

Forecasts & Trends

By Gary D. Halbert



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Economic & Investment Overview: Economic reports released were once again generally positive. The index of Leading Economic Indicators was unchanged in the latest report as was the Consumer Confidence Index. Consumer spending was slightly higher as well. Retail sales rose 0.6% in February for the fourth consecutive month. Durable goods orders rose in February also. The employment picture finally improved markedly in March with over 300,000 new jobs created across industry lines. Meanwhile, corporate profits have skyrocketed in the last six months. **The Bank Credit Analyst** remains optimistic about the economy. They expect GDP growth of 4% this year and 3-4% in 2005, barring any major negative surprises.

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. As discussed last month, BCA continues to believe the odds are good that the Fed will not raise rates this year, or at least not until after the election. As a result, BCA believes that the equity markets will recover, perhaps strongly, in the next few months and go into the election on a strong note. They also believe Treasury bonds, which have enjoyed a nice rally recently, will again come under pressure in the weeks and months just ahead.

Consumer Spending Still In Good Shape

For the last two years, we have been told by the media that consumers are “tapped-out” with the record large amount of debt. Yet consumer spending has been on a steady increase ever since the end of the recession in November 2001. **Personal consumption expenditures rose again in the latest reporting period and are up 7.2% in the last 12 months.**

It is true that household debt levels are at a record high. However, as I have written several times over the last year or so, over 70% of all consumer debt is in the form of home mortgages which are well collateralized. As you will recall from previous issues of **F&T**, BCA has steadfastly argued that US consumers were in better overall financial shape than the media would have us believe.

BCA continues to believe that consumer spending will remain firm over the next year. While consumer debt levels remain high, and the savings rate low, **the BCA editors believe that consumer spending will continue to surprise on the upside in 2004 and 2005** as it has for the last couple of years. This is just one more reason why the economy is likely to continue growing at a healthy pace.

The Interest Rate Outlook

With the latest good employment news, analysts are again questioning when the Fed will raise interest rates. BCA's most likely scenario, as already mentioned, continues to be that the Fed will not raise interest rates this year. The editors believe that the Fed is still concerned about the deflationary threat that existed in late 2001 and 2002, and will defer any interest rate hike until it is even more obvious that the inflation rate is back on a moderate rise.

Such a policy by the Fed may seem strange, since the Fed has been fighting inflation for the last 20 years or longer. However, the US economy flirted dangerously close to deflation

during the 2000-2001 recession, and BCA believes this scared the Fed into a new policy. BCA maintains that, unlike in previous years, the Fed will keep interest rates abnormally low until they are sure that the deflationary threat is dead and gone. Specifically, they believe the Fed wants to see inflation trends begin to rise modestly for at least a couple of quarters before they raise short-term interest rates.

BCA maintains that the most likely time for the Fed to raise rates for the first time will be in early 2005. The editors admit they could be too optimistic and they offer the following analysis:

“At least three months of solid employment gains will also be needed... This leaves open the possibility of a rate hike in August, but the odds are much less than 50%. Then we have the problem that the Fed will not want to raise rates too close to the November elections. ... the next realistic opportunities will be at the December [2004] or January [2005] FOMC meetings.

Even once rates start to rise, the Fed will move gradually in order to avoid causing too much market turmoil. The implication is that monetary conditions will stay very accommodative for the foreseeable future. This should be bullish for both the economy.

Gasoline Hits Record High

Gasoline prices hit an all-time record high in March. AAA reported that the average price for a gallon of regular unleaded gas across the US hit \$1.76 on March 29. In California, gasoline prices topped \$2.10 per gallon on average in late March. Consumers are complaining that the government should do something, and many are crying foul play by the big oil companies. This is nothing new.

OPEC oil ministers met in Vienna on March 30 and decided to cut daily oil production beginning on April 1, but this is not likely to happen. As you will read below, OPEC has been cheating on production quotas for the last six months, and they're not about to stop now with the current high prices.

The Bush administration was disappointed with OPEC's decision as it has been lobbying allies in OPEC to increase, not decrease, oil production. So much for that plan. John Kerry, announced his new plan for lowering fuel prices on March 30, with the same lame ideas we've heard in the past. Below I'll tell you why neither Bush nor Kerry will lower gasoline prices significantly anytime soon.

In fact, gasoline prices are likely to continue to increase as we head into the peak consumption period from now through August. Most consumers do not plan to cancel travel plans and stay home this summer just because gas prices are 11-15 cents a gallon higher than a year ago. As I will discuss below, there are no quick fixes to the current energy problem.

The bottom line is that global demand for oil and energy products is booming. Gasoline consumption is rising rapidly, not only in the US but also in China, India and elsewhere around the world. Meanwhile, inventories of crude and refined fuels are the lowest in years. In addition, some of the major producers of sweet light crude, the grade of oil best suited for making automobile fuel, are reaching capacity limits. Add to that a global energy transportation shortage, and you have all the ingredients for higher prices.

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