

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: December 13, 2005
Subject: Gloom and Doom? Mostly, it's All in Your Head.

We frequently have the office TV tuned to CNBC or Fox News to keep an eye on what is happening in the financial markets and around the world. Most news organizations seem to have an inherent bias toward playing up the bad news and overlooking the positive things that happen daily around the world.

News writers have certainly had plenty of negatives to work with. The first half of this decade has been fraught with a seemingly endless string of disastrous events, including the 9-11 attacks and a new war, a stock market crash and a slew of natural disasters around the globe. The daily business news highlights layoffs, the movement of manufacturing jobs overseas and the ballooning federal deficit. Politicians on both sides of the aisle are clamoring for an end to the tax cuts put in place by the President in 2003. Most domestic airlines are operating in bankruptcy and two of the "big-three" auto makers have had their debt downgraded to junk status. The Federal Reserve has increased interest rates 13 times in as many meetings since June 2004, which has boosted the cost of consumer and business credit. Energy prices are up sharply and personal bankruptcies recently hit an all-time high. Is it any wonder that when asked about the state of the economy, more than 40% of people interviewed think that the country is in a recession? There are more than a few "Chicken Littles" who think the sky is falling and that the U.S.A. is headed for an outright depression, ala the 1930s.

So what's the real story? We think it helps to look at the actual numbers to understand where the economy is currently and where it is headed. In the late 1930's, the unemployment rate peaked at over 17%; in November, it was 5.0%. Out of the last 384 months (32 years), the unemployment rate has only been lower in 47 months, all of which were in the late '90s. Last quarter, real GDP has expanded at an annualized rate of 4.3%, well above its multi-year average of 3%. Data from the Federal Reserve shows that US-based factories are producing at a record pace and rising productivity—up more than 5% in each of the last two years--has allowed factories to remain competitive. And there's more. Eliminate the tax cuts? Why? According to the US Treasury, since the May 2003 signing of the President's tax cuts, federal revenue after bottoming in 2003 has jumped to \$2.15 trillion, the highest level of receipts in federal history. Well what about the tax burden on the middle class? Have the rich gotten off the hook? Since 1980, the richest Americans' share of all income taxes paid has soared to 34.3% in 2005, up from 19.1% in 1980, even as their average tax rate has fallen by one-third according to *Investors Business Daily* (Monday, December 12, 2005). In the nine quarters preceding the tax cut, GDP grew at an annual rate of 1.1% but in the nine quarters since May 2003, GDP has grown at an average annual rate of 4.5%. And the rapid growth in entrepreneurship, jobs, income and wealth has made us all richer and more secure. Believe it or not, 57 million Americans now own stocks—that means roughly half of all households. And the median income for shareholders? Mind you we're not talking Bill Gates or Warren Buffett, the answer is \$65,000 according to *Investors Business Daily*. Doesn't seem like only "rich" people own stock. The fact of the matter is that the U.S. economy is tremendously durable, and although many people have been adversely impacted by events beyond their immediate control, most of those setbacks will be temporary and the majority of folks are doing just fine.

A few weeks ago, the *Wall Street Journal* carried an editorial by Brian Westbury, of Claymore Advisors, LLC, that addressed the pervasive feeling of gloom and doom that seems to have gripped so many. Unlike many of his fellow economists, Brian has a knack for interpreting and explaining sometimes arcane economic data in terms we can all understand. See what you think.

Pouting Pundits of Pessimism

By BRIAN S. WESBURY

Wall Street Journal December 2, 2005; Page A10

During a quarter century of analyzing and forecasting the economy, I have never seen anything like this. No matter what happens, no matter what data are released, no matter which way markets move, a pall of pessimism hangs over the economy.

It is amazing. Everything is negative. When bond yields rise, it is considered bad for the housing market and the consumer. But if bond yields fall and the yield curve narrows toward inversion that is bad too, because an inverted yield curve could signal a recession.

If housing data weaken, as they did on Monday when existing home sales fell, well that is a sign of a bursting housing bubble. If housing data strengthen, as they did on Tuesday when new home sales rose, that is negative because the Fed may raise rates further. If foreigners buy our bonds, we are not saving for ourselves. If foreigners do not buy our bonds, interest rates could rise. If wages go up, inflation is coming. If wages go down, the economy is in trouble.

This onslaught of negative thinking is clearly having an impact. During the 2004 presidential campaign, when attacks on the economy were in full force, 36% of Americans thought we were in recession. One year later, even though unemployment has fallen from 5.5% to 5%, and real GDP has expanded by 3.7%, the number who think a recession is underway has climbed to 43%.

This is a real conundrum. It is true, bad things have happened. Katrina wiped out a major city and many people are still displaced. GM has announced massive layoffs. Underfunded pension plans are being handed off to the government. Oil, gasoline and natural gas prices have soared. Despite it all, the U.S. economy continues to flourish.

One would think that this would give pouting pundits reason to question their pessimism. After all, politicians who bounce back from scandal get monikers such as "the comeback kid." Athletes who overcome personal tragedy or sickness to achieve greatness are called "heroes." This is a quintessential American tradition, and the economy is following the script perfectly. The more hardship it faces, the more resilient it appears. The list of pessimistic forecasts that have been proved wrong grows by the day.

The trade deficit was supposed to cause a collapse in the dollar; but the dollar is up 10% versus the euro in the past eight months. The budget deficit was supposed to push up interest rates; yet the 10-year Treasury yield, at 4.5%, is well below its 2000 average yield of 6% when the U.S. faced surpluses as far as the eye could see.

Sharp declines in consumer confidence and rising oil prices were supposed to hurt retail sales; but holiday shopping is strong. Many fear that China is stealing our jobs, but new reports suggest that U.S. manufacturers are so strong that a shortage of skilled production workers has developed. And since the Fed started hiking interest rates 16 months ago, 3.5 million new jobs and \$750 billion in additional personal income have been created. Stocks are also up, which according to pundits was unlikely as long as the Fed was hiking rates.

So, where is all of the pessimism coming from? Some say that the anxiety is warranted. The theory goes like this: Globalization and technology are a massive force that levels the playing field. Because capital and ideas can move freely around the world, foreign wages will move up, while U.S. wages fall, until some sort of equilibrium is found. It's a compelling story. After all, real average hourly earnings in the U.S. fell 1.6% during the 12 months ending in October.

However, there are numerous reasons to believe that this statistic is not giving an accurate picture of the economy's health. First, history shows that when oil prices rise sharply, real earnings take a temporary hit. As a result, a snapshot of inflation-adjusted earnings data in the wake of Katrina is misleading.

Moreover, for the past 30 years, real average hourly earnings have declined by an annual average of 0.1%. But this can't possibly reflect reality. In the past 30 years, cell phones and computers have become ubiquitous. Home and auto ownership have climbed. More people dine out; travel; attend sporting events, movies and rock concerts; and join health clubs. Over those same 30 years, real per capita consumption has increased at an average annual rate of 2.3%. Hourly earnings data do not include tips, bonuses, commissions or benefits, and therefore will always lag actual increases in living standards.

Some observers of the current economy, such as New York Times columnist Thomas Friedman and former Clinton economic adviser Gene Sperling, argue correctly that globalization is inevitable and, in fact, good. Nonetheless, they focus on those who are hurt by the transitional impact and suggest that government intervene to offset any damage from plant closures or job losses.

But this has never worked. The history of economic progress is one of innovation and change. This "creative destruction" can never be a pain-free experience for every individual involved. The new must replace the old. Attempting to alter this fact of life, and create a utopia where no one experiences pain, has always led to more unhappiness than before. Germany's near 11% unemployment rate and the recent riots in France are the latest evidence of government's inability to successfully fight market forces.

One key reason the U.S. economy has outperformed other industrialized nations, and exceeded its long-run average growth rate during the past two years, is the tax cut of 2003. By reducing taxes on investment, the U.S. boosted growth, which in turn created new jobs that replace those that are lost as the old economy dies. Ireland is also a beautiful example of the power of tax cuts to boost growth and lift living standards.

Economic growth is the only true shock absorber for an economy in transition. To minimize the pain of technological globalization and address the anxiety that these forces are creating, free-market policies must be followed. While tremendous pressures are building to increase government involvement in the economy, it is important that the U.S. stay the course that brought it out of recession.

To meet the challenges that lie ahead, a vibrant, flexible and expanding economy is absolutely necessary. While it is tempting to think that government programs are necessary to address anxiety, in reality only the free market can successfully navigate today's rough waters. In the end, it will be the private sector, not the public sector, that quells all this anxiety and creates the opportunities so many desire.

Since we have nothing to add to Brian's excellent essay, we'll close this last *E-Memo* of 2005 with our best wishes to you for a Merry Christmas and a prosperous and Happy New Year!

FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029
262-369-5369 (Jon Bruss) • 262-369-5742 (Bob Ollech)