

## **Forecast & Trends** **by Gary D. Halbert**

The US economy is clearly slowing down. Actually, it was already slowing down before the twin hurricane disasters. Gross Domestic Product growth slowed to 3.2% in the 2Q, down from 3.8% in the 1Q and 4.2% for all of last year. Consumer confidence plunged in September, with the largest monthly drop in over 15 years. Personal consumption spending also fell by 0.5% in August (latest data available), the largest monthly decline in over four years. I fully expect spending will be worse when we get the report for September. Retailers are now bracing for a poor holiday shopping season. Remember that consumer spending accounts for almost 70% of GDP.

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So, the question is, are we facing a recession? Most of my sources, including The Bank Credit Analyst, do not believe we are headed for a recession. Most believe we are facing a couple of sub-par quarters in which GDP growth will be in the 2% range or a little lower. The pattern in the last three major hurricanes (Andrew, George and Ivan) was a brief economic slowdown over several months, followed by a strong rebound in the economy. Unlike those previous major hurricanes, this time we face sky-high energy prices. As a result, the economy is likely to face a longer recovery from the latest natural disaster. At the same time, the inflation numbers continue to look troubling, and this means the Fed is likely to continue raising rates. This also is not good for the economy.

My investment advice is unchanged from last month. While the stock markets have held up better than I expected following the hurricanes, I would use this opportunity to reduce your exposure to equities, unless they are professionally managed. Bond yields have been rising over the last month, and I would expect this to continue. So I would recommend below average positions in bonds as well.

Gold has risen to new highs near \$475 as this is written, largely in response to the higher inflation numbers. However, with the economy slowing down, I would not chase this rally in gold. The inflation numbers are likely to slow down as the economy sags over the next several months.

In this issue, I include some interesting analysis by Dr. George Friedman of Stratfor.com regarding the economic impacts of the hurricanes. Specifically, Dr. Friedman discusses the state of the Gulf Coast ports and the importance of the Mississippi River to US commerce. In light of this, there should be a lot of volatility in the commodities markets for the foreseeable future, and hopefully this will mean good news for our futures funds.

## Introduction

In this issue, we will focus initially on the latest economic indicators, the outlook for the next 6-12 months, and the latest thinking from The Bank Credit Analyst. We have seen several troubling economic reports over the last couple of weeks. As examples, consumer confidence and new home sales have both plunged much lower than expected.

The \$64,000 question is whether the economy is headed for a recession following the hurricane national disaster, or are we looking at only a moderate slowdown for a few months, followed by another surge in growth sometime next year as the rebuilding of the Gulf Coast shifts into high gear? The answer is not entirely clear just yet. I'll tell you why below.

What are the implications for the investment markets? The stock markets have held up exceptionally well in light of skyrocketing oil and gas prices and two of the worst hurricanes in history back-to-back, but I still expect to see more weakness to come. Bond yields have risen more than expected over the last couple of months as inflation fears are rising, and I expect rates to climb even more for the balance of this year.

## The Economy Slows Following the Hurricanes

Literally everyone in the forecasting business is trying to figure out just how negative the effects of two of the worst hurricanes in history will be on the US economy. Obviously, a starting point is to look back at other major natural disasters to look for parallels. And that is easy enough to do if you have plenty of time, resources and money.

Fortunately, The Bank Credit Analyst did just such an analysis and published it in their latest October issue. They looked at the economic impacts of hurricanes Andrew, Georges and Ivan. Immediately following each of those major hurricanes, we saw a sharp drop in consumer confidence, a decrease in personal spending and a significant drop in manufacturing and construction. There is no reason to expect otherwise following hurricanes Katrina and Rita.

The good news, however, is that within a few months of those hurricanes, the economy recovered quite strongly. That data would suggest that perhaps we will see the same pattern this time, and that after several months of slowdown in the economy, we should expect it to rebound very strongly. Unfortunately, there are several reasons why the next rebound may not be so quick or so strong, if at all.

First of all, we've never had two monster hurricanes hit the oil and gas-laden Gulf Coast so close together. We've all heard that it will cost \$200 billion or more to rebuild New Orleans alone, perhaps another \$100 billion to rebuild the rest of the Gulf Coast, and another \$50-\$100 billion to rebuild western Louisiana and eastern Texas following Rita. We've never seen numbers like that before. And all of this is on top of our record large budget deficit.

Second, these previous disasters did not occur with a simultaneous huge spike in energy prices. As we all know, soaring gasoline prices are taking a big bite out of our collective wallets, and that is money we would otherwise be spending into the economy or saving. As I wrote in my August 30 E-Letter, many economists estimate that GDP will be cut by around 1% (or more) due to oil prices being at \$60-\$70 per barrel.

Third, the largest seaport in the nation is still operating at a mere fraction of what it was before Katrina.

The bottom line is that the economy is likely to get hit harder this time around, and take longer to recover, than in the three previous major hurricanes. Between the energy price spike, the plunge in consumer confidence and restricted traffic at the ports and on the river, I believe we could see GDP drop to 2% or even lower for the next several quarters.

## The Latest Economic Data - Not So Good

Earlier this month, the Commerce Department confirmed that GDP grew at an annual rate of 3.2% in the 2Q, down from 3.8% in the 1Q, and down from 4.2% for all of 2004. So the economy was already slowing down before the hurricanes. The Index of Leading Economic Indicators fell 0.2% in August (latest data available) for the second consecutive month.

Also troubling, the Consumer Confidence Index plunged from 105.5 in August to 86.6 in September. This is the largest monthly drop in 15 years, putting the index at its lowest point in over two years. Personal consumption spending also fell by 0.5% in August, the largest monthly decline in over four years. I fully expect spending will be worse when we get the report for September. Retailers are now bracing for a poor holiday shopping season.

Remember that consumer spending accounts for almost 70% of GDP. Most forecasters assume that consumer confidence plunged simply because of the hurricanes, and that it will rebound strongly in another month or two, as it has following past hurricanes. I don't agree. I'll tell you why below.

The ISM manufacturing index fell to 53.6 in August from 56.6 in July. The index is down from its peak (for this cycle) of 59.1 a year ago.

New home sales dropped a surprising 9.9% in August, over double analysts' expectations. Housing starts fell 1.3% in August. Fortunately, existing home sales remained strong in August. There is no question that we are in a housing bubble, and there is no question, in my mind at least, that the slowdown in the economy is going to take some air out of that bubble. The only question is how much?

Historically, most bubbles do not end pretty. This is why I continue to recommend that you consider unloading real estate or houses that you may be holding for speculative/investment purposes. If I'm wrong and the bubble continues for another year or two, feel free to give me grief about it. But I would take profits now if you can. Finally, economic reports weren't all bad in the last few weeks. Durable goods orders rose 3.3% in August and have been up in four of the last five months. The ISM Index rebounded in September as many companies boosted orders, but this was primarily due to fears of hurricane-related shortages in the next several months. Yet the bad news definitely outweighed the good, at least recently.

## The Fed Trudges Onward & Upward

On September 20, Greenspan & Company raised the Fed Funds rate for the 11th consecutive time to 3.75%. Many had hoped the Fed would take a break in light of the twin hurricane disasters. But not only did they raise the rate, they stuck to their policy language indicating additional rate hikes at a "measured" pace.

There are many, including The Bank Credit Analyst, who believe that the Fed is going to overshoot on the upside. The Fed has a long history of over-reacting both on the upside and the downside. The risk, of course, is that they raise rates too much, and this causes the economy to go into a recession.

The Fed really is in a "conundrum." On the one hand, they see soaring energy prices and a Consumer Price Index that rose 0.5% in August and is up 3.6% year over year. They also see the Producer Price Index that is up 5.5% year over year. Remember, Alan Greenspan's main purpose in life (he thinks) is to keep inflation under control.

On the other hand, the Fed is also very concerned that deflation could well unfold whenever we hit the next recession. I absolutely agree! This fear makes them want to raise short-term rates as much as they can, so that they have some ammunition - in the form of interest rate cuts - to fight the next recession.

So don't be surprised if we get yet another rate hike on November 1. Not good for the economy, especially if the Fed hints of yet another rate hike in December.

### Are We Headed For A Recession?

Most of the sources I respect do not believe that the hurricanes and Fed policy will push the economy into a recession. The latest survey of leading economists suggests that the economy will have only a mild slowdown in the aftermath of the hurricanes. The latest survey from the National Association of Business Economists saw an average cut in GDP estimates by less than one-half a percent over the next two quarters, as reported by the Wall Street Journal last week.

Estimates like these (large groups of economists) are almost always too optimistic. These numbers are almost certain to come down more - probably a lot more - over the next couple of months. As noted above, I see GDP growth dropping to an annual rate of 2% or less as the damages from the hurricanes are quantified, especially if gas prices remain as high as they are today.

The Bank Credit Analyst has a similar view as mine. They expect GDP growth will fall below 3% for several months. They had been predicting a slowdown in consumer spending even before the hurricanes hit. But they do not believe the economy is headed into a recession. They say: ***"The bottom line is that the economy may remain more subdued than generally expected early next year, but a recession still has low odds."***

Most forecasters, including BCA, believe that the economy can rebound strongly after a couple of weak quarters, especially if President Big Spender (oops, I mean Bush) and Congress spend several hundred billion on hurricane rebuilding.

But let us not forget: Americans in general are in a really FOUL MOOD! The latest FOX Opinion Dynamics poll showed that 85% of Americans are fed-up with soaring gasoline prices. This will only get worse as the weather turns colder and people have to pay sky-high prices to heat their homes.

77% of Americans, based on this poll, are also fed-up with partisan bickering in Washington. Surprisingly, more respondents said they prefer that Democrats regain control of Congress in the 2006 elections than those who want the Republicans to remain in the majority. This is troubling! 58% said they are now against the war in Iraq. This is the highest anti-war reading we have seen. President Bush's approval ratings remain in the dumps, lower than Bill Clinton's ratings ever were.

For all these reasons and others, there is NO guarantee that consumer confidence is going to rebound anytime soon, as it has after past disasters, and it could get even worse. If consumer spending continues to fall, the slowdown in the economy will be considerably worse than most analysts are currently predicting.

### Not a Good Environment for the Stock Markets

Last month, I strongly recommended that you take profits in most of your stock investments (unless professionally managed) and move to an under-weight position in equities. After being a stock bull for many years, I have turned much more cautious for reasons noted above and others. I have not changed that view, even though the equity markets have held up quite well despite two national disasters and more Fed rate hikes.

Disappointing economic news is very likely to continue for the next 3-6 months or longer. As discussed above, consumer confidence and spending may not rebound sharply anytime soon. And it appears a given that the Fed will continue to hike rates, at least for a while. None of this is good for stocks in general.

I'm not predicting a bear market in equities, but I believe the most likely scenario is that stocks break out of the 18-month trading range to the downside. If correct, it remains to be seen just how much selling will result, but I can assure you that it could be significant. **So I continue to recommend that you move to an under-weight position in your equity portfolio.**

Obviously, if most of your equity portfolio is managed by professional "active" managers, then you do not need to reduce your positions - provided, that is, that your manager(s) has a good track record of getting out of the way of major market downturns.

As noted above, most bonds have already begun to move lower, and this could well continue. With inflation numbers clearly on the rise, bonds will likely continue to move lower. On the other hand, with the economy due to slow down - and for longer than most analysts expect - this should serve to limit losses in bonds. Net result: a continued trading range, most likely.

### Don't Get Blown Away By Hurricane Scams

As always, there are those who are peddling new scams to take advantage of good-hearted folks who want to help the hurricane victims along the Gulf Coast. Beware of any group that is calling you to donate money for hurricane relief, unless it's the American Red Cross or the Salvation Army or some other well-known charitable group.

[By the way, if you get lots of unsolicited sales calls at home, as we do at the Halbert house, here's a tip. Rather than just say no, or hang up on them, be sure to ask: Do you have a "do-not-call list"? Telemarketers are required by law to have such a list. When they answer yes, then say: Put my name on your do-not-call list. They're required to do so.]

In addition to the new hurricane scams out there, the "gloom-and-doom" crowd is having a field-day in the wake of the twin disasters. Now, their predictions of gloom are even more shrill than ever. Stocks are going to hell in a handbasket, so sell everything you own; inflation is going to explode; interest rates will double; precious metals will skyrocket; and of course, the US economy is headed for a depression. And on and on.

Yet what you will notice in almost all of the gloom-and-doom pieces is an offer to sell you something to protect you from the guaranteed horrors that lie ahead. These people have no shame. They will try to capitalize on any opportunity to: 1) pump you with fear; and 2) then suck you in with fear. Just say no!

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