Is the Economy Really So Bad?

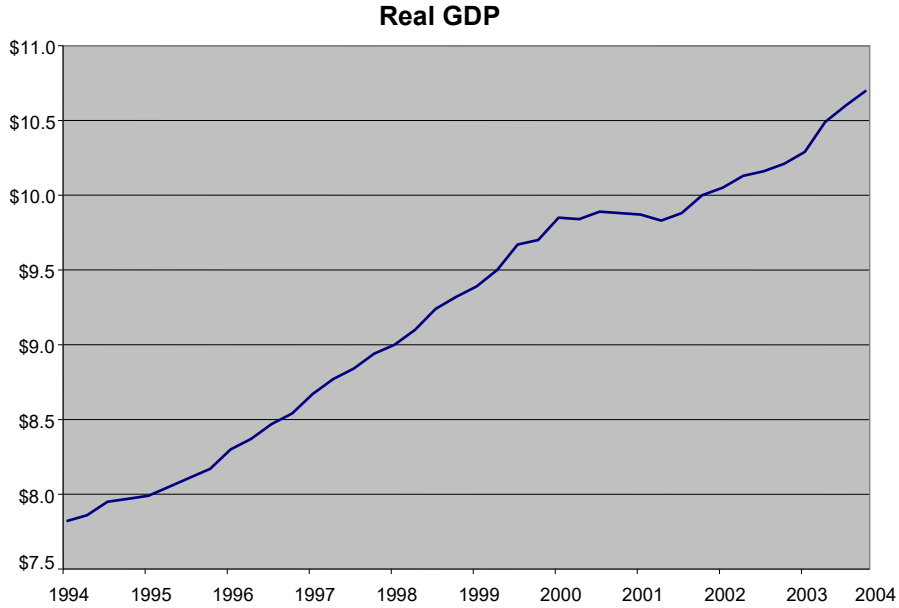
The stock market is a no-called-strike game. You don't have to swing at everything – you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, "Swing, you bum."

Warren Buffett, 1999 Berkshire Hathaway Annual Meeting

Many investors believe that the stock market's track record generally mirrors the performance of the economy. If this premise is accurate, then the logical conclusion is that the stock market's lackluster performance so far this year reflects a weak economy and poor economic prospects. After all, the Dow Jones showed a gain of less than 1% for the first six months of 2004, while the 10-year U.S. Treasury note had a negative return of .80% for the same period. U.S. Treasury bills and money market funds returned .30-.40% for this period. All in all, a very uninspiring six months in the capital markets which must, therefore, mean a poor U.S. economy.

Nothing, of course, could be further from the truth. The stock market does reflect the performance of the economy but over the long term rather than the short term. Over the short term (less than five years), there are many other factors which affect the performance of the broader stock market such as inflation, interest rates, stock market valuations (P/E ratios), elections, fiscal policies, liquidity and funds flows, and geo-political circumstances. But since much of the media daily casts doubt on the strength of the U.S. economy, let us take a brief look at some facts about the U.S. economy.

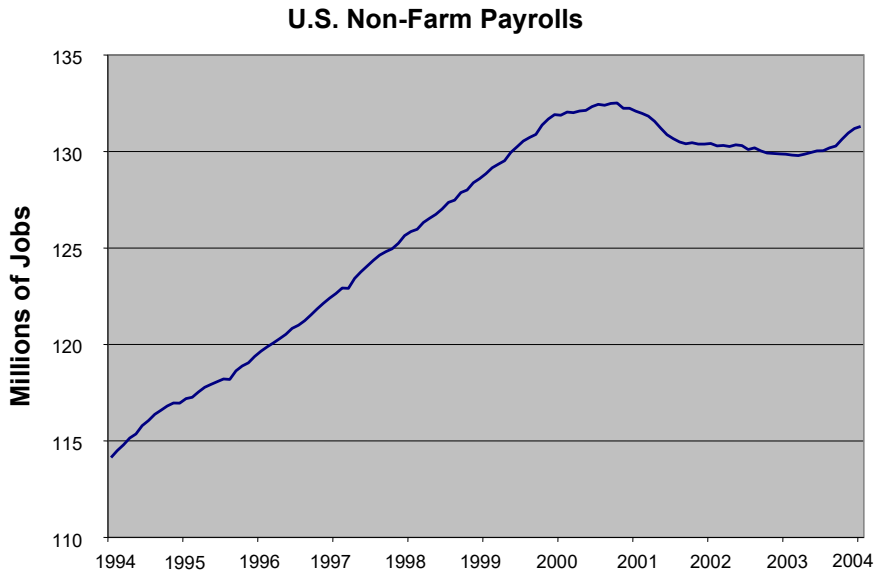
Gross Domestic Product



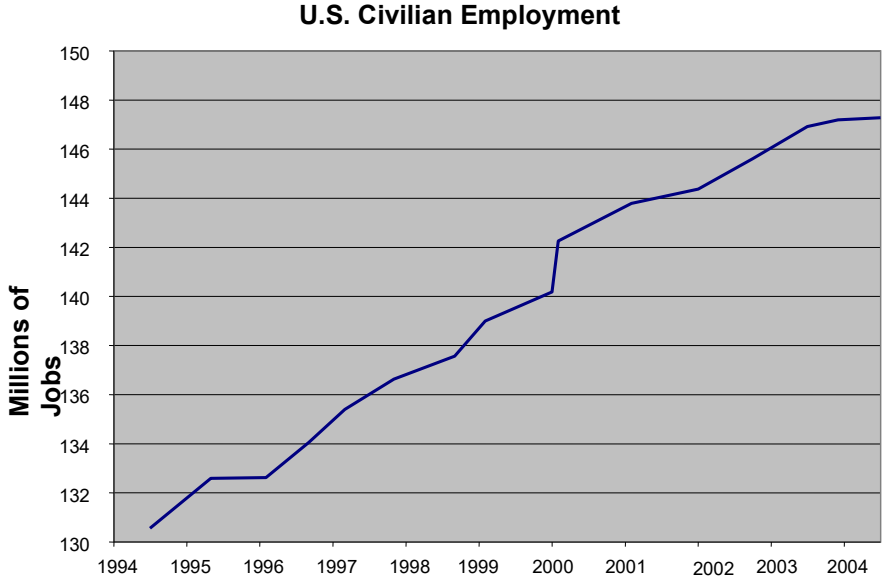
As can be seen from the above graph, real GDP dipped slightly during the brief recession which started in the fourth quarter of 2000 and ended during the fourth quarter of 2001. Beginning in early 2002, real GDP resumed its growth and began to accelerate strongly during the second half of 2003. GDP growth in the second half of last year was 6%, moderating in 2004 to roughly 4%. Currently, GDP is approaching $11 trillion – approximately 10% above the start of the recession when the Bush administration took office.

Jobs and More Jobs

As the presidential election campaign has swung into high gear, we have frequently heard of the "jobless recovery." Some stock market pundits believe that the current recovery is illusory, as it is built upon a temporary consumption binge fueled by tax rebates and mortgage refinancing. The Democratic presidential nominee has even called the last three years the worst job record since the Depression, as there has been, according to him, a net loss of two million jobs in the U.S. during this period. While it seems a stretch to equate the current economy to the Depression, when 25% of the work force was unemployed, the graph below does seem to lend credence to the claim about the number of jobs lost since 2000.



But there is more to the story. The above graph tracks all private non-farm jobs including employees in offices, factories and stores as well as federal, state and local government workers. The graph below tracks employment in all civilian capacities. This includes employees in the above non-farm statistics plus farm workers, laborers, employees in small businesses and the self-employed. This graph shows an unbroken trend of rising employment over the last three years – including during the 2001 recession. This chart demonstrates that roughly three million jobs have been created since the end of 2000.



Since the start of this year, there has been strong job growth in the U.S. – especially in jobs tracked in the non-farm payroll numbers. Over 500,000 jobs were created in both the first and second quarter of this year. Many observers believe that the U.S. economy will create 2.5 million jobs in 2004. They believe that we are in the midst of a durable economic expansion fueled by lower taxes, innovation and productivity gains, flexible labor, and growth in small businesses and among the self-employed. These graphs also mask the tremendous change that occurs continuously in the job market. In any given quarter, approximately 7.5 million jobs are created, according to David Malpass, chief global economist at Bear Stearns, and roughly that number are lost. The incremental growth of 100,000-500,000 is what shows up on the economic graphs on the previous page.

What is remarkable about the U.S. economy is the unemployment trend starting with the Reagan presidency. The graph below shows the U.S. unemployment rate, which spiked to a high of 11% in the 1981-1982 recession as the inflationary spiral was broken by President Reagan and Fed Chairman Volcker, and currently is at 5.6%. What is notable is how the unemployment rate during each recession is lower than that of the previous recession. The unemployment rate following the 2001 recession peaked at slightly over 6% – roughly half of the rate in 1982. The U.S. track record in this regard continues to be the envy of the industrial world, as the unemployment rate in France and Germany continues to track at double digit levels.



"Hamburger Flipping" Jobs

Most of us have heard the criticism that many of the jobs currently being created are not quality jobs; rather they are menial jobs and don't pay a living wage. These jobs are derisively called "hamburger flipping jobs." In the early 1900's those in search of employment knew the story of Horatio Alger who succeeded through hard work, integrity and creativity. Now, some in politics and the media scorn these entry level jobs as demeaning and poverty-inducing – only suitable for immigrants. This, of course, is a deeply destructive way of thinking. Who of us has not worked in a restaurant waiting on tables, or caddied on a golf course or worked on a landscaping or construction crew? Work, even at the menial level, if performed with excellence, fosters dignity, teaches industry, and is in itself ennobling. Entry level jobs teach workers how to take responsibility, be polite, show up on time for work, and deliver on their commitments. How many dozen CEOs like Dave Thomas of Wendy's had their first job working behind the counter or like Carly Fiorina, CEO of Hewlett Packard, working as a receptionist? No, jobs at the bottom of the ladder can and do lead to the top, and it is an illusion to believe that the path to riches is the lottery or the class action lawsuit.

Will the Strong Economy Lead to a Higher Stock Market This Year?

It would be good to be able to answer this question with a resounding yes. Unfortunately, the answer is maybe. There are four issues which cause investors anxiety, and the two most important pitfalls are non-economic. The risks are as follows: higher interest rates, higher energy prices, Iraq and the War on Terror, and the presidential elections.

The Federal Reserve raised the Fed Funds rate from 1% to 1.25% in June. Four more Fed meetings are scheduled before year-end. It is our view that the Fed will gradually raise short-term interest rates during this period so that the Fed Funds rate will be at 2-2.25% by year-end. This is widely anticipated by investors and should not cause the market too much pain. Energy prices spiked during the second quarter of 2004 but have not done significant damage to the economy. The U.S. economy is much less vulnerable to higher energy prices than it was several decades ago, and we do not believe that energy prices at this level will derail the economy or hurt the stock market.

One or more terrorist attacks on U.S. soil continues to be a risk. The Democratic and Republican conventions being held this summer in Boston and New York are natural targets, but, in our view, another attack on the U.S. would likely strengthen American resolve rather than weaken it as was the case in Spain. With the first turnover in Iraq having taken place in late June, there is a reasonable chance that the Iraqi government can muddle through until the elections in January 2005. But a terrorist attack is always a wildcard when forecasting the likely performance of the U.S. stock market.

The U.S. presidential election is now the biggest factor influencing the stock market until November. Market strategist Ned Davis has written that during presidential election years, the Dow Jones has averaged –.75% during the first five months of the year, while it has risen 10.7% during the period June through December. The first five months of 2004 certainly held true to this pattern. However this is not a normal presidential election, as the country is bitterly divided in what promises to be a very close election. It is reminiscent of the 1800 election when it took the House of Representatives 36 ballots spread over 5 days to elect Jefferson rather than Burr. Aside from differences about Iraq and foreign policies, there are major differences between President Bush and the Democratic nominee Kerry on fiscal policies. Kerry has promised to raise taxes on capital gains and dividends, estate taxes, and income taxes. He also would like to try to pass a national health care plan, and there has been much talk about trade protectionism. No presidential candidate since Hoover has campaigned on a policy of trade protectionism, as the majority of economists believe that a major cause of the Depression was the protectionist Smoot-Hawley tariff.

Most investors attribute the re-invigorated economy and resuscitated stock market to lower taxes. With the Democratic presidential nominee calling for higher taxes in the midst of such a close election, we believe that the stock market will mark time until the outcome of the election appears easier to call. Fundamentally, the stock market appears to be somewhat undervalued, using both the Rule of 20 and the Federal Reserve earnings yield methodologies. Patience, however, is still required. Bond returns will likely be negative for the full year, and stock market investors, who hate uncertainty more than anything, will hold off switching from cash to stocks until the election is less opaque. Fortunately most of our clients understand this and are not chanting, like Buffet's investors, to swing at any pitch, but rather are encouraging us to wait for the right pitch to come across the plate.

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