Profits not Politics

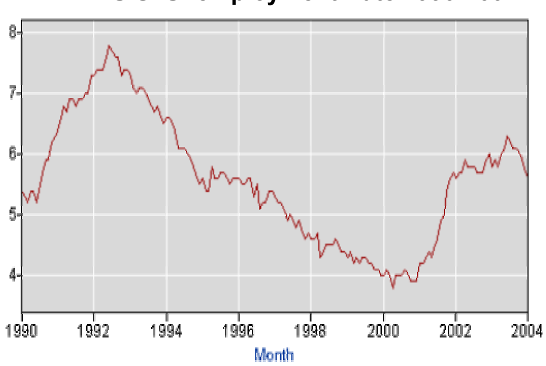
Ben Hock, managing director and senior investment officer with A I M Capital Management, Inc. provides insight into the politically charged discussion of recent economic data.

A great deal of debate, discussion and distortion regarding both the present and future state of the U.S. economy continues to permeate the news. If one were to focus solely on the evening news, it would be hard not to conclude that the prospects for the future are indeed dire. The unemployment rate and job uncertainty continue to be foremost among the list of concerns, with the federal deficit running a close second. A host of would-be Presidential candidates, while campaigning in the dead of winter, espouse negative points of view, which make for catchy sound bites, but not economic reality. Indeed, it has become generally accepted that is a "jobless" and low-paying recovery, with employment gains that are sub-par when compared to prior recoveries; however, a closer examination of the data is needed to gain a more measured view of the current economic situation.

Employment Statistics

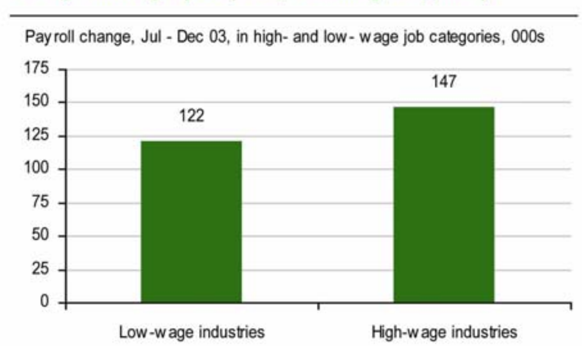
With regard to the unemployment rate, the most current reading is 5.6%, down from a peak of 6.3% in June. The unemployment rate peaked at 6.3% for this cycle following the recession, while the 1990 recession cycle had a peak reading of 7.8%. Likewise, employment gains immediately following previous recessions were often viewed skeptically. It was not until major data revisions were made, often after the fact, that large gains were realized in the employment numbers. Additionally, another myth is that this is a low pay recovery, with new employment being created only among low-wage or "hamburger flipper" jobs. On the contrary, one can see that gains in high-wage industries have actually exceeded low-wage industries, according to year-end data.

U.S. Unemployment Rate 1990-2004



Source: Bureau of Labor Statistics

The private payroll turnaround in H2(03) was not concentrated among "low-wage" jobs (a.k.a., "hamburger flippers").



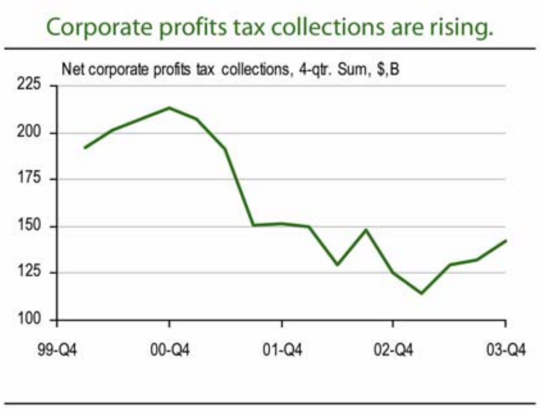
Source: Bureau of Labor Statistics and UBS

Manufacturing Employment

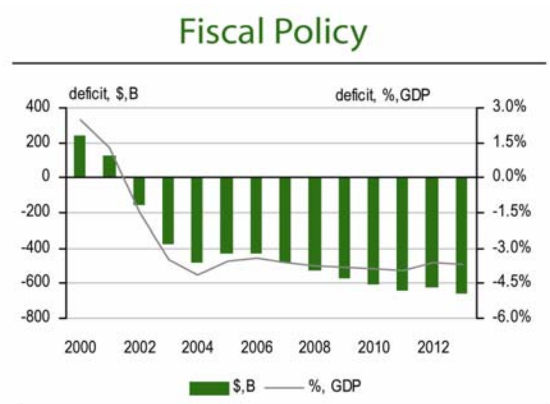
Manufacturing employment is yet another hot button political issue. Yes, manufacturing jobs have been lost in this recovery, and yes, there is a distinct trend for growth in the service sector at the expense of the manufacturing sector. This trend has been in place for many years, and is not new; manufacturing employment in the US has declined steadily after peaking in the late 1970's. The global economy is no different, as every major industrial economy, including China, continues to exhibit a loss of manufacturing jobs. Much of the decline in manufacturing employment can be explained by structural changes in the labor market, such as the increased demand for "new economy" or high tech skilled labor, a replacement of workers with machines, and sizable productivity gains, meaning that more work can be done with fewer employees.

Federal Budget Deficit

Another major concern revolves around the size of the budget deficit. The US is running a substantial deficit, roughly $475 billion and approximately 4% of GDP. While daunting in dollar terms, this deficit as a percent of GDP is not at record levels. The deficit as a percent of GDP was roughly 6% during the Reagan years compared to today's number. Furthermore, it is important to note that tax receipts will increase due to rising corporate profits and an expanding economy, which should help to shrink the size of the deficit. Consequently, budget deficit forecasts may prove to be too high.



Source: U.S. Treasury



Source: UBS

Corporate profits

The real issue for market participants, once we get past all of the political posturing is the corporate profit outlook, which continues to be bright. Sustainable GDP growth between 4-4.5%, coupled with low inflation and interest rates, should encourage a positive environment for corporate profits. An extra benefit will likewise come from the decline of the dollar, which will serve to improve the profitability of foreign operations. Due to these factors, cost cutting measures, and sales gains, in the fourth quarter of 2003, U.S. companies booked the strongest quarterly profit growth since 1993. Looking ahead, we could anticipate that corporate profits will increase between 12-14 % in 2004.

While at first blush, the economic data may appear to be worrisome, after a closer inspection, it appears that the current economic cycle is not dramatically more vulnerable than past cycles in history. As a final thought, it must be remembered that while each cycle is different in the final analysis, investors seek profits, and in this sense the outlook remains positive.

The opinions and trends expressed are those of the manager, and there can be no guarantee they will be achieved or continue.

***Sources**: Bloomberg, Business Week, Bureau of Economic Analysis, Cnn/Money.com, ISI Group, UBS Investment Research, United States Bureau of Labor Statistics, and United States Treasury.

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