

Monthly Chartbook

June 2004

Table of contents

Executive summary

Macro-economic review

Inflation expectations

Federal Reserve watch

Outlook and forecast

Executive Summary

The economic indicators are no longer signaling rapid growth, but slower growth is appropriate at this point in the cyclical recovery.

Employment and company earnings will hopefully be the factors that drive the economy higher from here, and both appear poised to do so.

This is partially as a result of recent low interest rates and growing money supply which have both provided the opportunity for growth in the above conditions.

The rise in rates and lower money supply growth signal slower growth rates going forward but also likely improving conditions for employment and earnings.

Macro-economic Research

Given the recent tributes to President Reagan and the impact the current state of the economy will have on the upcoming election, we thought it would be appropriate to review the numbers behind the policies during each administration.

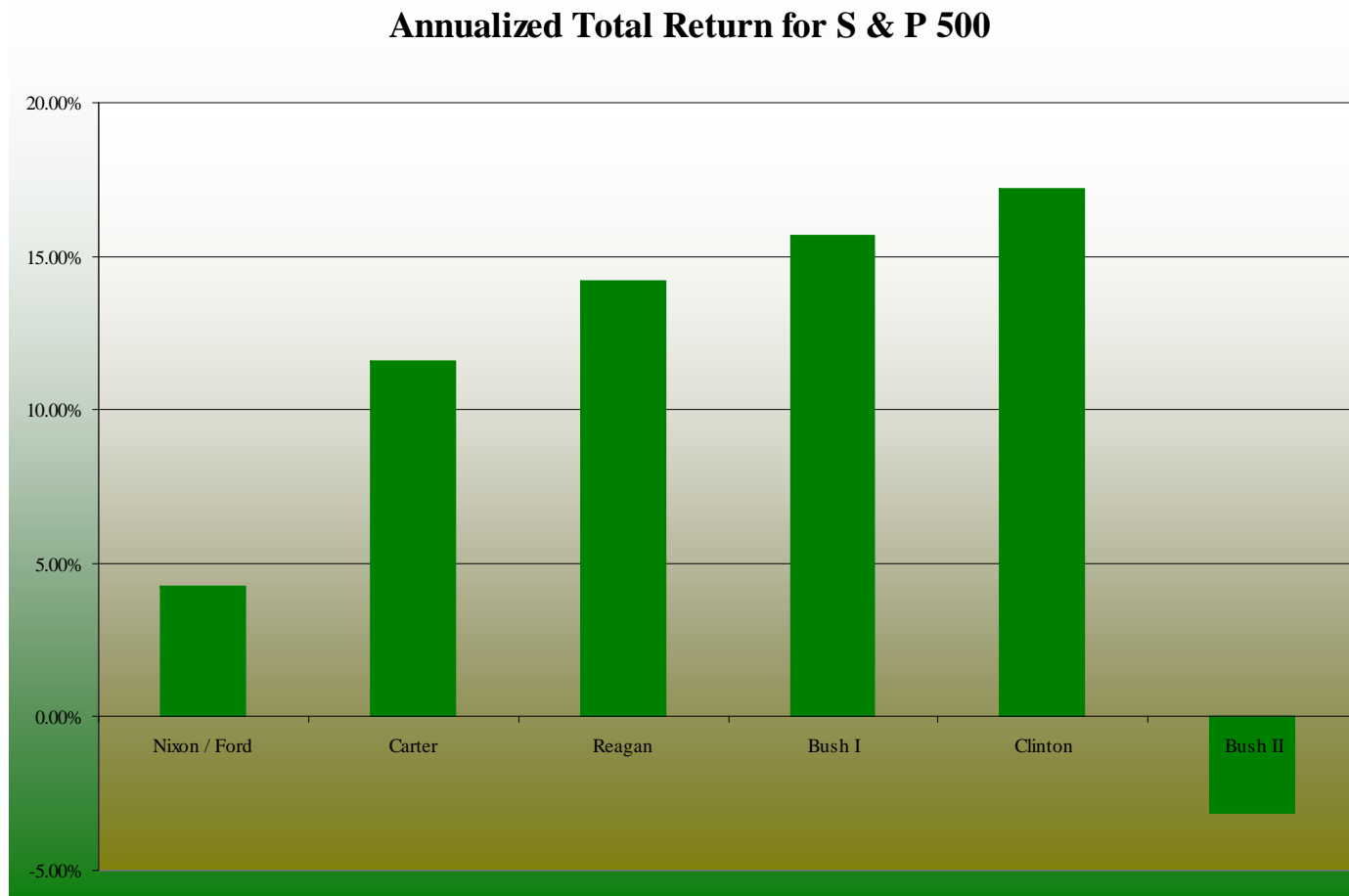
Terms are assumed to run from the beginning of the January of the President's inauguration until the end of December prior to his successor taking office.

It is important to note that the effect of a policy change can and will have an impact beyond the defined tenure of a President, and this study does not attempt to measure the changes leading up to a change in administration.

As an effort towards full disclosure, the principals at Cornerstone are oriented towards a responsible application of supply-side economics believing that consumers and the marketplace make the best the allocation of funds among competing goods and services.

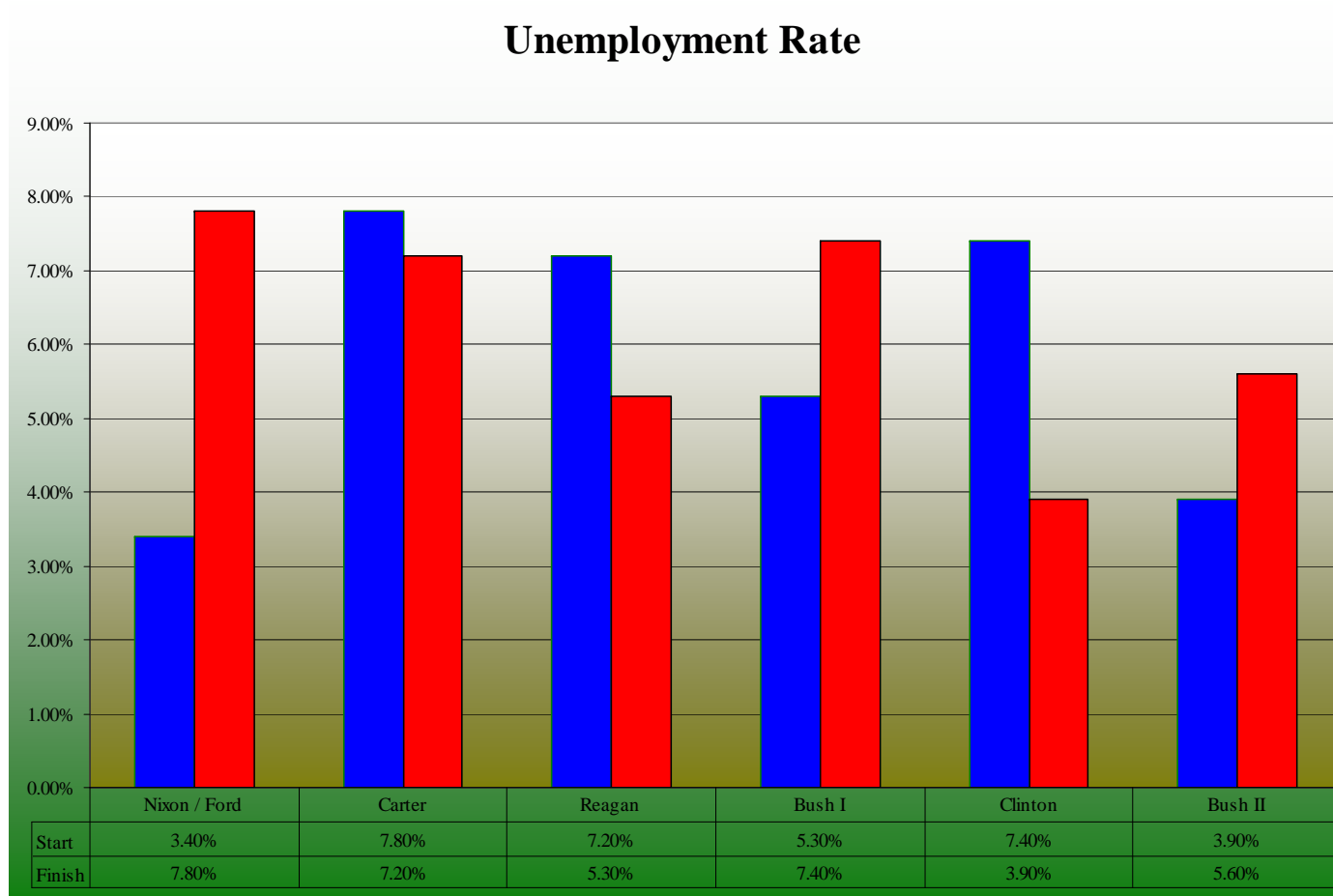
That said, here goes...

Macro-economic Research



The challenge in the interpretation of this chart is that the decisions made by investors in the months prior to the administration change can have significant impact on these results.
For example, the market bubble was pricked at the beginning of Bush II's term and has been difficult for him to overcome in 3 + years in office.

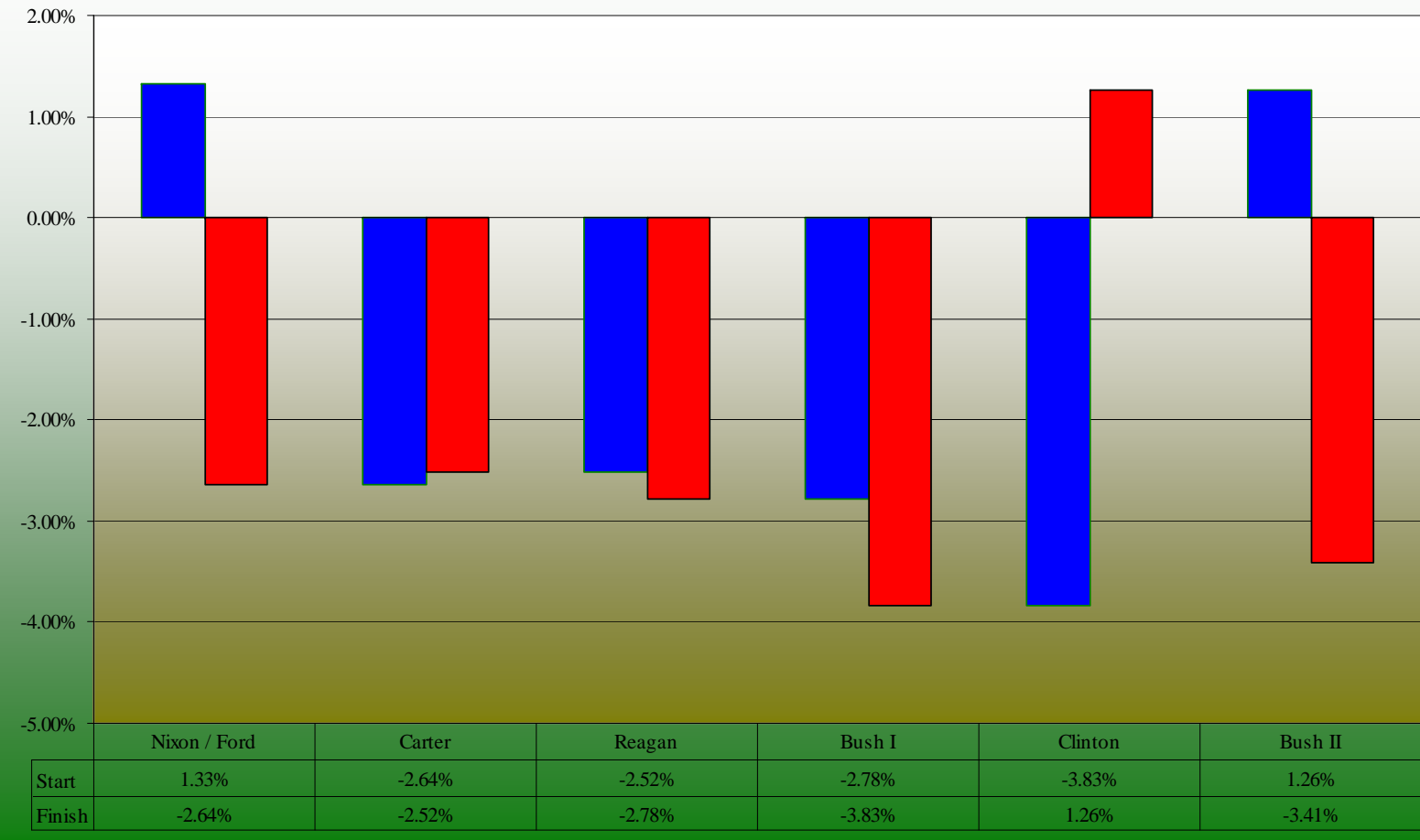
Macro-economic Research



The highest percent gain in unemployment occurred during the Nixon / Ford administration (129%), and the largest percent decrease happened while Clinton was President (-47%).
 Although Carter experienced a decrease while in office, the overall level was still too high for the American public.

Macro-economic Research

Deficit to Gross Domestic Product



Macro-economic Research

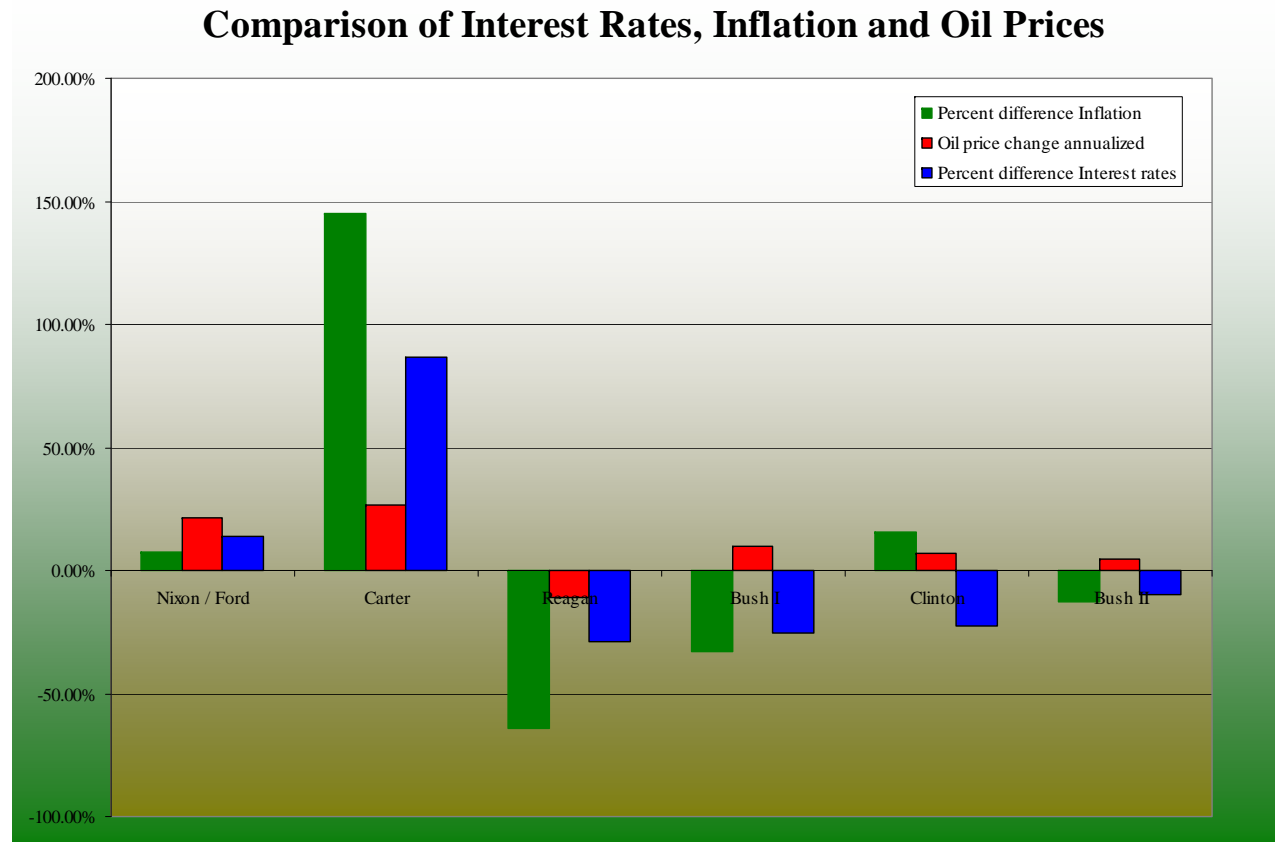
The government deficit cannot be viewed as an absolute number; it should be considered with respect to the country's Gross Domestic Product to assess the potential impact to the economy.

At the same time, the economic circumstances then prevailing should also be factored into any analysis:

- specifically, if an economy is in a recession, it may be appropriate for the government to “spend its way out” of lower growth rates in anticipation of higher tax revenue in coming years when the economy is on more solid footing
- in the same way, tax cuts should provide additional funds for consumer spending (in turn, creating more jobs); but the near-term result is deficit spending
- finally, there may be some unique situations for a specific time period; as an example, much of Bush I's deficit was related to the spending necessary to correct the savings and loan problems of the early 1990's

The most important discovery here is that the deficit when Reagan assumed office was only slightly lower than when he left office. During the middle of his term, this ratio was substantially higher than at the end (or any time since then). If deficit / GDP reaches its lowest point shortly after tax cuts, does this bode well for Bush if he were to win a second term?

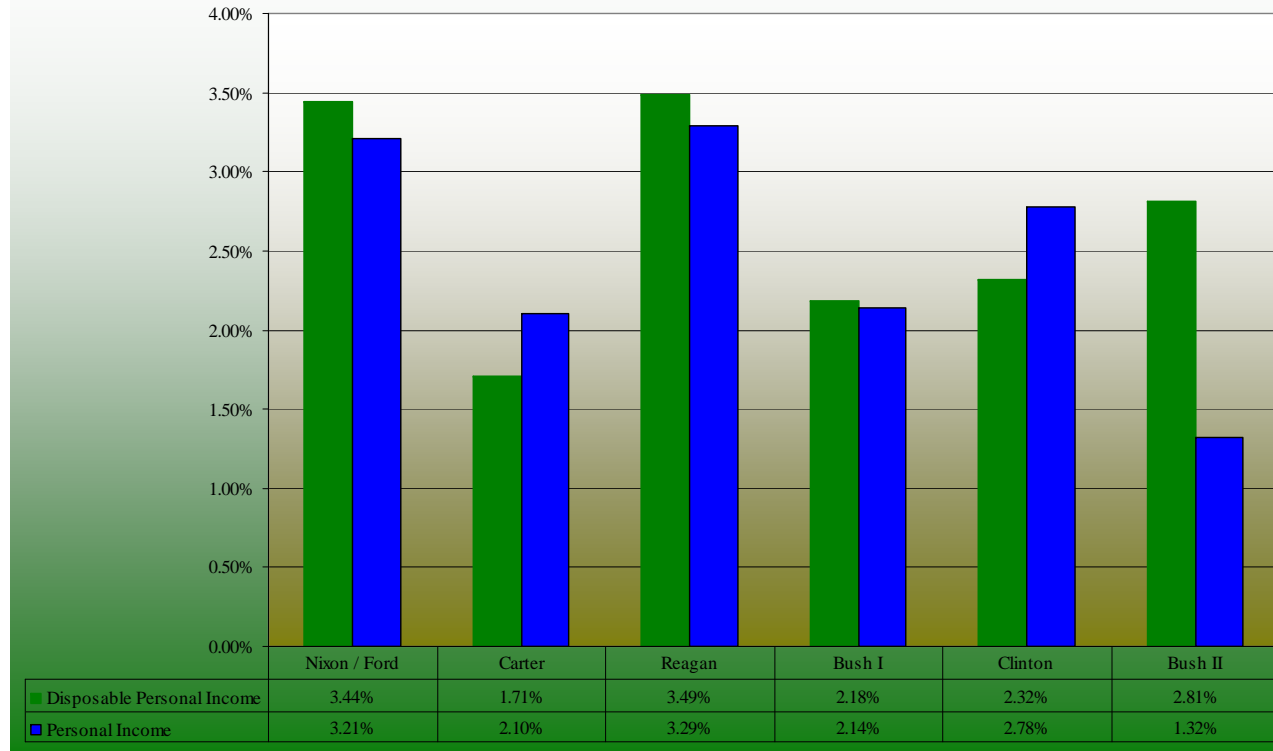
Macro-economic Research



The price of each of these factors affects the consumer's ability to spend money and their perceptions of spending ability going forward. The highest increase in inflation was 145% (from 5.04% yr/ yr to 12.35%) over Carter's term, much of which was reversed under Reagan (-64%). The interest rate used is the 10 year Treasury, which approximates changes in the 30 year mortgage (after adding 168 basis points).

Macro-economic Research

Change in Personal Income (Adjusted for Inflation)



This could be the most important indicator of on-going economic prosperity – increases in the consumer’s ability to spend. Also, note the difference between Personal Income and Disposable Personal Income (after taxes have been taken), especially in the case of Bush II.

Macro-economic Research

Inflation was absolutely what did Carter in, and interest rates rose accordingly. This was partially due to increases in oil prices (which rose almost 27% annually during his term).

Reagan and Bush I were in office during the taming of inflation, which resulted in lower interest rates that brought mortgage rates down as well.

Clinton and Reagan both saw fantastic job creation during their presidencies--14.5% and 15.3% of the beginning of term labor force, respectively (18.6 million jobs and 16.5 million jobs).

Disposable personal income is a critical measure because its growth signals potential increases in either savings or consumption...

- this holds favorably for Bush II (2.8%), while his father had a much lower rate of growth (2.18%).

- Clinton and Reagan presided over the periods with the most prosperity, but the disposable income growth under Reagan was about 50% higher than during Clinton's term.

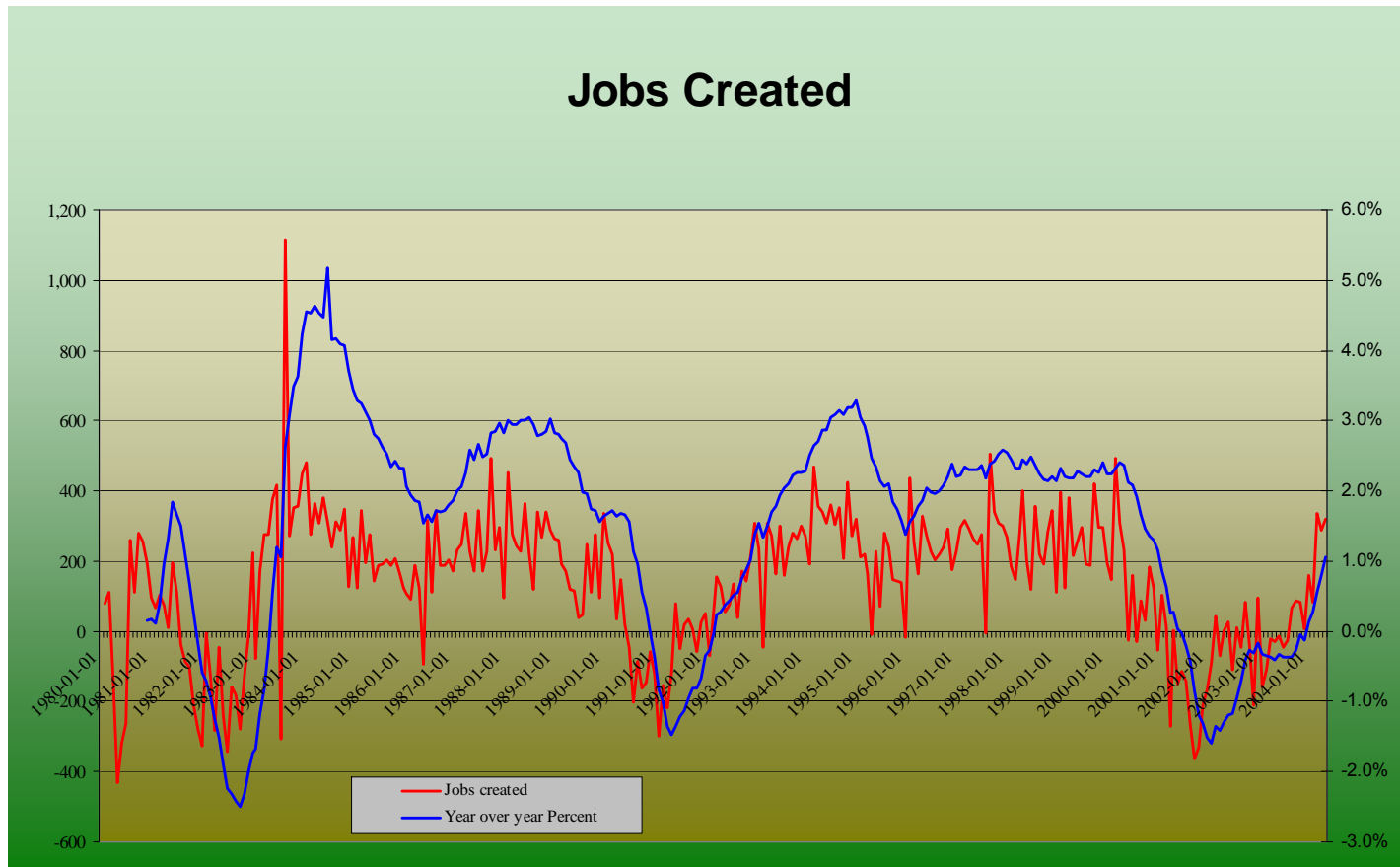
Macro-economic Research – Current employment

Employment remains critical to move the market from its present trading range, and all indications are positive.

- Strong job creation – almost 1 million new jobs in the past three months (something that was unthinkable at the beginning of the year).
- The “help wanted” index has increased dramatically in recent periods.
- Employment pressure is increasing (meaning pressure is gradually shifting from employees to employers).

However, employment pressure lags the weekly leading indicators, which have recently peaked. Does this indicate a slow move towards more pressure on employers that will recede shortly?

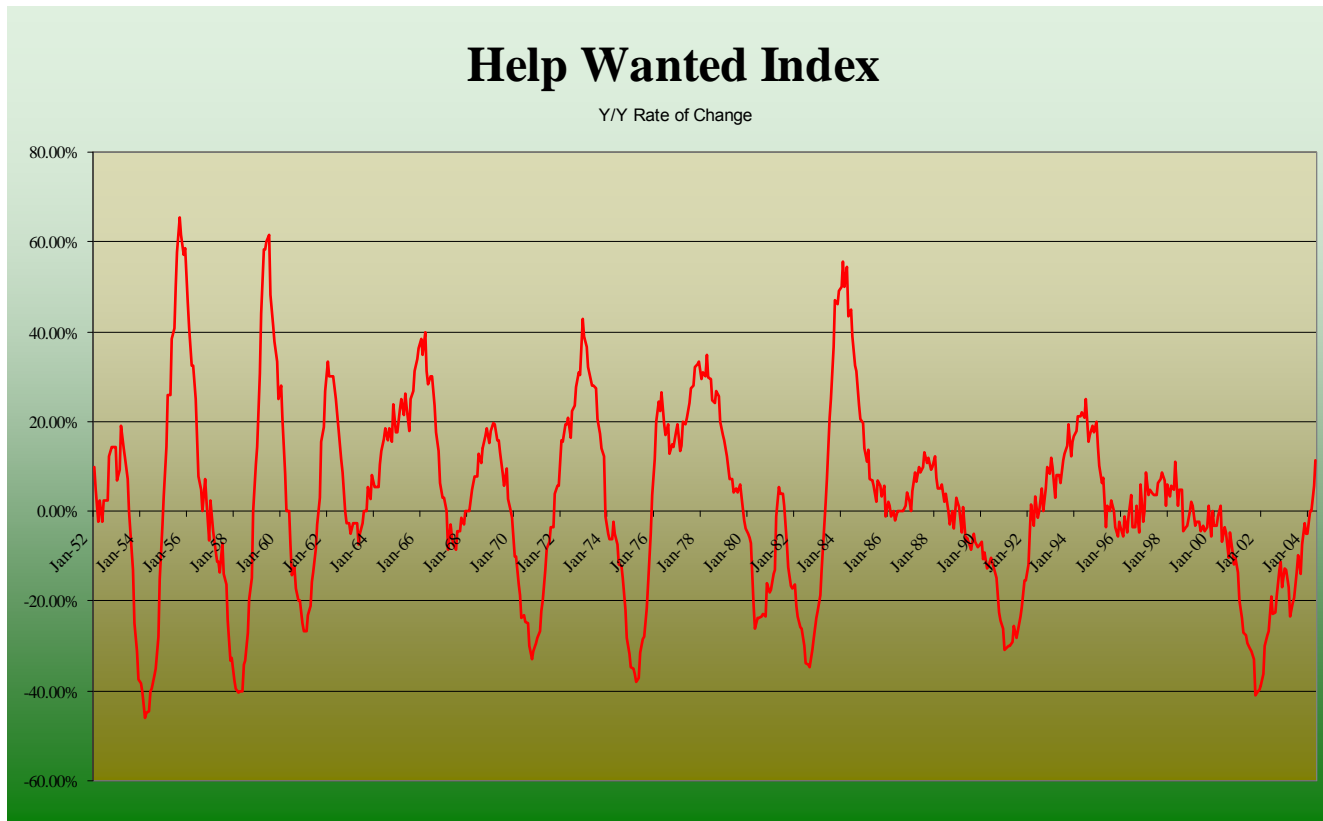
Macro-economic Research



The past three months have shown strong job creation, with an average of over 300,000 new jobs each month (almost 1.2 million since the beginning of the year).

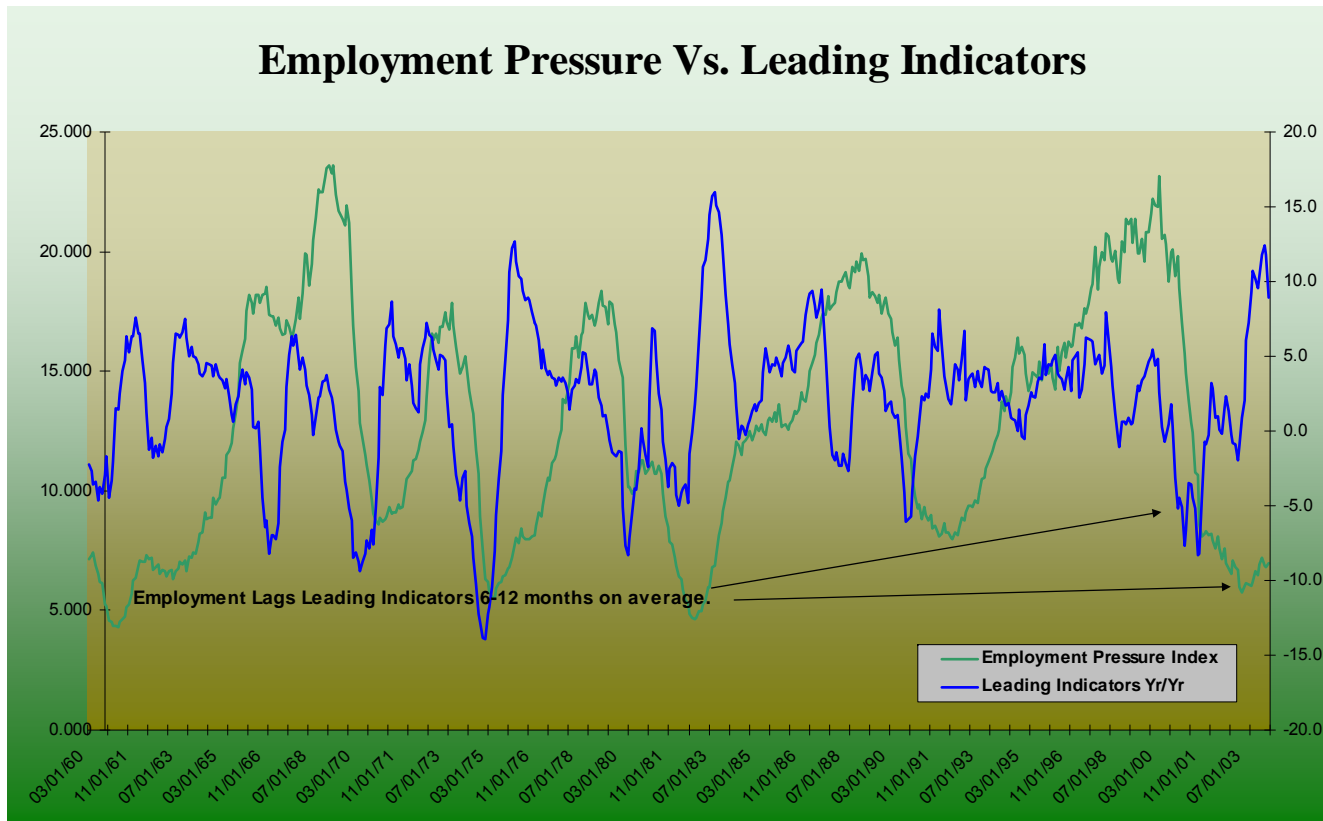
The percent of jobs created year over year is now above 1% for the first time since January of 2001.

Macro-economic Research



The rate of change in the help wanted index has moved much higher (and well off its lowest level).
Anecdotally, based on signs advertising openings at places of business, this indicator should continue to get better.

Macro-economic Research



The employment pressure index (left scale) is slightly higher, which means more pressure is slowly shifting from employees to employers.

But, this trough has been the longest over the measurement period, and the leading indicators have peaked. Does this mean employment growth may be curtailed?

Macro-economic Research

Keys to increased stock market valuation:

Company earnings

– higher company earnings lower the market Price Earnings ratio; unless there is multiple contraction for the overall index, stock prices should consequently rise.

Employment

– an increase in employment will result in higher personal income, which is the primary force behind consumer spending.

Inflation

– a previous study in the Chartbook indicated the market PE doesn't contract significantly when inflation remains below 5%; it is uncertainty that the market does not like.

Capital Markets Expectations

Index	Current	Forecast		Range	Time Frame
S&P 500	1140.84	Trading range	↑	1075-1250	End of 2004
Ten Year Treasury	4.58%	4.65%	↔	4.35%-4.875%	9 months
Inflation (all Urban)	3.00%	2.75%	↔	2.25%-2.75%	12 months
Fed Funds	1.25%	1.25%-1.50%	↑	1.25%-1.75%	3 months
S&P 500 Earnings	\$51.85	\$56.00	↑	\$53-58	3q2004
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

Inflation expectations

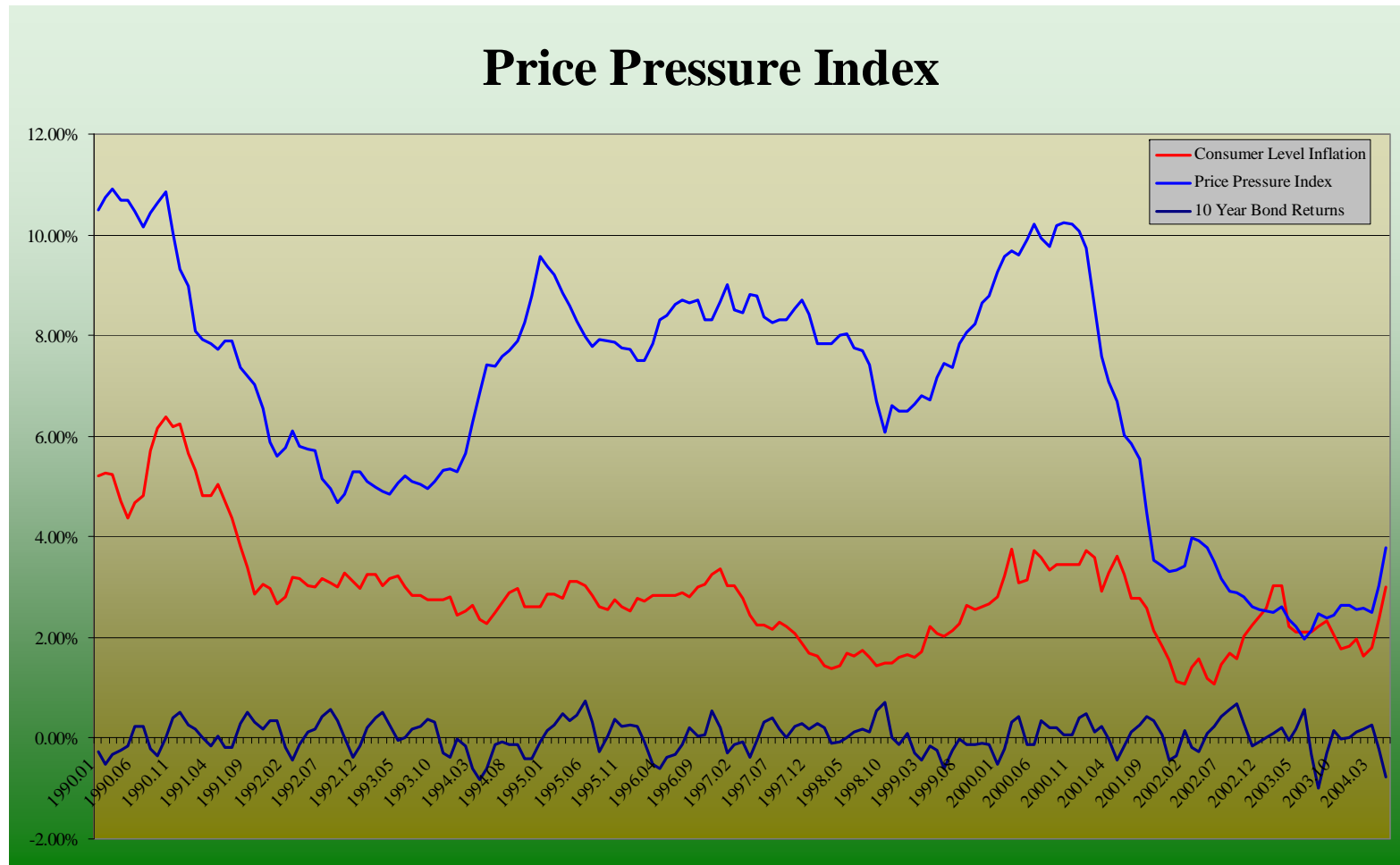
Price pressure moved significantly higher last month signaling an increase in consumer prices.

- CPI shot up to 3% year over year partially as a result of higher energy costs.
- Inflation excluding food and energy is up 1.7% on a year over year basis. Although we all have to eat and drive, the rate of change using this metric is more stable due to the volatile costs of both food and energy.

CPI experienced a sharp move up above the 3 year moving average as price increases have worked their way through the supply chain.

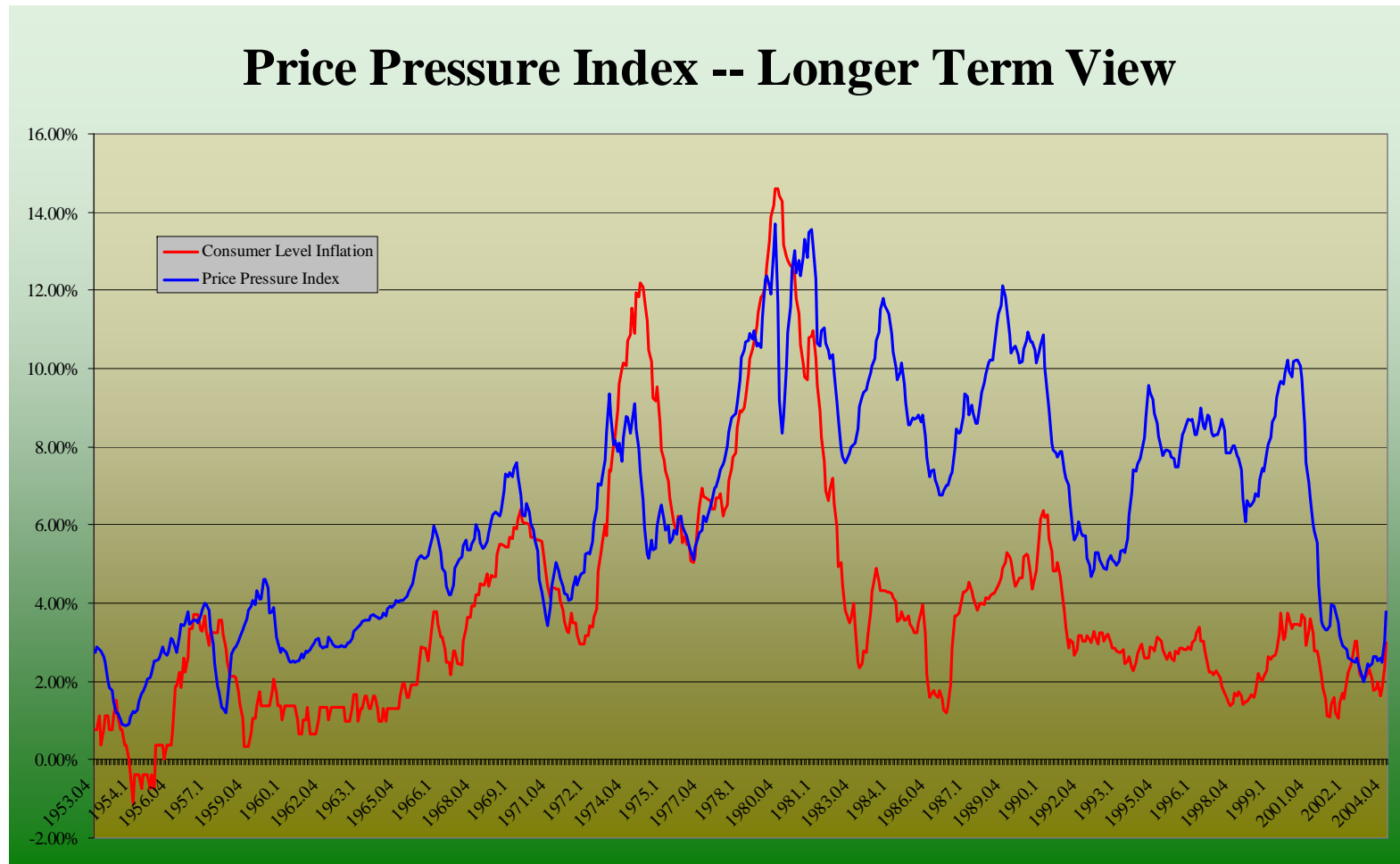
However, in its statement, the Federal Reserve indicated it believed a portion the recent increase in inflation was due to “transitory effects” meaning that oil prices were artificially high (which we discussed in last month’s Chartbook).

Inflation expectations



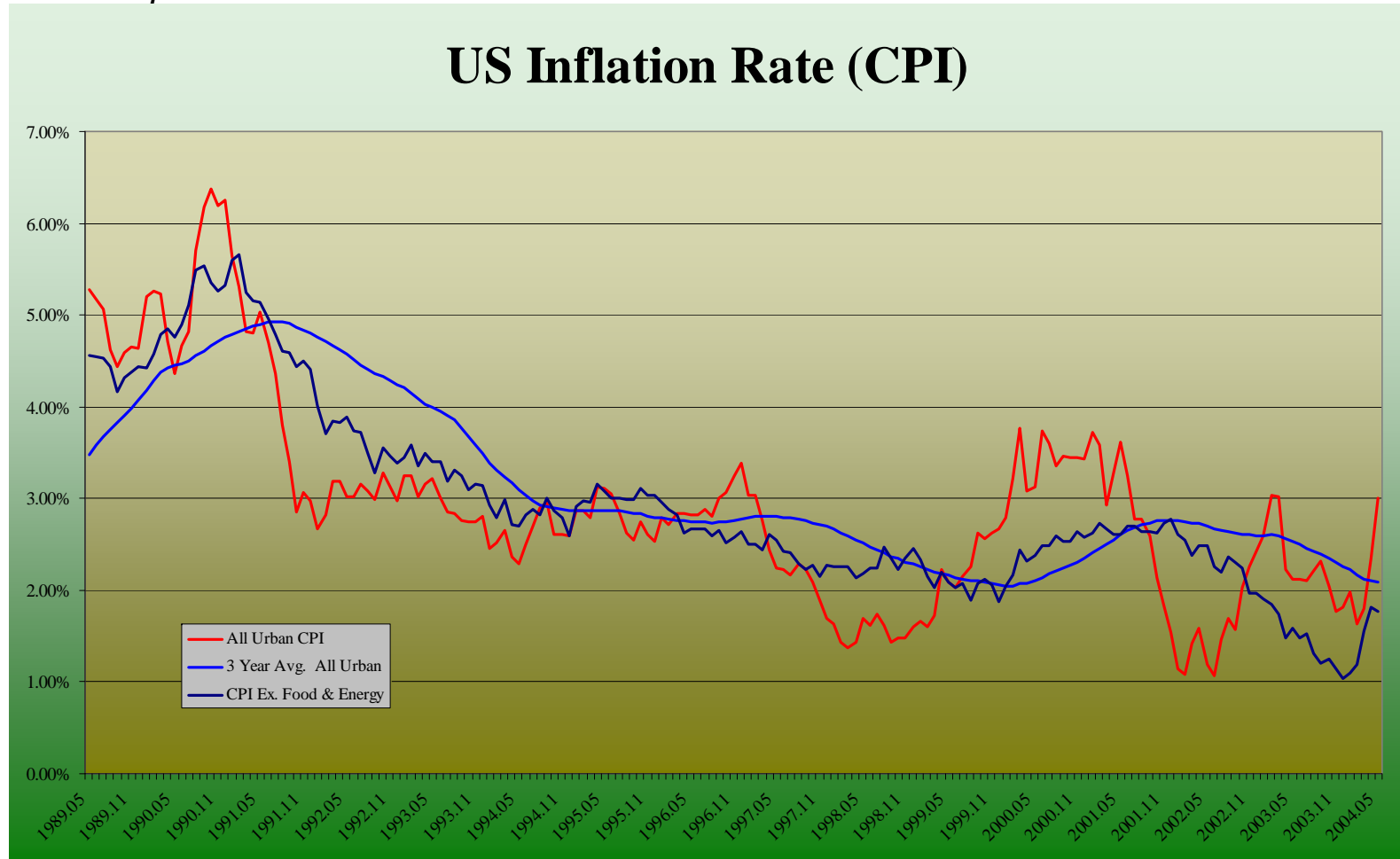
The Price Pressure index increased sharply this month indicating higher consumer prices and on-going pressure on prices in the coming periods. This causes us to maintain a bearish outlook on bonds.

Inflation expectations



Although it moved off its low this month, price pressure and consumer level inflation are still well within reasonable levels. Based on recent research in the Chartbook, there is no PE (multiple) contraction at inflation levels below 5% on a year over year basis.

Inflation Expectations



The increase in consumer prices has been due to higher energy costs as well as increased demand for goods caused by the global recovery (especially natural resources).

Federal Reserve Watch

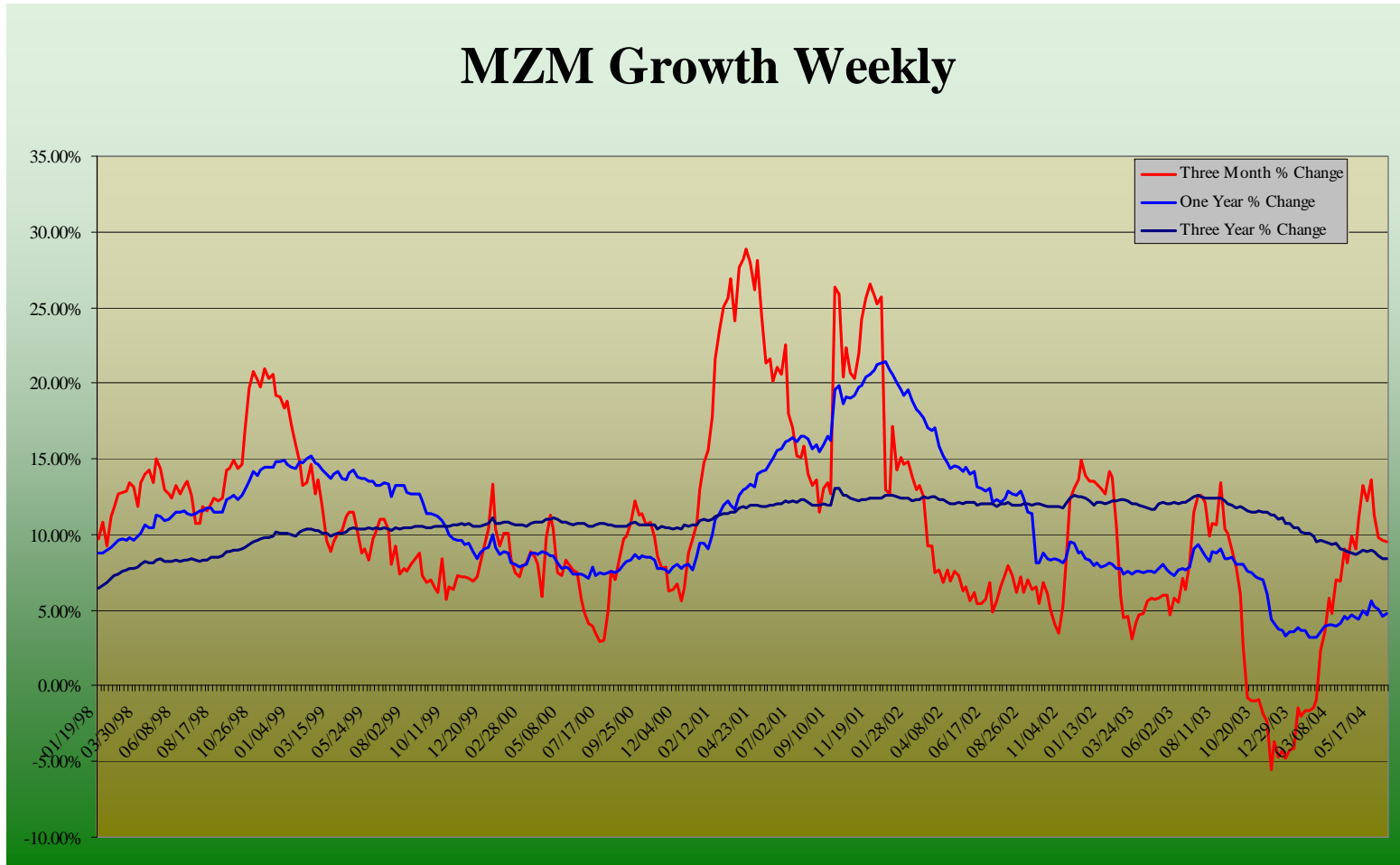
Monetary policy will “remain accommodative” even after the much anticipated rate increase.

- there was no change in market interest rates (10 year Treasury, etc.) upon the announcement, although traders modified their expectations for future rate increases given the policy statement provided.

At the same time, however, the near-term growth rate of the weekly measure of money supply has slowed significantly.

Both higher rates and lower money supply will have a detrimental effect on the economy’s leading indicators.

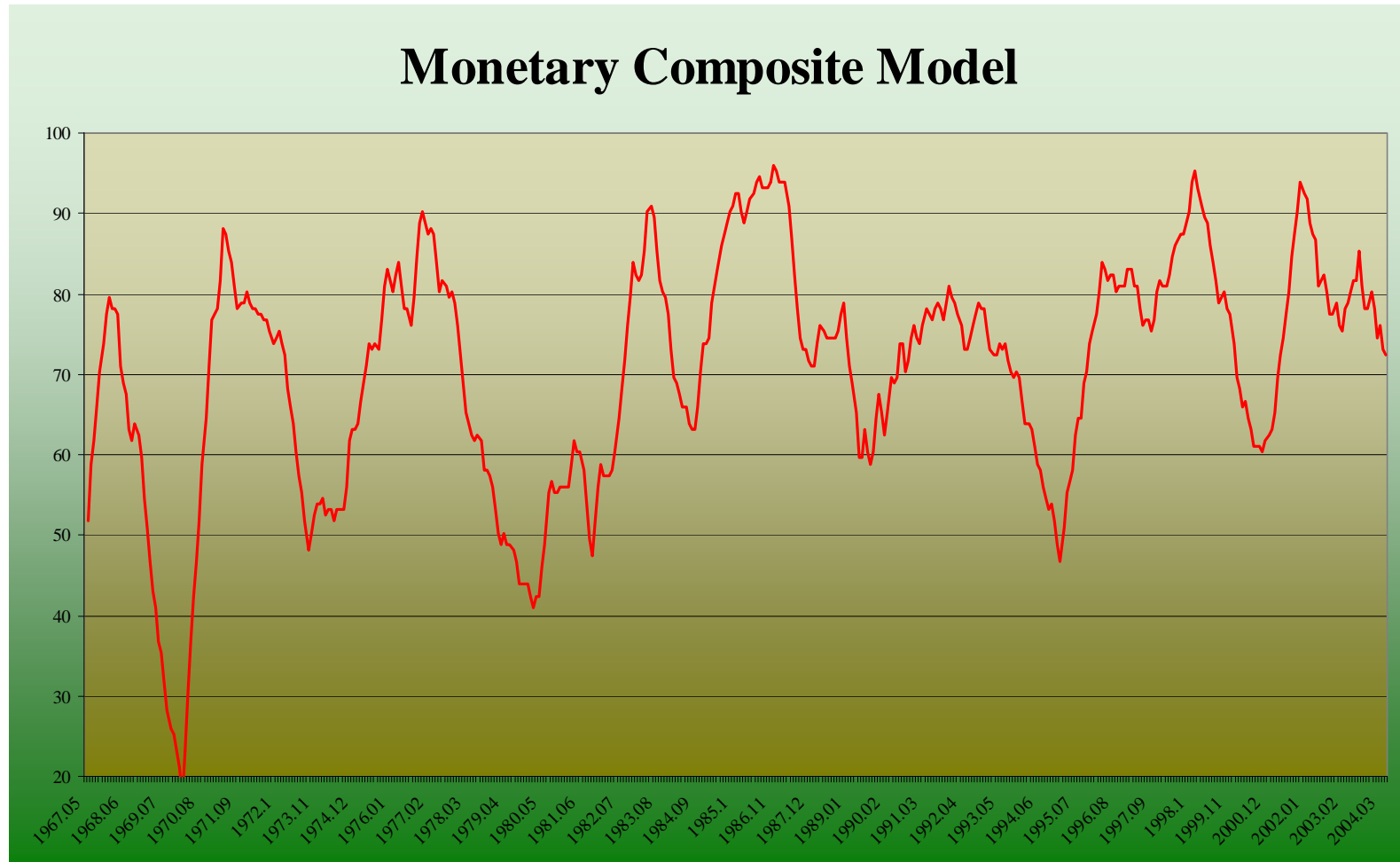
Federal Reserve Watch



Money Zero Maturity (MZM) is a broad measure of liquidity that is significant to lending, business activity, and equity prices.

The 3 month growth rate of money supply has declined after rapid growth since the beginning of the year.

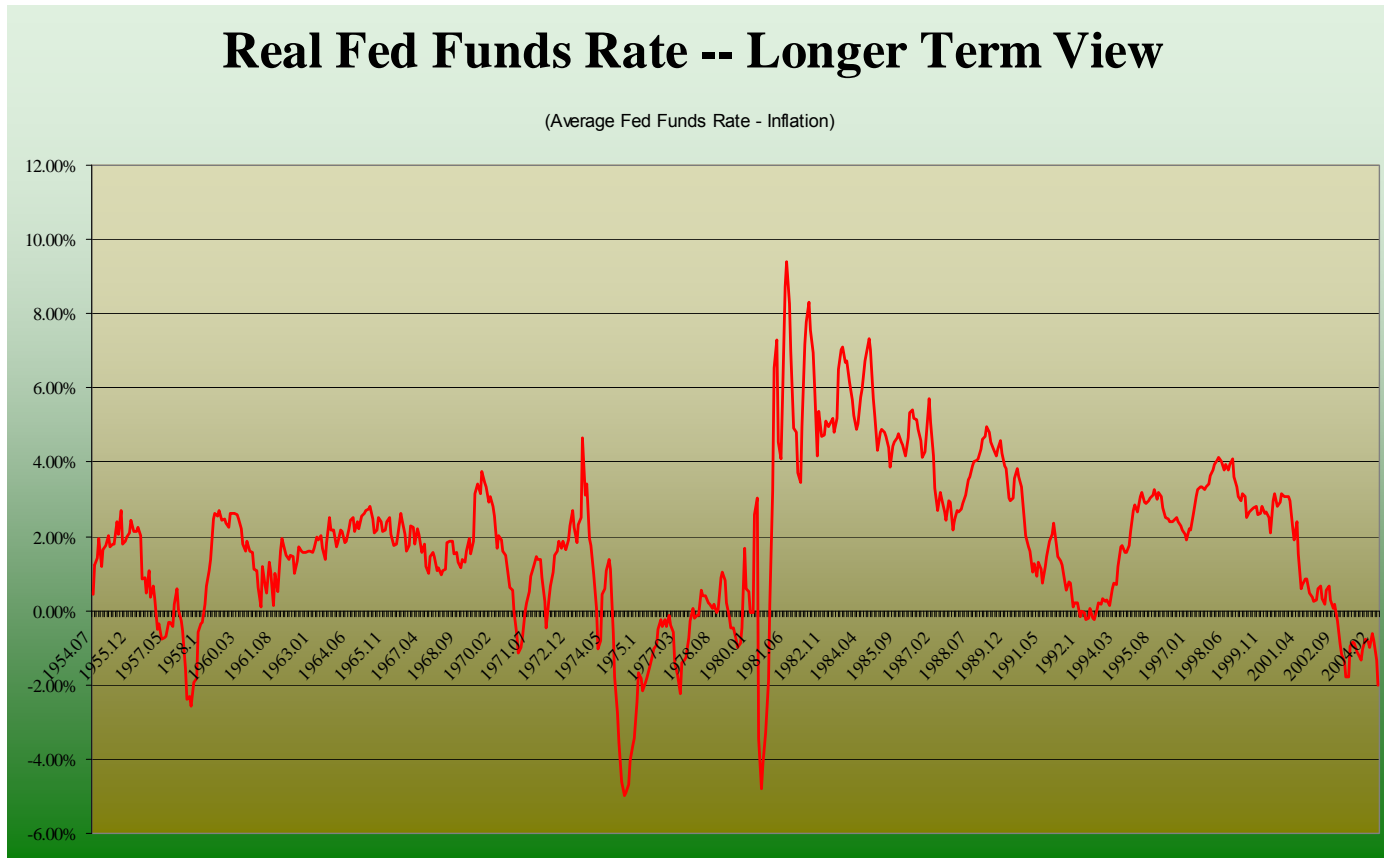
Federal Reserve Watch



The direction of trend in this series is as important as the level. A score above 50 indicates the Fed's monetary policy is accommodative.

Higher interest rates as well as slowing money supply have affected this model and will likely continue to do so as its measure declines.

Federal Reserve Watch



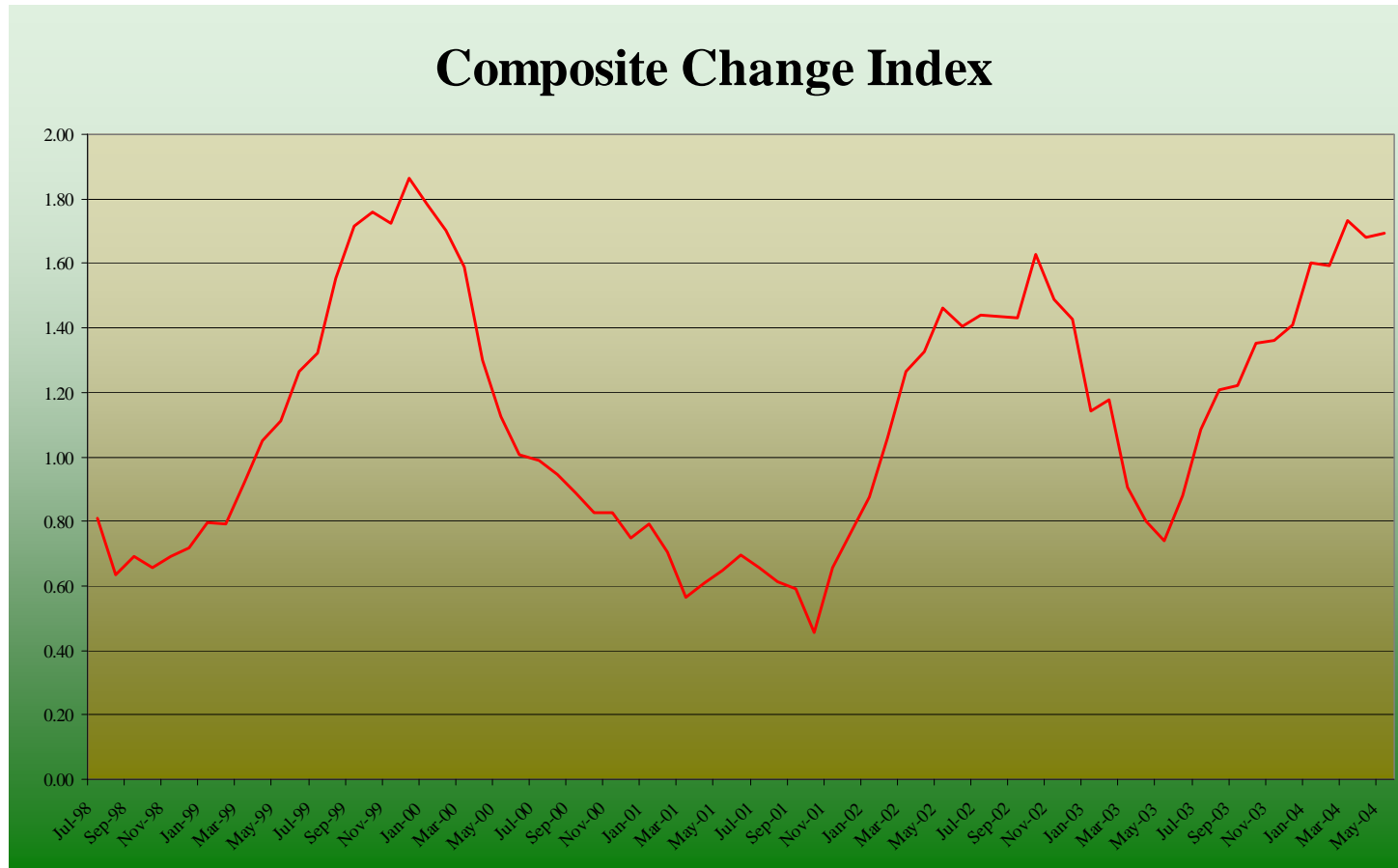
Even with the rate increase, real interest rates are strongly negative as inflation has increased more than rates have. The year over year changes for inflation will likely moderate while interest rates gradually rise over the remainder of the cycle.

Outlook & Forecast

Although the stock market is facing somewhat of a headwind regarding higher inflation and lower money supply, the outlook is generally positive.

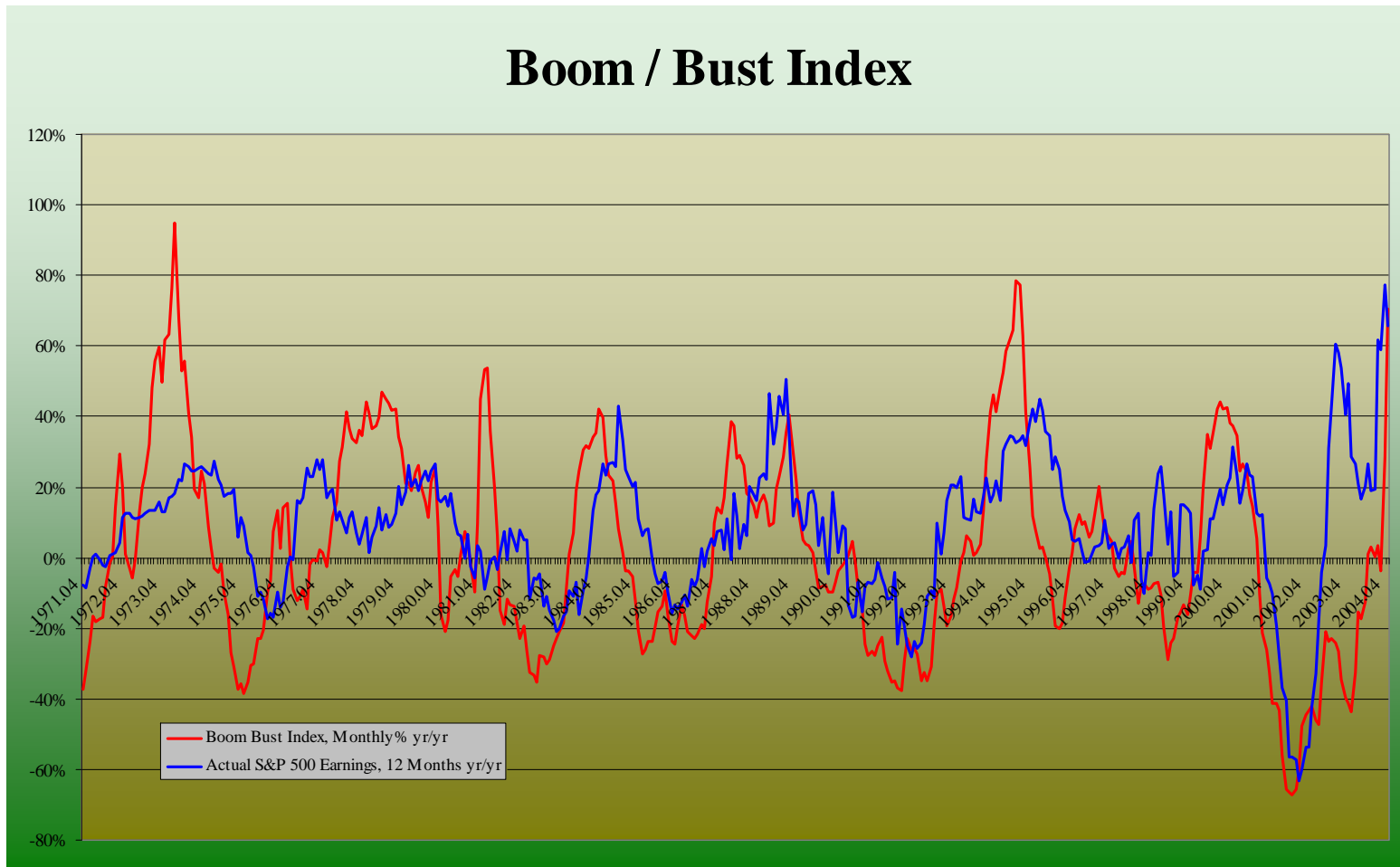
- our models anticipate increases in both employment and company earnings
- but, we must be cautious as economic growth has slowed (a feedback mechanism of the rate increase and lower money supply)

Outlook & Forecast



The composite change tends to lead earnings, and values over 1.00 are considered bullish.

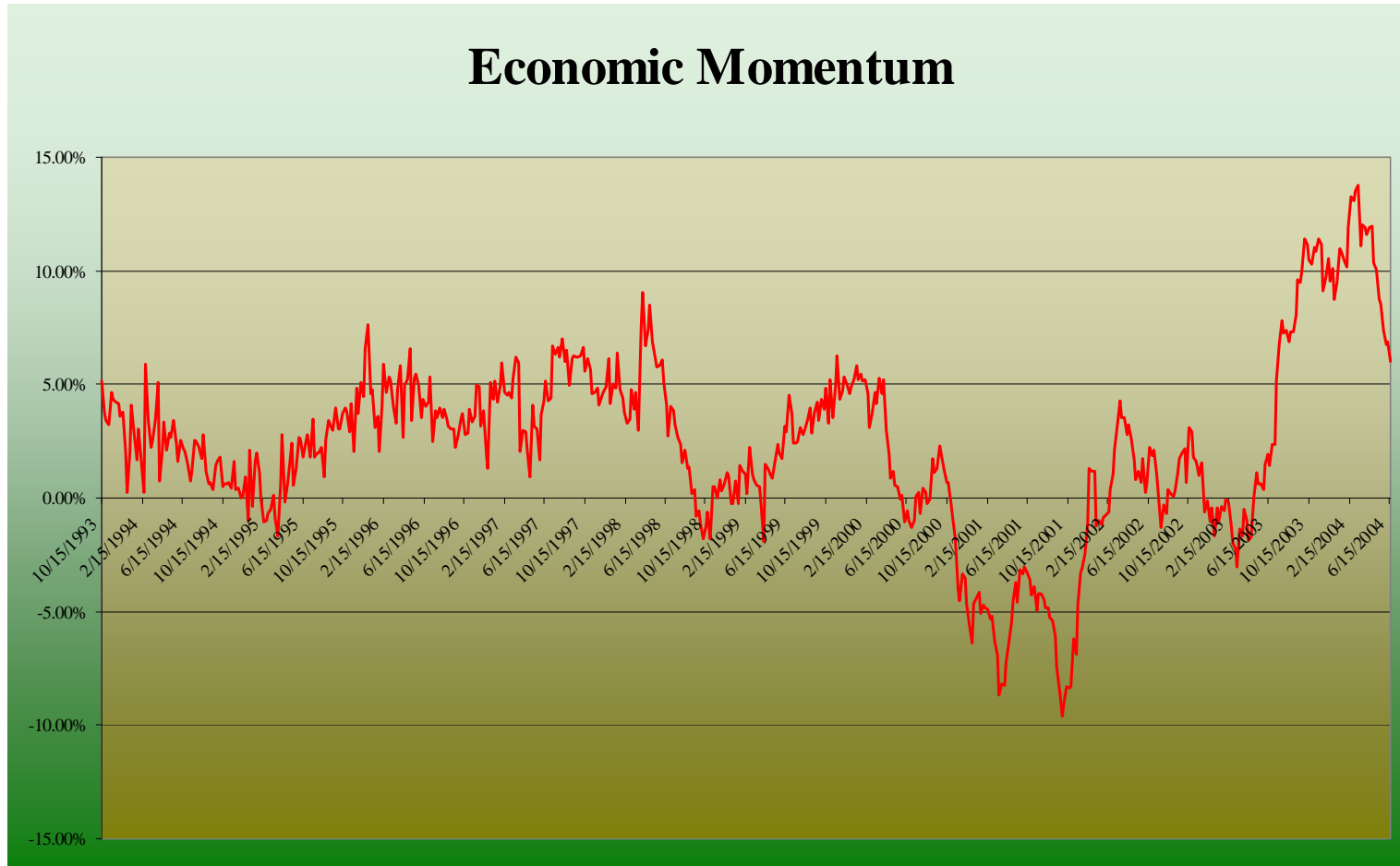
Outlook & Forecast



The Boom/Bust Index tracks several key variables within the economy that correlate with earnings.

The red line is predicted S&P 500 earnings direction, indicating positive movement continuing. This chart is one indicator that company earnings in the third quarter will be strong.

Outlook & Forecast



Data presented is the ECRI Weekly Leading Indicators (source: www.businesscycle.com).

The 52 week rate of growth has declined from recent highs, but still remains at a robust level above 5%.