

## **Forecasts & Trends**

By Gary D. Halbert

### **Firing On All Cylinders**

The economy is now firing on all cylinders and job growth is poised to improve significantly over the next 6 to 12 months. The Commerce Department reported that the economy expanded at an annual rate of 8.2% in the 3Q up from 7.2% in its previous report and 3.3% in the 2Q. Best of all the latest GDP report showed a significant increase in business investment spending in the 3Q up 18% for the quarter.

Perhaps second best of all, the manufacturing sector expanded at the fastest rate in almost 20 years in November. The Institute for Supply Management's manufacturing index jumped to 62.8% in November, up from 57 in October. This marked the fifth consecutive monthly rise in factory output.

Corporate profits soared 30% above year ago levels in the 3Q. This was the largest year-over-year gain in corporate profits in 19 years. Companies have been reluctant to hire new workers over the last year, but with the latest surge in profits and continuing strong demand, the unemployment rate should continue to fall in the months ahead.

Consumer confidence also rose in November. The Conference Board reported that its Consumer Confidence Index jumped to 91.7 in November, up from 81.7 in October. Retailers reported that department store sales on the Friday after Thanksgiving (the biggest shopping day of the year) rose 5.4% over the same day last year.

The gloom-and-doom crowd, while never silenced, has toned-down its always pessimistic rhetoric about the economy. Ditto for the Democratic presidential candidates. Interesting, isn't it, how these groups never admit they were wrong, but just go silent and move on to other issues? Fortunately, my best sources have been mostly dead-on regarding the economic turnaround in the last year or so.

### **How Long Can It Last?**

Now the question is, how long can the good economic news last? Clearly, the economy cannot continue to grow at an annual rate of 8+%. Most economists now expect the growth rate to cool to a 4-5% rate in the 4Q and slightly below that in the first half of 2004. Those expectations would seem reasonable in light of the latest 8.2% report.

Yet, there are also many respectable analysts who believe that this recovery could well fizzle after the first half of the year. Most in this camp argue that the excesses built up in the '90's boom were not corrected by the mild recession of 2000-2001. Likewise, they point to record consumer and federal debt and conclude that these problems will spell an early end to this recovery. These, of course, are all serious and valid points that don't bode well for the future, but the question is when?

While the storm clouds are clearly on the horizon, this economy may yet continue to surprise on the upside for at least two reasons. First, US productivity rates have advanced by record proportions over the last several years, thanks in part to the recession. While this contributed to the rise in the unemployment rate, the surge in productivity is bullish for the US economy in the long run. Second, those predicting an early end to the recovery fail, in my opinion, to recognize the powerful stimulus of the near historical low interest rates we have enjoyed over the last few years.

Finally, while consumer debt levels are at record highs, there are not indications that consumers are about to fall off a cliff in terms of spending. Actually, consumer spending is expected to increase by 4-5% in 2004. As noted above, business investment spending has finally kicked in, and this will cushion the economy even if consumers slow down their spending.

The bottom line is that this recovery should continue for another year, and perhaps even longer, unless there are some major negative surprises to come.

### **The Bank Credit Analyst's Latest Thinking**

As you know, I have been a continuous subscriber in BCA for over 25 years. While not perfect, BCA continues to be the most accurate forecaster of significant economic turning points and major financial market trends that I have ever read. This month, I will summarize and quote

from BCA's December issue. I found their analysis of what the Federal Reserve is, and has been, thinking particularly interesting.

The foundations under the U.S. economy are getting stronger. The corporate sector is emerging from its severe retrenchment, thereby reducing the economy's dependence on continued strong growth in consumer spending. With demand becoming more balanced, there is less need for major policy stimulus, and the odds are good that the economy will continue to deliver positive surprises in the coming year.

The Federal Reserve is taking nothing on trust. The Fed's base case is that the economy will grow at a decent pace next year, but it does not have a huge degree of confidence in this forecast. The Fed has thus made it clear that it will retreat only slowly from its current highly stimulative stance.

The maintenance of abnormally low interest rates will substantially boost the prospect of solid economic growth and will foster continued risk-taking by investors. Equities should keep outpacing both bonds and cash in 2004, even though the absolute gains from stocks will likely fall short of those achieved this year...

It is sometimes argued that the Fed has seriously erred by easing policy so aggressively during the past couple of years. The sharp drop in interest rates encouraged consumers to take on more leverage rather than retrench, and also stopped the equity bubble from fully deflating.

There is no doubt that keeping the fed funds rate at 1% has created financial distortions and fueled speculation. However, the Fed has explicitly wanted to encourage more risk-taking, to counter the retrenchment that normally occurs in the wake of a burst asset bubble. The Fed was not able to prevent a deep cutback in corporate sector spending, which make it all the more important to prop up the consumers.

After the bubble burst, the corporate sector suffered the worst downturn in profits since the 1930's. If the Fed had not taken aggressive action to boost housing and consumer spending, the squeeze on the corporate sector would have been even more severe, which would have fed back into even weaker employment. The end result could have been a self-feeding downward spiral of economic activity and asset prices, presumably triggering a full-fledged debt deflation.

The Fed's policy has not been costless. By encouraging the consumer sector to take on more leverage rather than rebuild savings, the Fed has raised the stakes for the next downturn. The downside risks in the next recession may be much greater than they would otherwise have been, because of increased debt levels. However, the Fed decided that it was worth trading almost certain disaster in the recent cycle for a potential threat at some point in the future.

The same argument can be made for fiscal policy. The Administration has been responsible for turning a large structural fiscal surplus into a large deficit, with possible serious long-term consequences. Nonetheless, tax cuts played an important role in supporting the consumer at a time when the corporate sector was engaged in a vicious retrenchment.

One might reasonably have expected a very deep recession given the bursting of one of the greatest asset bubbles in history, the shock of September 2001, the rash of corporate scandals, and high energy prices. The fact that the U.S. suffered the mildest downturn on record is testimony to the power of the massive stimulus thrown at the economy.

Even so, the economy skirted dangerously close to deflation, and the Fed is not convinced that the danger period has ended. The Fed has lost confidence in its own and everyone else's economic forecasts. The Fed's economic models did not work very well during the past couple of years.

What the editors are saying here is that the economy's near-miss with deflation during the recession basically scared the pants off Alan Greenspan and the Fed governors. In response, they overreacted and will probably not breathe a sigh of relief until they see the inflation rate begin to inch higher. In doing so, they not only managed to avert deflation but they significantly softened the recession, and now we find ourselves in a roaring economy. Of course, as BCA pointed out, this has resulted in higher debt levels and much greater risks whenever the next recession comes along.

### **When Will Rates Go Up?**

This, then, brings us to the question, when will the Fed begin to raise interest rates again? The Fed knows that a 1% Fed funds rate is too low and will eventually need to be raised to

between 4% and 5%, a level that is consistent with potential GDP growth. The Fed also knows that the longer rates stay at 1%, the more problematic the adjustment will be for the markets. They likewise know that leverage and debt levels will continue to build as long as rates remain extremely low. Nevertheless, these are regarded as minor problems compared to those associated with raising rates too soon. The bottom line is that the Fed feels under no pressure to change its stance just yet.

Following the last FOMC meeting Greenspan stated that it is the Fed's intention to hold rates at these low levels for a “**considerable period.**” As usual, no one knows what he means by that. The latest strong economic news has led many to suggest that the Fed may begin raising rates any day now. However, BCA believes that the Fed will insist on seeing “sustained strength in the labor market (several months of at least 150,000 job gains),” and clearer signs that the threat of deflation has passed.

Thus, the BCA makes the case that any such rate increases won't begin until the Spring, or maybe even the middle of this year. And they believe that the Fed will move slowly when they do start to move.

*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](http://www.profutures.com).*