Godsey & Gibb Associates

Investment Watch

Issue No. 11

December 12, 2003

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FEAR, SEARCHING FOR A PLACE TO HAPPEN

Not so long ago, June 25th in fact, the mainstream investment community clutched the always delicately worded press release of the Federal Open Market Committee (FOMC) with a keen evaluation of the following portion of the release:

> *"… The probability, though minor, of an unwelcome substantial fall in inflation exceeds that of a pickup in inflation from its already low level."*

Given that the FOMC is the sole body that guides the direction of U. S. short-term interest rates, the investment community latched on to that single phrase. The news headlines proclaimed deflation as imminent, not low or slow inflation, but DEFLATION. Of course the FOMC did reduce Bank Lending Rates to a 45-year low of 1%! The bond market followed with panic, driving the 10-year U.S. Treasury yield to a low of 3.11%, also a low not seen since the 1950s. Since that time, 10-year interest rates have edged higher, to 4.2%, as evidence indicating improving economic strength has continued to materialize.

Again, on December 9th, the FOMC provided a press release expounding its views, as it maintained an unchanged target of 1% on the Federal Funds rate for Bank Lending. This press release followed:

> *The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that output is expanding briskly, and the labor market appears to be improving modestly. Increases in core consumer prices are muted and expected to remain low.*
>
> *The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal.* ***The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation****. However, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be maintained for a considerable period.*

Once again, the mainstream focal point centered on the single phrase that NOW says, "the probability of an unwelcome fall in inflation has diminished." In other words, deflation is NOT a likely threat. Thus, the markets immediately interpreted this as a signal of emerging INFLATION and rising interest rates. Over and over, the markets live in "fear, searching for a place to happen".

Quote of the Quarter

" The strength and breadth of the economy's growth are impressive. We've got enough going on now so that it's clear that this recovery is sustainable – at a growth rate of about 4% percent or so."

Former
Federal Reserve Governor
Lyle E. Gramley

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GRADUAL IS AN INTERESTING TERM

In early June of this year, we wrote, "In turn, interest rates will rise again. It is likely that down the road a ways, the next press headline will be worries of rising inflation. **Assuming so, then our U.S. policy makers have done their job well; they successfully reflated the economy toward growth**." Our view has been, and still is, that stimulative actions of fiscal policy, through targeted tax reductions, along with the Fed's aggressive monetary stimuli of numerous rate cuts and accelerated monetary policy, were appropriate actions with the intended goal of reflating economic growth, thus fighting deflationary pressures.

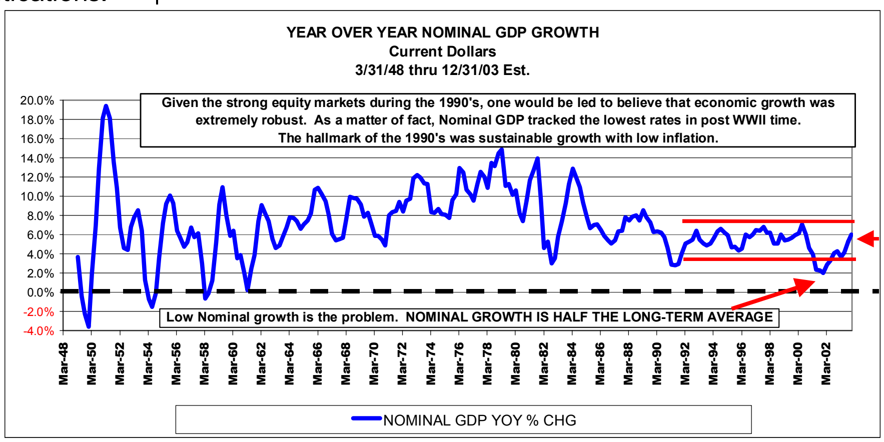
Regressing in time, had we possessed a crystal ball with the ability to predict, with pinpoint accuracy, the surprisingly positive future of economic reports, no one would have believed our outrageous prognostications. Who would have imagined that Nominal Gross Domestic Product (NGDP) would have expanded by 10% in the 3rd quarter, the best growth since 1987, especially after such attention was paid to the weakness of nominal growth in earlier quarters? Who would have believed that Real GDP growth (roughly defined as NGDP inflation adjusted) would exceed any quarter's growth dating back to December of 1983? Nonetheless, each of these economic thresholds was surpassed, along with a number of other surprisingly positive advancements:

- Oct. Wholesale Inventories Increased 0.5%, the biggest increase this year, as Wholesale Sales improved by 2.0%, the most since May of 1999 and following an increase of 1% in September.
- The Institute of Supply Management (ISM) Manufacturing Index surged to a 19-year high, led by stronger orders and production that are prompting factories to hire.
- Oct. Construction Spending, led by residential construction, rose by 2.2%. However, both Public Construction and Office Building Construction rose 1.2% and 0.3%, respectively.
- Worldwide Semiconductor Sales grew 23.3% year-over-year in October.
- Durable Goods Orders, orders for items made to last at least three years, increased 3.3% in October, the most since July of 2002, following a 2.1% rise in September.
- November Non-Farm Payrolls (jobs) increased for the 4th consecutive month.

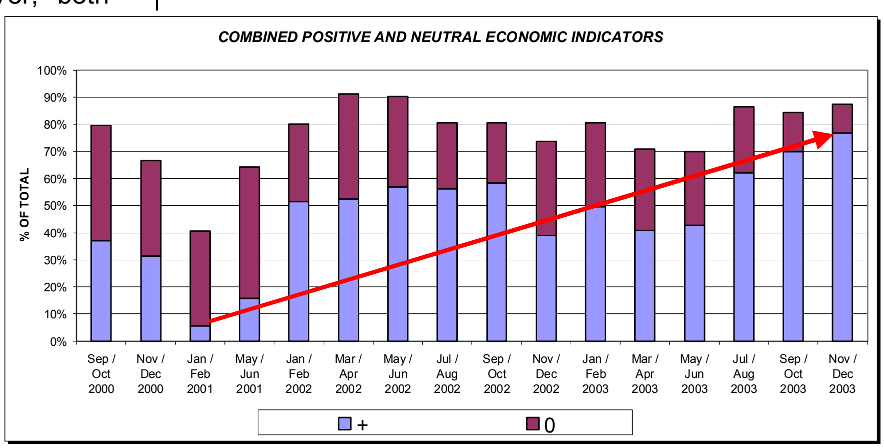
Even with our constructive views, we would have squashed these "projections" as overly optimistic. While the list of reported positive results could go on, former Federal Reserve Governor Lyle E. Gramley may have summarized it best:

> *"The strength and breadth of the economy's growth are impressive. We've got enough going on now so that it's clear that this recovery is sustainable – at a growth rate of about 4% percent or so."*

Nonetheless, our observations keep us on the "gradual" track. As early as 2001, we wrote of a moderate economic recovery marked by "gradual" but steady U.S. and World economic improvement. During the elapsed time, many obstacles to positive economic growth



surfaced, but the basic premise remained intact. Regardless of our feelings, all measured indications continued to point to an established trough in the economic downturn at some point in 2001. While positive progression has been far from a straight line up, our measures of Economic Indicators continued to guide our views to a gradual positive progression. However, "gradual is an interesting term", with varying implications dependent on the degree of anxiety inherent in the



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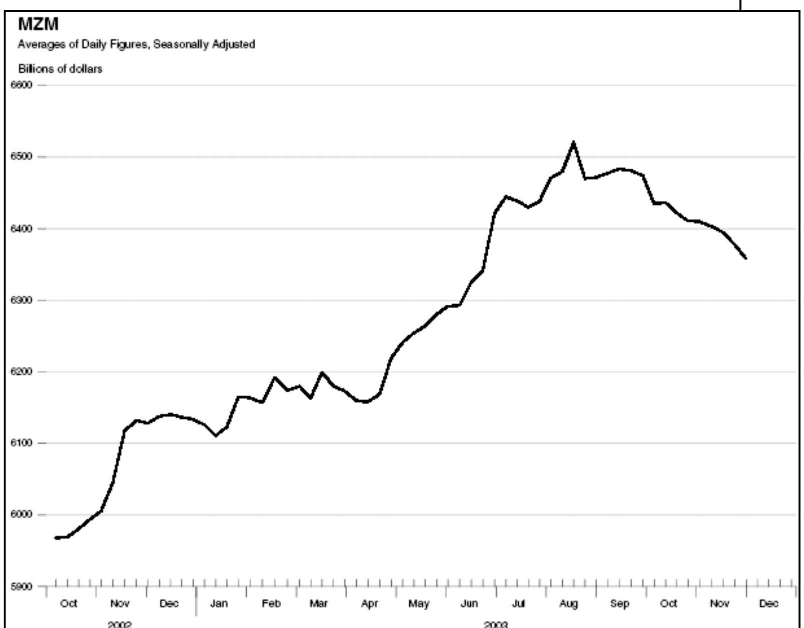
observer. Regardless of the recent surge in economic indications, our guide remains on the path of gradual upward progression, with a higher probability of sustainability.

PASSING THE BATON

Much has been reported about the "jobless" recovery, driven by rampant Consumer Spending, while the much-needed Corporate Capital Spending lay dormant. Remarkably, the recovery from the depths of 2001 has been uncharacteristically driven by Personal Spending, particularly on Housing/Construction and Retail/Autos, two areas that normally experience tremendous spending retrenchment during downturns. Many proclaimed this unsustainable due to massive debt accumulation. All the while, Personal Income rose, Personal Savings accumulated, and the "Mountain of Money" in Personal Savings and Money Market Accounts swelled to an astounding record $6.5 trillion.



Source: Federal Reserve Bank of St. Louis

While Monetary Policy and Fiscal Policy appeared to be working, the desperate and elusive Capital Spending was nowhere to be found for several years. Goods and Materials Production Capacity was so abundant worldwide that much time has been required for business capacity consolidation, elimination, and obsolescence to take place. Though the Cost of Capital (cost on borrowed funds) has remained at 50-year lows, there has been little need for corporations to borrow, spend, and invest. With little or no corporate development and Corporate Profits declining, the end result was negative Job creation. Appropriately, the Fed reduced interest rates, lowering the Cost of Capital and increasing the availability of money via Money Supply. Fiscal Policy called for reduced Corporate Taxes, via targeted accelerated depreciation, encouraging Corporate Spending. Still, time was required as corporations balanced the need for expansion with the ability to produce adequate returns.

In early 2002, we reported that the last quarter of 2001 registered the first report of positive Corporate Profits, after five consecutive negative quarters. To date, Corporate Profits have continued to post eight consecutive quarters of improved profitability.

Then finally, the emergence of Corporate Spending! In early 2003, the first indication of acceleration in Corporate Spending was revealed when Equipment and Software Spending rose 6.2% and Fixed Investment grew by 4.4%. In the 2nd quarter of this year, Business Investment in Equipment and Software grew at an 8% annual pace. And the preliminary estimate for the 3rd quarter showed that Equipment Spending jumped 18.4%, the biggest increase since the first three months of 1998. Accordingly, Non-Farm Payrolls has demonstrated four consecutive monthly increases, as corporate financial structures improved and pent-up demand gradually returned.

Economic development during recent years has paralleled that of a long, grueling, 1600-meter relay. Each measured leg is an exhausting and painful sprint, though the destination is far at a distance. In the end, success is an accumulation of multiple contributing factors. The contributing factors rarely demonstrate simultaneous peak performance and require acute precision and coordination during each period of transition. Often, the transition periods are not smooth, marked by stumbling and staggering. Similarly, the progression from economic recession to economic recovery has been uneven and, at times, the transition seemed doubtful. However, recent news lends confidence to the belief that Consumer Spending, which has provided strength for such a long time, has been successful in "passing the baton" to the next leg, Corporate Spending. While we can never signal with certainty, "all clear", it does appear that a new and vibrant contributor (Corporate Spending) has taken a lead role toward producing sustainable U.S. economic growth.

SO WHAT WAS THE FED'S MESSAGE

If one closely examines the most recent view of the Federal Open Market Committee, in its entirety, several straightforward conclusions can be drawn:

- ♦ The Fed remains accommodative in monetary policy.
- ♦ U. S. worker Productivity is robust, supporting growth.
- ♦ Output (growth) is expanding briskly.

- New Job creation (Labor Market) is materializing, at a modest pace.
- Inflation is low, and is expected to stay low.
- The risk of experiencing Deflation has diminished.
- **AND, these COLLECTIVE conditions are expected to be maintained for an extended period of time.**

This *collective* view of gradual, sustainable growth, with low inflation, is supported by our analysis of the data. Clearly, the implications are that excess stimulus will be removed, meaning interest rates will rise at some point. However, given the current facts and data, it is not clear that rates should move any time soon and/or at any great magnitude. In fact, it is entirely possible that short-term rates could rise to a more normal relationship with long-term rates, as long-term rates experience only a moderate rise. Future movement in interest rates will likely be dependent upon the future rate of economic growth and the forward inflationary rate of growth, unknown at this time. For now, evidence of above average growth is absent for both measures. Following the theme of "Globalization and Democratization", which we have followed for more than a decade, one can argue that barring a major shock OR "irrational exuberance", an environment of low sustainable growth with low inflation is a condition that could be maintained for a long period of time.

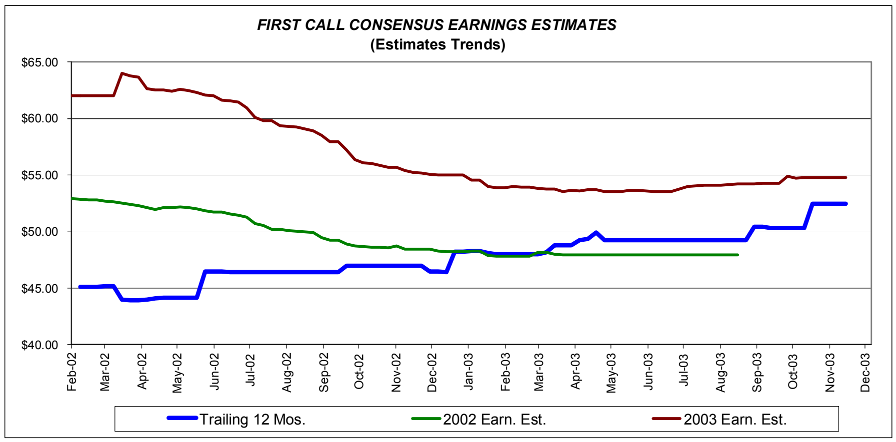
THE HIDDEN SIDE OF EXPECTATIONS

So often we speak of the investment markets as being forward-looking, a mechanism which discounts future expectations to present values, if you will. We firmly believe this to be the case, but "expectations" can be a funny thing. There is no certainty or guarantee with expectations; reality may be more or less. As we track expectations, we also find it critical to measure reality, the results of here and now.

Frequently, we see stocks rise or fall as actual results are reported that are either greater than or less than "expectations". We even see stocks rise as a company reports a loss that is less than the expected loss, or fall as the gain is less than the expected gain. When viewing the markets as a discounting mechanism, this process is rational.

On the other hand, the reality of a company reporting higher earnings quarter after quarter is most important. For a long-term investor, owning companies that demonstrate the ability to continuously compound earnings, adding shareholder value, is paramount.

Throughout all of 2002, with fears of corporate corruption, and during the early part of 2003, with fears of a war-torn economy, earnings expectations declined. Thus, the equity markets declined. Interestingly, throughout that same period, Corporate America continued to add shareholder value as "Actual Earnings" improved quarter by quarter. Even though everything is about expectations, "the hidden side of expectations" is that fear and excitement can often divert attention away from the most important measure, reality.



But reality is only clearly seen through a rear-view mirror. So we continue to use all available measures and remain true to our investment discipline. That is, to construct and maintain a diversified investment portfolio, built with companies exhibiting characteristics superior to those of the general market, based on business performance and quantitative probability, and to manage those assets with a view over the complete investment cycle.

(See www.godseyandgibb.com for more information and an archive of past views and positions.)