

Goelzer Investment Management
Economic & Market Review and Outlook
April 3, 2004

Goelzer Investment Management

Economic & Market Review and Outlook

April 3, 2004

Election season is upon us once again, providing excitement and intrigue for some and inducing yawns in others. Is the world falling apart, or are things the best that they have been in a long time? It's easy to hear both messages these days, reminding us of the proverb about the three blind men each using a different simile to describe the same elephant. It's also easy to grow weary of the endless political banter. Criticisms about the government not doing enough of one thing or too much of another are abundant. But is this criticism alone productive and inspiring? Stephen Covey, the best-selling author of *7 Habits of Highly Successful People*, points out that between stimulus and response, we have the power to choose our reaction—a uniquely human prerogative. Perhaps the tendency to be cynical and tired in election season can be turned on its head and into something invigorating. It could be what is most needed today is what President Kennedy called for over forty years ago: a focus not solely on ourselves but on the bigger picture. How will you choose to respond this year to make a positive difference?

The Economy

- The level of gross hiring in the fourth quarter of 2003 was lower than in the months immediately after September 11, 2001. This despite 8.2% growth in GDP during the third quarter of 2003. While much has been said of the downside to this heretofore “jobless recovery”, the lesser mentioned upside has been a dramatic increase in productivity, a main component of corporate profit growth.
- Business investment continues to be strong. Importantly, equipment and software sales, a key driver of this productivity increase, were up impressively in recent quarters: 17.6% and 14.9% in Q303 and Q403, respectively.
- The result of slow job growth during a period of relatively robust economic expansion and low interest rates has been several consecutive quarters of earnings growth well above expectations. When the numbers are tallied for the most recent quarter, expect earnings to have grown by approximately 18% versus the same period last year.
- Prices for raw materials and commodities have driven the NAPM prices paid index to its highest level since January 1995. Gold, long thought of as an inflation hedge, has been exceptionally strong—is inflation, and in turn, higher interest rates, on the way?

Outlook: While the unemployment rate remains at what is a historically very acceptable level (from a free market economic perspective), the slow pace of net job creation and wage growth at this point in the expansion remains a much debated issue, especially in this politically charged election year. Technological advances have doubtless enhanced the already stunning productivity of the American worker, but this trend can't continue forever. To shed some additional light on this issue, it's important to recognize the power of a particular mega-trend in our economy, underway for the last 50 years: in the 1950s, roughly 50% of our GDP was attributable to manufacturing; manufacturing now represents less than 20% of GDP. As we progress toward an economy that better reflects our competitive advantages (entertainment, financial services, intellectual capital, entrepreneurship, health care, innovation, etc.), worker retraining and education take on increased importance in maintaining our global economic strength.

Stock Market

- After a strong start this year, stocks suffered a setback following the recent attack on commuter trains in Madrid, Spain. Investors were reminded that terrorism remains a threat. Consequently, the major market indices are roughly flat thus far in 2004, though it's worth noting that the S&P 500 has turned in better results than either the Dow Jones Industrials or the NASDAQ composite.
- Financial, consumer staples, and energy stocks have out-performed the broader indices thus far this year, while the health care, industrials, and basic materials sectors have lagged.

Outlook: It's interesting to note that the best performing sectors in the first quarter were the more defensive areas of the economy, reversing a trend in the latter part of 2003 which favored more economically sensitive sectors. These defensive sectors—notably consumer staples, financials, and energy—tend to include companies committed to raising dividends. Despite favorable demographics, health care continues to struggle under the weight of the drug re-importation issue and from political and regulatory uncertainty. Economically sensitive sectors, such as industrials and materials, took a breather during the quarter after a very strong

Goelzer Investment Management

Economic & Market Review and Outlook

April 3, 2004

showing in recent months. Equity returns in these areas were subdued by higher energy prices (companies in these sectors are typically reliant on natural gas and petroleum products in their manufacturing processes) and lingering concerns in some minds as to the sustainability of this economic recovery. All said, first quarter profits are likely to be strong. Higher tax refund checks resulting from the tax cuts enacted in 2003 and the home mortgage re-financing boom have yielded higher monthly discretionary income, albeit partly offset by near-record high gas prices. Business investment is also on pace to exceed the remarkable rebound it enjoyed in 2003, a very important key to ensuring a self-sustaining economic recovery.

Bond Market

- Despite all the fundamental data that would suggest otherwise, the price of the benchmark 10-year US Treasury Note has risen since the first of the year, driving the yield down from approximately 4.40% to 3.84%.
- Investment grade corporate bond yield spreads over Treasuries continue to be tight. Currently, government agency bonds (with an implied government guarantee) yield more than their corporate peers despite also carrying higher credit ratings.
- *Jobs, Jobs, Jobs.* Though the unemployment rate in March inched up to 5.7% from 5.6% (a function of more people being drawn back into the workforce), roughly 500,000 net new jobs have been created thus far in 2004.

Outlook: One could devote several pages to the issues surrounding the current level and future direction of interest rates. We may very well be nearing an inflection point in Federal Reserve monetary policy. Suffice it to say that for now, in our view, the Fed will most likely hold the line on interest rates—barring an unforeseen job creation surge in the months ahead—through the election. However, once the shift from a neutral bias occurs, interest rates could very well move meaningfully higher in a relatively short time frame, making longer maturity bonds a very poor investment choice.

Feeling very much like a broken record, we continue to believe that the next major move in interest rates will be up. The question in our minds is simply when, not if, this will happen. It's clear that the twists and turns of employment reports increasingly whipsaw economic growth projections and financial asset values. The Fed has vowed to remain on hold until either inflation heats up or the employment picture brightens; that may mean a Fed funds rate at 1.00% for the remainder of 2004. Given our view, we continue to favor bonds with short to intermediate maturities. This strategy seeks to both protect against the adverse effect of rising interest rates and take advantage of investment opportunities when yield levels are higher. Perhaps this view received some tentative initial confirmation with the March employment report.

DJIA 10357.70 S&P 500 1126.21 10 Yr. US Treasury 3.84%