

Forecasts and Trends

The Bank Credit Analyst's Latest Forecasts for 2006 and Beyond by Gary D. Halbert

BCA Remains Optimistic for 2006

In the mid-1990's, BCA predicted that the US economy had entered a multi-year, technology-driven economic "long-wave upturn" which would last for many years, perhaps a decade or longer. BCA defined their economic long-wave upturn as a period of relatively strong economic growth with only modest recessions along the way. In short, they predicted that the US economy would surprise on the upside, and it repeatedly has over the last decade.

In the 1995, they also predicted that inflation would trend significantly lower over the next five to ten years, which it certainly has. And they predicted that interest rates would decline substantially over the same period of time. Indeed, we saw interest rates fall to 40-year lows in the last couple of years.

In their bold forecast for 1995, the editors also predicted a spectacular bull market in stocks and bonds at a time when most analysts were bearish. What followed was the greatest bull market in stocks of all time, with a similar move up in bonds.

As long-time clients will remember, I questioned BCA's long-wave forecast at the time as a result of our bulging federal budget deficits, trade deficits and the falling personal savings rate. I even challenged Martin Barnes in 1995 in an interview that we reproduced and made available free to our clients. As Barnes pointed out in that interview, BCA was well aware of the many financial imbalances. He even admitted, readily, that a "day of reckoning" will come at some point in the future. Nevertheless, Barnes was convinced that the day of reckoning was somewhere well out on the horizon and the BCA has stuck to its optimistic long-term forecast. They have been correct as usual and investors who doubted them and invested for the worst as advised by the gloom-and-doom crowd, missed two of the great bull markets in history and probably lost a LOT of money over the years.

As for 2006, BCA continues to believe that the US economy is still in the midst of a technology-driven, long-wave upturn which could continue for several more years.

In the short-term, the editors still believe that US economic growth cooled modestly – well below 4% in the fourth quarter of last year (although we don't yet have data to confirm this), and that it will be below the 4% level in GDP again in the first quarter of this year. But, they believe that 2006 will be yet another year of very respectable economic growth (3-3fi% in GDP).

BCA's outlook for 2006 is somewhat the reverse of that offered by the 56 economists surveyed recently by the Wall Street Journal. The WSJ economists expect GDP growth to be 3.5% in the first half of 2006 and then slow to 3.1% in the second half of the year. BCA's view is different in that they expect growth to be slower in the first half of the year and then accelerate in the second half. Either way, both groups expect a very respectable year in terms of economic growth.

Most importantly, the centerpiece of BCA's latest forecast is their belief that inflation will remain low for the next year or longer. If inflation remains low as they expect, then interest rates should remain low as well, and the economy should deliver solid growth, although probably not another year of 4% GDP. In short, they expect another year of 3-3fi% growth in GDP and no recession in 2006.

Martin Barnes and his fellow editors readily admit that if they are wrong about their forecast for continued low inflation, then most, if not all, of their specific market forecasts will be wrong as well. They clearly recognize that another large spike in energy prices, for example, could cause inflation to rise well about their expectations. Yet in their most likely scenario, the "core rate" of US inflation stays relatively low for the next several years, interest rates remain low and the US economy continues to grow.

The Problems with BCA's Optimistic Forecast

Having been optimistic about the US economy for over a decade, I suspect that more than a few clients and readers must think that Martin Barnes and his team are eternal optimists and subscribers to the "perma-bull" theory so pervasive on Wall Street. I must admit that it is tempting to doubt BCA's latest rosy forecasts.

We all know that the federal budget deficits are record large; we all know that the national savings rate fell into negative territory in 2005; we all know that the trade deficit is off the charts; we all know that the only thing supporting the US dollar is massive foreign buying of greenbacks; and we all know that this period of borrow-and-spend prosperity will come to an ugly end at some point.

It is important to note that BCA fully agrees with everything in the paragraph just above. They simply do not believe that the day of reckoning comes in 2006 and maybe not even in 2007 or even longer.

We all see the national debt piling up and the fact that neither political party can restrain spending. The signs continue to mount that the huge bull market in US real estate is leveling off at best and the housing boom has been a huge source of liquidity for US consumers, which are driving this economy (and in fact the global economy). We all know that foreigners will not continue to hold bulging amounts of US dollars forever. As noted above, there will be a very ugly end at some point.

BCA simply argues that we are not there yet: *"Current trends in the US trade balance cannot persist indefinitely, but they are likely to be sustained for quite some time. Even if private capital flows into the dollar fall back from recent high levels, it is virtually certain that Asian central banks will step in to fill the breach, as they did between 2002 and 2004. It is not in anybody's interest for a dollar crisis to trigger a US recession, and Asia would be especially hard hit. That is why the region's central banks are quite prepared to be the dollar buyers of last resort for the foreseeable future...it all comes to an end when it is no longer in the economic and/or political interests of Asian governments to sustain this arrangement."*

The emerging economies around the world, and especially in Asia, are reaping huge benefits by running large trade surpluses with the US. America, meanwhile, can continue to borrow-and-spend precisely because these foreign countries are willing to be paid in US dollars and are content to hold growing amounts of our greenbacks, which for now remain the world's "reserve currency."

This arrangement will come to an end at some point, and it will not be pretty, but BCA argues that such an end will not happen in 2006, and maybe not for several more years, barring some very negative surprise(s).

No doubt, many of you will disagree, but in the almost 30 years I have read BCA, it has rarely paid to disagree with them.

BCA on the Markets – Good News and Bad

Up to this point, this summary of BCA's latest forecasts has been quite encouraging – continued economic growth, low inflation and low interest rates. But that's where most of the good news ends. Let's start with stocks and bonds.

As they have for the last year or so, BCA suggests that US equities are likely to remain in a broad trading range with a mild upward bias in 2006. BCA's most encouraging advice is that because

the US equity markets lagged many of the international markets in 2005, they are likely to “see some catch-up in the coming year.”

Let's hope so! The Dow Jones Industrial Index was actually fractionally lower in 2005; the S&P 500 Index gained only 3% for the year; and the Nasdaq Index was up only 1.4%. While BCA is slightly more optimistic on equities in 2006, it looks to be another difficult and potentially frustrating year for most equity investors.

If correct, this continues to suggest active management strategies such as sector rotation and traditional market timing. Several of the professionally managed equity programs I recommend significantly outperformed the major market indices in 2005. Maybe it's time you consider them, if you haven't already. (Past performance is not necessarily indicative of future results.)

As for bonds, BCA has a similar outlook – a continued trading range. While the editors expect there to be some minor trends, up and down, in bond yields over the next year or two, they predict that *“yields will be relatively modest by the standards of the past few decades.”*

Again, this forecast is based on BCA's view that inflation will be mild for the next year or longer. The editors go on to say, *“...the conquest of inflation means that bonds have a relatively boring asset class.”* Within that overall context, the editors believe that US and Australian bonds will perform best in 2006.

In the area of foreign currencies and the US dollar, BCA has a similar mixed view for the next year. While the editors continue to believe that the US dollar is in a long-term bear market, they are not compelled to reinstate short positions. They were correct that the dollar would rebound in 2005. They are not so certain about the dollar's path in 2006 (and neither were the economists surveyed by the Wall Street Journal). Here, again, it could be another trading range. For now, BCA's favorite currencies for 2006 are the Canadian dollar, which has already advanced significantly, and the Japanese yen.

Next we move on to the **real estate market** which has been a bonanza for many investors in recent years. As noted earlier, the signs continue to mount that we have seen a peak in real estate prices. My advice late last year was to take some profits and lighten-up on any speculative real estate you owned, including real estate mutual funds. I stand by that advice, and it's not too late to do so.

The big question now is whether real estate prices, including home prices, are in for a steep decline or rather just a modest correction. BCA suggests the latter. The editors believe that home prices will fall in the hottest markets, especially the coasts, but they do not see a major plunge in home prices on the national level. They point to the pattern of home prices in Great Britain, which saw a similar boom but no major implosion in prices. ***“House prices in the U.S. are likely to stagnate rather than collapse.”*** Let's hope they are right on this one.

As noted above, all of these forecasts are based on the assumption that no major negative surprises can occur in 2006. Obviously, the threat of terrorism remains as a wild card. Another huge spike in oil prices is also a wild card. While the editors of BCA remain long-term bullish on oil and energy prices, and recommend buying on dips, they do not expect that energy prices will rise to the point of snuffing out the strong economy in 2006.

I must remind you that while BCA has been my single best source for economic and financial advice for almost 30 years, they are not perfect. No one is. With that said, I recommend BCA very highly. I encourage you to visit their website at www.bcaresearch.com.

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