

Global Economic Outlook

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At its 12 August monetary policy meeting, the Federal Reserve Board chose to leave its federal funds rate (the overnight rate at which member banks exchange excess reserves) unchanged at the multi-decade-low of one-percent. Just such a decision, of course, had been widely anticipated by market participants. In keeping with a practice adopted only in May, the Fed once again, in a released statement, provided a two-part assessment of the slate of risks facing the U.S. economy. While the Fed perceived that the "upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal", it also held, separately, that "on balance, the risk of inflation becoming undesirably low is likely to be the predominate concern for the foreseeable future."

It's reasonable to conclude then that this heightened concern, or vigilance, on the part of the Fed about too little inflation will persist for some time, beyond the point, even, where the sustainability of the current expansion can no longer be reasonably questioned. Indeed, Fed Governor, Ben Bernanke, in a July speech, suggested that prices could continue to fall, perhaps by as much as 0.5%, even if economic growth approached or exceeded its potential rate of four-percent. For the second quarter, U.S. GDP growth has been initially estimated at 2.4%, a moderate but no less welcome increase from the quite sluggish 1.4% reading over the previous two quarters. The personal consumption expenditure index (PCE), the Fed's preferred and closely monitored inflation gauge, rose at an uncomfortably low 0.9% in the second quarter, markedly off the pace of the first quarter's 2.7% rise. The Fed's unusual addendum to its 12 August statement, "that policy accommodation can be maintained for a considerable period," seemed designed to reassure markets that short-term rates, at least, would not be lifted until absolutely necessary, although just what constitutes a "considerable period" remains patently unclear, most likely even to Fed officials.

Bond investors, however, are not likely to be lulled into complacency or become otherwise encouraged by implicit promises of this sort. In a display of confusion or disappointment, or both, over the Fed's quarter percentage point rate cut at its June policy meeting, and without clear indication that the Fed might actually attempt "unconventional" purchases of Treasury securities, bond managers and traders promptly and unrelentingly sold their Treasury positions, causing the benchmark ten-year note's yield to spike from its forty-five year low of 3.07% to more than 4.50% in mere weeks, its greatest monthly move in nearly twenty years. The selling was both abrupt enough and severe enough to cause substantial dislocations in much of the fixed-income market, particularly the \$5 Trillion market for mortgage-backed securities. Bond yields rose overseas as well, particularly in Britain and Germany, but also in Japan, where yields rose to their highest levels in almost a year-and-a-half! At the time of this writing, or mid-August, the market for short-dated fed funds or Eurodollar futures contracts assign more than a 15% probability of an *increase* in interest rates by the end of the year. The probability rises to more than 90% by the middle of 2004.

Of course materially higher long-term interest rates present an undesirable headwind to a recovery now righting itself and gathering momentum. With mortgage rates rising, albeit from very low levels, the booming demand for new or existing homes is certain to cool down. The pace of home refinancing has steadily declined in recent weeks and currently stands nearly two-thirds below May's record volume. Existing homeowners who have re-financed do benefit, of course, from lower monthly payments, and presumably, have more disposable income as a result, but the risk that future overall consumer spending falters materially (in the absence of massive home equity extraction) now seems more legitimate.

So far, however, the July data releases, which as of yet do not yet adequately reflect the surge in interest rates, suggest that second quarter GDP growth may, in fact, be revised *upward*, to something close to 3 percent. The Institute of Supply Management's manufacturing and service sector diffusion indexes both increased and correspond to growth rates in excess of 3 percent. It is also likely that recent data on personal consumption, construction, inventory restocking by businesses and the narrowing of the record U.S. trade deficit reported in June have already lifted the growth trajectory of the United States to a pace not seen since the third quarter of 2002, or something on the order of four percent or more.

Sustaining a growth path of this sort, though, requires that employment stabilizes (or corporate firings end), that consumers remain inclined toward spending their child care tax credits instead of saving them, and that both business capital investment and manufacturing exports rapidly improve. The latter requirement, of course, is most directly related to competitive price pressures, but it is also dependent on the strength of the United States' trading partners. Euroland area growth currently fails to show much in the way of solid improvement, but there are flecks of optimism (German business confidence and retail sales, French industrial production). The European Commission forecasts third quarter growth of the euro-sharing nations in a range between 0 and 0.4%. Germany contracted by 0.1% in the second quarter, and French GDP also fell by 0.3%. Italy has recently entered recession. Beyond further interest rate reductions, which seem unlikely at this point, outright tax cuts (pledged in France and approved in Germany) offer hope of stimulating consumer demand in Europe.

In Japan, a rise in exports to the United States is bolstering expectations for an improved business outlook. Capital spending has increased along with wages and employment, but consumer spending, still restrained by deflationary psychology, is probably not yet robust enough to propel the Japanese economy much beyond its current 2.3% growth rate in real terms. The Nikkei- 225 Stock Average, however, is once again over the ten thousand mark, and is up over 35% from its 28 April low (as of 20 August). Higher stock prices, declining unemployment rates (to 5.3%), and an overall moderate rebound in the Japanese economy should help Prime Minister Koizumi in his re-election bid on 20 September even as he grapples with resolving the problem of 45 trillion yen of bad loans.

Other Asian economies, notably China, Taiwan, and South Korea have also achieved rapid export growth and, together with Japan, collectively control the largest foreign exchange surplus in the world. In particular, China, by seeking to ensure the stability of the Yuan, has evolved into a fiercely competitive trading partner. China remains the leading beneficiary of foreign direct investment, having surpassed the United States in 2002. In September, U.S. Treasury Secretary Snow will have completed visits to China and Japan, and will have also attended a meeting of Asia-Pacific Economic Cooperation in Phuket, Thailand. It is hoped that the meetings will have equitably addressed, or at a minimum, begun to address exchange rate issues, the removal of trade barriers, and new ways and means of promoting economic growth in all countries.