

Global Economic Outlook

March 2003

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At the time of this writing, the evening of President George Bush's second State of the Union address to Congress and the people of the United States, and the eve of the Federal Reserve Board's first Open Market Committee meeting of 2003, financial market participants remain largely risk averse. As the early, promising buying in U.S. equities quickly faded, investors seemed more inclined to scale down their expectations for near term economic growth and corporate profits.

Now, with more than half the S&P 500 companies having reported fourth quarter earnings, fully 85 percent have met or exceeded analysts' reduced targets. Of chief concern is that earnings' quality remains lackluster. Corporate profitability continues to result more from balance sheet restructuring and productivity gains (i.e., cost cutting including jobs cuts) rather than from revenue growth. Additionally, the outlook provided by managers across many industries remains hesitant.

The growing perception that a U.S.-U.K. led war against Iraq remains inevitable and that such action could be a significant restraint on economic activity clouds the horizon. Select asset and currency price distortions caused by these growing uncertainties have greatly influenced overall trading activity. Consequently we have seen gold and crude oil prices rise sharply, equities fall, the dollar continues to erode and funds flow into the relative safety of U.S. Treasury securities.

Under the weight of geopolitical and business uncertainty, the United States economy continues to perform at less than its potential growth rate. Fourth quarter Gross Domestic Product (GDP), or the sum total of all goods and services produced, expanded at a meager 0.7 percent annual rate. For all 2002, the economy grew at 2.4 percent but lost 125,000 jobs in the process. Although an improvement over 2001's anemic 0.3 percent annualized rate, it is nonetheless far short of what is needed to support a

sufficient rate of job creation. Clearly, the fourth quarter report's highlight is the 1.5 percent gain in business capital spending, the first increase in real terms in five quarters.

Personal consumption remains the economy's most consistent and favorable aspect. Residential housing investment continues at a record pace, but it is reasonable to expect that this activity will abate in 2003, particularly if interest rates rise.

For its part, the Federal Reserve Board is likely to hold rates steady for the foreseeable future, having already injected a considerable amount of liquidity into the financial system. Also of great interest to the Fed is the specter of deflation, which has plagued the Japanese economy in recent years. Of late, this concern has quieted as basic materials prices, industrial commodities, and gold have all increased. Nonetheless, the Fed stands ready either to cut its 1.25 percent main policy rate further or to buy bonds from banks should the economy falter, risk slipping backward into recession, or if disinflationary pressures intensify and take hold.

In addition to the Fed supplied monetary stimulus, President Bush, in his State of the Union message, has proposed a US \$674 billion fiscal stimulus plan. The plan extends unemployment benefits, brings forward or accelerates personal tax reductions, and suggests eliminating double taxation of corporate dividends. Implementation of the Bush proposal, or a modified version, however, will take many months.

Looking globally, there is little expectation this year that other large economies will contribute significantly to world output. Wolfgang Clement, Germany's Economics Minister, recently revised downward (for the second time in three months) his forecast for German growth to 1 percent. In Japan, the bleak outlook persists. Recent gains the euro and yen have achieved against the dollar will also pressure these and other nations' exporters, further hampering growth.

It is likely, then, that the United States will be looked to as the engine of world growth in 2003 and beyond, particularly if the twin stimulus plans spur activity and geopolitical tension dissipate. In this environment, we would expect U.S. Treasury bonds to underperform corporate bonds and mortgages, equity prices to firm, and oil prices premiums to recede.