

## The Global Economic Outlook

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As is commonly understood by now, the morning of August 29<sup>th</sup> brought the worst natural disaster in U.S. history to the gulf coast region. Countless lives were either destroyed or upended, and billions of dollars estimated in property losses. In the days following, an outpouring of both public and private resources was marshaled to the affected areas. Little more than two weeks later, in preface to his remarks before the United Nations General Assembly on countering world poverty, disease, and terrorism, President Bush thanked the more than 115 nations offering solace and support. Then, on September 15<sup>th</sup>, in a speech from New Orleans to the American people, the President affirmed his commitment to rebuild the hurricane-devastated communities by outlining a series of proposals designed to provide, among other benefits, immediate and permanent housing for the displaced or homeless, investment credits for weakened or distressed businesses, and employment, job training and educational funding opportunities for those in need.

Although no explicit cost estimates were assigned to the President's open-ended plan for reconstruction, it is likely the total required federal spending could well exceed some multiple of the \$62.3 billion in emergency aid already approved by Congress. While few in Congress may quarrel with the underlying intent of or need for the President's plan, spending on such a scale, combined with the ongoing cost of the war in Iraq, is likely to sharpen the budgetary debate. At issue in particular will be whether a number of expiring tax provisions, including the 2003 reduction in stock dividend rates and personal deductions for state and local taxes paid, should be renewed or left temporary.

Before Katrina, the proposed \$70 billion in extended tax cuts would have met with considerable support, especially as the federal budget deficit was on path to improve this fiscal year, declining perhaps to \$331 billion by September 30<sup>th</sup> from 2004's record \$441 billion. Today, however, increasing calls for fiscal responsibility—while operating under the still-as-yet-uncertain storm related effects—necessarily means greater dissention in

Congress. Nonetheless, the United States economy has consistently proved resilient and flexible when confronted with unanticipated shocks. In recent years, a fundamental component of the U.S. economy's generally favorable performance has been the relatively low level of long-term interest rates, even as the Federal Reserve steadily increased its benchmark overnight rate.

Total output growth in the U.S., or the change in real gross domestic product, has consistently surpassed 3% for the past nine consecutive quarters. In the April through June quarter, inflation adjusted GDP expanded at a 3.3% annual rate even as businesses accumulated little in the way of additional inventories and the trade gap *widened* by some \$1.75 billion. Although the prospects for a continuation of the established growth trend (except for current quarter Katrina-related diminution) remain reasonably good, the outlook for inflation is decidedly less positive. The year-over-year change in U.S. wholesale and consumer prices in August was 5.1% and 3.6% respectively. While the Federal Reserve, of course, has, for many months now, characterized the expectation for future non-energy related price increases as either modest or "contained", the slow erosion in productivity gains and steady increases in unit labor costs—particularly as labor slack is removed—might begin to color this expectation somewhat differently. The market view of inflation risk, judging from the increasing yield differential between nominal and inflation protected Treasury securities as well as the rise in gold to a 17-year high (despite a drop in the euro), is already less sanguine. While Katrina may continue to impart upward pressure on prices for energy and building materials or interrupt supply chains, these distortions are still likely to be transient and of less consequence to the Federal Reserve. Nonetheless, the Fed did once again raise the federal funds rate on September 20<sup>th</sup> – the 11<sup>th</sup> increase in 15 months—as it continues to see monetary policy as accommodative.

In Europe, much attention was paid to Germany's crucial mid-September election—the ambiguous result of which unequivocally injected uncertainty into the country's political direction. It remains to be seen what form a unifying "grand coalition" of disparate parties takes to create the new German government. What seems eminently more certain now is that the pace of on-going free market, labor, and social reforms will slow. Of more general concern in Europe, however, is the persistent oil shock. Nations such as France, Italy, Hungary and Poland are either implementing energy tax relief programs as aid to individuals and industries or contemplating such, but only at the risk of still higher budget deficits.

In Japan, the world's second largest economy, annualized GDP growth surprisingly matched that of the U.S. in the second quarter on strengthening capital investment. Although the yen, in recent trade, has not appreciated in response to increasing international flows to the region, the country's Nikkei stock index crossed the 13,000 mark for the first time in four years in September. In contrast with Germany, recent election results in Japan suggest the majority is willing to undertake deep structural reform—and that positive sentiment has been quickly reflected in asset prices. In China, export to the U.S. and European Union has been central to its 9% growth rate over the past two years. Configuring a more balanced economy, however, will most directly depend on achieving Premier Jiabao's job growth goals.