



## Barometers of Prosperity

October 18, 2004

Here we are at the beginning of another autumn accentuated by the hype of the presidential election. Yet, after months of positive economic data, the equity markets are still drifting, interest rates remain surprisingly low and the public mood is hardly what one would call euphoric. In poll after poll, many Americans remain skeptical about the economy. So, we've been wondering: What theory explains the uncoupling between how the economy is doing and how people think it is doing? The short answer is that corporate America is generating record profits, small consultants are thriving, and entrepreneurs are budding, but why aren't average workers benefiting? Let's not address that perceived problem yet but go on to examine other barometers of prosperity inherent in America's land of economic freedom that contribute to wealth creation.

There are about 8,000 actively traded companies in the United States with more than 140 million workers on U.S. payrolls. No doubt, corporate profitability has fueled a strong economic recovery. Over the past year, robust corporate profits sparked a sharp rise in equity markets (up as much as 28% in small value stocks). However, the average worker may not have done as well as the market or as corporations even though employment has improved and wages have risen. Many companies continue to see significant double-digit earnings growth while average hourly earnings for workers are up only 2.0% and disposable income is up 3.9%. On a positive note, inflation remains low and mortgages outstanding have quadrupled during the past four years so the average worker is benefiting from low inflation and low interest rates, factors that mitigate slow growth in earned income.

Throughout history, there has been tension between business and labor. Presidential candidates do battle about who is helping the middle class. A new term, outsourcing, has emerged describing the loss of jobs to foreign competitors. This battle to secure reasonable relations between companies and the people is not confined to the U.S. Extreme examples exist with France being one example. Two hundred and twenty-five years ago, another disconnect had serious consequences. Animated by a deep sense of injustice and inequality, citizens of Paris stormed the royal prison known as the Bastille and freed its prisoners. So began the French Revolution. Across the ocean, the new United States applauded.

We live in a rather different world today. America is the most prosperous country in history, but not all Americans agree. The present situation is hardly unprecedented. At various moments in American history, corporations and wealthy individuals have accounted for a substantial portion of the nation's wealth. In 1890, for instance, after a period of technological innovations and business upheavals (sound familiar?), the richest 1% of American families owned half of the national wealth. Today, there is a far more even distribution. Over the past two years, as the economy has recovered, large corporations have been responsible for nearly 50% of the growth, while workers have accounted for somewhat less. In past recoveries, by comparison, workers have accounted for 65% of the growth in national income while corporations have averaged 15%.

This gap between corporate profitability and wage growth may explain why many Americans think that the economy is not doing as well as it is, and why the economic prosperity looks to be an issue during the presidential election. Normally, the headline numbers showing 4% annual GDP growth and 3.9% growth

in personal disposable income should be strong enough to make the economy a benefit for the incumbent (Bush) and liability for the challenger (Kerry). That relationship may not hold this time.

To most Americans, economic statistics don't matter. They're just numbers. What matters is the number on the paycheck, the price of gasoline, and maybe most of all, expectations! If income is growing less than 4% a year, but people expect their wages to grow 6% a year, they will feel that they aren't doing as well. If you earn \$100 and were expecting \$90, you'll probably feel pretty good. If you earn \$100, and were anticipating \$150, you'll probably feel lousy.

In the past, the imbalance between labor and capital has always been temporary. As companies become more profitable and the economy accelerates, the labor market tightens and workers tend to gain leverage. The result is rising wages. Today, however, because of what is being called "the global labor arbitrage," companies are using information technologies to find labor globally where it is least expensive, and that is extending to services as well as to manufacturing. The result could well be a long period where corporations, rather than workers in industries that compete with imports, account for a larger share of economic growth. Of course, lower prices of those same imports keep inflation low for the rest of us.

### **U.S. Economy**

With all the attendant risks and uncertainties that prevent many of us from seeing the forest through the trees, the forest still looks pretty good. There are positive barometers of future prosperity. Despite economic data pointing toward lower growth than that achieved through the first part of this year, the U.S. economy still harbors enough cyclical positives to maintain a trend growth rate of 3.5% to 4%.

The moderate increase in consumer prices early this year sapped buying power and confidence while triggering widespread speculation of an aggressive timetable for Fed tightening. Three months of benign inflation readings have buoyed consumers and eased interest rate pressures. Nevertheless, in the third week of September the Federal Reserve raised the Fed Funds rate by ¼% to 1.75% -- still at 43-year lows. The Fed's assessment that "policy accommodation can be removed at a pace that is likely to be measured" was a repeat from its August policy statement and allows the central bank flexibility in how fast to move back to a neutral policy. Even with the increases in oil and commodity prices, inflation remains very tame. This fact can partly be attributed to the rise of China as a highly efficient, low-cost manufacturer and the continued integration of information technology into every aspect of people's lives.

The most recent report on durable goods orders also was more encouraging than its headline number suggested. This important report, which points to future activity in manufacturing, appeared to be discouraging at first glance, with a larger than expected decline last month. But excluding the transportation sector orders for durable goods rose a solid 2.3%, with healthy increases in many sectors including computers and electronic products (+4.1%). Shipments of durable goods (+1.7%) were at their highest level since April 2000, and unfilled orders were the highest in more than three years. This performance in manufacturing bodes well for growth in employment and incomes.

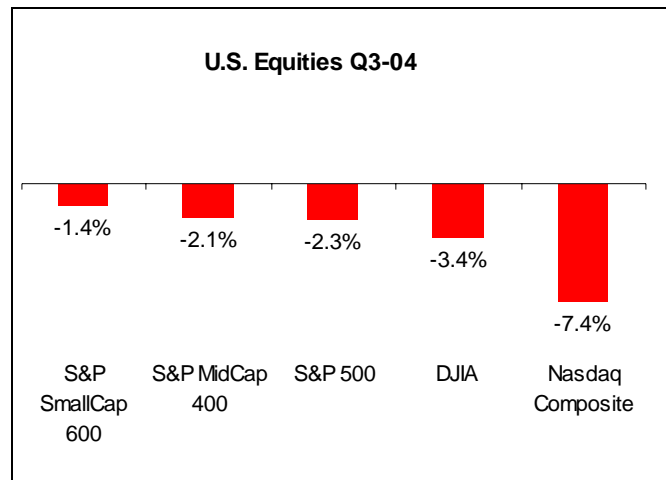
The overall employment picture remained the same: not good, not bad. The national unemployment rate declined to 5.4% during September -- the lowest level since October 2001. The current employment situation, as we have been saying for many months, highlights the shift away from the past patterns inherent in the manufacturing sector. Companies are meeting their needs with a robust combination of a lean labor force and the efficient use of information technologies.

Consumers continue to fuel modest and consistent economic expansion. Discretionary spending and income growth have been sluggish -- mostly aggravated by the high price of oil. Consumer spending for the second quarter was revised to a 1.6% annual growth rate, compared to 4.1% in the first quarter.

The manufacturing industry continued to show strong gains in output and productivity even as the labor force has declined. The ISM Index, one of the best gauges of manufacturing activity, slowed slightly during the quarter while industrial production was up 5.2% year over year, with manufacturing production up 6.8% for the same period. Though business spending has not increased as rapidly as many expected, it has registered steady gains that has led to very healthy manufacturing numbers.

### U.S. Financial Markets

The third quarter turned out to be another disappointing period for those invested in U.S. stocks. Virtually all U.S. equity indices ended down. The Dow Jones Industrial Average posted an overall decline of 3.4%, the biggest percentage quarterly decline since the first quarter of 2003. The S&P 500 fell 2.3%, leaving it up 0.24% on the year while the Nasdaq Composite Index, with its high component of technology shares, fell harder, down 7.4%, leaving it down 5.3% so far this year. Overall, small capitalization stocks continued their winning streak compared to their larger cap brethren while value stocks of all sizes significantly outperformed growth stocks.



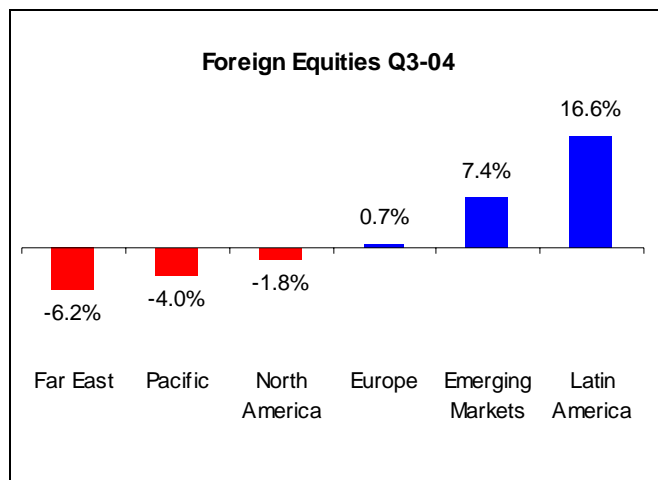
The breadth of bad news toward the end of the third quarter was striking. Oil futures surged above \$49 a barrel, near a 21-year high, and more companies warned of quarterly earnings disappointments than in any other month this year. At the end of September, the election outcome remained uncertain and so did the future of Iraq and the dangers of terrorism. Unfortunately, investors in equities have been struggling with losses since the market peaked in February.

Based on history, a weak September stock performance isn't unusual. The typical stock pattern, in fact, is a rally in late summer followed by a September slump. Although stocks historically show gains for most months, they have averaged a small decline in September since 1900. One reason is that September is the last month of what often is a difficult quarter. Many companies tend to slow down over the summer and then stage their strongest performance in the fourth quarter. In September, investors are returning from vacations and beginning to worry whether companies will live up to the market's expectations.

To the amazement of many investors, including us, Treasury bonds were among the third quarter's best investments. Despite three successive interest-rate increases by the Federal Reserve, beginning on June 30, the yield of the benchmark 10-year Treasury note finished the quarter at 4.125%, near a six-month low. To find a quarter like this, turn the calendar back to 1971. Treasury-bond prices rose during the past three months, pushing yields lower. What made the latest quarter unusual was falling bond yields even while the Federal Reserve was continuing to raise its target short-term interest rate. Our half-full view of this dramatic rally from a yield near 4.9% just three months ago is that the flattening yield curve reflects the favorable outlook for inflation and high marks for Federal Reserve monetary policy. Still, the size of the move also strongly suggests a lack of confidence in the staying power of the expansion. Additionally, strength in the bond-market is partially a result of people using bonds as a parking place until they are confident in the staying power of the economic expansion before investing in the stock market.

### Foreign Financial Markets

Foreign equity markets generally stabilized during the past three months as investors decided interest rates wouldn't rise as quickly as they had feared. The Dow Jones World Stock Index excluding U.S. stocks fell 0.2%, in the third quarter, while regional indices as measured by Morgan Stanley Capital International fared better. Latin America was the star-performing region as higher oil prices boosted equities in Argentina, Brazil, Mexico and Venezuela. Investors were willing to purchase riskier assets during the third quarter that benefited Emerging Markets: Turkey, India, and South Africa posted solid double-digit gains. Investors warmed to continental



Europe where corporate earnings are expected to grow faster than those in the U.S., but rate rises in the United Kingdom and other European countries coupled with slowing economic growth resulted in a moderate gain for the overall region. The Pacific region declined over the last three months as Japan, one of the worst-performing markets in the third quarter, fell on profit-taking after the economy made headway in its struggle against a decade of deflation. The worst performing region was the Far East: investors took profits as fears about a hard economic landing in China and the absence of clear direction for the global economy prevailed.

During the third quarter, economic news from Japan was mixed, with the corporate sector showing continued strength, while private consumption remained weak. Corporate investments rose 11% year-on-year while current profits increased 34% during the same period. However, the Japanese employee experienced falling wages along with fewer jobs (the unemployment rate rose from 4.6% to 4.9%). Additionally, spending by households fell 2.5%, the third decline in as many months. Consumer spending accounts for approximately 60% of Japan's GDP and it will be difficult for a sustained economic expansion to take root as long as both consumer spending and sentiment remain weak.

In China, fixed asset investments within the steel industry, one of the sectors specifically targeted by the government's credit rationing, grew 44% during the quarter. Foreign direct investment flows, which rose 15% from a year earlier, seem undeterred by the engineered slowdown. Across the Peninsula, Hong Kong and Taiwan had positive news during the third quarter. Hong Kong's latest consumer price index data for July posted a 0.9% increase year-on-year, thereby ending sixty-eight months of deflation. GDP grew by 12% when compared to the lower (SARS-impacted) quarter of last year, prompting the government to raise its full year forecast to 7.5%. Taiwan's economy grew at its fastest pace in four years as GDP expanded by 6.7% in the most recent quarter on the back of an increase in manufacturing output and trade. The government raised its full-year 2004 economic growth forecast to 5.9%. On a more somber note, Typhoon Aere hit Taiwan with winds up to eighty miles an hour, which left several people dead and shut down Taiwan's stock exchange for two consecutive days.

On the European continent, weakness in France and Germany offset strength in Belgium, Ireland, and Norway. During the third quarter, solid performance by pharmaceutical companies contributed to strong results among euro zone health care stocks, while poor returns among Internet and IT services companies drove information technology stocks sharply lower. Europe's economic recovery remains on track, with stronger growth in Germany and France. The rebound has been fueled by demand for exports, however, raising questions about its sustainability given slowing growth in the U.S. and China.

During the third quarter Brazil posted GDP of 5.7% as growth in the agricultural sector coupled with a nascent spark in consumer spending came in stronger than expected. Additionally, Brazil's key interest rate – now at 16% - has not been raised in 18 months. This stability in interest rates gave businesses and consumers alike confidence in a strong future economy. In Argentina, the government's latest proposal that forecasts investors will lose 75% of the value of the bonds they hold (versus 90% in an earlier plan) was welcomed by financial markets as the country moved closer to a final debt re-structuring. During the quarter, inflation concerns grew in Mexico that sparked fears of monetary tightening in the months ahead. At the end of the quarter, President Vicente Fox gave his state of the nation address in which he announced cuts in the retirement packages of workers in the healthcare, electricity and telephone sectors. Fox has been trying to push through an opposition Congress his tax, energy sector and pension reforms since he took office in 2000.

## Conclusion

Business leaders, investors, and Americans are clearly concerned about interest rates, oil prices, Iraq, terrorism, and the election. These concerns are and have been affecting investor behavior. There is the absence or at least the perceived absence of a major new trend (X factor), product or technology that could transform the way we live, and act as a catalyst to investment and growth in our economy. On the other hand home ownership and newly created businesses coupled with a record new level of American wealth creation (the value of all assets like stocks, bonds, homes and businesses—less debt and liabilities—has surpassed even the 2000 technology bubble) are barometers of future prosperity.

Globally, the steady economic expansion fueled by U.S. consumption and by Chinese production and consumption shows no signs of dissipating anytime soon. While China is a dramatic force of change, its effects have been felt most in rising commodity and material prices and in pricing pressure on electronics, textiles, and a variety of durable goods. China has yet to prove that it is a source of innovation. Conversely, the United States is an innovator, and will likely continue to be one given our free-to-choose philosophy, our economic freedom, and our ability to identify opportunities. Take one of the leading health challenges in the U.S. today: obesity. Tens of millions of Americans are dangerously overweight. For those health care companies that can develop treatments, there is a large market and a growing need. Both presidential candidates have spoken about the importance of technology in the management of health care services. Technological advancements are seen as a primary way to cut costs from the ballooning healthcare system and to improve patient care. Finding ways to address these and other healthcare issues will benefit society as a whole and should contribute to economic growth.

We also think that there's a great opportunity in energy. Over the past 15 years, U.S. oil imports have risen sharply as consumption increased with no uptick in domestic production. While the price of crude for most of that period declined, it has dramatically risen over the past year or so. There are many reasons for this increase. One is due to increased demand from China. And while it is true that adjusted for inflation, Americans pay less for gasoline at the pumps than they did 20 years ago, one by-product of cheap fuel has been inefficiency. Because of a loophole that allows SUVs to be classified as light trucks, they do not have to meet the same fuel efficiency standards as regular cars. Since SUVs now account for the majority of new domestic car purchases, nearly half of our oil consumption is driven by our driving needs.

A long-term policy of greater energy efficiency and independence has the potential to kick the economy into even higher gear. The combination of government and corporate resources in this effort would require new R&D spending as well as massive new capital spending on everything from electricity grids to power plants, generators, solar panels, and diesel engines, it would lead to more economic activity in almost every industry. Economic booms require an X factor, such as the railroads in the late 19th century, the automobile and electrification in the 1920s, and computers and the Internet in the 1990s. Energy independence is a potential catalyst and an opportunity waiting to be seized.

Forty years ago, when the United States was entering the Vietnam War, inflation was rising, and everyday, people lived with the fear of global nuclear war and annihilation. The equity markets were volatile during that period, but the economy grew steadily, and successful investors found strong companies. We are in a similar climate today, and though the equity markets may do better now than they did then, stock picking at the company level will be a crucial factor for success. It would be nice to live in a perfectly safe and secure climate, but in the meantime, the economy, businesses, and the markets can thrive even in a tumultuous, chaotic, and rapidly changing world. We think that equity markets have quietly entered a phase of steady gains fueled by good fundamentals, attractive valuations, and cautious investor sentiment. These characteristics have not yet diminished widespread investor concerns, but concern and upward movement in the markets can co-exist.

**A Quote for Thought:** “In the business world, the rearview mirror is always clearer than the windshield.”  
*Warren Buffett*

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