

## The Global Economic Outlook

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It seems quite reasonable—despite formidable challenges, both certain and uncertain, which nearly always exist—to expect the United States' economy to extend its three-year expansion well into, if not beyond, 2005. U.S. Gross Domestic Product increased at a 4.4% rate in 2004, the best performance since 1999, and it appears that much of this growth momentum has carried into 2005's first quarter. This initial strength and better-than-expected breadth of activity across business capital equipment spending, residential investment, and especially, consumer spending, bodes well for sustained corporate earnings growth and equity market returns. Unsurprisingly, U.S. household wealth recorded its strongest gains ever last December on both higher home and stock market price appreciation. Future spending by consumers, however, will be most directly related to growth in wages.

The Federal Reserve will likely continue on its now well-established course of lifting its overnight interest rate toward something it considers at least “neutral” – or a level that neither aids nor restrains growth. The remainder of these increases and the future targeted fed funds rate depends on a continuation of the recently evolving trends toward moderately increasing inflationary pressures, slowing productivity growth, higher unit labor costs, gradually improving labor market conditions, and, certainly, whether above-potential overall growth is sustainable.

While the Fed itself has openly wondered whether its prolonged “easy money” policy might have contributed to excessive risk-taking in the financial markets related to the unanticipated stability of long-term interest rates and narrow risk premiums, it has remained dismissively complacent in its outlook for inflation. The Fed's preferred and lowest gauge of inflation, which is linked to personal consumption expenditures, is forecast to only increase between 1.5% and 1.75% in 2005. There remains the real threat, however, of flow-through risk to higher general prices not only because of higher

oil prices but also higher import prices and corporate operating costs—both the result of broad-based, sustained dollar weakness.

Certainly, much has been made already of the dollar's two-edged decline. It is, primarily, a reflection of the structural imbalances that are playing out on a global scale. The U.S. current account deficit, or the net result of all trade and investment flows between the U.S. and its trading partners, last quarter exceeded \$665 billion, or considerably more than 6% of U.S. domestic product. Robust consumption combined with a relative lack of savings in the United States has made necessary the daily importation of some \$2 billion of "excess" savings from other countries' less avid consumers. The risk to the U.S. is that this daily inflow of capital declines, or that it simply demands a higher return as the dollar falters. A gradually depreciating U.S. dollar together with a rise in interest rates, however, should begin to curb U.S. excess demand (especially with respect to the interest sensitive or durable goods sectors of the economy) while benefiting the export sector and encouraging greater foreign consumption.

This dollar-led rebalancing of the world's economic order will be particularly felt among the leading export-driven economies as their own currencies appreciate. Early in 2004, Japan seemed to have made progress in stimulating domestic demand, but consumer spending slowed dramatically in the third quarter. Looking forward, business spending and exports alone will likely be insufficient to lift the nation's fourth quarter 0.5% growth rate, especially if demand in China moderates as pledged. Pressure on the Japanese economy will undoubtedly increase if the dollar buys fewer than one hundred yen and companies cut domestic capital spending in favor of investment in overseas production.

China, which for a decade has fixed its Yuan to the dollar at a predetermined rate of exchange, is likely at some point to participate in the world's market-driven rebalancing of economic forces. Of course, the necessary financial infrastructure—especially greater banking efficiency, flexibility, and reform with the appropriate central bank oversight—needs first to be firmly in place. China is rapidly developing its domestic economy as imports, investment, and consumer driven retail sales increase at extraordinary rates. The country, though, has yet to negotiate its much-desired reduction in output growth from the previous two years' heated, 9% plus rates.

Among the euro-sharing nations, growth in 2005, according to the European Central Bank as of March, is forecast to be a modest 1.6%. Consistent appreciation in both the euro and in oil prices has done much to discourage business confidence in the region. It is now quite likely that the European Central Bank will refrain from raising its key policy-setting interest rate from 2% before the second half, especially if core inflation (expected to be below 2% in 2005) remains contained, despite newly eased restrictions on EU member nation deficits. The German export-led economy, which contributes a third of the euro region's output, unexpectedly contracted in the fourth quarter. Current unemployment in Germany, higher now than when Chancellor Schroeder won election six-and-a-half years ago, remains a considerable restraint on any engineered growth in domestic demand. The threat now also of corporate cost cutting or of exporting productive capacity to less costly neighboring locales weighs significantly on the outlook for Germany's challenged recovery in 2005.