Topical Study #73: Ten Conundrums Of 2005

OAK ASSOCIATES, *ltd.*

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I. Introduction

Earlier this year, on February 16, when the federal funds rate was 2.50%, Fed Chairman Alan Greenspan caused a stir by saying that he was surprised that the bond yield had remained flat around 4% even though he had been raising the federal funds rate since June 30, 2004, when it was only 1%. Here we are in July; the Fed is still raising short-term rates, the fed funds rate is at 3.25% and the bond yield is still around 4%. Mr. Greenspan's "conundrum" remains an interesting one, though now there seem to be almost as many explanations as there are economists.

Since the start of the year, equity investors have been agitated about plenty of other conundrums, and by the dire predictions of a few Nostradamus wannabes who have been predicting that these conundrums will be resolved apocalyptically. I have offered mostly optimistic assessments of them. I have explained why I don't believe that "it will all end badly." So far so good, I think. However, now that we have passed the halfway mark for 2005, it might be useful to review and, if necessary, reassess the conundrums. Here is a list of the top ten that I will discuss in this Topical Study.

1) ***The Inflation Conundrum***: Why does inflation remain so low despite strong economic growth, low unemployment, rising capacity utilization, and soaring commodity costs?
2) ***The Consumer Conundrum***: Why does consumer spending continue to grow so rapidly despite relatively weak employment gains and soaring gasoline prices?
3) ***The Profits Conundrum***: Why are profits growing faster than widely expected despite higher materials costs and so much domestic and foreign competition?
4) ***The Dollar Conundrum***: Why hasn't the foreign-exchange value of the dollar collapsed as some predicted? Why has it rebounded this year even though the trade deficit is at a record high?
5) ***The Twin Deficits Conundrum***: Why haven't the merchandise trade and Federal budget deficits caused any major problems for the US economy and financial markets?
6) ***The China Conundrum***: Why does China continue to grow 9% per quarter despite warnings that such fast growth is unsustainable?
7) ***The Commodity Markets Conundrum***: Why are commodity prices no longer soaring if the global economy is still booming?
8) ***The Stock Market Conundrum***: Why isn't the stock market responding better to better-than-expected earnings?
9) ***The Bond Market Conundrum***: Why have bond yields been so stable while the Fed has been raising interest rates?
10) ***The Greenspan Conundrum***: Why is the Fed Chairman continuing to tighten when inflationary pressures are easing?

Let me know if I forgot any conundrums. OK, here I go….

II. The Inflation Conundrum

Real GDP has been growing for fourteen consecutive quarters, averaging 4.4% per quarter since the second quarter of 2003—the best performance in two decades. The unemployment rate is only 5%, down from the previous cyclical peak of 6.3% during June 2003. The capacity utilization rate is 80%, up from the previous cyclical low of 74.4% during December 2001 (Figure 1). Commodity prices are up sharply since late 2001, and the price of oil has tripled (Figure 2). The pessimists warned that inflation would be surprisingly high this year. I disagreed, and saw signs of a cyclical peak earlier this year.

So why does inflation remain so low? Why is the personal consumption deflator excluding energy and food up only 1.6% from a year ago? Even with energy and food included, the inflation rate at 2.2% is very low compared to the previous three decades. Why are wages up only 2.7% from a year ago (Figure 3)?

The answer to these questions in a word is Competition. In the United States, industrial deregulation starting in the late 1970s increased competition in many key industries, including airlines, trucking, banking, telecommunications, media, gaming, and utilities. Labor markets became more efficient as companies restructured to become more competitive. In other words, workers lost their job security, but they gained jobs in companies that not only survive, but thrive in the global economy. The end of the Cold War in the late 1980s and China's entry into the World Trade Organization in December 2001, unleashed the forces of globalization. World trade has become freer. National markets have become more open, more integrated, and more competitive.

Faced with so many competitors around the world, company managers lost their pricing power. They had no choice but to increase productivity. The information technology revolution provided the tools they needed to do so. Technology has become increasingly commoditized thanks to competitive pressures within the industry to provide more and more powerful hardware, software, and services at lower and lower prices. In other words, IT deflation has powered productivity, which has been the main reason why inflation remains so low. Productivity has been growing at a compounded rate of 3% since the mid-1990s (Figure 4).

Does cheap foreign labor explain why wage inflation remains so low in the US? Yes, but probably more indirectly and more positively than widely understood. Cheap imports from low-wage countries like China have helped to keep a lid on consumer goods inflation, which boosts the real purchasing power of consumer incomes. In other words, our workers' pay demands are subdued not only because they may fear losing their jobs to foreign workers, but also because imports are dampening the increase in their cost of living.

III. The Consumer Conundrum

Productivity solves the inflation conundrum. It also solves the consumer conundrum. Rapidly growing productivity is the main reason why real pay per worker is growing roughly three times faster over the past 10 years than from the early 1970s through the mid-1990s. Over that previous long time span, employment usually rose faster than real pay per worker during economic expansions. That's because the labor market was flooded with relatively young and inexperienced new entrants, including both baby boomers and females of dual-income households. The good news is that they mostly found employment. The bad news is that real pay per worker was depressed along with productivity. Over the past 10 years, real pay per worker has been growing as fast as or faster than employment (Figure 5).

In an odd way, productivity may partly explain why crude oil prices have soared so much higher than widely expected and why high energy prices aren't depressing consumer spending on other goods and services. In the US, consumers have never been more prosperous because fast-growing productivity has boosted real pay per worker, which is probably the best way to measure the standard of living. In other words, prosperity is driving up the cost of gasoline because we want to, and can afford to drive more to places that prosperous people go, including shopping malls, restaurants, hotels, and theme parks.

In nominal terms, total personal consumption of energy goods and services has been rising more rapidly than disposable personal income. These expenditures were 5.3% of their disposable incomes in May, up from a low of 3.8% in January 2002. However, the percentage is no higher than it was just before the 1973 energy crisis (Figure 6). In other words, for most consumers, energy was extremely cheap a few years ago. Now it is less so, but affordable nonetheless.

IV. The Profits Conundrum

You guessed it: Productivity solves the profits conundrum too. Despite the soaring costs of materials and energy, the first quarter's after-tax corporate profits (as reported to the Internal Revenue Service) rose to a record high of $964 billion, at an annual rate. That's up 37% from a year ago. Of course, some of this impressive gain was attributable to a big drop in allowable depreciation expenses during the first quarter after the 2002-2003 tax incentives expired. Nevertheless, in the National Income & Product Accounts (NIPA), so-called after-tax corporate profits from current production—which are adjusted to eliminate inventory valuation profits and are based on economic rather than tax depreciation—also rose to a record high of $985 billion, up 8.3% from a year ago (Figure 7).

Figure A: Consensus Expected Earnings Growth, 2004/2003, 2005/2004, And 2006/2005*

Sector/Industry Group	2004A	2005E	2006E	Sector/Industry Group	2004A	2005E	2006E
Oil & Gas Storage & Transportation	-/-	-/+	19	Movies & Entertainment	40	13	16
Advertising	4	473	18	Multi-Line Insurance	39	13	12
Oil & Gas Drilling	33	170	68	**Utilities**	1	13	10
Tires & Rubber	-/+	123	30	Automotive Retail	14	12	11
Insurance Brokers	-58	78	19	Trading Companies & Distributors	23	12	14
Diversified Metals & Mining	378	64	-30	Distillers & Vintners	12	12	12
Internet Software & Services	97	58	27	Diversified Banks	9	12	8
Electronic Manufacturing Services	349	55	29	Integrated Oil & Gas	57	12	-5
Independent Power & Energy Traders	-2	49	19	Household Products	10	12	10
Oil & Gas Equipment & Services	46	47	18	**S&P 500**	20	12	10
Human Resource/ Employment Services	269	45	21	Data Processing & Outsourced	6	12	14
Diversified Chemicals	64	44	19	**Financials**	9	11	9
Property & Casualty Insurance	17	39	2	Food Retail	-14	11	9
Fertilizer & Agricultural Chemicals	18	36	19	Electric Utilities	2	10	8
Education Services	44	31	24	Hypermarkets & Super Centers	19	10	14
Construction & Farm Machinery	109	31	13	Office Electronics	50	10	16
Internet Retail	61	30	27	Leisure Products	8	10	13
Oil & Gas Exploration & Production	32	29	-4	Asset Management & Custody Banks	14	9	13
Commercial Printing	31	29	12	Building Products	30	9	14
Health Care Facilities	-22	26	19	**Consumer Staples**	9	9	10
Application Software	69	26	18	Computer & Electronics Retail	26	9	15
Materials	88	26	8	Investment Banking & Brokerage	23	9	8
Homebuilding	38	25	10	Household Appliances	5	9	10
Railroads	13	25	19	Housewares & Specialities	11	9	9
Aluminum	42	25	20	Tobacco	4	9	8
Computer Storage & Peripherals	55	24	19	Food Distributors	16	9	14
Steel	-/+	24	-26	Paper Packaging	55	9	13
Hotels, Resorts & Cruise Lines	42	23	19	Consumer Finance	21	9	12
Electrical Components & Equipment	19	22	13	Apparel Retail	15	8	14
Biotechnology	20	21	17	Distributors	11	8	8
Agricultural Products	71	21	-2	Oil & Gas Refining & Marketing	154	8	-4
Drug Retail	11	21	15	Systems Software	24	7	11
Semiconductors	89	21	14	Environmental & Facilities Services	11	7	15
General Merchandise Stores	2	21	16	Motorcycle Manufacturers	20	7	11
Communications Equipment	167	20	18	Soft Drinks	8	6	10
Energy	54	20	-2	**Health Care**	12	6	11
Department Stores	33	20	17	Restaurants	28	5	12
Managed Health Care	31	19	16	Regional Banks	5	5	9
Broadcasting & Cable TV	178	19	42	Integrated Telecommunication	-11	5	7
Health Care Supplies	20	19	14	Packaged Foods	5	5	8
Industrial Machinery	39	19	14	Publishing	10	4	10
Construction Materials	18	18	9	**Telecommunications Services**	-8	4	8
Aerospace & Defense	31	18	15	Casinos & Gaming	19	4	14
Construction & Engineering	-4	18	25	Office Services & Supplies	8	3	8
Industrials	20	18	16	Diversified Financial Services	8	2	12
Health Care Services	22	18	16	**Consumer Discretionary**	28	2	19
Air Freight & Logistics	23	18	10	Multi-Utilities	3	1	6
Computer Hardware	16	18	15	Airlines	neg	-/-	-/-
Industrial Gases	19	18	14	Metal & Glass Containers	13	0	16
Apparel, Accessories, Luxury Goods	19	17	13	Pharmaceuticals	8	0	8
Specialty Chemicals	23	17	11	Brewers	8	-1	8
Home Improvement Retail	19	16	14	Wireless Telecommunication	30	-4	18
Personal Products	25	16	10	Home Entertainment Software	-7	-4	19
Specialized Finance	26	16	11	Electronic Equipment Manufacturers	1978	-5	31
Life & Health Insurance	19	16	12	Photographic Products	13	-7	12
Health Care Equipment	23	16	14	Gas Utilities	-1	-8	7
Information Technology	48	15	15	Health Care Distributors & Services	7	-9	19
Specialized Consumer Services	-4	14	14	Gold	21	-10	20
Industrial Conglomerates	7	14	14	Diversified Commercial & Professional	22	-14	17
Home Furnishings Retail	26	14	15	Real Estate Investment Trusts	-12	-17	10
Home Furnishings	38	14	14	Forest Products	159	-19	-9
Specialty Stores	16	14	16	Semiconductor Equipment	627	-23	33
Paper Products	130	14	19	IT Consulting & Services	-85	-66	633
Thrifts & Mortgage Finance	-13	13	6	Automobile Manufacturers	43	-73	74
Footwear	27	13	10	Auto Parts & Equipment	5	-154	-/+

-/+ = Industry expected to return to profitability, -/- = industry expected to report a smaller loss,
neg = industry expected to report a larger loss.
Source: Thomson Financial.
* As of July 14, 2005

Figure A shows the actual 2004 and the consensus expected 2005 growth rates of earnings for the 110 industries we track in the S&P 500. Earnings for the composite are expected to increase 12% this year. There are 68 industries that are expected to show faster growth than the S&P 500, with 64 of them not in the Energy sector.

Rapid growth in productivity is keeping a lid on unit labor costs, thus boosting unit profits. Over the past four quarters through the first quarter of 2005, nonfinancial corporations' unit profits rose 10.9% (Figure 8).

V. The Dollar Conundrum

The world has been on a *de facto* Dollar Standard since the early 1970s. Because the US economy is by far the largest in the world, and since so many of the commodities, goods, and services that are traded among countries are priced in dollars, our currency accounts for a major portion of the global money supply. The growing world economy needs an increasing supply of money, and therefore dollars. Probably the best available proxy for the global money supply is non-gold international reserves held by foreign central banks. These rose to a record high of $4.0 trillion during April, with foreign official dollar reserves (FRODOR) also rising to a record high of $1.4 trillion (Figures 9 and 10).

On August 15, 1971, President Richard M. Nixon announced that the United States would no longer redeem currency for gold. This ended the Gold Standard and the Bretton Woods system, which had been in effect since 1946. Under this system, named after the New Hampshire town in which it was devised following the end of World War II, most countries settled their international balances in US dollars. The US government promised to redeem other central banks' holdings of dollars for gold at a fixed rate of $35 per ounce.

However, persistent US balance-of-payments deficits steadily reduced US gold reserves. By the summer of 1971, other countries held three times more dollars than the United States. Confidence in the ability of the United States to redeem its currency in gold fell sharply, forcing the Nixon administration to abandon the gold standard. Paul Volcker, who was undersecretary of the US Treasury at the time, was the architect of the bold move. Subsequently, the price of gold soared, hitting a record high of $850 an ounce during January 1980.

VI. The Twin Deficits Conundrum

The Dollar Standard has been very advantageous for the United States. Since the dollar is the key international reserve currency, any difference between the US trade deficit and net private capital inflows will be completely financed by foreign central banks'

purchases of US Government securities. Because the overall balance of payments always balances, the role of the dollar in international finance virtually guarantees that foreign central banks provide some and maybe much of the financing of the Twin Deficits (Figures 11 and 12).

While I share some of the widespread concerns about our widening trade deficit, I think it is important to see the positive impact it is having on the global economy. Americans are importing a record $1.5 trillion of merchandise. Cheaper imports are boosting the purchasing power and therefore the standard of living of American consumers. Foreigners are enjoying a great deal of prosperity by selling so many goods to Americans.

Prosperity solves lots of problems. Here, in the United States, the Federal budget deficit is narrowing significantly because tax revenues are unexpectedly strong as personal incomes and corporate profits continue to grow rapidly. Wealthier foreigners are investing some of their assets in US securities, thus helping to "finance" the trade deficit. So while the US merchandise trade deficit is at a record $703 billion over the past 12 months, net purchases by private foreigners of US securities is near record highs at $543 billion.

VII. The China Conundrum

The Chinese government is obsessed with what I call the "Growth Imperative." The government fully realizes that failure to expand employment could have serious consequences for the country's social and political stability. To ease the tension, the government has an annual goal of creating 8 million jobs.

To do so, policies must be very stimulative to keep real GDP growing by at least 9% annually, if not more. This is because Chinese economists in the Labor Science Research Institute of the Ministry of Labor and Social Security estimate that every 1% increase in real GDP generates 700,000 to 800,000 jobs. During the 1980s, when productivity was much lower, such an increase might have produced over 2 million jobs.

VIII. The Commodity Markets Conundrum

Commodity prices don't go up forever. They are extremely cyclical. During recessions, they are very depressed. During recoveries, they tend to soar. Once the global economy has recovered and is back on trend growth, increased supplies stimulated by high commodity prices tend to outpace the slowing pace of demand. So commodity prices tend to fall during the expansion phase of the global business cycle.

IX. The Stock Market Conundrum

The stock market has been trading like one big cyclical stock. Better-than-expected earnings are greeted with caution rather than exuberance, mostly because Sarbanes-Oxley has caused managements to curb investors' enthusiasm about future prospects. So the impact of better-than-expected earnings has been dampened by a declining P/E for most sectors and industries of the S&P 500.

In other words, stocks, in general, are acting the way cyclical stocks, in particular, have always behaved: The P/Es are highest when investors believe that earnings have troughed and the P/Es are lowest when they believe that earnings have peaked. In fact, this may be the most pervasive explanation for why the overall market's P/E has been weak. Investors are putting more weight on the cyclicality of earnings rather than their potential growth rate. So as S&P 500 earnings have soared to new highs, investors have been lowering the valuation they are willing to pay for these "peak earnings," which continue to move higher.

Indeed, P/E compression has been widespread (Figure 13). Growth stocks have suffered the most pain because they had the highest valuation multiples. However, I believe that we will start seeing more P/E divergence over the rest of the decade as growth investing makes a comeback.

X. The Bond Market Conundrum

Of all the conundrums, I think the one in the bond market is the least puzzling. It really boils down to explaining why the yield curve has been flattening over the past year as the Fed has been raising the federal funds rate. The simplest and most obvious explanation is that bond investors believe that tighter monetary policy will keep core inflation around 1.5%. Furthermore, the spread between the 10-year Treasury bond yield and the federal funds rate tends to be highly correlated with the growth rate in foreign official dollar reserves (FRODOR), which has slowed significantly this year. FRODOR is my favorite measure of central-bank-provided liquidity.[1]

XI. The Greenspan Conundrum

In our "Fed Watcher," we monitor numerous correlations between the cycles in the federal funds rate and key economic variables.[2] You'll see that most of the variables suggest that the Fed's latest tightening cycle started later than usual. Our models also

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[1] See Figure 4 in the latest issue of our "FRODOR Guide," http://www.yardeni.com/PremiumData/frodorcb.pdf
[2] It is posted at http://www.yardeni.com/PremiumData/fw.pdf

suggest that the Fed should be easing by now, or at least no longer tightening. Then again, the Fed started late and has had to catch up (Figures 14 and 15).

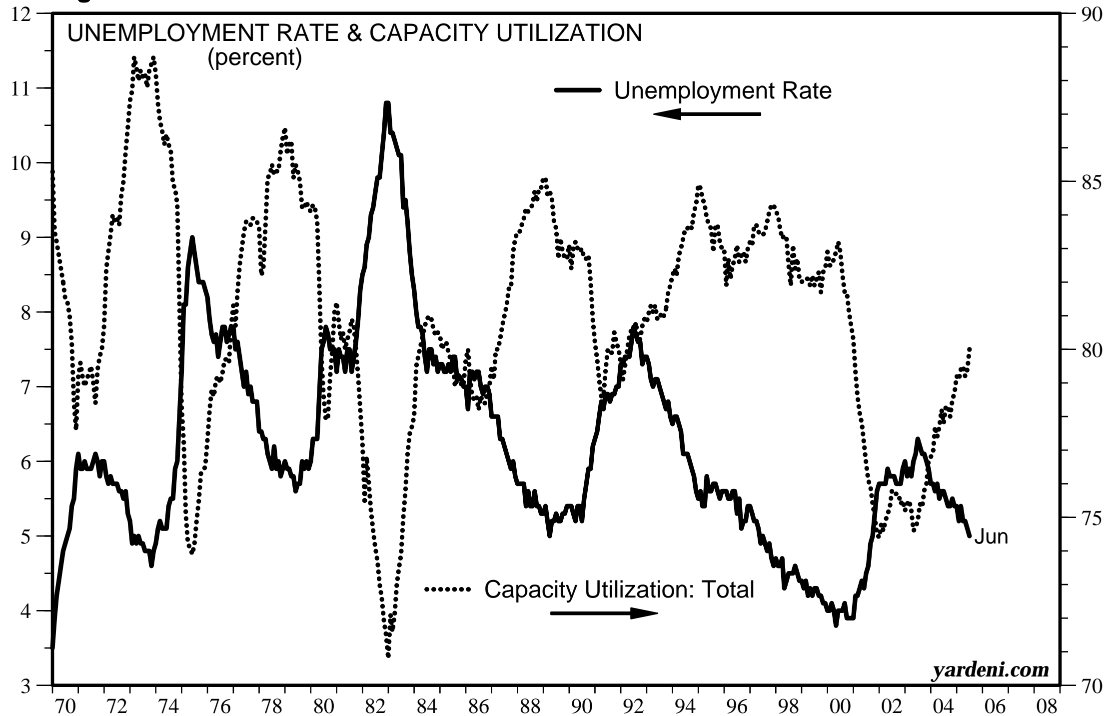
In his latest Congressional testimony, Fed Chairman Alan Greenspan made it quite clear that he intends to proceed with the "measured" tightening campaign even though inflationary pressures have obviously moderated recently.[3] He is aiming to get the real federal funds rate closer to neutral. That probably means that the FOMC will vote to raise the federal funds rate 25 basis points at each of the next three meetings (August 9, September 20, and November 1), putting it at 4% on November 1. Given that core inflation is around 1.5%, these hikes would put the real rate at 2.5%. That should do it. I think Mr. Greenspan would also like to leave his friend and successor, Ben Bernanke (my choice), 400 basis points between the fed funds rate and zero for the next time the Fed will have to ease.

* * *

[3] His latest semiannual monetary policy report to Congress can be found at http://www.federalreserve.gov/boarddocs/hh/2005/july/testimony.htm

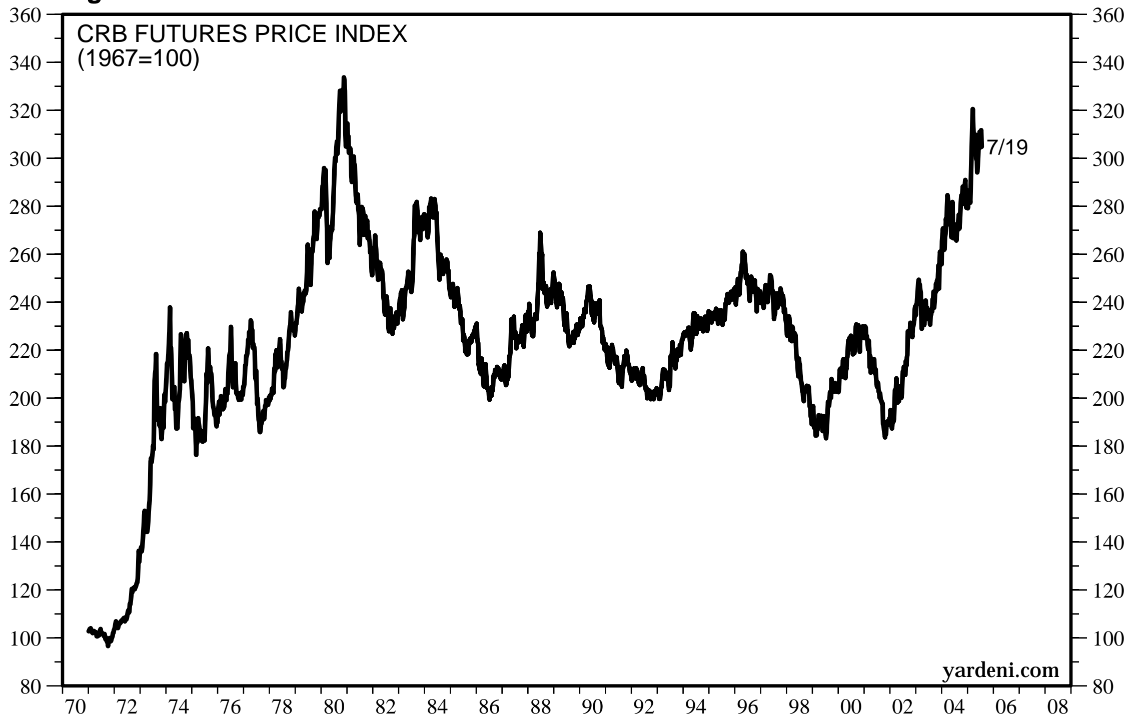
- Resource Utilization -

Capacity utilization rate is highest since December 2000, while unemployment rate is lowest since August 2001.



Source: US Department of Labor, Bureau of Labor Statistics and Board of Governors of the Federal Reserve System.

Commodity prices remain at cyclical highs.

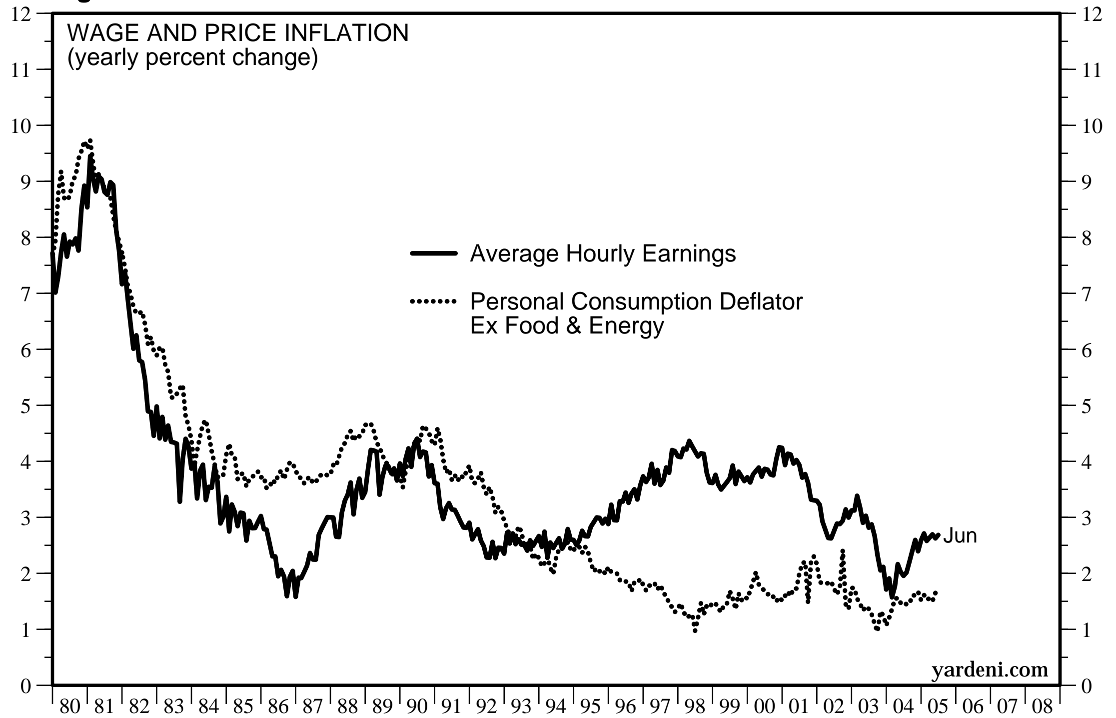


Source: Commodity Research Bureau.

- Inflation -

Both wage and price inflation remain subdued and stable. Since the mid-1990s, wages have been rising faster than prices thanks to faster growth in productivity.

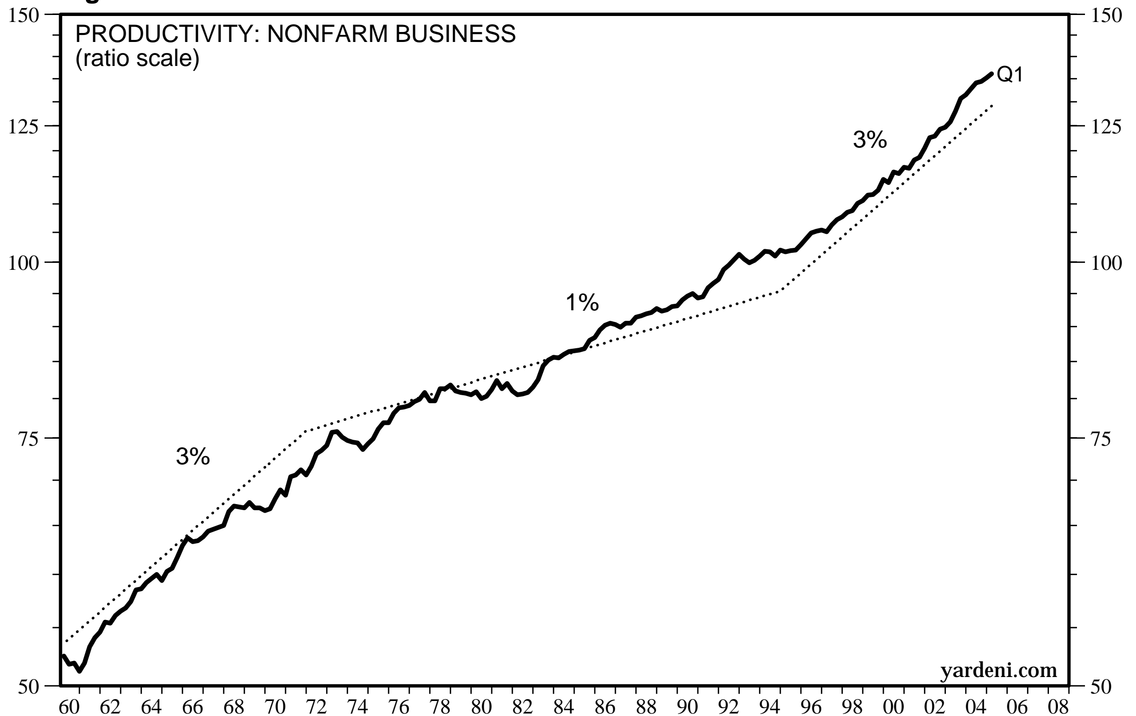
Figure 3.



Source: US Department of Commerce, Bureau of Economic Analysis.

Productivity is at a record high and has been growing at 3% per year, on average, since the mid-1990s.

Figure 4.

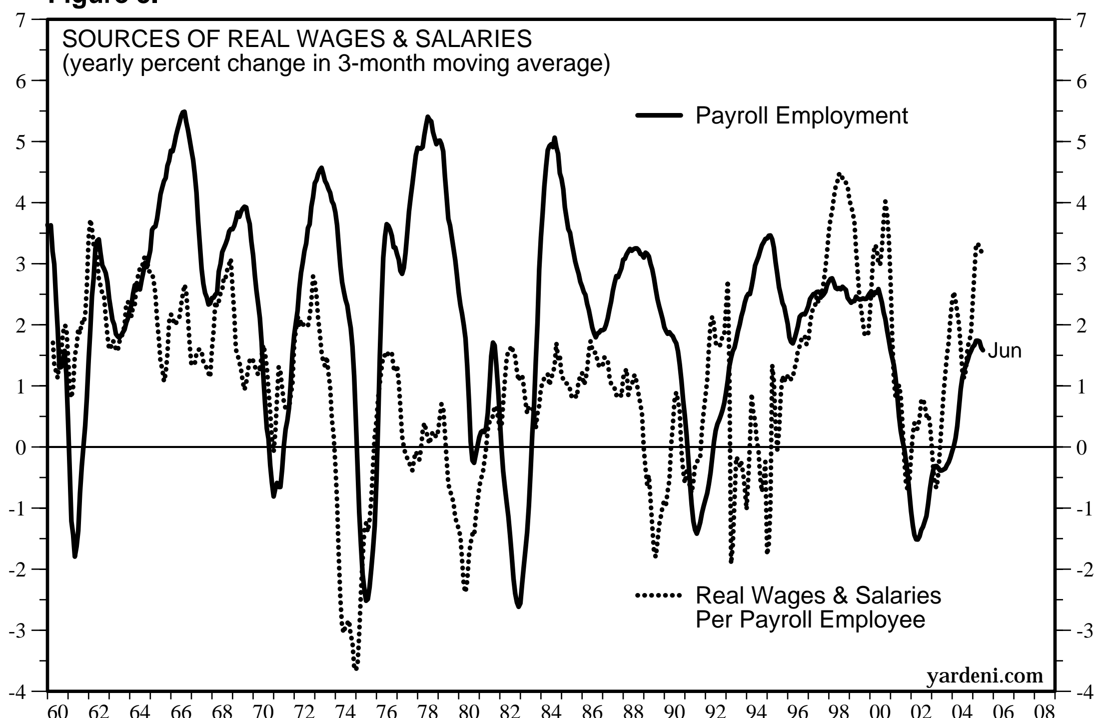


Source: US Department of Labor, Bureau of Labor Statistics

- Purchasing Power -

On a three-month basis, total real pay is up about 5% from a year ago with real pay per worker up about 3.5% and the number of workers up 1.5%.

Figure 5.



Source: US Department of Commerce, Bureau of Economic Analysis, and US Department of Labor, Bureau of Labor Statistics.

Through May, consumer spending on Energy goods and services was only 5.3% of their disposable incomes. That's up from a low of 3.8% in 2002, well below 8%+ in the early 1980s, and about the same as before the first oil shock of 1973.

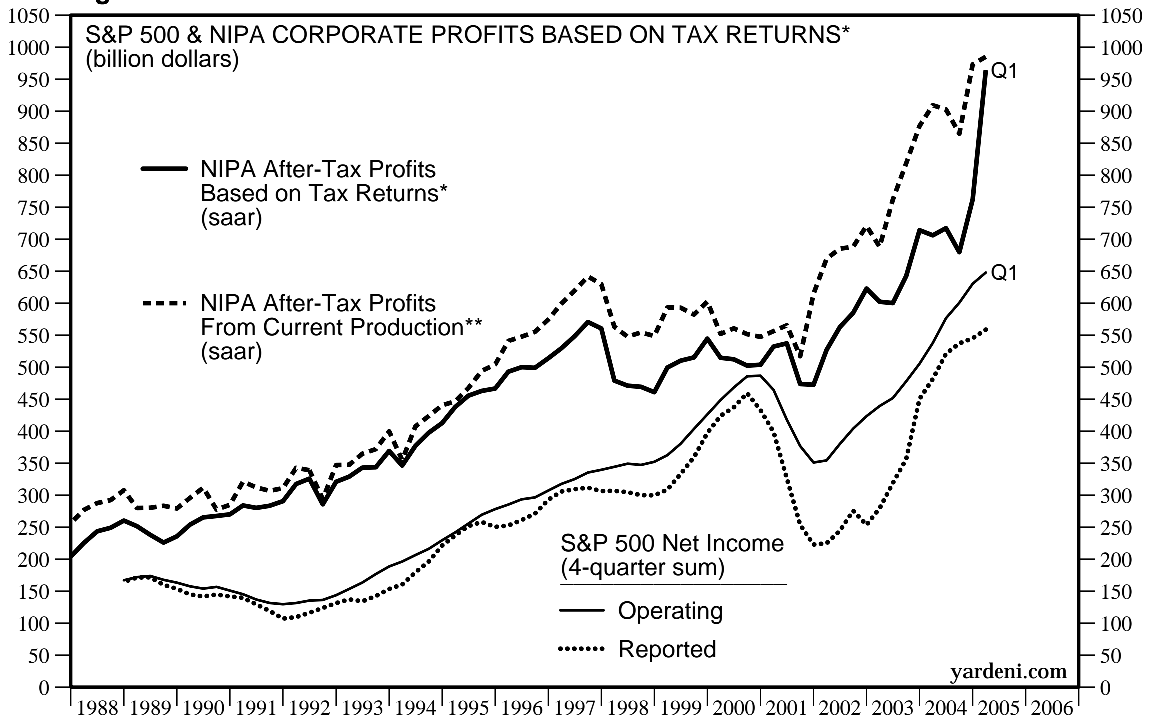
Figure 6.

Source: US Department of Commerce, Bureau of Economic Analysis.

- Profits -

NIPA after-tax profits based on tax returns soared to a new high during Q1 2005 thanks partly to reduced depreciation expenses following the expiration of 2002/2003 tax incentives. This measure of profits excludes write-offs, so it is similar to S&P 500 operating net income rather than to S&P 500 reported net income. Cash flow profits (from current production) rose to record high in Q1 2005 also.

Figure 7.

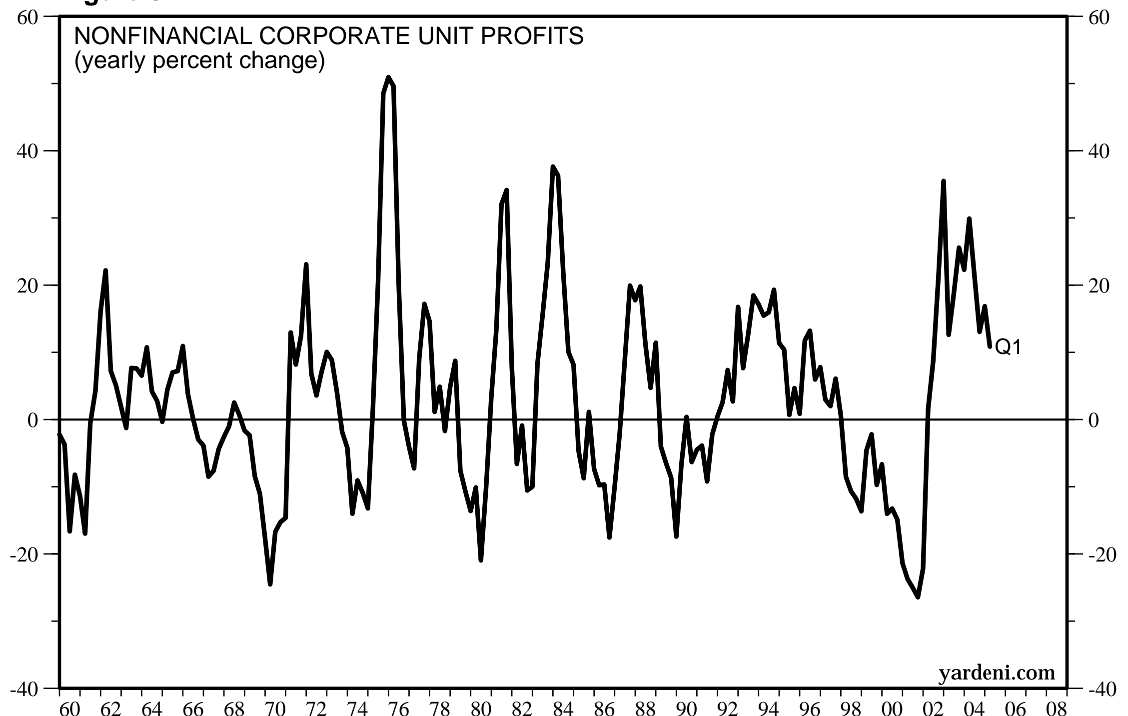


* Excluding IVA & CCadj. ** Including IVA & CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.

Source: US Department of Commerce, Bureau of Economic Analysis, and Standard & Poor's Corporation.

Unit profits still growing at double-digit pace.

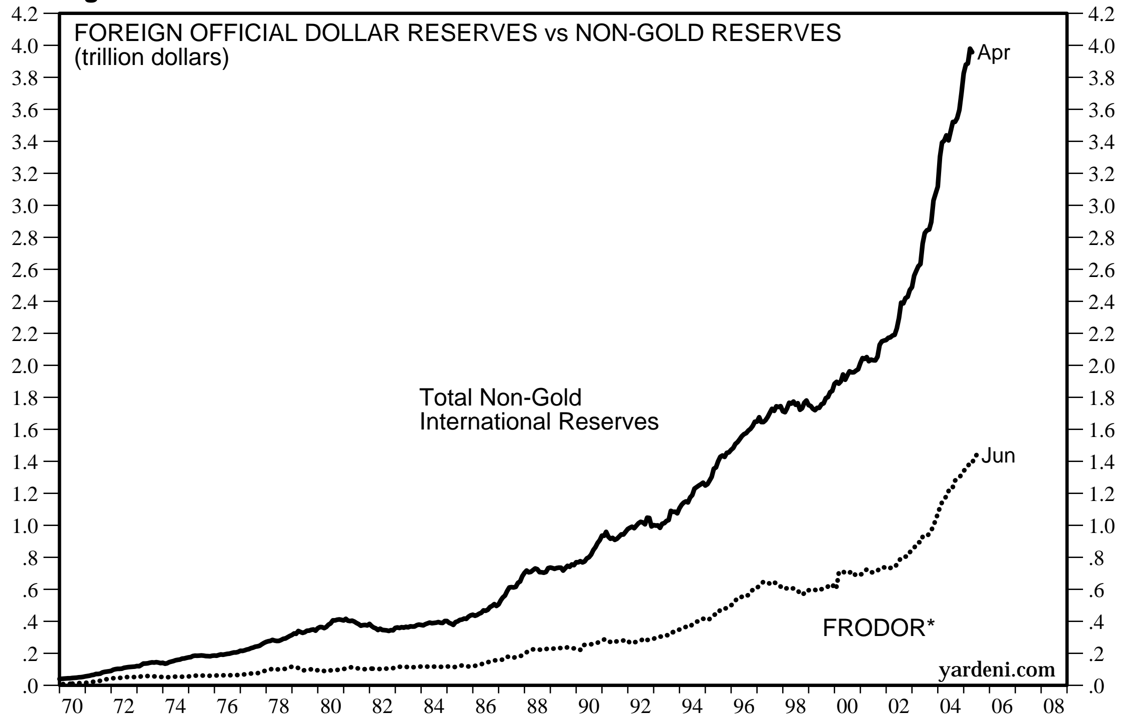
Figure 8.



Source: US Department of Labor, Bureau of Labor Statistics.

- FRODOR -

Figure 9.



* Data from 1952 to 1996 are foreign official assets held at the Fed in US Treasuries. From 1997 to the present, data are marketable US Treasury securities held by the Fed for foreign and international accounts. Data from 2000 onward include Federal agency securities.

Source: IMF International Financial Statistics and Federal Reserve Flow of Funds Table L.107.

Central banks' holdings of dollar reserves has been soaring along with their holdings of non-gold reserves.

Figure 10.

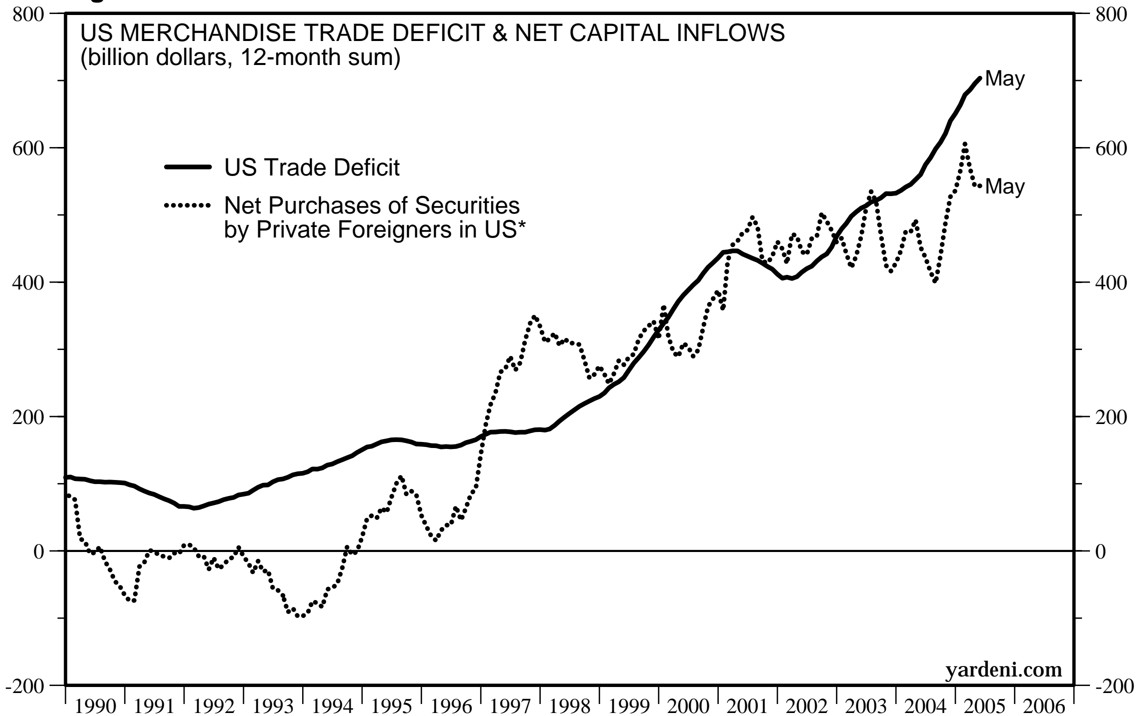
* Data from 1952 to 1996 are foreign official assets held at the Fed in US Treasuries. From 1997 to the present, data are marketable US Treasury securities held by the Fed for foreign and international accounts. Data from 2000 onward include Federal agency securities.

Source: IMF International Financial Statistics and Federal Reserve Flow of Funds Table L.107.

- Twin Deficits -

The trade deficit is huge, but so are net purchases of securities by private foreigners in US.

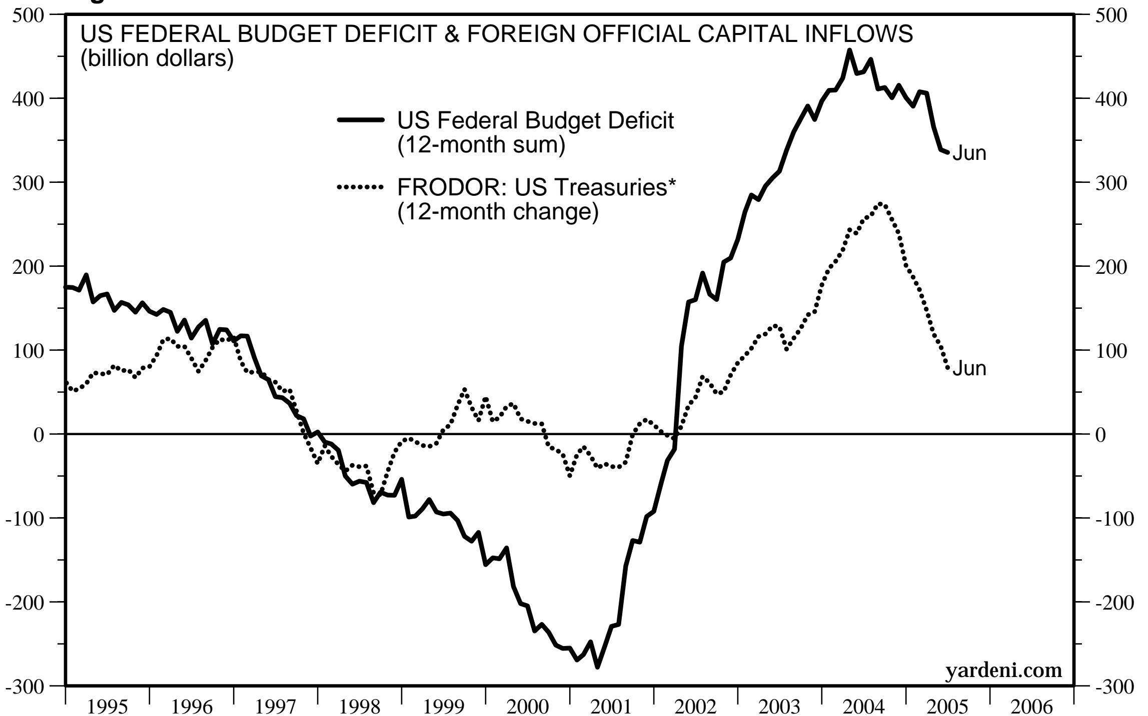
Figure 11.



* Includes Treasury bonds and notes, government agency bonds, US corporate bonds, US corporate stocks, foreign bonds, and foreign stocks.
Source: US Treasury Department, Board of Governors of the Federal Reserve System, and US Department of Commerce, Bureau of Economic Analysis.

Foreign central banks are financing less of the US budget deficit, while foreign private investors are financing more of it. Meanwhile, the deficit may be narrowing.

Figure 12.



* Foreign Official Dollar Reserves held in custody for foreign and international accounts at Federal Reserve.
Source: US Department of the Treasury and Board of Governors of the Federal Reserve System.

- S&P 500 P/Es -

Figure 13.

CONSUMER DISCRETIONARY

······ S&P 500 P/E*

INDUSTRIALS

CONSUMER STAPLES

INFORMATION TECHNOLOGY

ENERGY

MATERIALS

FINANCIALS

TELECOMMUNICATIONS SERVICES

HEALTH CARE

UTILITIES

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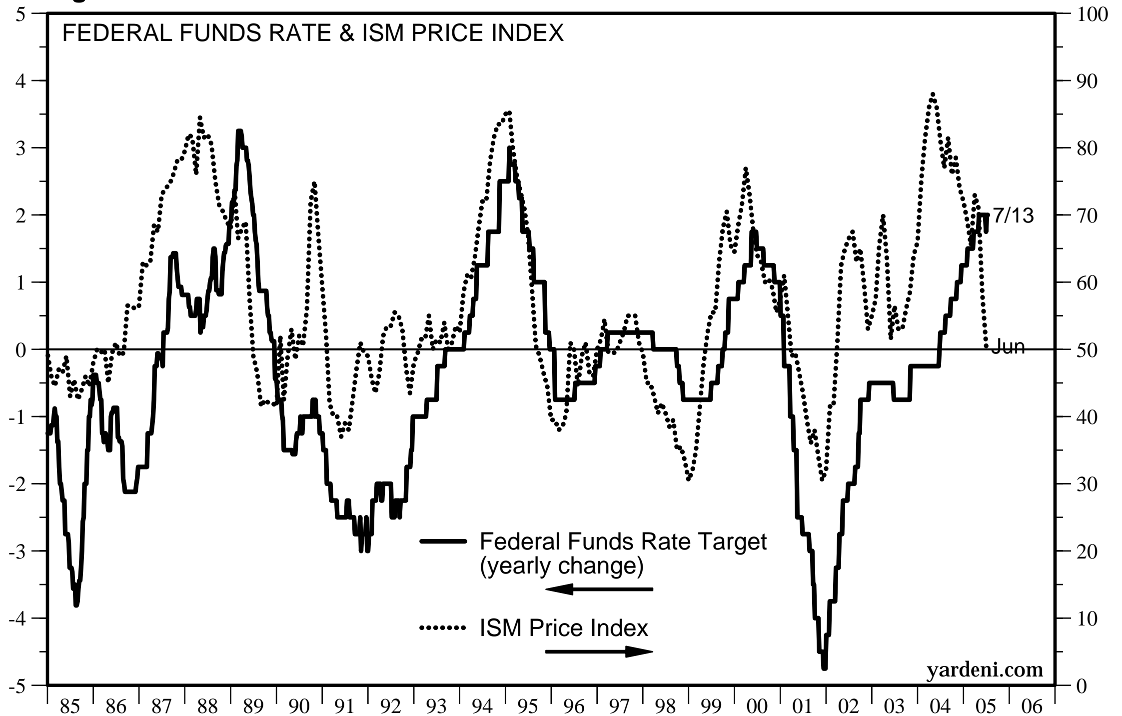
* Price divided by 12-month forward consensus expected earnings per share using mid-month data.
Source: Thomson Financial.

- Federal Funds Rate Models -

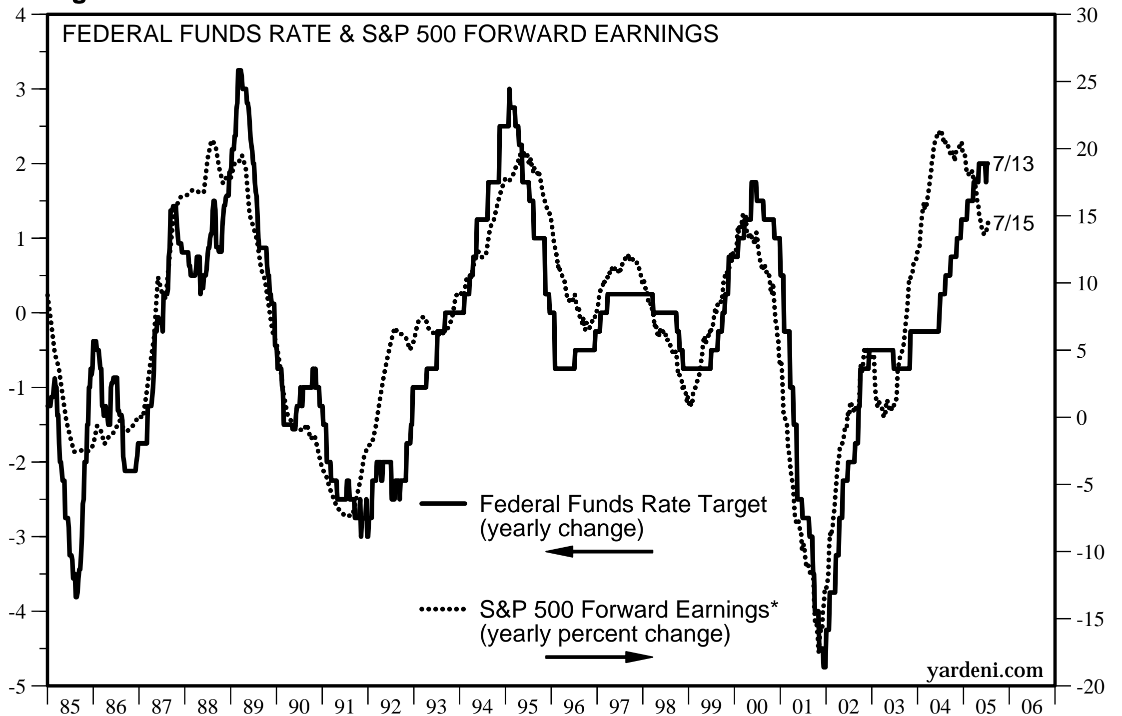
The Fed was slow to tighten during the latest monetary policy cycle. These models suggest that they should stop tightening soon.

Figure 14.



Source: Board of Governors of the Federal Reserve System and Institute for Supply Management.

Figure 15.



* 52-week forward consensus expected operating earnings per share. Monthly through March 1994; weekly thereafter.

Source: Board of Governors of the Federal Reserve System and Thomson Financial.

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