STELLAR CAPITAL MANAGEMENT, LLC

Economic & Market

Commentary

Clear Skies

Clear skies do not always mean clear sailing, but they do mean that many noticeable uncertainties have been removed from the current economic picture. As our political and economic environments have become more certain, businesses, individuals and market participants have gained confidence and have been able to comfortably take a longer-term perspective.

As we discussed at the beginning of this year, "a long-term perspective helps businesses carry out capital spending and hiring plans, consumers look to the next 10 years of their income to finance current consumption, and investors look past the next few quarters of revenue and earnings growth." Over the last 12 months, we have seen businesses begin to carry their own weight, and the recovery of 2003 lead to the continuation of economic growth in 2004. During this time, the Federal Reserve has been methodically pushing short-term interest rates back to prior levels, so the Fed Funds rate can again be used as a stimulus tool when needed in the future.

We muddled through most of the year under the weight of multiple uncertainties and truly confusing news flows, until midway through the fourth quarter, when politics took a back seat to reality. The markets have reacted positively, with all major stock market indexes rising, and surprising stability in the bond market. Some of the major issues still at hand are the rising dominance of China as a producer and consumer, a weak U.S. dollar, and the twin deficits (trade and budget).

The Shanghi Express (China) has to be managed, as it cannot be stopped in its tracks. Its growth is not unlike the growth of an upstart country called America centuries ago, or the growth in many other countries since the rule of the mighty Egyptians. We call it outsourcing, and the Chinese call it attracting jobs: it just depends which side of the ocean you are on. Outsourcing cannot be stopped without damaging our own and other major economies. The world leaders know this, so look for a cooperative dialogue between the major economies to manage the global impact of outsourcing.

The weakness in the U.S. dollar is something we had expected. While our economy has avoided some of the other baggage (higher interest rates) that typically come along with a weak domestic currency, we have not yet seen a marked increase in our exports versus imports. This weakness is having an effect on many other countries as the up-and-coming manufacturing hub of the world (China) has kept its currency pegged to the value of the U.S. dollar. As the U.S. dollar weakens, Chinese goods become even cheaper on the world markets. In that dialogue regarding outsourcing mentioned above, look for some action regarding a more market-valued, rather than pegged, Chinese currency.

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The twin deficits will be in the headlines, and will likely be in the center of discussions regarding the Bush agenda. Both deficits will have to be addressed, and how they are addressed will be very important. The trade deficit is a function of our rate of consumption versus our rate of production. Some economists believe that the trade deficit is less of a problem than others would like us to believe. The cornerstone of this belief is that, under a floating exchange rate, the balance of payments between countries is always zero, as a trade deficit is accompanied by an offsetting capital inflow (read investment in our capital markets). If that is the case, expect more focus on the budget deficit than on the trade deficit.

Tax policy will be reviewed, and any adjustment will have to pass the budget deficit litmus test, or it will be scorned by the public and by elected officials wishing to repeat their term in office. One lesson regarding tax policy was learned during the Reagan administration. It was here that we learned that phased-in tax cuts delay economic activity until it can be more favorably taxed. We would hope that any tax policy change will be made without a phase-in period, so we can continue at or above our current growth rate without a pause. This will also serve to increase tax revenue, which will further reduce the budget deficit, as it is and always has been a function of economic growth.

Many economic indicators are moving in the right direction, and the markets have been trending in the right direction. While we are past the big earnings rebound, the economy should be able to sustain expected growth rates. Maintaining expected economic growth rates is critical to maintaining decent earnings growth rates for corporate America, which should, in turn, drive the stock market.

To our clients and friends, best wishes for an enjoyable and safe New Year.

Stephen J. Taddie
Managing Member
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