Lavery Consulting Group

April 15, 2004

The Economic, Financial Market and Political Environment

The polls suggest a tight ’04 Presidential election race between President Bush and Democratic challenger, John Kerry. The outcome may well be decided by highly contested races in 18 key states. Prolonged job market weakness should work to Kerry’s benefit. If we look at employment conditions thru the **February employment data reported in early March**, in 17 of the 18 battleground states, unemployment rates were higher than at the start of the Bush Presidency. Nevada is the lone exception. 4 of the 18 states have shown payroll job growth from January ’01 (Bush’s first month in office) thru February ’04: Arizona, Florida, Nevada, and New Mexico. These 4 are all Sun Belt states experiencing rapid population growth in recent years. Employment declines since January ’01 have been sharpest in the frost-belt industrial states of Michigan, Ohio, Missouri and Pennsylvania, and in Oregon.

Unemployment Rates and Changes in Employment
In the 18 Battleground States

	Electoral	**Unemployment Rate**			**Payroll % Change**	
	Votes	Jan '01	Feb '03	Feb '04	Jan '01 - Feb '04	Feb '03 - Feb '04
Arizona	10	3.8%	5.9%	5.3%	2.63%	2.00%
Arkansas	6	4.7	5.7	5.5	-1.14	0.09
Florida	27	3.9	5.3	4.6	3.05	1.82
Iowa	7	3.0	4.3	4.1	-2.16	0.36
Maine	4	3.3	4.9	5.0	-0.41	0.36
Michigan	17	4.6	6.9	6.6	-4.95	-1.62
Minnesota	10	3.3	4.8	4.7	-1.41	0.28
Missouri	11	4.4	5.5	5.1	-2.68	-0.65
Nevada	5	4.4	5.1	4.4	6.30	3.88
New Hampshire	4	2.8	4.2	4.2	-2.56	-0.65
New Mexico	5	4.7	5.9	5.6	3.61	1.05
Ohio	20	3.9	6.2	5.9	-4.22	-0.71
Oregon	7	4.8	7.9	7.1	-3.06	-0.11
Pennsylvania	21	4.2	5.9	5.1	-2.50	-0.58
Tennessee	11	4.0	5.4	5.0	-0.85	1.38
Washington	11	5.6	7.4	6.1	-1.47	0.87
West Virginia	5	5.1	6.4	5.4	-1.81	-0.51
Wisconsin	10	3.9	5.8	5.2	-1.40	0.57

Source: Bureau of Labor Statistics

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Compared with year-earlier levels, employment has risen in 12 of the 18 states. Employment is still falling in Ohio, Michigan, Missouri and Pennsylvania. Unemployment rates are lower currently in nearly all of the 18 states vs. a year earlier, but this can be attributed to the rise in discouraged workers, dropping out of the civilian labor force. The unemployment rate is still greater than 6% in Michigan, Washington, and Oregon. Bush carried Ohio in 2000, but looks vulnerable there in '04. Bush lost Michigan in 2000; this is potentially fertile ground for Kerry in '04. The labor market situation in Pennsylvania (a state with 21 electoral votes that Bush lost in 2000) shows a less bleak jobs picture than Ohio and Michigan.

In thinking about the election, the timing of employment news is vital in shaping voter perceptions. The last employment report before the November 2 election covers the month of September. It is slated for release on October 8, nearly a month before voters go to the polls. Between now and the election, there will be six monthly employment reports, following the surprising March surge, reported on April 2. In 1992, data now show that employment began to strengthen markedly in October of that year, but that came too late to help George Bush Sr. In comparison, the April 2nd report of strong March gains in employment was very important for George Walker Bush. Further, it is critical for George W. that employment show **continued strength between now and the election.**

John Kerry will argue that even with the robust payroll gain of 308,000 in March, the economy still has lost a net 1.84 million jobs since January 2001, the month Bush took office. Kerry is campaigning on a "put jobs first" promise. Kerry's warnings about the possible consequences of a ballooning budget deficit have resonated well with voters. Bush ads have bashed Kerry as a waffler on issues and as a tax and spend liberal.

Bush has been hit hard on the terrorism front. Former anti-terrorism coordinator, Richard Clarke, has revived the issue of whether Mr. Bush's team was negligent in dealing with al-Qaeda before September 11, 2001, and whether the invasion of Iraq distracted attention from the real pursuit of terrorists.

In late March, John Kerry headed for Detroit to lay-out a jobs plan, specifically tax incentives for companies that refuse to outsource jobs. Evaluated in economic terms, this is a bad idea. It impedes free trade and spends money to create a disincentive for jobs to flow to countries with a comparative advantage in labor. Evaluated, however, in political terms, it's brilliant. This strategy allows Kerry to portray himself as a centrist, pro-business Democrat.

Wall Street is divided on the two candidates. The general thinking is that Bush would be good for stocks. If Bush is re-elected, with a majority in both the House and the Senate, he will seek to make his tax cuts permanent, the very tax cuts that have stimulated economic growth. The general thesis on the Street is that Kerry would be good for bonds, because his focus on reducing the deficit would keep interest rates lower than would otherwise be the case. Kerry would also raise taxes for families with incomes over $200,000 and impose a higher statutory rate.

The economic recovery is alive and well with annualized growth rates of 8.2% and 4.1% in the final two quarters of 2003, the fastest growth in 20 years. Moreover, the National Bureau of Economic Research says that the recession ended two-and-a-half years ago, in November 2001. While some are quick to blame the recession on George W. Bush, the economy turned downward well before the 2000 election. Today, despite terrorism, corporate scandals and war, the economy is growing nicely. The March retail sales jump of 1.8% and the strong 0.7% rise in business inventories suggests a 6% annualized GDP growth rate in the first quarter of '04.

Wednesday's release of a March CPI, up a stronger than expected 0.5%, leaves the CPI up 1.7% over the past 12 months, but shows the CPI over the past 6 months grew at an annual rate of 2.3%, up 5.1% annualized over the last 3 months. With the CPI, plus the early April report of a surge in job growth and Tuesday's release of March retail sales, many investors worry that Fed tightening can't be far away. The consensus on Wall Street is that the Fed will tighten not later than in August or September. I do not, however, expect the Fed to tighten until early 2005. A tightening of 1 percentage point over the course of 2005 would double the fed funds rate from 1% to 2%. But, it would still leave the Fed reasonably accommodative, as real short term interest rates would be zero. The Fed believes that wage and salary inflation will not be a serious threat until the unemployment rate approaches 4%. That figure implies a gain of two million additional jobs from current levels, which is some time away. I doubt the Fed will engage in serious tightening until the unemployment rate goes below 4.5%, and that's probably some time late in 2005.

Pricing incentives like "zero down" and 0% interest on auto loans, significant personal tax cuts, very low inflation, a very accommodative Fed policy, and a related wave of mortgage refinancing fueled consumer purchasing power over the past several years. Consumer spending actually rose from 67% of real GDP in 1998 to over 70%. This cycle is very different from the typical post WWII expansion. On average, wages and salaries have increased 9% in real terms in the first two years of the average postwar recovery. In this cycle, however, wages have risen a meager 1% in real terms in the past year. **Consumer concerns focus on jobs, the surge in violence in Iraq, and rising energy prices.** The sharp rise in gasoline prices, up 28 cents per gallon this year, threatens to drain disposable income, resulting in consumer retrenchment.

Growth is now being driven more by wealth than by income. Recently released Federal Reserve Flow of Funds statistics for the third quarter of 2003, show that over the four-quarter period thru the third quarter of last year, household sector net worth (homes, equities, and other assets) advanced $4.5 trillion. (This is reminiscent of the $5.9 trillion net worth burst in 1999). Over the same four quarter period thru Q3:'03, disposable personal income advanced $400 billion. Total household sector debt jumped by $900 billion over the same period, twice the rate of expansion in 1999. Total debt-public and private- has grown by $6.5 trillion since 2000.

These debt expansions are a cause for caution, as is the narrowing of the spread on corporate bonds between investment grade and junk. And, for all the euphoria regarding

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the double digit gains in corporate profitability in 2002 and in 2003, one needs to do the fundamental analysis on a company by company basis as to the sources of profit growth. How much is due to curbing labor costs? How much is attributable to currency translation? Lower corporate taxes have a positive effect on profits. Companies selling goods overseas, for example, pay the tax rate where the sales occurred. Foreign taxes are typically lower than the domestic rates, so a company's overall tax hit goes down as its exports rise. Going forward, taxes may be more of a drag on earnings. The European Union has imposed tariffs on U.S. exporters, and the depreciation tax benefit in President Bush's 2002 stimulus package disappears at the end of this year. A company news release can trumpet double-digit sales increases, and make no mention of the beneficial effect that currencies had on the results. One might have to consult the company's regulatory filings for that significant detail. Are stellar company results an effect of true organic/economic growth, or are they the consequence of economic engineering. Investors need to know. Investors need to size up organic growth.

The excesses of an asset driven economy are being fueled by artificially low interest rates and helped by dollar asset purchases from Asian Central banks, trying to suppress rises in their own currencies, so as to fuel export-led recoveries in Asia. The Fed runs the risk that by cushioning the impact of the burst in one bubble, they may be inflating another in housing. The ratio of home prices to income is now at a record high. Total mortgage debt as a % of domestic non-financial debt has risen to nearly 42%, a record.

The second half of '04 lacks incremental fiscal stimuli. With the savings rate (savings as a percent of disposable income) near its bottom, job creation and income growth are essential from here. I am sanguine about employment growth over the next six months and upward revisions to the non-farm payroll gains in the entire second half of 2003. This bodes well for income growth and the continuation of the economic expansion thru 2006.

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