Economic & Market
Commentary

Big Ben

The U.S. economy has been performing quite well despite many crosscurrents that are making headlines. Economic growth faltered for the first time in two and a half years at the end of 2005, as the year's natural disasters limited GDP growth in the fourth quarter to only 1.7 percent. This was better than the 1.1 percent initially estimated in January, and it put full-year GDP growth for 2005 at 3.5 percent, well above the 20-year average of 3 percent. Many economists believe that the shortfall in the fourth quarter will be made up in activity reported in the first quarter of 2006, as growth did not disappear, but was just delayed. Economic data received so far give merit to that argument.

Cries about the jobless recovery have been silenced by rising job growth and falling unemployment (similar to the mid to late 90's), new order and shipment growth hovering between 7 and 9 percent annually (near 10-year highs), and healthy manufacturing productivity. The widely-noted negatives have been rising energy prices, emerging inflation pressures, the deflating real estate bubble, and rising short-term interest rates. To date, investors' perception has been that the good news has outweighed the bad, and is reflected in the S&P 500 and Dow Jones Industrial Average approaching all-time highs, each gaining a little over 4 percent in the first quarter.

Big Ben (new Fed Chairman, Ben Bernanke) and the rest of the Federal Reserve have to consider these crosscurrents as they manage monetary policy. On the heels of the positive economic data reported so far in 2006, the Fed increased short-term rates by ¼ point to 4.75 percent this month, marking the 15th straight increase. This reflects a continued concern by the Fed that rising energy and other commodity prices could push inflation higher, and a feeling that the economy can accommodate higher interest rates. Longer-term interest rates continue to seesaw their way higher too, maintaining a relatively flat yield curve, but at higher levels. This upward pressure on interest rates pushed the Lehman Brothers Credit Bond Index of bond prices down about 1 percent for the quarter.

Since the effects of Fed policy always have a time lag associated with them, concerns continue to mount that the Fed may eventually place the proverbial "straw that breaks the camel's back" on the economy and the markets by raising rates too high. If the camel begins to wobble (i.e., the economy begins to slow) look for rate cuts on the horizon to limit any slowdown and maintain a decent growth trajectory. While this may make the markets a bit jumpy, it is how things have worked historically at the Fed. We will know more after reading the minutes of this month's Federal Reserve meeting and seeing the results of its next meeting on May 10th.

The economic growth data are significant in that inventory levels have been growing at a slower rate than sales over the last 2 ½ years and capacity utilization rates have been steadily increasing to levels not seen since the mid 90's. Typically, inventories either grow or shrink in anticipation of expected order levels, and often exhibit larger swings than orders. During an upturn in the economy, one would expect inventories to at least keep pace with order growth. In this upturn, inventories have risen at a slower pace than orders, leading to the lowest inventory-to-sales ratio on record, and a smaller contribution to GDP growth than in the past. If this trend continues, expect businesses to make additional capital expenditures to increase capacity so rising order flow can be met. This spending should contribute to additional economic growth, at some point.

Economic data related to inflation will garner some additional attention this year, as inflation seems to be one of the more important gauges on Big Ben's dashboard. In 2005, the major contributor to cost increases was oil, which led the 3.6 percent increase in inflation. Although the "core" inflation rate (which excludes energy and food) was only up 2.1 percent, the biggest question is how much permanent inflation is created by higher energy prices? Of interest is that Greenspan's favored core Personal Consumption Expenditures (PCE) price index (another measure of inflation) has been softening despite the surge in energy prices and stands at 1.8 percent year over year.

Employment and income growth are healthy, and are providing the underlying support for economic growth, but the outlook for consumer strength could soften under tighter Fed policy and the continued drag of higher energy prices. Assuming that the economy maintains its current positive trajectory and that businesses continue looking for additional employees in a low unemployment environment, wage pressures should continue to mount. Employment costs rose 3.1 percent (wages were up 2.6 percent and benefits up 4.5 percent), but -- to date -- increasing productivity has offset rising employment costs thereby keeping a lid on inflationary pressures.

A well-respected economist recently reminded me of the "misery index" (the sum of the unemployment rate and inflation rate) used in the late 70's to describe how bad things were getting. Today, that index is at lows not seen since the "go-go Sixties." So, despite the twin deficits, and all else that is perceived to be wrong with America these days, something must be going right!

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