Outlook for the Economy in the Coming Year

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0. Let's Remind Ourselves What Weight to Put on Crystal Balls and Economists' Projections

As ever, forecasts work well when current trends continue, they work poorly to predict turning pts. (When you most want accuracy)

- My 1979 prediction of $65 oil finally came tru
- My 3% GDP growth prediction didnt

I. How is My Crystal Ball This Year?

At the end of last year I predicted 3% growth this year - That turned out to be a bit on the low side. (Third quarter GDP grew by 4.3% after a 3.3% second quarter) Why was I off? The short answer is that I expected our massive Federal deficits to cause interest rates to rise - Even though the Federal Reserve did what it could at the short end, interest rates at the long end stayed low largely due to huge foreign central bank purchases of Treasury securities. Essentially the Chinese among others have given us a huge interest rate subsidy which has fueled continued housing sector growth.

II. The Past Year

A. We are still in the expansion that started in November 2001.

Note that the determination of an end was delayed until July 2003. Though the aggregate evidence is less ambiguous now it seems that the expansion is not spread evenly across the economy. Big winners are rich people, and the housing sector.

B. Business cycle evidence

- Employment - The Unemployment rate has gone from 6.4% at the trough to around 5% now

The unemployment rate is down to 5.0% from 6.4, but this leaves out all of the discouraged workers. The number of workers compared to the overall population remains low - and wages are essentially flat - workers are not sharing in the expansion

- Industrial Production - OK so far this year, durable goods orders up in Oct.

- Wholesale/Retail Sales -

The overall wage bill is still pretty flat. Consumers keep right on spending. This will end at some point. Early signs on Christmas season are lackluster

- Personal Income -

The trend from last year continues - The overall wage bill is stagnant compared to what we would expect with 3.5% GDP growth, meaning that consumers wouldn't have a lot more money to spend if it weren't for the increase in housing prices and consumer willingness to borrow on this value. Virtually all of the increase in income we have seen in the aggregate statistics has gone to profits and not wages. This dampens the multiplier effects we can hope for. Personal savings were at an all time low of 0.2%. They actually went NEGATIVE over the past summer. This, obviously, is not something we can rely on to continue being our engine of growth.

- Debt Service Ratios & Financial Obligation Ratios high.

Any rise in long interest rates is going to be painful

- Inflation -

Last year I predicted it would remain low - and I was right. Now the obvious danger is oil prices. They are going to stay substantially higher than before and this is going to spread through the economy. Even though they have come down recently they are still high compared to last year.

- Beware "core" inflation figures. Core figures exclude energy and food on the theory that they are more volatile. They are - but if the increase is permanent then it legitimately belongs in the core measure because it isnt going to fluctuate back down again

III. Current Policy Stance

A. Alan Greenspan has steadily increased rates - Bernanke promises continuity-

- What the next moves be? Given the leakage of inflation from fuel prices in tot the rest of the economy, undoubtedly higher, but the only real question is how fast rates will rise. I predicted they would go up to 2-3 percent this year, They actually went up to 3 3/4 (maybe even 4 by the time of this talk). They should continue up this coming year as long as growth continues given the push from oil prices. However, if 10 yr. rates remain at 4 1/2 there is a limit to how much higher short rates can go without serious danger of tipping us into a recession.

- Bernanke is the best choice we could have hoped for out of this President. He will worry about deficits as Greenspan did but still will be powerless to do anything about it. If anything, he will need to be at least as firm as Alan to prove his credentials.

B. Fiscal Policy

- Short term outlook

-Some improvement from one time only factors now est $331 bn

1. Tax holiday for foreign profits in 2005 only
2. More income in higher brackets - taxed at higher rate
3. It is NOT higher growth that is improving budget estimate

- Long run budget estimates still awful

IF tax cuts enacted since 2001 are implemented AND AMT relief is extended then revenue as a percent of GDP will average 17% over the next ten years, less than the average in the 90's 80's 70's 60's or 50's.

Spending continues to grow. Giant pork barrel bills. War in Iraq. President continues his unbroken record of never vetoing a spending bill - we have spectacles like the bill to trade the quarter of a billion dollar bridge to nowhere in Alaska for a repairs to bridges in New Orleans

Happily, the outlook for FURTHER tax cuts is that they are unlikely.

V. The Spend and Borrow Policy Continues. Where Will it End?

A. We need the foreigners to fund our deficits more than ever

- Trade Deficit set to top $750 bn. Could easily go to $800 bn. Financing now comes mainly from China, Taiwan Korea and other East Asian countries and oil exporters. Japan is out though they still hold large stocks of our debt. This will be a major problem when we start having to pay back what we are currently borrowing.

- Personal Savings now LESS THAN ZERO - Some argue that we are just doing the world a favor soaking up all those savings they want to have. I would argue that the central banks of places like China will have a degree of power over us that is not a good thing either economically or politically

B. Congressional chairmen show no signs of curtailing spending

- Bush's weakness will reduce whatever leverage he had with Congress to show a little restraint. Don't look for any turnaround until at least after the next election. The highway bill showed that even the most ridiculous projects can get funded. Yes, they canned the bridges to nowhere in AK but they left the money in the budget without an earmark. The budget is no better off and the bridges can still be built

C. Social Security reform is dead (thank God)

As I noted last year, SS is OK until at least 2040 (and 2050 according to CBO) - so even if we wait a few years we can still get away with a relatively minor fix - If we reverted to a pay as you go system after 2040 or 2050 beneficiaries would still get 75-80% of benefits that they were promised. To suggest that the system will collapse is just wrong. Another way to take care of the gap would be to repeal the tax cut on people earning over $500,000 a year.

Given that the proposal from the Administration was to cover the $2 trillion additional (approx) financing gap that would be caused by privatization by borrowing, it is clearly very good news for the fiscal balance that moves in this direction are dead.

D. Tax reform?

This is still a live desire of the Administration and I actually can imagine a tax simplication I would like.

But the President's commission has actually proposed ending the mortgage interest deduction as well as ending the deduction of state income taxes, which would be a disaster for NY.

However, I am not too worried as I have a firm prediction:
"Pigs will fly before any politician wanting to be reelected votes for these measures"

E. The Growing Danger from Our Trade Balance

- It gets worse and worse
- Financed by countries that are not our allies
- When the crunch comes we will have to shift production from building houses to export and import replacement sectors - This wont be easy or quick - price changes may be drastic (houses in the down direction and traded goods in the up direction)

V. Where are We Going Now?

A. Could we be at a peak in the cycle?

- OK GDP figures but

- higher interest rates have to bite at some point.
- oil prices have to bite at some point
- all housing booms end sooner or later

One of these days I will be correct when I say this but there is already evidence of a slowdown - housing starts down and unsold inventories up

B. Where Could the Impetus for More Growth Come From?

- If Consumers are Going to Spend, Where Will They Get the Money?

- Employment numbers - still reason for caution

The employment to population ratio remains low - Lots of people are without jobs and the jobs many have aren't very high quality. More importantly, most of the increase in income in the past year has gone to profits and not wages, limiting the money people have in their pockets

- Consumer spending keeps rising but personal savings is now actually negative

Hard to see how there can be major increases from this source. Far more likely is that consumers will retrench as the reality of higher fuel prices hits along with higher interest rates

Also - Consumer confidence numbers tanked big time in August/Sept. but recovered in most recent readings. Seems to be driven entirely by gas prices and warm weather so far.

- Housing - The Peak is Here! (I really mean it this time)

I said last year that housing usually peaks 1 - 3 years after the market - or around the time interest rates start back up again. This has been going on for a year now but long rates have stayed pretty much where they were thanks to foreign central banks. But it is difficult to imagine the market getting MORE overheated. Prices are getting out of reach in many regions.

- P/E numbers look more reasonable than a year ago but still high

They are lower than at the height of the bubble a couple of years ago but with the P/E of the S&P 500 in the low 20's they are predicting higher bond yields and/or somewhat lower?? stock prices. It is also still well above the historical average. But the NASDAQ P/E is still in the neighborhood of 30 even when you exclude all of the negative numbers for those companies not making a penny

- Will Business Investment Grow More?

- Capacity Utilization - Still in the 70's
- If they were confident they'd be hiring more
- Still, the latest business investment data is good

- Will the Foreigners Help Us Out?

- Oil at around $60 - 70 - May fall back a bit if growth does but we are never going back to where we were a few years ago

- Foreign Business Cycle News - China continues to try to put the brakes on while Europe is not much help.

V. Opinions

A. Growth

I expect the peak to occur sometime in the next year. The fourth quarter figures are likely to come in lower than the third quarter given consumer sentiment. The big question is whether long interest rates will rise. For the answer, we need to ask what foreign central banks will do. If I have to guess I will say 3%.

B. Inflation

CPI

Oil Prices are causing inflation to rise. We could easily see 3% next year or even 4% if growth continues at the high end of the range and oil remains very high. However, if growth does slacken we will likely see inflation remain low by long run historical standards, though higher than the last couple of years. However, the prospect for a sharp and sustained rise is low given the still relatively low capacity utilization and the slack in the labor market

Stocks

S & P P/E now in the high teens. Closer to historical levels than previously. Seem to have worked out the bubble of the 90's. But the high teens is still relatively high by long run standards.

Housing Prices

Not likely to be any inflationary impulse from here if prices are at a peak. But then again I said that a year ago. But that raises the odds that I am right at this point. It is bound to be true sooner or later