

The Global Economic Outlook

December 2007

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Since late summer, a persistent strain in financing markets together with increasing subprime mortgage defaults and home price deflation persuaded both the Federal Reserve and the Bush Administration to unusual action. The Fed, by early December, had reduced its benchmark policy rate by a full percentage point even against gathering evidence of increasing inflationary pressures. Unsurprisingly, perhaps, the cumulation of those rate reductions had little effect in easing conditions in the market for interbank loans. Banks had become suspect of still undisclosed concentrations of underperforming mortgage credit and sought to conserve liquidity in the likely event of future earnings and capital shortfalls. The Fed's new Term Auction Facility, devised in concert with the central banks of Canada, Great Britain, Switzerland, and Europe, was established to shore up confidence in the interbank lending market and to moderate overly restrictive credit conditions. The program both reduces the cost of short term loans to banks and expands the field of qualifying institutions. While the TAF is likely to be successful in administering and distributing liquidity within the global banking system, it is unlikely by itself to resolve much of the underlying credit problem.

The Bush Administration has taken action targeted at weakened home owners. It first introduced legislation to expand the availability of federally insured credit to subprime borrowers at risk of foreclosure by lowering down payment amounts and lifting qualifying loan amounts. It also managed an unprecedented accord among private lenders, investors, and mortgage servicers to freeze rates on adjustable rate mortgages for certain first-lien troubled borrowers. For now, certainly, these measures are very early-stage, and their overall future effectiveness is largely uncertain. It remains how well or poorly the programs' beneficial effects become transmitted throughout the economy, or, indeed, resonate with constituents. The odds of further general economic deterioration emanating from housing market weakness have risen markedly in the United States. Gross Domestic Product for the quarter just ended is likely to range between only 0.5% and 1.0%, considerably below the third quarter's 4.9% rate, as consumer demand has waned along with business capital investment and inventory accumulation. Export growth, aided by both a weaker dollar and increasing overseas demand, has been a salutary feature of the aging expansion in the United States.

Growth preservation over the course of 2008, however, might require even further action on the part of the Federal Reserve and the Administration—more likely in the form of fiscal stimulus, or temporary tax cuts, rather than continuing sharp reductions in interest rates. Total earnings growth among the nation's largest companies has subsided substantially over 2007, hindered, in part, by the 35% reduction in the earnings of financial firms. U.S. equity market returns in 2007 have largely met our mid-to-high single digit expectation. For 2008, barring an outright recession, and with both monetary and fiscal stimulus in train, earnings growth should once again resume an upward sloping trajectory, helped by favorable year-over-year comparisons and still reasonably buoyant international trade.

In Japan, the risk of economic contraction in 2008 is also quite real. In the December Tankan report, a widely followed survey of business firms, optimism among manufacturers achieved its weakest reading since September 2005. Eroding business confidence is mostly related to higher energy prices, a stronger yen, and the uncertain global growth outlook. While both import and export growth has slowed in Japan, the nation's current account balance surged 45% over the past year to more than 2.2 trillion yen. Exports to the United States fell by 1.5% but increased 12.5% throughout Asia and nearly 25% to Europe. Japan's surplus in income balance similarly reflects an increasing trend in diversification in its overseas investment away from the U.S. Although the nation enjoys still quite favorable balances in trade and income, domestic demand is likely to be constrained by weaker personal income growth, reduced discretionary spending, and quite possibly higher taxes.

In China, both industrial output and exports have slowed over the second half of 2007 as the government restrained bank credit growth and reduced tax-based incentives for exporting firms. In 2008, the country's overall growth rate is expected to slow to 10.5%, according to the Asian Development Bank. Inflation in China, advancing at a 6.9% annualized rate as of November (the highest level in eleven years), is likely to encourage further action by country's central bank. Recent favorable increases in domestic consumption, however, not only reflects higher inflation-related spending (especially with regard to housing, food and energy) but also suggests rising income growth will eventually ensure domestic demand represents a more equitable share of overall GDP growth.

In Europe, financial market expectations for higher prices are also on the increase—the main reason the European Central Bank did not accede to December rate reductions as in Canada, Britain, and the U.S. European inflation increased to 3.1% in November, considerably above the ECB's 2% target. Labor costs increased 2.5% from the year earlier period, and monetary policy officials are especially vigilant against the prospect of higher fuel and commodities' costs seeping into wage and more general price levels. Complicating the policy decision is the outlook for weaker growth across Europe's largest economies. Both the Ifo and Ipw, leading economic institutes in Germany, have lowered their forecasts for German growth in 2008—mainly on weaker spending and a currency-related reduced competitiveness among German exporters.

The Bank of France also revised its outlook on Europe's second largest economy, citing weakness in both industrial production and consumption. Although the Sarkozy government recently enacted EUR14 billion in new tax cuts and labor market reforms, consumer optimism has fallen consistently over 2007's second half.

In South America, the growth outlook remains somewhat more positive. Brazil's economy registered an impressive 5.2% growth rate in the annual period ending 30 September, the fastest rate since 2004. Interest rates in Brazil have been reduced by almost half over the past two years which has encouraged both investment and output. Employment growth has also expanded markedly with more than 2.1 million new jobs expected to have been created in 2007, up more than 20% from 2006. Personal consumption is outpacing GDP growth—suggesting quite healthy internal demand—and capital investment, a key factor in determining intermediate term potential GDP, recorded its largest gain since 1995. In Chile, the world's leading copper exporter, growth expanded at a 4.4% rate in the most recent year-over-year period. In December, the country's central bank raised its main policy instrument by 25 basis points to 6%. In its statement, the bank indicated that it expects inflation will rise moderately above its target in the short term, but noted that private consumption and investment remains "dynamic."

