BENEFITS AND PENSIONS MONITOR
PENSION FUND INVESTMENT – EMPLOYEE BENEFITS MANAGEMENT

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Soft Landing Ahead for U.S. Economy

By: Joe Hornyak

In 2006, it was a good year to bet against U.S. growth, says Christopher Probyn, chief economist at State Street Global Advisors. The natural maturation of the U.S. business cycle, the lagging effects of the run-up in energy prices, and the inevitable cooling of an unsustainably hot housing market all contributed to some slowing.

The early data suggests that 2007 will also be a good time to bet against the U.S. with the current slowdown likely to persist through the first half of the year, limiting GDP growth to just 2.2 per cent for the year as a whole, he says.

Still, there is good reason not to be pessimistic. Most economists put the prospects of a recession at about 30 per cent, which is not alarming. The jump in energy prices in 2005 and early 2006 proved that this sector alone cannot cripple the economy the way it once could.

As well, business **investment** remains robust, the drag from international trade is waning, and the spillover from housing to consumer spending should be limited by tight labour markets, solid income growth, and **healthy** household balance sheets, says Richard Marston, a finance professor at the Wharton School of the University of Pennsylvania.

All of this indicates a mid-cycle 'soft-landing,' similar to what occurred in 1995, is far more likely than a recession.

Financial Markets

However, while the U.S. economy slowed in 2006, the financial markets provided some surprises.

To start, the bond market remained remarkably resilient. When the tightening cycle began in mid- 2004, the Fed funds target was one per cent, and the yield on the 10-year Treasury note was around 4.9 per cent. Now the Fed funds target is 5.25 per cent, and the yield on the 10-year note is right around 4.5 per cent. A number of explanations have been put forward to explain this resilience – including pension fund reform, increased central bank credibility on inflation, foreign central bank purchases out of foreign exchange reserves, and parking of petro-dollars.

However, the latest rally may have gone too far, says Probyn. Bonds appear vulnerable at current levels, with investors overly optimistic about the prospects for near-term Fed loosening. Unless growth prospects deteriorate significantly – making rate cuts a real possibility – a reassessment, which takes the 10-year yield back to five per cent, seems likely in 2007, says Probyn.

Meanwhile, stocks behaved much as they did during the 1995 soft-landing. Equity investors once again proved able to shrug off the impending slowdown in economic and, presumably, earnings growth to bid prices higher. As well, based on the 1995 experience, stocks still have a way to run.

Jeremy Siegel, a finance professor at Wharton, looks for the markets to be fairly good. He says U.S. stocks could be up 10 per cent this year.

"I think the biggest positive for the stock market is low interest rates," says Siegel. "We have good emerging markets growth, decent European growth. Japan is sputtering right now, but it's not as bad as it used to be.

"Standard & Poor's Equity Research Services sees multiple factors driving the market higher. Including dividends, it predicts a 10 per cent total return for the S&P 500 in 2007.

The primary drivers for the anticipated return will be:

- economic expansion led by investments rather than housing and consumer spending
- continued corporate earnings growth, driven by expanded international sales and a weak U.S. dollar
- attractive valuations for the broad U.S. markets

"We believe 2007 will be a good year, not as good as 2006, but one strong enough to provide investors with a 10 percent total return," says Sam Stovall, chief investment strategist. "In addition to such factors as attractive valuations and the strong potential for an economic soft landing, history shows us that the third year of a president's term has provided the best annual returns for any in the four-year presidential cycle."

The Dollar

The dollar also surprised with its strength. Most analysts expected the mid-cycle slowdown in the U.S. and the corresponding end of rate hikes to generate dollar weakness, especially given the monetary tightening cycles underway in the eurozone and Japan, as well as the chronic U.S. current account deficit.

However, after selling off over the first five months of the year, the dollar regained its value against the euro and, particularly, the yen. It appears that analysts paid too much attention to the direction of rates, rather than their absolute values. While the interest rate differentials may be narrowing, they remain firmly in favour of the U.S., particularly relative to Japan. However, forecasters say the dollar has to go lower over the intermediate term as part of the process of removing global imbalances.

The Housing Slump

Marston is concerned that the slump in the U.S. housing market could undermine consumer spending and result in real economic trouble. "I really think this is going to be a more prolonged decline than other people think," he says. After real estate prices dropped in 1989, he says, it took many parts of the country until the mid- 1990s to recover.

The housing sector is especially risky because of the use in recent years of adjustable- rate mortgages and sub-prime loans. Many of the variable-rate loans issued in recent years are now adjusting to higher interest rates. This is causing borrowers' monthly payments to soar. "What we've done is made our financial markets efficient enough to let families dig holes to bury themselves," he says.

As well, recessions often follow big gains in asset prices. The 2001 recession followed the big stock gains of the late 1990s. Today, the asset-price gains have occurred in housing.

Franklin Allen, a Wharton finance professor, also is concerned about threats from the housing sector. Much of the growth in consumer spending in recent years has been a result of consumers refinancing their mortgages. This, plus the soaring housing values, gave them more cash to spend. With housing prices dropping across the U.S., homeowners are less likely to refinance which means they will not have that extra money.

Despite his concerns, Allen thinks while the dollar will continue to fall and interest rates and inflation could rise, neither will cause serious damage. At worst, the economy "will probably just go into gridlock, which is probably a good thing," he says.

Inflation

Not surprisingly, the Fed is worried about inflation, which represents a turnaround from 2003 when it was worried about deflation, says Probyn. Core CPI inflation – excluding food and energy – decelerated from 2.8 per cent in late 2001 to a low of 1.1 per cent in late 2003, before rising to 2.7 per cent by October 2006.

The core consumer spending (PCE) deflator – which Probyn calls the Fed's favourite measure of inflation – has followed a similar path, leaving it at 2.4 per cent in the last months of 2006, above the Fed's one to two per cent comfort zone.

It can be argued that swings in inflation primarily reflect special factors such as spillover from the run-up in energy prices. Another factor is the low interest rates earlier in the decade which encouraged home purchases, lowered rents, and reduced the CPI both directly and indirectly.

These and other forces such as the decline in hotel accommodation rates following 9/11 contributed significantly to the decline in core inflation between late 2001 and 2003 and its rise in 2004. Advocates of this view tend to believe that inflation will soon fall back into the Fed's comfort zone, especially given the recent decline in energy prices and slower growth, says Probyn.

He believes that inflation is "more of a scare than a threat. While we happen to believe that economic growth will be sufficiently weak to prevent the Fed from tightening in 2007, and infl ation will remain suffi ciently high to prevent it from loosening, there is two-way risk. The greater one is that inflation accelerates or even just fails to decelerate, requiring the Fed to resume tightening to prevent any deterioration in inflationary expectations. However, there is also a much smaller, although non-zero, risk that if the soft-landing threatens to become too hard, the Fed will do what it did in 1995 ... deliver some growth-insurance cuts," he says.

The China Factor

The biggest issue in the U.S. for 2007 may be China's economy and currency policy. Many U.S. politicians want China to let its currency, the Renminbi (RMB), appreciate against the dollar which would make Chinese goods more expensive to foreigners. This, in turn, would allow other countries to compete better with China. So far, China has resisted any major appreciation of the RMB.

Marshall W. Meyer, a Wharton management professor, thinks the Chinese government may eventually let the RMB rise in response to international pressure. Not only will this be good for countries competing with China, it will be good for the Chinese because it will redirect them from putting their surpluses into U.S. Treasury bonds, which only earn 4.5 per cent. Instead, the Chinese may invest at home.

However, a free floating RMB may well be disappointing for the rest of the world. China would still be a tough competitor even if the RMB rose 30 per cent or 40 per cent against the dollar. In fact, much of the current economic weakness in Mexico and other Latin American countries comes from their inability to compete with China.

The Chinese economy is not without problems and these problems could pose a threat to the rest of the world, says Meyer. Capital markets are stalled on the mainland so Chinese people do not have many opportunities to pay for higher education or save for retirement. Chinese banks have not been modernized and they have lent enormous amounts that may never be paid back.

Finally, in recent years, the government has allowed its citizens to move larger sums of money out of the country. If worried people take their money out of the country in search of safer investments, it could cause a run on Chinese banks similar to the ones that occurred in other Asian countries in the 1990s. The Chinese government may then have to start selling the enormous reserves of U.S. Treasury bonds it holds, causing interest rates to soar in the U.S. and other countries.

Economic Forecast

The U.S. economy will cool off because of a slowing housing market and rising energy prices, but will experience a soft adjustment and modest growth in 2007.

John B. Taylor, a Stanford economics professor, expects the United States' growth in gross domestic product to be three per cent, down from 3.2 per cent in 2005 and 3.9 per cent in 2004.

Peter Wall, JPMorgan Chase's chief investment officer for private client services, foresees U.S. growth falling to "around two per cent" as the nation avoids a recession.

Taylor was responsible for the label 'The Long Boom.' About 10 years ago, he noticed a pattern of shorter, milder, and less frequent recessions after the expansions in the 1980s and 1990s, respectively the second-longest and longest expansions in U.S. history.

He notes that "The United States economy just marked the five-year point in its current economic expansion. It started back in November 2001 just after the 9/11 terrorist attacks and the 2001 recession, which was brought on by the sharp stock market drop

and tight financial conditions in 2000. This expansion – the first of the 21st century – is already the third-longest expansion in United States history, excluding periods of major mobilizations such as during World Wars I and II."

He says when you "splice these three recent expansions together with the two short recessions in between, you have a truly phenomenal and certainly unprecedented period of stability and growth. The Long Boom began with the end of the severe recession that ended in November 1982, so it has just entered its 25th year. Since it began, 46 million jobs have been added to U.S. payrolls and the Dow Jones Industrial Average has gone from under 1,000 to more than 12,000."

Wall says, "the surprise of 2007" will be that "the U.S. slows, and the rest of the world doesn't." While U.S. profits will grow six to eight per cent with equity markets up eight to nine per cent, returns will be slightly higher in Europe and Japan, where the pace of earnings and cash flow is on the rise." ■

Joe Hornyak is executive editor of Benefits and Pensions Monitor