

# C *Economic & Market* Commentary

## Economic Growth and Corporate Profits

The U.S. economy is humming along, as evidenced by the Gross Domestic Product (GDP) running above its 30-year average. The March 20<sup>th</sup> final revision to the GDP estimate showed “real” (inflation adjusted) GDP for the 4<sup>th</sup> quarter rising 3.8 percent, up 0.70 percent from the advance estimate. That pushed the full year GDP growth number in 2004 to 4.4 percent from 3.0 percent in 2003. The upward revision to the GDP estimate came from an upward revisions to exports, business fixed investment, and inventory investment. The proverbial “fly in the ointment” is energy pricing, and its effect on economic growth and price inflation.

The health of corporate America is improving, as well. Corporations have experienced a marked reduction in write-offs as a percentage reduction in operating earnings, and back-to-back (2003 & 2004) positive free cash flow numbers. Free cash flow (cash available to spend after financing capital projects) numbers had been negative from 1994 to 2002 because of rapidly rising capital investment in the 90’s, and then rapidly falling corporate profits in 2000 and 2001. The cautious nature of capital investment described in our 2002 year-end *Commentary* has led to an improvement in the quality of corporate earnings, which have risen to levels not seen in over 15 years. Reported profits have been exceeding estimates in many growth industries, as the deliberate and return-oriented investments companies have made in labor and capital have panned out.

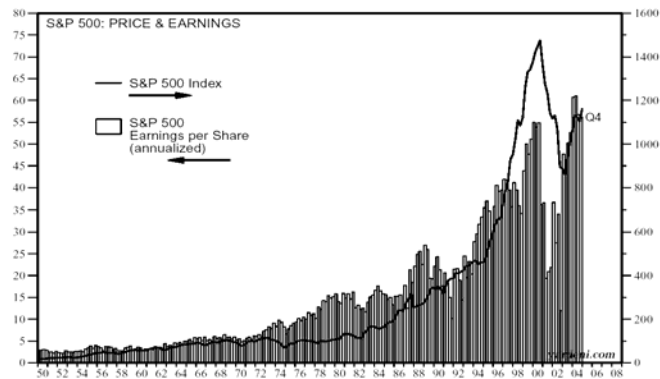


Chart 1

We have previously stated that it would require earnings growth to push the stock market higher. Many of you reading this *Commentary* will be familiar with Chart 1, which shows the strong relationship between S&P earnings and the value of the S&P stock index. We look for that relationship to continue.

Some current focal points of economic discussion are the negative trade balance and the action of the Federal Reserve. As discussed in previous *Commentaries*, a negative trade balance is not the end of the world. When viewed separately as Chart 2 and 3 on the next page show, both exports and imports are growing; it just happens that we are consuming more than we produce. We would expect the widely

watched “trade deficit” to self-correct to some extent, as the weaker U.S. dollar should become a more positive influence on exports.

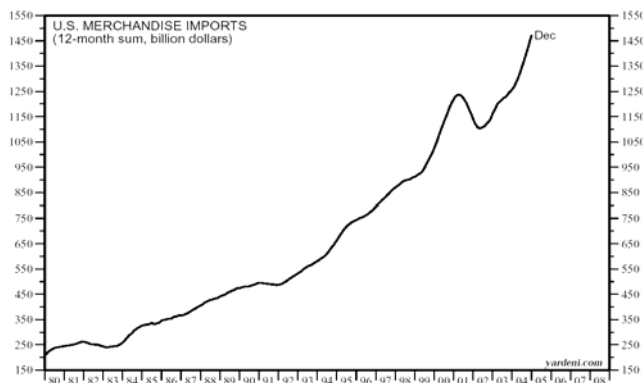


Chart 2

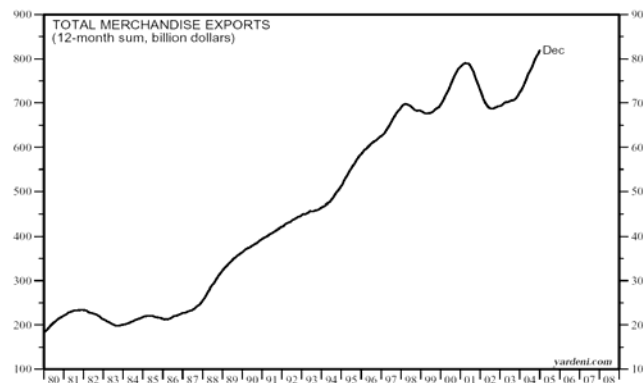


Chart 3

The Federal Reserve is always in the headlines, as its actions with regard to short-term interest rates draw attention. As short-term rates have risen, the benefit of borrowing short-term to buy longer-term bonds (the “carry trade”) has dwindled. Big players in this arena have been commercial banks paying sub 1 percent rates on checking and savings accounts, then buying 4 percent government bonds, and pocketing the 3 percent difference. Higher short-term rates have forced banks to find healthy corporations to borrow money from them at profit margins similar to what was available from the carry trade. Chart 4 shows the recent upturn in commercial bank lending.

With commercial banks now back in the game, capital investments should be easier for many firms willing to use debt financing to build larger and stronger businesses. The upward revision to the business fixed investment in the 4<sup>th</sup> quarter GDP estimate may be a signal that business capital investment is gaining strength. With these revisions to GDP estimates come revisions to productivity estimates, and potentially to earnings estimates, as well.



Chart 4

The economy looks healthy, and since the market turn in mid 2003 we have maintained a rather fully invested position in stocks with respect to our clients’ needs and objectives. We continue to advocate dividend-paying stocks, and if the stock market stays in a trading range similar to the 70’s, dividend payments will account for a substantial part of the total return offered by stocks. Many companies have been announcing dividend increases over the last two years, and investors realize a better after-tax return on dividends today than in the 70’s when dividend rates were higher. This is due to the 15 percent Federal tax rate on qualified dividends versus the top marginal tax rates of 70 percent in the 70’s. In our opinion, it’s not a bad time to own stocks in some well-run companies and get paid a tax-advantaged dividend to boot.

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