THE BOND MARKET ASSOCIATION

Economic Outlook

December 10, 2001

The Economic Outlook: Economic Recovery Expected to Begin in Second Quarter 2002

Summary

The Bond Market Association Economic Advisory Committee predicts in its year-end forecast that the U.S. economy is likely to continue contracting in the fourth quarter of this year and into the first quarter of 2002. Economic recovery is expected to begin in the second quarter and is likely to accelerate throughout the second half of 2002. For 2001, the economy is weaker than had been anticipated by the group in its midyear forecast. Most members of the Committee had expected economic growth to accelerate in the second half of this year, but the terrorist attacks dramatically altered the economic landscape. The panel largely believes that the impact of the events of September 11 delayed the economic recovery, but expect the effect to be temporary.

Most Committee members expect the Fed to ease interest rates 25 basis points on December 11, and the majority look for an additional easing in January 2002. The group expects inflation to remain benign in 2002 and most members expect energy prices to recede at least until midyear—barring any oil shocks that may result from tensions in the Middle East.

Forecast

The Advisory Committee expects GDP to contract 0.3% in 2001, measured from fourth quarter to fourth quarter, the first contraction since 1991.[1] GDP growth is expected to resume in the second quarter and is anticipated to average 2.5% for the year 2002. Inflation, as measured by the CPI, is expected to remain benign at 2.0% in 2002, unchanged from the Committee's forecast for 2001. Most of the group expect energy prices to remain low or fall in the short term, but anticipate some upward pressure on prices when global demand picks up in the second half of 2002. Committee members indicated that the energy price forecast is subject to the risk of an oil price spike if Middle East tensions accelerate. The unemployment rate for 2001 is expected to average 4.8% and is anticipated to rise to 6.1% in 2002. A majority of the group expect unemployment to rise until mid-year as businesses continue to shed workers in an effort to trim costs.

[1] All growth rates are inflation-adjusted, and annual comparisons are measured from fourth quarter to fourth quarter. The forecasts discussed in the text and appearing in the accompanying data table are the medians of the 24 individual members' submissions.

The Bond Market Association Economic Advisory Committee Forecast

(Inflation-adjusted year-over-year percentage change unless otherwise specified. Forecast numbers appear in **bold**.)

	2000	2001	2002
Real GDP (yr-to-yr)	4.1	**1.0**	**0.8**
Real GDP (4Q–4Q)	2.8	**-0.3**	**2.5**
CPI (yr-to-yr)	3.4	**2.9**	**1.4**
CPI (4Q–4Q)	3.4	**2.0**	**2.0**
Personal Consumption	4.8	**2.9**	**1.4**
Nonresidential Fixed Investment	9.9	**-3.2**	**-5.5**
Housing Starts (millions)	1.57	**1.60**	**1.52**
Real State & Local Gov't. Spending	3.2	**3.7**	**2.0**
Merchandise Trade Deficit (billions current $)	452	**432**	**450**
New Home Sales (millions units)	0.9	**0.9**	**0.9**
Existing Home Sales (millions units)	5.1	**5.2**	**5.0**
Unemployment Rate (cal. yr. avg.)	4.0	**4.8**	**6.1**
Federal Budget Surplus (FY, billions of $)	+237	+127	**-50**

Quarter-to-Quarter % Changes in Annual Rates

	2001				2002			
	I	II	III	IV	I	II	III	IV
Real GDP	1.3	0.3	-1.1	**-1.5**	**-0.2**	**2.5**	**3.5**	**4.0**
CPI	4.2	3.1	0.7	**0.0**	**1.6**	**2.0**	**2.1**	**2.0**
Personal Consumption	3.0	2.5	1.1	**2.2**	**-1.1**	**2.6**	**3.0**	**3.4**
Nonresidential Fixed Investment	-0.2	-14.6	-9.3	**-13.3**	**-7.9**	**-1.3**	**3.8**	**5.5**

Interest Rates

(monthly average %)	Dec. 01	Mar. 02	June 02	Sept. 02	Dec. 02
Fed Funds	**1.75**	**1.50**	**1.50**	**2.05**	**2.50**
2-Year Treasury Note	**2.75**	**2.70**	**2.65**	**3.00**	**3.60**
10-Year Treasury Note	**4.65**	**4.60**	**4.80**	**5.00**	**5.20**
30-Year Fixed-Rate Home Mortgages	**6.83**	**6.70**	**6.80**	**7.05**	**7.20**
Municipals (Bond Buyer GO Index)	**5.13**	**5.00**	**5.00**	**5.18**	**5.30**
Moody's Corporate Bond Index (A rated)	**7.50**	**7.35**	**7.35**	**7.35**	**7.45**

Exchange Rates

(monthly average)	Dec. 01	Mar. 02	June 02	Sept. 02	Dec. 02
Yen/Dollar	**124**	**126**	**128**	**127**	**126**
Dollar/Euro	**.89**	**.89**	**.90**	**.90**	**.89**

The Committee expects interest rates to fall in the first half of 2002, but expects rates to rise in the third and fourth quarters. The group anticipates that the Federal budget will switch to a $50 billion deficit in Fiscal Year 2002, and most members expect deficits for at least the next three years. In foreign exchange markets, the Committee expects the dollar to strengthen slightly against the Japanese yen to 126 by December 2002. The dollar is expected to remain stable against the euro, hovering around $0.89 per euro in 2002.

Monetary Policy

There is widespread agreement within the Committee that the Fed has correctly pursued aggressive easing of interest rates in 2001, and the majority said the Fed has done a good job of recognizing the economy's problems and acting quickly. All but two members of the group expect a 25-basis-point cut in the Fed funds target rate on December 11. The two dissenting members expect no action on Tuesday. Most Committee members anticipate another 25-basis-point cut in the Fed funds rate in January 2002 and expect the rate to trough at 1.50%. Most of the group expect the Fed to begin tightening in 2002, with half of the group expecting that to occur in the third quarter and the rest divided as to whether the Fed will act to raise rates in the second or fourth quarter. Members indicated their belief that the Fed will not raise rates as long as inflationary expectations remain low and until the economy shows clear signs of a sustained recovery.

The Economy

Regarding the current recession, most of the economists surveyed believe the terrorist attacks pushed the U.S. economy into recession. Economic weakness was already apparent, but the attacks deepened the contraction and contributed to the decline in third-quarter economic activity. The group largely believes that most of the impact on consumer and business confidence will be temporary. However, members cited several effects, such as increased security and defense spending, and changes in business practices—i.e., less travel—which are more likely to remain in the long term. The Committee members were divided in their opinion regarding the timing of the start of the recession. Although over one-half of the group agree with the NBER's proclamation that the recession began in March 2001, others believe the onset occurred either earlier or later. There was strong agreement among Committee members that economic growth will resume in the first half of 2002, spurred by monetary and fiscal stimuli, lower energy prices, inventory rebuilding, and a rebound in confidence. Committee members indicated that additional terrorist attacks, oil supply disruption, longer and deeper layoffs than currently expected, and global economic weakness pose the major downside risks to their current forecasts.

Bond Issuance

The Committee expects issuance in the Treasury market to rise in 2002, with the increase concentrated in the short end. The members were divided in their opinion regarding Federal agency issuance. The disagreement stems from a divergence in outlook regarding the demand for housing and expectations regarding mortgage refinancing activity. The Committee's consensus forecast for 30-year fixed-rate home mortgages is 7.20% for December 2002, up from 6.83% anticipated for December 2001. The group was unanimous in their belief that municipal issuance would increase or remain strong as a result of declining revenue that will force states and localities to finance budget deficits. In contrast, more than half of the respondents expect corporate bond issuance to decrease following very strong new issue volume in 2001. However, several members said they expect corporate issuance to rise as the economy expands and corporate interest rates remain low. The Committee expects asset-backed issuance to remain strong in 2002. Auto loan-backed issuance is expected to increase following strong auto sales, but slower consumption growth is expected to lead to a decline in consumer receivable-backed issues.

The Bond Market Association Economic Advisory Committee

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