

October 10, 2005

## After the Storms

The devastation caused by Hurricanes Katrina and Rita, and its implications for the economy, has prompted many questions from our clients. In this quarterly letter, we will offer our answers to the most-asked questions, and our views of the prospects for the economy and financial markets in the coming months.

**Question: The headline of my local newspaper says, “Recession Looms.” The author says some economists are predicting that the disruptions to the economy caused by the recent hurricanes will produce a recession. With so much of the Gulf Coast area literally under water, how can a recession be avoided?**

Answer: We see very little chance that a recession is near. The economy went into the storms with a low 4.9% unemployment rate and most data suggested that the economy was likely growing at near 4%, a faster pace than the 3.3% rate of the second quarter. If we went into the storms with GDP growth near 4%, the odds of a negative reading appearing soon are unlikely because the momentum of the economy is a bit like that of a giant ship -- if it is running at a high speed, even if the engine is shut off, it will continue its forward motion for a time. One anecdotal bit of evidence of the good pre-hurricane economy was the much better-than-expected earnings announcement by Federal Express (FDX). FDX is often seen as a bellwether of economic activity because of its widespread service to businesses and consumers. FDX's better-than-expected results also offer us important insight into the state of the economy before the storms hit, because FDX's quarter ended on August the 31, and thus, contained little of the storms' effects.

The reason that analyzing the pre-storm economy is so important is because post-storm economic data will be so convoluted with seasonal adjustments and corrections that watching the reported data for the next several months may be worse than just sticking your finger in the air and guessing which way the wind is blowing. In this regard, the status of the pre-storm economy is vital in that it at least gives us a starting point from which to judge the string of economic data that will be forthcoming.

Economists estimate that the affected area represents about 3%-4% of the US population. Even taking GDP growth to zero or below in the affected area, by itself, will not damage the economy enough to cause a negative GDP reading for the other 96%-97% of the economy.

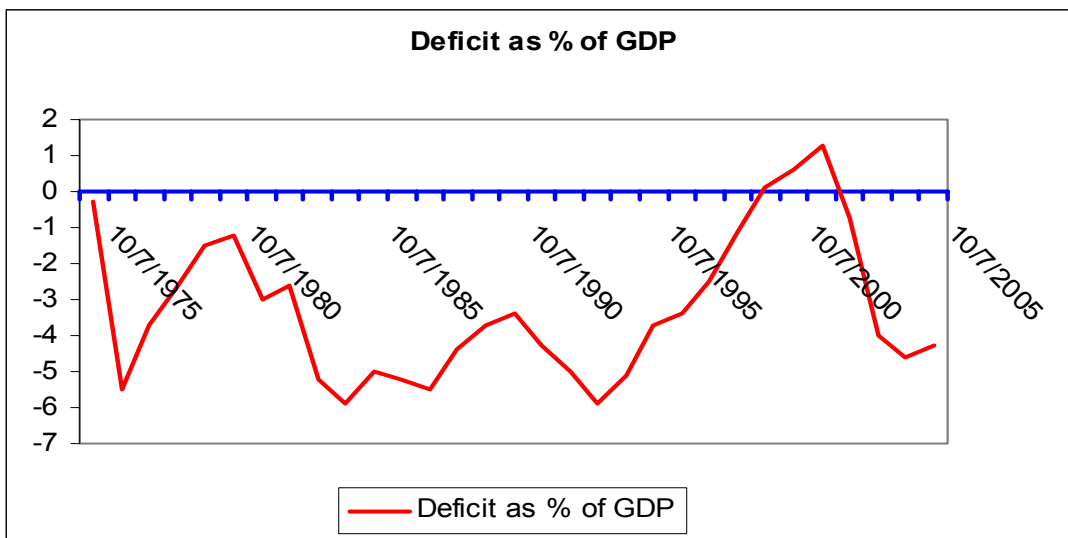
Before the storm, Standard and Poors, the largest rating service in the United States, was estimating GDP growth of 3.7% for the third and fourth quarters. On Thursday of last week, after a thorough review of the business prospects for the affected areas and post-storm analysis of nationwide retail and commercial activity, they cut their growth estimate to 3.1% for the next two quarters. S&P is one of the first major forecasting firms to officially change their growth estimates, and the cut was less than half of what had been the buzz in the media. S&P's modest lowering of its growth estimates is also a good sign that the economy is still on a strong footing in the aftermath of the storms and has not lost much momentum from what is known as the CNN effect. The CNN effect is when business slows in the broader economy because people not in the affected areas are glued to their TVs and not following their normal consumption patterns.

Finally, even though GDP growth will slow over the next two quarters, it will receive a huge lift when the rebuilding starts, as we will describe in our answer to the next question. Don't forget, however, as we said earlier, the economic data in the coming months will be extremely volatile and the markets will twist and turn with every new twist and turn of the data.

**Question: With the government borrowing billions to finance the reconstruction, won't that drive the budget deficit out of sight and interest rates higher?**

Answer: The government's borrowing is estimated to push the deficit to near 6% of GDP by 2007, a level we have not seen since the early 1990s. However, this will not be a cataclysmic level, and we believe it will be temporary. Over the past 30 years, the average annual budget deficit of the US economy has been about 3% of GDP. Budget deficits have not been a death knell for the economy or financial markets, either in the United States or in other countries. Indeed, the United States has had budget deficits almost continuously since 1970 see Chart I.

**Chart I  
US Deficit as % of GDP**



The chart shows that we have been in surplus only three years during this period. It is also well known that the surpluses of the late 1990s were a bit illusory, having been made possible by the high-flying tech stocks and the capital gains they produced. Additionally, Table I (below) shows the current budget deficits of the other major world economic powers.

**Table I  
Deficit as % of GDP  
Mid-Year 2005**

USA	Japan	Germany	England	France	Italy	China	Canada
-4.3%	-6.9%	-3.9%	-3.0%	-3.4%	-2.9%	-2.9%	0.7%

Deficits are not unique to our country. The only major economy in the world with a budget surplus is Canada. Japan, which has among the highest savings rates in the world, has a deficit of almost 7% of GDP, a level the US has not seen in the last 30 years.

**It's About Growth**

Deficits are not the great worry of most economists; that is reserved for growth and jobs. Table II shows the GDP growth and the unemployment rates of the world's economic powers.

**Table II**  
**World GDP Growth**  
**Last 12 Months**

	<b>USA</b>	<b>Germany</b>	<b>Italy</b>	<b>France</b>	<b>Japan</b>	<b>England</b>	<b>Canada</b>	<b>China</b>
<b>GDP Growth</b>	3.6%	0.6%	0.1%	1.3%	2.1%	1.5%	2.6%	9.5%
<b>% Unemployed</b>	4.9%	11.7%	7.7%	9.9%	4.3%	4.7%	6.8%	4.3%

Contrary to the constant bashing of the US economy by the mainstream media in this country, the United States has the second highest growth rate among the world's largest economies, and among the lowest unemployment rates. If the US had the economic statistics of Germany or France, the media in this country would dissolve into apoplexy. And let us issue a warning here: If the mainstream media has been so far off in their understanding and reporting of the economy since 9/11, it would be dangerous to "take their word for it" in the coming blizzard of confusing data. Because of this, we will be commenting more frequently on our take of the economy in the weeks and months ahead.

There is little correlation between deficits and interest rates. Interest rates are much more a function of inflation, which we will discuss in the next question. Indeed most developed nations of the world now have higher-than-average budget deficits and lower-than-average interest rates than they have had over the past 25 years.

**Question: What about inflation? With oil prices going through the roof and big budget deficits, can an uptick in inflation be far behind?**

Answer: It is important to remember that storms such as Katrina and Rita at first produce a deflationary jolt to the economy by destroying wealth and the means of production. Looking at the situation from the perspective of one family in the affected area, the deflationary effects are easier to see. Even if this family is fully covered by insurance it will be many months before their house will be rebuilt, and they will almost assuredly suffer a loss in their net worth by the time the whole ordeal is over. There is little likelihood that they have returned to their jobs, and almost all ordinary activities have been suspended. In addition, most of their time over the next few months will be consumed in putting their lives back together and making hundreds of life-affecting decisions from where to rebuild to what color to paint the house. They still have their money in the bank and their investments, but they are almost sure to have lost important papers and memorabilia that will be impossible to replace. The money that the government and insurance companies are putting into the affected areas is just a fraction of the money that the local economy was producing before the storm. Thus, deflation is the first economic force to hit the area; there is nothing to buy and little money to buy it with. Proof of this can be seen in that the utility serving New Orleans has already filed for bankruptcy, and the City of New Orleans has laid off half of its workforce.

Deflation will turn to inflation when the rebuilding process is firmly under way. The rebuilding of the Gulf Coast is a massive undertaking and will cause the demand for labor and materials to outstrip the supply. Consider this; the depreciable life of a house is about 40 years. That means in an area with zero population growth, normal housing construction and maintenance will be about 2.5% per year of the housing stock in the area. This means, for every house destroyed in the Gulf Coast area, it will take about 40 times more labor and materials to rebuild than would be needed in a normal year. In Louisiana alone, it has been reported that nearly 200,000 houses have been severely damaged or destroyed. As mentioned in the earlier question, this massive rebuilding will be the main reason the economy will be strong in 2006.

Although the freely flowing money in the affected areas from the government and insurance companies will attract adequate labor and materials, it will come at premium prices because it must be imported from other parts of the country. As craftsmen and equipment are drawn to the Gulf Coast region by high wages and plentiful work, it will have a ripple effect all across the country. The craftsmen who stay behind in the unaffected areas will become swamped with work, which will cause their prices to rise. Having said this, the construction trades represent only about 6% of the US workforce; thus, big wage gains in this sector will have only a modest inflationary effect across the whole economy.

Some experts are forecasting that combining the uptick in inflationary pressure in the Gulf Coast area with higher oil prices could push inflation up as much as 1% nationwide, but we don't think that will happen. It is our strongly held view that oil prices have reached a point where consumers are balking at the high prices, and this is borne out

by government statistics that show gasoline consumption has fallen 4% since the storm. Oil prices are down almost \$9 per barrel from their peak of \$70. Good old supply and demand are at work, and we think oil prices could fall even further because the summer driving season is over, which will take much pressure off of the refineries, and in doing so, also take pressure off of inflation.

**Question: I am worried about oil supplies. Isn't it possible that the world is running out of oil faster than we thought and, prices will just keep rising?**

Answer: Three important voices in from the field of energy have made official statements about the worldwide energy supply recently. Representatives from Saudi Arabia and Exxon spoke last week at an international oil conference and sought to reassure the public about the amount of oil still in the ground and how long it will last. Saudi Arabia's oil minister stated that his country would soon be nearly doubling its proven reserves, because of new technologies and higher prices. Exxon president Rex Tillerson said that the world may contain three trillion barrels of untapped oil from conventional oil fields, oil sands, and other deposits. Mr. Tillerson's figure was corroborated by the US Geological Survey.

Using the three trillion barrel figure, world wide production would not peak until almost 2040. At that point, the world's proven oil reserves will start to decline at a faster rate than new reserves can be discovered. That may not sound like a long time until you remember that the experts have been incorrectly predicting the end of oil supplies for a long time. In 1919 the director of the Bureau of Mines predicted that oil reserves would be depleted in 2 to 5 years. In 1958 a noted energy scientist predicted that oil production would peak in the late 1990s. After the oil shocks of 1973 and 1979, bookshelves were full of experts suggesting that the oil supply would end soon. That did not happen, and oil prices subsequently sank below \$10 a barrel in the mid-1980s as new discoveries and conservation created a glut of oil.

Moreover, today the high cost of gasoline is not entirely a function of oil shortages. It is a problem of infrastructure. There has not been a new oil refinery built in this country for almost 30 years and far too little has been invested in pipelines and other infrastructure. The following quote comes from one of the leading oil analysts, Keven Norrish of Barclays Capital in London.

"What we are seeing is not a function of the world running out of oil. What we are seeing is the legacy of a very long period where investment has been far too low. The problem is getting the oil out of the ground and delivering it to consumers."

As you've heard us say before, as oil prices rise, two important economic forces come into play: innovation and substitution. Let's just take one innovation, the hybrid engine. Toyota's Prius electric-gasoline hybrid engine is rated at 48 miles per gallon. That is twice what the average full-size sedan gets today. In addition, it emits 90% less regulated tailpipe emissions and 50% less greenhouse emissions. Hybrids, at present, do cost more, but as more people buy them, the cost differential will go down. There will be other innovations; Mercedes and Toyota are experimenting with high-mileage Diesel engines, and General Motors is studying hydrogen engines and fuel cells. As more and more of these innovations come to the market, we believe people will make the switch.

As a result of sharply rising oil prices, a whole new generation of Americans is now being introduced to our dependence on foreign oil. We believe this younger generation is much more environmentally conscious than the baby boomers and is likely to be early adopters of the new technologies that will be sprouting up.

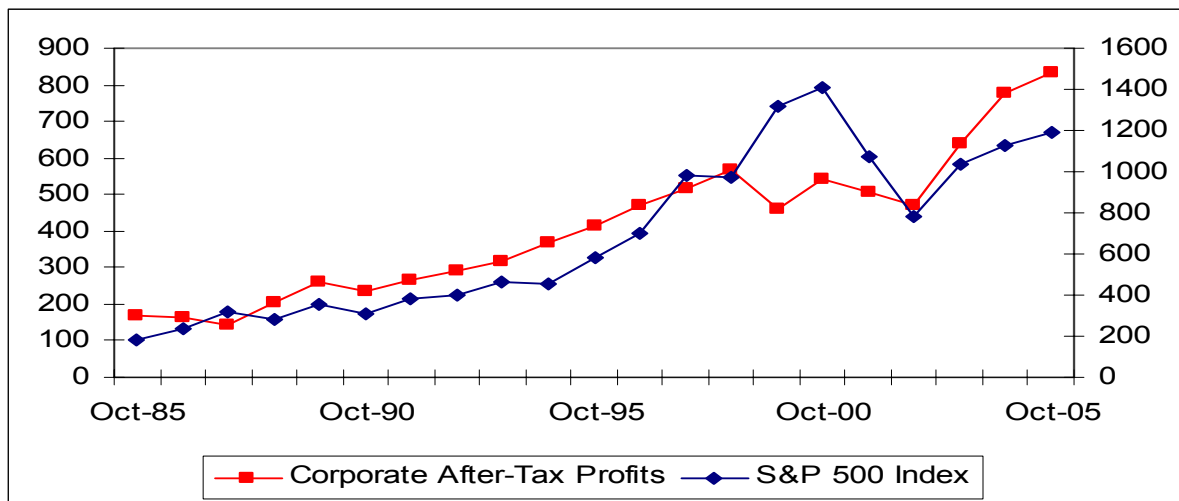
The bottom line on oil consumption is this: if the current 24 mpg average of all vehicles in the US were to quickly move to the 48 mpg rating of the hybrids, the US could slash its foreign oil consumption by 50%. We think the matter of our dependence on foreign oil has finally reached the consciousness of consumers. For this reason, we are optimistic about the business prospects for the leading companies in energy savings for automobiles, homes, and appliances.

### **Prospects for the Stock Market**

As measured by earnings and dividend growth, US stocks have had a solid year, with earnings growing by nearly 15% and dividends growing by over 10%. Yet stock prices, for the most part, are negative. Because price growth is highly correlated with earnings and dividend growth, the poor performance of stocks during 2005 has been both surprising and perplexing. Looking at Chart II, below, you can see this divergence.

From 1985 through 1998, corporate earnings (here we are using total corporate after-tax profits as reported to the IRS, a figure which companies have no incentive to exaggerate.) were fairly well reflected in their stock prices – as profits rose so did the stock prices. The first divergence we notice happened in 1999, as after-tax corporate profits declined and stock prices, fueled by the Tech stock mania, continued to climb. As we know, and the chart shows, stock prices required a severe correction to get back in line with corporate profits.

**Chart II**  
**Corporate After-Tax Profits vs S&P 500 Index**



Since the end of the bear market in 2002, corporate profits have rebounded, impressively, reaching a series of new all-time highs. Stock prices, on the other hand, have experienced only one year, 2003, of similar growth. Today, profits continue to grow and widen their divergence from prices. Based on current earnings, inflation, and interest rates, our models indicate that the S&P 500 Index should be near 1400, versus 1196, as we write this letter. Chart II would seem to agree with our calculations.

This divergence can be explained by rising oil prices and the Federal Reserve continuing to raise short-term interest rates. Oil prices would not ordinarily impose such a headwind to stock prices. But because oil prices have hit a continuing series of all-time highs, they have created a constant source of worry for investors. While we agree that higher and higher oil prices are reason to worry, we believe that it has been the Fed's long series of interest rate hikes that has put the brakes on the stock market. Every time they have hiked rates, the market has seemed to hold its breath until the next Fed meeting. Ironically, the rate hikes have not slowed the economy much, but they have flattened the stock market. And because the economic growth has stayed near 4%, the Fed's string of rate increases has gone on longer than we would have guessed.

We fully expect that early in 2006 the Fed will stop raising rates. When that happens, the market has a lot of catching up to do. Does that mean we expect stock prices to rise? Yes we do. As soon as the Fed signals that they will stop raising rates, the market will catch up quickly to the growing earnings it has been ignoring. We believe the valuation of the stock market may well be as mis-priced today as it was in 1999, only in the opposite direction. Ben Graham, considered the father of financial analysis, once said, "In the short run the markets are a voting machine (popularity contest), while in the long run they are a weighing machine (measure of value)" We think when he made that statement, he was thinking about times like these. The value drivers of Corporate America -- cash flows, earnings, and dividends -- are all moving higher. History shows us over and over that prices ultimately follow values, not the other way around.

Blessings,

Greg Donaldson  
 Director of Investment Strategy

Mike Hull  
 President