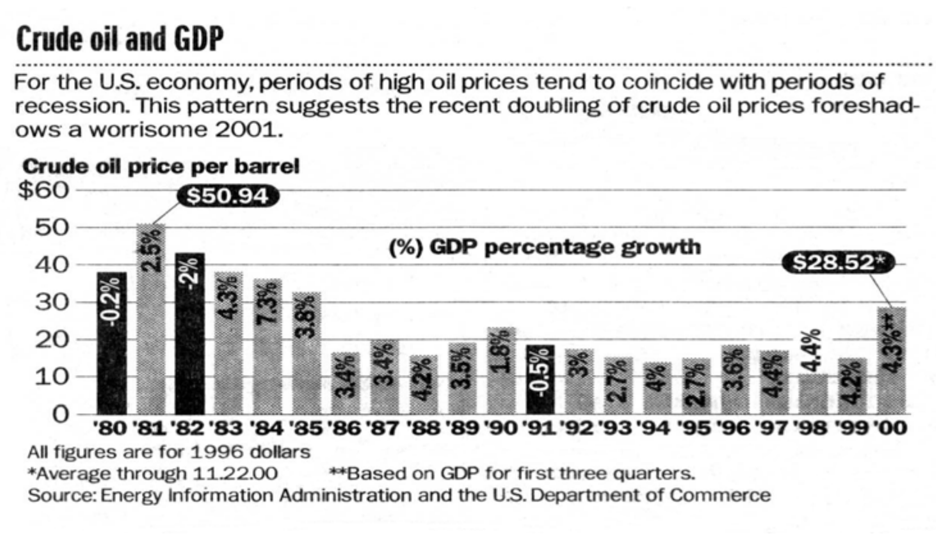
GSI
Market View

3rd Quarter 2001

We have argued in the past that higher energy prices have acted as a silent tax on the consumer, the corporation and the government. For the consumer, it restrains spending. For the corporation, it increases costs, reducing profit margins. For the government, it eats into our balance of payments, because of our increasing dependence on foreign oil.

In the 1980's energy was a much larger component of the cost structure of consumers and corporations. Hence, energy was an important factor in driving inflation to double-digit levels. Remember? Inflation reached 13% and short-term interest rates were at 20%. Productivity improvements were hardly existent. *Although that is not the case today (productivity remains strong and inflation is at the low end of the historic range) high energy prices have contributed to the current economic slowdown.*

Earlier this year, The Wall Street Journal published a chart relating the price of crude oil to GDP (Gross Domestic Product). The commentary states that, "periods of high oil prices tend to coincide with periods of recession." This chart is shown below:



The $50.94 price per barrel of crude oil in 1981(noted in the panel at the left) is much higher than the $37.20 price reached in the last twelve months.

However, that recent high price is about three times above the low experienced about two years ago. *Now, energy prices are dropping due to increased inventories of both oil and natural gas.* According to The Wall Street Journal dated June 28, 2001, the price has declined to $25.61 per barrel of oil. Natural gas prices have retreated to close to $3 per million British thermal units from highs of nearly $10 last winter. Gas at the pump has moved noticeably lower, and it is especially interesting that the timing of the sharp downward move preceded the fourth of July holiday.

We thought it might be interesting to conduct a mathematical exercise with the price of gas to determine what lower gas at the pump prices might mean to the consumer. Recently, we noted one service station in the Twin Cities area was selling 87 octane unleaded regular for $1.28 per gallon. The going price in our area is somewhat higher, but that price was available. *That price is at least 30 cents lower than what were paying earlier this year.*

The average family probably drives two cars. Using a typical lease example, average driving mileage is 12,000 miles annually. *At 20 miles to the gallon (probably high) a reduction of 30 cents per gallon would mean a savings of $180.* Double that amount and it works out to $360, tax -free. That is an important savings for many families. Lower natural gas prices result in added savings.

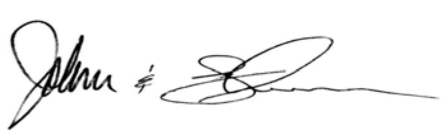
There are flaws is this argument, because energy prices could turn the other way and go higher again. But, if this savings continues it will be added to savings from lower interest rates orchestrated by the Federal Reserve and lower taxes at the state and federal level. Now, the numbers begin to add and make a difference. *A three-pronged cost reduction for consumers and corporations simply has to have an effect on economic growth and corporate profitability. Timing is unknown but the probability that these factors will kick in is high.*

History suggests that lower interest rates produce stronger economic results with a six month lag. The first interest rate cut was January 4, 2001. Five rate reductions have been made so far this year, and more are expected. Tax refund checks from the federal government should be arriving soon, and some states will be adding to that amount with tax refunds sometime this year. The modest federal income tax rate reduction applied to payrolls beginning July 1. *Add to these factors the effect of lower energy prices and it is easy to conclude that most families and singles will pocket at least $1000 to place in the spending stream, although some of this amount could end up in savings.*

It seems to us that the consumer should pull our domestic economy out of the current slowdown sometime in the second half of this year. Consumer spending tends to multiply each dollar spent about 3 times as it works its way through the economy. *This activity should produce higher corporate profits later this year and in 2002.* Higher corporate profits should result in greater investment spending by corporations, the real driver of our economy. Surely, a good part of corporate investment spending will be in some form of technology to improve efficiency and productivity.

One other factor that should support better times in 2002 is the political factor. 2002 is an election year and the stakes are high. *The current administration will no doubt make a strong effort to have the economy in better shape going into the election in November, 2002.*

There are many reasons to believe that we will experience a better economic environment as we complete this year and move into 2002. It is our feeling that the stock market will respond with higher valuations. The bond market may stabilize and not experience significant change as interest rates should continue low and productivity could continue to be strong.



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