Godsey & Gibb Associates
Investment Watch

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Quote of the Quarter

``The essence of investment management is the management of risks, not the management of returns."

Benjamin Graham
(1894-1976)
Columbia Professor of Finance
"Father of Modern Security Analysis" and author of
Security Analysis (1934) and
"Stabilized Reflation",
Economic Forum (1934)

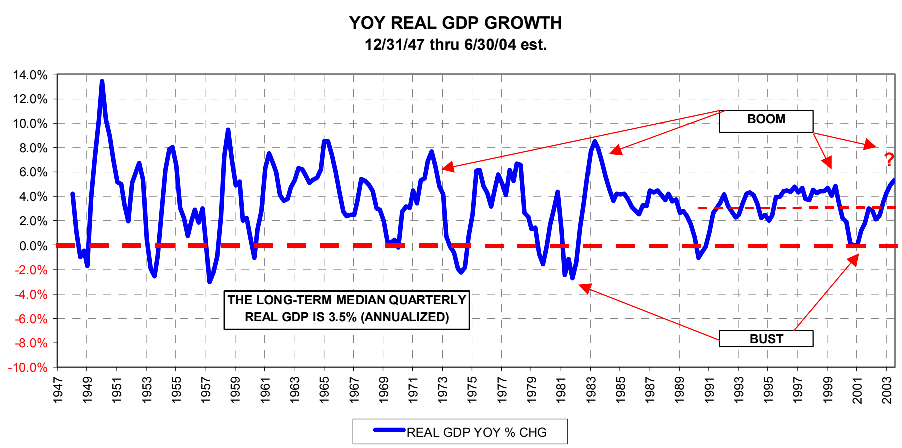
IT IS TIME!

In February we wrote:

> *"So now it's universally accepted in the financial community that an economic recovery has arrived. Without a doubt the Synchronized Global Recovery is under way, as demonstrated by solid improving growth in the U.S., but also in Japan, Canada, the United Kingdom, China and Southeast Asia."*

Since that time, Japan reported economic growth of 5.6%, completing a second year of expansion, and a turnaround in the six-year long decline in prices was proclaimed "real". The Bank of England raised lending rates for the third time since November, to the highest level in 2 ½ years, in an effort to curtail housing inflation. Similarly, China embarked on a strategy to cool its over-heated growth in production and production capacity. China grew its economy by an extremely high rate of 9.9% in the first quarter of 2004, when its targeted rate for sustainable growth is a still high 7%. Lastly, the U.S. payroll growth report surged, showing a creation of 288,000 new jobs in April with an upward revision in the March Payroll Report, to 337,000. February's job report was also revised higher, demonstrating positive job creation for eight consecutive months with positive job creation in manufacturing for the last three months. Clearly, the *Synchronized Global Recovery* is under way.

As we review the data, measuring the progression of economic growth, we discover that virtually all of our measured economic indicators demonstrate growth that is strong, improving, or stabilizing at a high level. In the most recent years, which were marked by numerous economic disruptions, these studies have served us well in providing an accurate picture of macroeconomic developments. As early as the last quarter of 2001, the first in a series of improved Corporate Profits reports emerged. As we prepare to go to print, the report on U.S. Corporate Profits revealed a tenth consecutive quarter of year-over-year growth, and the strongest year-over-year increase since 1984. Recent data has also demonstrated an improved industrial and manufacturing sector, with rising Industrial Production, rising Capacity Utilization, growing Inventories, improved Pricing Power, greater Business Confidence, an increase in Spending by corporations, and an increase in Jobs. Of course, the Housing and Consumer Spending segment of our economy remained vibrant



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throughout our 3-year downturn and saved what could have been an extremely painful economic drought.

Nonetheless, our downturn was far from painless, and throughout the long and constantly troubled period, we repeatedly used words like “gradual” and “patience” to define the progression of our recovery. The collective managing powers, at the helm of our economy, appropriately guided monetary and fiscal policy, providing unprecedented growth in monetary stimulus and forcing interest rates to near fifty-year lows. But now, with the economy firmly growing above trend, ***IT IS TIME;*** it is time for excess stimulus to be removed and for fifty-year low interest rates to rise in an effort to “*normalize”* interest rates and monetary policy.

APOCALYPSE NOW, AND AGAIN, AND AGAIN

The fact that the Federal Reserve Board is about to raise its “overnight” lending rate (the Fed Funds Rate) is far from a secret. This is the most telegraphed decision by the Federal Reserve Governors in memory and underscores the term “transparency”, as the Fed has often addressed the desire to provide greater transparency to the decision making process of the FOMC (Federal Open Market Committee). However, this time the Fed has broadcast its message with billboard proportion in an attempt to be crystal clear. It is important to note that it is customary for major U.S. banks to adjust the Prime Rate immediately following any change in the Fed Funds Rate. This point is meaningful, in that the Prime Rate frequently serves as the basis of consumer and variable rate loans and credit. Therefore, home equity loans and credit will become more expensive to maintain.

> *“The rapidity of the apparent bottoming out of core inflation, and its subsequent upswing, has naturally gotten the attention of all of us who are determined to contain inflation and preserve the price stability it took almost 20 years to achieve.”*
>
> Al Broaddus – Richmond Federal Reserve Governor

Of course statements like this, following the FOMC’s report on May 4th, along with the March and April Employment Payroll Report, have proven to be the catalyst for driving long-term interest rates higher. (The FOMC only controls short-term interest rates, while intermediate and long term interest rates change daily based on the open investment markets.) In anticipation of the inevitable higher forward interest rates, the bond market has driven the yield on the 10-year U.S. Treasury Note from this year’s low of 3.68%, to the current rate of 4.73%. Abrupt panic moves on the part of investors, such that we have seen recently, are far from unprecedented. As a point of reference, it was less than a year ago when the markets panicked over the mere mention of deflation, and the yield on the 10-year U.S. Treasury tumbled to a low of 3.11% as of June last year. Outright deflation never materialized, so the markets quickly adjusted upward, based on more rational thought and less hysteria.

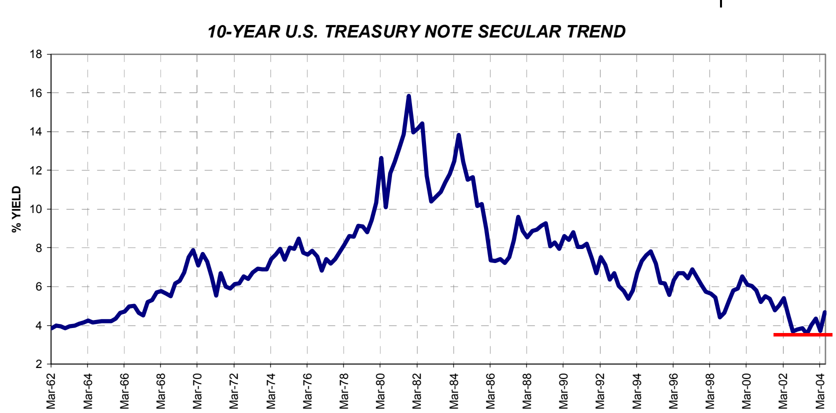
Unfortunately, panic is often created by the short-term nature of the market place. Recently there was a report published by a well-respected economist, which stated his views, fears, and criticisms surrounding our current economic environment. On May 14th, 2004 he wrote the following:

> *"Should The Fed Be A Little Worried?"*
> *"How did the Fed miss the mark so badly? Why didn’t they see inflation coming? And why are most Fed governors so apparently complacent about inflation? The Fed and most forecasters missed the mark on inflation so badly because they failed to appreciate how much and how broadly final demand has accelerated."*

Oddly enough, the same economist wrote the following at the peak of fear surrounding deflation on June 16th of last year:

> *"Fed concerns today focus on a lack of pricing power throughout much of the economy. With the economy flying so low to the ground any shock could drive us back into recession with falling prices. Further job losses and rising real consumer debt burdens would provide a very unfamiliar policy environment. Inflation is the devil we know. Deflation with rising consumer real debt burdens is an exit off the economic highway the Fed wishes to avoid. The lack of pricing power comes at a time where healthcare and insurance costs are soaring. This makes it extremely difficult for Corporate America to complete the balance sheet adjustments necessary to switch from a cost cutting mode to a growth mode."*

Swaying in the direction of the breeze is so easily achieved in the financial markets. For this reason, we choose to be guided by our measures of economic indicators and take the path of Fed Governor Ben Bernanke, of San Francisco, when he said,



> *“The likelihood that the pace of rate normalization will be `measured' represents a forecast about the future evolution of policy, not an unconditional commitment on the part of the committee.” He went on to say, “The pace of tightening will of necessity respond to evolving economic conditions, particularly the strength of the ongoing recovery in the labor market and developments on the inflation front.”*

The economy is expanding above trend with the GDP (Gross Domestic Product) growing at a rate of 4-5% this year (the long-term trend is 3.5%). And yes, inflationary measures are rising in every available indicator. The GDP Deflator is +2.5%, the PCE (Personal Consumption Expenditures) Deflator

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YOY (year-over-year) is +1.6%, the CPI YOY (Consumer Price Index) is +2.3%, and the PPI YOY (Producer Price Index) is +3.7%. While we unmistakably recognize that inflation is rising, we also view it as no surprise. Furthermore, we recognize that it has been the intent of the Fed to *create inflation*, to "*reflate"* the economy. In June of 2003, at the high point of deflationary alarm, we wrote in *Investment Watch*:

> *"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."*

As such, we have no desire to continually seek ***APOCALYPSE NOW, AND AGAIN, AND AGAIN***, chasing every worry imaginable, while ignoring the many positives that just a year ago we sought to achieve. All the same, we are not complacent with rising energy prices and other geopolitical risks. With market interest rates already moving in advance of Fed action, and oil and general prices rising, we believe the combination will by default cause a "tightening" effect on the economy, at least to some degree. As of this writing we have already seen signs of slowing in the mortgage markets and a moderation in New Orders for Durable Goods. It is our view that at this stage of the economic cycle, the Fed has graduated to a level of *normalizing* interest rates and *normalizing* inflation, thus, *normalizing* economic growth at a slower, but sustainable non-inflationary pace. That's the Fed's new strategy.

BEWARE OF WHAT YOU ASK FOR!

Often we speak of the movement in the stock market as a leading indicator of economic strength. Historically, the accuracy has been quite good. So much so, that stock price movement is a component in The Conference Board's Index of Leading Economic Indicators (LEI). If we use this measure and regress in time to January 2003, the situation was quite dire. The headline news talked of three consecutive years of negative stock market returns, an occurrence not seen since 1939-1941, and talked of a potential fourth negative investment return year. We wrote in *Investment Watch* of the enormous and unprecedented monetary and fiscal stimulus provided by the Fed and global Central Banks as the world grudgingly, but systematically, progressed toward growth. Fast forward to our current date and we have a Synchronized Global Recovery.

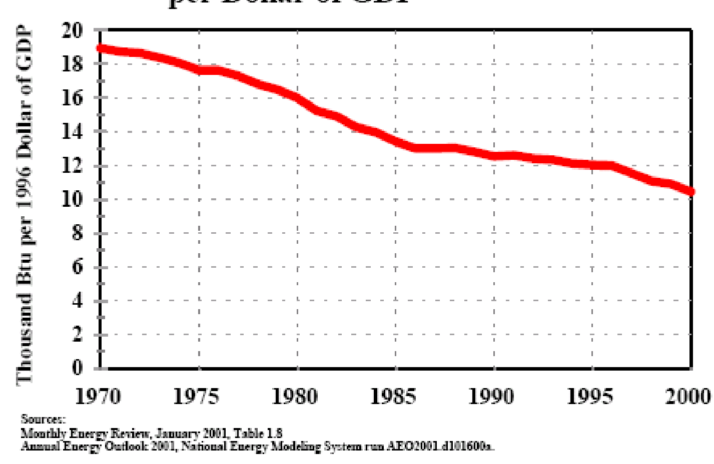
By definition, stronger growth begets greater demand, which in turn generates the need for greater supply. Now synchronize global demand and toss in some unexpected positive growth and the outcome is a degree of unwelcome supply constraints. In other words, as the saying goes, ***BEWARE OF WHAT YOU ASK FOR BECAUSE YOU MIGHT JUST GET IT***. And so goes the energy markets, crude oil in particular. And this is without consideration of any geopolitical risks factored into the equation, which also adds to pricing pressures.

Given that the aforementioned nations constitute the largest industrial nations on Earth, it is no wonder that there has been a surprising spike in the demand for crude oil. According to Energy Intelligence Group data, World Oil Demand has increased from an average 76 mb/d (million barrels per day) in 2000 to over 82 mb/d in early 2004, while World Oil Supply grew from 76 mb/d in 2000 to 81.7 mb/d now. That's an increase in demand by +7.9%, but an increase in supply by only +7.5%. According to the International Energy Agency (IEA), China's apparent energy demand is expected to rise in the second quarter by 20.9% over the demand during the same period in 2003, and this is after China's crude oil imports rose by 26.7% in the last year.

OPEC (Organization of Petroleum Exporting Countries) and other oil producing nations reduced oil production to adjust for declining demand during the downturn. The surprising surge in global strength dramatically expanded energy demand, overwhelmed supply, causing supply constraints. Without question, oil supply fell behind the demand curve, thus driving prices to new high levels. It is clear why China wishes to slow growth to a more moderate level; it is clear why the U.K. is raising rates, and it is clear why U.S. interest rates are rising in anticipation of Fed intervention. The combination of already higher interest rates and higher energy costs should in turn curb economic growth, thus oil demand, and assist in restraining the upward surge in oil prices. However, given the developmental growth of *Globalization and Democratization* over the past fifteen years, and assuming the world continues on a path favoring democratic and capitalistic doctrine, it would be premature to expect a dramatic decline in energy prices and it may be outright naïve to expect to see oil prices back in the low $20 range. Higher energy prices are likely here to stay.

But there is good news! Higher oil prices are not as damaging to the economy as it may appear, or as destructive as during earlier time periods. Numerous studies point to greater elasticity in the relationship between GDP growth and oil prices. Various observations have been cited for this relational change over time, but one simple explanation involves inflation adjusted pricing. According to the EIA (Energy Information Administration, a division of the DOE) the average cost of oil used by U.S. refiners was $35.24 a barrel in 1981. Adjusted for inflation, and in today's dollars, the equivalent cost would be $72.61. We have just recently topped $42 per barrel during the current year, twenty-three years later. Similarly, the

Figure 2. Energy Consumption per Dollar of GDP



inflation adjusted cost of a gallon of 1981 vintage Premium Unleaded Gasoline, which averaged $1.47, would be $2.36 in 2004 dollars. Nevertheless, while the negative effect of higher energy pricing on economic growth has become more elastic, it has not become inconsequential.

IT'S MORE THAN JUST PUMPING MORE OIL

And since we mentioned gasoline – well, why the shortage and higher prices? Maybe it's energy companies, or Saudi Arabia, or politicians, or Venezuela, or Iraq, or maybe it's about 1990, RFG, and MTBE. The year 1990 marked the passage of the Clean Air Act of 1990; its amendments required reductions in automobile emissions and the new regulations went into effect in late 1994. Additional phase-in regulations were staged in 1996, 1998, and 2000. Generally speaking, the Act required the reformulation of gasoline (RFG) for major cities in an attempt to lower carbon monoxide emissions. True to form, California established its own statewide composition standard that went into effect in 1996. RFG required the blending of gasoline and other oxygenation agents that would increase the oxygen content in gasoline and enhance the "clean" burning of fuel. MTBE (methyl tertiary butyl ether), a petroleum bi-product, has since become the most frequently used additive for blending RFG.

Certainly it is apparent that the Clean Air Act requirements have increased the production cost of gasoline in the past decade. Based on a multitude of regional and city specific requirements, the refining industry now produces a reported 30 - 40 varying formulations of gasoline across the U.S. Each stage of implementation has raised the base cost of gasoline. Now consider the fact that there are only 153 operable petroleum refineries on U.S. soil today, as compared to 319 in 1980, and according to the EIA, refining capacity has declined by 1.2 mb/d over the same period. Given that gasoline demand has risen over the past twenty years, the U.S. has been forced to import more and more refined petroleum products, further increasing end product costs. Lastly, effective January 1, 2004, MTBE was banned from use in California, New York, and Washington state, while four more states have scheduled an MTBE ban for later this year. Undoubtedly, this is yet another catalyst behind rising gasoline prices. It is clear to see that the current gasoline dilemma is complex. It's not as simple as tapping the strategic reserves or even increasing OPEC, Russian, or North Sea production. ***IT'S MORE THAN JUST PUMPING MORE OIL.*** Especially since U.S. refineries are already operating at more than 95% of their capacity.

THE COMPLETE INVESTMENT CYCLE

So what's an investor to do… with energy prices high, gold prices rising, fear of rising inflation, interest rates up, geopolitical strife, and stock market volatility? Well, that's precisely a description of the environment during the summer of 1984. During the subsequent twenty years, prognosticators predicted four recessions (we had two) and a few depressions, the stock market crashed five times (well, they didn't all crash), oil went from $40 to $10 and back to $40 (several times), Germany went from the most productive nation to… something less, and the United States went from the least productive to one of the most productive. The Soviet Union divided, the Berlin Wall fell, the Iron Curtain folded, and China joined the WTO (World Trade Organization). And the Dow Jones Industrial Average climbed from 1,087, in 1984, to today's level of 10,181 and there was trouble, worry, fear, and chaos throughout every up and down and zig and zag that comprise a part of an economic cycle.

It seems like just yesterday that investors feared that the market had risen too far, too fast. Well… it was yesterday, but our reference was really about 1985; and 1989, and 1991, and 1995, and 1998, and 2000, and 2003. Without hesitation, we can boldly say that during each of these periods our emotions and fears were as vibrant and extreme as those of any other human being. It is for this precise reason that our business of investment management is guided by an established and measured set of principles that constitute our investment discipline.

Historical measurement, of both the Dow Jones Index and the S&P 500, demonstrates a 97% correlation between growth of earnings and price movement. With this point in mind, our primary objective, as long-term investors, is that of building and maintaining a portfolio of investment assets that exhibits superior characteristics and measures of present and future earnings streams, relative to the present value or price of those assets. We then attempt to compound those returns over time. As an example, the primary "core" companies in our portfolios averaged earnings growth of +34% during the latest quarter; this compares to +26% for the S&P 500 Index. Assuming we can reproduce these results over time, the probability of suitable investment compounding is enhanced. From this point, we frequently make reference to companies as having "added shareholder value."

So again, what is an investor to do? If our objective were that of short-term trading, then our principles and discipline would be different. But it is not, so we will continue to follow the principles of our established discipline, realizing there will be up and down short-term cycles, to manage the risks of the businesses we own, and to focus our interest toward long-term compounding over ***THE COMPLETE INVESTMENT CYCLE***. In the coming months, we will offer greater detail and depth to our view of The Complete Investment Cycle.

(For greater detail on our investment philosophy and approach, visit www.godseyandgibb.com.) Also, for a White-Paper study supporting our investment discipline, which was produced by a leading global independent research firm, please contact us.)