

Hoisington

INVESTMENT MANAGEMENT COMPANY

1250 S. Capital of Texas Hwy. #3-600, Austin, TX 78746 (512) 3277200
www.HoisingtonMgt.com

Quarterly Review and Outlook Fourth Quarter 2002

Balance Sheet Strains Restrict Economic Growth

Efforts to make debt more manageable in the private sector will limit the growth in real GDP to a 0-2% range in 2003. At the end of September 2002, U.S. private sector debt totaled a record \$1.59 for each dollar of GDP, up from \$1.55 four quarters earlier. Consumers went deeper in debt last year as mortgages were refinanced in record amounts. According to FNMA, equity cash-outs from home values amounted to a staggering \$130-140 billion. This amount equaled more than half of the increase in consumer spending in 2002. In the face of declining stock market wealth and a loss last year of 438,000 private sector jobs, consumers further indebted themselves by purchasing automobiles with 0% financing. This additional indebtedness appears increasingly perilous since both payroll and household employment registered larger percentage declines over the past two years than in all but two of the recessions since the Korean War (Chart 1). While corporations did not borrow for capital spending, they borrowed heavily to pay dividends, buy back shares of stock and fund losses. Corporate debt relative to GDP surged to an all-time high in 2002.

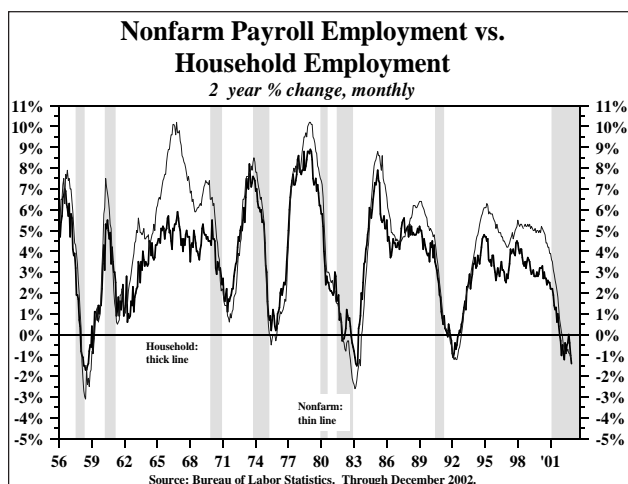


Chart 1

Debt repayment could be the dominant force in the economy, not only for 2003, but also for the next several years. This was the case in the early 1990s when private debt for each dollar of GDP was cut by 11%. The Fed Chairman has stated that the deleveraging of the early 1990s created a considerable “headwind” to economic growth. As funds are shifted from the income stream to debt repayment the economy will struggle going forward. A potential unpleasant consequence is a rising jobless rate that could reach 7.5% in 2004. This deleveraging will result in the stagnation of capital spending and moderating inflation, causing interest rates to fall.

Debt Deflation versus Price Deflation

The GDP deflator should range between 0-1% this year. This should not be surprising since this price index is up only 0.8% in the four quarters ending Q3 2002. Accordingly, nominal GDP expansion in 2003 should be in a range of 0-3%. Such paltry growth in top line revenues will mean that gains in corporate profits will be minimal at best. The aggregate economy may escape price deflation this year because notable price pressures are evident in selective areas. These include medical care (including insurance), downstream crude oil uses, property and casualty insurance, college tuitions, and taxes/fees of state and local governments. However, “debt deflation” may continue to be experienced even without price deflation. Spreading credit problems are evidence that existing debt levels are no longer sustainable.

The delinquency, foreclosure and bankruptcy trends all point in the same direction. The latest delinquency rate on credit cards was 3.8%, within 0.2% of the high reached in the 26 years that this data has been recorded. The mortgage delinquency rate was

within a fraction of its ten-year high. This suggests that foreclosures and bankruptcies that have already reached record levels are headed even higher. Last year an unprecedented number of public companies went bankrupt, with the dollar amount also a record. Over the latest twelve-month period, business and nonbusiness bankruptcies totaled a record 1.5 million (Chart 2). The early stages of debt deflation have already started even though price deflation has not. As the deleveraging process proceeds, the saving rate will rise at the expense of consumer spending and business investment. Corporations will have to shift funds from employment to debt repayment, and unemployment will, over time, rise considerably. Moreover, the stresses of this process are accentuated because the normal cyclical underpinnings of the economy are significantly diminished from a year ago.

Waning Cyclical Influences

Assuming a modest 1% rate of growth in the final three months of the year, real GDP is estimated to have gained 2.8% over the four quarters ending 2002. This increase was considerably better than the .1% rise recorded in the similar period ending 2001. However, it is important to point out that if the recession did indeed end in the last quarter of 2001, this was the second worst rebound ever recorded following a recession. An examination of last year's expansion reveals several obstacles to growth in 2003.

Anticipating some gain in the fourth quarter, real inventory investment accounted for 1.2% of the total 2.8% GDP rise in 2002, representing 42.9% of the total increase. Real final sales (calculated by

deducting inventory investment from GDP) rose by only 1.6%, which is the same frail pace set in 2001. With inventory levels now rebuilt, inventory investment will be a neutral factor in determining growth in 2003.

The final sales outlook in 2003 is less encouraging than in 2002. Last year, housing and government spending rose, but this was essentially offset by a contraction in capital spending and a wider net export deficit, meaning the net increase in final sales, can be attributed almost entirely to better consumer spending. The 2001 tax cut was the deciding factor that pushed consumer spending higher. From the end of 2001 to November 2002, the federal personal tax rate fell as a percent of personal income from 15.1% to 12.2%. The 3% drop in the tax rate was therefore greater than a 2.5% increase in real consumer spending; the remainder was saved, resulting in a rise in the saving rate. Without the tax cut, the economy's growth rate, even including the rebound in inventory investment, could have easily been flat, or even negative in 2002. The question is whether 2003 spending can be sustained by the recent proposals for fiscal stimulus.

Will Federal Fiscal Stimulus Save the Day?

One method of measuring fiscal stimulus is to examine the entire budget impact, including tax cuts and spending increases, rather than to use the more micro approach of analyzing targeted income tax proposals. In this manner, the Federal budget, on an

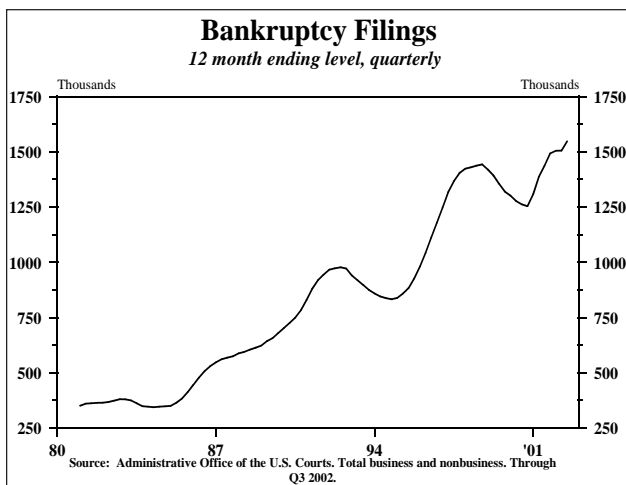


Chart 2

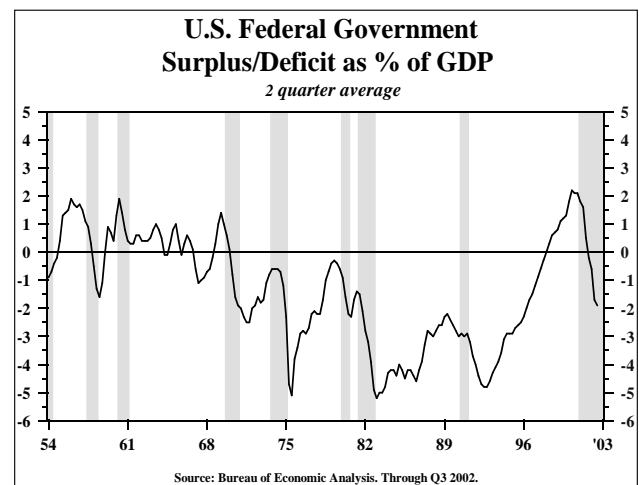


Chart 3

annual rate basis, went from a \$213.2 billion surplus (2.2% of GDP) to a \$200.7 billion deficit (1.9% of GDP) in the past two years (Chart 3). Thus, the net stimulus over the past two and one quarter years amounted to \$413.9 billion (3.9% of GDP). If there is a war with Iraq at a cost of \$50 billion, and the entire Bush tax plan is passed, which is problematic, the deficit in the next two years will rise another \$125 billion (only 1.2% of GDP). This is less than one-third the increased dollar stimulus of the past two years, and less than one-fourth the stimulus increase when expressed as a percent of GDP. In spite of the second most massive swing in fiscal stimulus in fifty years, the economy performed poorly in 2002.

Fiscal Shortcomings

The net benefit to the economy of the increased deficit has turned out to be much less than simple budget multipliers suggest, and will undoubtedly prove to be less effective in the future due to three inherent shortcomings of fiscal policy. First, increased budget deficits reduce the capital available to finance the private sector. Second, when the government sector accounts for a greater share of economic activity, overall productivity drops because private sector productivity is considerably greater than that of the government, which is essentially zero. Third, financial problems are so acute at the state and local governments that they will be cutting expenditures or raising taxes to stem record deficits (Chart 4). According to the National Conference of State Legislatures, the budget gap for state expenditures is in a range of 13-18%, more than double the gap in 1991-92. Unlike the Federal government, most municipalities are required to balance budgets. Consumption expenditures of the

state and local governments constituted 12.2% of GDP in the third quarter, compared with 6.6% for the Federal government. In short, the actions of the state and local governments will be an offsetting drag to any Federal stimulus program.

Has the Weaker Dollar Changed Global Dynamics?

In recent weeks the dollar fell to a three year low against the Euro, and dropped sharply relative to the yen and other major currencies. This development raises the following questions: 1) Does the weaker dollar mean that foreign economies are strengthening relative to the U.S. economy? 2) Will the lower dollar boost U.S. exports and thus act as a stimulant to U.S. growth? 3) Is the dollar headed for a multi-year decline?

From Q4 2001 to Q4 2002, real domestic demand in the U.S. is estimated to have risen 2.1%. For the “Euro twelve” and the 15 largest foreign economies, real domestic demand is estimated to have been flat. In the fourth quarter, weak U.S. measures of manufacturing activity were nevertheless better than comparable gauges in Europe.

Deflation in Japan appears to be deepening. Industrial production there continues to decline due to rapidly falling domestic demand. Not surprisingly, the intensifying deflation has led to a record level of personal bankruptcies in Japan, incredibly one-third higher than in 2001. In China, deflation has apparently strengthened as well. Standard and Poors’ estimates that bad loans in China amounted to an enormous 43% of China’s GDP. Thus the world is revealing its dependency on the U.S., and the slower growth here is, in fact, causing a shift to declining demand worldwide.

The weakness in the dollar is unlikely to boost exports. U.S. exports are far more sensitive to the real growth in foreign economies than to swings in foreign exchange rates. In fact, as the dollar has weakened, U.S. exports have deteriorated relative to U.S. imports. In October, U.S. goods imports were down 9.8% from their cyclical peak, but U.S. goods exports were off by a much more severe 15.1% (Chart 5). More important, however, may be the fact that while the dollar depreciated 6.9% against major currencies in 2002, the

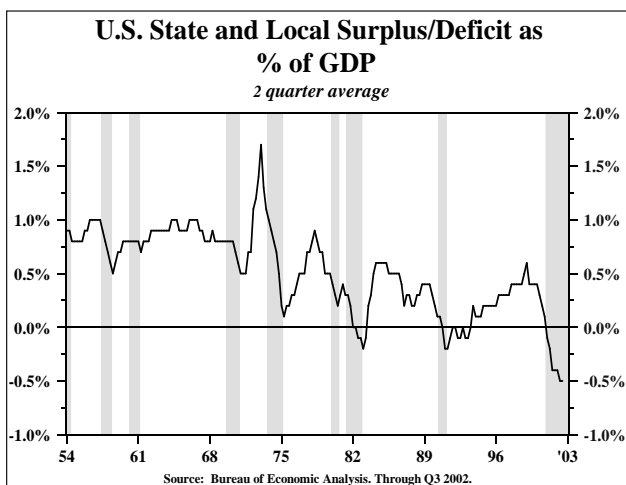


Chart 4

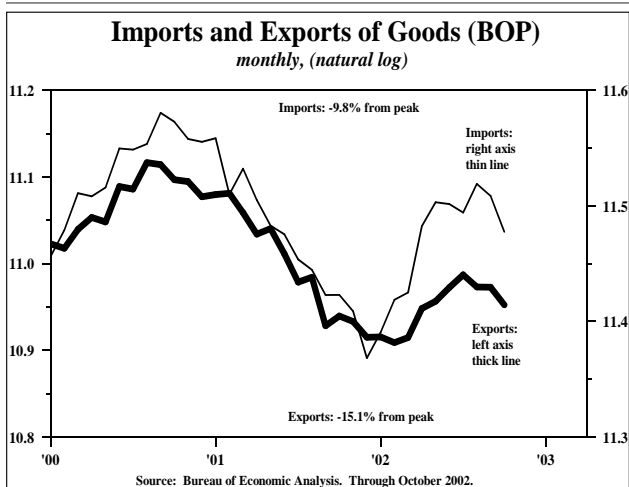


Chart 5

real broad trade weighted index of the dollar declined only 1.5%. In fact, the dollar actually rose, or held steady, versus some of our trading partners such as China, Mexico, Brazil, other Latin American countries, and Canada. Therefore, the recent weakness in the dollar will not provide a boost to U.S. exports.

Two considerations suggest a lengthy drop in the dollar is not likely. First, foreign economic growth has consistently lagged swings in U.S. economic growth by two to three quarters. Thus, the sharp reduction in U.S. growth from the third to the fourth quarter of 2002 will lead to a dramatic contraction in foreign economic growth in 2003. When this happens, the demand for dollars should increase. Second, a policy geared to achieve a systemic devaluation of the dollar would worsen, not ameliorate, global economic problems. The reason is straightforward; the rest of the world needs to sell to the U.S., and if these sales are cut, there is no market large enough to make up the loss. In Q3 2002, the U.S. real net export deficit was a record 5.1% of GDP, up from 1.5% five years earlier. Thus, in half a decade the U.S. trade deficit shifted 3.6% of U.S. real GDP to the rest of the world.

A monetary policy designed to dramatically lower the dollar could bring about the disastrous result of competitive currency devaluations, as occurred in the late 1920s and early 1930s. These actions were referred to as “Beggars Thy Nation” policies. Exports were not boosted because global aggregate demand was too weak. In the current global picture of insufficient aggregate demand (or too much aggregate supply), if we could achieve some sharp reduction in

our imports and/or increase in our exports, other countries are not in a position to allow that to happen. Unemployment is much worse in Europe and many other parts of the world than in the United States.

No Recovery Ahead for Capital Spending

The bottom line for capital spending in 2003 is too much excess capacity, too little top line growth, and depressed corporate profits. First, in November, manufacturing plants operated at 73.3% of capacity, just 1% above the fifteen year low reached in December 2001. Indeed, the November operating rate was almost 4% lower than at the start of the last extended period of corporate deleveraging. In short, new plant and equipment is not needed because the current stock of capital is being used so lightly. Second, nominal GDP growth is likely to be in a range of 0-3% in 2003, suggesting that competitive pressures will be severe, allowing for little increased expenditures in new equipment.

Third, the most recent after tax corporate profits of all nonfinancial corporations was \$202.9 billion in Q3 2002—equal to the same level nine years earlier. While nonfinancial firms are the key to longer-term gains in employment and capital spending, the picture is not much brighter when profits at financial firms are added. Total corporate profits in the third quarter were \$453.8 billion, or the same level as in the first half of 1995.

The Continuing Case for Lower Treasury Yields

In light of our analysis for subpar real and nominal economic growth caused by an ongoing need for debt repayment, the environment for Treasury bonds looks quite favorable. The vast majority of economists surveyed in the *Wall Street Journal* are bearish on Treasuries. They assume that the reflationary policies now being pursued by monetary and fiscal authorities will be successful. It is also argued that interest rates are just too “low”, and therefore must rise from these levels. Indeed, in nominal terms, bond rates at 5% appear low in the context of the last twenty years. However, long Treasuries traded comfortably around 3% in the 1950s, and in a deflationary

environment such as Japan's, the twenty-year Treasury debt is below 1.5% and the ten-year maturity is yielding less than 1%. If the twelve-month change in the U.S. GDP deflator of .8% is subtracted from the nominal yield of 5%, a very healthy 4% real return is available to the investor. This high real yield is double the average real yield recorded on long Treasury debt of 2.1% over the past 131 years. Thus, interest rates appear to us to be high, not low, in real terms, with considerable opportunity for lower real yields.

Second, it is counter-intuitive to believe that rising interest rates can somehow manufacture a recovery. The postwar history is a picture of recoveries

being spurred by lower rates. If fiscal and monetary policies are to be successful in reflation of the economy, then almost by definition interest rates have to fall. The refinancing activity that added \$135 billion to consumer pocketbooks last year would go to zero if there were even a modest rise in interest rates in 2003. Further, consumer and business investment would be retarded under an environment of rising interest rates. To be sure, "some day" interest rates will begin to rise, but we believe that the current structural headwinds will postpone that time for several years.

Van R. Hoisington
Lacy H. Hunt, Ph.D.