

The Economy – Solid Growth, But Below Expectations

By Gary D. Halbert

The Latest GDP Report: Most economists believe that the US economy has been in a “soft spot” for the last few months. Yet in its advance report, the government estimated that Gross Domestic Product grew at an annual rate of 3.7% in the 3Q following 3.3% in the 2Q. While the report shows the economy still on a strong growth path, it was disappointing in that most economists had expected a number above 4%. Some are now revising their 4Q estimates down to 3.0-3.5%.

There is general agreement that the economy must grow by 3.0-3.5% just to keep the unemployment rate steady. Anything below that range indicates that the unemployment rate will begin to rise again. Likewise, it is believed that we need growth of 4% or more if we are to create new jobs and see the jobless rate continue to fall.

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The government also reported that consumer spending rose by a surprising 4.6% in the 3Q following 1.6% in the 2Q. Despite that, analysts continue to predict that consumer spending, which makes up over two-thirds of the economy, will fall off significantly any day now. Yet the government reported on Monday that consumer spending rose 0.6% in October, well above expectations.

The government also reported that durable goods orders rose a surprising 16.8% in the 3Q after being unchanged in the 2Q. In the same report, the Commerce Department reported that consumer prices rose at an annual rate of only 1.8% in the 3Q versus 3.5% in the 2Q.

The ISM manufacturing index fell slightly in October to 56.8 following 58.5 in September. While the latest report is disappointing, any number above 50% indicates that the manufacturing sector is expanding. The ISM index has been above 50 for 17 consecutive months.

Leading Indicators & Consumer Confidence Fall For 4th Month

The Conference Board reported that its Index of Leading Economic Indicators fell 0.1% in September for the fourth consecutive month. While the Index is still in positive territory, the trend is not encouraging. Fortunately, the string of monthly declines has been very modest.

The Conference Board also reported that its Consumer Confidence Index fell in October for the fourth consecutive month as well. The latest household survey found that consumers are most concerned about the economy and what happens six months from now, more so than today.

Yet despite falling confidence, Americans continue to buy homes at a near-record pace. New home sales rose 3.5% in September, while sales of existing homes were the third highest on record, up 3.1% in September.

The Next Recession

Now that the election is behind us, you will begin to read and hear more analysts speculating about when we will hit the next recession. Unless there is a major negative surprise, it is safe to say that we will not see a recession in the next six months, and maybe not until late 2005 or even 2006. Yet I believe it is also safe to say that we will hit a recession sometime in President Bush's second term.

I happen to believe that the next recession, whenever it comes around, will be a serious one. Record budget deficits, trade deficit, falling dollar, etc. will all make the next recession a bad one. How bad, I don't know. I will be writing more on this subject in the months just ahead. But for now, let's take a look at the latest forecasts from The Bank Credit Analyst.

BCA's Latest Forecasts for the Economy & the Markets

BCA Downgrades 2005 Forecast

As you know, The Bank Credit Analyst is one of the most widely followed and respected research groups out there. Here are some excerpts from their latest November issue:

"The recent rise in crude oil prices has been unambiguously bearish for the economy and the stock market. Consumer spending power and confidence have been undermined and profit margins have been squeezed, adding to the business sector's already cautious mood. On a more positive note, the oil shock does not yet seem large enough to induce a recession.

The economic drag from higher oil prices is being partly offset by the stimulative effects of lower bond yields and a weaker dollar. However, the core problem facing the economy is that consumer spending will not be sustained unless there is a marked pickup in employment. In turn, that will require businesses to adopt a more expansionist mindset.

It is easy to understand why many businesses are still cautious. The rise in oil prices has fueled worries about the economy and profits, the geopolitical news is unremittingly gloomy, and there is uncertainty about the result of the forthcoming elections.

The economy has actually performed quite strongly this year, but it is hard to see where future momentum will come from without a stronger job market. Low mortgage rates are sustaining a high level of housing activity, but affordability has eroded in response to rising prices, and the level of home sales and construction have probably hit a plateau... A further drop in mortgage rates could unleash a new wave of mortgage refinancing, giving a lift to consumer spending, but the impact would be temporary.

Again, the key to sustained spending growth must be more jobs and the picture here has been disappointing. Unemployment claims have stopped falling in recent months and small business job openings and hiring plans appear to be flattening out.

The conditions are in place for employment growth to improve [once we get through this soft spot] and our models continue to predict a pickup over the coming year. However, the longer that hiring stays weak in the near term, the greater the danger of a consumer retrenchment [recession].

The decline in the Conference Board leading indicator suggests that economic activity will remain on the soft side for at least another few months. However, it is premature to worry about a recession developing in the coming year. The overall [monetary] policy environment is still relatively accommodative and although high oil prices are hurting, financial indicators do not point to any major problems. [Emphasis added, GH.]

We had thought that growth next year would average between 3% and 3½%, but that now looks optimistic unless there is an early and sustained retreat in oil prices. Growth in the range of 2½% to 3% seems more likely for 2005, assuming oil prices drop back to around \$40 in the first half of the year. Economic growth of less than 3% would be below potential, implying that inflation would stay muted. It would also ensure that the Fed puts its tightening policy on hold." [Emphasis added, GH.]

BCA Moves From Optimistic To Cautious

As recently as a few months ago, the editors at BCA expected the economy to grow by 3½-4% in 2005. Then they lowered their forecast to 3-3½% due to the spike in oil prices. Now, they have lowered that forecast again to 2½%-3% - if oil prices fall back to the \$40 area. And of course, there is no guarantee that oil will fall to \$40 or lower.

The BCA editors make it clear that they do not expect a recession in 2005. However, having been a continuous subscriber to BCA for the last 27 years. I can tell that Martin Barnes and his fellow editors are becoming more cautious in their outlook for next year. Like me, I sense that the editors are beginning to think about the next recession.

BCA on Stocks & Bonds

In light of the downward revision in BCA's economic forecast for next year, the editors continue to recommend "neutral" positions in equities. Neutral, in their case, means average holdings of stocks and mutual funds, not above or below average. Unfortunately, the editors do

suggest that the equity markets may well continue in a fairly broad trading range for the next several months if not longer, unless oil prices fall to the \$40 area or lower. In that case, they believe stocks can stage a meaningful rally.

I agree. I still believe there is a window of opportunity for stocks to surprise on the upside in the next several months, and especially if oil prices move somewhat lower. This is why I believe investors should be in the market today, especially if you use professional Advisors who can move out of the market if conditions change for the worse.

The BCA editors continue to recommend “below average” holdings of Treasury bonds and other high quality bonds. The editors do expect bond yields to remain low in the months ahead, but they do not see rates moving significantly lower from current levels. And they believe there is the potential for rates to move higher next year. While Treasuries and other high quality bonds have done well this year, the editors believe the risks are too high at this point.

I agree with BCA on Treasuries and other high grade corporate bonds. However, I continue to believe that there is more upside potential in high yield bonds this year and into next year. Remember that high yield bonds tend to do well when the economy is recovering.

BCA's Conclusions

“The bottom line is that we are in a frustrating period where no major U.S. asset looks very appealing. Stocks should outperform bonds in the coming year, but neither asset is likely to deliver outsized returns.

As we discuss in this month's Special Feature, there are better opportunities outside the U.S., such as European and emerging market equities. Also, there is a strong case for focusing on countries and sectors that offer a high dividend yield. From a longer-term perspective, the conditions seem ripe for a mania to develop in energy and commodity-related assets and in China-related investment plays.

Thus far, we have not mentioned the forthcoming U.S. elections... We tend to believe that whoever occupies the White House, policy will be severely constrained by the large fiscal deficit, and neither George Bush nor John Kerry will be able to carry out their election promises. The trends in the economy and oil will be a more important influence on how the markets move in the months ahead.”

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is \$197 for 12 issues and may be obtained by visiting his website at www.profutures.com. Reprinted with permission from ProFutures Forecasts & Trends.