

The Global Economic Outlook

September 2007

By Christopher J. Sullivan, CFA

Mr. Sullivan is Chief Investment Officer of UNFCU and UNFCU Financial Advisors. He is responsible for managing UNFCU's US \$1.25 billion securities portfolio. His comments on the international stock, bond and currency markets appear frequently in the leading multi-media press.

Over much of the summer, many of the world's financial markets experienced sharp increases in volatility and a consequent reduction in investor complacency—a surprising reversal of market conditions and sentiment which had long conspired to compress risk premiums across a variety of risky assets, particularly credit instruments. A primary catalyst for such change, of course, was the rapidly deteriorating performance of certain mortgage-backed bonds and other structured securities which either held or derived substantial portions of their investment return from subprime mortgage loans. These types of loans suffered delinquency and outright default not only because of lax underwriting or aggressive lending practices, but also because of increasing interest rates and stagnating home prices—economic shifts which elevated home ownership costs but eliminated exit options for questionable borrowers.

Although the Federal Reserve had largely expected that the resulting disturbances from rising delinquency rates in the subprime mortgage market would be mostly contained, the central bank did act, in August, to ease an unusual “seizing-up” of the interbank lending market—a condition which left unattended posed substantial risk to the broader U.S. economy and the global financial system. The European Central Bank and the Bank of England similarly intervened as limited transparency and heightened suspicions of faltering asset quality among banks caused rather severe dislocations in the normally smoothly functioning money markets. The Federal Reserve is likely to act further, beginning at its September Open Market Committee meeting, to ease the increasingly tighter financial conditions which now more clearly risk curtailing the six-year economic expansion in the United States.

Until now, the U.S. economy had been growing moderately, albeit unevenly, as the housing sector subtracted between 0.5% and 1.3% from GDP over several quarters. Consumer spending, which represents more than two-thirds of total economic output, has proved considerably resilient to date, and has been supported by overall increases in household wealth and wage gains deriving from generally favorable labor markets. Manufacturing and business capital investment have also been steady sources of growth, particularly as enhanced competitiveness, robust world demand, and dollar erosion have benefited U.S. exporters.

It remains whether financing issues or increasing uncertainties about the economic outlook dampen either investment or production. U.S. corporate profitability has mostly exceeded expectations for many quarters as a rising percentage of businesses (especially those with international sales) had been able to lift prices and expand margins. Given the pace of previous earnings growth and the context of the current economic environment, it is likely that future earnings growth subsides to more a sustainable level. According to Bloomberg L.P., the annualized year-over-year earnings growth rate for the S&P 500 companies is expected to be 8.5% in 2007. Among those sectors expected to out perform are Telecommunication Services and Healthcare, while Consumer Discretionary and Energy lag.

The economies bordering the United States had been performing quite well ahead of the global credit crisis. In Canada, factory shipments accelerated briskly in July and unit labor costs rose nearly 5% in the quarter ending in June from the year-earlier period, or the most since 1991. Although Canada now faces greater inflationary risk with gathering wage cost pressures, weakening productivity growth, and higher capacity use rates, the Bank of Canada recently suspended its campaign of monetary tightening, citing the already reduced availability of credit. To the south, Mexico has seen the risk premium of its sovereign debt widen sharply relative to U.S. Treasuries since the summer onset of the global risk reduction phenomenon. Nonetheless, the Calderon government projects real GDP growth rates of 3% in 2007 and 3.7% in 2008. The outlook also contains a balanced budget in 2008 and a current account deficit of 1% of GDP. Notable also for Calderon was recent congressional approval of a major tax reform program aimed at closing widely abused corporate tax loopholes while yet protecting its slowing oil industry. The modest additional revenue will benefit new social programs and reduce mounting healthcare and pension costs. Further south, Brazilian growth continues largely unimpeded. The economy grew at a year-over-year real rate of 5.4% in the second quarter and is projected to expand at a 4.5% rate in 2008. Brazil's strengthening currency, growth in exports and reserves in recent years have encouraged substantial foreign investment.

In September, the European Central Bank held its main policy rate at 4% after having increased it eight times since 2005. The central bank is particularly concerned that rising wages (up 2.5% year-over-year), record low unemployment (6.9% in July), increasing energy prices, and an expanding monetary base are together likely to exert upward pressure on inflation. Although recent readings on inflation have been largely favorable, expectations for a further policy tightening this year are priced into rate futures. Expected growth rates for Europe's largest single economy, however, have been adjusted downward by the nation's main economic institutes for this year and next as uncertainties surrounding higher oil, a strong Euro, and existing credit conditions accumulate.

In China, inflation accelerated to its highest level in more than a decade in August, reaching 6.5% on sharply higher food costs. The Bank of China again increased bank reserve requirements as well as both lending and deposit rates in September in its continuing effort to restrain lending and dampen growth. The World Bank recently raised its forecast for Chinese annual output growth in 2007 to 11.3% from 10.4%. Overinvestment in both real estate and productive capacity has shown little sign of moderating, and the country's eight-month cumulative surplus in trade so far this year totals a record \$162 billion. The lack of sufficient policy effectiveness in China to date presumes an eventual (but nearer perhaps) meaningful appreciation of the Yuan together with a relaxation of capital controls in order to ease excessive monetary strain. There would appear to be few other remaining options.

