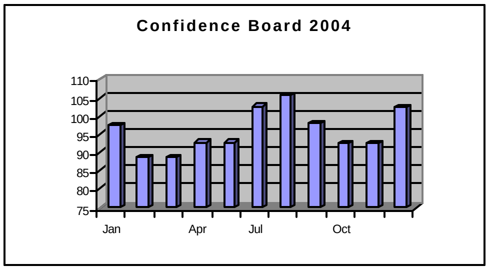


Rate increases by the FOMC is the second major topic of 2004 but why the FOMC felt they could raise the rates is the real story. The FOMC had a plan for 2004 which was to start hiking rates mid-year to achieve 2.0% by year-end. That could not have happened if payrolls had stalled inflation had risen or overall growth languished. But, none of these conditions occurred. Payrolls continue to grow. Jobless claims continue to stay below the 2003 averages (334K versus 343K) and jobs creation continued at an average of 185,000 per month throughout the year. With positive hiring surveys the outlook is good and should keep consumers spending at a 3.5% level well into and through 2005. The less than stellar ISM payroll figures for December do show a decrease but in a range consistent with flat payrolls.

Driving those payroll numbers are business spending and manufacturing. Business spending is expected to be in the double digit range in 2005 as shown in the new orders index of the Philly Fed (which included back orders and net exports). It has been four years since the tech boom and business needs to replace the at-one-time-excess technology that smothered them for so long. Compare today with the boom of the 90's. The manufacturing index averaged 52 during the 1990's but the December index moving to 58.6 from 57.8 suggests a much more broad-based economic growth - not just one industry (tech). Business is expected to invest in new equipment as well as technology thereby aiding manufacturing. US companies have been using the low interest rates to issue record numbers of investment grade and junk bonds. Investment grade bonds are up to $689b from $665 in 2003 and topping the previous record of $668 in 2001. They have cash to buy.

All this activity is reflected in GDP (the value of all goods and services produced in the US). GDP grew 4.5% in the first 9 months and with a 4Q forecast of 3.4% the annual growth should be about 3.5%. This was boosted by consumer spending which has been up the last three straight years. The GDP deflator, the broadest measure of inflation, is pointing at 1.4% for the year. If the Fed target is 2.5% on rates and core inflation stays at 1.5 to 2% then the real fed funds rate is 0.5-1% which is neutral.

Consumer spending naturally hinges largely on confidence and confidence is high. In December the confidence indicator showed the most increase since 5/03. The number of people seeing jobs as "hard to find" is down (26.4%) and those seeing jobs as "plentiful" is up (19.4%). Even those "expecting raises" rose to a high for the year bringing the overall confidence average to 96 for the year!



OIL

A major story this year was oil. Since March when it left $30 a barrel behind, it rose to a high in October and appears to be settling around $40 - closing at $45.45 in December. The primary causes of the rise were supply disruption, official stances to carry higher back-up supply, and improvement of world economies. The Lukos bankruptcy in Russia and the re-establishment of government control should keep oil high but nearer the $40 level in 2005.

THE TRADE DEFICIT

The deficit stands at $413bb at the end of 2004 - up from $375bb in 2003 and is expected to stay at about $400 in 2005. The Administration wants to cut it in half in four years which will require solid economic growth especially considering terror threats and military costs. Currently foreigners virtually finance the deficit through purchase of US debt and continued funding is tied in part to the strength of the dollar. The Laffer Report makes the interesting point that just because we have the largest trade deficit at 5.6% it doesn't mean we are living beyond our means. With floating currencies the trade deficit is the same as capital surplus - much like a growth company borrowing to build. And the US is the only well-developed growth country. China has not only linked the yuan to the dollar but followed US monetary policy in reducing the percent of GDP running through the government from 82% to 30% and building commerce! Laffer jokes this is like outsourcing Greenspan!

THE US DOLLAR (Down 7.7% vs euro and down 4.5% vs yen)

Linked to the deficit is the dollar which is perhaps the most interesting story of the year - if only because we haven't seen such a move since the 1980's. The story of oil, the deficit, and the dollar are intrinsically linked. Since 2002 a 15% drop in the trade weighted dollar has created a 5.25% increase in import prices. Compare this to a 30% decline in the 80's which caused a 24% increase. The world economy is different now. It is global and the effects and risk are spread more evenly. The Administration has not defined its dollar strategy but certainly hasn't acted to stop the decline because of a positive export effect. (The negative import effect has been absorbed largely by manufacturing since competition allows no price increases.) The real concern, of course, is that we can attract enough investors abroad to fund our deficit. China and Japan have both threatened liquidations but backed off not for esoteric reasons but because they need it. China alone has to hold $500bb in liquid dollar assets to support the dollar value of the yuan. Foreign investments are down, the Treasury has seen foreign portfolio inflows down $48bb in October, the lowest since 10/03. Lessening investments continue to move the dollar down.

The foreign moaning about the dollar should make the benefits of the decline more obvious to us. Our debt is still the best investment especially compared to others like Germany, France, and Japan all of which are struggling to regain any economic growth. As oil remains around $40 the inflation caused by the dollar should be balanced by energy costs. As economies world-wide grow the dollar should regain its footing.

THE INEVITABLE LOOK (GUESS?) FOR 2005

The growth and confidence of 2004 should spill over into 2005. Without major shocks, the economy should be fundamentally healthy with some cyclical inflationary risks monitored by the FOMC. If growth is moderate but solid the rate increases should moderate but leave the front end most vulnerable to increases. The decrease in money market assets (from $2.1t in Jan. to $1.95t in Dec) should continue which will move funds out of the 3month to 1 year sectors raising rates on a basic supply-demand basis. If business activity continues or increases the rates could accelerate. A survey of economists predict:

	2Q'05	4Q'05
Two year	3.76%	4.42%
Five year	3.91%	4.73%
Thirty year	5.27%	5.52%

It is anybody's guess. What is yours?

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