

C *Economic & Market* Commentary

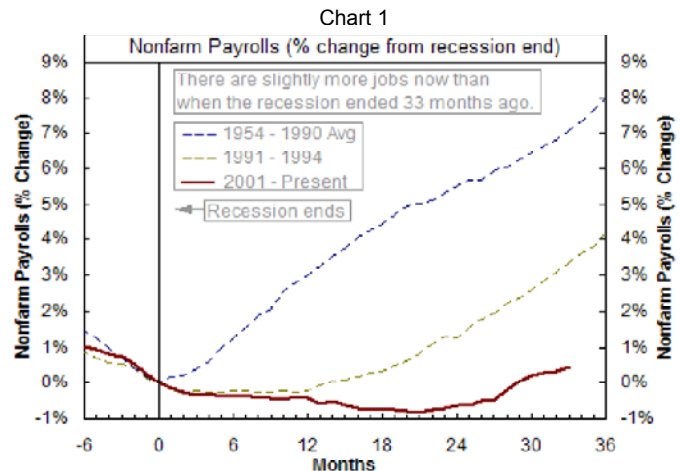
Texas Tea

Oil and the upcoming elections are on everybody's mind, as well as the front page of most newspapers. In the weeks leading up to the November 2nd election, much will be said about the economy. One political party will say that things are moving in the right direction, and the other will say that things could be better. Given that both parties draw from the same data, the difference in opinion seems to be based on the time frame each camp assigns to the current administration's responsibility. The economic recovery phase is coming to an end, and the continuation of economic growth, however bumpy, is at hand.

We expected to see higher interest rates on the 10-year Treasury, since we expect to see a modest increase in inflation, further weakness in the U.S. Dollar, and rising short-term interest rates. The inflation rate has moderated, the U.S. Dollar has stabilized, and while short-term rates have risen, the 10-year Treasury yield dropped from recent highs of about 4.8 percent to below 4 percent, prior to settling in just above 4 percent at quarter end; below where it started the year. In the face of rising oil prices, the yield curve has been flattening, as short-term rates have risen and long-term rates have fallen. We believe that the recent drop in longer-term interest rates is an aboration.

A couple of things are at play in the oil markets. Russian President Vladimir Putin seems to be employing KGB-type tactics in driving Yukos (Russia's largest oil producer) out of business, while at the same time setting up a government-owned joint venture in the oil business. An oil-thirsty China, continued attacks on Iraq's oil industry, and other political flash points in oil-rich countries have also contributed to pushing oil prices higher. The consensus (which so far has been wrong) is for oil prices to fall as the terror and intervention premium fades, and China's economic growth cools...stay tuned.

One economic "hot button" this election season is employment growth or the lack thereof. As Chart 1 indicates, jobs are being created, but with a longer lag time from the recession end, as was the case after the last recession. This trend coincides with the continuing shift in the employer base, marked increases in productivity, and continued cost consciousness as major employers attempt to squeeze more output from their current workforce.



As expected, and as evidenced by recent economic data, growth is moderating rather than accelerating. Barring any surprises, economic growth as shown in Chart 2 should come in at about 3.5 percent, which could result in seven straight quarters of growth greater than the 20-year average of 3 percent. The Federal Funds rate should be at 2 percent by year-end, and likely over 3 percent by the end of 2005.

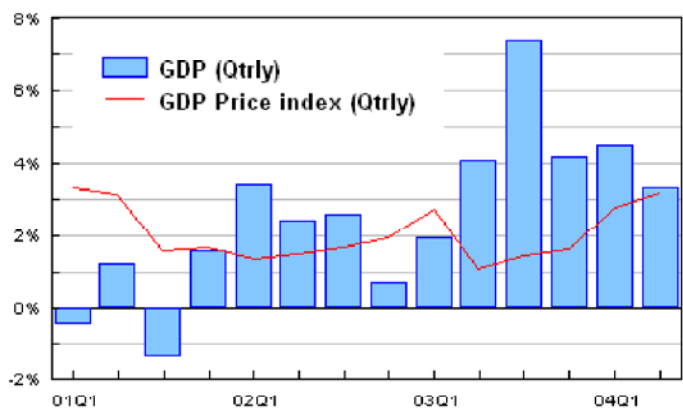


Chart 2

The real oddity has been that the rising price of oil has been accompanied by falling interest rates. While the bond market will regularly put a premium on a potential outcome, it seems the market is predicting that the economy will hit a major roadblock. In our opinion, the recent moves in each have been overdone to some extent, and we not think that the bond market is in sync with the economy. While the markets always like instant gratification, patience is a virtue when it comes to growing an economy the size of the United States of America.

The major stock indexes have been trading water, moving within about a 5 percent range for most of the year. It seems the markets are reflecting the uncertainty of continued economic growth, geopolitical issues and election-year jitters. For the financial markets, portfolio income has become a more essential component of return than in the past. Many companies have announced increases in their dividends, and some have just begun paying dividends to their shareholders. As we have stated in earlier commentaries, while we are likely in a period where corporate earnings grow at a faster pace than stock prices, this growth, if continued, will ultimately pull stock prices higher.

Steve Taddie
September 30, 2004