THE ECONOMIC SITUATION

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2005: The year of the rooster

Okay all you Gamecocks, this is your year. The Chinese year of the rooster is upon us. According to the lore, it is year for strutting and preening, but also a year for careful financial management, a time for getting things in their place and well organized. The rooster takes the place of the monkey, whose year has just passed from view. Enjoy the rooster while it is here. The year of the tiger arrives in 2010. And don't forget about those Bulldogs, Yellow Jackets and Tar Heels.

How did the monkey treat the Great American Bread Machine?

The answer? Better than average.

When all is said and done, the year 2004 will turn out to be a pretty good one, at least for the record keepers. GDP growth for 2004 will come in at about 3.9%, quite an improvement over 2003's 3.0%, and a far cry better than 2002's paltry 1.9% growth rate. Driven largely by increased consumer purchases as well as the return of business shoppers to computer stores, the Great American Bread Machine has been running on Washington-made high-test fuel. Tax cuts and low interest rates juiced the economy along the way. When 2004 came to an end, so did the supply of high-test fuel, or so it seems. We will soon learn how this baby runs on real economic fuel.

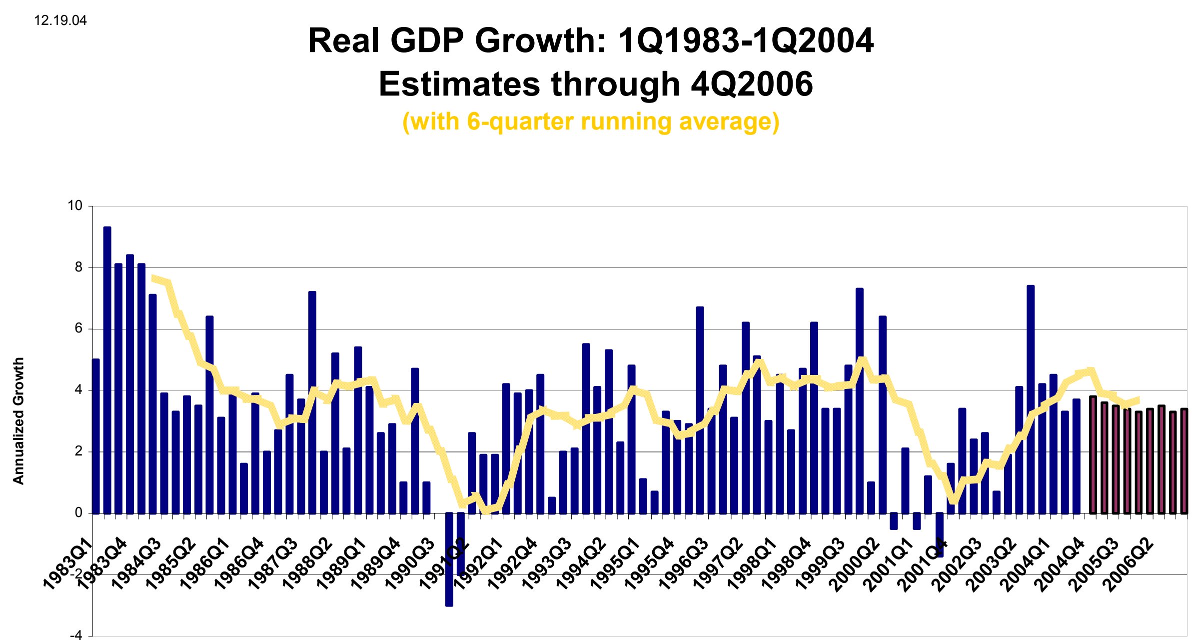
As 2004 was closing, deficits were looming. Meanwhile China was shipping huge amounts of manufactured goods to satisfy U.S. consumers, while the Chinese took the dollars earned and invested lots of them in U.S. government debt. This fueled government growth and helped keep interest rates and prices low. Now, part of the tax cuts have expired and the size of the deficit is causing even the best of the pork barrel spenders to question their behavior. No one is predicting additional tax increases, but there is ample discussion of fiscal restraint, and the Fed is once again raising interest rates.

What are the forecasters saying about 2005?

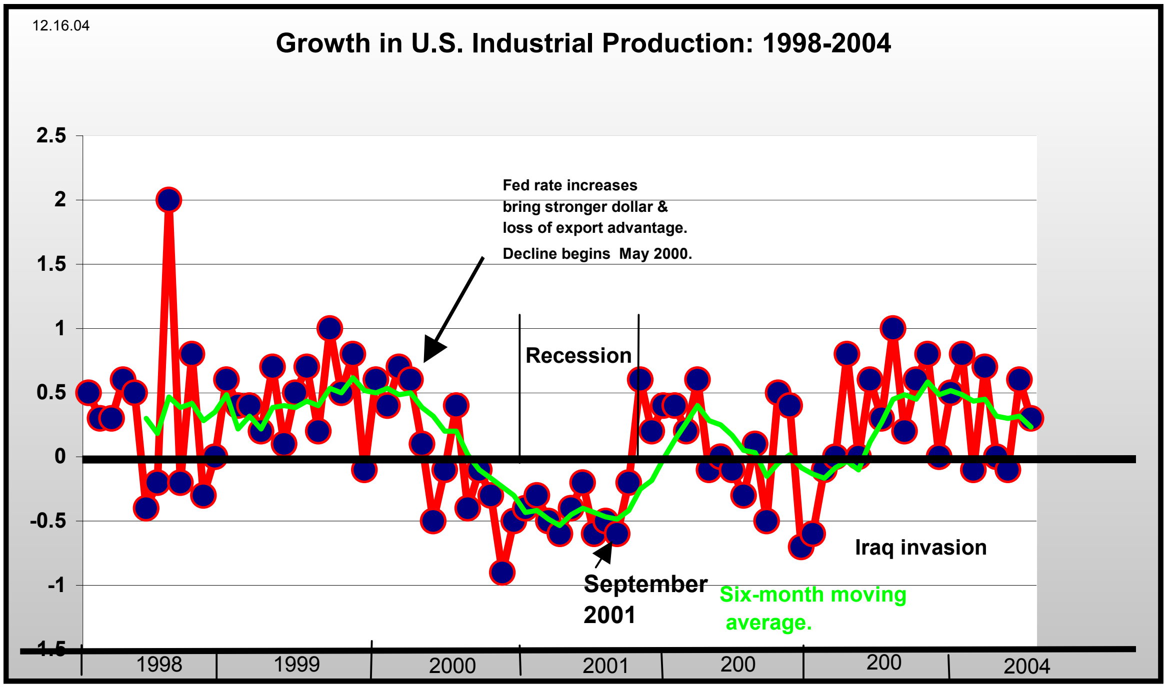
First, the world. The prospects for global economic growth are rather promising. Indeed, we are at one of those rare times when economic growth for the major world regions is balanced. The long leading economic index maintained by the Economic Cycle Research Institute (ECRI) shows 3.6% growth for the 18 major world economies. The current growth of leading indicators is 3.3% for Europe, 3.5% for North America, and 4.0% for Asia-Pacific.

Now to the U.S. It just so happens that GDP growth forecasts for the U.S. are almost dead on the ECRI number. The U.S. Treasury's December 17 forecast expects GDP growth of 3.5% for the year ahead and 3.4% for 2006. Things taper off a bit after that, with GDP growth averaging 3.1% by 2010. A bit more optimistic forecast was provided on December 13 by USC economist Don Schunk. Don predicts 2005's GDP growth will hit 3.8%. Economy.com's November forecast calls for GDP growth of 3.4% for 2005, 3.2% for 2006, and some improvement thereafter.

The Treasury projections for next year are inserted in the accompanying GDP growth chart below. The six-quarter running average that passes across the bar chart assumes a flat profile with an uptick. Of course, when the real data arrive, the shape will look more like saw teeth than a plane.



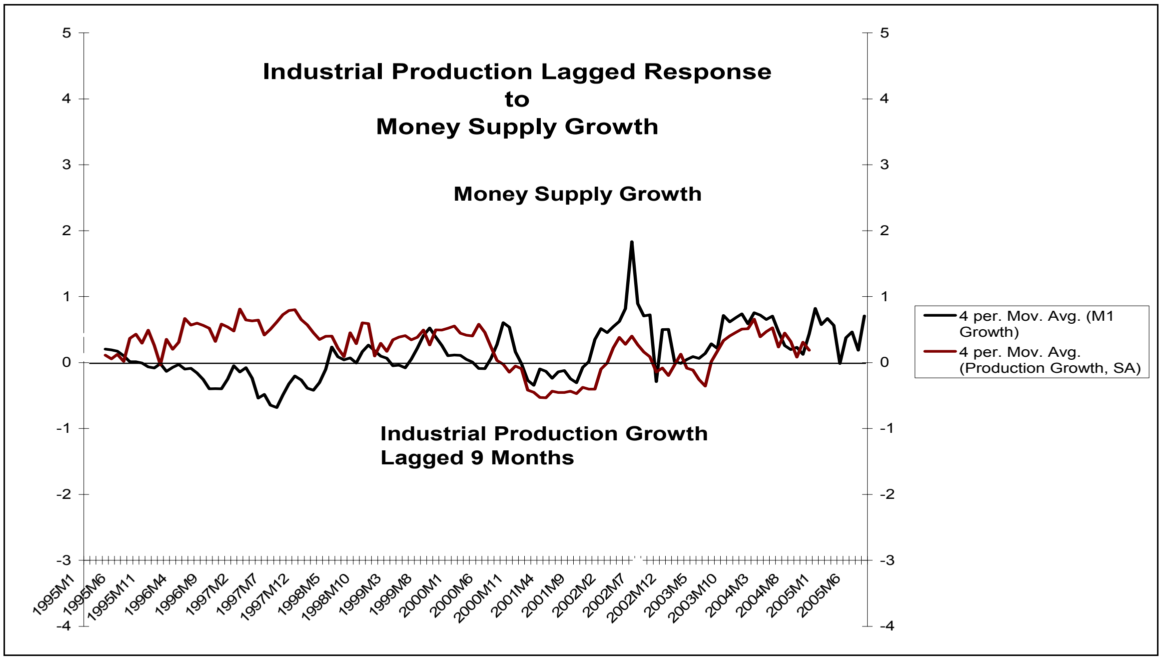
With GDP growth weakening, we would certainly expect to see less-than-rosy data for industrial production in the next chart, which plots monthly data through November 2004. What we see is a rather vigorous industrial economy, but one that is slowing slightly. A comparison of the 2004 growth pattern with that of 1999 should encourage those who think America's industrial heartbeat is haltering. But while the beat is strong, higher energy prices, rising interest rates, and adjustment to intense global competition do reduce the pace.



What does money growth say about the future?

Economists long ago determined that economies march to the beat set by central bankers. When the Fed sends more money to the economy, industrial production is stimulated, but not the next day. Milton Friedman, a leading monetarist, identified a systematic relationship between money and the economy. It takes about nine months for hot cash to do its deed.

Consider the next chart, which maps the growth of M-1, a basic money supply metric controlled by the Fed, into growth in industrial production. Notice that the data for industrial production are lagged nine months on the money supply data. For example, a January change in the money supply is related to industrial production in October.

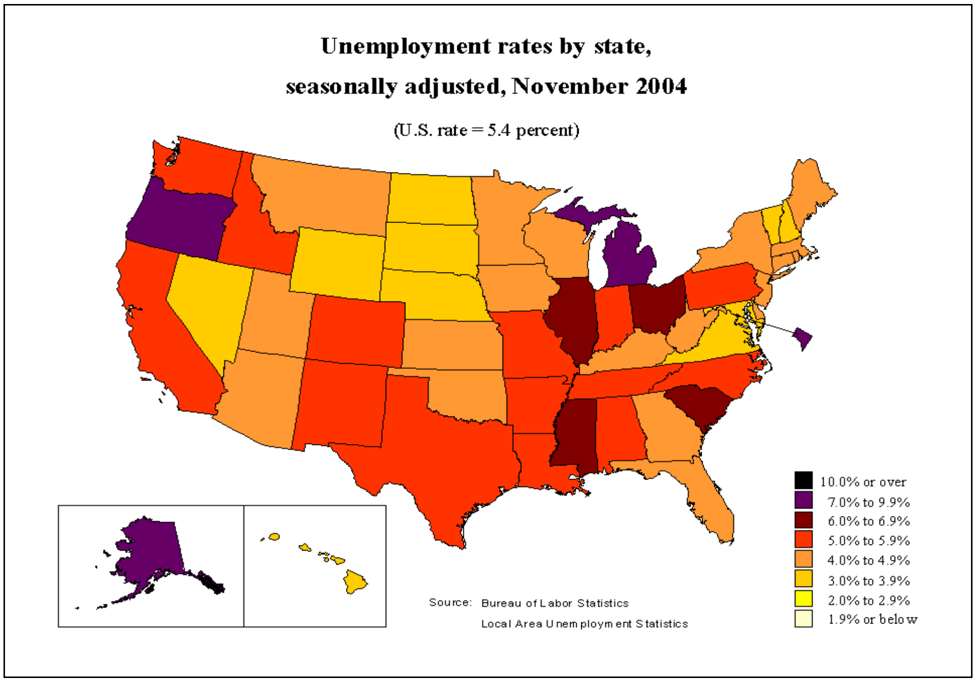


There are several things worthy of comment. Notice the tall steeple of money supply growth that occurs in September 2001. This is the 911 action taken by the Fed. The money valves opened wide, only to be closed soon thereafter. Also, notice the close relationship between money growth and lagged production changes registered from 2000 to the present. Professor Friedman’s fit seems to be working.

Now, consider what the next nine months may bring. As the black line tells us, new money growth is already rushing through the economy, zigging and zagging as it goes. The promise? Industrial production growth will rise in the first four months of 2005, sag a bit, and then rise again. The forecast suggests 2005 will look much like 2004, with a bit more variation.

How does it look on the map?

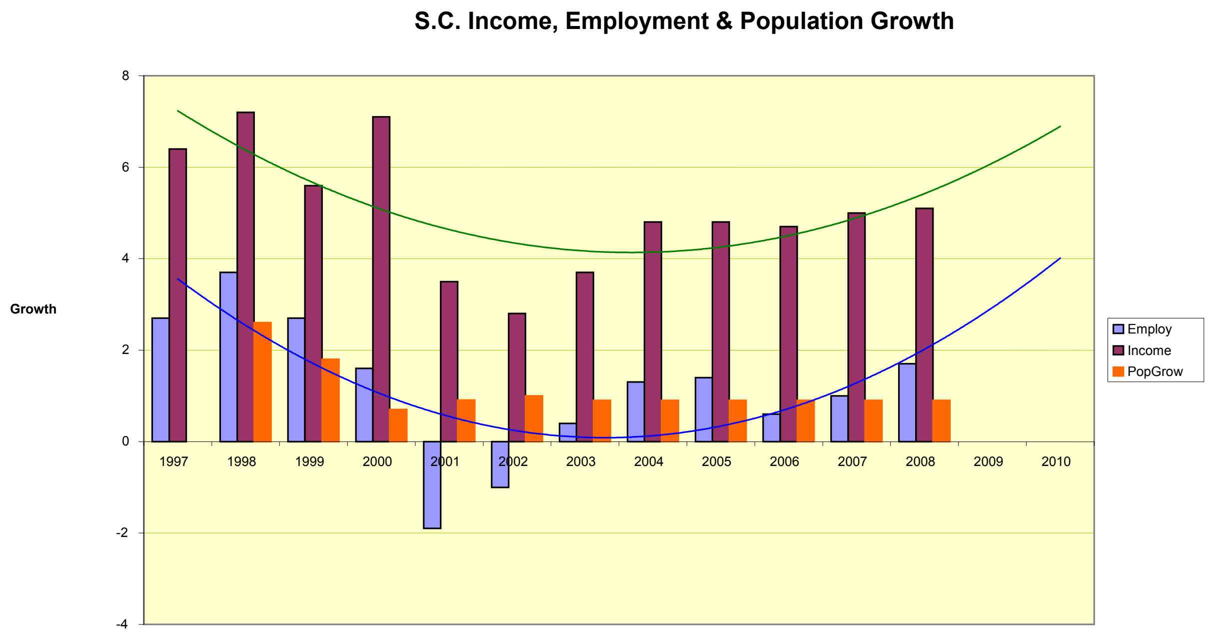
Industrial production is the data counterpart of the nation’s manufacturing economy. Previous Economic Situation reports have shown how the recent manufacturing recession left an unemployment imprint on the national economy. Unemployment rates rose and stayed high longer in the heavy manufacturing states. That effect, which shows up mainly in states east of the Mississippi, combined with the dot.com bubble shakeout to shutter plants along the Pacific coast. The recession is long past and the nation now enjoying an expanding economy, but the effects of the deep manufacturing decline are still seen in the next chart.



The higher unemployment rates are still at recessionary levels in six states: Oregon, Mississippi, South Carolina, Wisconsin, Ohio, and Michigan are lagging the expanding national economy.

And what can we say about South Carolina?

To focus on South Carolina, let's first examine the record and forecasts for total personal income growth and employment growth provided by Economy.com. They predict 4.8% growth in personal income, which is the same as for 2004. Employment is predicted to grow 1.4%. These and earlier data are shown in the next chart. There are three distinct periods seen in the employment growth data. The years 1997 to 2000 show strong positive growth. The years 2001-2003 are the recession years, when employment declined. The years 2004 and beyond are expected to show positive growth, but at diminished levels relative to 1997-2000. A similar pattern is seen in personal income growth, with the forecast years showing recovery, but not to the higher levels of 1997-2000.

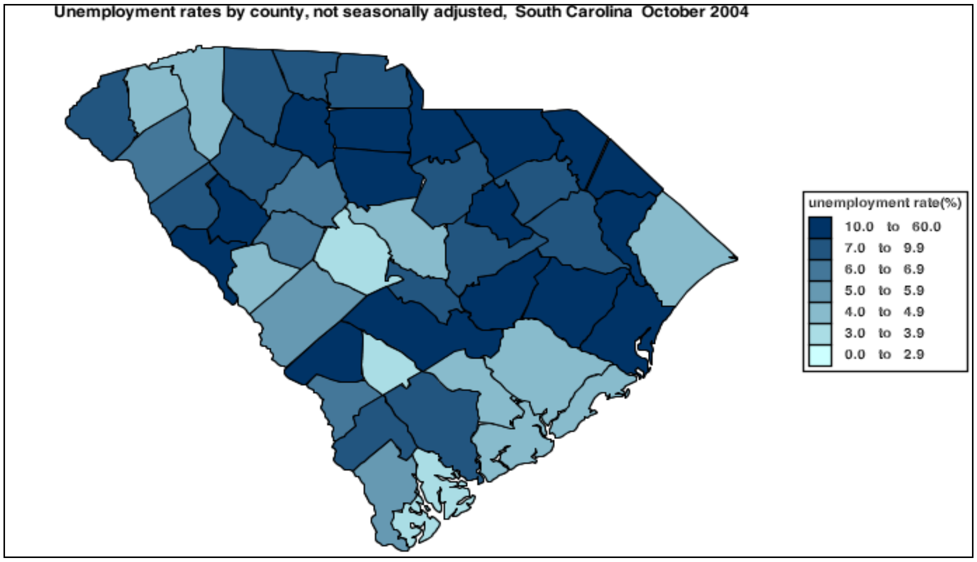


Trend lines have been inserted into the graph to illustrate when the two time series might achieve their earlier higher performance levels. If the future path is like the past, then the past higher income growth can be expected by 2009-2010. Higher employment growth will come a bit sooner, again assuming the future path mimics the past. But what lies behind the data? There is more to the story than a fitted polynomial can explain.

Population growth, an often overlooked source of total personal income growth, is one of the main drivers. The chart's orange bars tell the story, as anticipated by the Economy.com forecaster. Generally speaking, population growth was highest in the high income growth years. Growth has fallen with the recession when employment gains disappeared, and population growth is not expected to rise significantly in the years ahead.

The South Carolina county imprint

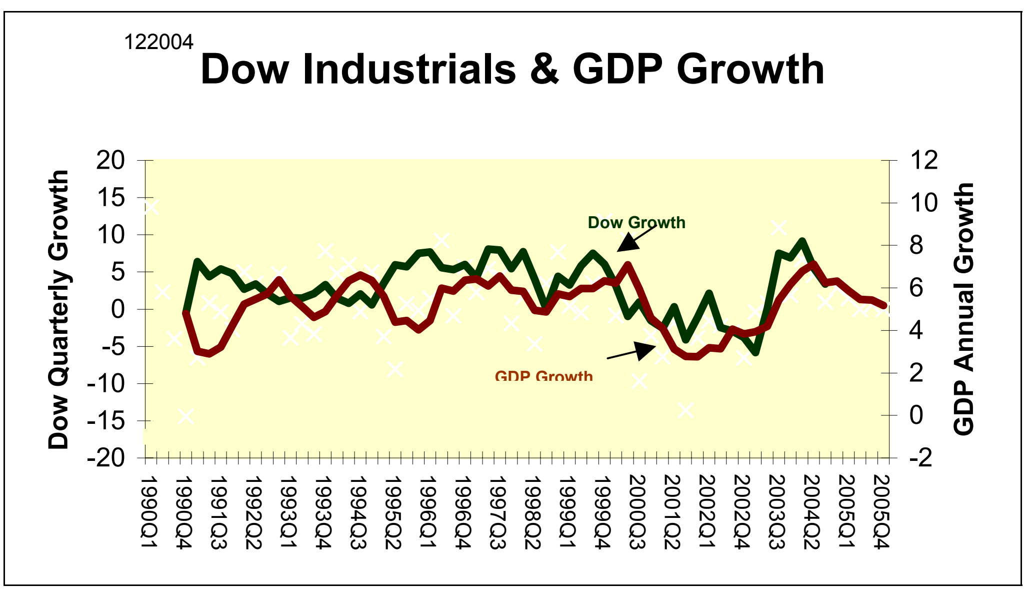
Just as with the nation, the recession/recovery imprint in South Carolina has created a crazy quilt pattern of unemployment rates. The chart here for October 2004, the latest available from the U.S. Bureau of Labor Statistics, shows brighter economies along the coast, in the very center of the state, and emerging in the Upstate. There are also observable patterns that relate to the state's older textile regions and to those counties located away from the coast and off the path of the interstate highways.



Whither the Dow?

Making forecasts for the Dow-Jones Industrial Average is treacherous business, but something all investors do implicitly when they choose to put their hard-earned savings in the hands of Wall Street. Granted, most investors are in it for the long haul and what might happen in a given month or year is almost immaterial to their longer- term objectives.

Having said this, let's look at some data. The next chart maps a relationship between the nominal growth of GDP and the quarterly growth of the Dow-Jones Industrial Average. With GDP estimates for the next 12 months inserted, it is possible to get out on a limb and make a statement about the Dow. The relationship suggests the Dow will experience quarterly growth that averages around 2%, or 8% for the year. This gives a year-end number of about 11,700.



Whither the dollar?

The declining value of the dollar against other currencies brings a mixed blessing. U.S. export industries experience an increase in demand for their goods, but prices rise for inputs that are often obtained from outside the U.S. American tourism flourishes a bit when foreign visitors rush to our shores to buy favorite goods that are suddenly cheaper here than at home. U.S. firms that repatriate earnings from foreign subsidiaries sustain losses when foreign currencies are converted to dollars. And foreign firms that repatriate earnings from U.S. operations experience a windfall.

As they say, it all depends on whose ox is gored.

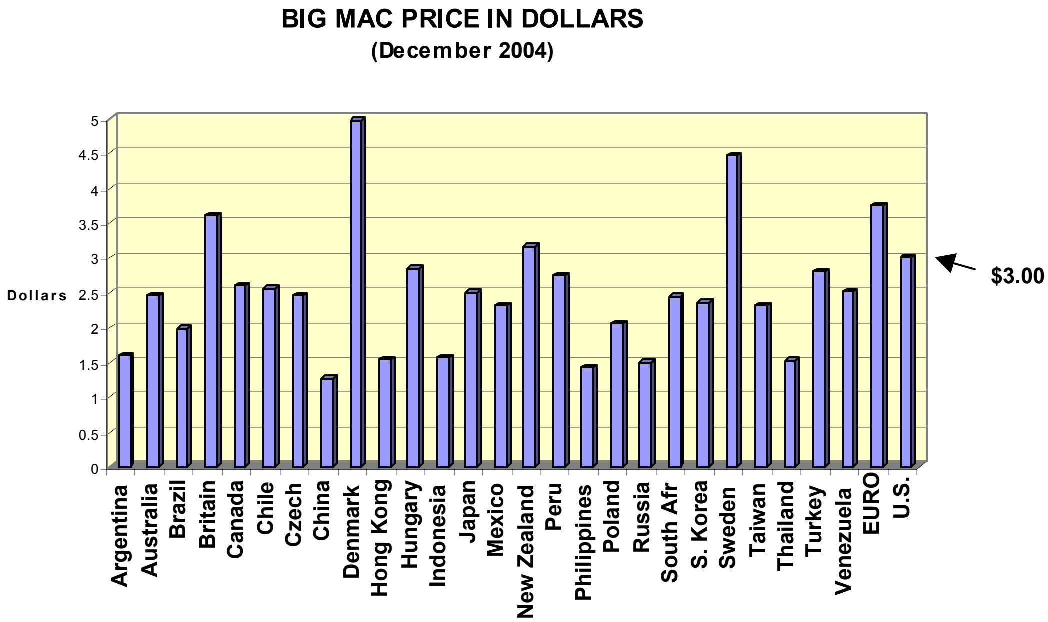
Explanations of forces behind the declining dollar range from lower relative U.S. interest rates, higher U.S. inflation, the huge and growing U.S. deficit, and the likelihood that the U.S. will inflate its currency to help reduce the real cost of paying of federal debt. In point of fact, it is extraordinarily difficult to build empirical models that accurately forecast currency values.

One thing we do know is the dollar is relatively out of kilter in a number of countries. One indicator is the Economist magazine's Big Mac Index. Periodically, the Economist goes shopping for Big Macs in countries around the world. Theoretically, under rather rigorous circumstances, the price of Big Macs should be roughly the same worldwide when the dollar is converted to another currency. Of course, there are troublesome things like different wages, fringe benefits, land values and so on. Even with the trouble, the data are interesting to consider.

The chart below is based on December 2004 data. At the time, a U.S. Big Mac was selling for roughly $3.00. The chart shows what happens when a shopper travels the globe converting dollars to local currencies and then shops for a Big Mac. It is clearly tough going in Scandinavia. Denmark and Sweden are the high priced countries. Their countries seem to be overvalued.

When shopping in China, a Big Mac can be bought for about $1.25. One can get almost three for the price of one in the U.S. The Chinese yuan is apparently undervalued. The same is true about Russia, Indonesia, South Africa, Thailand, and The Philippines.

If nothing else the Big Mac chart helps identify relationships that seem out of kilter with the realities of the market place, which suggests that change is in the wind.



The emerging picture for 2005

So, what does all this say about the outlook for 2005? Taken together, the forecast elements discussed in this report are summarized in a final chart, where December 24 values for the various estimates are shown in parentheses. The pattern reveals an economy that will be operating at a pace slightly higher than the long-term average growth rate. It will be an economy that struggles slightly with higher priced energy, rising interest rates, and emerging inflation.

2005

The Year Ahead
(Dec. 24, 2004)

GDP Growth	**3.70%**	**(4.20%)**
Inflation (Core)	**2.50%**	**(2.00%)**
91-day T-Bill	**3.00%**	**(2.10%)**
Prime Rate	**5.75%**	**(5.00%)**
10-yr. Treasury	**5.00%**	**(4.17%)**
30-Mortg.	**6.25%**	**(5.35%)**
Dow-Jones IA	**11,700**	**(10,800)**

It will also be an economy that faces some daunting risks. These include:

- A war that, like all wars, destroys human and physical capital
- A continuation of higher energy prices that are war related
- Prospects for currency value revisions in China, which could raise prices here for imported goods, and push interest rates higher.
- A federal deficit that feeds a larger government, which, in turn, reduces the vigor of the private economy.
- Rising financial regulation that stifles creativity and capital formation.

Ending on a happy note. It's a Daisy.

Anyone out there who ever dreamed of getting a Daisy air rifle and finally found one under the Christmas tree will appreciate the story that lies behind that famous BB gun. If having a BB gun is a good thing, and take it from one who shot out the rear window of the family car, this notion is debatable, then those who produced and sold the Daisy did well by doing good. 'Sounds like a stretch, doesn't it?

The story about the Daisy begins in 1886 in Plymouth, Michigan, where the Plymouth Iron Windmill Company had been producing and selling windmills to farmers for four hard years. The firm had not been a rip-roaring success in marketing windmills and looked around for a premium, a gift, to include when farmers bought a new windmill. Another Plymouth company, the Markham Air Rifle Company, came to the rescue.

Markham had a new all-metal gun that just fit the bill for a marketing premium. When the new gun was demonstrated to the windmill company president, he was so impressed that he exclaimed "Boy, that's a daisy"! The name stuck, and the premium became so popular that Plymouth Iron Windmill Company stopped making windmills, changed its name to Daisy Manufacturing Company, and flourished.

There are some interesting lessons in the story. Focus on making your customers happy and you may get happy. As painful as it may seem at the time, be willing to leave a line of business that is failing and convert to one that may be totally different, but one that is flourishing. And think about the president of Plymouth Iron Windmill Company who was overjoyed when he saw that first Daisy.

All best wishes for a wonderful 2005.

It is never too late to have a happy childhood!