

# Economy at the Crossroads?

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In last week's Web Buzz we mentioned nine various occurrences that could prick the economic & market bubble created by the Federal Reserve during the late 1990's. The first on the list was a sudden interest rate rise and number three was debt saturation. The events of last week imply at least that both of these may be under way.

First of all, the last two months of strong employment numbers have many bond participants selling their positions. The fear is, again, growth will get out of hand and inflation will return with a vengeance thus eroding the value of fixed income securities. On the other hand retail sales came in below expectations for April, which may well indicate that the consumer is pulling back on his spending due to heavy debt commitments. Please refer to the chart below which is repeated from the last week's (5/3/04) Buzz.



We believe this could be a most interesting convergence of events. Our thinking goes as follows: One year of recession (2001) and two years of weak economic recovery (2002 & 2003) have created pent up demand in the industrial portion of the economy. This is due to their not replacing capital items because of the lack of profits. Now that profits have recovered somewhat, they are making these purchases. This is a definite plus for the economy. There is, however, no pent up demand on the part of the consumer. His borrowing and spending has been unprecedented over the last 3 years. The annual increase in mortgage borrowing went from \$376.7 B in 2000 to \$758.1 B in 2003. Total consumer debt for the years 2002 & 2003 was \$1,655.6 B. Per the GDP numbers capital spending is less than 15% of the economy while consumer spending is 70%. It's easy to see from where most of the impact will come.

Could it be that we will witness a revival in the industrial economy along with a slowdown in the retail area? We would think so and the deciding factor could be interest rates – if they go much higher a recession seems certain by year-end.