Godsey & Gibb Associates

INVESTMENT WATCH

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Quote of the Quarter

"What we have is the makings of a turnaround in economic activity which in the past has almost always been signaled by an improvement in financial conditions."

Federal Reserve Chairman
Alan Greenspan

Deflation, a Weak Dollar and a Colossal Budget Deficit – these are the barriers to positive U.S. economic development, or are they?

The Three Present Dangers

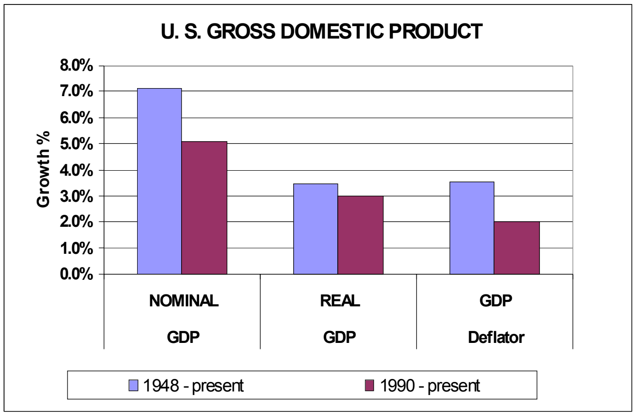
Deflation, a Weak Dollar and a colossal Budget Deficit – these are the barriers to positive U.S. economic development, according to the latest press. It was exactly a year ago when corporate governance was the headline story that threatened the survival of U.S. leadership in global economic affairs. Time has passed and our economy has endured, needless to say. Today's headlines accentuate the latest newfound worries thrust upon U.S. economic development. Our view of the "Three Present Dangers" will present a different picture, not one of collective disaster but one of coordinated recovery.

We do not believe that deflation is a serious risk to the U.S. economy. As a matter of fact, the U.S. economy is not experiencing deflation (declining prices), but is experiencing an environment of disinflation (lower rates of inflation). This disinflationary environment has been present since the fall of the Berlin Wall and fostered the "stable growth with low inflation" environment through much of the 1990s. Technological advancements, NAFTA, the expansion of Asian economies, and the general democratization of global economies have all played a hand in maintaining global pricing pressure. But because deflation is getting increased attention by the press and some economists, we feel it is important that we address its impact and implications.

Deflation or Disinflation

First of all, the reason for the current discussion about deflation lies in the anemic rate of growth in the overall economy. Most economists had predicted that the economy would be growing at a faster pace at this point in the recovery. The Real GDP (Gross Domestic Product) only grew by 1.9% during the first quarter and 1.4% during the fourth quarter of 2002. Nominal GDP, crudely defined as economic growth before adjustments for chain weighted price increases, was up only 4.4% and 3.2%, respectively. Since 1948, Nominal GDP has averaged 7.1% while Real GDP has averaged 3.5% and the deflator (inflation) averaged 3.5%. Year over year, the GDP Deflator bottomed at 0.8% during the September quarter of 2002 and has risen since.

The fact that the GDP deflator increased by only 1.6% year over year, at the end of March, actually aided Real GDP and provided a higher *real* growth than had the economy experienced higher inflation. Since the end of 1990, Nominal GDP has averaged 5.1%, Real GDP 3.0%, and the GDP Deflator 2.0%. Disinflationary... yes. Deflation... no.



Source: Bloomberg L.P.

Now with the war over, gasoline prices declining, and interest rates still low, why is the economy growing at such a tepid pace and why do so many people remain pessimistic? Part of the answer has to do with the character of the recovery and the conditions from which we are recovering. Let's not forget that the depth of the recent economic decline was a function of the cumulative excesses throughout the late 1990s. U.S. Industrial Capacity Utilization rose to a height of 84.8% in January of 1995, historically a peak rate, and continued to maintain a high rate throughout the late 90s. Not only was a high utilization rate held, but production capacity continued to grow in excess of 5% annually, and that's in the U.S. alone, not including global capacity growth. The global economy created such excess capacity that when demand faltered, prices weakened, revenue declined, and profits and employment followed. The process of eliminating this excess capacity involves a combination of the absorption of capacity, the elimination of capacity, and the obsolescence of capacity. With U.S. utilization rates currently at 74.4%, this process is in progress, but it takes time. The economy like a pendulum moves in opposite directions, and the downturn's depth has been directly linked to the pressure of the extremes of the expansion. Accordingly, pricing power is in hiding, but deflation is not imminent.

The economy has recently, in fact, begun to display some signs of strengthening, but the level of expectation remains significantly high. While most people hope for a return to economic growth of 3-4%, the core of the recovery will probably be in the range of 2-3%, and this gap creates the mood of skepticism that prompts the ongoing discussion about anemic growth and deflation. The odds today favor a modest level of economic growth that is sufficient to benefit companies that are able to prosper in an environment with low nominal growth.

A Weak U.S. Dollar

At the same time that the deflation question is being raised, the U.S. dollar has exhibited extended weakness, which arouses questions about the effect of a weak dollar on our economy. As the dollar weakens, prices for imports move higher and prices for U.S. exports decline. The net effect is that imports slow and exports rise as the production of U.S. goods become more competitive in the global arena. As such, the importation of price deflation is discouraged, and along with other monetary action such as increased money supply and interest rate reductions, the Fed has in place the appropriate tools for fighting deflation and ultimately reflating the economy.

Let us not forget that from 1995 through 2001 the U.S. dollar was in clear command of global currencies, rising over 47%. The recent decline in the U.S. dollar vs. the Euro has demonstrated a retracement to a level close to the Euro dollar's early 1999 inception. This decline represents a corrective adjustment after six successive years of clear U.S. dollar domination. Many factors contribute to the volatility of currency pricing. In the end, however, currency strength is a direct reflection of economic strength and the strength of confidence in a currency, as has been demonstrated over extended periods of time. Given the current economic weakness in the Euro nation economies, an impending rate reduction by the ECB (European Central Bank), and the increased competitiveness of U.S. exports, it should only be a matter of time before the U.S. dollar regains its confidence and strength.

A Colossal Budget Deficit

Finally, some fear that the recent tax cuts will cause the federal budget deficit to soar, creating upward pressure on interest rates and weighing down the economy. To the contrary, our view is a fear that rates do not rise, at least to some degree. Rising rates would be a confirming indication of an improving economy. Clearly, we do not favor running an increasing federal budget deficit. However, we do view the recent fiscal actions as stimulative and constructive toward economic expansion and a resulting expanded tax base.

In conjunction with the Fed's aggressive monetary stimuli of rate cuts and accelerated monetary growth, we view these actions as appropriate toward reflating economic growth and fighting deflationary pressures. Recently Federal Reserve Chairman Greenspan said, "What we have is the makings of a turnaround in economic activity which in the past has almost always been signaled by an improvement in financial conditions." He added, "Starting presumably in the third quarter some modest pickup in employment, especially because of the tax cuts which go in effect as of July 1st, will create a fairly marked increase in after-tax income in the third quarter and one must presume that a goodly part of that will filter into consumer markets and one extends that to the labor market."

Source: Baseline

As we review the "three present dangers" and look at them in relation to one another, the picture changes considerably. Low inflation or disinflation is advantageous to both the consumer and the corporation, as pricing pressures remain low. However, only the fittest corporations will thrive as profit margins thin and pricing remains non-existent. Fear of falling prices induces the Federal Reserve to keep rates low and supply ample monetary funds, which keeps the cost of capital low for corporate and individual borrowers alike. A weak dollar, while sounding undesirable, can have beneficial effects. It means that the goods we export cost foreigners less, helping U.S. manufacturers sell more products abroad. Simultaneously, it raises the price of imports, countering deflationary tendencies. Lastly, this is a time when it is desirable to accept controlled deficit spending, to avert long-term deflation and to provide increased demand that helps coax the business cycle upward.

While we can never predict with total certainty, it appears that the economy is beginning a modest but sustainable recovery and that businesses are positioned to take advantage of a low growth environment. When the business upturn begins in earnest, company profits and personal incomes will rise, creating greater tax revenues that flow to Washington and to statehouses. That will turn deflationary pressure into inflation, the dollar will strengthen, and revenue will flow toward balancing the budget. 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.