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MAS011104

Head's Up on 2004

Year-end reviews are all the fashion, but such reviews are often distorted by the most recent events that strike the market. We had sketched some issues in December and the events of January now seem to be filling out our year-end conjectures. Since we didn't send it out, thinking we would ask some profound questions on currencies and some troubling issues on jobs but didn't get it done then, we will append it to this commentary.

Since December 23rd when our remarks were first drafted, equity markets have rallied, but also have exhibited

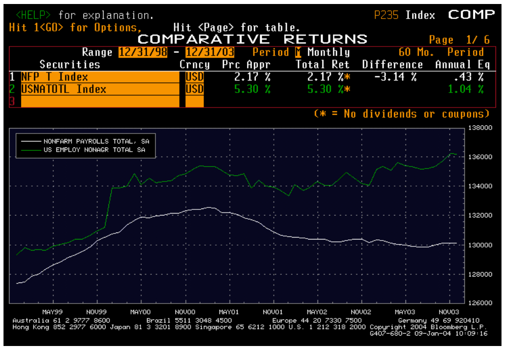
	12-23-03 Close	01-09-04 Close	Absolute Change	Percentage Change	High/Low
INDU	**10341.3**	**10458.9**	**117.6**	**1.14**	**10592.4/10305.2**
SPX	**1096.02**	**1121.86**	**25.84**	**2.36**	**1131.92/1094.04**
CCMP	**1974.78**	**2086.92**	**112.14**	**5.67**	**2100.25/1969.23**

a pattern surprising to some Seers at year-end 2002 who predicted low single digit returns and falling volatility in 2003. Each index found its low during the reference period on Christmas Eve (12/24/03) when the only traders around were likely to be those cashing out on a good year. Each market rallied to its high on 1/08/04 before the shocking Employment Report created substantial "Willies" last Friday. We will come back to the Missing Unemployed shortly, but we found it interesting to observe that Beta was in the saddle again, despite sentient remarks of analysts predicting this year would feature the turn of the Big Cap Multinationals in position to benefit from the falling dollar. Apparently the sentiment of 2003 continued into 2004---namely, go for volatility in the search for recovery.

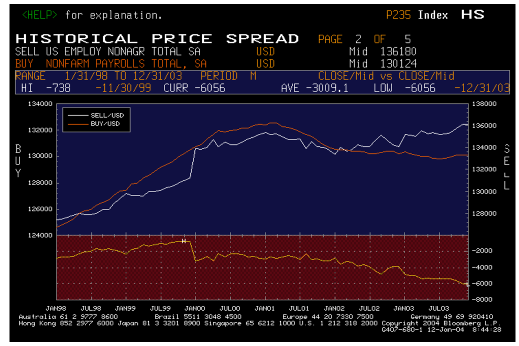
Technology stocks were still the stock ***du jour*** with the noted change in business optimism as was seen in the shockingly good ISM report of January 2, 2004. In the credit markets, until the shock of last week's employment report, the bond trade was completely range bound. Only on Friday, did the 10-Year break out, producing a yield below 4.10. During the year, the 10-Year had gone above 4.40. Again volatility was the key, with an absence of real direction…

All of this came to an end with last Friday's Employment Report that showed no job creation at all (a faint 1,000 jobs created in the month) and a reduction in the prior month's numbers. Between the January 2nd ISM blowout, the non-manufacturing ISM, cooled, but only slightly. In the interval, most reports seemed to encourage investors that the Goldilocks productivity revolution was well "in train" and that the economy could do even better than the (upwardly revised) forecasts of Wall Street economists both for QI and the entire year now suggested.

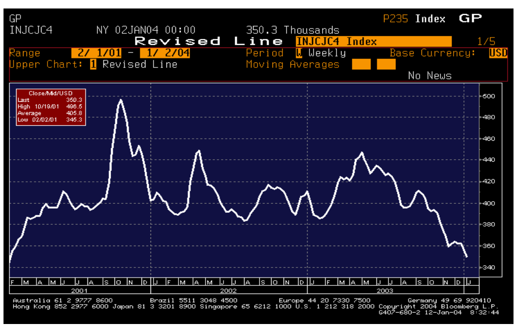
Then, came Friday's shocker, and the market took a nosedive while the Bond Junkies drove the 10-Year below 4.10, seemingly on the way back to the threes. Even the rather optimistic chant of ***Fedspeak*** got overwhelmed by the resumed fears of a Jobless Recovery. We profess no great bean counting ability on labor data, but we do observe that year-end surveys suffer from all kinds of ailments. What now appears to be non-existent job growth (after five months of modest gains) could again be modified by January data that might be more promising. We have no firm explanation for why job growth is so feckless, but we do observe that President Bush now wants to grant a kind of amnesty to "illegals"---which could involve some substantial numbers (the number seven million is frequently cited). This only serves to underscore the kind of "undercounting" that may accompany the large flow of labor from south of the border. What is curious, of course, is that if the ‘illegals’ are in fact employed, they are still spending their incomes and that means even more outrageous productivity numbers since their hours works go unrecorded in many of those surveys but some of the spending must get counted in normal GDP estimates. How an accurate counting of actual



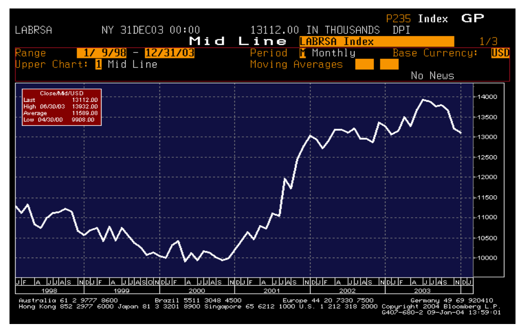
Household versus Establishment Measurement Gap



Employment Spread 1/31/98-12/31/03



Initial Claims 4 Week Average



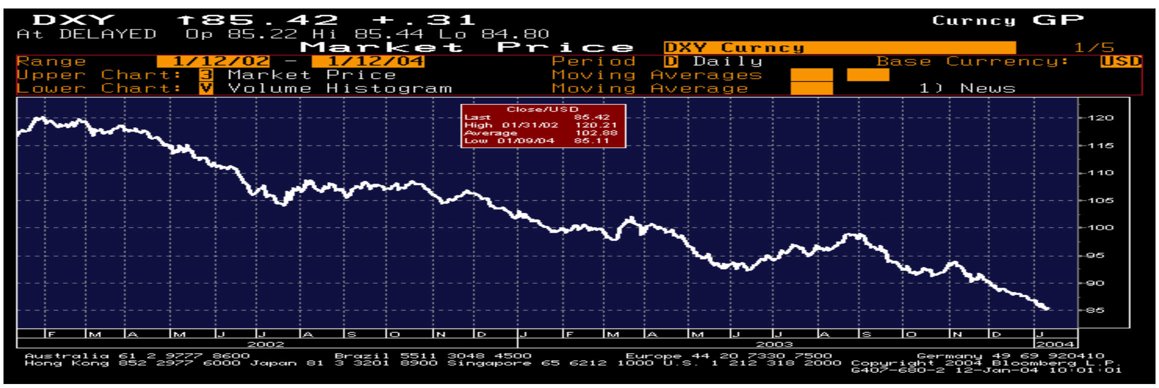
Growing Labor Pool

employment, legal or otherwise, might revise downward the productivity data is obvious. However, one has to assume that the ‘undercounting’ is on the increase in a substantial way over this business cycle in order to put a correct interpretation on the recent employment data which we quote here. (See **MAS090703 When Data Mislead: the uncounted employed**).

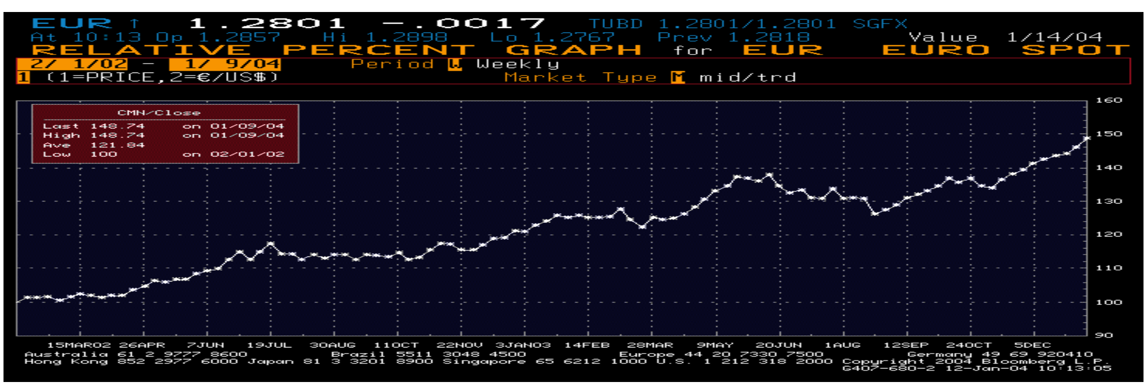
> **If the fraction of the economy that is underground keeps growing, and we do nothing about estimating it in the way we collect data, then productivity is going to rise, simply as an artifact of the enumeration problem. The macro implications are interesting. Since consumer income will continue to rise, even when a portion of that income is not “counted,” corporate profits are going to rise, driven by this expanding consumption. It will seem over time that measured ‘savings’ are falling because our measured ‘income’ number is going to understate how much spending power is available to consumers.**

It will be many Ph.D. dissertations from now before we have a good handle on these conjectures. In the meanwhile, we have to confront the absence of growth in “measured jobs,” and the decline in hours worked. Another possibility suggested by some pundits is that there were many voluntary (or corporate induced) retirements as the year was drawing to a close, coupled with the absence of strong job creation, except on the temporary side. And, the latter phenomenon could possibly be related to the growing cost of non-wage benefits that keep growing, creating very uncertain cost conditions many years out. With large amounts of uncertainty, we could expect Business to err on the side of Temporary as opposed to Permanent Job creation. The real issue is whether corporate pessimism that was the outgrowth of all of the headwinds from 2002 and 2003 is now on the rise again?

Falling Savings, Larger Deficits and Dollar Flight: In addition to the puzzle of "missing jobs," we have yet to reconcile the falling savings rate and the very strong behavior of corporate profits. If permanent jobs are not added to the workforce, it stands to reason that corporate profits will rise, particularly if output can be sustained with this composition and volume of employment This will help our national savings deficiency but it is unclear whether this is simply cyclical behavior or if it points to a structural change. Further, the decline in the measured consumer savings rate coupled to a larger government deficit has created worry at least as far as the FX market traders are concerned. But dollar decline is also a compositional issue. Against which currencies is the dollar declining? Clearly, it is not the currencies of export driven Asian countries. Mostly, it has been the Euro that has taken the 'beating,' by showing unprecedented strength. Measured on a weekly basis since 01/09/99, the Euro has risen some 50% against the dollar while the trade weighted dollar index over the period since February 2002, the trade weighted dollar index has fallen a mere 35%.



Trade Weighted Dollar Index



Euro Currency

This Administration seems to be enjoying the Old Italian maxim, **"Revenge is a dish best served Cold!"**

The Europeans have not yet reacted to this decline with a wholesale change in policy, but new ECB President, Trichet, began to speak out (up?) on the subject this past week. Combined with the continued protectionist rant on the Chinese currency, it suggests to us that the Rest Of the World's surplus problem still needs treatment. The U.S. cannot cure its international payments deficit unless the ROW can suddenly take the cure for its mercantile desires of permanent surplus. Or, to put it another way, despite the IMF's recent critique about the U.S. savings insufficiency, the surplus countries need to find other drivers for their domestic growth other than growing U.S. import demand. That necessity seems both obvious and highly unlikely to be fulfilled, particularly by the Europeans and the Japanese.

The Coming International Monetary Conference: All of this leads us to the view that sooner or later, and perhaps sooner, we will see another International Monetary Conference where the failures of individual country macro-economic policies can be hidden by a Coalition of Willing Currency Changers as it were that will mask domestic policy changes under the guise of International Cooperation. That it has happened before---even with a Republican President---strongly suggesting it can happen again. Perhaps it will wait for the election, but perhaps not?

The Fed is not a publicly active participant in such currency realignments, but it will clearly have a view on what needs to be done to create a more enduring external equilibrium. The Fed's "considerable period" doctrine certainly amplifies the difference in U.S. policy response to the "end of the Boom" economic adjustments and it differs strongly with the views of the ECB in this regard. Some observers of U.S. Fed policy see method in the "considerable period" doctrine with respect to international monetary events. It puts huge pressure on the Europeans to make their monetary policy much more expansionary---perhaps even to give up some their previous fascination over the benefits of a "strong currency."

Chinese export strength seems a convenient cover for such an international monetary event. The Fed has made some generic comments on fixed rate regimes, while the Treasury, with its much more overt political agenda sallies forth against Chinese as a source of poor American job growth. That said, however, official policy measures to rectify the situation is more than a bit half-hearted. If the U.S. did not need China for geopolitical support, it is likely that the normal protectionist urges of the Congress would force the Administration's hand. Now, however, despite the rhetoric, U.S. policy toward China seems distinctly benign. This will allow the current Administration to play both sides of the street until the election---unless the currency market force the issue to be confronted much sooner. Some analysts speculate that realignment will occur at the upcoming G-7 meeting next month. Perhaps, but we doubt it. Missing Jobs, however, are transatlantic phenomena, and Euro escalation does not make it easier for the EU to create a good recovery, particularly with its fiscal policy hands tied somewhat by the Growth and Stability Pact and a Central Bank that looks only to the "medium term."

At the beginning of this year, Greenspan and Bernanke took their views of the Fed policy process to the annual meetings of the American Economic Association. Greenspan trotted out his now well-known view that formulaic methods of monetary policy could be hurtful, and it was better to think of the making of monetary policy as an exercise in "risk management." The relevant implication is that Fed policy continues to be in the never-never land of only somewhat limited transparency and maximal discretion. It is better than many countries, but it may still not be quite good enough even for a dovish Board Member such as Bernanke. And the exposition of the reasoning behind Fed policy moves gets frequent criticism from both Academe and Wall Street.

While the U.S. appears to be troubled by its "imbalances," the U.S. economy got a bit of backhanded praise since the year began. That praise came with the discovery of an apparently massive fraud in Italy. Italy may not have Mad Cow, but it definitely has Mad Accounting and Mad Financial Supervision. The Italian public is mad at the accountants, mad at the principals of the Parmalat dairy group and mad at the possibility that despite its "Euro" status, it may start to have a country risk premium applied to its financial securities. It is interesting to note that while Italy is "ahead" of the U.S. on the matter of formal auditor rotation (9 year maximum tenure), such rotation did not save it from this hugely embarrassing fraud. Corporate Governance is a global issue---and it will become more so in 2004 and beyond as capital markets continue their process of globalization. If Corporate Governance scandals supply headwinds---the wind is likely to keep blowing this year. One wonders whether a Chinese scandal or two will not even out the criticism of American accounting disasters of the post-boom economy? Can China have a boom of such proportions without a major financial scandal? We are doubtful. The rewards for the manufacture of earnings and good balance sheets are much too strong and punishment too remote and too infrequent.

Finally, we have to say something about Oil Prices as a continuing problem for the global economy. Plain and simple, the Cartel named OPEC has not withered away. In the absence of strong non-OPEC supply growth, a spate of Cold Weather in the U.S. is definitely going to work its will on the low inventory in private hands. The U.S., of course, has contributed to the Cartel's recent strength. It continues to pile up crude in the SPR and did not use it to break the price thrust. Over the past decade, private inventories have melted and public inventories have grown. Since no one can predict when the public inventories will be used, the fear that they will come into the market at the peaks has undermined the building of large private stocks. This is an accident waiting too happen.

In the name of "security," this Administration has done perilously little to cause markets to ration crude and fuel supplies. No real energy program will help the U.S. unless it begins to focus on demand restraint as well as supply inducement. As we put this note to bed, the FT ran a large story on the constricted traffic pattern in the Bosporus that is slowing much needed crude supplies for European refiners. Turkey wants a pipeline to carry Caspian Basin crude to its Mediterranean Port of Ceyhan. The argument over location of a new pipeline from the resurgent oil fields of the former Soviet Union has both geopolitical and economic roots. With the Russian government's efforts to limit the power of its Oil Generals, the fight over location must continue.

The China factor plays here as well. As China grows, it accelerate growth in other parts of Asia---and the combination means more strain on raw material supplies. Crude prices can indeed get pushed up absent a strong recovery in Iraqi oil supply. Unfortunately, the pipelines from Iraq going west have been repeatedly sabotaged, and they are in a frightful state of repair even without sabotage.

It is in this context that the dissatisfaction of oil producing Arab states can easily be expressed. They can make a point of limiting or threatening to limit output expansion and extract rent from the West---while hiding behind the impact of dollar weakness. While we do not believe that higher crude prices will interrupt either the U.S. or the ROW's economic recovery in 2004, we think it can play on the issue of confidence---a headwind that can continue to blow. Since so much of the world's economic recovery is tied to a continuation of a strong U.S. growth performance in 2004, anything that reduces the 'animal spirits' of the U.S. business community has the potential to reduce investment in 2004 and impact world economic growth. The race between higher domestic investment and a re-birth of job growth that will sustain household consumption---what we call the Attenuation hypothesis---will be the pivot point for the U.S. economy in 2004.

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MAS011104

ECOMENTARY? is published for clients of **Munk Advisory Services**, **LLC**
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