

Global Indicators

U.S. Financial Markets
May 2004



Global Indicators U.S. Financial Markets May 2004

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FINANCIAL MARKET HIGHLIGHTS

MAY 2004

- Job growth of more than 300,000 positions in March triggers expectations of less accommodative monetary policy and rising interest rates.
- The financial futures' market expects Federal Open Market Committee (FOMC) to raise interest rates by one-quarter of one percent by summer and by one-half of one percent by fall.
- The yield curve slope increases and low-grade corporate bond spreads decline as the market projects job growth will enhance confidence, spending and expansion.
- Inflation projected by the market increases another one-tenth of one percent in April to 2.5 percent annually over the next decade versus the 1.7 percent increase in consumer prices exhibited over the last year.
- Most market observers expect the central bank will change their policy statement to reflect more concern with inflation than deflation, and to provide disclosure that the FOMC will begin to increase interest rates soon.
- The fiscal deficit hits US\$300 billion by mid-year and consumers receive tax refunds of US\$142 billion, projected to be mostly spent -- not saved or invested -- by taxpayers.
- Commodity prices continue to jump with the exception of oil, and the U.S. dollar gains value against the yen, euro and pound sterling.
- The Index of Leading Indicators again rises in March after not changing in February; Six of the ten components are positive.
- The industrial sector exhibits evidence of continued growth as new orders, export orders, employment and backlogs all rise.
- The equity markets remain little changed as expectations of rising sales and improved profits are offset by projections of mounting interest rates.
- Consumer confidence is little changed after plummeting early in the year; Retail sales and consumer spending remain impressive.
- The housing market's sales and construction retain strength but a mortgage interest rate spike of more than 50 basis points will sap exuberance.
- Vacancy rates at office buildings decline and more non-residential construction is anticipated when new jobs are created.

FINANCIAL MARKET TRENDS

Employment Numbers Buoy Market

Less Accommodative Monetary Policy Projected

The U.S. economy added 308,000 new jobs in March. The market reacted swiftly to the long-awaited positive news on employment, as the futures' market also shifted abruptly. The market projects an 88 percent probability that the Federal Open Market Committee (FOMC) will increase the trading range of federal funds by one-quarter of one percent by August and an 82 percent probability the central bank will increase rates by one-half of one percent by October. Members of the FOMC disagree about the threat of inflation to the market. Donald Kohn, a Federal Reserve governor, recently indicated the risk of inflation accelerating remains low: "Given high

unemployment and business operating below capacity, competition for jobs and market share should remain intense and hold back wages and prices." Meanwhile, William Poole, president of the St. Louis Federal Reserve Bank, said, "The stronger economy, lower dollar, commodity-price increases to include energy prices suggest an unexpected increase in prices outweigh an unexpected drop in inflation." Despite public debate among members of the FOMC about trends within the economy, the market believes the central bank soon will raise interest rates from the current 46-year low of one percent.

Table 1
Monthly Interest Rate Trends

Money Market (Three-month)	April 2004		March 2004	
	Rate	Spread	Rate	Spread
U.S. Treasury Bill	0.93%	0.00%	0.92%	0.00%
Commercial Paper	1.07%	0.14%	1.03%	0.11%
Certificate of Deposit	1.08%	0.15%	1.04%	0.12%
Capital Market (20 to 30 Years)				
U.S. Treasury Bond	5.03%	0.00%	4.42%	0.00%
Corporate Bond				
High-grade (Aa)	5.84%	0.81%	5.28%	0.86%
Medium-grade (Baa)	6.25%	1.22%	5.65%	1.23%
Low-grade (B)	7.39%	2.36%	7.27%	2.85%
Mortgage-backed Security				
Fannie Mae (FNMA)	5.40%	0.37%	4.69%	0.27%

Source: *The Wall Street Journal* and *Merrill Lynch Indices*

Table 1 illustrates the monthly change in interest rates applicable to key short-term money market and long-term capital market securities. The money market reacted little. Although the financial markets clearly believe that the Federal Reserve shortly will raise short-term interest rates, the central bank has yet to pull the trigger. Long-term capital market interest rates reflect expectations; long-term interest rates surged in April trading. Ten-year U.S. Treasury note yields jumped by 65 basis points in the past month. Long-term mortgage interest rates increased from 5.4 percent posted in March to 5.9 percent in April. The still hot housing market will begin to cool as higher mortgage rates place pressure on the ability of

prospective home-owners to afford monthly principal and interest payments. Most observers within the financial market expect the FOMC to change the wording of their policy statement when they next meet in early May and then raise interest rates six weeks later. Table 1 also illustrates the monthly shift in interest rate spreads; A spread reflects the difference in yield between a corporate or governmental agency security and a U.S. Treasury instrument of comparable maturity. Interest rate spreads change in response to perceptions of default risk and tolerance for credit risk by investors and traders. Few spreads changed except for the important low-grade corporate bond market.

Table 2
Monthly Interest Rate Spread Trends

Spread	April 2004	March 2004
Yield Curve	3.47%	2.83%
Medium-grade Corporate	0.41%	0.37%
Low-grade Corporate	1.55%	1.99%
Inflation	2.50%	2.40%
Election	1.35%	1.47%

Source: *The Wall Street Journal* and *Merrill Lynch Indices*

Several interest rate spread relationships, to include the yield curve spread, corporate bond credit spreads, and the U.S. Treasury Note/Treasury Inflation-protected Security spread provide information that may be used to project future economic conditions, and to confirm recently-released information about trends within the U.S. economy. Individual indicators may and periodically do provide false indications of strength or weakness. The composite spreads provide a reasonable representation of market

expectations. Table 2 illustrates the monthly trend for each of the key interest rate spreads. In addition, the table includes an “election spread” that will be tracked for the remainder of 2004 to illustrate the market’s perception of the presidential election between Senator Kerry and President Bush.

- **Yield Curve Spread** -- The yield curve provides a graphical relationship between the yield and the remaining term of a U.S.

Treasury security. The yield curve spread is defined as the difference in yield between ten-year U.S. Treasury notes and three-month U.S. Treasury bills. The slope of the yield curve partly reflects expectations of interest rates in the future. A more positive slope indicates the market expects interest rates to increase by a larger amount and/or rates will rise more quickly. Higher U.S. Treasury interest rates are consistent with projections of the U.S. economy making the transition from the lingering recovery to solid and sustainable expansion. The yield curve spread increased by 64 basis points in April after falling by more than 50 basis points in the first quarter of 2004. The yield curve spread increased from more than 280 basis points at the end of March 2004 to almost 350 basis points by the end of April. The yield curve spread has averaged 180 basis points over the past 20 years. Three-month Treasury bill yields changed little in April but ten-year U.S. Treasury notes ratcheted up almost two-thirds of one percent. It was a bad month for the bond market. The markets long have had more concern with the threat of inflation accelerating than deflation concerns offered by many economists within the central bank. More importantly, the steeply upward sloping yield curve is consistent with expectations that gross domestic product (GDP) will increase by well over four percent in 2004.

- **Corporate Credit Spreads** -- The corporate credit spread reflects the difference in yield between corporate securities of comparable maturity but different asset quality. The low-grade corporate bond spread provides an especially good gauge of the market's perception of and tolerance for credit risk in the market. The yield spread between low-grade (e.g., BB, B and CCC credit ratings) and high-grade (e.g., AAA and AA ratings) corporate debt plummeted from a low 199 basis points at the end of the first quarter of 2004 to an unusually low 155 basis points at the end of April. Yields on high-grade

corporate debt increased more than 50 basis points in April trading but low-grade debt interest rates increased by a little more than ten basis points. The markets are seeking high yields from the low-grade corporate debt market given the lack of appreciation in equity prices and the still very low interest rates applicable to the money market. Meanwhile, the spread between medium-grade (e.g., A and BBB ratings) and high-grade corporate bonds increased by four basis points in monthly trading to 41 basis points. The very narrow low-grade credit spread is consistent with the more steeply sloped yield curve; the market has overcome recent uncertainty expressed regarding the pace of continued economic growth and corporate expansion in the United States.

- **Inflation Spread** -- The popular price indices illustrate historical price trends. The financial markets can be interpreted to identify future inflation expectations by focusing on the difference between the nominal yield for 10-year U.S. Treasury notes, which were used to derive the U.S. Treasury yield curve spread, and the real rate for 10-year Treasury Inflation-protected securities. The inflation spread increased by ten basis points in April after increasing by almost 80 basis points during 2003. Consumer prices have increased by 1.7 percent in the past year. The market projects the low inflation rate will accelerate to 2.5 percent per year over the next decade. The U.S. dollar is beginning to gain value after losing heavily over the past several years to other key global currencies. The U.S. dollar appreciated 1.5 percent against the yen and 3.3 percent against the euro in April as currency traders project strong growth in the U.S. will be accompanied by rising interest rates. The cost of imported goods increased by .9 percent in March after rising by .4 percent in February. Import prices have increased by 1.2 percent in the past year. The cost of imported goods increases as the U.S. dollar loses value, and exporters have an

opportunity to increase the price of their goods given the increase in value of other key trading partner currencies. Inflation from import prices will subside if the U.S. dollar retains its strength against other currencies in the second quarter of 2004. A stronger dollar will also place pressure on surging exports increasingly enjoyed by U.S. manufacturers.

- **Presidential Election Spread** -- The presidential candidate selection for the November U.S. election appears set between President Bush and Senator Kerry. The Republican president advocates keeping marginal income tax rates low for all taxpayers. The Democratic challenger advocates increasing marginal income tax rates for high-income filers. Low marginal income tax rates favor investment by consumers in corporate bonds while high marginal income tax rates favor selection of tax-exempt state and local municipal debt. The corporate bond/municipal bond spread should narrow if the market believes President Bush is more likely to win and the spread should widen if the market perceives Senator Kerry will prevail. Although there are many factors that affect capital market interest rates, to include issuance, corporate profitability, state and local government fiscal balances and

so forth, the spread also reflects existing and projected marginal income tax rates. The election spread declined from 147 basis points at the end of the first quarter of 2004 to 135 basis points at the end of April. The marginal tax rate that equates the return between a pre-tax yield of a corporate bond and an after-tax yield of a municipal bond decreased from 27.8 percent at the end of the first quarter of 2004 to 23.1 percent as of April. A lower tax equivalence and lesser spread suggest the market now believes President Bush is more likely to obtain four more years to effect public policy. The market results are consistent with a new poll released by ABC News and the *Washington Post* of registered voters; President Bush enjoys a five percentage point lead over Senator Kerry. The markets and polls will change many times prior to the November election given military and diplomatic results in Iraq, global terrorism and the U.S. and worldwide economy.

Market optimism exhibited in April can be traced to one economic release -- the 308,000 new jobs created. It is critical that new jobs continue to expand by more than 100,000 per month for the recent confidence to be fully justified.

Inflation Accelerates

The popular price indices continue to rise and refute the deflation analysts of the central bank.

- The Producer Price Index increased by .1% in February after jumping by .6% in January. The core rate of wholesale prices, which remove volatile energy and food costs, increased a minuscule .1% after rising by .3% the first month of the year.
- The Consumer Price Index increased by a potentially worrisome .5% in March. Core

consumer prices increased by .4%. Consumer prices have increased by 1.7% in the last year versus a 1.6% gain in core consumer costs.

Despite preliminary evidence that shows prices are rising more quickly, neither inflation nor deflation appear problematic. The unemployment rate remains stubbornly high at 5.7% and industrial capacity utilization rates remain historically low at 75%.

Table 3
Monthly Commodity Cost Trends
(Percentage Change)

Commodity	April 2004	Past Year
Food	0.5%	25.3%
Industrial	0.8%	50.8%
Gold	1.2%	26.2%
Oil	-0.8%	26.5%
All-commodity	1.0%	30.2%

Source: *The Economist*

The commodity markets provide another source of information regarding price pressure faced by business and consumers. Although companies are able to offset the cost of rapidly rising goods purchased by operating more efficiently and/or by accepting lower gross profit margins, the cost trend applicable to commodities cannot be ignored. Table 3 illustrates the monthly and annual trend in the percentage cost of key goods traded in the commodity market. Gold prices, which provide a harbinger of inflation, increased by another one percent in April after jumping by more than 25 percent during the past year. In part, gold prices reflect prior depreciation of the U.S. dollar, continuing political and military operations in Iraq,

heightened tensions within the Middle East and terrorist activity in Europe. Food prices also increased by one-half of one percent in April and remain 25 percent higher than a year ago. Oil prices, by contrast, fell almost one percent in April despite continuing efforts by the Organization for Petroleum Exporting Countries to cut output to maintain prices. The all-commodity index increased by one percent in the past month. The commodity markets provide evidence that inflation -- not deflation -- could again emerge to thwart the existing very accommodative monetary policy. As inflation rates rise, the real or inflation-adjusted rate of interest applicable to the trading range of federal funds becomes even more accommodative.

Governmental Policy

Monetary policy remains very easy. Not only are interest rates on federal funds at a 46-year low, the money supply continues to expand quickly. Money supply growth contributed positive impetus to the Index of Leading Indicators in both March and February. The narrow money supply, M1, increased by 1.8 percent in April while the more important broad money supply, M2, expanded by 0.9 percent in the past month. The narrow money supply has increased 6.4 percent in the past year while the broad money supply has increased a

more manageable 4.0 percent. Total reserves in the banking system increased by 0.7 percent in April. There appears to be ample money and liquidity in the financial markets and banking system to support growth. Free reserves, which equal excess reserves less reserves borrowed from the Federal Reserve, within the banking system hover near a very high and positive value of US\$2 billion. The futures' market projects the central bank likely will increase the trading range of interest rates several times during the remainder of

this year. Even if interest rates are doubled to two percent, the real rate of federal funds will remain low by historical standards.

Fiscal policy is stimulative. The 2004 fiscal deficit through March reached almost US\$300 billion. The administration expects the deficit to exceed US\$500 billion for the fiscal year that ends in September. Although tax revenues increased 16 percent in March relative to a year ago, expenditures rose almost 19 percent. Through early-April, the federal government has disbursed US\$142 billion of tax refunds. According to a

recent survey compiled by Cambridge Consumer Credit Index, 68 percent of Americans receiving a refund in 2004 expect to spend the money this year versus 59 percent that spent the refund a year ago. The large refunds and enhanced spending plans will maintain economic momentum through the second quarter of the year. GDP expanded by a revised 4.1 percent in the final quarter of 2003; the Blue Chip Economists project even quicker growth in the first two quarters of 2004 as monetary policy remains accommodative and fiscal policy stimulative.

Manufacturing Sector Gains Energy

Index of Leading Indicators Rises After Pause

The Index of Leading Indicators compiled by the Conference Board increased by .3 percent in March after showing no change in February. Six of the ten components used to construct the Index increased in March to especially include more firms reporting slower deliveries and growth in the money supply. Four of the factors within the Index decreased to include a then more narrow yield curve spread and then declining stock prices. Confidence of chief executive officers polled by the Conference Board in another survey surged to the highest level reported in more than 20 years. About one-half of the CEOs contacted expect to hire more workers during the next year versus only 12 percent expecting to reduce staff. Job growth is critical if the expansion is to prove sustainable. Many, but not all, industrial indicators recently released are positive.

- Business inventories increased by .7% in February as sales expanded by .5%. The important inventory-to-sales ratio was unchanged at a low 1.33 months.
- The monthly index compiled by the Institute for Supply Management for the manufacturing sector increased to a reading of 62.4 in March relative to 61.4 a month earlier. A reading above “50” indicates growth.

Purchasing managers contacted indicated strong growth in new orders, export orders and backlogs.

- Yet, industrial production declined .2% in March as demand for utilities fell after an unusually harsh winter. The capacity utilization rate at the nation’s factories, utilities and mines declined by .1% to a still low 75.2%.

The manufacturing sector is now contributing to solid growth in the U.S. Industry must hire more workers to enable the consumer sector to promote continued rapid expansion. A recent poll conducted by Manpower, Inc., shows that 28 percent of firms contacted expect to hire more workers in the second quarter of 2004, which is about twice as many firms offering new jobs than reported three months ago. Only six percent of the firms polled expect to reduce the number of workers in the April to June period.

Overall, industry has kept inventory levels low. Although capacity utilization rates suggest significant excess capacity is available, not all of plant and equipment available is productive or up to current technological specifications.

The Commerce Department reported that pre-tax corporate profits surged by 29 percent in 2003. The 27 percent rise in equity prices over the past year reflect the underlying improvement in profits. Table 4 illustrates the recent monthly change in the prices of equities within the broad-based Standard & Poors 500 Index. Stock prices inched up 0.4 of one percent in April trading even though the price-earnings ratio applied by investors fell from 17.7 times next year earnings to 17.6 times. Higher

stock prices pushed the dividend yield down to 1.58 percent. Dividend yields remain 65 basis points higher than yields on three-month U.S. Treasury bills. Equity prices are being held in check by the expectation that short-term interest rates soon will rise; bonds become more attractive after interest rates increase unless offset by sufficient growth in corporate earnings. Most financial market traders remain leery of terrorism domestically and the spread of war internationally.

Table 4
Monthly Equity Market Trends
Standard & Poor's 500

Standard & Poor's 500	April 2004	March 2004
Index	1,128.2	1,123.8
Price-earnings Ratio		
Trailing Year	22.5x	22.3x
Next Year	17.6x	17.7x
Dividend Yield	1.58%	1.60%

Source: *BusinessWeek* and *Standard & Poor's Corporation*

Consumer Confidence Remains Unchanged

Consumer confidence was unchanged in March after plummeting by nine percent in February. About 30 percent of the 5,000 polled by the Conference Board believe jobs are hard to get, relative to 28.9 percent with such a pessimistic perspective a month earlier. More ominously, 10.1 percent of households project their income will fall over the next half-year versus 8.4 percent expecting lesser income a month earlier. The consumer requires several consecutive months of large job gains and far fewer casualties of U.S. soldiers and marines in Iraq before gaining significant confidence. Despite the plunge in confidence early in the year, the majority of consumer statistics remain positive.

- Personal income increased .4% in February after rising by .3% in January. Consumer spending increased by .2% in February after

jumping by .5% in the first month of the year. Because personal income increased more quickly than spending in February, the personal saving rate increased by .1% to a still low level of 1.9%.

- Consumer credit expanded at an annualized pace of 2.5% in February after a large 9.5% annualized jump in January.
- Sales at retail stores open at least one year increased by 7.2% in March from year-earlier levels. The gains were broad-based; Costco reported 10.0% growth, Nordstrom indicated 15.9% growth and Ann Taylor showed 12.0% growth.
- Retail sales increased by a large 1.8% in March with or without the inclusion of

volatile car sales and gasoline. Retail sales are running 8.2% above year-earlier levels.

The strong consumer sector statistics suggest GDP should expand in the four to five percent range in the first quarter of 2004.

The housing market remained strong prior to the recent jump in long-term U.S. Treasury and mortgage interest rates.

- New home sales increased by 5.8% in February to 1.16 million annualized unit sales. The supply of new homes available for purchase fell to 3.8 months from 4.1 months in January.
- Existing home sales also increased 2.0% in February to 6.12 million annualized unit sales. The median price of existing homes sold increased by 5.7% from a year ago to US\$168,100.

- Construction spending, by contrast, declined .1% in February as residential construction fell by .3% but commercial construction jumped by a strong 1.1%.
- Office vacancies declined .1% in the first quarter of the year to a still high 16.8% but apartment vacancies increased .3% to 7.1%.
- Housing starts increased 6.4% in March to 2.007 million annualized starts.

Mortgage interest rates increased by more than one-half of one percent in the past month. Rising interest rates will crimp the booming housing market and curtail refinancing activity that provided the consumer sector incremental spending power. Prior to the rate hike, progressively more mortgagors were borrowing with interest-only or adjustable-rate loans to enhance the affordability of home purchases. With the interest rate spike, fewer prospective home-owners will be able to afford a mortgage loan regardless of loan structure.

Summary

The markets reacted quickly to the large number of new jobs created in March. Most surveys of the manufacturing sector, the service sector and company CEOs indicate firms are more likely to hire than fire for the remainder of 2004.

Productivity gains that averaged 4.8 percent between the fourth quarter of 2001 and the end of 2003 will be unable to continue for the foreseeable future. Firms will need more workers to increase production when the U.S. economy returns to more typical productivity gains of 2.6 percent per year. If the U.S. can add 125,000 plus workers monthly over the rest of the year, economic growth

will reach sustainable expansion. Job growth will improve confidence and spending even if the torrid housing market cools. New jobs will lead to the construction of new offices in selected markets. More expensive mortgage loans will lead to greater use of apartments, declining vacancy rates and again new multi-family construction. A less vibrant housing market will be offset by a more robust commercial real estate market. New job creation -- subject to an orderly transfer of government in Iraq -- will affect the presidential election. Job growth remains the central concern of the U.S. economy.

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