

Forecasts and Trends by Gary D. Halbert

Summary: Hurricane Katrina will prove to be the worst national disaster in U.S. history, far greater than the nightmare of 9/11, both in terms of lives lost and property destroyed. The rebuilding effort is now estimated at \$150 billion, and that number is likely to be low. An estimated 700,000 people are out of work across the Gulf Coast, and that number could increase significantly. This disaster has occurred while oil and gasoline prices have hit new record highs, further exacerbating our economic problems due to the hurricane.

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Over the last month or so, most economists raised their GDP forecasts for the second half of this year to 4% or above. Consumer spending and confidence rose, unexpectedly, in August despite soaring oil and gasoline prices. Now, however, it is almost certain that GDP will slow, perhaps significantly, for the rest of the year due to the impact of the hurricane and soaring oil and gasoline prices. Most economists suggest that GDP will be shaved by 1-2%.

At present, it does not appear that the economy is headed for a recession, just a marked slowdown. However, if oil prices soar to \$100 a barrel, there is a very good chance that a recession will follow. While I do not expect oil prices to reach \$100, nothing can be ruled out at this point.

It remains to be seen whether the Fed will halt its interest rate hiking cycle as a result of the national disaster. The next FOMC meeting is September 20, at which time we will know for sure. I will be surprised and disappointed if the Fed continues to raise rates in this dicey environment. (They did raise the rates again after this article was written.) The stock markets have held up amazingly well in the face of record oil and gasoline prices and even despite the hurricane and the devastation across the middle Gulf Coast. Yet despite the firmness of the equity markets in recent days, I expect the most likely scenario is that stocks break out of the long trading range to the downside in the weeks ahead. I recommend reducing positions in stocks and equity mutual funds now, unless those assets are directed by professionals using "active" management strategies.

The Economy

Thus far, the US economy has weathered soaring oil and gas prices quite well. Consumer confidence and spending were both up in August, to the surprise of many. Over the last month or so, most economists were revising upward their estimates for the second half of this year and the first half of next year. Most of the revised estimates are for GDP to grow by at least 4% for the second half of 2005 and first half 2006.

But that was before oil spiked to \$70 a barrel, before gasoline surged above \$3 per gallon and before Hurricane Katrina wiped out much of the Gulf Coast. These events make it all but certain that the US economy is going to go through another "soft patch" in the coming months. Hopefully, it will only be a soft patch and not a recession.

While some economists disagree, there seems to be a general consensus that for every \$10 the price of oil rises above \$50 -- that shaves approximately 0.5% off of GDP. So at \$70 oil, that would reduce GDP by 1% or so. While I am not an economist, I think another big variable in this kind of analysis is *how long* oil prices remain above \$50. If oil prices remain well above \$50 a barrel for the next six months or longer, then I believe the effects on the economy will be more serious than 1% off of GDP. Again, hopefully not enough to throw us into a recession.

The Hurricane Fallout

Obviously, the hurricane fallout will be negative for the economy. How negative, we do not yet know. It remains to be seen how long it will take to get the Gulf Coast ports operational. Over one-fourth of the nation's imports and exports pass through these ports. The longer it takes, the worse it is for the economy. Ditto for the refineries and the offshore drilling rigs.

It is estimated that approximately 700,000 Americans were instantly (and indefinitely) put out of work by the hurricane. This will cause an immediate spike in the national unemployment rate, which had fallen to 4.9% in August. Likewise, the loss of tens of thousands of businesses along the Gulf Coast and miles inland will be a drag on GDP.

The bottom line is that we should expect to see disappointing economic numbers through at least the end of the year. The good news is that my best sources, including The Bank Credit Analyst, believe that the US economy is strong enough to avoid a recession, unless oil soars above \$100 a barrel and unless more negative shocks occur. A convincing case can be made that the economy will rebound strongly early next year as the rebuilding of the Gulf Coast gets into high gear. The government looks poised to pump at least \$100 billion into the rebuilding effort. This will create jobs and stimulate the economy next year.

Bad News for Stocks - Reduce Positions

The stock markets have held up amazingly well as oil prices soared to \$70 and gas prices to \$3 a gallon. Normally, this would be a very bullish indicator. But I fear that the coming months of disappointing economic news will begin to weigh on the equity markets. There is a high probability that the broad markets will break out of the 18-month trading range to the downside. I hope I am wrong.

The Bank Credit Analyst has a similar view, and in their September issue, the editors recommended that clients and subscribers reduce equity positions to "below average" weightings in their portfolios.

Neither BCA nor I believe that we are headed for a new bear market in stocks. It could be that the equity markets are resilient enough to simply continue in the broad trading range. Yet as noted above, I think the most likely scenario is a breakout below the trading range. If so, there is likely to be follow-on selling that drives the market lower for a period of time.

You may recall that I turned bullish on stocks in February 2003, just before the war in Iraq began. If you followed my advice and moved to a fully invested position in stocks and equity mutual funds at that time, you have done very well. If you bought an S&P 500 index fund back in February of 2003, you should be up approximately 40% (or more) at this point.

If you followed my advice in February 2003 (just before the war) to move to a fully-invested position in stocks and/or mutual funds, I would now take at least partial profits. You might consider taking all your profits off the table, or at least use a "trailing stop." As noted above, I do not believe that stocks are headed into a new bear market. The good news is that if stocks break out of the trading range to the downside, and a lot of selling ensues, that could present us with another outstanding buying opportunity.

Whether that bubble bursts as many predict, or rather it just slowly loses steam, remains to be seen.

Real Estate - Time to Sell?

I think we can all agree that the housing market is indeed a "bubble" at this point. Whether that bubble bursts as many predict, or rather it just slowly loses steam, remains to be seen. I won't speculate on that, other than to say that most bubbles end badly, especially for the players who came late to the game.

We are already seeing a slowdown in the rate of increase in home prices and real estate in general. The disappointing economic news we are likely to see over the next several months will not be good news for the real estate market in general.

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