

THE ECONOMIC SITUATION

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- **Spring comes at last.**
- **And GDP growth is looking good.**
- **How about the employment picture?**
- **Is inflation coming back?**
- **Why is gasoline so dear? Is it all about OPEC and Arabs?**
- **South Carolina's economy is improving.**
- **One more hero.**

An economic spring has sprung.

It came almost with the coming of spring. And just as sudden. What had been doom, gloom, and fear of deflation, outsourcing and the demise of America's great job machine changed. Just as quickly as a leafless rose bush can produce green foliage and red blooms, the economy began to produce profits for corporations, higher incomes for consumers, and yes, concern about inflation instead of deflation, and finally, some real job growth.

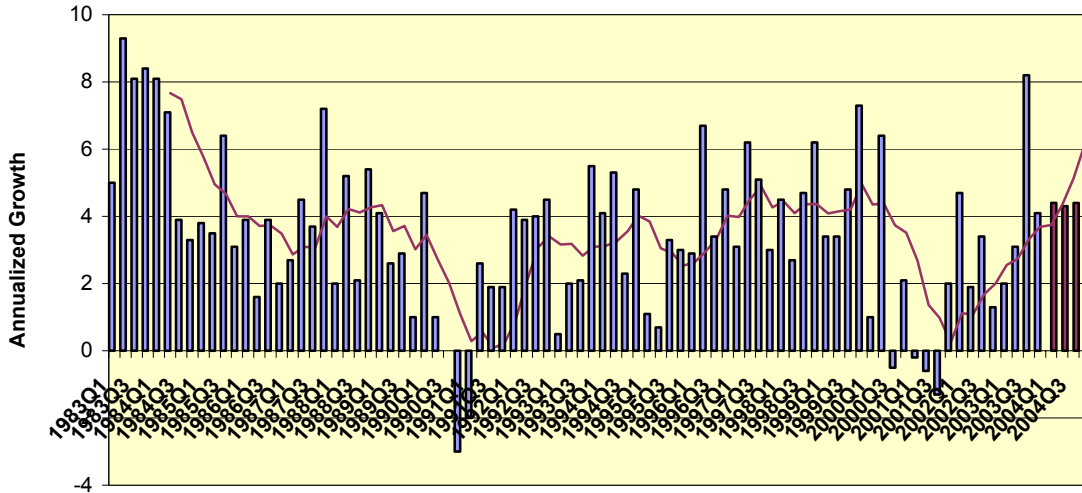
Some may have wondered if spring would come again. It did. Pass the word.

The GDP growth picture is shown in the chart below. Here we see actual growth as recorded through 4Q2003 and projected growth till the end of the year. Just as a return of spring caught the pessimists flatfooted, the return of GDP growth caused a host of forecasters to tune up their numbers.

Consider the 32 forecasts surveyed in late February by the Federal Reserve Bank of Philadelphia. Three months earlier, the band of brothers predicted 2004 real GDP growth would average 4.3%. Now, the latest forecast calls for 4.6%. The forecast for 1Q2004 is 4.6%, up from an earlier 3.9%.

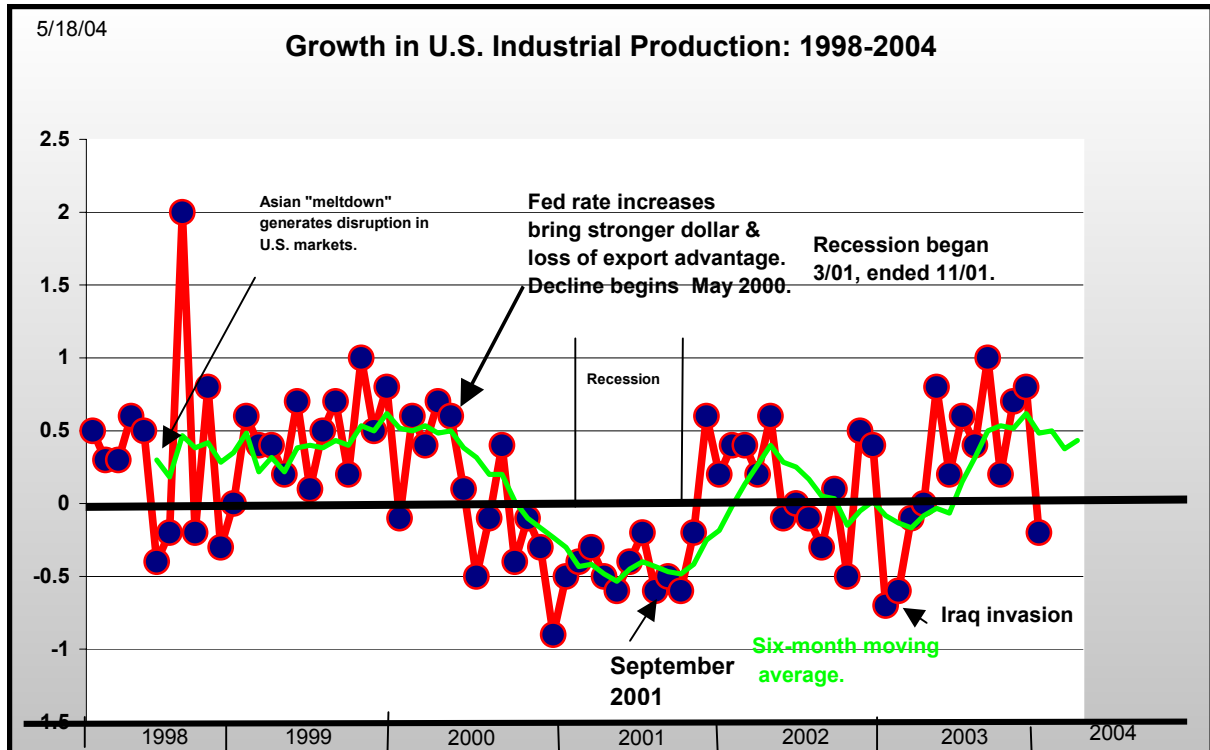
Slightly better news is seen also for the predicted unemployment. 2004 unemployment is predicted to average 5.6%, just a wee bit lower than the current number.

Real GDP Growth: 1Q1983-4Q2003
Estimates through 4Q2004
 (with 6-quarter running average)



U.S. factories are turning the corner too.

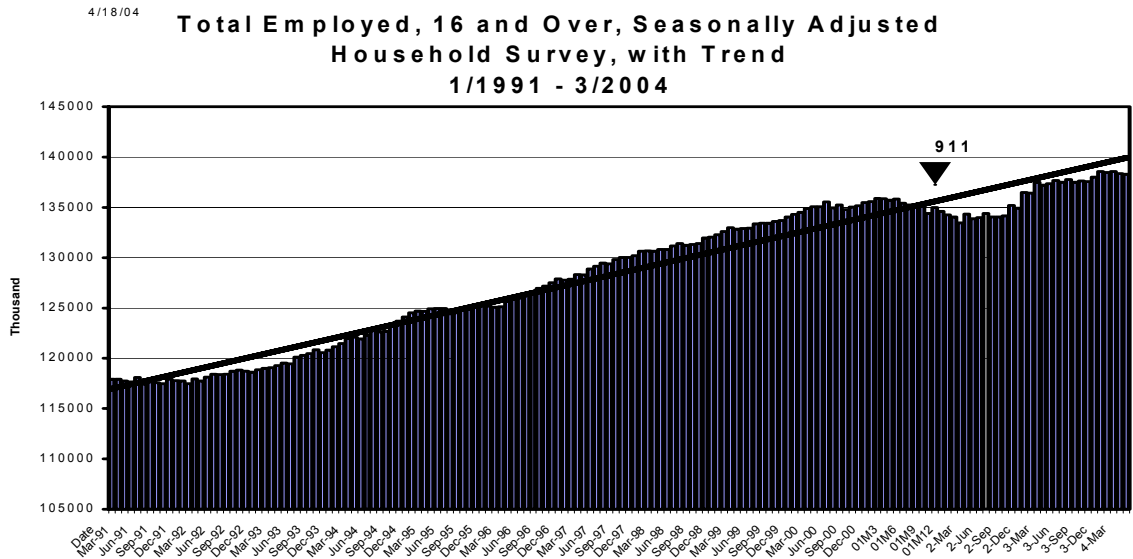
The long troubled manufacturing sector is also showing the right stuff. The warming economy generated some rather high industrial production numbers, as shown in the next chart. Yes, the growth rate for March fell below the line, but the trend is surely positive, and the implied pace is rather lively. Three things are spurring the industrial recovery: a weaker dollar that stimulates exports, higher income that stimulates consumption, and strong retail sales that require inventories to be replenished.



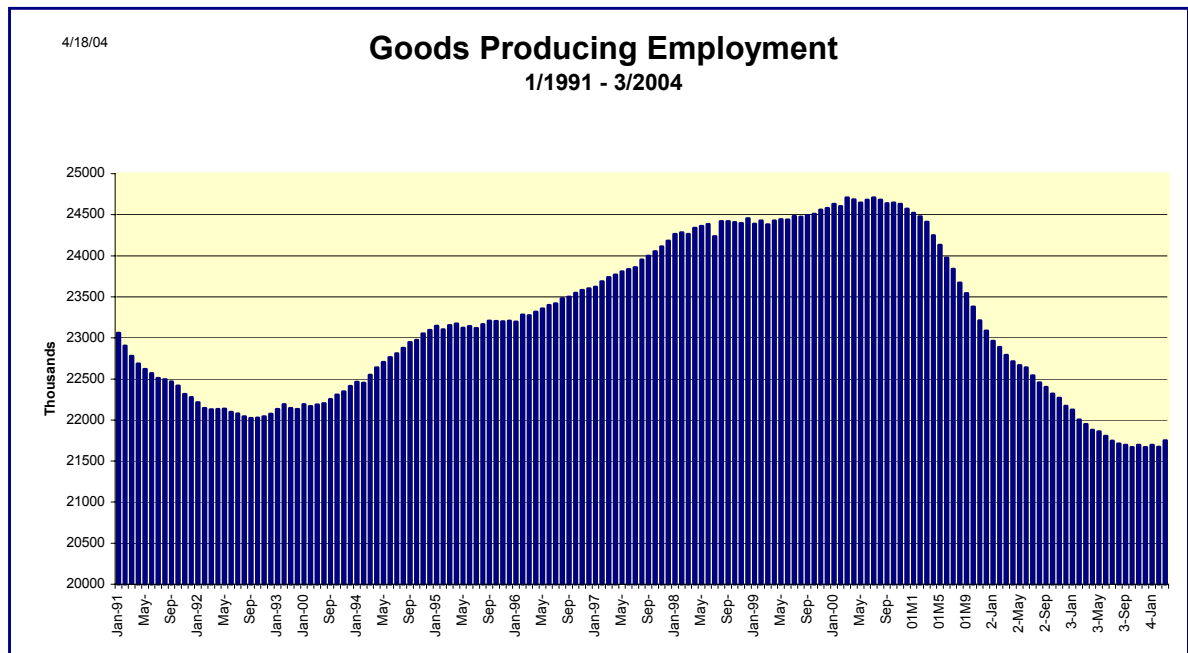
What about jobs?

The Philadelphia Fed's forecasters weren't so optimistic about the prospects for job growth. They believe monthly payroll job growth will average 91,000 jobs in 2004. They predict twice that much in 2005. However, the Fed's forecasters were doing their work long before the job report for March was announced. That report brought sounds of great rejoicing. More than 300 thousand new jobs were added in March. This was the first sign of a major thaw in what appeared to be a frozen labor market.

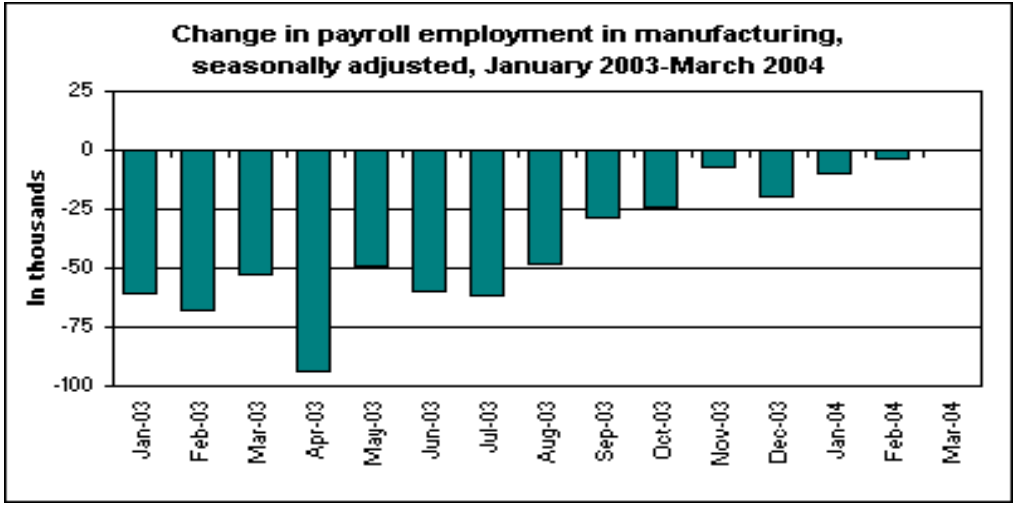
The next three charts fills in the canvas for some key features of the U.S. labor market. The first chart gives monthly data on total U.S. employment. This count is based on the Department of Labor's Household Survey. Here we see the forces of the Fed-induced recession as they play through the labor market. We also see the recovery as it generates meaningful employment growth. As we can see, the gap between trend and growth is finally closing. We must keep in mind that the data observed are from the Household Survey, not the payroll survey, which shows less employment growth.



The next chart shows total employment in manufacturing, a very different and troublesome picture. Once again, we see a bottoming out and some recovery.

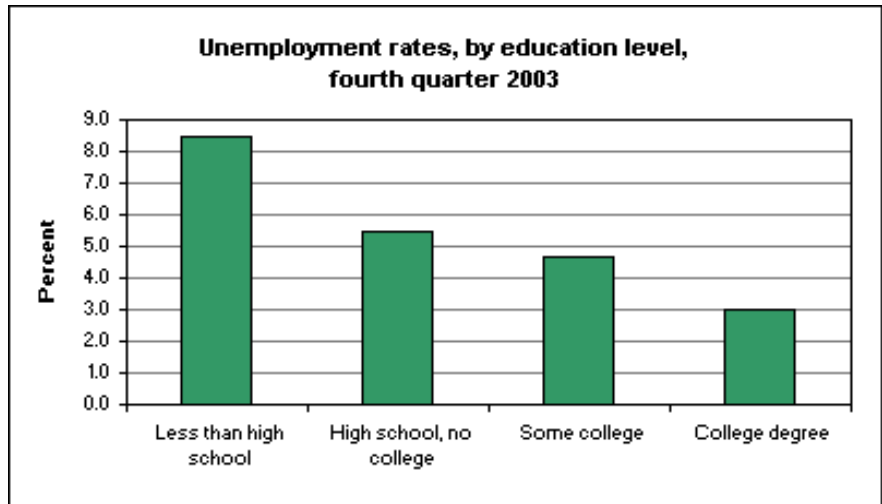


The next chart focuses on growth in manufacturing employment. This highlights the recent good news. There is zero growth March, instead of job losses. A straight-line forecast predicts positive numbers for April.



Is it really a white collar recession?

Some have suggested that this recession and recovery have been different from those in the past in two ways. First, the economy has recovered, but employment has not. There is no doubt about the slow employment recovery. Second, white-collar workers have at least shared if not suffered more in the job losses. The next chart showing unemployment by educational attainment speaks to this last question.



If it is a white-collar recession, then it is white collars with less than a high school education. Clearly, a major part of employment difficulty relates to the fact that typical job openings require more knowledge than is provided by a high school education.

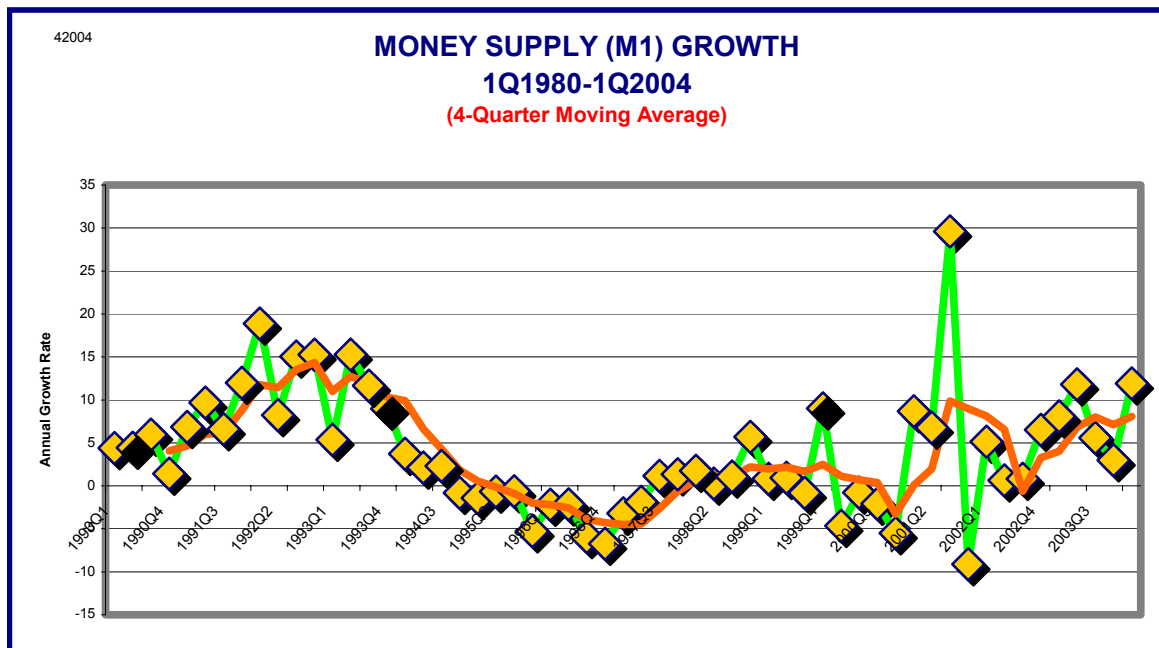
What about inflation?

There is a whiff of inflation in the air, partly because of the weaker dollar, which causes imports like crude oil to command a higher price, and partly because of monetary action.

Fundamentally, of course, inflation is a monetary phenomenon. Stated at the simplest level, inflation is too much money chasing too few goods. And, of course, money comes from just one place: the Federal Reserve Board. The Fed can increase or decrease the flow of funds coming into the economy through the purchase and sale of U.S. government bonds in the securities market place. The Fed can also relax the rules imposed on commercial banks that discourage lending. Through a combination of these and other policy actions, the central bank can juice things up or slow them down, but always with a lag. It takes time for Fed money supply action to affect the way the economy performs.

What does the record show now?

The next chart shows the growth rate of one basic measure of money flowing into the economy, M1, which is the sum of money held by citizens either in the form of cash or demand deposits.



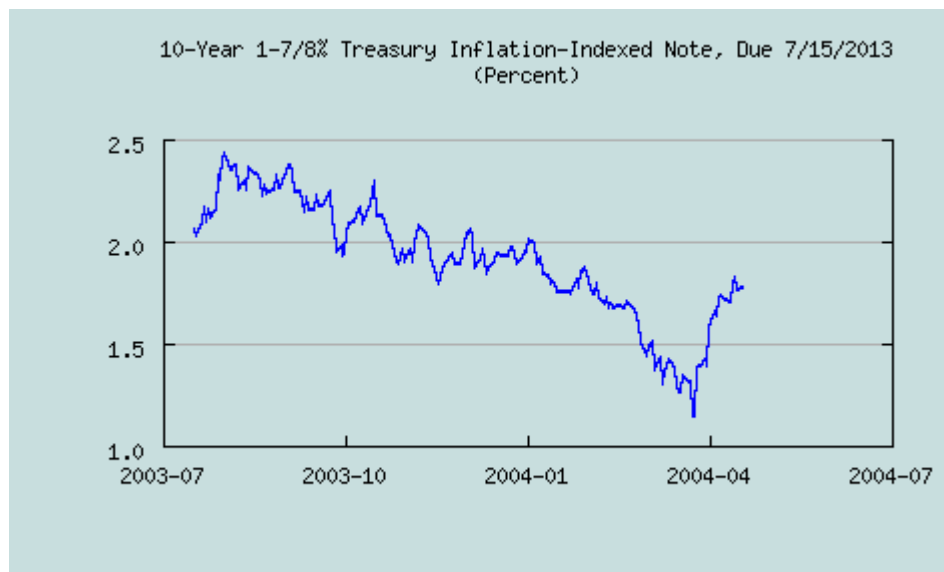
A quick glance at the chart reveals the massive increase in the supply of money that came immediately following 911. The Fed did all it could to cushion the economic effects of

the terrorist attack. One can also see that the Fed immediately mopped up some of that extra money. The Fed giveth and taketh.

A look at the more current period tells us that the Fed has been pumping it up. Is this because of fear of deflation? Or is the Fed attempting to keep interest rates low, until the world discovers that inflation is in the air (which is when the world requires higher interest income on loans in order to recover losses from inflation)? We don't know. All we have is the record.

But what are worldwide investors betting? How much inflation are they expecting? More than a hint of an answer to these questions is found in the yield on the U.S. Treasury's inflation-indexed note, a debt instrument that promises to pay the holder an inflation-adjusted rate of return. The yield on the note observed in the marketplace tells us what investors are thinking.

The next chart, which contains data through April 20, 2004, gives a recent record of daily yield on the 10-year inflation-indexed note. As can be seen, the note did a good job predicting inflation for 2003. We now know the record. CPI inflation for 2003 was 1.9%. Most recently, the note's yield has risen to about 1.75%, after falling to almost 1.0%. Apparently, world investors are betting on mild but rising inflation.

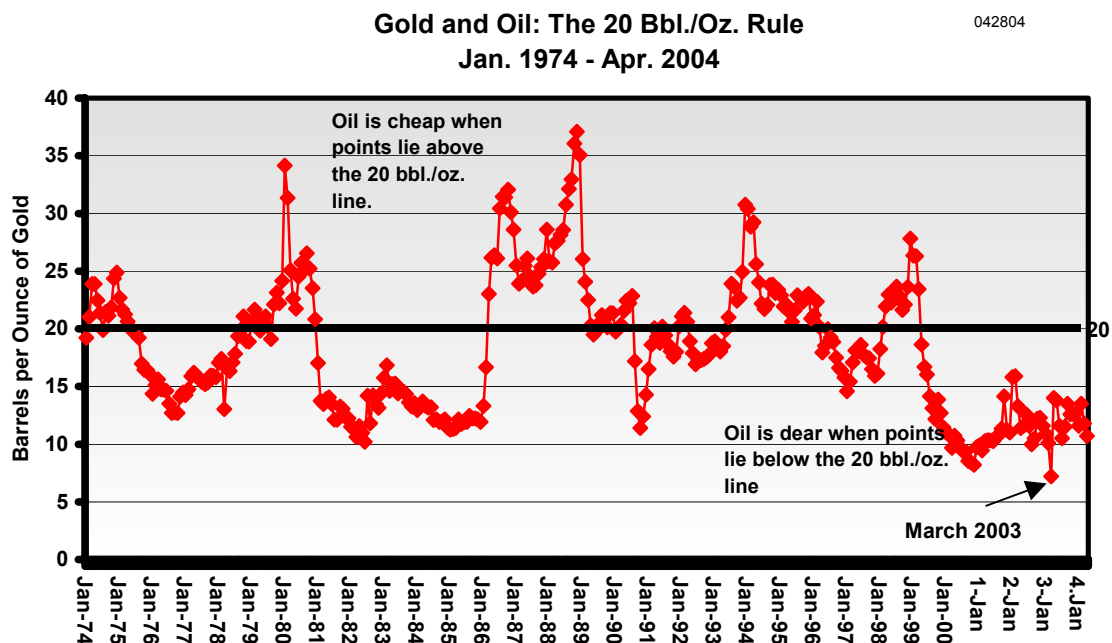


The forecast? Expanded money supply leads to expanded economic activity, and if the growth outstrips output, more price inflation. Right now, the world is predicting some price inflation.

Look for the CPI to rise by 2.15% over the next 12 months, as compared to 1.9% in the previous 12 months. And look for an associated increase in interest rates, short and long.

Oil, gold, and gasoline.

First, a memory refresher for new readers. There is a relationship between the price of gold and oil that commands at least a bit of respect. That historic relationship says that an ounce of gold will buy 20 barrels of crude oil, on average. (Be careful about that “on average” business.) The chart here shows the relationship and how it has worked out for the last 30 years. As we might expect, given all that is going on in the Arab world, things are not working out so well right now. Indeed, the gold price of oil has been at peak levels for four years, with only slight improvement.



We all see this and feel it when we fill up our cars and trucks with gasoline that hits close to \$1.70 a gallon in South Carolina. Or is that what we see?

Interestingly enough, the high price of gasoline has more to do with U.S. policy than OPEC or Arab policy. The chart tells us that there has been no sudden acceleration in the real price of oil, when measured in gold. But that is clearly not the case with gasoline at the pump where the price is measured in dollars. Part of the problem is with restrictions on supply; another part is with the falling value of the dollar.

So, what's going on?

Several things. First off, there is limited domestic gasoline refinery capacity. In fact, there has not been a new refinery built in the U.S. since 1976, and there are none on the drawing boards. Of course, the last 30 years have seen huge growth in gasoline demand.

Why no refineries? It is practically impossible for refinery builders to satisfy the requirements of the nation's environmental regulations. And if they were satisfied for some gasoline fuels, it is not clear that they would be satisfied for the production of other gasoline fuels. Those same environmental regulations now specify different gasoline formulations for different U.S. regions, depending on their air quality challenges.

Since we burn more gas and produce no more, part of the slack must be coming from somewhere else. Yes. We import roughly 10% of the gasoline we burn on a national basis. Some 25% of the gasoline burned in the northeast comes from abroad. In other words, we depend on other nations to provide 50% of our crude oil needs, and 10% of our gasoline requirements. That weaker dollar hits both prices between the eyes.

Of course, there is even more to the story. And again it is not about Arabs, but about political action in Washington. Between 1983 and 2000, access to federal land in the west for gas and oil exploration was reduced by more than 60%. Exploration and production from 460 million offshore acres has been closed down.

While pointing the finger at Washington politicians, we must also point out that the taxes paid per gallon of gas have risen rather sharply too. In March, the taxes collected on a gallon of gasoline averaged 47 cents per gallon, with variation across the different states. This included 18.4 cents in federal taxes. By comparison, average taxes per gallon were 29 cents in 1981. Government got a bit greedy during the intervening years.

In spite of all the moaning and groaning about gasoline prices, we can still rejoice when the prices are adjusted for inflation. In 1981 the price of gasoline peaked at \$1.35. That translates to \$2.77 today. Pass the word. Gasoline has gotten cheaper! A lot cheaper. New SUV anyone?

Bothered by high prices at the pump, and who isn't? There is far more to it than OPEC and Arab oil producers. In fact, most of the problem lies elsewhere.

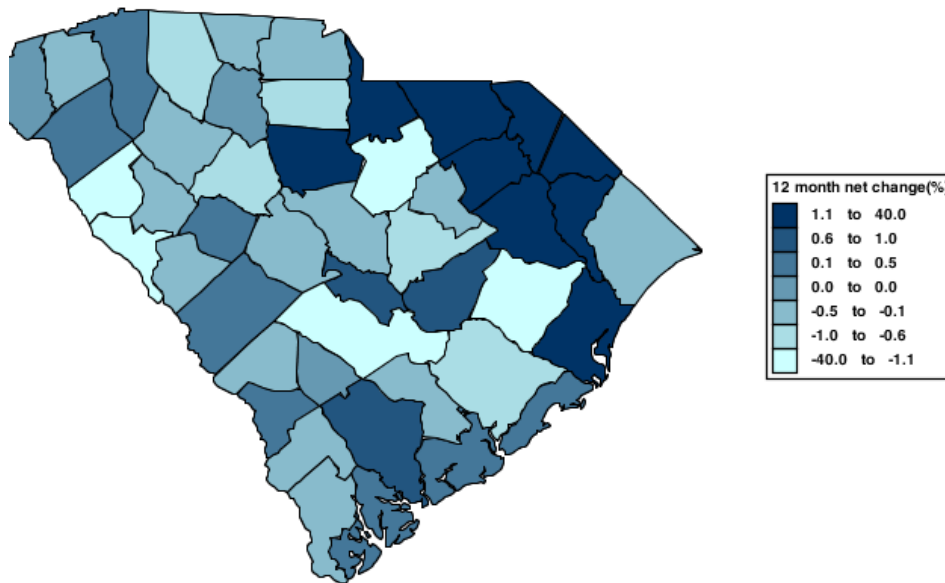
South Carolina's economy is back among the vibrant.

With the national economy chugging at a faster pace, we should be prepared to grease the rails for the Carolina economy. All signals are looking good. Retail sales are strong, which means consumers are out there shopping. Home sales and starts are strong. Corporate profits are rising, and finally, employment is picking up again.

Improvements in employment are seen in the chart here that shows changes in county unemployment rates over the last 12 months. The chart looks like a quilt. Notice that the lighter colors indicate improvements in the unemployment rate. Darker colors indicate that employment opportunities have worsened. Things are looking better in at least 10 counties, and the prospects are better for many others.

At the same time, it is important to revisit the unemployment data shown earlier that relates to levels of educational attainment. Educational attainment varies across South Carolina, which means that employment attainment will vary as well.

12 Month Change in Unemployment Rate, February 2004



Still looking for heroes

Anyone who has flown on Delta Airlines recently will have likely read about C.E. Woolman, the incredibly creative entrepreneur who, in 1928, started the airline with a few crop-dusters in the Mississippi Delta. Woolman, educated in agriculture, was working as a Louisiana county agent in an effort to eliminate boll weevils. From a brief flying experience in Peru, he knew that he could do well by doing good if he expanded his activities to include carrying people and the U.S. mail. In a matter of a few months, Woolman had three new Curtis-Wright Travel Air monoplanes marked with the now famous Delta logo and bearing the motto: Speed, Safety and Comfort.

Mr. Woolman, a true visionary in his field, was undoubtedly an able manager. But like other successful entrepreneurs, Woolman had a passion for service. His daughter tells us that when weather prevented a plane from departing on schedule, Woolman would buy dinners for the passengers, or bring them to his home to spend the night. He knew that the customer would determine his ultimate success.

I met Mr. Woolman years ago when I was calling on Delta Airlines at their Atlanta corporate offices. At the time, I was in the bearing business, and Delta's Atlanta jet maintenance operation was an excellent prospective customer. Like most other salesmen, I spent a good part of time waiting to see purchasing agents and maintenance engineers.

As I sat in Delta's waiting room one day, Mr. Woolman's driver pulled his Chrysler Imperial to the front door and out stepped Delta's famous president. I happened to be the only person sitting in the waiting room. Instead of stepping on the elevator that day, Mr. Woolman turned and walked to where I was sitting. He introduced himself and then asked how long I had been waiting and whom I was waiting to see. I quickly answered that I had not been there all that long and gave the name of the bearing buyer.

"Your time is valuable," Mr. Woolman said. "I don't want you spending it waiting for my people."

Mr. Woolman went to the receptionist and asked her to call the buyer and to tell him that he should arrange to see me as quickly as possible.

I was received rather quickly with more than the usual expression of good will. But though I never became a major Delta supplier, you can be sure that I never forgot the service lesson Mr. Woolman taught me.

Mr. C.E. Woolman is one of my heroes.