Investment Watch

3rd Quarter, 2003

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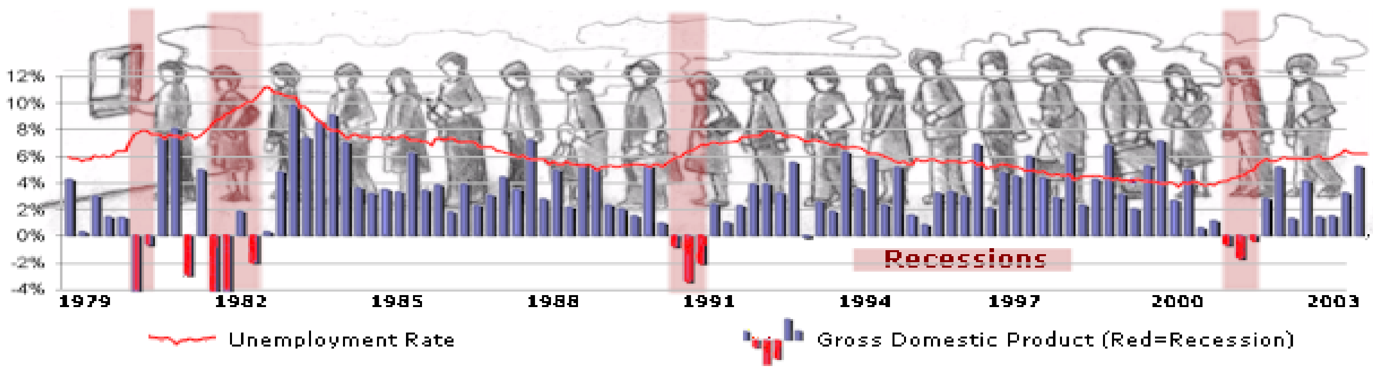
"THE JOBLESS RECOVERY"

Recovery! ***What recovery?*** The experts agree we are positively in a sustained economic rebound and have been for some time. During the last quarter, the National Bureau of Economic Research who declares such events told us the economic recovery began on November 1, 2001. Also, Greenspan by his actions anticipates little inflation for the foreseeable future. Economic growth and price stability = **Economic Nirvana!**



So why aren't we turning somersaults, besides risking sure injury to our old bones? In my opinion, we haven't savored the rewards of the economic upturn due to **high unemployment**. It's no longer just a statistic. The unemployed are people, fellow Americans. Our feelings about them are deeper now since we are a more united nation. We care more, and therefore hurt more, for our unemployed neighbors.

In *USA Today* the front page story headline read, "**2 years in a row, more in poverty**… Economy perking up—but hiring still lags." More than a million Americans sank into poverty last year. The unemployment rate increased from 4% to 6% and more than 2.5 million jobs have disappeared during the Bush administration. Come election time, unemployment will be a political *hot potato*.

When will it end? Economists keep predicting new jobless claims will fall. Instead, claims have risen to over 400,000 which suggests payrolls are shrinking and the economy is contracting. *But wait*, aren't we in an economic expansion? Hold on, I think I can make sense of these apparent dichotomies.

But first, before I go out on a limb, let's analyze the relationship between unemployment and economic cycles as shown in the graph above. During recessions the economy contracts and people lose jobs resulting in higher unemployment rates, as shown by the red line. When the economy rebounds, the Gross Domestic Product (bar chart) rises and you'd expect the unemployment rate to instantly begin downward, like it did after the 1980-82 recession.

However, the experts tell us, "unemployment is a trailing indicator of economic expansion". This "trailing" nature of unemployment rates versus economic growth is clear after the last two recessions, 1991 and 2001. The unemployment rate continued to increase after both rebounds started and a long time passed before it began to decline. *déjà vu?*

"THE JOBLESS RECOVERY"
(cont'd)

We called it the "downsizing of America" back then. But, unlike the 1992 rebound, where it took only five quarters for people to be rehired, this time we've already waited eight quarters and still no sign of an employment rebound! So much for the past being a prognosticator of the future. Why has it taken so long this time for jobs to materialize? **PRODUCTIVITY!**

Productivity advances deliver more goods with fewer workers. Take the last quarter for example, productivity advanced 6.8% while the GDP grew by 3.3%. Therefore, we needed 3.5% **less workers** (6.8% minus 3.3%). You've got it! Productivity is a two-edged sword—one blade cuts a higher standard of living for those employed while the other edge cuts the jobs of those less fortunate, increasing unemployment.

If these dramatic productivity gains continue, our economy must grow faster than the 3% historic average if we are to create more jobs. However, growth over 3% is presumed to fuel inflation. Do we have to choose between high unemployment or high inflation? This productivity Nirvana is feeling a lot like Hades. <u>What a dilemma!</u>

I'm on the limb now, so give me a little rope. Productivity gains from technological advances will -

- Allow companies to produce more goods for less, thereby boosting profits.
- Make profits soar, encourage confidence, fuel corporate expansion and payoff in more jobs.
- Decrease unemployment.
- Expand our economy by well over the 3% historic levels, but will not fuel inflation.

Experts agree. Analysts' forecast corporate profits to be 15% or more for the next couple of years. The Bureau of Economic Research projects the economy to grow at a 5% annual rate in this the third quarter.

Normally a dramatic expansion like this would ignite inflation, but not this time. This expansion is being driven by productivity gains. **Productivity gains bestow price stability**. This means we can support sustained growth in excess of the 3% historic norm and not fuel inflation. I think Greenspan also agrees because he has vowed not to tighten the money supply for the foreseeable future when inflation is still his darkest enemy.

Finally, unemployment will drop substantially, not only due to economic growth, but also due to demographic shifts. Our labor force is not expanding as fast as it has in the past. Over the next two decades the baby boomers will retire. This will squeeze our labor supply. The experts forecast a labor shortage.

And here we are... economic growth, price stability and full employment! Wow! You think I'm just a September optimist? A September optimist views the glass as half full, the pessimist as half empty, and the Cubs' fan is just waiting for the glass to spill. If you think my theories a long shot, sometimes the long shots come through.

How else could this play out? What's the worst case scenario if I'm wrong? There are some dark clouds on the horizon that even my rose colored glasses can't hide. The pessimist's view of all this is that Americans are losing jobs overseas, the Trade Deficit is at an all time high at 5% of GDP, and the Federal Budget Deficit has soared to $450 billion from a surplus of $200 billion a few short years ago. This will fuel inflation, cause the consumer to tighten his belt, and stop the recovery in it's tracks.

Productivity, getting more goods from less input, will ultimately payoff in higher living standards for all Americans. Let's hope that we can withstand these storm clouds and allow productivity to drive our nation into the ***new economy***. *déjà vu.*

Keith Kowalczyk 9/30/03