

SKBA CAPITAL MANAGEMENT, LLC

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Is the Boom Off the Economic Rose?

*By Andrew W. Bischel
President & Chief Investment Officer
&
Kenneth J. Kaplan
Chairman & CEO*

The “soft patch” in economic activity that started in June and July turned into the “Dog Patch” of stock market performance in August, September and October. The real question is, however, is this the beginning of a new trend, or just a pause in the trend of economic growth? We tend to believe the latter.

Much of the economic news has been great. The annual rate of real GDP growth over the last five quarters topped 4%, despite the second quarter slowdown. The CPI gained just over 2.5% over the last year despite the surge in oil and commodity prices. Furthermore, corporate profits advanced at a robust pace. It’s not quite a classic boom (which has higher inflation). But many economic indicators, from consumer confidence surveys, payroll employment reports, and retail sales, to business order rates, have provided a decidedly mixed picture of the state of economic growth. Overall, uncertainty about the economic and financial market outlook has grown, and rising uncertainty is a killer of positive stock market momentum and a boon to safe-haven investments like Treasury bonds.

The worst of all worlds would be a return to an environment of stagflation – the combination of anemic real growth (i.e. 1-2% annually) and a rising inflation rate (i.e. 4%+). Whereas many environments favor one asset class or another, neither stocks nor bonds benefit from stagflation. Rising CPI inflation and interest rates hurt bond returns, and when combined with slowing corporate profit growth and falling P/E ratios, stocks perform poorly as well. By our estimation, if stagflation were to be the order of the day over the next two years, the S&P 500 and 30-year T-bonds could produce negative returns (total, annualized) at -14% and -4%, respectively. Not a pretty picture!

The recent surge in the price of oil to over \$50 is the single most important negative impact on real economic growth and financial markets. The change could cause a massive transfer of wealth from U.S. consumers and businesses to foreign oil

producers. Some estimates have suggested that the high price of oil has taken one percentage point off the annual rate of real GDP growth. Yet the oil consumption represents a far lower portion of GDP, around 3-4%, than was the case in the late 1970s, when oil consumption accounted for nearly 10% of GDP. It would take significantly higher prices to derail the recovery. Since over the short run the consumption of oil is relatively price inelastic, one cannot accurately forecast where spot prices might top out. Furthermore, there is a significant “terrorism premium” built into current prices as the market worries about the stability of the flow of oil from the Middle East, particularly Iraq. A successful election in Iraq and the impact of conservation and substitution effects on demand could cause prices to return to more normal levels over the next two years. In the meantime, high oil prices are likely to somewhat suppress the pace of real economic growth.

We’ve captured this effect with our multi-scenario forecasting tools in recognizing that the economic “Boom” scenario, which combines high real GDP growth (4%+) with a rising inflation rate, is somewhat less likely to occur than had been the case three months ago. (This can be seen in the multi-scenario analysis table on the following page that looks at the two-year outlook.) This does not, however, offer much comfort for the impact of oil prices on the inflation rate. If slower real growth occurs, it is likely to still be accompanied by a rising inflation rate. This is why we’ve modestly boosted our probability that we might experience “Stagflation” instead of a “Boom.” Stagflation is still likely to remain only a low probability, however, for reasons we’ll discuss.

There is another source of rising uncertainty, however, that is finite in duration – the presidential election outcome. Businesses and individuals eventually adapt to whatever economic rules are set by federal and state governments as to tax rate and regulatory policies. But when they don’t know what those rules will be, they tend to freeze decision-making processes. Why hire? Why invest? While the candidates offer significantly different visions of what the rules will be on the playing field, just knowing the likely new rules will facilitate businesses in making investment and hiring decisions. We suspect the stock market will rally regardless of who wins the election (once the result is known and legal challenges completed!). The short-term slowdown in real economic growth is also likely to come to an end.

SKBA Multi-Scenario Outcomes & Expected Returns

2 Years to: 09/30/06

Scenario Forecasts		Boom	Stag- flation	Historic Norm	Perfection	Recession		
SKBA Probabilities		25.0%	10.0%	50.0%	10.0%	5.0%	100.0%	
Today's Values 09/30/04		Our Expected Values	Expected Values & Annualized Returns by Scenario*					Our Expected Returns
\$1,115	S&P 500	\$1,270	8.0%	-13.5%	12.1%	24.4%	-24.2%	7.9%
4.95%	30 Yr T'Bond	5.8%	-7.5%	-3.7%	1.3%	4.6%	21.0%	-0.1%
1.93%	6 Month T'Bill	3.5%	3.7%	3.0%	2.5%	2.2%	1.3%	2.7%

* Expected Returns are subject to change and should not be viewed as a promise of future performance.

This doesn't mean the economic policies propounded by the candidates will not impact the economy and financial markets differently over the long term. They could. Lower marginal effective tax rates have a proven history of boosting the incentives to work, save and invest. Lowering tax rates also reduces the incentive to shelter income from taxation (whether among those in high income tax brackets or in the underground economy). At a minimum, if current tax rates are not made permanent, we will experience a stealth tax increase as the current 15% tax rate on dividends and capital gains is scheduled to disappear in 2008. Other tax rate cuts will expire a couple of years later.

The somewhat counterintuitive impact of this stealth tax hike would be the acceleration of economic growth in the near term, as businesses (including S-corps, LLC's and partnerships) "make hay while the sun *still* shines," at the expense of long-term growth. With the hay in the barn, the farmer (read entrepreneur) heads for shelter (and business inactivity) as the storm clouds approach.

But it doesn't have to be this bad. Yes, a booming economy is somewhat less likely, but a perfectly acceptable scenario, "Historic Norm" (which forecasts around 3% real GDP growth and 2.5-3.5% rate of CPI inflation), still receives our highest probability (recently boosted to 50%). There are many reasons, some of which we highlight below.

The U.S. Congress finally addressed the WTO's ruling against the tax subsidy on the foreign export sales of U.S. corporations by eliminating the tax break on exports and lowering the tax rate for U.S. "manufacturers." In an odd lucky break, just about every corporation (excluding financial companies), is defined as being a "manufacturer," and in place of the export tax break, the

corporate tax rate will be lowered from 35% to 32% (albeit phased in to 2010). The most important immediate benefit will be the elimination of the current 12% tariff on U.S. exports to the European Union. This "tax" on U.S. manufactured goods had been progressively rising each month as Congress dragged its feet about responding to the WTO's ruling. Although exporters like Boeing, Caterpillar and Deere will see their export sales tax benefit disappear, the elimination of this 12% tariff will be a significant benefit to the competitiveness of their product prices and those of most other exporters of manufactured goods.

Indeed, all U.S. exports to the EU should benefit, although as manufacturers have anticipated the passage of this tax bill, they may have slowed shipments to the EU to await the lower actual implementation of the lower tariff – just another part of this post election benefit awaiting the economy.

Another important feature of this tax bill is the reduced tax on the repatriation of foreign earnings of U.S. domiciled corporations. For one year, corporations may repatriate foreign earnings (on which U.S. tax liability has been deferred) at only a 5.25% tax rate! Expect a big horde of cash to come back into the States to fuel corporate capital spending trends in 2005. Another reason capital spending trends are likely to take over the growth momentum in the economy and offset the possible slowdown in the pace of consumer spending is that non-financial corporate balance sheets are in the best shape in over a decade. The "Rating agency reign of terror over corporate America," a term we coined in describing the devastating impact debt rating downgrades had on corporate investment from 2000 through 2003, came to an end in 2004. The effect of the investment boom derived from Y2K spending (anybody remember the Y2K investment bubble?) has been worked

through the economic system. Cash balances of S&P 500 companies are at 10% of assets, a record level. U.S. capital spending trends have already grown at a fast pace over the last year. There's plenty of financial capacity to step up the pace of investment if confidence in the rules of the playing field returns.

Even the massive growth in financial corporation debt could pose less of a systemic risk (particularly due to the explosive growth in the use of derivative securities) to the economic system. As a side benefit of the accounting scandals at Fannie Mae and Freddie Mac, both companies will be required to raise their equity capital ratios – an important reduction in financial risk they face and they pose to the financial system.

On the monetary policy front, the Federal Reserve Board still maintains an extraordinarily easy stance, with short-term T-bill yields at less than the rate of inflation, creating negative real interest rates. As we've stated in prior client newsletters (see "So What Should You Do in Your Portfolio – Say Bye Bye or Buy Buy to Bonds?"), negative real interest rates encourage all kinds of price speculation – in commodities, gold, energy, real estate, and "carry trades" that use inexpensive short-term borrowing to fund longer duration financial or real asset contracts. Negative real interest rates also encourage the debasement of the exchange value of the currency, and the U.S. dollar's decline does not appear to be over.

In changing strategies in June, the Fed is now pursuing a deliberate strategy of raising short-term interest rates at a "measured" pace to eliminate negative real interest rates. So far, bond investors have interpreted this to mean the Fed won't allow inflation to get out of hand. The long end of the Treasury yield curve has rallied (with declining yields) under this presumption. Given what's going on in the domestic economy and worldwide on the economic and inflation front, these

expectations are likely to produce great disappointment. We expect that the CPI inflation rate will exceed 3% in 2005 and perhaps 4% in 2006. This is not even remotely anticipated in today's bond market yields. Indeed, the CPI inflation rate implied by the yield on 10-year TIPS (Treasury Inflation-Protected Securities) fell from 2.7% in May back to the 2.3% level recently, below the current rate of inflation.

The good news for the economy and the stock market, however, is that short-term rates won't take a bite out of the economy until they rise above 3.5%. Today's steep yield curve already discounts the expectation that short rates will rise. So between today's 1.75% Fed Funds rate and a level that reestablishes a positive real interest rate level, bond returns are likely to remain inversely (negatively) correlated with stock returns. This is despite the fact that long-term T-bonds, in isolation, offer extremely unattractive rates of return over the next two- and five-year horizons. Their diversification and safe-haven benefits to portfolios still exist – at least for now.

So on an expected value basis, we believe real GDP growth will stay above the 3% rate, CPI inflation will rise above 3%, long-term T-bond yields will rise back up above 5.75%, and for the next couple of years, the stock market (as represented by the S&P 500) will produce annualized returns of 8-9%. So, although a few petals have withered and fallen off, the "B(1)oom" isn't off the economic rose. It's way too soon to give up on the economy and stocks.

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