Jamesson Associates

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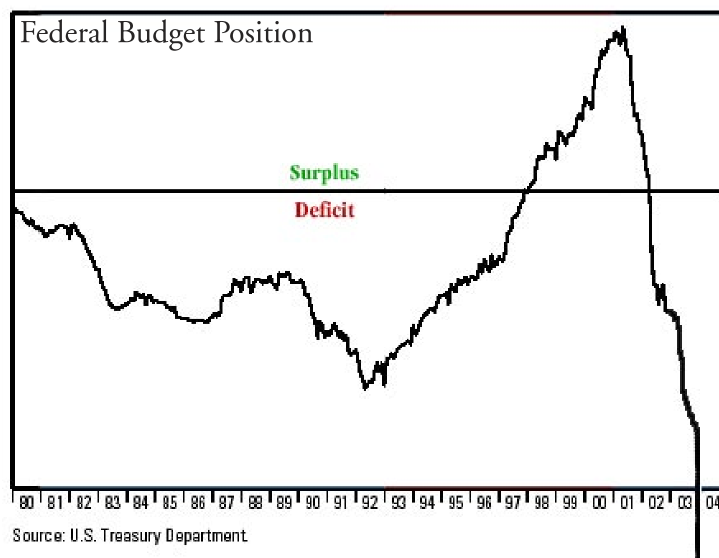
Recent Economic Events

The American economy showed very solid but still below-potential growth in the second quarter. Driven by substantial improvements in productivity, inflation remains under downward pressure, and headwinds to employment growth continue to blow. Additionally, Federal finances have deteriorated further.



GDP increased by 3.1% in real terms during the second quarter of 2003, but over half of the increase was due to defense expenditures by the Federal Government. Let's hope that this source of "strength" will be fleeting. The pleasant surprise in growth was not enough to turn around the inflation rate. The GDP price index was up only .2%, down from 3.4% in the first quarter. Adjusting for food and energy, the core rate rose .6% versus the previous 1.8%. During the second quarter, productivity rose 6.8%, and unit labor costs fell by 2.8%.

More general inflation statistics also continue to show modest price pressure at best. Core PPI was up .2% in July, keeping the annual change at 1.5%. The core Producer Price Index edged up .2% in July, an amount equal to the entire increase from one year ago. There appears to be some movement in the raw commodity indices. The CRB index has moved back over 242 for the first time since early March and is within 10 points of its annual high achieved in February. Gold also appears to be breaking out to new territory. Commodity prices have been advancing for a while, but follow-through at the wholesale and retail level has been scant.

Employment statistics seem to be stabilizing but have yet to improve. Both new and existing claims for unemployment insurance have receded from their recent highs. However, while the former have settled in at the more neutral 400,000/week level, the latter have begun to increase once again. The Conference Board asks those it polls whether jobs are "plentiful" or "hard to get." The plurality in favor of the latter is at a new recovery high. Its correlation with the unemployment rate is very good, and this, combined with the still-MIA Help Wanted advertising, suggests the unemployment rate may have further upside.

The real economic story over the past three months has been the increase in projected current and 10-year Federal budget deficits. New estimates suggest a deficit of $480 billion for this fiscal year and a pick-a-number shortfall over the next decade. In fact, the ten-month deficit through the end of July totaled $324 billion, a figure larger than any

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Recent Economic Events (continued)

full-year deficit in history. Couple this with the potential for further spending in the Middle East and for a prescription drug benefit (not included in the official out-year projections), and we are likely to be drowning in red ink as far as the eye can see.

The implications are significant. It's no coincidence that as the new figures were digested by the market, rates were pushed upward. Turns out deficits do matter. Furthermore, anyone with even a short-term memory will remember that the previous deficits were brought under control only when first President Reagan, then President Bush, and finally President Clinton all raised taxes, and Mr. Clinton fought a standoff with a Republican Congress limiting spending in the last half of the 1990's.

The economy appears to be stabilizing and trying to grow at potential. Inflation remains low, so there is little constraint on policymakers at present. It is likely that the pedal-to-the-metal approach will stay in place until there are more hopeful signs on the employment front. Then, and only then, will we have to turn to the inevitable issue of an exploding Federal budget deficit and the debt necessary to cover it. For now, the rise in rates associated with that concern appears to be a secondary consideration.

Commentary

Labor Day 2003 – As I sit down to write this commentary, I have been reviewing a number of statistics concerning the American worker. Some of the more trenchant:

- Over 2.5 million fewer Americans are on the payroll than in early 2001, with over 1 million jobs lost since the end of the recession in late 2001.
- American workers put in an average of 1825 hours in 2002, while Europeans on average work 10-20% fewer hours.
- 83% of workers recently polled indicated it was likely they would seek new employment once the job market recovered.
- My oldest son just entered college and will need a job soon enough.

Although the last item is the most important for me, on a more general level, it seems that Americans will put up with a lot and work hard. However, when the fear of joining the unemployed lifts, a good deal of volatility awaits. But when will the concern lift?

A debate has arisen over whether good jobs have been temporarily or permanently eliminated during the recession and ensuing weak recovery. Some contend that the job loss is the normal pattern, and as the economy moves into high gear, employment growth will pick up substantially. Others suggest that outsourcing, previously focused on low value-added manufacturing jobs, has now migrated to the information-intensive service industries. Morgan Stanley reports,

"Indian employment in IT-enabled services (ITES) outsourcing (of which about 40% is in call centers) jumped by 54,000 to 160,000 in the year ended in March… [and] by March 2004, India will host 60–70,000 more jobs in ITES. Small wonder: … the cost of an Indian ITES employee is just 15% of a U.S.-based employee."

Recent reports in *Business Week* suggest that even the Indians are losing out to English-speaking Chinese in call center outsourcing. The relentless pressure on costs is driving many companies to use lower-cost employees wherever they can be found. Furthermore, the global network provided by the Internet has placed cutting-edge technology in the hands of workers in less

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Commentary (continued)

developed countries almost as quickly as it has in the United States. This is a structural issue that will not go away.

Even President Bush has noted the situation. Pre-vacation, Mr. Bush opined that his tax cuts were doing the job and that no more would be needed to restore the economy to health. Post-vacation, the President stated, "We have a responsibility that when somebody hurts, government has got to move." As Arsenio might say, "hmmm." Is there an election on the horizon?

The US economy is going through another wrenching change as the free market seeks to rationalize inputs of capital and labor. The key is productivity. American workers are more productive and work longer and harder than virtually any others in the world. This suggests that some of the concern over jobs moving is overblown, but it also suggests that real improvement in domestic employment may be delayed by companies trying to further leverage gains in productivity.

I am not yet despondent over the course of events. (Matthew doesn't graduate for a few years.) That leaves enough time for a vigorous debate on the both the short-term issue of specific stimulus for job growth and the long-term issue of structural pressures on our competitiveness. It finally appears that the political process is focused on this issue rather than that of taxes or of foreign policy. It's about time. The battle between "reduce taxes and the jobs will come" and "use tax revenues to target job creation" has been joined. Let's all choose up sides.

Market View

Since my last newsletter in early June, the bond market has backed up by roughly 100 basis points while the stock market has inched ahead. Reasons are easy to identify. For the bond market, the negatives have included the evaporation of Fed credibility, the exploding structural federal budget deficit, and initial signs of a growing economy. The stock market has absorbed these same facts along with the sharp increase in interest rates and decided to mainly digest its gains from March.

As I suspected last time, one of the major financial markets was likely to be wrong in its assessment of economic prospects. It appears that the bond market was the loser. However, the rapid increase in interest rates suggests that there may be opportunity even if the bond bull market has ended.

If the Fed is successful in moving the inflation rate back up to 2%, it is likely that the Federal Funds rate will increase. The question: how high?

BCA Research, a respected economic analysis firm located in Montreal, suggested in its September *Fixed Income Monthly* that the equilibrium real Federal Funds rate is 3%. With inflation targeted at 2%, the implied equilibrium Federal Funds rate would be 5%. In his August 2003 Fed Focus, Paul McCulley of PIMCO, the largest fixed-income manager in the world, suggested that the appropriate real Federal Funds rate should be equal to zero after-taxes. Assuming an inflation rate at 2% and an economy-wide tax rate of about 20%, the real pre-tax rate needs to be 40 basis points. Adding the real rate to the inflation target of 2% yields an equilibrium Federal Funds rate of 2.4%.

The difference between these estimates (both from respected sources) is not academic. Were we to agree on the 5% level, we would have to stay away from any but the shortest fixed-income investments. Were we to fix on the 2.4% level, it would appear that the market has overshot.

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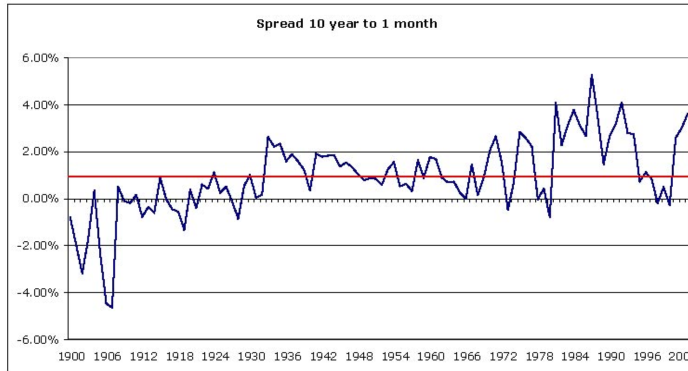
Market View (continued)

Some facts. Since 1900, the one-month Treasury rate (the closest approximation to Federal Funds) has averaged a bit over 3%. Adjusting for inflation, the rate is about .60% according to my figures. It was judged a bit higher (.90%) by Dimson, Marsh, and Staunton in their book *Triumph of the Optimists.*



My conclusion: the equilibrium rate is probably higher than 2.4% but not nearly so high as 5%. My best guess is 2.75%, which incorporates a "successful" inflation target near 2%. Given the extremely positive slope to the yield curve, I believe that there are values to be captured — short and long-term. The long-term spread between the one-month and the ten-year rates is shown on the chart. Since 1900, the average (shown in red) has been less than 1%, and yet it is over 3.5% today. Even a Federal funds rate of 2.75% should support a ten-year rate close to the 4% level. This means the current rate of 4.5% has a good deal of cushion.

Three possibilities suggest themselves. First, invest in two or three-year securities which capture rates of 2% to 3% — much higher than sitting in short-term options at below 1%. Second, be a hero and buy long-term bonds at 4.5% or higher. Eventually, the low level of inflation will reward you with solid real returns. Third, invest in TIPS which protect you against inflation but lock in a real rate (near 2.4% today for 10 years). The risk on TIPS is that the real rate is 4% (3% short-term plus a 1% term premium) as BCA suggests rather than my estimate of 2% (1% short-term plus a 1% term premium). By the way, the long-term average real rate since 1900 has been about 1.5%.

The stock market? Your guess is as good as mine. If the recovery becomes self-sustaining, good stocks will appreciate. Better yet if they pay a dividend. If not, the bear market will resume.

Editor's Note

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Late July/early August found the Jamesson family on vacation in Montreal and Quebec City. We played the part of Americans to the tee by using only English (and twangy upstate New York English at that) and prominently displaying an American flag in the front window of our van. Nevertheless, we found all of the Canadians we encountered to be friendly and helpful. Perhaps the loathing reported in the rest of the world has simply bypassed our northern neighbors. In any event, we had a great time but were eventually worn down by the sheer Frenchness of the experience. So, any doubt of my provincialism has been permanently laid to rest.