

Forecasts & Trends

By Gary D. Halbert

Economic reports released over the last month were very encouraging. The economy is gaining momentum. GDP rose at an annual rate of 4.2% in the 1Q and will likely do even better in the second half of the year. Several of the latest economic reports were much stronger than expected. The recovery remains on solid footing.

With the latest good news on the employment front, discussions have shifted once again to the question of when the Fed will raise interest rates. The odds have clearly increased that the Fed will raise short-term rates before the election. If the Fed does make a move, it will likely be only a quarter-point or half-point increase in the Fed funds rate.

Despite worries about higher interest rates and inflation, the stock markets rebounded in April as I suggested last month. I continue to believe that stocks will perform well for the balance of this year based on the strong economy, and despite an interest rate hike or two along the way, should that actually happen. Bonds are a different story. Treasuries have been hammered over the last month, and the decline very likely has further to go. BCA continues to believe that stocks will outperform bonds for the rest of this year and perhaps longer.

The Economy Is Booming

Despite what you hear from the gloom-and-doom crowd and John Kerry, the US economy is booming. On April 29, the Commerce Department reported that GDP expanded at an annual rate of 4.2% in the 1Q. The latest GDP report was slightly below expectations because businesses did not increase inventories as much as expected. That is actually good news for the economy going forward, especially in light of the economic reports discussed below.

The Index of Leading Economic Indicators rose 0.3% in March and is signaling continued strong economic growth. Durable goods orders jumped 3.4% in March versus estimates of only a 1% increase. That followed a similar rise of 3.8% in February, and for the 12 months ended March, orders for big-ticket items are up a whopping 16%. The Institute for Supply Management's manufacturing index rose again in March to 62.5. ISM says this equates to a 6% overall growth rate in the economy.

The Commerce Department also reported that businesses boosted their inventories by 0.7 percent in February (latest data available) - the biggest increase since August 2000 - a sign that companies are feeling better about the recovery's staying power. Despite the latest increase, inventories remain very low, and this suggests strong hiring growth in the months to come. This also means we should see a significant increase in capital spending during the rest of 2004 as businesses ramp-up to rebuild inventories.

On the consumer side, retail sales jumped 1.8% in March even though advance estimates suggested less than half that amount. For the 12 months ended March, retail sales are up 8.2% over year ago levels. Shoppers treated themselves to a wide range of goods in March, spending on cars, clothes, furniture and building and garden supplies.

New home sales surged 8.9% in March, the largest monthly increase in nine months. This occurred despite the fact that mortgage rates have been on the rise recently. Freddie Mac reported in late April that the national average 30-year fixed mortgage rate rose to 5.94%.

Consumer spending accounts for over two-thirds of all economic activity (GDP) in the US. Despite the constant warnings from the gloom-and-doom crowd and the Democrats, consumers continue to spend, and this is good news for the economy. Economists said the improved job climate; tax refunds and continued low borrowing costs made shoppers feel more inclined to indulge in March.

While the official unemployment rate edged higher from 5.6% in February to 5.7% in March, over 308,000 new jobs were added, hitting a four-year high. While many doubt that employment growth will continue at this pace, the latest reports suggest that this economy will continue to surprise on the upside.

Inflation Fears Arise, Interest Rates to Rise

Strong economies almost always give rise to inflation, and this one will be no different. In March, the Consumer Price Index rose 0.6%, and the Producer Price Index rose 0.5%, both higher than expected. For the three months ended March, the CPI rose at an annual rate of 5.1% versus only 1.9% for all of 2003. A big reason is the surge in energy prices over the last several months. Yet inflation is not likely to get out of control and will likely average 2½-3% for all of 2004. Actually, the Fed has wanted to see inflation increase somewhat to be sure that the deflationary threat has passed.

While the Fed has been happy to see the economy growing strongly and inflation rising slightly, this does mean that interest rates will be heading higher. In fact, they already have. The yield on 30-year T-bonds has risen from near 4.75% to 5.25% in the last month, while the 10-year T-Note rose from 3.75% to near 4.5%. This has meant big losses for investors in most bond funds.

For months now, I have warned that yields on long-term bonds were going to rise, and I have recommended that investors reduce positions in Treasury bonds specifically. I hope you took that advice. While these inflation-sensitive markets may have over-reacted a bit in the last month, I believe long-term rates will be even higher over the next six months to a year.

On numerous occasions in this newsletter, I have recommended that investors consider my favorite professional bond manager - Capital Management Group. I am happy to report that CMG has managed to avoid the carnage in the bond markets over the last month or so. I'll come back to CMG later on.

Will The Fed Raise Rates?

The Question Is When. As noted above, I am in the camp that believes interest rates are headed higher, including short-term rates. Virtually everyone agrees that the current 1% Fed Funds rate is too low. Even at 2% - double the current rate - the Fed funds rate may be too low. In fact, the rate is likely headed back to 3-4% over the next 12-18 months, especially if the economic recovery continues.

Earlier this year, I predicted that the Fed would not hike the short-term Fed funds rate before the election. However, the latest surprisingly strong economic data and the March inflation numbers clearly increase the odds that the Fed will raise rates once before the election. It still won't surprise me if the Fed waits until after the election; on the other hand, a modest increase (quarter or half point) before then won't surprise me either.

Everyone is speculating about when the Fed will raise rates. We're thinking that the Fed would move rates up at the June FOMC meeting, or they would wait until after the election. Clearly, the Fed would prefer not to make a move at the August or September meetings, since the election campaign will be in full swing by that time. Greenspan would prefer to remain apolitical.

Actually, it may not matter much when they raise rates. As noted above, the bond markets have already reacted sharply to the growing likelihood of a rate hike before the election. Some analysts argue that the bond markets actually over-reacted in April to the possibility of a rate hike. Assuming we see only a quarter-point or half-point increase in the Fed funds rate, the bond markets may already be priced accordingly. Even so, rates will be trending even higher later on, and that is bad news for bonds.

BCA's Latest Thinking

The Bank Credit Analyst continues to be bullish on interest rates. "The Federal Reserve has downgraded the inflation threat. However, inflation has clearly turned and the prospect of tighter monetary policy will continue to weigh on the markets. The fed funds rate is headed above 4% over the next couple of years. Ten-year Treasury yields will likely reach 6% or higher before a cyclical peak is reached. The upturn will be more dragged out than in the past. Real yields seem low given the strength of economic activity and a sharp rise in the corporate sector" return on capital. The Fed's low interest rate policy, weak business credit demand and large-scale purchases of bonds by foreign central banks are largely responsible. These supports will diminish going forward.

The sharp sell off in U.S. Treasuries during the past month has not created a buying opportunity because the fundamental backdrop to the market will deteriorate further over the coming year. Inflation will edge higher, the Federal Reserve will begin to tighten its monetary stance and real yields will increase from current unusually low levels. While the Fed's low interest rate policy may remain an anchor for bond yields in the near run, the risk/reward trade-off for Treasuries is unattractive... There is nowhere safe in long-duration fixed-income securities when interest rates are in a cyclical uptrend." Interest rates are going up in BCA's opinion!

Stocks - Another Good Year in 2004?

The stock markets should also benefit from the good economic news which is likely to continue for the balance of this year and very likely into 2005. Corporate profits are poised to improve significantly over the next year or longer. It is in this context that BCA continues to recommend above average holdings of equities.

There is little disagreement that higher interest rates loom as a negative for equity prices over the next couple of years, especially if rates are going to the levels suggested by BCA above. However, interest rates are expected to rise only modestly over the next 6-12 months. This should be more than offset by the good economic news and improved earnings, so we still have a window of time in which stocks should perform well.

Another factor which could help push stock prices higher is new money coming in. Inflows to equity mutual funds rose by over \$88 billion in the 1Q according to AMG Data Services. Still there is a mountain of cash sitting in money market funds that could move into stocks and stock funds. Likewise, we may well see increasing movement from bonds and bond funds to stocks and stock funds as fixed income investors decide to cut their losses.

Keep in mind I am not predicting another year like 2003 when the S&P 500 rose over 28%. And volatility is likely to remain high. However, returns over the next year could be very respectable, especially if there are no major negative surprises.

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