"My readers have been unanimous in urging reduction in overall length but virtually all of them also suggested "small additions."

M. W. Reder
Journal of Economic Literature March 1982

The three principal "engines" of economic growth are generally accepted to be the consumer, the government and the business community. All three are, to one degree or another, always spending. At the margin, however, there is usually a clear major player – the one component that dominates the growth of the economy.

During the Great Depression, when businesses closed their doors and unemployment ran 25% or so, the government stepped in and provided jobs through things like the Civilian Conservation Corps . . . .which I think is worth revisiting. Gradually income was put into workers pockets and right when a final push was needed, World War II arrived.

After the war, industrial America began to switch to consumer goods and we entered a long period of often sizeable business cycles as manufacturers struggled to balance production with demand (and employment). The things we bought then tended to be both manufactured goods (as opposed to services) and fairly high dollar items: cars, homes, furniture and the like. Inventory management, as now, was difficult and, as now, tastes changed and manufacturers of, for instance, cars caused a ripple effect as they changed models, built plants, bought equipment and tracked demand. Imports were barely a blip on the screen – and most were poor quality.

As we enter the second quarter of 2006, some, but not all of these elements have changed. Today, the largest exporter is Western Europe – the European Union – at more than 40% global exports, much of it coming here. We have sharply reduced our manufacturing capacity, relative to total U. S. production of goods and services, and sharply increased services. With this change – this reliance on off-shore manufacturing – has come softer business cycles and softer changeovers from one economic "engine" to another.

Currently, the consumer is easing back on spending in aggregate while the industrial sector is easing back into dominance with new plant and equipment spending. These are at-the-margin changes – not radical – but changing roles nonetheless. At the moment, consumers are being faced with higher gas prices, the tax bill, less refinancing of their mortgages and rising interest payments on their overloaded credit cards. The big one – mortgage equity withdrawal – has been a major source of spending. The good news is many refinanced at lower rates; the bad news is fully one-half of the cash taken out, by some estimates, was spent. (The rest went to remodeling, second homes and yes, even some savings.) The current good news is that average hourly earnings have continued to grow, unemployment is very low and inflation is, for now, not an issue.

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Ed Hyman refers to the consumer sector as the front end of the economy and the industrial sector as the back end. I don't believe he's yet named the government sector and, knowing him, that probably reflects decorum, not a lack of ideas.

In any case, we are shifting from a front-end consumer "engine" to a back-end industrial "engine" as the primary economic driver. These transitions are almost definitionally awkward. We expect stumbles – headlines that one week talk about a ". . .collapse in retail sales. . ." and the next week about sharp rises in the price of materials. Consumer sentiment will probably be dominated by pump prices – an obvious irritant – and yet be held up by solid wage gains and low unemployment.

In the stock and bond markets this transition should see rising bond yields – falling prices – as wage and material costs work through the system and stocks of high-end consumer goods, oils and financial services do pretty well. Industrial spending also is showing up in technology stocks and, interestingly, in the investment banking stocks as mergers and acquisitions pick up.

Industrial companies are, as a group, cash rich. Stock buy backs and acquisitions are our estimate for what they do with their cash. Dividend increases remain strong, but we believe they were more a temporary decision than permanent – sort of what to do to keep stockholders happy until our earnings and stock prices are appreciated by others.

So, in spite of a very poor fourth quarter of 2005 – Katrina and all – last year came in at a solid 3.5% rate and this year looks to be close to that.

Corporate (all) profits continue to grow – at over 9% last year and likely that again this year.

Government spending ran a $376 billion deficit last year – smaller than 2004 by 17% according to Arthur Laffer and, on the record, just 3% of our Gross Domestic Product – our total annual production of all goods and services. Facts do tend to get in the way of the ". . .we are living beyond our means. . ." crow.

A weaker dollar has strengthened the sale of our goods overseas – we expect continued (small) improvements in our trade deficit. This, too, will strengthen corporate earnings, especially those industries that are heavy traders in foreign markets.

Our view remains that the stock market is undervalued; most earnings reports will surprise on the upside and, because we don't see a major interest rate move coming, stocks won't be discounted by higher rates. Our feeling is that the 10-year Treasury will trade in the 4.5%-5.5% band for the next year or two and thus have minimum impact on stock prices. High-end consumer goods, tech stocks, investment bankers and retail banks that have great markets, i.e. the Japanese community, the Hispanic community, etc., continue to interest us. Ed Hyman's team put it best – corporate profits are up

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about 120% since 2002 while stock prices are up only 66% - which dovetails nicely with Art Laffer's view that stocks are undervalued 60% plus. The first quarter earnings numbers will be up, to our mind, about 12% to 13% - and a word of caution – not that much in the second quarter.

And therein lies our message: rising earnings, undervalued stocks, controlled inflation and an awkward transition from a front end to a back end driven economy.

What don't we like? Well, autos, casinos, cable companies, household appliances – the discretionary front-end players. Home software, health care, soft drinks – small ticket items, seem more appealing. Oil, both equipment and drillers, remain of interest.

Overseas we continue to hold 10%-25% of client portfolios in Japan and both emerging and developed nations. Our view is that oil wealth and the long, sharp rise in raw materials has created a solid stimulus to their economic growth . . . .but we're watching it closely.

For now, then, a well-diversified stock portfolio seems to be the place to be for the long run.*

On a different note, our web site is up and we're gradually filling it with our outlook and theme pieces. Please stop by at www.sansgrouplLLC.com – and e-mail to me at jim@sansgroupLLC.com is always welcome. Now all we need is a name for the government sector. . . .

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* *"Unfortunately, theory is silent on exactly when the long run arrives."*
(S. Peltzman: *Journal of Political Economy*, June 2000)

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