



William A. Harris, CFA
Portfolio Manager

A Post-Katrina Mosaic

Sorting economic facts from noise is difficult in the aftermath of a catastrophe like Hurricane Katrina, in part because of the distorting array of emotions, but also because of the simultaneous rush of data whose origins vary by date — the macroeconomic numbers being posted now in early September reflect what was happening before the hurricane hit, whereas the scraps of reporting we receive hourly about the aftermath have much urgency, but little coherence.

It's like looking at a china vase before and after it has smashed. We can picture the vase as it was last month, yet we are getting its pieces back now two and three at a time, mixed with shards of something new. While the vase can't be put back together precisely as it was — the summer's pre-Katrina economy cannot simply reconstitute itself — we can try to assemble a mosaic portraying economic trends as we head into the end of the year.

The Late Summer Economy

August's industrial output fell short of expectations with a rise of just 0.1%, though US factories' output beat this total with a 0.3% rise. The Producer Price Index (PPI), which measures pre-consumer inflation, was up 5.1% from a year ago due almost entirely to increases in energy costs; a decline in food costs gave a smidgen of relief. The federal deficit was running at an annual rate 12% above last year's record. Our trade deficit with China ran 29% higher than the same period last year, but even so, total imports actually fell 0.7% as the US bought fewer foreign durable goods. Existing home sales dipped slightly, but new home sales more than made up the difference. Non-farm jobs increased 169k, for a three-month 195k average deemed consistent with 3.2% GDP growth.

Altogether, the economy resembled a somewhat homely piece of crockery, but one capable of holding water. Except for maybe one crack: August's retail sales dropped 2.1%, the biggest decline in almost four years. The notion that the US consumer was acting beleaguered even before Katrina made landfall is troubling, as consumer spending

has heretofore been a tireless engine for the economy.

The Market's Reaction

In the first two weeks following the storm, US stock markets actually rose some 3%, as oil prices moderated in anticipation of significant releases from the strategic petroleum reserve. In addition, stocks have been helped along by hope that the Fed may relent in hiking interest rates till it has a better sense of the storm's secondary and tertiary economic consequences.

General Outlook

The dominant and highly preliminary estimates of broad impact are a 0.5-1.0% reduction of 2005 GDP due to diminished productive capacity, job losses, distribution snarls, soaring gas prices, and assorted chaos. Relying on specific forecast numbers right now can be hazardous, so let me suggest some generalities.

Reconstruction will get going in earnest come 2006, and though the sheer volume of activity will resemble a boom, I suspect that the crush of federal dollars will prove less broadly stimulative than many hope. Nonetheless, lost jobs will come back and the reconstituted infrastructure and housing stock will have enduring value, though earning back the aggregate investment will likely take decades rather than years. Most important, normalcy will return.

In the near term, automotive gas prices will ease relative to their recent spike, but they will remain high by historical standards, as refinery capacity was tight even before the storm caused production shut-ins and compromised distribution. Natural gas production will remain curtailed going into the heating season, and price spikes will be particularly acute in the Midwest this winter. Utilities often pre-buy their gas, so some of the pain will be deferred until next year's contracts are negotiated.

All of this points toward more wholesale inflation (PPI), both because of high energy costs and because raw material needs for reconstruction in the Gulf states will keep commodities expensive. Meanwhile, these lofty input costs will be hard for corporations to recover via increased prices, as consumers pay more to fuel their cars and heat their homes. After three years of tremendous growth, corporate profit margins may start to show the pressure.

Bill Harris