# THE ECONOMIC SITUATION

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Recession/Deflation? What's next?
The nation's economy: Little things mean a lot.
Income growth: Still at a crossroads.
The latest South Carolina forecast: Riding on the shoulder of the yellow brick road.

**The recession index has subsided, but deflation?**

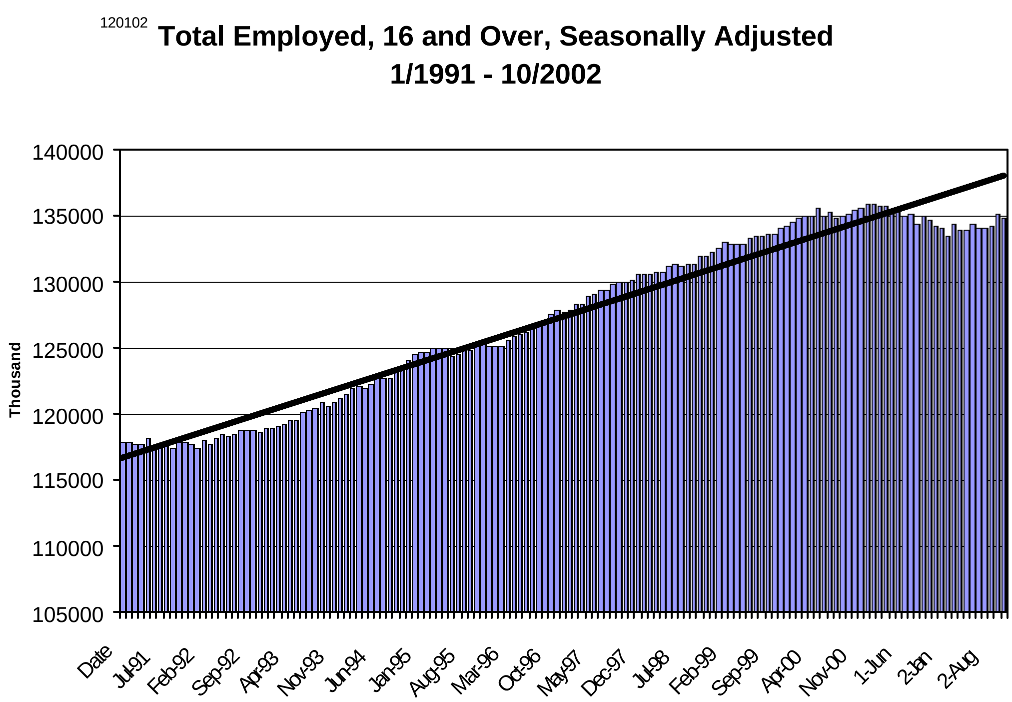
In late November, the *Economist* magazine reported that its highly accurate recession index, which peaked in 2001's first quarter, had headed south and was no longer flashing red. The index is formed from a count of the word itself. How many times does "recession" show up monthly in the *New York Times* and *Washington Post*? Yes, the recession is gone. We can relax, a bit. But wouldn't you know? The magazine's deflation index is now sounding the alarm. It is a count of the word's frequency in the *Financial Times* and *Wall Street Journal.*

Simple measures like these lend credence to the words of Federal Reserve Chairman Greenspan when he recently said the U.S. economy is now balanced, but moving through a soft patch. In November, he joined his other committee members in a move to lower interest rates one more time. Their concern? Deflation. From all appearances, however, the deflationary forces have been quelled. Next thing we know, we see mild signs of inflation, very mild.

**Not much employment growth, but incomes continue to rise.**

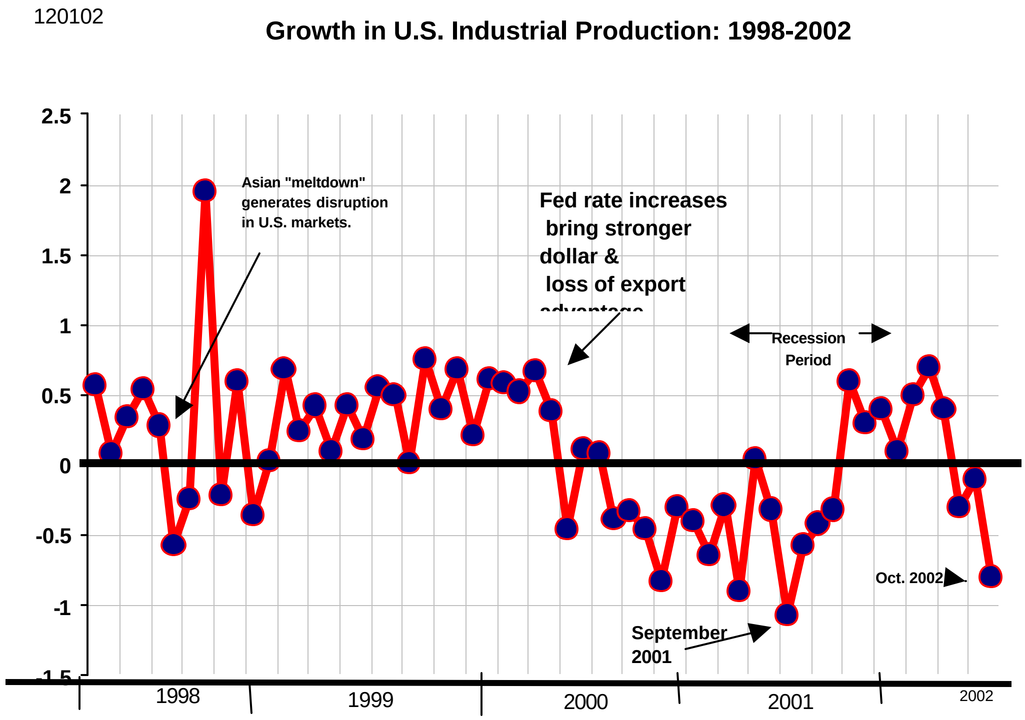
The soft patch is obvious in employment data. Since July, the economy has followed a ragged, but positive, growth path. Real GDP growth has moved from a fairly strong positive 4.0% in 3Q2002 to signs of a paler but positive number for the year's final quarter. November's unemployment rate crept up to 6.0%, giving another sign that strong productivity growth continues to make this recovery a jobless one. But when considered in a historic perspective, 6% unemployment is hardly bad at all. And while employment has shown little growth, salaries and wages continue to rise. The result? Growing incomes continue to fuel consumer spending.

The picture is shown here in a series of charts. The first chart shows the employment picture, with data ending in October 2002. A trend line that fits the data is also shown. As can be seen, the bottom of the employment sag seems to have formed. Positive growth is taking shape. The bars in the chart are getting taller. When meaningful employment gains do materialize, it will be because manufacturing has begun to generate some small positive numbers. Meanwhile, we must recall that unemployment can rise in the face of job growth, if the number entering the labor force exceeds the number of new jobs. And that is what has happened.




The manufacturing employment challenge is seen clearly in the next chart. Industrial production is not grabbing hold. With capacity utilization still below 80% nationwide, growth in demand for manufactured goods has yet to make a dent on the need for firms to invest in new capital equipment. As seen here, America's factory economy, which earlier was sputtering positive growth numbers, has lost ground for three consecutive months. But hang on. The signs suggest it will turn around next quarter.

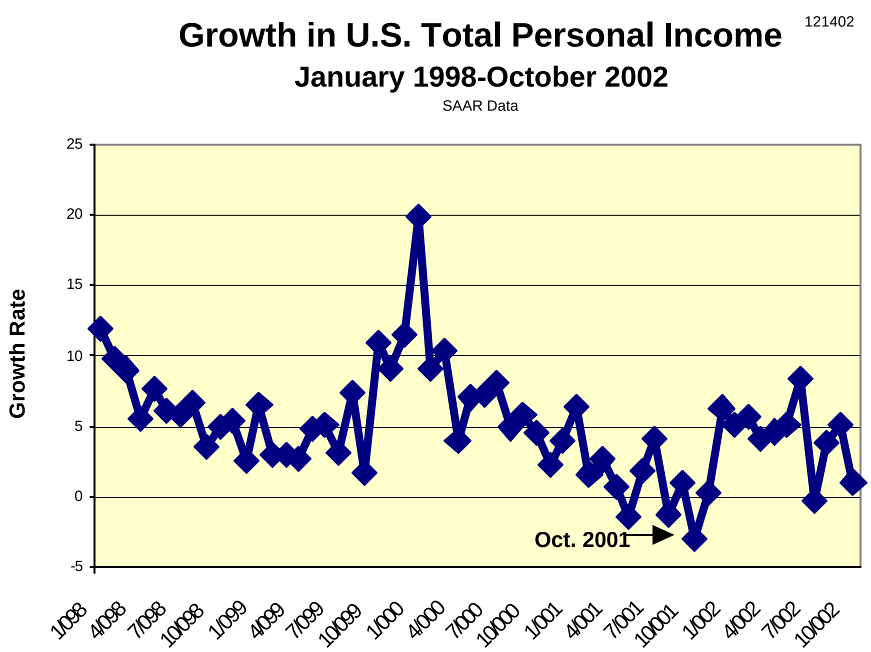
While cutting production to accommodate the realities of a slow world economy, manufacturers are once again squeezing out profits from their operations. According to Commerce Department data, corporate profits, compared to last year, rose 12.2% last quarter. Higher profits provide the raw material for improving plant and equipment when the time comes. They also make it possible to expand output.




### How about those hearty consumers?

With employment gains and higher profits, the services economy is the growth engine now. And while factory employment is not expanding, those who are employed are earning more than ever. The result? Total personal income growth is still pumping positive numbers, which translates into strong retail sales and housing starts. The next chart tells the tale. As can be seen, a sharp decline in income growth started in January 2000 and finally bottomed out in October 2001. Growth hit the zero point, then reversed and headed north only to slip into negative territory again in July. What can we say? The economy is once again pumping income at a positive rate, but the pulse beat is erratic.

Little things mean a lot.



**And so what does all this say about GDP growth in 2003?**

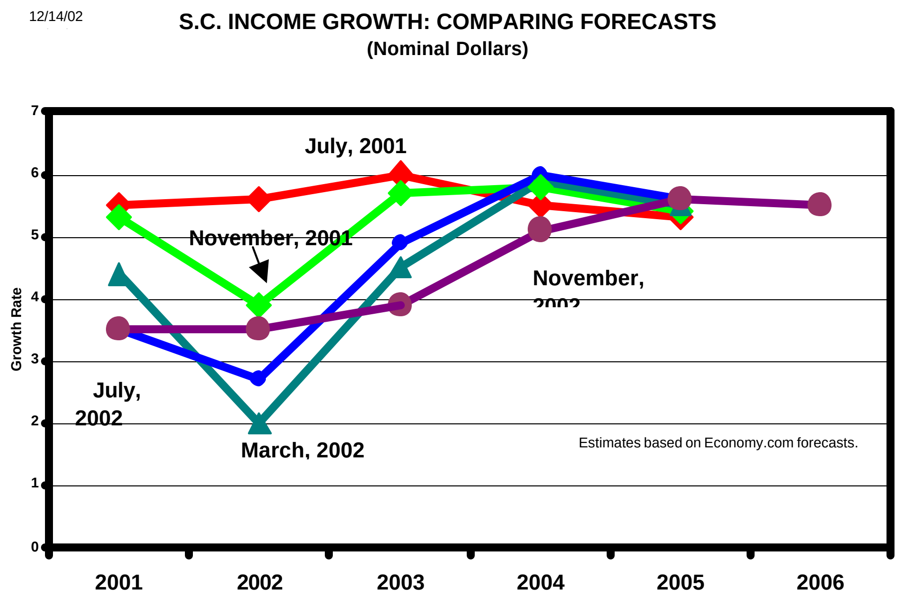
The pattern of employment, production, and growth in total personal income suggests positive but certainly not rip-roaring GDP growth lies ahead. The Fed's looser money policy implies the growth will come with some inflation, but not enough to do mischief to interest rates. Relying on recent projections provided by economy.com, the GDP forecast calls for moderate growth ahead, with hardly any of the tall timber seen in late 1990s.

**South Carolina: Lagging the nation.**

The evidence for the national economy suggests a bumpy road ahead, but no recurring recession. What about South Carolina? High performance is just not in the cards. But before getting to the details, consider a series of forecasts for state total personal income provided at different times in the last year by economy.com. The chart below shows the dated forecasts. The first is made in July, 2001, which is of course before 911. The second comes in November, 2001, after 911. Then, there are three subsequent forecasts, the most recent being November 2002.

Close examination of the series reveals several noteworthy aspects of South Carolina's changing economic fortunes. First, we can see that the earlier expectations for the recession were overly optimistic. As time passed, the forecasts were revised sharply downward. Then, the revisions turned out to be too pessimistic. Now, the November forecast contains a lot of actual data for 2002 and is looking forward to 2003 and beyond.

The revisions we see are not so much about South Carolina as they are about the nation. After all, we march to the nation's drumbeat, and the beat has weakened during the periods covered by the forecast.



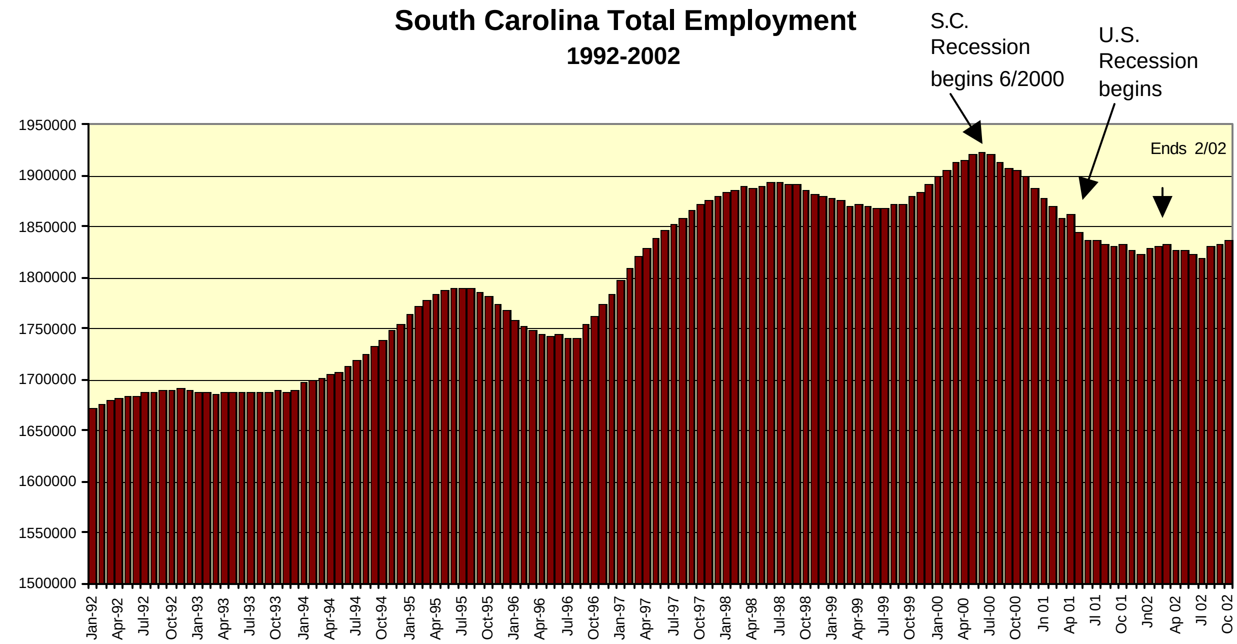

The small effects of the recovery are seen in the state employment data, which look a lot like the national pattern. From all appearances, a bottom has formed and a bit of growth is emerging. About 1% employment growth is expected in 2003, with 2% projected for 2004. Perhaps, we will see close to a full recovery by 2005. It's a long way back to the yellow brick road. Right now, we seem to be riding on the shoulder.

**Basic Elements of the 2003 Forecast**

In a way it is less than fortunate that the year ahead promises to be a rather straightforward projection of the current one. Put another way, there are no major pending policy actions that might trigger a quick and meaningful response. Yes, there are promises of tax cuts or at least accelerating the cuts that are in the works. And yes, there are also the economically dangerous implications of war in Iraq and unpredictable terrorist responses. Recognizing these uncertainties, but not accounting for them, the forecast for 2003 suggests the following: Real GDP growth will come in at 2.5% to 2.75%. This compares with 3.8% for 2000 and 4.1% for 1999. No yellow brick road next year. We should add roughly 2% for inflation, which is quietly rearing its head, and we get nominal GDP growth of 4.5% to 4.75%.

Given the still relatively mild inflation, but with the Fed hitting the bottom of the barrel for rate cuts, next year's interest rates should still look rather attractive. Long-term rates, like the 10-year Treasury bond, should hover around 4.70% to 5.00%. Not much change. Shorter rates, on the other hand, will nudge up a bit. We should observe 2% to 3% yields on the 91-day Treasury bill, as compared to 1.6% now. In short, the good days for refinancing mortgages will still be around.

Stronger GDP growth and relatively mild interest rate movements should combine to yield a happy environment for stock market movement. Unfortunately, though, the keepers of the Dow-Jones don't always read this newsletter. If they did, they would know that next years' Dow-Jones Industrial Average should reach 10,800 by the end of the year. (They should also know that the average should be 9,450 now!)




**Thinking about the year ahead**

At a recent conference with a small number of law school professors, we talked late one night about how unbelievably fortunate we are. So many of us have achieved what some call the great American Upper Middle Class standing. In truth, we agreed, we are richer than we ever dreamed we could be in the 1960s and 1970s when we started our professional careers. As an example, one person at the dinner table commented that she and her family can afford to travel most anywhere in the world every year or so, and while not staying in the five-star hotels can do quite nicely in the economy quarters provided by the market. All the sights of Venice, Paris, and New York are the same, no matter where you might be sleeping. Yes, the market is a marvelous thing.

The conversation then turned to the deeper matter of how we fortunate ones might focus some of our good fortune on other people. It seems hard at times to really match your desire to give with real needs, my dinner companions said. And they are right. It isn't easy to know that gifts will really do the job intended. As we talked, we realized that the market for charitable actions offers help here too. Firms, not-for-profit and otherwise, are there to help us match our good intentions with real outcomes.

That market works too. Since 1990, charitable donations by individuals have grown 50%, from $110 billion to $164 billion in 2001, according to *Business Week*. Precious gifts of time and goods are not even counted in these numbers. Along with this record level of giving has come a new demand for accountability. People are giving and demanding to know that real needs are being satisfied. Even more, donors are now joining the ranks of the organizations they support, this to make certain that the gift keeps on giving.

Andrew Carnegie, the tough steel maker who worked to put public libraries in most of America's major towns and cities, put it this way, we are told:

*Rich men should thankful for one inestimable boon. They have it in their power during their lives to busy themselves in organizing benefactions from which the masses of their fellows will derive lasting advantage, and thus dignify their own lives.*

We are all rich, at least rich enough to make things a bit better for those still searching for the first rung on the ladder.

Although 2003 GDP growth may not be all that cheery, what individuals do with their share of it can be.

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