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Seeing Through the Storm

The storms of life often distract us, then disorient us, and finally blind us. Storms produce so much destruction at the human level because they overwhelm our senses, dim our perceptive powers, and too often, compel us to run. It is the running that frequently leads to the greatest destruction – because we are running blindly.

As we write this letter, the people of the Gulf Coast are riding out the fourth hurricane of the year. The media has reported each successive storm like a wave of a military invasion, including wind and surge statistics, body counts, and storm-side reports from brave weather people who seem to close each report with, “Conditions deteriorating.” Judging from the media, we might conclude that by now Florida must surely be under water, with not a building left standing. But calls to many of our clients in the Sunshine State reveal that, while there is certainly damage in some areas, most of the state is high and almost dry. The media is reporting that large numbers of Floridians may be moving north, yet none of the people we talk to have suggested any plans to move back to the mainland.

While the loss of life and property are tragic, we do not believe Interstate 75 will be jammed with northbound Floridians heading for safer parts of the country, and we think it would be an unwise thing to do. First, they would have to buy the idea, also being bandied about by the media, that says Florida will experience a permanent increase in hurricanes in the years to come; and second, they would have to leave behind a big chunk of their net worth, because an exodus of even modest proportions would sink the real estate market and residential prices. Our guess is Floridians will rebuild as they have after every hurricane in the past, and very few of them will be rejoining us Midwesterners for our cold winters. For our part, we think there is also good reason to believe that we Midwesterners will find ourselves kicking Florida sand off our shoes this coming winter.

We spoke to a long-time Florida resident, who told us when the storms get really tough, he and most of his acquaintances tune into the weather stations and official hurricane sites on the internet and shortband. He said the popular media spends too much time worrying out loud about “what if’s” and “could it be’s” to be of much value when a storm is bearing down on you. He said he needs to know the facts: Where is it? How fast is it moving? Where is it heading?

Economic Weather Report

The financial media has also been working their own series of storm stories: terrorism, recession, skyrocketing oil prices, higher interest rates, jobless recovery, and the uncertainties posed by the presidential race. They have also given us their versions of economic body counts and gravely closed their reports with, “Conditions deteriorating.” And, like the weather reporters, the financial media have engaged in fearful “what if’s” and “could it be’s.”

As you know, for many years, we have cautioned our clients against taking almost anything concerning the economy at face value from the financial media. How often have you seen a headline during the day on CNBC spun one way, and the morning paper spins it another? The single most often asked question we get from our clients is where they can get straightforward, straight-shooting economic analysis. Our answer has been the same for a long time: The Value-Line Investment Survey, The Standard and Poors Outlook, and Bloomberg Financial

Services. All of these organizations charge a fee for their services, but their analysis is clear and is correct far more often than it is wrong.

In this letter, we would like to provide you the unvarnished facts about the U.S. economy like the hurricane centers provide for the residents of Florida in the tough times: Where is it? How fast is it moving? Where is it heading?

To do that, we have a pop quiz we would like for you to take. Read each question very carefully, watch for trick questions, and be sure you understand exactly what we are asking. Our purpose is not to be cute or play games with the very serious subject of the US economy. Our purpose is to help you listen to the media's economic reports with a more practiced ear.

Pop Quiz

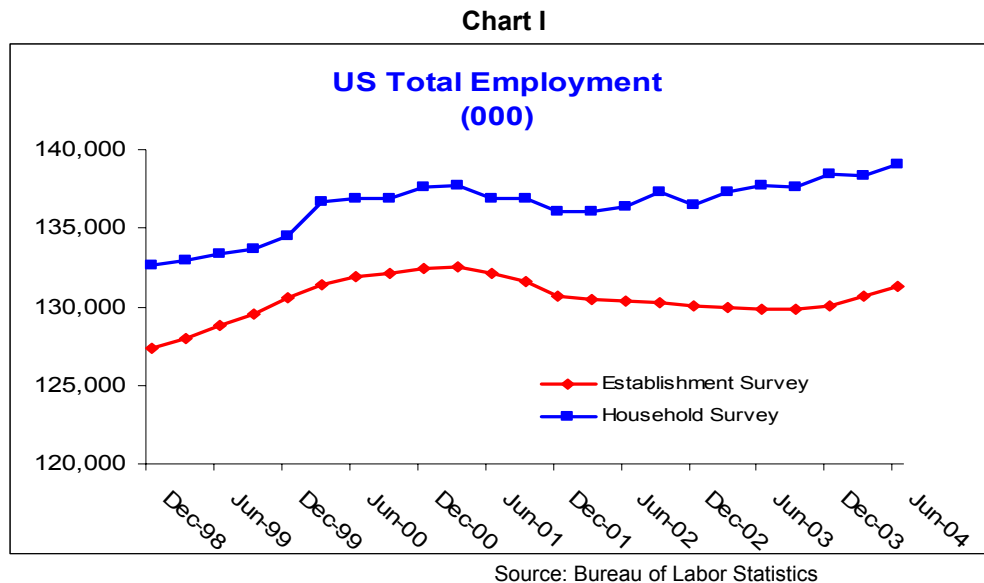
1. According to the Bureau of Labor Statistics Household Survey, how many jobs have been gained or lost in the last four years?
 - A. Lost two million
 - B. Lost 200,000
 - C. Gained two million
 - D. Gained 500,000.
2. The price of West Texas Intermediate crude oil as of the end of September 2004 was almost \$50 per barrel. That represents what percentage increase over its price in September of 2000?
 - A. 150%
 - B. 50%
 - C. 33%
 - D. 75%
3. The Bureau of Labor Statistics also tracks the Consumer Price Index (CPI). The CPI (inflation) rose 3.4% for the twelve months ending August 2000. How much has the CPI increased in the last twelve months?
 - A. 5.1%
 - B. 3.8%
 - C. 4.3%
 - D. 2.7%
4. Gross Domestic Product (GDP) measures economic growth adjusted for inflation. According to the latest government figures, a recession began in the US in:
 - A. Third quarter of 2000
 - B. Third quarter of 2001
 - C. First quarter of 2002
 - D. There was no recession.
5. According to the Bureau of Economic Analysis, After-Tax Corporate Profits have grown by what total percentage over the past four years?
 - A. Negative 7%
 - B. Positive 40%
 - C. Positive 15%
 - D. Positive 3%

Answers and Analysis

Question 1 – Jobs: We might as well get the tough one out of the way first. It is also a trick question. The answer we are looking for is C, gained two million. According to the Bureau of Labor Statistics, in August of 2000, roughly

137 million people were employed. The same survey for August 2004 showed over 139 million employed (Chart I below). The question, however, is controversial not only between the presidential contenders, but it is also creating extensive debate among economists. This is because there are two US Government employment surveys, Household and Establishment, and each is collected in a different way and discloses a slightly different look at the employment situation.

The Household Survey is compiled from 60,000 random surveys with households across the country. The Establishment Survey is compiled from payroll records at over 160,000 selected institutions. In its simplest terms, the biggest difference between the two is the inclusion of the self-employed in the Household Survey that is not included in the Establishment Survey. Most economists we follow would say that there are more people working today than four years ago because of one reason – homebuilding. During this time, the US has enjoyed the strongest housing boom in our history. It is well known that sole proprietors encompass a large percentage of the homebuilding workforce, and they have more than made up for the job losses that have occurred in industry. Chart I shows graphs of both data.



By any measure, the US economy is adding jobs.

The patterns of the two graphs are very similar, showing strong job growth through the end of 2000. By the middle of 2001, job growth had flattened out, and by the third quarter of 2001 (after 9/11) jobs were being lost. This is where the two measures of job growth began going in different directions. The Household Survey started higher in the middle of 2002, while the Establishment Survey continued to trend sideways to down until the end of 2003. In 2004 the survey's data trends have reconnected, with both now showing solid uptrends in the number of jobs.

Analysis: As we see it, the bottom line on employment is that since the beginning of this year there is job growth, no matter how you count it, and that is very good news for a continuation of economic growth. The chart of the Household Survey is clearly higher today than it was four years ago, and, according to it, more people have a job today than at any time in our history. The media is just wrong to call this a jobless recovery. We actually believe the explosive growth in small businesses and sole proprietorships is good news long-term. These smaller firms, which the Household Survey counts and the Establishment Survey does not, can grow and create new jobs a lot faster than can large corporations. The media has missed this story completely because they have fixated on the Establishment Survey, which is primarily driven by large companies. The big news here is what this means for investors. This job growth is the surest sign that the underlying economy is growing and has staying power.

Question 2 – Oil Prices: The answer is D, 75%. This question is important because the two previous oil spikes in 1973 - 74 and 1978 - 1979 were accompanied by sharp increases in inflation, which led to rising interest rates and a weakening economy. If this were to occur again, the good news we have seen in the jobs data would quickly

fizzle. The price of a barrel of crude oil was approximately \$28 four years ago, and today, it is near \$50, an increase of over 75%.

Analysis: On an inflation-adjusted basis, oil is still selling for less than it did in 1979, but that is little consolation when we see oil prices going up almost every week. The media has been predicting an upsurge in inflation ever since 9/11. It has not come, nor do we believe it will. The media fails to understand that energy's impact on the economy has been falling for 25 years. Today energy represents only about 7% of total economic production. Crude oil is just not as big of a deal today as it was in the earlier oil shocks.

The real problem with oil prices is that the sharp increase in price acts the same way a tax increase does. It takes dollars out of consumers' and businesses' pockets, leaving them less to spend on other goods and services. The spike in oil prices also has a negative effect on planning by individuals and institutions. The volatility of oil prices tends to cause them to pull in their horns a bit. No one knows how much it is going to cost to operate a car, or house, or industrial plant. People and businesses will continue to consume and invest, but, at the margin, there is a hesitation, and there is always the thought, "maybe I should wait a little longer to see what happens." That's human nature.

Oil is a problem, but we believe the group most worried about it is OPEC. Most of the energy leaders of the OPEC nations have been educated at leading US schools of economics. They understand monopoly theory. They know that a monopoly is a little like the goose that lays the golden eggs. Think of consumers and businesses as the geese and our dollars for oil as the golden eggs. We geese can lay just so many eggs per day. Pushing us to lay more and more eggs will lead to our exhaustion, a bad thing for the egg gatherers. Worse yet, it could lead to rebellion. We believe we are a long way away from exhaustion, but we think rebellion might be near.

We see the rebellion taking two routes: conservation and substitution. Statistics show that at the time of the last oil crisis in 1979, the US imported 32 million barrels of oil per day. Three years later that figure had fallen to 19 million barrels per day. This incredible fall in consumption, which stunned even the environmentalists, came from conservation in all parts of the economy: individuals, institutions, and state and local government. Today, substitution could have an even greater impact. Americans could potentially use 40%-50% less fuel for their automobiles by one action – making their next car a hybrid.

Hybrid automobiles use a battery-driven motor and an internal combustion engine. They are already available from Honda, Toyota, and Ford, and more models are coming nearly every month. The Honda Accord, one of the most popular cars in the US, will be available with a hybrid engine for the 2005 model year. It is rated at just under 40 miles to the gallon on the highway, nearly twice as efficient as today's average car. Most major auto companies will introduce broad lines of hybrid cars over the next two years. OPEC is well aware of what happened in the early 1980s, and they realize they are on borrowed time to get oil prices down before conservation and substitution become national obsessions again. We believe oil prices are very close to a peak. Indeed, we expect oil prices will fall by the first of the year.

Question 3 – Inflation: The answer is D. The Consumer Price Index has risen by 2.7% over the last year. In fact, during the last three months, the CPI, on an annualized basis, is running below 1.5%.

Analysis: Inflation has remained very benign. We believe it will stay that way because the Federal Reserve knows why inflation spiraled out of control in the 1970s and early 80s, and they are not likely to make the same mistake again. In the 1970s, the Fed was so concerned about the jolts the economy received from the oil spikes between 1973 and 1979, that they kept Fed Funds rates too low compared to inflation and raised rates too late. In 1979 Fed Chairman Paul Volker correctly saw that the lagging strategy was a failure, and he instituted a "leading" approach by pushing Fed Funds rates well above the rate of inflation. It was painful medicine, and the economy was choked off by the high interest rates, but by 1982 inflation had been tamed. Alan Greenspan, who replaced Mr. Volker as chairman in 1987, has maintained the leading strategy during his tenure and has made it the centerpiece of his inflation strategy.

We expect inflation to remain low. This will ultimately be good for the economy and stocks and bonds.

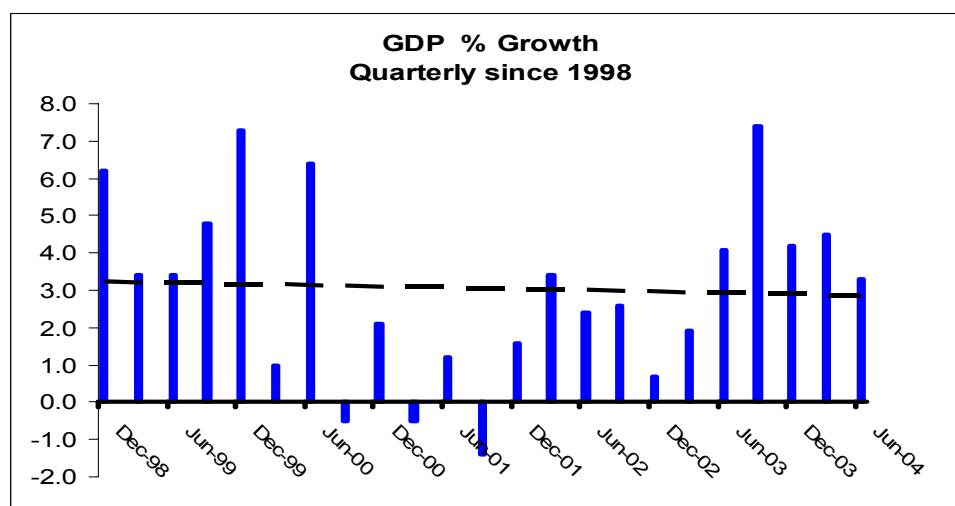
Question 4 – The Recession: The answer is D. By definition, there was no recession.

Analysis: The tracking of the US economy's \$10 trillion worth of goods and services is a massive undertaking and providing actual real time data is impossible. Because there is so much at stake for policy makers such as the Federal Reserve and for investors, the Commerce Department provides a flash estimate only thirty days after the end of each quarter. They make it clear that it is just an estimate, but the media – and almost everyone else – are always quick to take the numbers as final.

After the flash estimate, the Commerce Department continues to analyze personal and corporate tax data for more accurate readings and makes two more adjustments, usually before the end of the following quarter. But the final reading is completed approximately every three years. The most recent revision 2003 was released in July of this year.

It sure felt like a recession to us, but the definition of a recession is two consecutive quarters of negative growth. Chart II shows that in the recent economic slowdown there were three negative quarters – the third quarter of 2000, the first quarter of 2001, and the third quarter of 2001 – but no two of them were in succession.

Chart II



Source: US Commerce Department

By definition, there was no recession.

If job growth has created controversy, this economic reading has put everyone who is aware of it into fits. Prior to the last revision, the data showed negative growth occurred consecutively in the second and third quarters of 2001, which would have qualified for a recession.

The release of this revision was one of the most important revisions in history, but we saw very little in-depth analysis of it in the media. We think the reason is: it changed almost everything we thought we knew about economic activity in 2000 and 2001. It turned everything upside down, and no one wants to try to explain what happened, not even the Republicans, who would appear to have benefited from it. If you think about it for awhile, we believe you will understand why you have not heard much about it. The Democrats have been saying that the recession began on Bush's watch. Bush has been saying he inherited it. These are the beachheads that the two parties have staked out, and they have said it so long that it has become rooted in the media and in the minds of most Americans. The Republicans, who would seem to have something to gain by touting the revision, presumably, are not doing so, because they must believe that they are scoring as well on the economy as they can. To change the message, the current administration would have to say there was no recession because their own Commerce Department just told them so. This is obviously not a winning argument.

But our analysis here is not about political intrigue; it is about the facts of economic growth. The economic conditions that really exist will ultimately rule the day for our investment strategies and decisions. Here are the facts as we see them: Bush did inherit an economy that was dramatically slowing. During the last year of President Clinton's term, coincident with the Tech Wreck in stocks in the third quarter of 2000, the economy experienced negative growth. Fourth quarter GDP bounced back to show positive results, but the economy again

slipped into negative territory in the first quarter of 2001. In this regard, we believe history will credit the very weak economy during this period to the Tech Wreck. The negative growth immediately after 9/11 is not a surprise but appears to have been the bottom of the very slow economic growth.

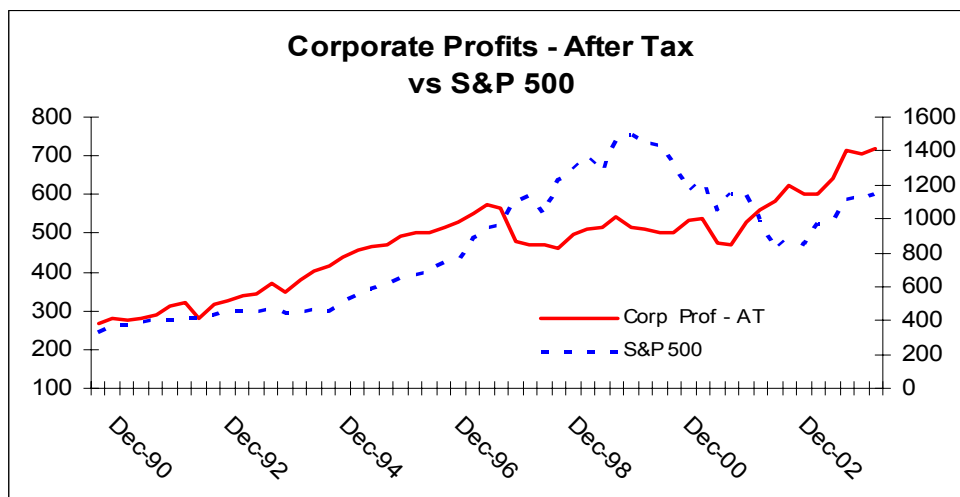
Before we leave GDP, look again at Chart II. The black dashed line running along the 3% level is the linear average of economic growth over the past five years. Most economists consider 3% - 3.5% as the optimal level of GDP growth. GDP growth has exceeded the dashed line for five quarters in a row.

Far too many people are still watching the clouds of the economic storm that passed through two years ago. But, they are facing the wrong direction. If they simply turn around and look, they will see a clear, new day has emerged. But then that doesn't sell many newspapers or advertisements, does it?

Question 5 – Corporate Profits: The answer is B. After-Tax Corporate Profits have risen 40% over the past four years.

Analysis: As they say, we have saved the best for last. The Commerce Department tracks many different types of economic data in preparing GDP. One that we find increasingly informative is Corporate Profits, after taxes. These data are not the earnings that are in companies' annual reports, or Wall Street analysis. They are the actual earnings US corporations report to the IRS on their tax returns. Chart III compares the S&P 500 Index with after-tax corporate profits since 1990. It tells a very interesting tale of a period that saw remarkable volatility in the stock market.

Chart III



Source: Bureau of Economic Analysis

Corporate Profits have reached an all-time high.

Through the first part of the 1990s, corporate profits and stock prices moved, as is normally expected, in harmony. Then, in 1997, something changed. Prices continued higher while profits, at least as they were reported to the government, began falling. As you may recall, this was during the Tech boom, and corporations were reporting rapidly growing profits to Wall Street and their shareholders. Yet, it appears they were telling the government (the IRS) a different story. The details of that dichotomy could provide enough material for three more of our quarterly letters so we will spare you that here. It is now clear, however, that the profits reported to the government were a truer estimate of investment values than stock prices. Eventually, stocks retreated to meet those values. Today, the chart vividly shows just how far back corporate earnings have come – all the way to a new all-time high.

This Much We Know

One of our favorite philosophers, Anthony deMello, was fond of teaching that the accuracy of our responses depends upon the clarity of our perceptions. Right now, in the midst of the presidential campaign, we find the

amount of misinformation flowing around is, at best, distracting and disorienting. The only way to make accurate decisions in managing your money is for us to clearly perceive where the economy is, how fast it is moving, and where it is heading. If successful, our quiz has led you to see how futile, and potentially destructive, trying to understand the economy through media sound bites can be.

That said, here is what we know:

- Yes, oil prices are at unprecedented high levels;
 - Yes, the war in Iraq shows no signs of ending soon;
 - Yes, terrorism will threaten us for years to come; and
 - Yes, the Presidential election is a big deal, but life is going on no matter who wins;
- but -
- The US economy has added 2 million jobs in the last four years and continues that trend today;
 - Our Gross Domestic Product is growing at the Federal Reserve's target of 3% to 3.5%;
 - Inflation poses no threat to slow this growth; and, most importantly to investors ...
 - Real Corporate Profits are growing at a rate we have not seen since 1997.

With the Dow Jones 30 Industrials down 7% since February, and corporate profits up over 20%, the Dow's PE ratio has fallen to just over 15. This brings the market back to its 80-year average PE ratio at a time when interest rates and inflation are 25% below their long term averages. In our judgment, the true value of stocks is 25% higher than current prices.

As the storm clouds of Iraq, oil prices, and the election begin to clear and the cries of "conditions deteriorating" start ringing hollow, more investors will see what we have described for you here and stock prices will be forced to catch up with their true values. We can't tell you the day that will happen, but it's closer than it was when we started this letter.

Blessings,

Greg Donaldson

Mike Hull