Godsey & Gibb Associates
Investment Watch

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### Quote of the Quarter

*"There's a lot of breadth to the strength in the economy and it's important for the Fed to return interest rates to a more normal setting."*

Jack Guynn, President
Atlanta Federal Reserve

# *Anatomy of an Economic Cycle – A Production*

## *Act I: Synchronized Global Economic Resurrection*

The journey into the New Millennium brought with it much more than fireworks and a New Year's celebration. It also marked the closing of a decade of uninterrupted global growth and expansion. Ten years prior, the U.S. economy had been mired in recession with a hangover from the Savings & Loan and Banking Crisis as the Fed's Resolution Trust Company took possession of non-performing financial institutions. Nonetheless, U.S. economic perseverance prevailed. The Fed provided multiple measures of monetary and fiscal stimulus via interest rate cuts, tax reductions, and increases in the supply of money in circulation, along with a strong and persistent bout of government spending to assist in stimulating the economy. Rapid success in Desert Storm, in early 1991, lifted consumer confidence and economic expansion was on its way. By 1992, an abundance of evidence pointed to the presence of a sustainable economic recovery. The resulting breadth and endurance of U.S. economic growth throughout the decade of the 1990s had not been felt since the 1960s, regardless of the fact that, historically, the U.S. economy averaged an economic slowdown every 4.9 years. And this time the economic expansion was a global affair, spanning across Europe to the remnant states of the old Soviet Union to the emerging countries of the Pacific Rim. Mexico joined with passage of NAFTA (North American Free Trade Agreement), and later China with its acceptance into the WTO (World Trade Organization.) *Globalization and Democratization* was the over-riding theme.

By the end of the year 2000, it was evident that the rampant and *exuberant* growth of the 1990s was at the least normalizing, if not nearing a curtain call. Similarly, the balloon of the bubbled equity markets had been punctured during the ensuing process and was rapidly deflating. In hindsight, it is clearly visible that the massive monetary liquidity that had been provided as a safety net for possible Y2K disruptions had been abruptly eliminated by the action of the Federal Reserve Board of Governors and other Central Bankers around the world. In fact, the Fed had been raising interest rates since June 1999, a normal signal of economic *restriction*. By the end of 2000, it was evident that the overwhelming declines of global equity markets had the potential to swell into a much broader and unintended consequence, the stagnation of global economic development.

By mid-November 2000, *stimulative* monetary actions were evident and in January 2001 the Fed initiated its first in a long series of thirteen interest rate cuts. The resulting journey of interest rate reductions would prove to retrace a period of nearly fifty years, as the recent series of struggles, mishaps, and shocks repeatedly rocked the U. S. and global economies. U.S. interest rate policy would prove to guide a tumble in rates from a high of 6.5% to a low of 1%, the lowest Federal Funds Rate since November 1954. Simultaneously, Central Banks around the globe were also reducing lending rates, increasing the supply of money in circulation, and cutting taxes, as a means of stimulating economic growth. Combined, these actions re-established an environment for global growth. And the U.S. economy, the largest on Earth, would again assert itself as the driving global force with sound financial strength and strong consumption. A ***Synchronized Global Economic Resurrection*** had begun.


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## *Act II: Reconstruction of Sustainable Growth – Conflicts*

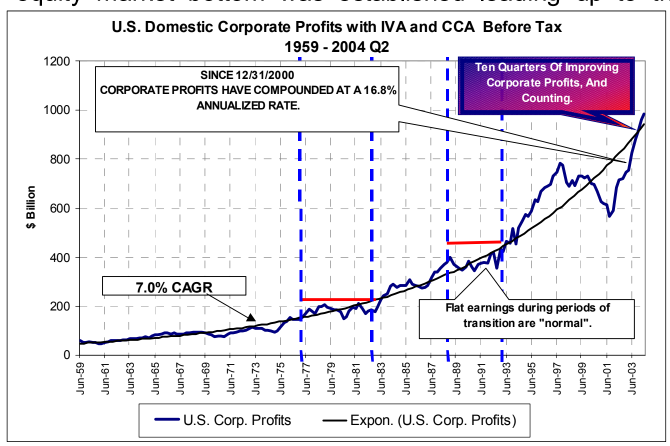
As the curtain rose on 2001, we found that our *Economic Indicators Analysis* had fallen from a record high in January 2000, to a low in January/February 2001. This low would later hold as the absolute cycle low in our measures of economic strength, providing a base from which to build. As economic growth progressed throughout 2001, our position was that of a moderate slow-down relative to past recessions, thus, a slow and moderate recovery. Stimulative actions were in place around the world, businesses were managing inventory and costs, and the U.S. consumer was demonstrating the greatest strength in Consumer Spending of any on record during a downturn. Housing and Auto Spending, which usually plummet during recessions, were actually expanding, as other measures of Consumer Spending continued with relentless determination. Weakness in the U.S. and global economies was measured by the absence of Corporate or Capital Spending. The *irrational exuberant* years of the 90s led to excessive growth in both Inventory and Production Capacity. Our position was that this Inventory and Capacity would require a work-down by either a reduction of inventory over time and/or the obsolescence of inventory and capacity. Either way, both would require time and great patience.

By the time the scene opened on 2002, U.S. and global equity markets appeared tired, but somewhat resilient. Our economic indicators continued to progressively improve, and U.S. Corporate Profits were once again expanding. Our view was that growing Corporate Profits would be a pre-requisite for improved Capital Spending and the data showed that the stage had finally been set for improved spending. The lagged effect would then lead to an improvement in job creation. The elements for ***Reconstruction of Sustainable Growth*** were in place.

## *Conflict: 9/11, Corporate Governance, Terrorism, the Iraqi War, and Deflation*

Without retracing the multitude of conflicts which have transpired over the past several years, it can simply be stated that the magnitude of these disruptions, distractions, and radical shocks, shook the confidence of the Capital Markets and the Confidence of Business Spending, thus delaying what was already accepted as a slow and gradual progression toward recovery. As such, and in the view of the Fed Governors, greater economic stimulus was required. By the close of the Second Act, the mantra of the Fed would call for an orchestration of "reflation" (or inflation creation) due to the fear of "deflation". And so it was, the Fed axed rates again and again, while exponentially compounding money in excess of an unprecedented 20% growth rate. Liquid U.S. cash accounts (MZM – money of zero maturity) swelled from \$4.6 trillion in November 2001, to a high of \$6.63 trillion in May of this year, a growth of 44% in less than three years. That equates to cash holdings equivalent to 55% of U.S. Nominal GDP (Gross Domestic Product), which is a massive *Mountain of Money* for the purpose of promoting economic growth, providing a low Cost of Capital, and reflating the economy. Simultaneously, economic fiscal stimulus was enacted through multiple consumer oriented tax reductions and rebates, in order to encourage continued Personal Spending. Incentives for Corporate Spending were put in place by means of accelerated depreciation, which promoted Business Spending on Equipment and Capital Construction.

Interestingly, throughout the many conflicts, Consumer Spending continued to grow as Corporate Capital Spending emerged as a new arrival in the scene. Corporate Profits continued to rise, but were ignored. All the while, Global Capital Markets continued to dive, sinking equity markets to new lows with multiple bouts of emotional panic attacks. Quarter after quarter, the data measuring a gradual and progressive improvement was disregarded, until a final equity market bottom was established leading up to the




military build-up for the Iraqi invasion. Needless to say, the production played out. By January 2004, global equity markets had catapulted from multi-year lows. The S&P 500 had advanced by 40% and the NASDAQ by 58%, however, they were still 24% and 59% below 2000 highs, respectively. In early 2004, many heard the trumpeting signal for a return to the rising equity markets. A call for an encore came with an endorsement that the once overlooked improvement in economic development was now clear and visible. The ***Reconstruction of Sustainable Growth*** was at hand, and ***Conflict*** a thing of the past.

## *Act III: Confident Resolution*

In early 2004, with fog cast from the stage, and ***Confident Resolution*** proclaimed, "visibility" surfaced from the depths of unspoken expressions. It was now clear! Corporate Profits had been rising since 2001, business earnings per share were surging, and with the aid of tax incentives, After-Tax Corporate Profit Margins were springing to all-time highs. Many were of the belief that "crystal clear visibility" was here for the foreseeable future. For those of us past our mid-40s, it is well understood that "crystal clear visibility" is something rarely attained or regained.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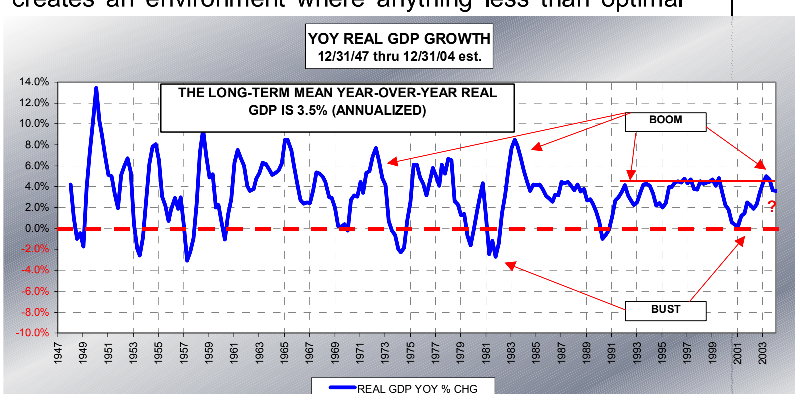
## *Conflicts Re-Emerge*

Most economic indicators have been pointing toward economic improvement for quite some time. Earnings and Revenue growth have been expanding since 2002. Capital Spending showed signs of rising in 2002. Productivity steadily rose to a high of 9.5% in the 3rd quarter of 2003, its second highest rate in 15 years. Earlier, Production increased as Hours Worked fell, so Productivity "artificially" increased on fewer hours worked. Recently, Hours Worked increased along with Production, so Productivity naturally declined. In late 2003, we referenced *"The Passing of the Baton",* signifying the expectation of Consumer Spending to moderate as Corporate Spending emerged as the bearer of the weight for economic growth. As early as February, we wrote of certain measures, i.e. Profits and Margins, approaching the upper boundaries of growth, therefore we expected a deceleration. We reiterated this point in May as our publication of *Economic Review and Perspective* confirmed numerous points of "moderation" in economic growth. However, the recent decline in the growth rate of Consumer Spending has been a surprise to the markets. Manufacturing, as measured by the Institute of Supply Management, recently expanded for the 15th consecutive month. Still, the rate of growth decelerated, so this was viewed negatively. For quite some time our models have led us to believe that a 3.5% GDP could be reasonably achieved in 2004. Yet, consensus expectations have been nearer 4.5% most of the year. As this anticipated growth has proved to be too high, there developed an attitude that the economy was growing weak, ergo the "soft spot". Interestingly, 3.5% GDP is the long-term average and considerably higher than much of the growth during the 1990s. Though now, 3.5% is not good enough, not as good as "expected". Just as a few years ago, "expectations" rule the day, and "fearless" forecasts have returned from the pages of earlier scripts. This attitude creates an environment where anything less than optimal results are viewed as a "negative surprise", and ***Conflicts Re-Emerge***. With no more Tax Rebate checks in the mail for consumers, no more Payroll Tax reductions for workers, and accelerated depreciation coming to a close by year-end, economic "moderation" should not be a huge surprise. Clearly the Fed is confident enough in the year-over-year Real GDP of 3.9%, that it is raising interest rates to remove excess stimulus.




## *This Time is Different*

> *"Little Sign of New Jobs After Year of Recovery, Unemployment Figures Show. Economy continues to experience a jobless recovery, with no indication that new jobs are being created."*

This news headline can be seen or heard on almost a daily occurrence. In fact, it is so commonplace that this headline was reported in Brussels, Belgium referencing levels of unemployment throughout the Euro Zone. Industrialized European countries have been losing jobs to the untapped labor force of Eastern European countries, or the 'New Europe'. We have seen reports of Korea and Taiwan losing jobs to China, Vietnam, Thailand, and Cambodia. We've even seen reports of the relocation of manufacturing from Mexico to China.

NEVER BEFORE, in the more than 200 years of U.S. economic history, has the economy experienced an economic recovery with such an enormous source of untapped labor. And it's not just the U.S., it's all industrialized nations on Earth. As earlier stated, *Globalization and Democratization* has been a common theme since the fall of the Iron Curtain. This fact, coupled with vast technological improvements and a networked global transportation system, makes every able-bodied worker of the world a potential source of labor. The World is changing and ***This Time is Different***. It's worth noting that the U.S. has one of the lowest unemployment rates of the G-7 industrialized nations with a relatively low rate of 5.4%.

## *Inflation is Baaack!*

> *"It is competition that drives down costs and prices, induces firms to produce the goods consumers want, and spurs innovation and the expansion of new markets abroad… In stark contrast… are the inefficiencies that result from monopoly…."*
>
> Council of Economic Advisers,
> *Economic Report of the President*, 1996

Though *This Time is Different*, some things never change! As early as 1776, Adam Smith referenced the *invisible hand* of competition as an efficient force in providing the market economy with the goods and services required by people, while minimizing the pressures on costs. Today, the *invisible hand* is alive and well, and holding pricing power in check. But in many ways the *invisible hand* is no longer invisible. We see the competition; an imbalance has surfaced.

During the past eighteen months, crude oil prices have risen from a low of $25 p/brl to a high of $49 p/brl, currently near $42. Much of the pricing pressure has been attributed to the threat of the elimination of supply due to geo-political threats. These risks focus on possible disruptions in the oil supply from Russia and Venezuela as well as the threat of terrorist disruptions in the Middle East. It is estimated that these risks account for as much as $10 - $15 of the perbarrel "political premium" mark-up. However, it is likely that the demand side of the equation may hold energy prices higher than previously expected, even if or when this political premium is removed. Through mid-year, China's oil imports jumped by 40%, and diesel imports increased by 175% year-over-year in July. China and India have materialized as major new energy consumers of world oil. All indications point to a continuation of this trend.

It is estimated that the U.S. consumes roughly a quarter of the world's oil and one-fifth of its industrial metals. The build-out of basic infrastructure in both China and India has created a ferocious appetite for these same resources that have so often been taken for granted in the U.S. China is close to becoming the world's third largest auto manufacturer with output forecast to top 5 million units this year. Statistics from the China Association of Automobile Manufacturers show sales grew 32% in the first half of this year, following a 75% sales growth in 2003. According to the Statistics Bureau of China, car ownership in urban areas doubled from a year earlier to 2 per 100 households in the first half of 2004. The average American household owns about two vehicles. If car ownership in China only doubled to 4 per 100 households, and considering the reported surge in new car registrations in India, it is clear that the global demand for gasoline, copper, aluminum, steel, and other input and production materials, such as oil, gas, and coal would continue to rise. In the first half of 2004, China's imports of iron ore grew by 35% and steel imports grew by 64%.

The merits of *Globalization and Democratization* are apparent when viewing measures of "Core" Inflation (ex. Food and Energy). As the standard of living of the global worker is raised, the desire for consumption will increase, which is generally good for the U.S., as long as we produce and export the goods and services desired. On the other hand, the unleashing of the pent up demand of the nearly 2.4 billion people in China and India has created a surge in demand for natural resources and materials. Typically, pricing pressures of this sort and volatility are often viewed as "transitory", and explain the theory behind exclusion when focusing on Core Inflation. However, pricing may not be as "transitory" as in the past. The U.S. is no longer alone at the global pool of resources and this situation warrants a close watch. When pricing pressure is "pushed" by the rise in demand for these key input materials, the potential for inflation to be passed on to the end product or service is apparent. Thus, ***Inflation is Baaack***!

## *Act III – The Sequel*

The reflating efforts of the Fed are obvious and the Fed appears persistent in raising short-term rates at a "measured pace", as "real rates" remain negative (inflation adjusted real interest rates.) Businesses will attempt to pass through these higher costs, but competition remains intense. When companies are unable to pass through higher costs, profits and growth will decelerate, such that we have recently seen. Economic growth slows, and again, conflict arises; will the economy work through the "soft spot" or will the weakness be more pronounced? Only time ever truly answers the question, as ***Act III Never Really Ends***, it just plays to ***The Sequel***. There is no final resolution. There is no final conflict. The *Anatomy of an Economic Cycle* only plays on, over and over, and is merely put to print by historians, with hindsight. We certainly have no inside track on the future script, though we are directed by the many events from the past.

It is clear and evident that the Fed wishes to move rates up to a more normal, non-inflationary level. It is also clear that excess monetary and fiscal stimulus is gone or going and consumers and corporations must carry forward on their own. Lastly, it is clear that Corporate Profit Margins have likely peaked and are decelerating. History guides us to recognize that these conditions have proven difficult for equities (stocks) as well as debt instruments (bonds). History also demonstrates that the future remains bright and full of opportunity, depending on ones expectations, of course.

Consider this: In 1993, the rate of growth in corporate profits peaked, yet stocks continued with strong earnings growth and the equity markets soundly advanced throughout the decade. In 1997, Corporate Profit Margins peaked, yet the equity markets continued to advance. Today corporate profits are 26% higher. In 1966, Before-Tax Corporate Profit Margins peaked and the record has never been broken, yet the Dow Jones Industrial Average has advanced more than 10-fold and dividends are seven times higher.

As earlier stated, we have no certainty in a written script for the economy or the markets. No one does. We continue to measure and weigh, balancing the strengths and weaknesses. It would be difficult to argue that the broad markets are outright cheap, however we can clearly make the case for the valuation of individual companies. More importantly, we continue to observe these companies as they increasingly create shareholder value by means of improved business performance, rising earnings performance, and increased shareholder equity, quarter after quarter. Yet the stock prices of these companies have frequently given way to market pressures of pessimism and fear. This builds the case for optimism, because ultimately, our time frame is long-term, not short-term, and our objective remains that of acquiring great businesses at reasonable prices, which have the ability to consistently compound, build value, and create wealth over time.

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