

# Hoisington

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## Quarterly Review and Outlook

### Third Quarter 2004

#### ATYPICAL

Unusual would be an appropriate description of the interest rate movement thus far in 2004. Short dated interest rates, typified by the Fed funds rate, moved higher from 1% to 1 3/4%. Simultaneously, the longest dated Treasury bonds declined in yield from 5.07% on January 1 to below 4.9% currently. This disparate movement in the yield curve, while indeed unusual, is not unprecedented. During the early 1960s, the Fed funds rate rose from about 1% to near 4%, yet the ten year note yield remained steady at around 4%. This episode is a template for today's yield curve movements. The reason the long rate remained steady during that time is similar to the rationale today, i.e., inflation remained quiescent (Chart 1).

#### CONSUMER PROBLEMS

The most recent reports on the core inflation rate suggest inflation is running about 1 1/2%, only marginally above the level at the beginning of the year. However, with oil, gold, and industrial metals prices soaring, it is fair to question how long the

period of low inflation will be sustained. Nobel Laureate, Milton Friedman, as others before him, defined inflation as, "too much money chasing too few goods", and that remains the premiere definition. The goods portion of the equation contains both a supply and demand component. The demand side is clearly a function of U.S. consumer spending. The American consumer represents 70% of U.S. GDP, and in turn the U.S. represents about one third of world GDP. The American consumer has sustained a high demand for goods throughout the past decade when final demand elsewhere was faltering and investment was shrinking. This critical demand source for the U.S. and world economies now appears to be waning. If this source of final demand fades, inflation will move lower, not higher.

Personal consumption, or spending, is funded primarily by disposable income, although a drawdown in saving or increased borrowing can be contributing factors. The reduction in saving to fund additional spending from this point forward seems improbable as the U.S. saving rate stands at .9%, virtually the lowest level in seven decades (Chart 2). Additional borrowing is always possible, yet the trend in outstanding consumer credit is clearly headed lower, with year

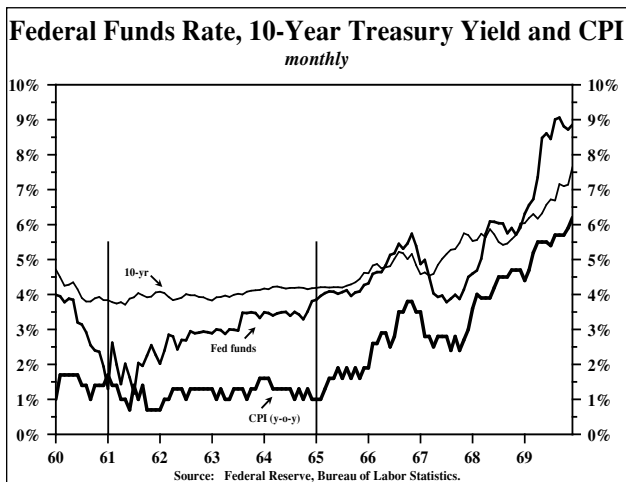


Chart 1

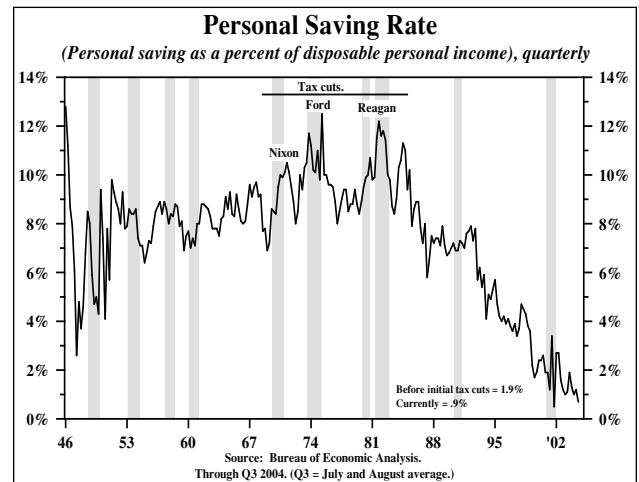


Chart 2

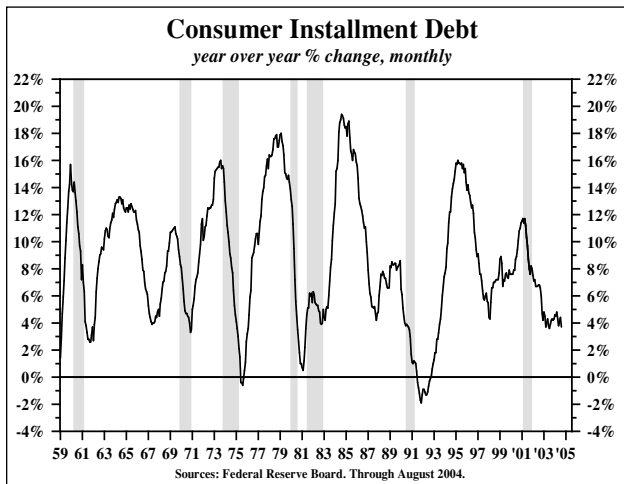


Chart 3

to year increases now less than 4%, near the slowest growth rates in a decade (Chart 3). Therefore, neither of these above-mentioned factors seem poised to sustain further rapid growth in consumption. Contrarily, they might actually retard future consumption if saving is built while debt is repaid.

Disposable personal income (DPI), therefore, is the primary source of spending power going forward, and this measure of future spending also points toward slower growth. The twelve month growth rate in real disposable personal income has fallen from 4.3% ending 2003 to only 1.6% currently. Theoretically, this would suggest that spending should expand no more than roughly 1.5% over the next year, or until, and unless, additional tax cuts, a new round of home refinancing, an increase in wealth, or accelerated job growth boost this critical source of spending.

### FEW JOBS

Labor market conditions are critical to income growth, which supports spending or the demand component of inflation. They also represent a potential source of reported inflation since labor costs represent about 80% of the input costs of businesses. Taxes, commodity prices, insurance, rent, etc. represent the remaining 20% of product costs. Today, no cost push factors are evident from the labor sector that would aggravate higher inflation. Average hourly earnings are expanding about 2%, near the slowest growth rates in 40 years (Chart 4). Further, the work week has averaged about 33.7 hours over the past twelve months, marking the lowest annual hourly level since the Department of Labor began measuring this statistic in 1965. Normally, businesses would begin to work

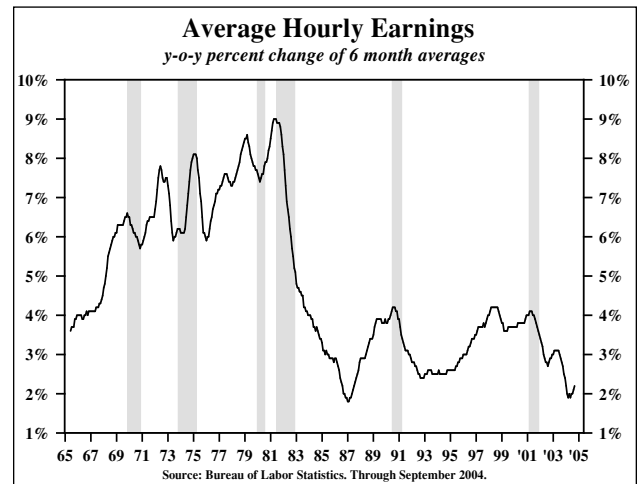


Chart 4

their existing work force longer hours before new hiring is initiated. The depressed work week expansion and slow wage increases are clear symptoms of the unprecedented weakness in the labor markets during this business expansion.

Whether this labor market weakness has been a result of the amazing stock market bubble and overinvestment associated with the euphoria of the 1990s, or other factors, it is notable that there are 1.7 million fewer private sector jobs than there were in December of 2000. Despite the addition of nearly 1.6 million private jobs in the past twelve months, since the recession of 2001, only 391,000 private jobs net/net have been created, compared with 5.3 million private jobs at the same point in the previous five business recoveries. This lack of job growth has caused individuals to drop out of the job force in droves, so that only 65.9% of the potential labor force is participating, down from the 67.3% peak in 2000. The number of unemployed stands at eight million individuals, and if discouraged and underemployed individuals are counted, the total would rise to 13 million, or 8.9% of the labor force. Incidentally, this is down from the peak of over 16 million, or 10.9% of the labor force, reached in January of this year.

This slack labor market is a central factor in explaining why there has been, and will continue to be, little evidence of a wage cost push toward higher inflation and thus higher interest rates.

### SLOWER SPENDING AHEAD

The persistent weakness in U.S. private payrolls (averaging gains of only 65,000 for the last

three months) may have its roots in the abundant labor available from China, India, or other low cost countries, or possibly the high productivity spurred by overinvestment. Regardless of the rationale, slow labor growth will impact economic growth in the ensuing quarters. Wages and salaries are the largest component of real DPI which, as mentioned before, has risen a modest 1.6% year/year. This portends a similar real spending growth rate over the next twelve months, provided the savings rate remains at depressed levels.

In addition to the lack of income growth, several other factors will contribute to slower spending ahead. First is the pervasive rise in energy prices. Total energy expenditures as a percent of wage and salary income are up 1.6% from the 6.2% level in 2002, a greater percentage move than the oil shocks of 1990 and 2000. Four oil shocks have occurred since the early 1970s and the economy has sustained four concurrent recessions. Can this event be different? A second retarding factor to consumer growth is the interest rate rise over the past twelve months which has continued to reduce the demand for credit. During the 1990s, significant backups in interest rates slowed the economy by about one third from its peak rate of growth prior to the backup (Chart 5). Third, current high debt levels exacerbated by the interest rate rise have already begun to slow the demand for credit. Debt to income ratios at 23.6% are slowly subsiding, providing fewer funds for new purchases. The total debt to asset ratio has exploded but is showing signs of rolling over (Chart 6). Further, spending has been augmented over the past three years by nearly \$250 billion (although estimates vary) via the extraction of equity from homeowner dwellings. The rate rise

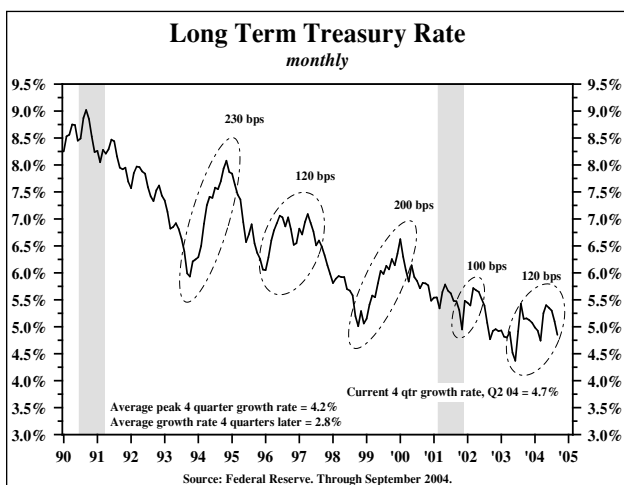


Chart 5

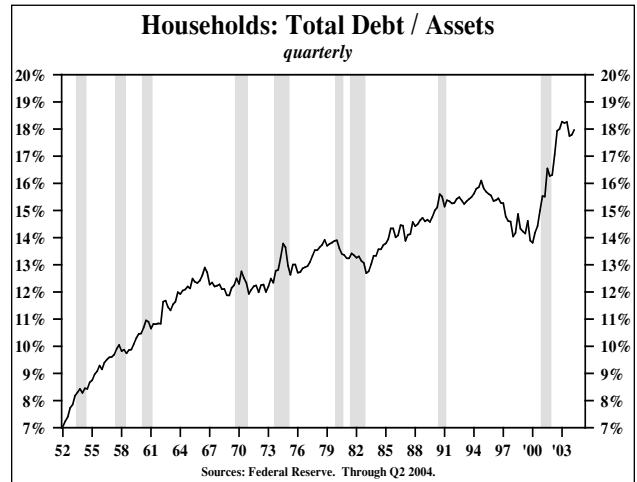


Chart 6

of the past twelve months has slowed this extraction dramatically, and a significant decline in interest rates will be required to ignite this powerful source for spending. Indeed, we expect such a sharp decline in interest rates, so that by the middle of 2005 spending will receive some support from this source.

The above factors, however, should slow spending to the 0% to 2% growth pace in 2005. While most of the post war recessions were associated with declines in consumer spending, nearly half of those recessions have been associated with spending in the 1% to 2% range. If, perchance, a reduction in wealth were to be derived from lower housing or equity values, a recession would ensue given the already low level of expected spending and the minimal level of saving.

The vast output capacity of the world, along with the enormously high investment ratios in the United States, assure an abundance of goods. Only the U.S. consumer has been a reliable purchaser of that output over the past decade. The growth outlook for that source of demand is, at best, lackluster. This infers that, rather than a high demand for too few goods, there will continue to be a surplus of goods relative to demand, a paucity of pricing power, and continued deflation in goods prices.

### EASY FED?

The 1% Federal funds rate, now 1 ¾%, implies an overly accommodative Federal Reserve. By the same logic, however, the near 0% overnight rate in Japan, installed in 1996, would similarly suggest an easy policy. It should be noted that the zero rate in

Japan did not translate into excess money growth and, in fact, could not control the deflationary impulses of that economic system. Similarly, our seemingly low Funds rate has not translated into “too much money”, or for that matter, higher inflation. Presently the money supply (M2) is expanding by a modest 4.2% (Chart 7). If the velocity or turnover of that money remains constant, nominal GDP should be about 4% over the next four quarters. Our analysis of velocity suggests a potential decline due to the lack of new financial innovations, meaning a sub 4% expansion. A 4% nominal growth rate could be divided into 1.5% inflation and 2.5% real growth, or for that matter any other combination, but it is clearly sub-par, top line growth. This slow growth is hardly the key ingredient for a high inflation cocktail.

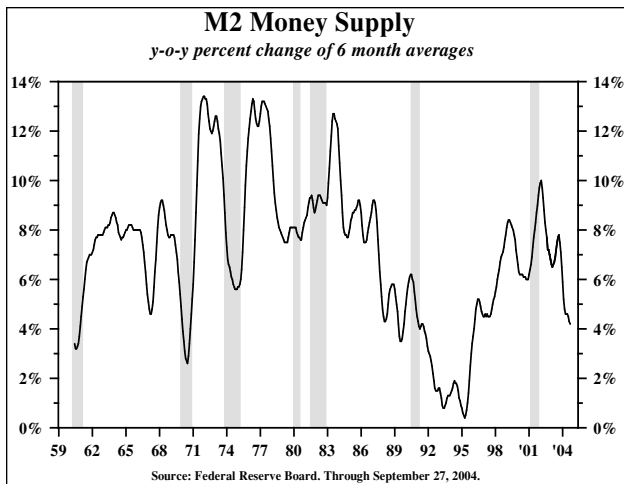


Chart 7

## TOO PESSIMISTIC?

It is rarely an odds-on bet to wager against the U.S. consumer or the U.S. economy. Over the past twelve months, nearly 2.2 million net new entrants entered the working age population. This flow of energetic labor provides for a powerful upside bias to the U.S. economic system. Second, those who now have jobs, some 139 million people, appear to be extremely productive, as evidenced by the productivity growth rate of nearly 4% over the past five years. Further, the strong entrepreneurial spirit of our citizens continues to create new and profitable businesses. For these reasons, recessions are a rarity. However, 2005 does not have to be a recessionary year for unutilized resources to expand. A real growth rate of over 3.8% is necessary to put to work all who wish employment and to reduce our present excess capacity in plant and equipment. Unfortunately, the outside factors buffeting the U.S. economy, such as intense foreign competition in goods, rising commodity prices, outsourcing of jobs, and disappearance of fiscal and monetary stimulus all suggest a real growth rate below the critical 3.8% level. This implies that aggregate pricing power will remain nonexistent, and inflation will continue its secular downward path. With inflation headed downward, long term Treasury rates, as always, will follow.

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