

## The Global Economic Outlook

December 2005

**By Christopher J. Sullivan, CFA**

**Mr. Sullivan is Chief Investment Officer of United Nations Federal Credit Union and UNFCU Financial Advisors. He is responsible for managing UNFCU's US \$1.15 billion securities portfolio. His comments on the international stock, bond and currency markets frequently appear in the leading multi-media press.**

The recent, surprising out-performance of the U.S. economy, notwithstanding a number of direct challenges, suggests its strength should persist well into 2006, especially as it will be aided by efforts to rebuild the hurricane ravaged Gulf Coast region. During the latest quarter for which we have complete data, U.S. real GDP expanded at a four-and-a-quarter annualized rate, nearly a percentage point above its potential or long-term sustainable growth rate, according to the U.S. Commerce Department. Productivity growth, or the rate measured in hours at which workers produce goods and services, also surged to nearly four-and-three-quarters percent during 2005's third quarter. This burst in productivity growth lends credence to the notion that the current expansion in business activity is still somewhat removed from its end stage—even without the benefit of external stimulus.

U.S. corporations, having largely worked through the repair of their balance sheets, delivered relatively consistent profit growth over the last eight quarters. Some moderation in this performance trend, however, is to be expected in 2006, especially as higher labor, raw materials, and energy costs, as well as tighter monetary conditions and on-going global competition, all induce compression in profit margins. Although the ability of firms to pass their higher costs through to consumers via higher product prices is still quite segmented, the world's leading central banks are acutely aware of a potentially expanding flow-through problem. The banks remain highly sensitized to the risk of the process achieving an albeit resigned but still general acceptance amongst their populations.

In his remarks following the European Central Bank's decision to raise interest rates on 1 December, President Trichet made explicit that the perceived risks to price stability "relate to uncertainties arising from oil market developments, the pass-through of previous oil price increases to consumers via the domestic product chain, the possibility

of second-round effects in wage and price-setting behavior, as well as further increases in administered prices and indirect taxes.”

Japan, of course, over the last seven years, has battled the opposite problem—a persistent *decline* in broad price levels, or outright deflation. It does seem now, however, that the Bank of Japan may be approaching the end of its long campaign of extraordinary monetary ease. Although core consumer prices in Japan still failed to register gains as of October, property prices did manage to break a fifteen-year decline in 2005, which encouraged residential investment from both individuals and real estate investment trusts. In our fall issue commentary, we noted that the nation’s willingness to undertake deep structural reforms would spur renewed asset price increases. In the interval from September to mid-December, Japan’s Nikkei stock index increased some three thousand points, or twenty-six percent in yen terms. Already, some particularly oppressive regulation has been lifted, and, certainly, Prime Minister Koizumi’s four-year old banking industry reforms have been instrumental in preparing the economy for its current newfound optimism. The yen’s surprising decline, though, to levels not seen in thirty-three months most likely reflects the widening interest rate differentials between Japan and other nations—a relationship which has shifted some national savings abroad. As both capital equipment and consumer spending improve, adding more of a much-desired balance to Japan’s largely export-driven economy, the key risks to sustaining such optimism about Japan, in my view, appear to remain mostly external, or are related most directly to both the strength of the Chinese manufacturing base and the buoyancy of the American consumer.

U.S. personal consumption, though frequently underestimated, could moderate somewhat over the course of 2006. Some moderation is especially likely as the pace of home equity extraction subsides with slowing home price appreciation, and wage gains do not materially off-set higher housing (mortgage), debt service (interest), energy (home heating and gasoline) and escalating health care costs. China, which is in the midst of a quasi-blended policy strategy (administrative but with nods toward market liberalization reforms) aimed at thwarting excess credit creation and investment, could very well orchestrate a “soft-landing” of its own, seven-percent variety in 2006.

Euroland growth in 2006 is expected to be little more than two-percent according to the Organization for Economic Cooperation and Development, or one-half percentage more than in 2005. Of course, a weaker euro exchange rate will benefit German exporters, but stimulating consumer demand growth toward the rate achieved by French consumers would insulate Germany from the vagaries of the global economy, exchange rates, and trade.