

2004 should be another good year for the economy and most of the investment markets. About the only thing that could derail that outlook would be another major terrorist attack on our soil. Otherwise, expect another good year.

In its final report on 3Q GDP on December 23, the Commerce Department confirmed that the economy rose at a blistering annual rate of **8.2%**. Consumer spending was stronger than expected in the 3Q. In the last report, the manufacturing sector surged ahead with the largest monthly increase in 20 years. This will lead to additional improvement in employment. While a growth rate of 8% is not sustainable, most economists expect growth of 4-5% in 2004.

In their annual forecast for the new year, **The Bank Credit Analyst** predicts that the economic recovery should continue until **2006**. This is a significant improvement from their previous forecasts in 2003.

The stock markets have started the new year on a strong note. The equity market should continue to advance in 2004, but probably not at the rates we saw last year. 2004 will very likely be a good year for market timers such as those we recommend. The bond market, on the other hand, will likely continue to struggle, with the exception of high-yield bonds which could continue to benefit from the economic recovery. Gold hit new highs in the first week of the new year, while the US dollar hit new lows (down over 30% against the Euro). Both of these trends could continue.

A Big Change In Their Outlook

During most of 2003, the editors at BCA emphasized that the US economy would "surprise on the upside." Now, in retrospect, that call was **dead-on**, especially given the GDP growth surged to an 8.2% annual rate in the 3Q. However, for most of 2003, BCA maintained a very cautious outlook for the period beyond 2004. Not that they were negative or bearish beyond 2004, they simply admitted that their economic models were not clear beyond that point.

Yet in their latest New Year forecasts, the editors have become much more confident that the economic recovery will continue beyond 2004. They say: ***"We have a high degree of confidence. The [monetary] policy environment should remain conducive to growth in all the major regions and leading economic indicators are pointing north. Barring some unforeseen shock, the current impetus toward stronger growth should continue.***

As a rule, economic trends do not change on a dime. There is a general rhythm to the economic cycle in the sense that once an upturn takes hold, it sets in motion a chain of events that becomes self-sustaining. The business cycle has averaged four to five years in recent years, which means the current one should be safe until at least 2006. The cycle typically comes to an end when increased inflationary pressures force policy to become restrictive. While we expect inflation to edge higher, it will not become enough of a problem to create the need for a monetary squeeze during the next year or two. We are particularly encouraged by the broad-based nature of the economic upturn."

This is actually a very bold move by the editors at BCA. They could have easily said only that they expect the recovery to extend beyond 2004. Suggesting that the recovery should continue for another two years, at least, is a much riskier position. But then, offering longer-term forecasts is nothing new for BCA, and their track record in doing so is enviable.

The Usual Caveats

BCA includes the usual caveats that could render their forecast too optimistic. Among those are a collapse in the US dollar, which they do not expect, a major banking crisis, which they do not expect, or a major war which, to them, also seems unlikely. BCA's major concern regarding their outlook for the next two years is **another serious terrorist attack in the US**. Of all the surprise events that could derail their positive outlook, the terrorist issue is the most serious in their eyes. Of course, this is a major concern to all of us in the forecasting business.

Storm Clouds Are Still Brewing

While BCA's outlook for the next two years is upbeat and positive - both in terms of the economy and the stock markets - they continue to have very serious concerns about the next recession, whenever that occurs. They continue to believe that the next recession could be very, very serious. **In fact, they state that the long-term economic upwave that they predicted back in the early 1980s could unravel in a potentially dangerous fashion whenever we hit the next recession.** But they also emphasize that they don't believe we are there yet, and maybe not for a couple years or more.

What this means to us as investors is that the good times may well last longer than many people currently expect. **We should therefore keep our money largely invested, rather than largely on the sidelines expecting the worst.**

The Rear View Mirror

Let's think back to late 2002 and early last year. The gloom-and-doom crowd was riding high. We had a recession in late 2000 and 2001. Never mind that it was the mildest recession in the post-War period, despite the serious effects of the 9/11 terrorist attacks. Yet the gloom-and-doomers maintained throughout 2002 and early 2003 that we were headed into a "double-dip" recession. They were absolutely convinced that US consumers were tapped-out financially and dangerously overloaded with debt. Therefore, there was no way that consumers could lead us into a new economic recovery, much less a recovery in stocks.

The naysayers were also convinced that we were headed into a deflationary spiral that would lead us into the “**big one**” (depression). This, they promised, would lead to a major decline in home prices - “the next great bubble to burst!” They also predicted that the US dollar would collapse in the world currency markets. The US dollar has fallen approximately 30% against the Euro, but it could hardly be described as a collapse. It has declined in a very orderly fashion that has not disrupted the financial markets.

Finally, the gloom-and-doom crowd argued that the Fed was out of bullets, and that all of the aggressive rates cuts would not be enough to pull the economy out of its dive. **The problem is, the economy never was in a dive!** Again, the recession was very mild by historical standards. Yet to the gloom-and-doom crowd, the US was finally headed over the proverbial cliff.

What Were We Saying?

Now, let's compare the above to what we have been saying in these pages over the same period. And before I do, let me say that the purpose here is not to toot my own horn. Candidly, if you have been reading this column for long, you know that I take most of my cues from **The Bank Credit Analyst**. While I disagree with them once in a while, that has become increasingly rare in recent years. And for good reason. **BCA has consistently had the best track record for calling major turns in the economy and the major investment markets of anyone I have read over the last 25+ years.** They're not perfect, but they're very very good.

In early 2002, BCA did voice some serious concerns regarding the possibility of deflation, but they were confident that the Fed was well aware of this threat and would deal with it accordingly. A little later in 2002, BCA became increasingly concerned that consumer debt levels were getting dangerously high. As a result, they began to focus more attention and research on consumer debt levels and reached very different conclusions from those in the gloom-and-doom crowd, and even many in the mainstream. **BCA determined from numerous sources that 70-80% of all household debt was made up of home mortgage debt, which in most cases is fully collateralized and therefore secure.**

Along the same lines, BCA studied housing trends and other related factors and concluded that home prices were not likely to fall significantly anytime soon. Independent of BCA's research, I found additional support for this view. For example, a major Harvard study released last year looked at housing demographics and concluded that, other than possible short-term dips, home prices would steadily rise over the next 10-20 years. I summarized that study in these pages.

On the basis of BCA's research, the editors concluded by late 2002 that consumers were not tapped-out financially, and that consumer spending might well be able to support a further recovery in the economy. This led BCA to forecast that the economy would “**surprise on the upside**” in 2003.

As the year came to a close, BCA became increasingly positive on stocks and increasingly negative on bonds, especially Treasury bonds. BCA was hesitant to recommend “fully invested” positions in stocks in late 2002 for several reasons. First, the stock markets were still in a clear downtrend, and BCA has never been one to “bottom pick.” Second, there were already clear indications that we were going to war with Iraq. So, BCA did not formally recommend that investors go back into stocks in a big way.

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