Economic & Market
Commentary

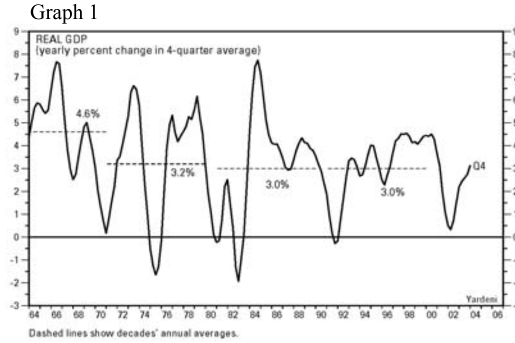
STELLAR
CAPITAL MANAGEMENT, LLC

March Madness

Economic results over the last three months have been fairly consistent with a growing economy. Most data have been neither much worse, nor much better than recent expectations. We are past the major leaps we saw during 2003, and experts are predicting real economic growth (GDP) of between 3½ and 4 percent for 2004. This would mean back-to-back years of real GDP growth coming in above the three percent average of the last two decades as indicated in Graph 1.

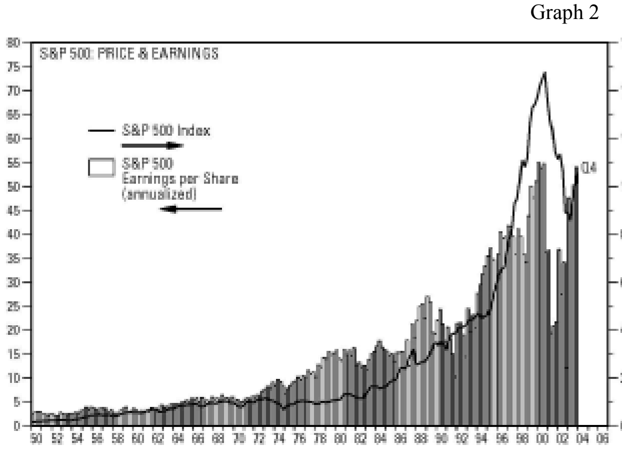
Our analysis of GDP growth shows that capital spending as a percent of GDP is rising, and consumption as a percent of GDP is falling, reversing the trend of the last few years. Consumption is still rising and is an important part of the economy, but it is growing at a slower rate than previously, and as compared to capital spending. This is a healthy development, as capital spending has been "missing in action" for the last few years. The rate of recovery in this part of the economy looks to be close to the rate of decline experienced a few years ago.

Graph 1



The Federal Reserve is playing a bit of cat and mouse with the markets on the Federal Funds Rate. We know the Fed wants to increase rates for a variety of reasons, but we also know it does not want to upset this very important economic recovery. Interest rate policy cannot be conducted in a vacuum; other economic issues must always be considered. Currently the policy makers are likely to be looking at the impact that oil prices, employment, trade, and geopolitical uncertainty are having on the economies of countries around the world and basing their decisions on that analysis.

Graph 2

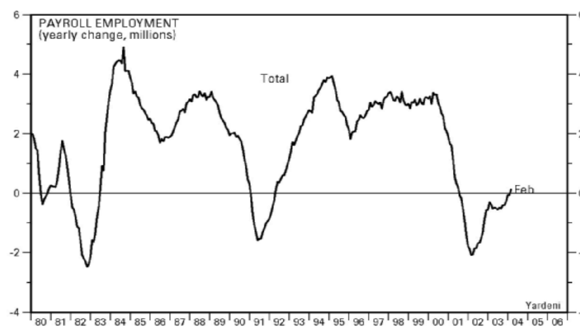


By most measures, corporate America looks healthy. S&P 500 earnings are at levels almost even with "pre bubble" levels, as companies are converting productivity gains into profits (Graph 2). Employment, contrary to what we have been seeing in the newspapers, is improving, and some of the data, while not purposely misleading, do not tell the whole story. As Graph 3 shows, payroll employment is rising, but not at the same rate as after previous recessions.

2200 East Camelback Road, Suite 130 ▪ Phoenix, Arizona ▪ 85016 ▪ 602.778.0307 (ph)▪ 602.277.4572 (fx)

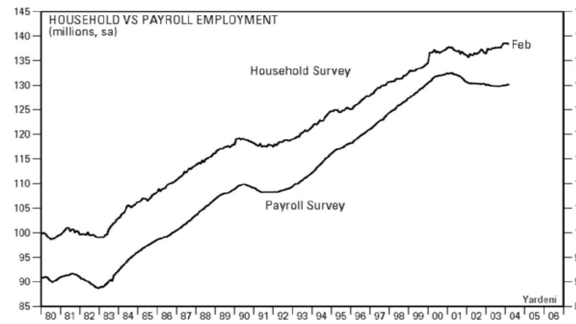
A good part of the explanation behind this apparent lag in growth is shown in Graph 4. The widening gap between household data and payroll data confirms the growth trend of non-corporate careers. The payroll data and the household data paint different pictures of the employment situation. Personal income figures as compared to wage and salary figures show support for a healthier than reported employment picture as

Graph 3



Source: U.S. Department of Labor, Bureau of Labor Statistics.

Graph 4



Source: U.S. Department of Labor, Bureau of Labor Statistics.

well. Corporations are a bit slower in their hiring trends, as they are still recovering from overly-optimistic assumptions, and do not want to make the same mistakes twice in five years, but, they will eventually catch up with human capital needs. The markets are essentially trading with corporate earnings, less a discount for the uncertainties described in the previous two paragraphs. We would expect that trend to continue. One of the concerns discussed by some analysts is whether this is as good as it gets, or whether even better times are ahead. The decline in stock prices in the last part of the quarter put the markets into negative territory for the year, and down to important support levels. The last half of March was spent flirting with these levels.

It's a political year, so expect to see economic data twisted to favor its presenter. Hopefully discussions will not focus on all that is bad about America, but will include conversations on how to continue doing the things that are right, and improve on the things that could be better. The big picture shows that we have seemingly successfully dealt with a major decline in the equity markets, a major act of terrorism on our soil, and turned what could have been a major economic set back into a mild recession.

Looking at the magnitude of the changes affecting the economy, fiscal deficits could probably not have been avoided. Federal revenue is tied to economic growth, and has stayed within a fairly tight band as a percentage of GDP for decades. When the economy sags, Federal revenues decline. If one concedes that the economic stimulus package stimulated the economy, the argument regarding the cause of the deficit is complicated. One must determine what the decline in GDP would have been without the stimulus package, and compare the expected net income (Federal revenue less spending) under that scenario with the net income attributable to the package. In addition, future growth rates and total GDP numbers will be different, so future Federal revenue and spending estimates must also be considered. Most sound bites do not capture the entirety of this issue.

Stephen J. Taddie
March 31, 2004