

# INVESTMENT UPDATE

Slip into the way-back machine, set the dial to “1992” and press the big red button. When the door opens you find yourself in a world that seems strangely familiar. There’s a looming presidential election featuring an incumbent named Bush who’s facing off against a popular young-ish Democratic challenger. Despite what appeared to be an easy victory in Iraq, the President is being roundly criticized for the unfinished business there. Meanwhile, his opponent is scoring points by banging on about the weakness of the US economy, as he paints a picture of an out-of-touch President with no plans to deal with the loss of jobs that occurred on his watch. President Bush claims the economy is moving ahead strongly, yet the electorate is divided on this and many other issues.

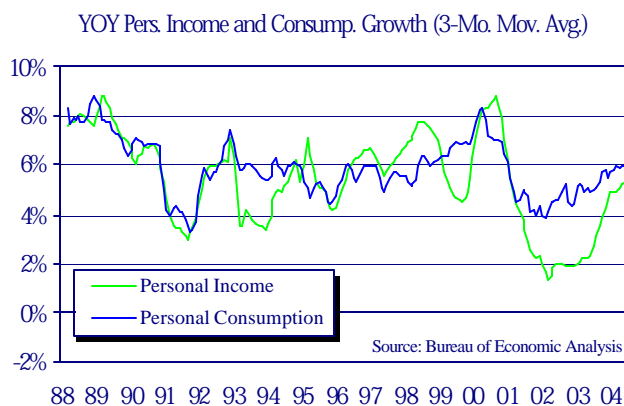
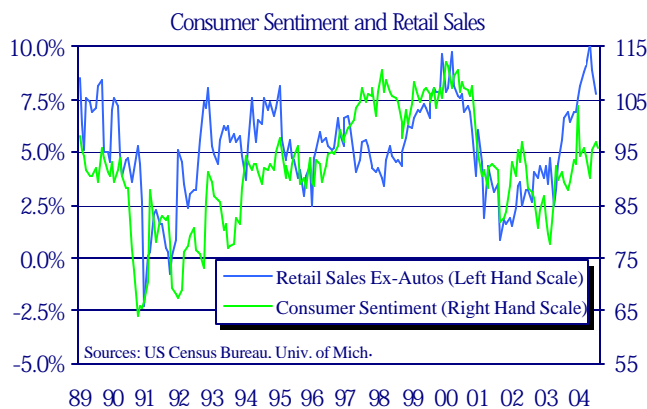
OK, maybe we’re stretching the comparison—obviously, much has changed in the past dozen years, primarily the degree to which the events of September 11, 2001 changed the lives of every American and dramatically altered US foreign policy. The cost of fighting the global war on terror has thrown a spanner into the US fiscal picture in a way that no one could have predicted a dozen years ago. The fact that the terrorist strikes occurred just as the US economy was heading south (after the all-too-predictable demise of the “New Economy”) has made it even more difficult for the US economy to find solid footing. For the average American, the world just seems a lot more unsettled these days.

Yet the comparisons are there, especially when we look at the business cycle here in the US. Our economy, after putting in a blazing performance in the first half of 2004, appears to have hit a slow patch, just as in the last cycle when talk of a phantom recovery became a highly effective mantra for the Clinton campaign (“It’s the economy, stupid”). While the terms have changed (today we hear about the “jobless recovery”, not the “double-dip”), the same question is being asked: Is

this recovery in trouble? We don’t want to keep you in suspense, so we’ll just say right up front, “We don’t think so.” Yet that doesn’t mean that there haven’t been, and won’t continue to be, bumps in the road. Recoveries never progress in a straight line.

To support this idea (and to hopefully liven up a dreary topic), we’ve included even more charts than normal in this month’s *Investment Update*.

First, let’s look at the US consumer. The top chart compares consumer sentiment and US retail sales from 1989 to mid-2004. What’s readily apparent is the similar pattern these two indicators took during both periods of economic weakness over this timeframe. From 1989 to 1991, retail sales (excluding automobiles) fell from an 8% growth rate to a -2% growth rate, while the index of consumer sentiment (a survey conducted monthly by the University of Michigan) fell from 95 to 65. The pattern was repeated in the 2000-2002 period.



But note how these dual measures of consumer attitudes and behavior at the cash register moved in the recovery phase. While sales tended to rebound fairly sharply, sentiment, in both cases, did not. After making what appeared to be a quick turnaround from its recessionary lows in 1990, sentiment slumped in late 1991 and into early '92. In fact, for the next couple of years consumers felt nervous but acted confident (again, James Carville gained near-mythical status as a political advisor to candidate Bill Clinton by exploiting consumers’ feelings of unease in 1992).

We see a similar pattern today. Despite a slight slowdown over the past two months, consumers are spending at a rapid pace (approximately 8% over last year) while consumer sentiment moves unevenly higher. This shouldn’t surprise anyone—when a recession is still fresh in consumers’ minds,



their perceived state of mind generally lags their more optimistic behavior.

The second chart compares personal income and personal consumption over the same time period. Once again, we see the drop in these indicators of consumer strength in both the 1989-'91 and 2000-'02 periods. As always, there are differences, especially in the dramatic downturn in personal income growth in the recent period. This is likely attributable to the more severe loss of jobs in the recent recession, as well as the very high baseline of income during the halcyon days of the booming late-'90's. When the economy began to slow down (and day-trading became unprofitable) the personal income component of GDP fell way off. Personal income didn't begin picking up until 2003. Today, with both consumption and income once again approaching a 6% year-over-year growth rate, the economy appears to be headed back to normal. Incidentally, these indicators, unlike many others, don't show any real slowdown at all over the past couple of months.

Now we turn to the other "half" of the economy, the industrial sector. The top chart on this page shows two measures of industrial output here in the US, capacity utilization and the year-over-year change in industrial production. Again, the two periods of economic weakness are easy to spot, as are the recoveries. The most striking feature of this chart is the anemic recovery in capacity utilization in the current period. This is perhaps the biggest disappointment of the current recovery, and a source of great dissatisfaction in the industrial Midwest states with the current administration. As the US becomes primarily a "service economy," there is a significant amount of slack capacity in the US manufacturing sector. Whether or not Mr. Kerry, if elected, could do anything to boost the US industrial sector and reverse the loss of US manufacturing jobs is, of course, an open question.

The middle chart shows the growth rate of capital investment in the US, and is significant in that it demonstrates the degree to which this segment of the US economy "fell off the cliff" in the most recent recession. By late 2001/early 2002, total capital investment in the US was falling at a rate of more than 10% per year. Yet today, with the possible

exception of "nonresidential structures" (i.e., plant and equipment—see previous chart for the explanation), expenditures on fixed items by corporations have rebounded to pre-recessionary levels. This chart, perhaps more than any other, demonstrates the strength of the current recovery, as companies tend to make large capital investments only when they have a strong sense of confidence in the future.

Which brings us to the final chart, which shows the tremendous period of payroll growth in the 1990's, as well as the extended period of headcount losses in US payrolls from 2001-03. The recent pullback of payroll gains in the second half of 2004, more than any other economic indicator, has spooked investors into questioning the health of the current economy. But we believe that the spike in early 2004 made investors overly optimistic about the future direction of payrolls. Our position is that this measure of the economy may not show the strong rebound that so many other indicators have demonstrated for a number of reasons. The primary factor weighing on payrolls is the rising cost of hiring new employees, not necessarily from higher

wages and salaries, but benefits. Medical and retirement benefits for full-time employees have been the biggest source of rising costs for businesses (health benefits costs up 50% in the last four years), a trend that isn't likely to reverse any time soon. Like the low level of capacity utilization, this is an economic indicator that, due to structural and demographic factors, may well remain depressed for an extended period, even in an otherwise healthy economy.

