

The Global Economic Outlook

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While strong evidence suggests the economic expansion in the United States remains fully intact, the prospect for a durable resurgence in growth in other regions of the world are now especially encouraging. The sharp reduction in U.S. gross domestic product in the fourth quarter of 2005, to a 1.6% annualized rate, was largely the result of a transient set of factors such as the aftereffect of hurricanes Rita and Katrina, an abrupt drop in government defense spending, and the withdrawal of attractive automobile incentives which reduced overall consumer spending. Already, though, it is likely that real growth for the quarter just ended will be measured in the vicinity of 4.5%, or better, as consumer demand rebounded over the warm winter months which, in turn, encouraged businesses to accumulate goods inventories drawn down over previous quarters.

Although questions remain regarding the ability of U.S. consumers to sustain their rate of spending in coming quarters as the labor market improves only moderately and wage gains underperform that of inflation, household wealth, according to the Federal Reserve, achieved a record \$52 trillion in the final months of 2005. Perhaps the greatest risk to future spending, beyond a spike in energy prices, is a continuing diminution in housing activity and the consequent deterioration in the ascent of home prices. In countries such as the U.K. and Australia, where increasing mortgage indebtedness belied a rapid unwinding of high rates of home price appreciation, spending by consumers contracted substantially.

Business capital spending, however, seems poised to contribute increasingly to overall demand growth just as consumer demand may subside. U.S. corporate profitability remains robust, increasing 15% for the S&P 500 as of the end of 2005, and has increased more than 10% across consecutive quarters for the past three-and-a-half years. Capital investment and infrastructure rebuilding in the U.S. and abroad should lend support over many segments of the economy. As a result, the outlook for U.S.

equity returns (relative to other more fully valued markets) is, in general, constructive as earnings, improved valuation metrics, and favorable corporate actions (dividend increases, stock buybacks, and mergers) support share prices.

In Europe, the persistent inflationary risk together with improving business confidence, higher German exports and lower unemployment, persuaded the European Central Bank in early March to raise its key policy rate for the second time in three months. ECB president Trichet characterized the rate, at 2.5%, as low and the overall monetary policy stance as accommodative, suggesting a predisposition toward continuing rate hikes. While this year's growth in output is likely to advance the most since 2000, according to the European Commission, the looming German VAT increase is likely to restrain growth in consumption in Germany and European gross domestic product in 2007's first half. It remains also whether German unions move to recoup ground lost to firmer monetary and fiscal policies via wage negotiations, and in the process, help sustain inflation above 2% in 2007 as well.

Also in March, the Bank of Japan's governing policy board voted to end its ultra-easy, or near zero interest rate policy, completing the triumvirate of leading central banks (Federal Reserve, ECB, BOJ) engaged in removing excess global liquidity and normalizing interest rates. The risk, of course, is that the banks underestimate the asset sensitivity of the global economy, leading to disruptions or worse in equity and real estate markets and jeopardizing gains realized in growth prospects. Japan's \$4.6 trillion economy is now on a path of sustained expansion, with growth at its fastest rate since the collapse of its equity market. Wages and consumer prices have each recorded gains in successive months, and both retail sales and capital investment suggest a trend toward a more appropriate balance in growth components.

In other regions of the world, growth remains on a largely unimpeded trajectory. In the fourth quarter of 2005, Indian GDP advanced at a 10% annualized rate, notably more than its previous 7-8% yearly rates. Government mandated infrastructure investment in India will add a potential new source of Asian manufacturing capacity. China's cautionary 10% average rate of expansion over the past three years, however, has led to an unmanageable investment surplus. Excess capacity across many categories of production has cut deeply into profit margins and raised the unwelcome prospect of mounting bad loans.

In Brazil, Latin America's largest economy, inflation and interest rates are on the decrease together with the nation's external debt. According to the central bank, growth is forecast to average 3.5% this year, up from 2.3% in 2005; and although a number of reforms have yet to be implemented, considerable economic progress has been achieved in recent years, auguring well for the country's October elections.