Godsey & Gibb Associates

INVESTMENT WATCH

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Quote of the Quarter

"Although we cannot know with certainty until the books are closed, the growth of productivity since 1995 appears to be among the largest in decades."

Federal Reserve Chairman
Alan Greenspan
November 2002

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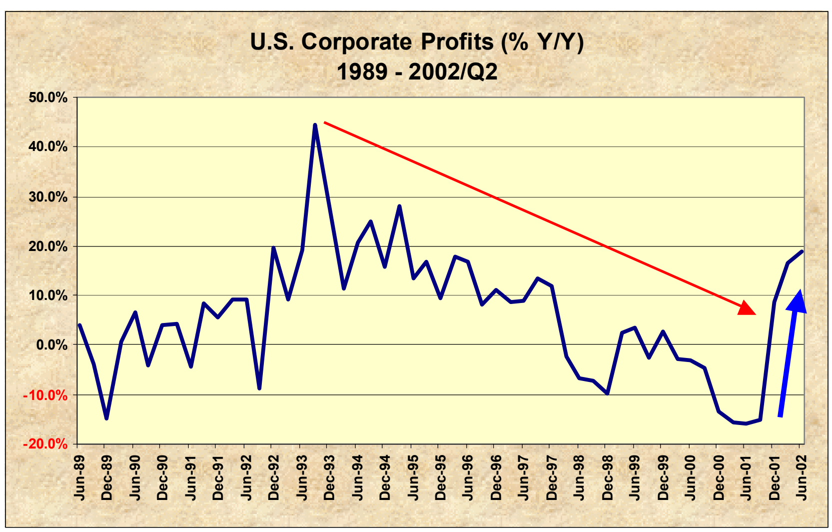
Earnings and productivity are up. There is a new team in charge on Capital Hill. But with terrorism back on the front burner, will the picture remain sanguine?

Which Way Is Up?

The U.S. economy continues to reflect a mixed picture. On one hand, some negative factors, such as declining consumer confidence and concern about the impact of a possible war with Iraq, have put a damper on the economic outlook. However, there are a number of positive influences, such as improving corporate earnings and low interest rates that are giving cause for optimism. Financial markets are looking for direction from these conflicting signals. We want to use this issue of 'Investment Watch' as an opportunity to look at some of the salient factors contributing to the current state of the economy and the financial markets, and to give an assessment of where we believe we will go from here.

Earnings On The Rise

Despite lamentations by some analysts about a lack of earnings growth, U.S. corporate profits have increased for three consecutive quarters. While some of those gains have been modest, it is clearly a positive change in trend. A recent revision in the tax law should perpetuate this trend by providing additional cash flow to companies able to capitalize on this change. The law permits companies to depreciate certain new capital projects more quickly, thereby reducing earnings subject to taxation, and, in turn, creating more cash flow. One strategist calculated that recent operating profits, as a result of this additional cash flow, are at least as high as they were in 1999.



Source: Bureau of Economic Analysis, Bloomberg LP

Other Signs Of Economic Strength Or Weakness

Consumer confidence weighs heavily on financial markets, and the Conference Board's Index has been trending downward since early this year. However, it is expected that with the recent positive movement in the stock market and oil price declines, this measure may begin to reverse and head upward. In fact, two other organizations that measure consumer confidence have recently recorded slight increases in their readings.

Another factor that influences consumer confidence is the unemployment rate, which has recently run between 5.6 – 5.7%. The four-week moving average of new unemployment claims, an important component of the unemployment equation, has been moving downward. This measure also correlates to growth in the U.S. economy (growth in GDP). If weekly claims average around 400,000, it is expected that the economy in the fourth quarter should grow at about a 3% pace. If that weekly average of unemployment claims drops to 390,000, fourth quarter growth is expected to rise to 4%.

There was positive news in the retail sales figures for October. Although flat overall, sales excluding automobiles rose 0.7%, the largest increase in six months.

While the consumer continues to fuel the economy, capital spending by businesses has yet to pick up as vigorously as hoped. Industrial production in October experienced its largest decline since September 2001.

However, businesses have been remarkably successful at reducing costs and deploying their labor forces more efficiently. Productivity increased 4.0% in the third quarter.

The Fed Will Do What It Can Do…

The Federal Reserve Bank's Open Market Committee recently lowered its benchmark interest rate 50 basis points, to 1.25%, the lowest it has been since 1961, and the twelfth consecutive reduction since January 2001. Alan Greenspan testified before a Congressional committee that the economy is currently encountering a "soft patch", which is restraining corporate spending. However, he also indicated that he does not believe that this is a long-term phenomenon that will lead to a more pronounced decline.

While the Fed is most often associated with fighting inflation, financial markets are currently more concerned about the possibility of deflation, a deep and lengthy decline in prices. Greenspan said repeatedly that the Fed does not anticipate the onset of deflation. However, he also made clear that if deflation becomes a problem, the Fed has a number of tools at its disposal with which to add needed liquidity into the financial system.

Will One-Party Government End Gridlock?

The Republican sweep in the House and Senate, plus continued control of the White House, created an initial positive reaction in the markets, as this was perceived positively for business. While Republican control of committee chairmanships will likely be more beneficial to some industries (healthcare, for example), the slim majority, particularly in the Senate, will not give the GOP a blank check. While the Democrats, as a result of the elections, may be more responsive to Republican policy initiatives, substantive bills will still require give and take from both sides before completion. Our belief is that more will be accomplished in the next Congress than was accomplished in the last.

Terrorism Continues To Be An Issue

One factor in our assessment that cannot be quantified is the continued risk of terrorism, and its impact on the global economy and the markets. While there is optimism in the diplomatic community that Saddam Hussein's willingness to allow U.N. inspectors to return to Iraq is a hopeful sign, financial markets do not yet seem convinced that war will be averted. Additionally, al Qaeda continues to make threats against the U.S., Britain and other allies.

The Congress seems focused now on creating a "homeland security" apparatus that will work to effectively counter threats from terrorist organizations. It is, as President Bush has said, a long-term process. We are encouraged by the progress made thus far in improving intelligence gathering and in building international support. We are confident that these efforts will continue.

Conclusion

We believe that the glass is half full rather than half empty. There are a number of signs that the economy is gradually picking up momentum. The Fed has said that it is committed to doing what it can to keep the economy on track. Threats of terrorism remain, but we have Federal, state, and local governments, intelligence and law enforcement communities, and vigilant citizens who are doing good work to combat the threat. It may be two steps forward, one step back for a while, but we believe that the economies and financial markets of the United States and of those countries in the global community who oppose terrorism will succeed and prosper in the long run.

As a consequence of the current environment, we continue to hold some defensive positions in client portfolios (e.g. healthcare, financial and consumer staples stocks), while at the same time adding positions in sectors more aligned with a modestly growing economy (e.g. consumer discretionary stocks).