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Interim Update and Comment *May 2004*

THE COMING SLOWDOWN

Back to back, strong employment numbers have increased the odds of an upward move in the Federal funds rate in June or August. The markets have priced this anticipated move into all Treasury maturities.

Despite their strength, we view the near-term numbers as transitory. Powerful restraining forces are impacting the consumer, and this will result in slower growth in the latter part of this year and into 2005. As a consequence, we fully expect interest rates to be lower by year end, and noticeably lower a year from now.

Regarding the recent employment reports, these items are of note:

- Payroll jobs rose 288,000 after upward revised increases of 337,000 in March and 83,000 in February. Incidentally, 270,000 of the April job gains came from the birth/death model, a statistical extrapolation rather than a direct increase in the job head count. Previously this model was called the plug factor.

- The normal sequence whereby firms increase the workweek while they are hiring was not in place for the second consecutive month. The average private workweek failed to recover after falling 0.1 hour in March.

- The economy added 21,000 manufacturing jobs in April and 9,000 in March. The increases do not appear sustainable since the manufacturing workweek fell a very sharp 0.3 hours in April,

after dropping 0.1 hours in March. Since February the manufacturing workweek has fallen 1%, with the drop in the workweek widespread throughout the manufacturing sector in both key durable and non durable goods categories. The manufacturing workweek was the lowest since December when it was 40.6 hours, the same as in April.

- The construction workweek fell 0.4 hours, reversing the March 0.2 hour gain, dropping the workweek in this sector to the lowest level since December 2003.

- Average hourly earnings rose 0.3%, boosting the year/year rise to 2.2%. Average weekly earnings fell to \$520.71 in April, down 22 cents from March with the softness in the workweek and job gains centered in low paying sectors. Moreover, the March decline was revised to a drop of \$6.35, compared with a preliminary decline of 88 cents. Weekly paychecks rose just \$10.69 versus April 2003, or a mere 2.1%. This is less than the inflation rate. Thus, job gains notwithstanding, the real standard of living would have declined in the past year if not for the cut in household income taxes.

- The economy is exhausting last year's stimulants. For the first time in four years consumers will not get an income tax cut this July, and they have already spent the 2001 to 2003 tax cuts. When Presidents Nixon, Ford and Reagan cut taxes, the personal saving rate jumped sharply. Thus, consumers were able to draw saving down and propel the economy for several years. But today we see a saving rate mired below 2%, which is equivalent to the pre-2001 tax cut rate. Since

the beginning of 2001, after-tax household income rose 10%, but pre tax wage and salary income gained a paltry 1%. Not only were the tax cuts key to a 4% growth in real consumer spending, but a record mortgage refinancing boom occurred in 2003 while interest rates were low. The rise in market interest rates has resulted in a collapse in mortgage refinancing, with the last 4 weeks 50% lower than a year earlier. The evidence is mounting that the former stimuli are waning.

- The consumer sector would be vulnerable to a downturn in normal circumstances, but conditions are far from normal since we are experiencing the fifth oil shock since 1970. Total consumer fuel expenditures have advanced from a 2001 low of 6.3% to 7.7% of wage and salary income in the quarter just ended, and energy prices are even higher now. This is a dead weight loss to the domestic economy. All of the four prior oil shocks led the economy into recessions, and this risk is present again because of the persistent weakness in average weekly earnings. Thus, with fuel rising sharply, especially in the heavy population centers on the coasts, consumers are being forced to shift spending from the discretionary to the necessary. The energy spike is showing its effects.

- Federal Reserve accommodation does not depend on whether the Federal funds rate (the overnight lending rate between banks) is rising or falling. Rather, it reflects the status of mortgage and long-term rates, as well as the rate of growth in money and credit. The news on this front is not good (see our quarterly letter.) Key interest rates have already risen, and contrary to what some

believe, money and credit growth is poor. In the last 12 months, both M2 and M3 are ahead by about 4%. Such rates of growth are the slowest in the past seven years. Over a longer time frame, the growth in M2 equals the growth in nominal GDP (inflation plus real growth). Thus, if inflation is 2% late in the year, this would mean that real growth will drop to 2% also, down from better than 4% in the first quarter. Business loans and non financial commercial paper are continuing to decline for the fourth consecutive year. Moreover, the monetary base (reserves injected into the banking system by the Fed) is up just 4.7% in the past year. This represents a sharp slowing, and replays the pattern prior to the recession of 2000-2001.

- With all the focus on the Fed and the perceived strength in back end sectors of the economy, the front end, or consumer, is already slowing. The personal spending trend ended the first quarter on a very weak note, rising at just a 1.2% annual rate in March, after annual rate increases of 2.4% in both January and February. The reason the first quarter growth in spending was at a 3.8% annual rate was the high entry point from the fourth quarter. The April evidence on the consumer is weaker. Vehicle sales were at a 16.4 million annual rate, the lowest since last October. This happened in spite of increased incentives at GM. Also, weekly surveys of consumer spending moved lower in April on a seasonally adjusted basis. Admittedly, the ISM manufacturing and non manufacturing indexes were strong in April, but they will not remain so if the consumer does not pick up the pace. In our opinion, there is nothing to provide the consumer a lift.

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