

Hoisington

INVESTMENT MANAGEMENT COMPANY

1250 S. Capital of Texas Hwy. #3-600, Austin, TX 78746 (512) 327-7200
www.HoisingtonMgt.com

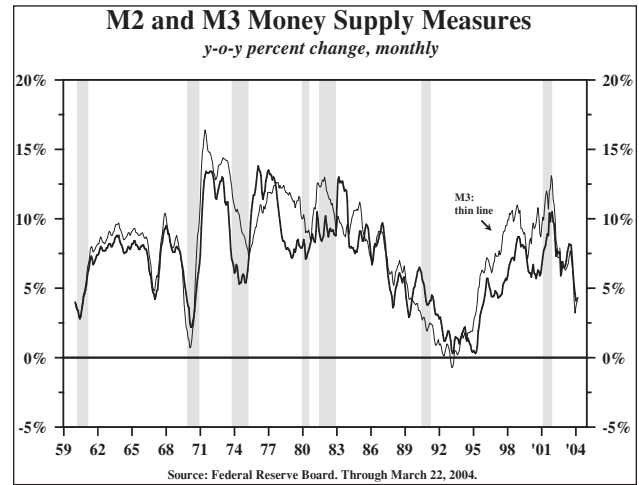
Quarterly Review and Outlook First Quarter 2004

Inflation - Micro or Macro-Determined?

Not all inflation is the same. Prices of numerous items are rising rapidly, as evidenced by the surge in the Commodity Research Bureau's Futures Price Index of nearly 11% year to date and 22% in the past twelve months. Not only are oil, copper, steel, zinc, cattle, soybeans, gold and silver prices rising rapidly, but so are medical care, pension costs, cab fares in New York and many other essential items. Most would conclude that these price changes are prima facie evidence that inflation is here. Therefore, the logic goes that the Federal Reserve is behind the inflation curve by maintaining the 1% Federal funds rate. Accordingly, interest rates must inevitably move higher and the Fed must adjust its target rate upward to mitigate the coming inflationary boom. Indeed, from a bottom up, or micro, perspective inflation is all around us. But inflation of individual items is not the same as inflation of all items.

The more comprehensive, or macro, definition of inflation is too much money chasing too few goods. Money, as measured by M2 expanded only 4.3% in the last twelve months, close to a seven year low (Chart 1). The Fed Chairman stated in recent Congressional testimony that this was hardly a sign of "excess liquidity". Simultaneously, the monetary base grew 4.8% over the past year--the slowest pace since the recession year of 2001. Such growth barely covered the rise of its zero multiplier currency component. This suggests neither lavish liquidity injection, nor a circumstance of too much money.

The other side of the macro ledger bespeaks of a massive abundance of goods, and the ability to produce even greater quantities. The capacity utilization rate of 76% in the U.S., and similar unused capacity around the globe, are evidence of a vast reservoir of output that could easily meet any increase in final demand. Labor, which generally represents about 80% of the cost of



production, is also in abundant supply. In the U.S., 8.35 million people are officially unemployed, but the degree of unemployment and underemployment is even greater. Workers so discouraged with job opportunities that they have quit looking for work stands at 514 thousand, the highest since 1994, and another 4.7 million people were working part time because full time work was not available. Thus, in the U.S. 13.6 million people could be called upon to produce goods at a marginal increase in cost. Unemployment rates of 9-10% in Europe, and higher elsewhere, suggest similar unutilized resources around the world. Too much money chasing too few goods? Hardly. Quite the opposite. Too many goods chasing too little money seems more like the current circumstance, and this is a definition of deflation, not inflation.

The unhappy fact is that rising prices of commodities, gasoline, medical care, food, and other non-discretionary items that people buy without concomitant increasing income is not inflationary, but disinflationary. In essence, the hike in such necessities acts as a tax in an income constrained environment. Income growth in excess of price changes is critical to getting the inflation ball rolling, and that simply is not happening.

Slowing Wage Increases

Wages play a pivotal role in determining inflation because they constitute income to households, and simultaneously expenses to businesses. Increases in prices of the selected items mentioned above have not translated into faster wage increases. In fact, wage increases have continued to moderate this year. Average hourly earnings rose 1.8% in the last twelve months, down from a 4.2% increase when real GDP first declined in late 2000. Moreover, the private work week was 33.8 hours in March, unchanged from a year earlier, and down substantially from the peak of 34 hours recorded in the late 1990s. Interestingly, while payroll employment has increased 627,000 in the last twelve months, the lack of a longer work week and the small increase in wages have resulted in average weekly earnings in March standing just 1.5% above the year ago level--just barely enough to cover the rate of inflation.

As the prices of basic necessities rise, households are obviously forced to shift constrained funds from discretionary to non-discretionary uses. In the latest month, consumer fuel expenditures were about 7.9% of wage and salary income, up 1.8% from the low reached in 2001. The rise in the energy share of the consumer budget over this span is similar to the jump that preceded the start of the 2000 recession. Such fuel increases typically serve to depress economic activity (Chart 2). Since fuel spikes preceded each of the last four recessions, the current jump in energy is clearly an unwelcome development.

The impact of the higher fuel and other basic

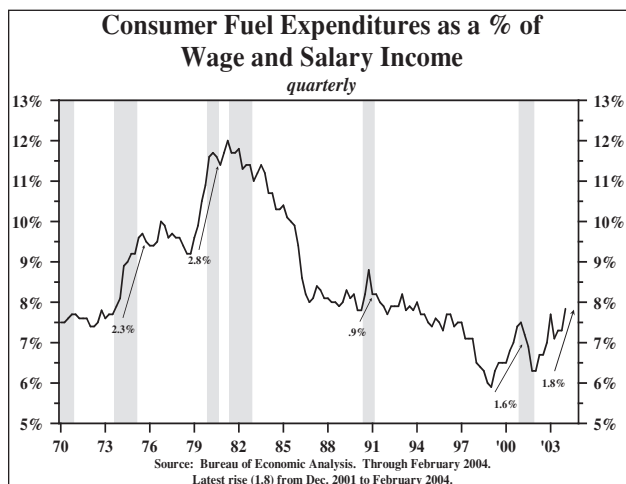


Chart 2

Real Disposable Personal Income and Real Wage and Salary index level, monthly



Chart 3

necessity costs on the overall economy has thus far been muted because of the tax cuts from 2001 to 2003 (Chart 3). Since the start of 2001, real wage and salary income is up by less than 1%, but real disposable personal income has moved ahead 9.8%. But, herein lies the rub. No further tax cuts are scheduled for 2004 or 2005. Therefore, the restraint on wages, the rising necessity prices, and the end of the tax cuts, all point to slower consumer spending later this year. Sharply declining interest rates, which would allow refinancing or other borrowing, would mitigate the slowdown.

The Understated Output Gap

This analysis focuses on the size of the output gap and the time that will be required for its elimination. In the fourth quarter, the output gap, which is the difference between actual GDP and potential GDP, as measured by the Congressional Budget Office, amounted to 1.5% of real GDP. However, this is a man-made estimate based upon the assumptions that productivity and the labor force are growing 2% and 1% per annum, respectively, thus creating GDP growth of 3% per annum. In view of the high investment to GDP ratio, it is probable that the productivity assumption is wrong. If the trend in productivity has been 3% per annum over the past five years, then the output gap would be 6.5% of real GDP, a circumstance we view as likely. This would mean that the current output gap is the second largest since 1949, only exceeded by that of the early 1980s.

What does this mean for the future? If the potential GDP is expanding by 4% this year and next (i.e., 3% productivity and 1% labor force growth) then the output gap will only close if real GDP expands by

more than a 4% rate. If, for example, real GDP grows 4% this year and 3.5% in 2005, then the output gap would be 7.0% at the end of next year, 0.5% higher than where the output gap actually appears to be. The point is that it will take 7 years of 5% growth in real GDP to eliminate the current deflationary gap. Once again, there is no record of sustained inflation with an output gap of this magnitude. Disinflation is the normal economic circumstance.

The Equally Large Employment Gap

An analysis of the employment gap corroborates the magnitude of the time required to close the output gap. In late 2000, payroll employment was 62% of the working age population. In March 2004, payroll employment was only 58.7% of working age population, reflecting a 1.8 million net decline in payroll jobs and a 9 million increase in working age population. If 62% of the population were currently employed, payroll employment would be 138 million, instead of the March level of 130.5 million.

This means that the current employment gap is 7.4 million. If our working age population continues to grow at roughly 230,000 per month, an amount equal to its growth rate since late 2000, 74 months (7.2 years) of monthly payroll employment increases averaging 331 would be needed to close the employment gap. Thus, in spite of the seemingly impressive gain of 308,000 payroll jobs in March, the employment gap hardly budged.

It matters little whether one prefers the output gap or the employment gap as a measure of excess resources, the fact is it will take years before either of these gaps is closed. In the meantime, the employment gap will continue to apply downward pressure on the rate of increase in wages, and the output gap will continue to force the inflation rate lower.

Is Money Growth Relevant Again?

From the 1950s until the early 1980s, one of the most reliably predictive economic indicators was the M2 money stock. When M2 growth accelerated, growth in nominal GDP did also, and when M2 growth moderated, nominal GDP followed. Reflecting this experience, the Federal Reserve adopted targets for the rate of growth in M2 as well as M3, and even in M1 for a limited period of time. But as the

1980s evolved, this strong tie between M2 growth and nominal GDP evaporated. In recent years, the Fed dropped targeted growth rates for M2 and M3. Now, signs are beginning to re-emerge that this pre-1980 link between M2 and nominal GDP is being reestablished.

To evaluate this extremely important development, let's consider why M2 was once such a good predictive indicator and why its historic role may now again be operative. The answer has to do with the equation of exchange developed by Irving Fisher of Yale in the *Purchasing Power of Money* written in 1909. Fisher, an outstanding theorist, also developed the concept of real interest rates, debt deflation and the variable weight price index. Fisher's equation of exchange, a truism, states that the stock of money outstanding (M2 in this case) multiplied by the velocity of money (i.e. the number of times that M2 turns over in creating nominal GDP) equals nominal GDP, or $M \times V = GDP$. From the time the Treasury market was decontrolled in the early 1950s until the banking system was deregulated in the early 1980s, the velocity of M2, or the V in the equation, fluctuated very little. Increases in velocity occurred, as did declines, but they were usually short-lived and largely self-correcting.

The reason may have been related to the fact that financial innovation was not dramatic for three decades, and what innovation occurred was very modest from year to year. Thus, over this time, velocity was stable, and growth in nominal GDP tracked very closely the growth in M2.

M2 velocity rose sharply in the early 1980s as the banking system was deregulated and financial innovation spurted ahead, with a plethora of new financial products available to an increasingly wide range of households and businesses. In the mid 1980s, M2 velocity settled down and even appeared to be returning to the upper end of the range established from the 1950s until the early 1980s. Then, velocity started moving higher in the late 1980s, a trend that accelerated for almost ten years. This period was once again a time of rapid financial innovation, one that included the growth of the derivatives market, new debt and equity products, proliferation in the number of mutual funds, hedge funds, and the burgeoning activities of Fannie Mae and Freddie Mac.

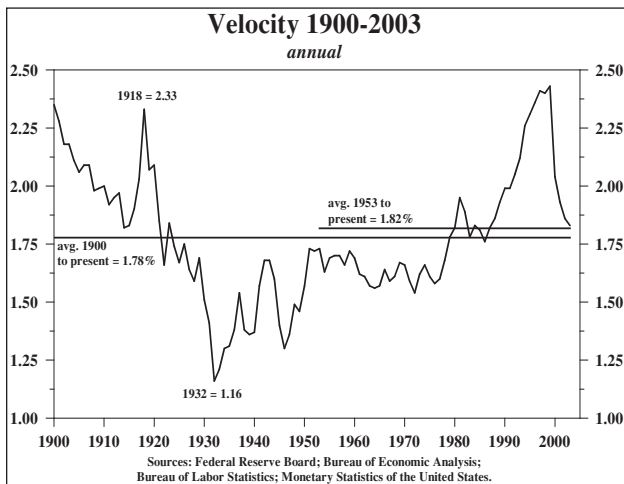


Chart 4

Since 1999, however, M2 velocity has declined substantially, from 2.43, to 1.83 in 2003. The 2003 average was, therefore, very close to the post 1900 average of 1.78, as well as the post 1953 average of 1.82 (Chart 4). Given the measurement error, we might very well assume that the long run average level of velocity is 1.8. An abatement in financial innovation may mean that M2 velocity will once again be in a stable range over time. This would mean that the growth rate in M2 will now track the growth in nominal GDP. With M2 currently growing 4.3% in the latest twelve months, the pace of expansion in nominal GDP would be in the same paltry range.

Which Direction is Velocity Likely to Take?

Monetary history suggests that velocity might be likely to fall a bit further over the next several years. This would have significant implications for both economic activity and Federal Reserve policy. Another period of rapid financial innovation occurred in the aftermath of the creation of the Federal Reserve in 1913. In 1914, the Fed's first full year of operation, M2 velocity was at the mid-range level of 1.82, almost identical to the current level. Five years later velocity jumped to 2.33, close to the levels reached in 1998 and 1999. From the peak in 1918, M2 velocity dropped sharply over the course of the next fourteen years, bottoming at the all time low of 1.16 in 1932.

Even a modest decline would be an unwelcome development since the rate of increase in nominal GDP would then be less than 4%. In other words, the Fed

would need to accelerate M2 in order to offset falling velocity. The bottom line is that money growth is low and poses a risk to the healthy continued expansion of the U.S. economy. The widely expected view of the Fed and others is that inflation this year will be around 1.5%, meaning that the real GDP growth rate could drop to 2.5% late this year as the tax stimulus wears off. Even the achievement of 2.5% real growth will not be possible if money growth remains stagnant and its velocity continues to decline.

Low Interest Rates for a Long Time

Although 59 of 60 economists in a Wall Street Journal poll expect interest rates to be higher at the end of 2004 than at the beginning, we believe that interest rates will remain low and work irregularly lower over the next several years. Seven considerations support this view. First, large output and employment gaps exist, and they are unlikely to be closed for several years. Second, debt levels are so high that any interim rise in interest rates would knock the economy back on its heels and delay the time needed to close the output/jobs gap. In fact, total private debt was a near record 1.63% of GDP in the final quarter of 2003. Third, rising market rates of interest would constrict money growth at a time when it is already depressed. Fourth, monetary policy needs to take up the slack from diminishing fiscal stimulus. The Federal deficit, as a percent of GDP, fell slightly to 4% in the final quarter of this year. By year-end, the deficit will have shrunk to between 3-3.5% of GDP. Fifth, the demand for motor vehicles is saturated, and with the exception of certain parts of the country, the demand for housing is close to being saturated. Any rise in market rates of interest would undermine vehicle and home sales. Sixth, a rise in market rates of interest would push the dollar higher, reinforcing the rise that has already occurred this year. This would work against any reduction in the trade deficit, slowing overall growth. Seventh, a rise in rates would put downward pressure on the already low inflation rate.

For these reasons, long-dated US Treasury securities should continue to be the safe, rewarding investment they have been for the past twenty years. The bull market in Treasuries continues.

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