

## Forecasts & Trends

### **The Economy Slows, But Not to Worry**

by Gary D. Halbert

At the end of July, the Commerce Department released its preliminary report on 2Q GDP, showing the economy expanded at an annual rate of 3.0%. That was somewhat less than the average expectation of 3.5%. On June 25, the government released its final report on 1Q gross domestic product. In that report, they revised 1Q GDP growth down to 3.9% (annual rate) from 4.4% reported earlier. That compared to growth of 4.1% in the 4Q of last year.

Keep in mind that growth of 3.9% and 3.0% are both strong, but the reaction to the latest preliminary report for the 2Q was rather negative. The media, of course, characterized the latest GDP report as very disappointing and a sign that the economic recovery is grinding to a halt. Not so, as I will explain below.

The economic recovery has slowed modestly as indicated by several reports over the last several weeks. Here's the rundown. The Index of Leading Economic Indicators edged down 0.2% in June (latest data available), the first monthly decline since March 2003. While some in the media made a big deal out of this, the LEI is still above where it was in the 1Q of this year. We would have to see this index fall for three consecutive months to indicate that the economy is in any trouble.

Consumer spending slowed slightly in June with retail sales falling 1.1%. Here, too, a modest decrease in one month does not suggest a trend. Durable goods orders declined by 1.8% in May, and the media made a big deal about that, yet orders for non-durable goods rose by 1.5% the same month. Durable goods orders rebounded, up 0.7% in June.

The Institute for Supply Management's ISM Index fell from 65.2 to 59.9 in June, the lowest level since December. The index had risen sharply for several months in a row, hitting a record high in April, so it is not unusual to see a pullback. Keep in mind that any reading above 50 indicates that the economy is growing. Here, too, we would have to see this index fall for three consecutive months to suggest that the economic recovery is stalling.

### **Not All Bad News**

The media has a tendency to focus on the bad news. Yet there have been several very positive reports over the last few weeks that you may not have heard about. Perhaps the most encouraging is the Consumer Confidence Index which soared almost 9 points in June to 101.9, the highest level since June 2002. Separately, the University Michigan's consumer sentiment index also rose sharply in June. The Consumer Confidence Index for July was released last week showing another jump of over 3 points to the highest level in two years. This is important because consumer spending accounts for approx. 70% of GDP.

Sales of existing homes hit a new record high of 6.95 million units in June, despite higher mortgage rates. New home sales hit a record in May. So, the housing market remains very robust even in the face of higher interest rates.

While the media made a big deal out of the latest jobs report, there are indications that hiring will increase in the months ahead. The Labor Department reported that 112,000 new jobs were created in June, versus 250,000 in May. Even though the July unemployment number was very disappointing, over one million new jobs have been created this year, and there are indications that new job creation will increase in the months ahead.

The National Association for Business Economics conducts a quarterly hiring survey of CEOs of major corporations. In the latest survey, 41% of respondents said they plan to increase hiring versus only 34% in the last survey taken in March. This suggests that the rate of new job creation will increase in the second half of this year.

Finally, the latest Wall Street Journal survey of economic forecasters is very encouraging. The Journal surveyed 55 leading economists earlier this month, asking for their predictions on economic growth. The average estimate is for GDP to grow by 4.4% in the 2Q and 3Q and 4.2% in the 4Q. They also predict growth of 3.7% in the first half of 2005.

## So the Economy Is Fine

Despite how the media and the gloom-and-doom crowd may spin it, the US economy remains on very firm ground. Solid growth should continue through the end of this year and well into 2005, barring some major unexpected surprise.

Obviously, if there is another major terrorist attack in the US, then we can throw these positive forecasts out the window. As discussed further on pages 5 and 6, we have all heard the new terror warnings which were announced on August 1, complete with specific targets the terrorists may have (or had) in mind. Unfortunately, it is impossible to know if these threats are real. But other than this risk, the economy will continue to grow.

In this article, I bring you the latest forecasts from our old friends at **The Bank Credit Analyst**. I have not written about BCA's latest thinking in a while because their forecast and their recommendations haven't changed in a while, until their current issue. As always, I consider BCA to be one of the most accurate forecasters of major economic trends, equity market trends and interest rate trends. I have been a continuous subscriber to BCA since 1977. Their research is quite expensive but well worth it.

Since the beginning of this year, BCA has maintained the following forecasts:

1. The economy would continue to rebound, perhaps surprising on the upside.
2. Inflation would turn higher, but not by enough to be overly concerned.
3. The Fed would nudge short-term rates up in the second half of the year.
4. Equity prices would trend modestly higher, especially in the second half – maintain above-average positions in stocks.
5. Treasury and other long-term bonds are overpriced and are not advised – maintain below-average positions in long-term bonds.

With the exception of equity prices not rising to this point, Martin Barnes and his fellow editors at BCA got it pretty much right as usual. So what do they think now?

First of all, the BCA editors believe the economy will continue to grow by 3-4% for the next year, absent a major negative surprise such as another serious terrorist attack on our soil.

They believe that inflation, as measured by the CPI, will settle in the 2-3% range. They also believe the Fed will continue to nudge short-term rates up, such that the Fed funds rate is 4% or higher by the end of next year (2005).

## BCA Downgrades Equities

BCA's advice on the investment markets is either “**above-average**,” “**average**” or “**below-average**” holdings. After having recommended above-average holdings of equities over the last year, the BCA editors downgraded their recommendation to average holdings in their latest August issue. They say:

***“The stock market was due for a period of consolidation after rising 45% [S&P 500] between March 2003 and February 2004, almost without a break. However, what should have been a ‘pause that refreshes’ is turning into a larger affair. There is still a chance that prices will resume their upward advance in the second half of the year given still decent earnings growth and low interest rates... The conditions for a major decline in stocks do not exist.***

***...However, there needs to be a catalyst to trigger renewed investor confidence [in the market]. Investors are weighed down by a long list of concerns including oil, geopolitics, rising interest rates, the sustainability of the economic expansion and the outlook for earnings.”***

As noted just above, the editors at BCA still believe the stock market may have some meaningful upside potential, but they also recognize that the markets could continue in a broad trading range. In fact, their latest most likely scenario would have equity prices rising only about 5% over the next year. If true, that will be a major disappointment to millions of investors.

The BCA editors also expect the equity markets to continue to be quite volatile. They once again advise investors to consider traditional market timing strategies and sector rotation. They say:

***“In a low return world, market timing will become more important and this means paying more attention to short-run cycles... There will be lots of mini-cycles for nimble investors to play... Market timing and sector selection will become much more important in terms of boosting returns to more acceptable levels.”***

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