Economic & Market Commentary

An Economic Sunrise?

Most mornings in Phoenix, one can step out onto the porch to take in the sunrise and get a feel for how the day may shape up. Barring a surprise dust storm or summer monsoon, one has a good probability of correctly predicting the weather for the rest of the day. The economic and market position we currently find ourselves in is somewhat similar to watching the sun come up over Four Peaks in the morning.

Through the recent period of darkness in the economy we correctly predicted that the markets would recover from the September lows, that the building blocks of an economic recovery were already in place, and that they would soon show up in the headline data. As described in previous *Commentaries*, positive factors such as lower energy prices, lower interest rates, higher government spending, and low inventory levels kept economic growth in the fourth quarter positive, and set the stage for a healthier 2002. More specifically, consumer spending rose over 6 percent in the fourth quarter, as a result of reduced costs and restored confidence. Government spending rose in the forth quarter, led by non-defense programs up 16 percent and defense programs up 9 percent, finishing the year strong enough to offset other areas of weakness. Business inventories had been aggressively cut throughout 2001, did not decline as rapidly in the fourth quarter as demand stabilized, thereby taking less away from economic growth. As all the economic data was pulled together during the first quarter of 2002, Gross Domestic Product was revised upwards twice to show 1.7 percent growth in the final quarter of 2001. Other "headline" economic data turned up as well during the quarter, confirming the underlying trend in the economy we had identified.

Oil and other commodity prices have rebounded, and interest rates have been trending higher. These are not necessarily bad developments, but fairly typical responses to an economic recovery driven by rising expectations of future conditions by businesses and consumers. The low inventory levels remain a positive building block for economic growth in 2002. However, we must move beyond an inventory driven snapback in production, and government spending to achieve a higher ongoing economic growth in order to complete the recovery. Recent policy decisions targeted to address this situation in conjunction with what we believe to be real underlying strength should result in a more stable economic environment this year than last.

Possible dust devils in the forecast:
However, corporate earnings are likely to be hurt by costs associated with ongoing anti-terrorism efforts, the adoption of more conservative accounting methods, and/or the costs associated with defending one's current accounting methods. In addition, the required change in the treatment of "goodwill" for accounting purposes by the Financial Accounting Standards Board could further cloud the issue of corporate accountability. The rule alters how companies account for the goodwill related to purchases of other companies. This should have a positive impact on earnings as it eliminates ongoing charges against earnings, but a negative impact on equity as it requires an immediate charge against equity if the current value of the intangible asset (in this case goodwill) has dropped below purchase value. Washington and

Wall Street are demanding greater accountability and greater disclosure from publicly traded companies and the auditors who check their books, as well less obfuscation from corporate officials. To the extent that the public gains greater access to better information, it may be the silver lining in the cloud that currently envelops the markets.

The possibility of future interest rate hikes that we discussed three months ago is now in the headlines. We were of the opinion that the Fed was going too far when they smothered the economy with rate hikes; today we believe they should not be too quick to meddle with rates during this delicate period for the economy. The outlook for low inflation remains good, as we have relatively low capacity utilization rates, relatively high productivity growth, a labor situation that is neither tight or loose, and a rather slim prospect for runaway inflation. At this time, we don't look for the Fed to attempt to slow down the economy. Instead, as the demand for funds in the economy naturally drives the cost of money higher, the Fed is likely to follow the market with rate hikes that gradually offset previous rate cuts.

Against the backdrop of more disclosure, the Fed announced in mid-March an effort to make its own policy decisions more transparent. Starting immediately, the Fed will announce the voting record of the members of the Open Market Committee on policy decisions on a "real-time" basis. The six-week lag between the announcement and the disclosure of the vote record has now been eliminated, as the list of members voting for and against the decision will be posted at the conclusion of the meeting. The Committee also decided to include in its announcement (maybe with a slight lag), the preferred policy choice of any dissenters. This should decrease speculation about Fed policy and may help promote market stability.

While the direction of the economy looks good, the protectionist trade policies currently endorsed by the United States are the looming clouds to the East. We have previously talked about the negative results that protectionist trade policies have on the global economy. Today it is lumber, steel and tomatoes that are making the headlines; tomorrow the list could grow. If we lead the world too far down this path, a mid-afternoon "monsoon" could wreck what would otherwise have been a nice day in the desert. As in the past, we believe that cooler heads will prevail, and that the "tit-for-tat" trade policies will reverse, avoiding any long-term damage to the US, or the global economy.

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March 31, 2002