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Economic Environment

"U.S. Economic Outlook: 2000-2001" by Al Schuler

The current U.S. expansion is now the longest in recorded history (8 years and 11 months), surpassing the previous record set between 1961-1969. This expansion is even more remarkable because it hasn't relied on a war effort to support massive government spending. Furthermore, GDP growth at this mature stage of the cycle is very strong, with the last three years' growth averaging over four percent annually, something that hasn't happened in 20 years. Here are some additional amazing facts:

- Real consumer spending grew 5.3 percent in 1999.
- Housing starts totaled 1.66 million (best since 1986).
- Single family starts were 1.33 million (best since 1978).
- Resale housing totaled 5.2 million, the third successive year it has been above five million.
- Car and truck sales reached record highs.
- Unemployment remains at a 30-year low.
- New home sales set another record high.
- The stock market soared for the fifth straight year of double-digit growth.

"The continuation of an 'economic party' depends on 'synchronized world recovery,' productivity growth and a steady FED."

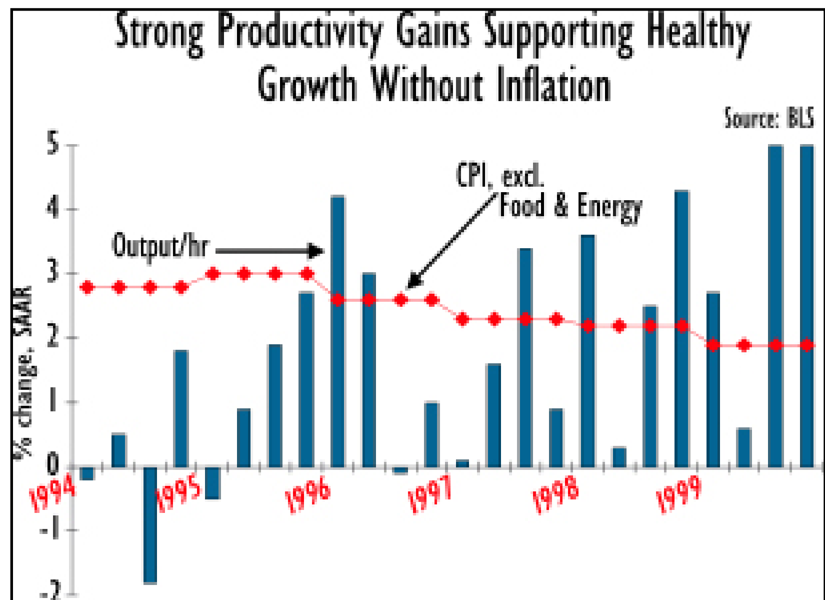

FIGURE 1

The list goes on and on. With all this phenomenal growth, you would expect substantial inflation if you subscribe to conventional economic thinking. However, the core CPI (excluding food and energy) increased only 1.9 percent in 1999, the smallest gain in thirty-one years. Although the PPI (wholesale prices) increased three percent, most of the increase was due to higher energy and food prices. The core rate increased less than one percent. Although we are seeing some inflationary pressure from the low unemployment rate, it remains well contained to date. The Employment Cost Index (ECI), a favorite indicator watched by the FED, was up 3.4 percent in 1999, no change from the year before. The conventional thinking is that eventually the tight labor market will drive costs and prices upward.

Consumer spending represents two-thirds of GDP and continued spending strength will depend on confidence and the ability to spend (i.e. real income growth). Interest rates are attractive because inflation has remained under control due in large part to strong productivity gains over the past four years. This has allowed many firms to absorb cost increases without increasing prices while still maintaining profitability—conditions necessary for earnings growth and stock market performance. Furthermore, the huge capital inflows to the U.S. have supported the dollar and reduced inflation threats from imported goods and services.

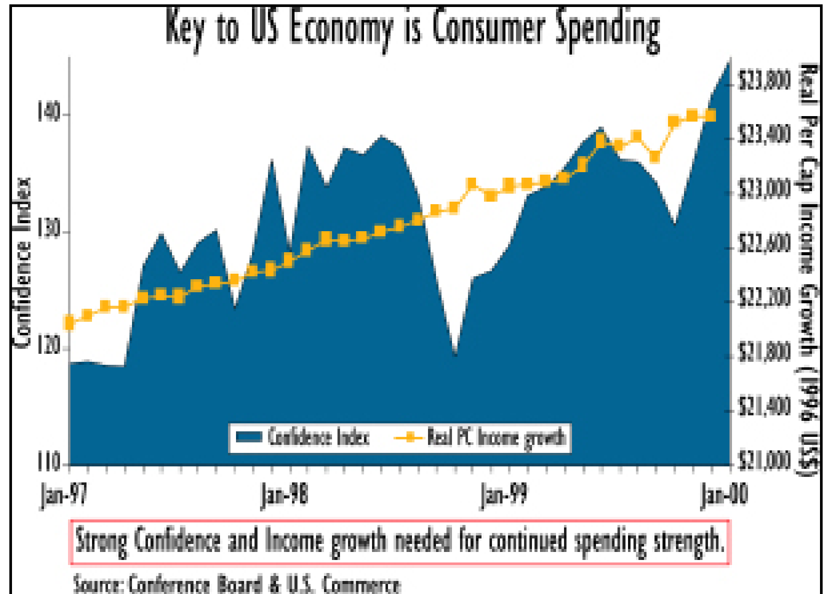

FIGURE 2

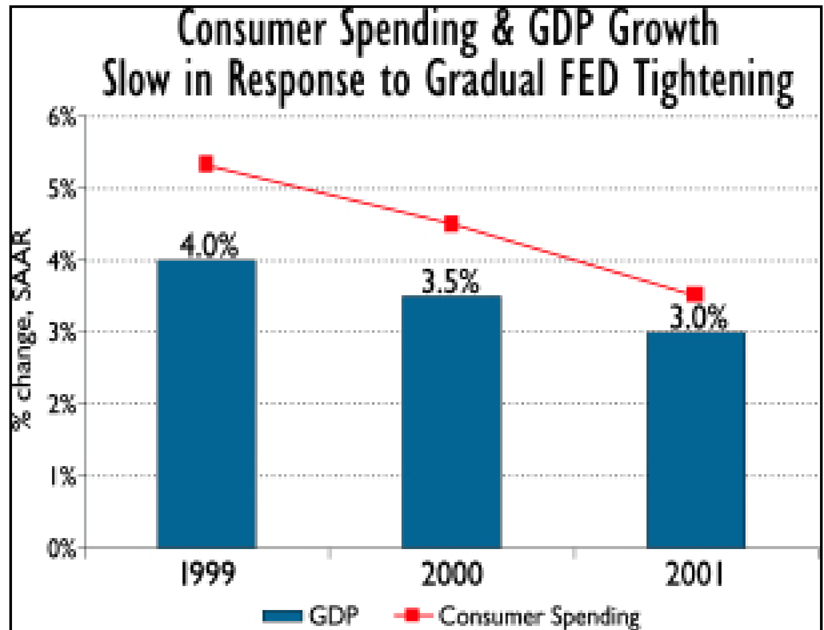

FIGURE 3

Another factor has been steady and appropriate FED action. To date, the FED has done a remarkable job of refraining from putting on the brakes (rapid interest rate increases) despite overwhelming evidence (conventional thinking) that the economy was on the verge of overheating. If the FED continues to read the economy correctly, interest rates should remain attractive; corporate profits will remain acceptable (this is critical to favorable stock market activity); job creation will continue; and consumer confidence and spending will move forward. Under this sort of scenario, housing activity (starts, resales, new home sales and remodeling) would remain healthy and demand for building materials would stay strong for another year or two at least.

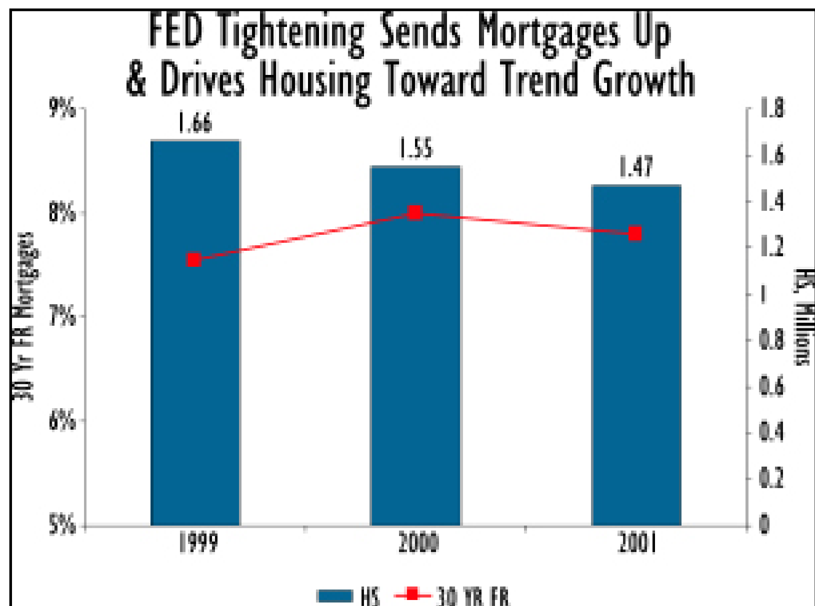

FIGURE 4

OUTLOOK FOR 2000 & 2001

A steady FED and synchronized world growth are necessary for a "soft landing" scenario.

The FED will probably raise rates gradually until they see clear signs that inflation is under control (possibly when the Employment Cost Index starts receding) and/or it becomes evident that the economy is cooling. The first installment in 2000 came on February 2 with a 25 basis point increase to the FED funds rate. The February increase follows three rate increases since last June; however, to date, signs of a cooling economy are not very evident, hence the need to stay the course. However, we now have an inverted yield curve (short-term interest rates are higher than long rates), and historically, that has correctly signaled an economic slowdown for five of the past eight recessions. There are two necessary ingredients to continued non-inflationary growth: productivity must increase at the appropriate rate and the FED must maintain its superb performance of nurturing growth without unnecessarily slowing the economy. The problem is that nobody knows what the non-inflationary rate of growth is, and that presents a dilemma for the FED. I believe that the "old rules" still apply (excessive growth leads to inflation), however, the "speed limits" are now higher thanks to better productivity.

Another rather unique dilemma is the need for a "synchronized world economic recovery." During the past three years, the U.S. economy has outperformed the rest of the world by a large margin. However, offshore economies are now improving, while the U.S. economy must be reigned in. (Japan is the one major exception as recent data suggest Japan's economy has stalled again.) Timing is important because, if offshore economies recover before the U.S. slows down, inflationary pressures simply escalate. The challenge is for the world's Central Bankers to coordinate a "synchronized" world recovery—no small feat.

I believe the world's Central Bankers will answer the challenge and our FED will continue reading the "tea leaves" accurately. If they do, this will create the necessary conditions for a "soft landing" scenario for the U.S. economy. Figures 3 and 4 summarize our "soft landing" outlook. Spending and GDP growth will slow moderately with higher interest rates; mortgages will trend higher and this will force conventional housing demand to pull back toward trend levels near 1.5 million.

DOWNSIDE RISKS

The main downside risk to this outlook is where the FED falls behind the inflation curve, thus allowing prices and costs to get out of hand. Such a scenario would require much stronger corrective FED action that most likely would precipitate a recession. Stock market performance is important because 50 percent of U.S. households now invest, up from 36 percent in 1992. Finally, outstanding consumer debt is 80 percent higher than a decade ago and the personal savings rate is at an all-time low. When consumers can't borrow any more, consumption will halt, corporate profit growth and job creation will slow, confidence will erode, and the economy could cool down very quickly.

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