

The Global Economic Outlook

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In his 28 March 2007 testimony before the Joint Economic Committee of Congress, Federal Reserve Chairman Bernanke presented a largely sanguine assessment of the prospects for a continuing, albeit modest, expansion of business activity in the United States. He admitted also, however, that such an outlook remained subject to significant uncertainties, especially with respect to the U.S. housing sector, business capital investment, and the future course of inflation. While real output growth in the fourth quarter of 2006 was upwardly revised by 0.3% to 2.5% (on greater inventory accumulation and a smaller deficit in international trade), growth in the quarter ended 30 March is likely to range between just 1.5%-2%, or considerably below the U.S. economy's long term sustainable rate of between 2.5%-3%.

The ongoing correction in the housing sector, of course, should continue to subtract materially from cumulative GDP growth in successive quarters. The mid-winter, tentative indications of stabilization that at first seemed promising such as the reported increases in housing starts, existing home sales, and mortgage purchase applications have become largely undone by pre-spring declines in new home sales, applications for building permits, and weakening sentiment, earnings disappointments, and equity price erosion among homebuilders. The rise in the national mortgage delinquency rate to 5% (the highest since 2003) not only presages tighter lending standards and, therefore, weaker housing demand, but also suggests consumer spending, though buoyed by improving employment and wage gains, may yet come under increasing pressure, particularly as food and energy prices have resurged.

These housing related events and the increasing potential for spillover effects into the broader economy have doubtless caused business leaders to remain circumspect, or cautious in their outlooks. As the Fed Chairman noted in his testimony, "Expenditures on capital equipment declined in the fourth quarter of 2006 and early this year." While much of the outsized decline in capital investment has affected mainly the automotive and construction related industries, there have also been significant reductions in other equipment and software purchases. Although some late cycle weakness in business capital spending is not unusual, the magnitude of the current slowdown is somewhat problematic.

Productivity growth, which had accelerated at a 4% annualized rate as recently as 2004, fell to just 1.4% by the fourth quarter of last year. While this slowing in productivity may be related, in part, to the age of the current expansion in the United States and the corresponding low level of unemployment, it may also be a reflection of past capital investment shortfalls, particularly in the period immediately following the bursting of the technology share bubble in 2000.

The risk, then, is that the existing contraction in business investment, if sustained, implies future reductions in productivity, and, consequently, reductions in long-term potential growth rates, and, *in extremis*, living standards. High levels of productivity, moreover, impede inflation as businesses more readily absorb higher wage costs into expanding profit margins rather than transfer those costs to consumers via higher prices. Indeed the chief reasons the Federal Reserve still remains predisposed toward further tightening of monetary policy even though growth is likely to remain subpar are: 1) inflation has long held above the Fed's 1%-2% tolerance band, 2) productivity growth has trended lower, 3) little economic slack remains as capacity use rates and labor markets have tightened, and, 4) business profit margins are contracting. Although business profitability has been remarkably consistent, advancing at quarterly double-digit rates for nearly four years, earnings growth for the S&P 500 is expected to slow dramatically, increasing just 3.3% in the first quarter, according to Thomson Financial. For the full year, profits are expected to grow at a more sustainable 6.3% - or somewhat closer to the long-term historical earnings growth rate of the S&P 500. The coming deceleration in earnings simply corrects a somewhat overdue normalization of profit growth expectations.

Outside the United States growth seems to be more firmly entrenched. The IMF, in its most recent *World Growth Outlook*, predicts 2007 global economic output of just below 5% - an unquestionably robust rate. The report envisions growth receding, however, in the United States to 2.2% from its previous central tendency forecast of 2.9%. Although risks to global economic stability have diminished in the last half-year, according to the IMF, the organization identifies several potential new causes of economic disruption including: a reversal of the current low level of financial market volatility; increasing corporate leverage and private equity activity; and disturbances in the U.S. asset backed securities market because of falling home prices.

In general, the threat of substantial dislocations emanating from global trade imbalances (i.e. escalating U.S. interest rates or a rapidly depreciating dollar) has waned with greater U.S. export growth and stronger world demand, but trade tensions, particularly between the U.S. and China, are, regrettably, on the increase. In a surprising turnabout with respect to trade policy, the United States announced in March that it would impose tariffs on select Chinese paper imports (a miniscule portion of total U.S. merchandise imports) to counter government subsidies provided to Chinese paper producers. Increasing protectionist actions, however, not only harm bilateral trade, but also expose the United States to a range of non-trade related retaliatory measures.

Interestingly, the decision to impose trade sanctions against China came amidst the establishment of a new (and world's largest) free trade agreement between the U.S. and South Korea. The new agreement removes most tariffs on nearly \$80 billion in bilateral trade – products ranging from U.S. raised beef to South Korean manufactured autos. Although China last year overcame Mexico to become the United States' second largest trading partner (producing a record \$233 billion U.S. derived surplus in the process), it still struggles to moderate and balance its fast-growing, export-led economy. In April, the People's bank of China Bank again raised banks' reserve requirements for the sixth time in the current cycle as lending growth and the money supply both increased by 17% in February. China has so far resisted pressure to expand its daily 0.3% trading collar around its currency, but has indicated a willingness to ease restrictions on goods imports and end tax advantages for exporting industries.

In Europe, the European Central Bank last month increased its projection for Euro-area growth in 2007 to 2.5%. The region's currency has strengthened measurably against the yen and dollar on the prospect of higher interest rates and asset returns. Average annualized earnings expectations for Europe's largest industrial companies now exceed 20% for 2007, or more than three times the expected growth rate for the S&P 500. Productivity growth has also become invigorated on continuing labor market reform in Europe and threatens even to exceed that of the United States in coming quarters. In Britain, the Bank of England's Monetary Policy Committee left its base rate unchanged in April at 5.25%, but it too remains predisposed to further interest rate increases. Nationwide housing prices appreciated 11% in the first quarter. In London, luxury property prices advanced 32% over the last year, mainly on unabated external demand from Asia, Russia, and the Middle East.

