Godsey & Gibb Associates

Investment Watch

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Quote of the Quarter

"Nothing is more important to the conduct of monetary policy than understanding and predicting inflation. The better the forecasts, the better the odds that policy will contribute to economic stability and efficient resource allocation."

Donald Kohn
Philadelphia Federal
Reserve Governor

Executive Summary:

- The cyclical U.S. economic rebound from the downturn of 2001 is over. A typical mid-cycle slowdown is apparent, which guides us to an estimated Real GDP growth rate of 3.0% – 4.0% for 2005, down from 4.4% in 2004, but healthy and above trend nonetheless.
- A Global economic slowdown is much more pronounced and uneven. Non-Japan Asia is showing evidence of slowing from a rampant pace. Japan, Canada, the UK, and Mexico are slowing, but healthy. Eurozone countries are exhibiting dismal growth.
- After experiencing a surge in cyclical reflation, particularly driven by commodities, inflationary pressures appear to be peaking and are expected to ease into a stable 2.0 – 2.5% range, currently 2.8% YOY. Long-term inflation should not be a problem as Global disinflationary tendencies remain in force. However, Energy prices and constraints remain a wild card.
- Interest rates, as measured by the 10-year U.S. Treasury Note, have been range-bound between 3.90% and 4.75% for most of the past year. For the foreseeable future there is no apparent evidence or cause to break from this trend, as long as U.S. Treasuries continue to be the favored risk-free investment of foreign investors and pension funds.
- The Fed is expected to continue raising the Fed Funds Rate, after raising short-term rates to 3.0% from 1% over the past year, targeting a "neutral" rate. While we believe it would be justified for the Fed to take a pause now, we see the Fed continuing on its path of "measured" rate hikes based on recent Fed comments.
- U.S Equities represent attractive long-term investments with reasonable valuations and attractive dividend growth, especially when compared to prevailing interest rates and alternative investments. Nevertheless, equity returns have been flat year-to-date. Given that corporations continue to deliver improving business performance with growing corporate profits and near record profit margins, long-term investors should be appropriately rewarded over meaningful periods of time.

U.S. Economic Outlook

The cyclical recovery that began in the second half of 2001 and accelerated into early 2004 has run its course – it's over. U.S. economic growth has been moderating for the past several quarters, which is a typical sequence of progression following an economic rebound from a downturn, frequently referenced as a "mid-cycle" slow-down.

Our October 2002 *Economic Review & Perspective* expressed the view that unprecedented monetary and fiscal stimulus was at work to provide fuel to lift confidence and the economy. We placed emphasis on having patience, stressing the gradual nature of the first recovery in the new millennium. Consumer spending was strong, which allowed time for corporate profits to improve and provide capital for increased business spending, a measure the economy severely lacked. Confidence was low with fears of low growth and deflation; as such, October 2002 marked the low point in the S&P 500, 50% below its year 2000 high.

Fast-forward a few years and we're now confronted by slowing monetary stimulus, rising short-term interest rates, slowing growth, and the fear of rising inflation. Interestingly, our 2002 letter referenced the following quote from the Fed's September 2002 FOMC meeting: "Over time, the current accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, should be sufficient to foster an improving business climate." Implicit in the statement is the fact that at some

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point in time, the "accommodation" would need to be removed. George David, Chairman and CEO of United Technologies Corp. was quoted as saying, "I have never seen this much stimulus in my life. I believe something has to happen in 2004." Clearly something did happen in 2004, with the economy expanding 4.4% over the full year, at which time the Fed began removing its extreme accommodation by raising interest rates and reducing Money Supply.

Currently, the U.S economy is experiencing a normal and expected "mid-cycle" slow-down. Even so, Industrial Production is up, Consumer Spending remains steady, Business Spending is healthy, Productivity is tracking above average, Consumer Confidence is turning back up above expectations, and Unemployment is low by historical standards. U.S. Real Gross Domestic Product (RGDP) is estimated to grow at a rate of 3.0% – 4.0% in 2005, down from an annual growth rate of 4.4% in 2004. This estimated level of growth for 2005 would be consistent with "above trend" growth when compared to the median quarterly RGDP growth of 3.3% experienced during the decade of the 1990's. As Mr. Greenspan recently stated, "The U.S. economy seems to be on a reasonably firm footing and underlying inflation remains contained."

Global Economic Outlook

The "mid-cycle" slowdown of economic growth in the global arena is much more pronounced and uneven. Japan continues to exhibit slowing trends from a peak in mid-2004. Canada and Mexico are both slowing on less consumer demand from the U.S. Russia just recently cut its growth forecast for the second time in a month, following downward adjustments from Taiwan, Thailand, Indonesia, Singapore, and South Korea, with weakness reported in Australia and New Zealand as well. Generally, South America has faired better on higher commodity interest. In Europe, growth in the United Kingdom was reduced due to slowing household spending after 51 consecutive quarters of expansion. The remaining Eurozone countries exhibit dismal growth and are on the brink of economic contraction. Unemployment in Germany measures 11.6% with 10.2% in France, holding at a four-year high. Italy's economy actually contracted in the first quarter. Adding to Europe's troubles is the lack of ratification of a European Union constitution, calls for structural reform, and demands for exiting the Euro currency.

While exhibiting the most robust World growth, China and India have also shown indications of moderating. India's economy is expected to grow by 7.2%, down from last years 8.5%, and though China repeatedly reports over 9% economic expansion, they continue to target 8% growth through curbing efforts. As an indication of some moderation, oil shipments to China fell by 13% in the first two months of this year, down from last year's 35% growth in imports. Still, oil demand is expected to rise by 10% in 2005. Also, Chinese vehicle sales are forecast to rise by 10% this year, but that's down from 15% last year and 75% in 2003.

In its semi-annual report, the Organisation of Economic Co-operation and Development (OECD) recently cut its forecast for 2005 economic growth in the industrialized world to 2.6% from 2.9%. It cut its euro-area growth forecast to 1.2% from 1.9% and lowered its expectation for Japan to 1.5% from 2.1%. Most foreign countries fail to have adequate domestic spending to promote self-sustained growth. Also, higher energy costs are having a negative affect on World growth, which are the equivalent of multiple interest rate increases. However, the OECD raised its forecast for the U.S. to 3.4% from its earlier forecast of 3.2%. Oil expenditures in the U.S. are expected to be less than 3% of GDP in 2005. In 1981, U.S. oil spending was over 6% of U.S. GDP. Over the past twenty-five years the U.S. has developed greater efficiencies in its use of Energy. This cannot be said for the many countries around the World.

Inflation

After the collapse of the technology led bubble of 2000, the World was left with unprecedented global capacity to produce goods and services, in terms of human capacity as well as production capacity. In late 2001, U.S. Capacity Utilization dropped to a low of 74.5%, after operating well above 80% during most of the 1990's "slow growth, low inflation" time period. To date, U.S. Capacity Utilization has crawled back to 79.4%, hardly an indicator of inflationary pressures.

In 2001, global capacity increased with China's acceptance into the World Trade Organization (WTO). Also, capacity is coming from the former Eastern Bloc countries of Europe, South America, Africa, Vietnam, Cambodia, Thailand, Malaysia, India, and from every global inhabitant seeking a better standard of living in a global society. Again, hardly a force conducive to lasting inflation.

The economic downturn, and resulting 2003 deflation panic, created an environment of unparalleled monetary and fiscal stimulus on a global scale, which **IS** inflationary. "Reflation" was the intent of every central banker around the globe – **And It Worked**. Cyclical inflation emerged from the leverage created by excessive stimulus, particularly driven by commodities and pent up demand. After experiencing this surge in cyclical reflation, inflationary pressures appear to be peaking. Our expected target measure for inflation is a stable range of 2.0% – 2.5%, as measured by the year-over-year CPI (Consumer Price Index). Long-term inflation should not be a problem as long as global "disinflationary" tendencies remain in force. However, Energy prices and constraints **DO** remain a wild card. Unlike capacity, Energy tends to be more finite in nature.

Interest Rates

Interest rates, as measured by the 10-year U.S. Treasury Note, have been range-bound between 3.90% and 4.75% for most of the past year. For the foreseeable future there is no apparent evidence or cause to break from this trend, as long as U.S. Treasuries continue to be the favored risk-free investment of foreign investors and pension funds.

Slightly more than a year ago our estimate for interest rates was similar to those of others; we were expecting to see a cycle bottom and then a rise in interest rates to 5.0% - 5.25% on the 10-year U.S. Treasury Note, unless the economy slowed. The Fed had already hinted intentions of rate increases, signaling a move to "neutralize" and tighten monetary policy. Global economic growth was "white hot," fueled by the unprecedented global monetary and fiscal

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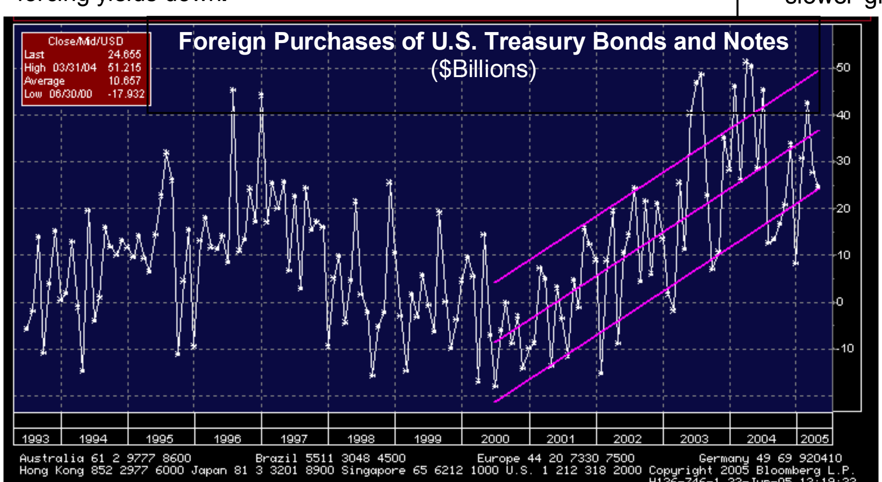
stimulus put in place from Year 2000 through 2003. U.S. Nominal GDP had been growing well above 6%, often presaging inflationary pressures. Japan was robust with the best growth prospects since the 1980s. Britain's economy had been consistently strong and was already on a path of interest rate increases. China and India were both surging, surprisingly, on demand from not only the U.S., but from every developed country in the World. Europe's growth was steady, represented by a strong Euro currency, though most of Europe's growth was being fueled by exports as they lacked strong domestic demand. During the downturn, EU Central Bankers squabbled over specific targets and reduced rates less than most other central banks, providing less monetary and fiscal stimulus. Then three things happened: Oil prices surged, global short-term rates stopped going up, and long-term bonds became hugely attractive to global investors and pension funds.

Oil prices surged from less than $30 per barrel to current pricing over $58 per barrel. Globally, energy prices have served as a substitute for monetary tightening, equivalent to multiple rate hikes. Additionally, the world also experienced tightening measures of one form or another in most countries throughout the world in an attempt to curtail inflation.

With a current quarterly account deficit of $195 billion (the difference between the nation's total exports of goods, services, and transfers and its total imports of goods, services, and transfers), the U. S. Economy must attract $2.1 billion per day from foreign investors, through purchases of Treasury bonds, stocks, and other securities, to keep our economy flowing. For years, this has been a potential threat to our economy. In times of a weak U.S. dollar, such that we have experienced in past years, concerns heighten as to whether the U.S. can attract enough investors. One risk is that the Fed would need to continue raising interest rates to "protect the dollar" and offer higher, competitive, interest rates relative to global rates. However, world economies slowed, foreign central banks either stopped raising rates or even cut rates, and the gap between foreign interest rates and U.S rates widened. Suddenly, U.S. rates became very competitive in the world arena for foreign investors. Rates were not required to rise further, so foreign investors flocked to U.S. Treasuries, forcing yields down.



Source: Bloomberg L.P

Reports have it that the demographics of an aging population in worldwide pension funds have pension fund managers behaving more conservatively, more closely matching projected cash outflows with the certainty of fixed income securities. Pension funds around the world have been rebalancing portfolios, raising their weighting in bonds and other fixed income securities versus stocks. Suddenly, there are not enough bonds to satisfy demand, forcing prices up and yields down. And it's a global affair. Governments and corporations around the world are taking advantage of the demand. The United Kingdom, France, and Italy have each issued new 50-year maturity bonds and the U.S. is re-evaluating whether to re-institute issuance of 30-year bonds.

Simply put, long-term interest rates need not rise as high as earlier expected under the persistence of a soft global economy, competitive U.S. interest rates, a widened gap in spreads between U.S. and global rates, and the demand side of bond buyers exceeding the supply side.

Fed Watch

The Fed is expected to continue raising the Fed Funds Rate, after raising short-term rates to 3.0% from 1% over the past year. Its objective is to remove excess monetary stimulus put in place during the downturn, targeting a "neutral rate."

As the Federal Open Market Committee (FOMC) reduced interest rates to a fifty-year low of 1%, it was understood that this "accommodation" would be removed at some point in the future. At that moment in time, deflation, slow job growth, weak business spending, and weak corporate profitability were all concerns addressed by the Fed. Unknowns of looming war and questionable corporate governance intensified the anxiety. Once economic growth was resurrected, inflation re-emerged, and the Fed signaled the commencement of Fed Funds rate increases. It was clearly stated that "accommodation would be removed at a measured pace" with the objective to reach a "neutral rate," a rate that is neither accommodative nor restrictive to economic growth.

After eight consecutive Fed Funds increases (and we should note that the Prime Lending rate, which guides most consumer loans, also steps up each time), increased energy costs, slower global growth, and corresponding lower global interest rates, one has to once again ask, "What is meant by 'neutral'?" Most economists target the neutral rate within a range of 3.5% to 4.5%. While we believe it would be justified for the Fed to take a pause NOW, we see the Fed continuing on its path of "measured" rate hikes based on recent Fed comments and remarks about a "conundrum."

The frequently referenced "conundrum," mentioned by Fed Chairman Greenspan, references the uncharacteristic DOWNWARD movement in long-term interest rates as the FOMC systematically pushes short-term rates UPWARD. The "conundrum," not only Mr. Greenspan's, but also most every bond rate prognosticator's of the past year, is clearly "unusual" in character. Even so, the causes of this uncharacteristic movement between long-term and short-term interest rates has now been identified and explained away by citing numerous global and structural differences vs. past time periods, as has been the case in this writing under *Interest Rates*. However, another possible implication of the "flat yield curve" (when short and long-term interest rates are nearly equal) would simply be that the bond market is indicating further weakness in the economy, and possibly a recession. This implication would be a more "normal" indication and has been highly accurate in past time periods. Still, there is enough evidence supporting future strength that our leanings remain toward strength, though we are mindful of alternative outcomes.

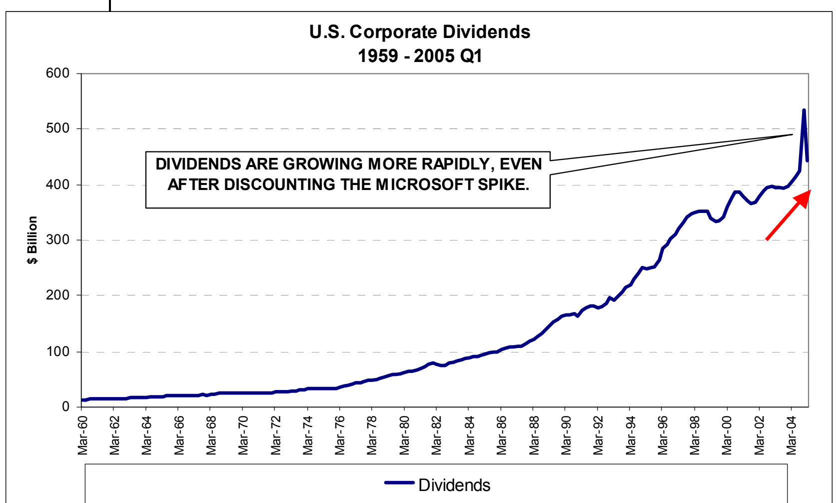
Equity Market Outlook

U.S Equities represent attractive long-term investments with reasonable valuations and attractive dividend growth, especially when compared to prevailing interest rates and alternative investments. Nevertheless, equity returns have been flat year-to-date. Given that corporations continue to deliver improving business performance and generate above average Productivity levels, with growing Corporate Profits, and near record Profit Margins, long-term investors should be appropriately rewarded over meaningful periods of time. However, reduced liquidity poses a short-term obstacle for equity market advancement.

The numbers are starting to stack up as the stories come out. Equity investments (stocks) are being shunned. Money Supply is going through a normal "mid-cycle" process of tightening by the Fed, never a condition favorable to stocks (so goes the saying, "Don't fight the Fed"). Also, the accumulated "Mountain of Money" (referencing the huge creation of Fed induced Money Supply) is flocking to fixed income, real estate, and other asset classes as liquidity for equity dries up. This is not totally surprising, as this phenomenon can be explained under Behavioral Finance. Simply put, money goes where it's treated best, especially so after a market downturn. Earlier we addressed the insatiable appetite for bonds and other fixed income assets and surely most everyone has heard stories of the suspected Real Estate "bubble." No doubt, with nationwide median housing prices up 15.2% year-over-year and the fastest gain in 25 years, there's likely to be excesses in at least some housing markets. According to *The Economist*, home pricing is booming throughout the World. Using a home price to rent ratio as a valuation calculation, The Economist shows house prices at record levels in America, Britain, Australia, New Zealand, France, Spain, the Netherlands, Ireland, and Belgium. Meanwhile, stocks plod along, gaining little respect, though business fundamentals and performance continue to improve, as was highlighted in the last publication of *Investment Watch*.

After every major market collapse, followed by a Fed induced rebound, there has been an extended stage in the behavioral cycle where equities have been shunned. During these periods internal volatility increases with lots of short-term movement, but no or minimal price advancement. It happened in the '30s, again after the '73-'74 meltdown, then again after the '87 Crash, **and it's happening now**. Following the '74 market bottom, the Dow Jones Industrials rallied back to near record highs by 1976, after which, equity markets continued to gyrate back and forth with no material advance for six years. Note that this was also a period when Real Estate was doing well as stocks were shunned. In hindsight, the late '70s and early '80s marked one of the best stock market entry levels in a generation.

After reading these comments, one could become positive for either bonds or stocks depending on perspective. These types of situations tend to form a life of their own and can persist as long as the trend is favored. Much like equity pricing in 1999 - 2000, as long as people will pay higher prices, the trend will continue. Today, with stocks priced at 15x earnings per share, bonds at 25x earnings, and the home price to rent ratio 35% above average (*The Economist*), equities looks particularly attractive as an asset class, especially when considering recent business performance along with the market's 1.8% dividend yield and an acceleration in dividend growth by corporations. When the equity market was "premium priced" in



2000, the 10-year Treasury was yielding 6.71% with 2.7% inflation and NOBODY WANTED IT. Now yields are around 4% with 2.8% inflation and everyone wants to buy debt. Remember, if rates remain low, equities are HELPED by lower costs. Consequently, Corporate Finances have been improving, Corporate Profits have been improving, Profit Margins are near record highs, and Corporate Taxes paid have surged, signaling economic improvement. In the short-term, liquidity RULES, and liquidity for stocks has been weak. However, over the past month Money Supply has turned positive, growing by over $43 billion, maybe an early indication of improvement. Even so, **IT MAY TAKE AS LONG FOR THIS TO WASH OUT AS IT DID FOR "IRRATIONAL EXUBERANCE" TO WASH OUT... BUT EQUITIES CLEARLY REPRESENT AN ATTRACTIVE ASSET CLASS FOR LONG-TERM INVESTORS.**