U.S. Fourth-Quarter Economic Update
January 2005

Summary of Recent Economic Developments

Economic growth stabilized in the second half of 2004, with professional forecasters[1] calling for real GDP growth of 3.7%[2] in 2004:Q4 and 3.4% for all of 2005. While the economy's growth rate may have been unspectacular in 2004, it certainly was strong enough to absorb capacity and push up inflation: The unemployment rate fell from about 6% in the second half of 2003 to 5.4% currently; the capacity utilization rate rose by about 2.5 percentage points to 79.2%; and core consumer price inflation, while still low by historical standards, picked up from 1.1% at the end of 2003 to 2.2% currently. Moreover, the strength in the economy was broad-based. Personal consumption expenditures (PCE), which looked to be cooling in the first half of the year, recovered in the second half. Business and residential investment were strong, although the sluggish third quarter in housing may mark the start of a longer-lasting slowdown in that sector. Businesses responded by increasing hiring. For the full year 2004, the economy created 2.2 million payroll jobs, much higher than generally anticipated at the beginning of the year. In contrast to strength elsewhere in the economy, the trade sector was a continuous drag on growth. Overall, the economy turned in a solid performance in 2004. While there are several fundamental imbalances that cloud the longer-term outlook, we are cautiously optimistic for 2005.

Figure 1: Key Macroeconomic Indicators and Interest Rates

Economic Indicator	**2003:1**	**2003:2**	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**	**2004:4**
Real GDP, Chg QoQ (%)	1.9	4.1	7.4	4.2	4.5	3.3	4.0	3.7f
Real PCE, Chg QoQ (%)	2.7	3.9	5.0	3.6	4.1	1.6	5.1	3.9a
Real Busi Inv, Eqp & Software, Chg QoQ (%)	4.5	11.0	21.7	12.0	8.0	14.2	17.5	
Real Residential Inv, Chg QoQ (%)	7.5	9.1	22.4	9.6	5.0	16.5	1.6	
Corp Profits w IVA & CCAdj, Chg YoY (%)	8.8	13.6	20.6	23.3	27.8	19.0	5.8	
Current Account Balance, Annualized (% of GDP)	-5.1	-4.9	-4.7	-4.5	-5.1	-5.6	-5.6	
Federal Budget, 12-mo Def or Surp (% of GDP)	-2.6	-2.9	-3.4	-3.5	-3.7	-3.7	-3.5	
Unemployment Rate (%)	5.8	6.3	6.1	5.7	5.7	5.6	5.4	5.4
Household Employment, Chg QoQ (000)	1051	324	-156	790	-1	750	369	629
Nonfarm Payrolls, Chg QoQ (000)	-175	-62	-3	179	595	628	402	606
Nonfarm Productivity, Chg QoQ (%)	3.7	6.7	9.0	3.1	3.7	3.9	1.8	
Capacity Utilization (%)	75.2	74.9	75.8	76.8	77.4	77.8	78.0	79.2
GDP Price Index, Chg QoQ (%)	2.7	1.1	1.4	1.6	2.8	3.2	1.4	
CPI, Chg YoY (%)	3.1	2.1	2.3	1.8	1.7	3.2	2.5	3.6a
CPI ex food & energy, Chg YoY (%)	1.7	1.5	1.2	1.1	1.6	1.8	2.0	2.2a
Nominal Personal Income, Chg YoY (%)	2.4	2.6	3.9	4.9	4.9	5.2	4.9	4.9a
Personal Savings Rate (%)	0.9	1.2	1.4	1.2	1.0	1.5	0.3	0.2a
Rate or Spread	**2003:1**	**2003:2**	**2003:3**	**2003:4**	**2004:1**	**2004:2**	**2004:3**	**2004:4**
Federal Funds Rate Target (%)	1.25	1.00	1.00	1.00	1.00	1.25	1.75	2.25
3-month LIBOR (%)	1.28	1.12	1.16	1.15	1.11	1.61	2.02	2.56
10-Yr Treasury Note Yield (%)	3.81	3.52	3.94	4.25	3.84	4.58	4.12	4.22
30-Yr Treasury Bond Yield (%)	4.83	4.56	4.89	5.07	4.78	5.29	4.90	4.83
Moody's Baa Long Corp Spread (bp)	212	163	191	153	133	149	138	132
10-Yr Interest Rate Swap Spread (bp)	44.1	34.4	42.5	40.6	40.0	51.3	45.6	43.0

* Figures are either quarterly or, if more frequent, quarterly averages. f = Forecast; a = Actual through Nov 2004 Source: EcoWin

Legend for all Figures: AR = Annual Rate; SA = Seasonally Adjusted; MA = Moving Average; C.O.P. = Change over Period

[1] Source: Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*; data courtesy EcoWin.
[2] The much wider than expected December trade deficit will likely cause downward revisions to Q4 GDP estimates.

Economic Outlook

Consumer spending, which supported the economy through the recession, improved further over the past year. Nominal personal consumption expenditures increased by 6%, and the just-released December retail sales report should further boost that figure. Looking ahead, ongoing gains in employment should support consumer spending, although we are probably approaching the point at which households will have to slow consumption. For the past three years, personal consumption expenditures substantially outpaced gains in personal income (Figure 2). For a time, tax cuts boosted disposable (after-tax) income and kept it roughly in-line with expenditures, but the fading impact of those tax cuts has meant that spending is now outpacing both disposable and overall personal income growth. As a result the savings rate declined to record lows in 2004 (Figure 3).

Figure 2: Spending Outpacing Income…

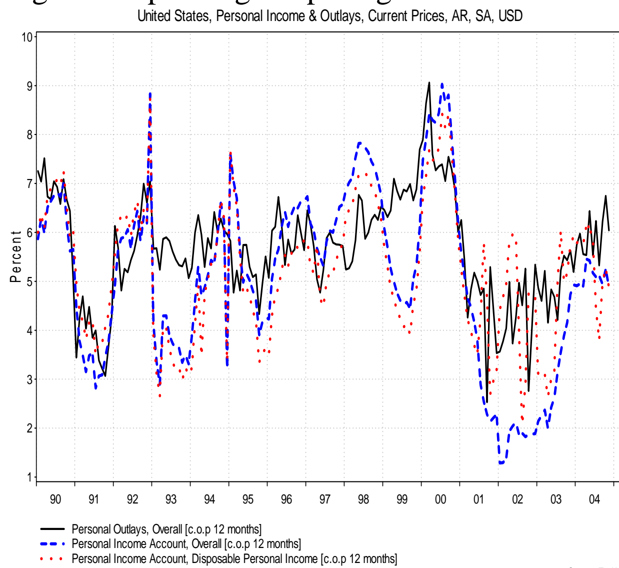
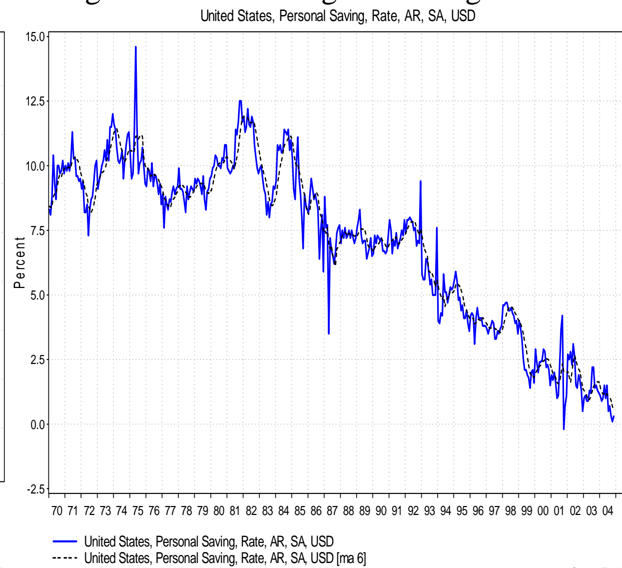


Figure 3: …Reducing the Savings Rate



While it's possible that consumers will cut even further into savings to support consumption, with the savings rate already near zero that seems unlikely. At some point consumption growth should slow relative to income growth, pushing up the savings rate and slowing the economy.

One of the ways households could boost their savings rates is by refraining from *dis-saving* in the form of borrowings against accumulated equity in their homes. Since 2001, homeowners took substantial equity[3] out of their homes via mortgage refinancing, presumably to support consumption (Figure 4). That's in contrast to earlier periods when, in aggregate, households generally put equity into their homes. When you think about it, equity addition is the normal state of affairs: Part of every monthly mortgage payment is a principal payment reducing the loan balance. Since refinancing applications, which have been falling, and home equity withdrawal are closely correlated, it seems likely that home equity withdrawal will also decline, which should increase the savings rate. Indeed, this is an important transmission mechanism for

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[3] Home equity withdrawal is calculated as the difference between private residential investment and home mortgage borrowing, using data compiled by the Federal Reserve. If borrowing is greater than residential investment, then home equity is being withdrawn as proceeds are used for spending or acquisition of financial assets. If borrowing is less than residential investment, then home equity is being added.

monetary policy: Higher rates encourage savings and discourage borrowing, leading to slower consumption growth.

Figure 4: No More Home ATM?

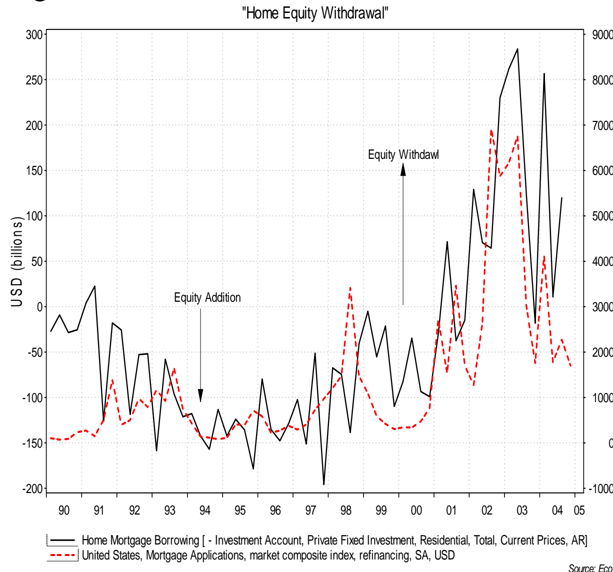
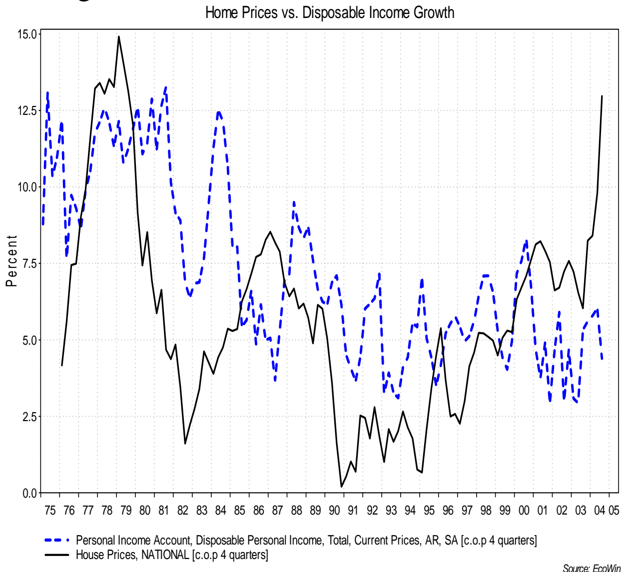


Figure 5: "Irrational Exuberance" at Home?



The **housing** sector has been a pillar of the economy since 2002, though it now appears poised for a slowdown. There are three reasons to expect this. First, housing affordability has declined recently as both mortgage rates and home prices have increased. Second, the rise in the homeownership rate – which hit a record 69% in 2004 – may be running out of steam, partly because some households simply don't want to own a home and partly because rental vacancies have made renting a home less expensive than buying one in many markets, *absent expectations of large capital gains* on the home. Of course, expectations of large gains on real estate are now the norm – and may represent "irrational exuberance" on the part of home buyers.

That leads us to our final point: Home prices have soared recently, dramatically outpacing gains in income (Figure 5). Because households ultimately cannot devote an ever-larger percentage of income to housing, it is inevitable that home price gains will trend back toward the growth rate of income. Income growth has averaged around 5% for the past 20 years, and home prices have tended to rise a bit more slowly than that. Thus, there's a large gap between current expectations of double-digit gains in home prices and the mid-single digit gains that are sustainable over the long term. The adjustment process in home prices could happen gradually (slower price *increases*) or abruptly (price *declines*). While outright declines in home prices at the national level have not occurred for at least the past 30 years, they have declined meaningfully on a regional basis from time to time. Adding it all up, we do not expect a housing bust, but we think the housing sector will slow in 2005.

On a brighter note, the **labor market** appears to be on a healthy course. After starting the year slowly, job gains have accelerated to about 200,000 per month, whether measured by the household survey or the larger establishment survey. Hiring has been broadly based by region and occupation. Although these numbers are below the pace of hiring during the boom years of the late 1990s, they are quite respectable and show considerable improvement over the past several years (Figure 6). Moreover, the outlook for hiring is also good, with hiring and help-wanted advertising surveys generally improving throughout 2004 (Figure 7).

Figure 6: Employment Gains Solidifying…

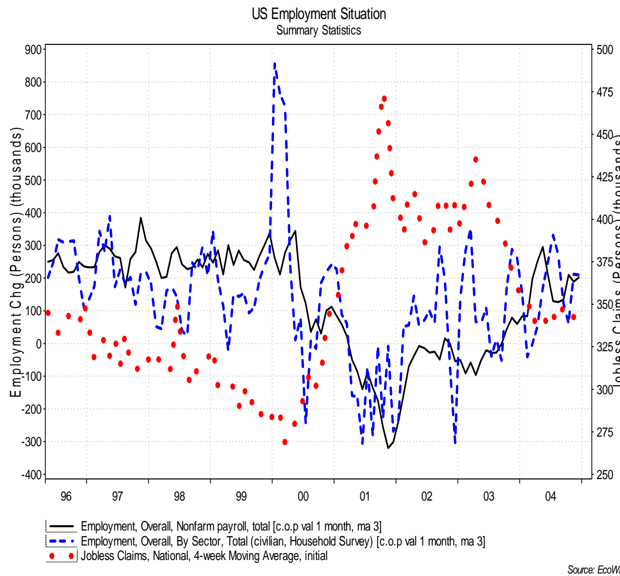
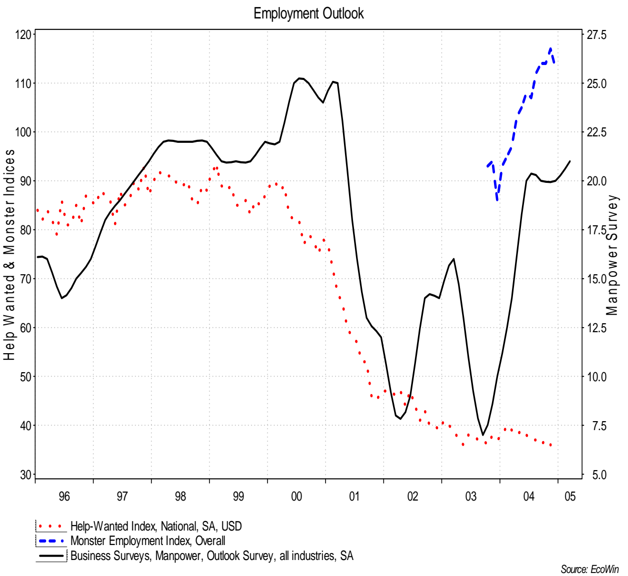


Figure 7: …Hiring Outlook Promising



The **inflation** outlook remains relatively benign, although inflation clearly bottomed in 2003. All major gauges of inflation increased by between one half and a full percentage point in 2004 (Figure 8). With the economy continuing to grow above trend, import prices no longer deflating and core intermediate goods prices rising rapidly, inflation pressures are likely to continue to build gradually (Figure 9). This is obviously of critical importance to the Federal Reserve. If inflation is steady to slightly higher, as the Fed expects, it can tighten monetary policy gradually. If inflation builds more rapidly, rates will rise higher, sooner. It's worth noting that the minutes of the Federal Open Market Committee (FOMC) meeting in December contained no discussion of deflationary risk, which had been a key reason for keeping monetary policy accommodative. Although the Committee is certainly not yet worried about inflation rising rapidly, it is clear that the FOMC's bias is toward higher rates.

Figure 8: Inflation Has Bottomed

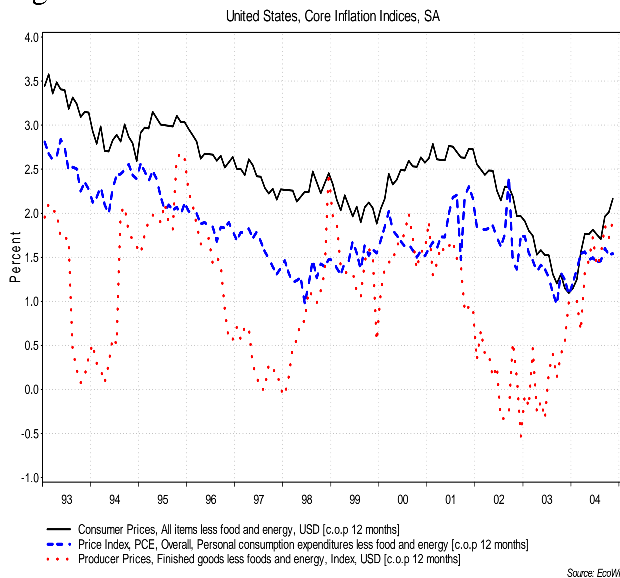
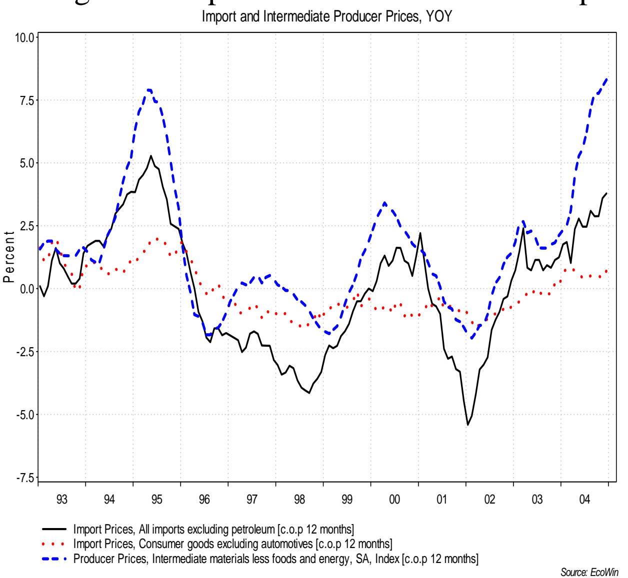


Figure 9: Import & Intermediate Prices Up



Turning now to the **business sector**, we can see that businesses are again expanding after a significant period of over-investment in the late 1990s. Business investment spending on property, software and equipment expanded briskly in 2004, yet that spending has done little to slow the increase in capacity utilization (Figure 10). Surveys indicate that companies are still catching up on capital expenditures put on hold until the economic outlook brightened. As a result, prospects for business investment appear strong. At the same time, profit margins are reverting toward their long-term averages (Figure 11). Businesses are facing higher input prices (especially energy and commodities), rising labor costs, cyclically slowing productivity growth and increasing corporate tax payments (as loss carry forwards are depleted and rapid depreciation allowances expire). Rising capital expenditures and slowing profit growth should lead to greater demand for credit over time.

Figure 10: Business Investment Increasing…

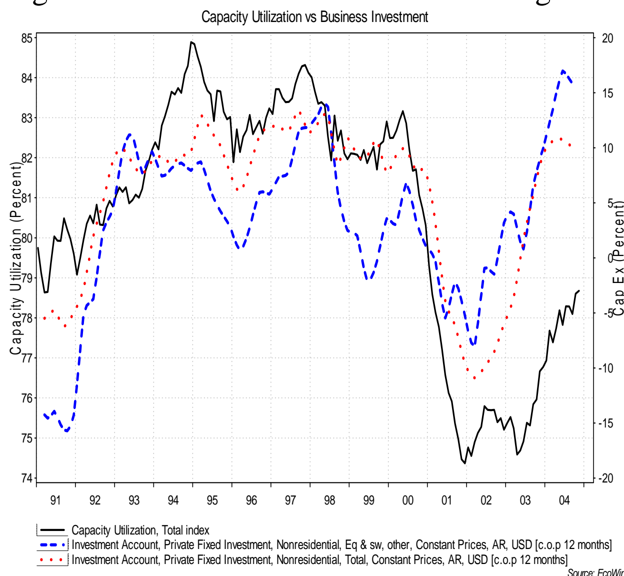
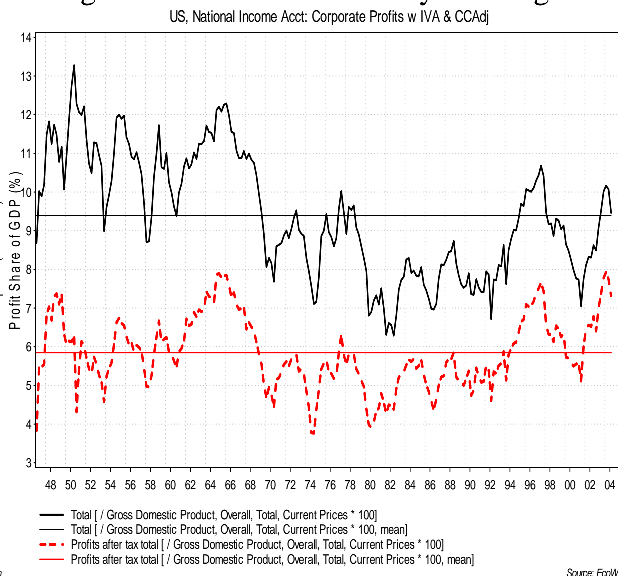


Figure 11: …But Profitability Slowing



The **government sector** should be a modest restraint on economic growth in 2005. Federal and state governments are seeking to hold the line on spending, while tax receipts are increasing in response to the recovery in the economy. The federal budget deficit is starting to turn around and should continue to do so barring an unforeseen slowdown in the economy (Figure 12). Likewise, state and local governments have tightened their belts and/or raised taxes, and in the aggregate their budget deficits have been erased (Figure 13).

The federal budget deficit could turn sharply wider if partial privatization of **Social Security** is signed into law. While details of President Bush's proposal have not yet been revealed, the idea behind the plan is that the federal government would allow individuals to divert some portion of current FICA tax payments into privately owned accounts similar to Individual Retirement Accounts. In return, the obligations of the Social Security system to those individuals would diminish in the future. Since the government spends those tax receipts currently[4], the Treasury would have to issue marketable debt to the public to make up for the lost revenue. In essence, the

[4] More precisely, the Treasury issues non-marketable debt to the Social Security Trust Fund, which turns over the tax receipts to Treasury. Those tax receipts are then spent on current Social Security benefits payments and other programs. Thus, the "trust fund" is simply an accounting entry on the federal government's books.

federal government would be recognizing a future, off-budget obligation (Social Security payments) by issuing a current, on-budget obligation (Treasury securities).

Figure 12: Federal Budget Turning

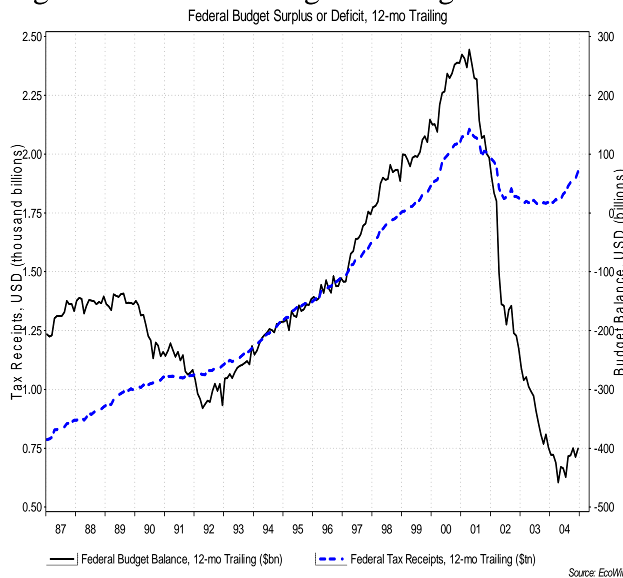
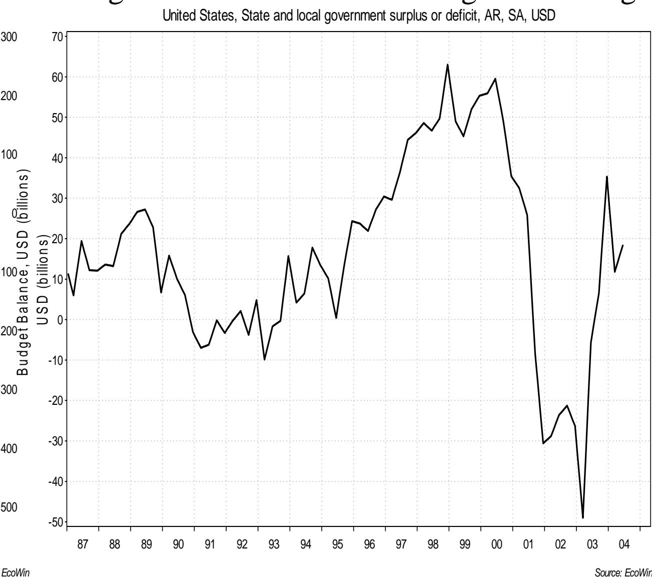


Figure 13: State & Local Budgets Mending



The plan may do some good in two ways. First, by increasing the budget deficit currently, voters may put more pressure on government to reduce current spending, leaving a larger share of the economy in the hands of the private sector and fostering higher economic growth. Second, assuming that individuals would invest their private Social Security accounts in a diversified portfolio of stocks and bonds, then in effect the Treasury would be borrowing money and, indirectly, lending it to corporations. This too should result in greater economic growth. Here's why growth is so critical: Only if the economy grows faster than currently projected will the government be able to meet its obligations under Social Security without sharply raising taxes or reducing benefits[5]. Ultimately, it's the ability of the federal government to assess taxes on economic activity that determines whether or not the government can meet its obligations. We will follow up on the progress of Social Security reform legislation in future Economic Updates.

Finishing up on the economy, a particularly troublesome area is the **trade sector**. The gigantic trade deficit, which hit a record in November, reflects the relative strength of the U.S. economy compared to many of its trading partners (Figure 14). It also reflects policy decisions by trading partners, especially in Asia, to fix or manage their currencies to exchange rates lower than where they would be if they were freely floating. Of course, some of the trade deficit is due to a desire by foreign investors to hold U.S. assets. If foreign investors wish to purchase U.S. financial assets, they must provide a net excess of goods and services in exchange for those assets. Foreign investors' appetite for U.S. assets is not unlimited, however. At some point – though probably not soon – foreign investors may require higher interest rates in order to accept more dollars. In any event, despite the recent fall in the dollar, it seems unlikely that the trade deficit will turn around quickly. Import growth has substantially outpaced export growth, yet exports need to grow more than 60% faster than imports just to *stabilize* the deficit at its current level. That's likely going to take some time to accomplish.

[5] Taking Social Security and Medicare together, it's virtually impossible to avoid tax hikes and/or benefit reductions, but that's a topic for another day.

Figure 14: Trade's a Drag

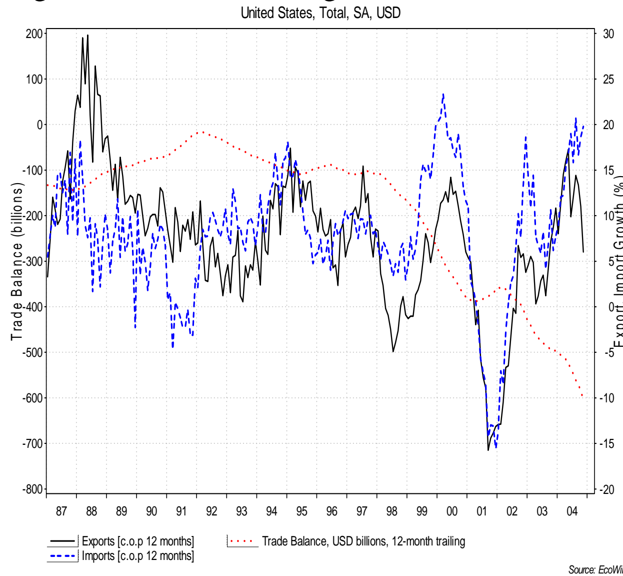
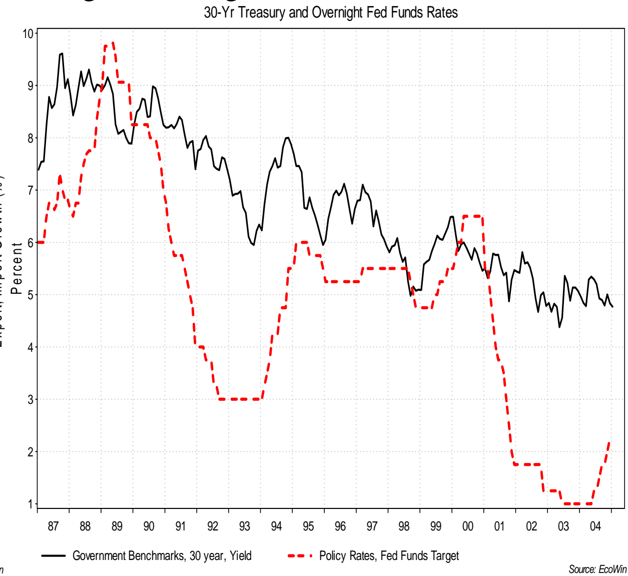


Figure 15: Tighter Fed, Stable Yields



Market Outlook

Long-term **interest rates** have remained broadly stable and in fact generally drifted lower as the Federal Reserve increased the fed funds rate from a low of 1% to 2.25% currently. The 30-year U.S. Treasury bond began 2004 around 5.05%, finished the third quarter at 4.90%, ended the year at 4.83%, and today sits at 4.73%. Moreover, it traded in a very narrow range. It's not uncommon for the bond market to anticipate moves by the Fed (see Figure 15), but it is uncommon for bond yields to rally and to exhibit such low volatility in the face of tightening. This relatively placid long-term rate environment was not a good one for our option-based hedging strategy, and it imposed a notable drag on the performance of our funds. Although we did not predict that rates would be so steady – indeed it's our policy not to predict interest rates[6] – the results of the hedge were predictable. In other words, the hedge did what one should expect in this market environment.

Looking ahead, we see more of the same for the next several months, though we would not be surprised by a gradual upward drift in interest rates. The market is pricing in three more 25 basis point rate hikes at the next three FOMC meetings. As our cautiously optimistic economic outlook implies, that's probably what we are going to get. Beyond mid-year, however, the picture is murkier. The market anticipates that the fed funds rate will finish the year around 3.35%, 110 bp higher than today's rate but only 35 bp higher than the expectation at mid-year. If economic growth hasn't slowed by then, the Fed should continue tightening by 25 bp per meeting. That would leave the fed funds rate at 4.25% by the end of 2005 – much higher than what the market currently expects. How far and how quickly the Fed decides to raise rates will depend upon the economic data. At this point, we're sufficiently optimistic on the economy to believe that the market has not priced in enough tightening by the Fed.

The fact that bond yields have not increased in response to this year's tightening of monetary policy is probably a major frustration for the Fed. The whole point of raising rates is to remove

[6] Although interest rate anticipation is emphatically *not* part of our investment process, as the comments in this Update make clear, we do have *opinions* about the economy, Fed policy, and interest rates.

the monetary stimulus that the Fed put in place following the bursting of the dot-com bubble. However, stable to lower long-term interest rates, a rallying stock market, soaring home prices, and a sharply weaker dollar have kept the cost of borrowing low while adding to household wealth, largely offset the policy tightening that the Federal Reserve has put in place! That means the FOMC may need to surprise the market at some point by raising interest rates faster or longer than the market expects. It may not happen, but current rates neither provide much protection if it does nor offer much reward if it does not. We'll stay hedged, thanks.

Figure 16: Borrowing Bottoming (?)…

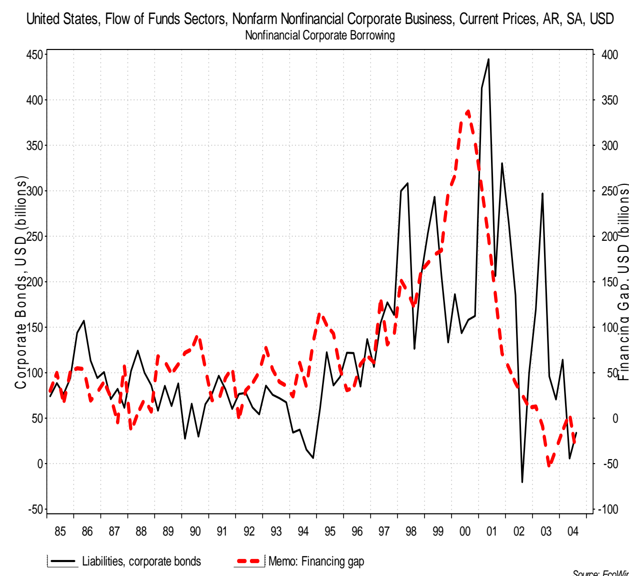
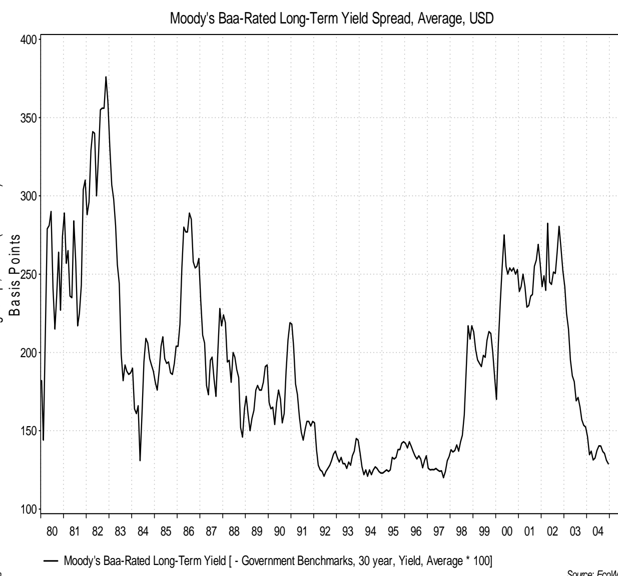


Figure 17: … And Spreads Are Tight!



Finally, our view on **credit spreads** is pretty unexciting. The rise in corporate profitability along with shrinking business investment from 2000 until 2003 meant that corporations had little need for external funds. The nonfinancial business financing requirement (the "Financing Gap") was actually negative over the past 18 months (Figure 16), though it seems to be bottoming. As we noted earlier, we anticipate that ongoing capital investment and slowing profitability will cause corporate borrowing to gradually increase as the expansion matures. At the same time, Treasury borrowing is likely to slow modestly. The combination of rising corporate borrowing and diminishing federal borrowing should eventually put upward pressure on corporate bond spreads, though probably not over the next couple of quarters. Still, corporate bond (and preferred) spreads are at the tightest levels since 1997, just prior to the Asian financial crisis (Figure 17). While we are not anticipating another crisis, we are being selective about the credits we own.

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January 14, 2005

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