Godsey & Gibb Associates

September 29, 2006

Where is the economy headed?

Our Economic Indicator model illustrated a pick-up of growth in the fourth quarter of 2005, following the hurricane disruptions during the 3rd quarter. Since that pick-up, our indicators have demonstrated a systematic downward drift that has guided our view toward economic moderation. Consequently, and much like the consensus view in the investment community, we are anticipating a continued slowing in the economy to below trend growth that stabilizes by mid 2007. Yet we do point out that we expect healthy growth… a soft landing if you will.

In our assumptions, we incorporate the following:

- We anticipate the FED will remain in a holding pattern on interest rates as the economy experiences a sustained, below trend growth pattern that breaks the momentum of inflation pressures.
- We expect Real GDP (Gross Domestic Product) to slow to near a 2%-2.5% growth rate, down from the robust 5.6% growth in the first quarter of 2006, and below the 3.3% long-term median trend.
- Nominal GDP (before adjusting for inflation) should trend between 4%-5%. This is significant since during nine of the past twelve quarters growth exceeded 6%, which has historically created an environment contributing to inflationary pressures. (See first chart below.)
- Much like the FOMC (Federal Open Market Committee) we see inflation receding to the 2%-2.5% range after earlier surging well above our targeted assumption, pushed by commodity inflation. Of importance here, we currently see no indications that inflation should fall back to the 2002 deflationary fear zone of 1% or less.
- Unemployment will likely pick up from its low 4.7% measure, pushing into the low 5% range. Judging by the very low trend in weekly unemployment claims, employment is currently holding up very well.
- Lastly, we expect Corporate Profits to decelerate into the single-digit growth range. Incredibly, Corporate Profits have increased by double-digit growth in sixteen of the last seventeen quarters, a measure that cannot persist when the economy decelerates by half.

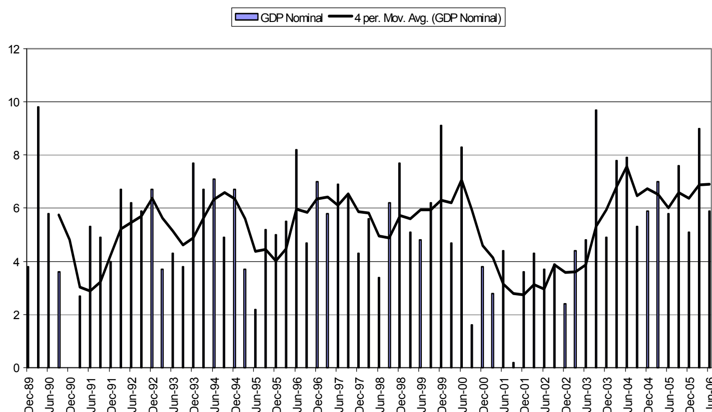
Why not a recession?

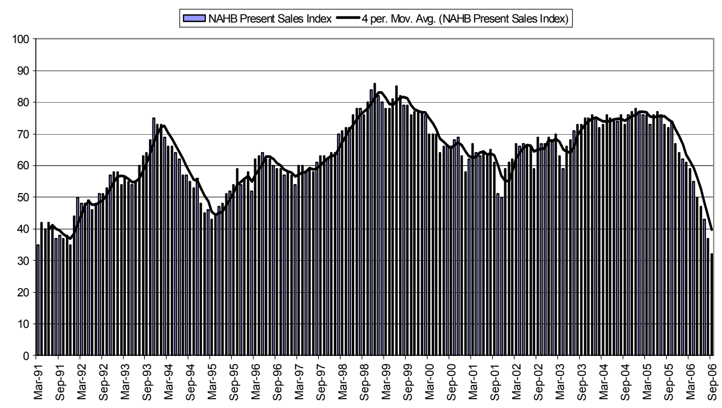
Detroit's auto companies are struggling and the once robust housing market is plummeting with New Home Sales down 17.4% YOY (year-over-year) in the steepest decline since 1994. The National Automobile Dealers Association reported that year-to-date SUV sales were down 19% in July. Yes, Detroit's *Big Three* and SUVs are struggling and that's the key; North American Total Vehicle Sales were running at a moderately healthy 16.1 million units as of August. Higher energy prices have driven sales toward more energy efficient imports. Still, Consumer Spending has slowed, particularly for Durable Goods and other "big ticket" items.

As for housing… Is there anyone who didn't talk about run-away home pricing and investment home speculation as recently as a year ago, when housing actually peaked? The downward slide in Home Sales has probably not bottomed and more pain is likely to be felt. However, the process of correcting a Housing Inventory glut that doubled over the past year is in place. Unlike traditional housing downturns, this one is about too much inventory and NOT about high mortgage rates. It would be difficult to make the case that a 6% mortgage is restrictive. Rates have even moved lower recently. As homebuilders have promptly reduced inventory production, "real" housing demand and supply should come back into balance more quickly. (Home Sales Index below.)

It is important to note that many economic indicators are "lagging" indicators or have a "lagged" influence. Inflation is a lagging indicator and the past seventeen Fed rate hikes and higher energy prices have a lagged effect on the economy. A simple example of this is the lagged "deflation fear" of 2003, though the trough of declining inflation bottomed in mid-year 2002.

It is clear that economic growth is not linear, but cyclical. Thus, our objective is not to extrapolate short-term trends, but to interpolate the cycle. When we balance the strengths of employment, industrial production, and capital spending, with the end of the rate hike cycle, abating commodity prices, lagging inflation and the lagged effect of energy prices, we believe a Soft Landing can be achieved and a Recession





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averted. Already in September, consumer confidence has risen on declining energy prices and while we always view confidence with extreme skepticism, we see anecdotal evidence of a slight pickup in consumer spending.

What could make us wrong? What we want to watch.
A slow down that accelerates as our strengths dwindle… that would do it. It could be a global economy that slows significantly more than we expect, or the shock from terrorism or other geopolitical risks.

Anytime the economy is slowing there is a degree of inherent fragility. So here's a few items we will be watching: Employment, weekly hours worked, orders, inventory, outputs, and employment costs. A watchful eye will be focused on Non-Residential Construction, which is expected to take up the slack of weak residential building. Also, growing exports, which have been improving with the aid of a weaker U.S. Dollar. Of extreme interest to watch are the Purchasing Manager's Surveys, which have had an incredible record of differentiating a slow down from a recession. Incidentally, the most recent data from Purchasing Managers indicate a solid growing economy. (Chart below, >50 illustrate expansion)

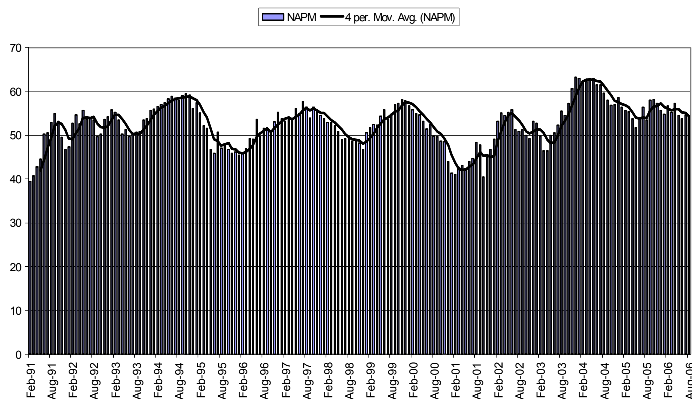
Traditionally, an inverted yield curve (when short-term interest rates are higher than long-term rates) indicates a slowing economy. ALL recessions have been preceded by an inverted interest rate yield curve. The tricky part is that all yield inversions have NOT resulted in a recession. We will be watching the magnitude of the current inversion. Eventually, the inversion will revert back to the norm, at which time the bond market will be signaling expected growth. However, globalization has made the bond market more involved.

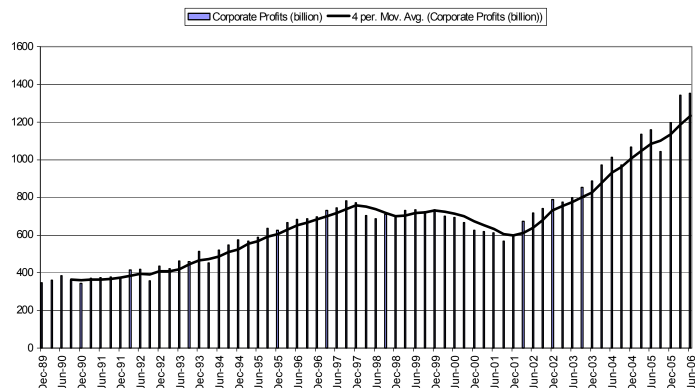
Upward pressure on foreign interest rates and rising domestic demand in foreign economies, such as Japan and Germany, makes U.S. debt attractive to foreign investors. Under this scenario foreign investment dollars have helped fuel the U.S bond markets while waiting for foreign rates to peak before making investment commitments. However, we are seeing evidence of slowing foreign economies such as Japan, China, and some emerging economies. It seems the traditional axiom to U.S. growth remains in force... "When the U.S. catches cold the World gets the flu." Still, growth abroad is expected to maintain a quite healthy 4% rate, in aggregate.

What does this mean for stocks?
First earnings – Economic growth is not going to be cut in half and still have earnings growing at a robust double-digit rate. Consensus analysts estimates still call for mid-teen level growth. We believe this is too high and that actual earnings growth will recede to high single-digit levels in 2007. The point is that solid earnings growth will remain in place. (See Corporate Profits Chart below.)

Accordingly, it's time to lean toward higher quality companies. The past few years have been favorable for smaller stocks and more cyclical industries. In the area of larger capitalized companies the gap between the "so called" value and growth styles has been the widest since 1998. Only the late 90's spread favored "growth." Conversely, the past several years have favored "value." This concept may be better served by viewing this differentiation as "cyclical growth" vs. a more stable, "consistent growth." The earlier mentioned duration of double-digit earnings growth provided by the economy, low interest rate stimulus, and ample investment capital, presented an environment more conducive to cyclical growth.

Being out of favor during the investment cycle can and is a painful event. Yet over and over, market history demonstrates many reversions of investor interest. While many have announced the re-emergence of Large Cap, stable, growth stocks, gaining attraction, only recently has evidence of such occurrence materialized. Timing a rotation has always proven elusive. But with recent monetary and fiscal policy curtailing economic growth, we believe conditions are ripe for a rotation to larger, "quality" stocks. Adding to this conviction is the fact that while the large company stocks underperformed, the pledge of consistent earnings power was not altered. Thus, Large Cap company earnings and cash flow powered ahead, building intrinsic value. Consequently, the valuation level of this equity asset class is uncommonly attractive, as "Growth" has now become more "Valuable."





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