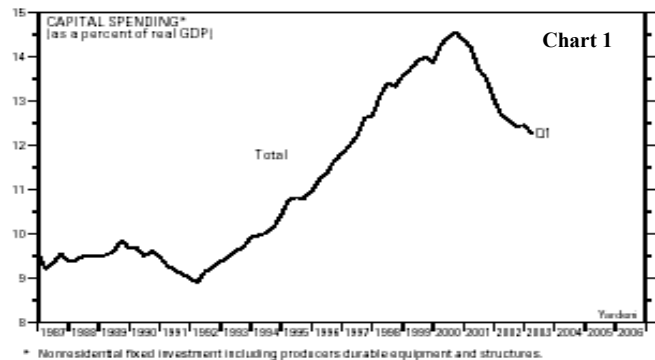


C *Economic & Market* Commentary

Half Full?

During March and April, reported economic activity slowed as individuals and corporations became more cautious about spending and investing until the war jitters faded. As we had suspected, the markets took these readings in stride as the battle had gone “our way,” and healthier consumer and corporate confidence levels have since emerged. Military issues have faded into the background and the domestic economic agenda is at center stage. During this time, both stocks and bonds have advanced, and the S&P 500 put in its best quarterly performance in about 5 years.

A contribution analysis of economic growth shows that the consumer has been the backbone of the U.S. economy for years. Over the last 3 years, consumption has grown from around 67 percent of the economy to roughly 70 percent, and government spending has grown as well from around 6 percent to 7 percent. The sore spot has been business spending which has dropped from 14.5 percent to roughly 12 percent (Chart 1). Through this sea of change, overall pre-inflation economic growth bottomed out at 2 percent growth (real GDP dipped negative briefly), and has since risen. These contribution percentages bring the obvious question... has the U.S. economy been kept afloat by an over-leveraged consumer?



The data show that consumer debt levels have been rising, but at a decreasing rate. Excluding home equity loans, debt was actually lower as a percent of personal income. Personal income growth had dropped sharply and barely stayed positive in 2002 before rebounding nicely in 2003. In spite of the decrease in personal income growth, a decrease in debt service payments (primarily tied to falling interest rates) helped spur consumption. The consumer should be able to hold his ground, and may get some help when businesses come back to the job market.

The key to the economy reentering another growth cycle is tied to what business does. We know that businesses hire people, which increases personal income, but inventory and capital investment are crucial as well. On the positive side, the joblessness rate (which is a lagging indicator) may be topping out as it spent its 19th week above the 400,000 mark. Inventory investment has bounced back from the lows of 2001-2002. On the negative side, while wholesale inventories seem to be at reasonable levels, retail inventories have exceeded the peaks of 1999 -2000, and may need a few months to sell down to more acceptable levels. Business equipment spending, a component of industrial production, has been falling

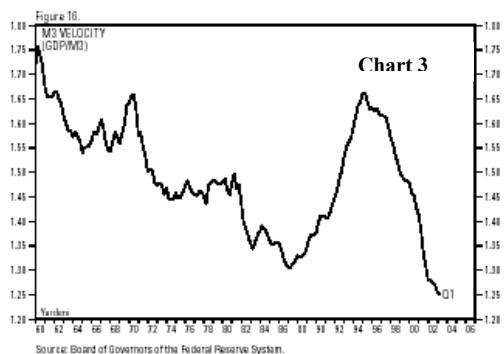
since the first quarter of 2000 and, while stabilized, has not shown signs of new life yet. New orders for durable goods, a leading indicator that might help the headline numbers, have been trending higher lately since falling sharply in the middle of 2000. Also of interest are non-defense communications equipment orders, which fell sharply from their peak in the first quarter of 2000. They are well off their lows and have risen sharply throughout 2003. If the confidence levels continue to improve, business spending could pick up and return to a more normal level of contribution towards economic growth.

While the stock markets have made up a lot of ground in the last quarter, lately they have paused, waiting for other positive economic signals to emerge and a follow-through on corporate earnings. Earnings are up, and the quality of those earnings seems to be improving. Write-offs, or one-time events, are down and averaged about 4 1/2 percent of last quarter's operating revenue, down from over 30% during the past seven quarters. We are more optimistic regarding the economy than we have been in a few years. The recent change to the tax code took the form of an economic tool rather than an income redistribution tool. The power these changes have to positively influence the economy and the stock market may be underestimated by many.

Some other distractions are some of the news headlines about deflation or its milder cousin, disinflation (prices increasing at a decreasing rate), taking hold of our economy. Deflation of the type that Japan has been battling for about a decade, or that we have battled in the past, is truly scary stuff. While it should not be dismissed out of hand, the best defense against deflation is an offense that focuses on economic growth. All of the policy indicators are pointing towards growth. Monetary policy has been aggressive, as the Federal Reserve under Alan Greenspan, has taken the Fed Funds rate to a 45 year low of one percent with its 13th straight rate cut. Fiscal policy is working in concert with monetary policy and has given us the most cumulative stimulus in decades. While the consumer price index for goods has dipped below zero three times in the last 25 years, services have not and currently register about 3 1/2 percent inflation. Depending on how one looks at the data, one could see deflation around the corner or just naturally occurring price declines as manufacturing centers seek out lower cost countries to manufacture commodity goods.

One of the keys to future growth may be bank lending. Over the last few years, banks have made fewer loans and purchased more government bonds (Chart 2), thereby driving down the velocity of money in our system (Chart 3). Yes, the Federal Reserve keeps pushing short-term rates lower, but if businesses are not borrowing (or banks are not lending), we won't get the full benefit out of the

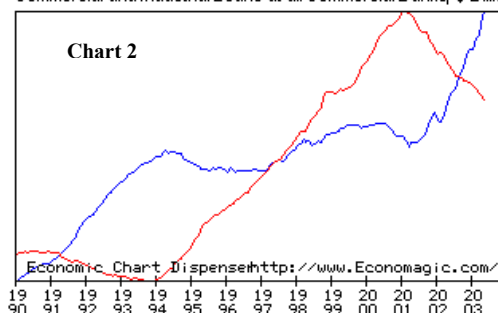
lower rates.



We have said before that with the amount of stimuli policy makers are throwing at the economy, something has to happen. We do believe that, ultimately, the big economic engine of the United States will come though with flying colors (pardon the pun). When this happens, we will likely see rising interest rates, rising stock markets, and rising corporate profits.

Banking Activity

- U.S. Government Securities at all Commercial Banks; \$ Billions
- Commercial and Industrial Loans at all Commercial Banks; \$ Billions



Stephen J. Taddie
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