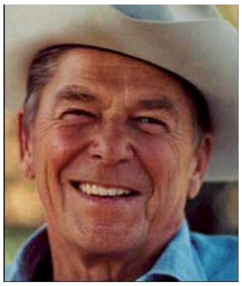
Investment Watch

2nd Quarter, 2004

Voodoo déjà vu

When the *Dreamer in Chief* former President, Ronald Wilson Reagan passed on earlier this month, there was an outpouring of praise for his many accomplishments—The Great Communicator, slayer of Communism, and the sunny optimist. But even in death his supply-side economic policies, born out of drastic tax cuts, are still his most controversial legacy. Yes! ***Reaganomics***, the economic policies that George Sr. dubbed "*Voodoo Economics*" are still thriving under the stewardship of his son George W., the President, *déjà vu*.



Reagan theorized that large tax cuts would stimulate the economy so dramatically that the resulting economic growth would get people back to work, increasing tax revenues and actually paying for the tax cut itself. A popular Political message in any era, *"we can have our cake and eat it too!"* This something-for-nothing message was especially well received back in 1980 when the unemployment rate was 7.5% and inflation was 12.5% producing a ***Misery Index*** of 20.

Robert Barro, a Chicago economist coined the phrase ***Misery Index*** as the sum of the unemployment rate and the inflation rate. In the '70s, high unemployment and high inflation both contributed to the ***misery*** of those times. In Reagan's campaign to oust Jimmy Carter, both Reagan and the press lambasted Carter for America's suffering and employed the ***Misery Index*** to measure the agony! The ***Misery Index*** not only measures the misery of the bad economic times, but also the joys of the good.

After Reagan defeated Carter, he pushed through enormous tax cuts to initiate his controversial supply-side economic theories designed to stimulate the economy. Not only did these tax cuts result in massive deficits, they did not stimulate the economy as predicted and in 1982, the country collapsed into the deepest recession in 40 years with unemployment peaking at 10.4%. Due to this prolonged, double-dip recession, Reagan's popularity slipped and interest in ***Reaganomics*** faded.

Reagan soon realized these budget deficits would cripple our country and abandoned his *voodoo economics* by raising taxes in '82 and '83. With the help of the tough inflation fighting polices of then Federal Reserve Chairman, Paul Volker, the high inflation and interest rates began to turn downward ushering in a new economic era.

When one economic era ends and another begins economists call it ***"The Turn".*** Before the end of Reagan's first term, the ***Misery Index*** began to fall heralding in the good times ahead of declining unemployment and inflation that would last until today.

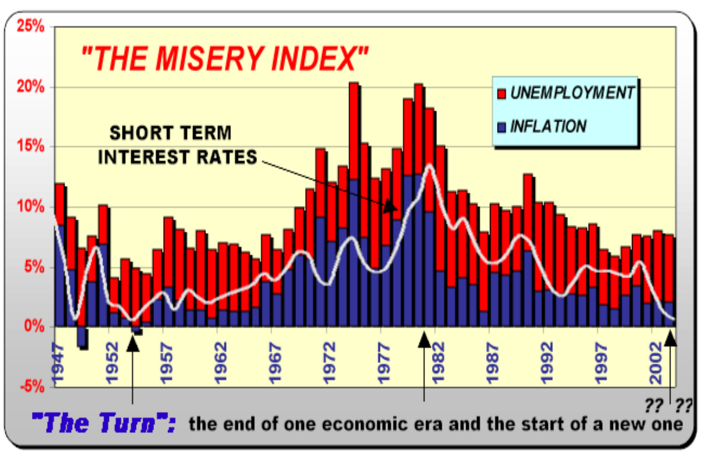
To his foes the legacy of Reagan's *voodoo economics* is repugnant, economic inequality and massive budget deficits which have resurfaced today. However, even his detractors admit that he captivated our nation rekindling the American Dream. His simple theories and his storytelling style brought hope to a troubled nation. *"Let us renew our hope and our faith"*, he professed in his Inaugural Address. "We have every right to dream heroic dreams."

How did Reagan instill hope in such a desperate economic time, when now we feel miserable in such great economic times? How can we feel so miserable when the ***Misery Index*** *has been so low for the last 10 years?*

Maybe because everyone is so worried we're at another turning point - a turning point which will usher in worse economic times! **"CHANGE"** is the most crippling word in the English language, especially when perceived to be for the worse.

But wait! Chicken Little's, *"The sky is falling"* scenario is not only premature but it could lead us to the fox's den! Stay with me and give me a little time to explain.

In the graph below, the ***Misery Index*** clearly shows you both the good and bad economic times. But when do ***The Turns*** actually occur? To see more clearly, I superimposed short term interest rates on the graph indicated by the white line. ***The Turns*** are now clearly visible, '54, '81 and '04. No wonder everyone's losing sleep! ***These Turns*** occur only about every 25 years. An epic economic event!



The Reagan era turn emerged from unbearable economic conditions while ***the Turn*** that will take place today is born to continue our good economic growth. The amazing thing is that ***The Turn***, although historically monumental doesn't result in immediate changes. After ***The Turn*** in interest rates there is a several year period before the old economic era ends and the new one begins.

Did you notice that I just predicted ***The Turn*** will occur today! Everyone knows that you can't predict interest rates, but today it's crystal clear— ***The Turn*** will happen at **2:15 pm Eastern Time on June 30, 2004**. That's when the Federal Reserve Board will begin it's "measured pace" of raising interest rates. We've been in a declining interest rate market for the past 22 years! Now we are entering a new economic era. This is why everyone is panicking! They don't know what the future holds! Let's try to figure this out.

The fed funds rate is at a 46 year low of 1.0%. Most people believe that a 3.5% - 4.0% rate is neutral, a lesser rate promotes economic growth. Greenspan's "measured pace" scheme means that, if inflation doesn't rear it's ugly head, a slow 0.25% increase will be the norm at each Board meeting. This will mark the major turning point. If passed at every Board meeting, it will take until the end of 2005 to hit 4.0%. Therefore, the monetary policy will be accommodative, meaning favoring economic growth.

Back in the '50s when the last upward ***Turn*** in interest rates began, there were 15 years of great economic times signaled by a low ***Misery Index.*** Between '53 and '65 the stock market reflected this with substantial gains. Things do move faster now. But with globalization and productivity improvements keeping inflation in check combined with soaring corporate profits and lower unemployment, the prospects for the future are bright for the economy.

As we counseled you last quarter, when interest rates rise the bond funds will decline in value. During this quarter, mid-term and long-term interest rates increased substantially. Therefore, as we predicted, your bonds have suffered. We hold to this prediction and believe this trend will continue. Reread the last issue and take action.

The shock of the higher interest rates also sent stocks reeling this quarter. However, the favorable economic conditions and the fact that monetary policy will remain accommodative (i.e. below 3.5%), should bode well for stocks in the future.

Okay, maybe like Reagan I'm that sunny optimist but give this at least as much credence as Chicken Little's, *"the sky is falling"* theory.

Let's all be thankful for the great economic times we have had and continue to have faith in our resilience as a people and our ability to cope with change. ***The Turn*** occurred today but our economic party is not over.

Keith Kowalczyk 6/30/04

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