THE BOND MARKET ASSOCIATION

EconomicOutlook

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Stars Aligned For Solid 2004 Growth

Members of the Bond Market Association's Economic Advisory Committee predict in their end of the year forecast survey that the U.S. economy will grow at slightly above four percent during 2004, according to the median forecast.[1] The panelists expect the four key drivers that have contributed to the upswing during the second half of 2003 to remain in place, leading to continued economic expansion in the coming year: stimulative fiscal policy, especially as the tax cut measures take effect, supportive monetary policy, a favorable domestic financial market environment, and a weaker dollar. Panelists forecast that a significant increase in capital spending by business, along with a higher rate of consumer spending, will lead economic growth. As mortgage rates start to move up from their lows during the coming year, the panelists expect some moderation in the housing sector. Nevertheless, housing will remain strong by historical standards.

The Economic Advisory Committee panelists unanimously expect that the Federal Reserve will continue to accommodate economic growth and, at the same time, provide insurance against any relapse back to the economic environment that led to the slowdown and deflation concerns—as unfounded as such concerns have turned out to be—through the early part of this year. The panelists do not expect the Fed to begin tightening until later in 2004 when there is indisputable evidence of a sustainable economic recovery.

Forecast highlights

The economy The median forecast calls for GDP growth to be 4.2 percent in 2004 compared to 2.9 percent for full-year 2003. (GDP growth in 2002 was 2.4 percent.) The individual panelists' GDP forecasts for 2004 range from 3.7 percent to 5.2 percent. The expectation of stronger year-over-year growth in 2004 takes into account the faster than expected economic growth spurt in the third quarter of this year. The median forecast calls for 4.0 percent growth in the fourth quarter, rising to 4.1 percent in the first quarter of next year and to 4.4 percent by the second quarter, then moderating somewhat during the second half to 4.0 percent in the third quarter and 3.9 percent in the fourth quarter of 2004. The median forecast is for 3.9 percent growth for both 2003 and 2004, measured fourth quarter-to-fourth quarter,[2] which compares to 2.9 percent in 2002 on a fourth quarter-to-fourth quarter basis last year.

The panelists expect business investment—nonresidential fixed investment—to lead the expansion, growing by 9.3 percent during 2004, with the growth rate exceeding 10.0 percent on an annualized basis during the second half of next year, based on the median forecast. The business investment expectations are based on increasing aggregate demand for goods and services, internally generated funds through increased corporate cash flow and profits, and a relatively low cost of capital as we enter the new year, reflecting a favorable market environment—appreciating equity market and narrowing of corporate bond spreads. Implicit in the projected capital spending increase is a higher rate of capacity utilization. The median forecast calls for consumer spending to grow at a 3.6 percent rate in 2004, up from the median forecast of 3.1 percent for 2003. The median projected lower unemployment rate of 5.8 percent in 2004 compared to 6.0 percent for 2003 contributes to the projected growth in consumer spending, along with the historically low though rising interest rates and the effect of the Jobs and Growth Tax Reduction and Reconciliation Act (JGTRRA) passed earlier in 2003. The individual panelists' 2004 unemployment rate forecasts range from 5.5 percent to 6.0 percent. Though we would expect less of a boost from mortgage refinancing activity in the coming

[1] The survey was conducted during the week of November 17–21 prior to the upward revision of the 3rd quarter GDP growth rate from 7.2 to 8.2 percent.

[2] 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.

year, based on the panel's median forecast, total home sales—both new and existing home sales—are expected to top the 6.6 million (5.6 million existing home sales) unit total of 2002 and reach 7.2 million (6.1 million existing home sales) in 2003. The median forecast calls for total 2004 home sales to match the 2002 level.

Committee members believe that the fiscal stimulus will add to the federal budget deficit through the 2004 fiscal year. The median expectation for FY04's deficit is $478 billion, with the individual panelist forecasts ranging from $425 billion to $600 billion. The consensus is that the deficit will peak in FY04 and recede thereafter. The principal reasons that the deficit will begin to decline after 2004 is increased tax revenues arising from economic growth and corporate profits. In addition, the respondents point to the possibility of a slower rate of growth in federal spending in a year following an election and as expenditures in Iraq subside.

Interest rates The expectation is that the Fed will stand pat through the first half of the year. The panelists, however, expect interest rates to move higher during 2004. The consensus view is that the FOMC statement accompanying the December 9 meeting will be similar to the previous FOMC statement after the last meeting in late October. Members do note that the Fed may make reference to recent economic growth and gains in the labor market. Several panelists also expect that the FOMC may soften the language concerning the period of time before the Fed would consider changing the target federal funds rate, laying the groundwork for perhaps hiking rates in 2004. In the October meeting, the FOMC had stated, "policy accommodation can be maintained for a considerable period."

All of the panelists expect the Fed to keep the target federal funds rate at 1.00 percent at the upcoming December meeting. Looking ahead to 2004, 95 percent of the panelists expect the target rate to remain at 1.00 percent through the first quarter, and 75 percent expect that the target federal funds rate to be at 1.00 percent through the second quarter. (None expect the Fed to cut rates through 2004.) The median forecast calls for a 1.00 percent federal funds rate through June, rising to 1.25 percent by September, and 1.75 percent by the end of 2004.

The median forecast has the yield on the 10-year Treasury note rising from 4.35 percent in December 2003 to 4.56 percent by March, 4.90 by September 2004 and 5.10 by December. The consensus forecast expects the yield curve to remain steep in the near term, and flattening in the 2- to 10-year range next year. The panelists are evenly divided among several factors that are contributing to the steepness of the yield curve—current accommodative Fed policy keeping short rates low with an anticipation of Fed hikes in the future; inflationary expectations; economic growth; and the deficit. The consensus expectation is that flattening is more likely to occur as a Fed rate hike becomes more imminent. More panelists suggest that the flattening will begin at the shorter end of the 2- to 10-year portion of the curve. The median forecast implies that the 2- to 10-year spread will decline from 245 basis points to 210 basis points between December 2003 and December 2004.

Home mortgage rates and yields on municipal and corporate bonds are also expected to increase. The median forecast calls for municipal bond yields to rise by 45 basis points, and corporate yields are projected to increase by 35 basis points between December 2003 and December 2004. The median forecast for the 30-year mortgage rate is 5.95 percent in December, rising steadily through next year, reaching 6.65 percent by December 2004. Despite the higher projected mortgage rates, panelists do not expect a significant adverse effect on housing demand; they forecast home sales to be at the 2002 level in 2004.[3]

Sustained Growth, Employment Gains Could Affect Fed's Assessment

While the panelists expect that the Fed will leave rates alone through early 2004, they believe that circumstances could change the Fed's assessment of the economy. Should economic activity accelerate rapidly, the Fed may adjust its assessment and raise the target federal funds rate. The panelists point to several possible indications of accelerated economy activity which could spur changes in Federal Reserve policy. They include continued accelerated growth rates, rapid increases in payrolls and employment such that the unemployment rate falls much below 5.0 to 5.5 percent, dramatic gains in capacity utilization, increasing corporate profits and sustained increased annualized inflation rates (for instance, above 2.0 percent). While the panelists do not think that circumstances will warrant further rate reduction, they note that an economic relapse, weak job growth or a geopolitical threat could lead to further Fed loosening.

[3] The range of panelist forecasts for the 10-year Treasury at the end of 2004 goes from 3.50 percent to 6.00 percent; and 5.52 percent to 7.40 percent for the 30-year fixed rate mortgage.

The Fed Is Implicitly Targeting Inflation Already, Split on Effectiveness of Explicit Targeting Strategy

On the question of whether the Fed should incorporate an explicit target rate of inflation, most panelists indicate that the Federal Reserve is already implicitly targeting inflation. Although opinions are divided as to the merits of explicitly targeting inflation, a slight majority of the respondents support explicit inflation targeting. Many of those that support explicit inflation targeting, however, believe that there should be discretion and flexibility, for example, to take into account cyclical forces. Of those panelists specifying an inflation target, the suggested target was generally between 1.0 and 2.5 percent. Among those offering a specific statistical inflation measure, both CPI and PCE price index deflator were offered, generally favoring a core inflation measure.

Communications are an Important Monetary Policy Tool

Although not a unanimous view, the panelists generally have found recent increases in communication by the Fed to be a positive development. Panelists hold divergent views from supporting more communication to a view that increased communication by Fed policymakers has led to confusion and incorrect interpretations. For instance, most panelists have found the dual assessments of economic growth and inflation to be helpful, though several believe it has led to confusion among market participants. There was also a strong sense that comments from Federal Reserve officials contributed to increased market volatility this year. Panelists find commentary that sheds light on the Fed's views of the economy helpful but have raised concerns about statements that may be interpreted as implying specific future action or suggesting a mechanical approach to policymaking.

Several Variables Could Lead to GDP Growth Above the Median Forecast, Affect Inflation Rate

The dominant view among the panelists was that the economy could grow at a rate in excess of the U.S. economy's potential growth rate for as long as a couple years. There was a range of opinion as to what that potential growth rate is—from 3.0 to 5.0 percent—but the typical estimate was about 3.5 percent.

The panelists identified a number of factors that could drive GDP growth above the median forecast. The most frequently mentioned variables were export growth, faster employment creation, additional consumer spending as a result of lower taxes, more rapid capital expenditures by business and an accelerated inventory build-up.

While the respondents generally indicated there is more "risk" in their forecast on the "upside" than on the "downside," they did identify threats to economic growth. By far, the most frequently cited concerns were terrorism and destabilizing geopolitical events. Other potential risk factors were lack of business confidence, a weaker than expected labor market, further deterioration in the current account trade imbalance, a "trade war" and higher energy prices.

The panelists also commented on "risks" to their inflation forecast. The median inflation forecast has 2003 CPI at 2.3 and 2004 CPI at 1.8 percent. Several factors were identified that could lead to higher rates of inflation. The leading risk factors were a declining dollar, rising energy prices, higher interest rates and a strengthening labor market. Conversely, the leading reasons for lower than expected rates of inflation were declining energy prices, a weak labor market and slower economic growth, and global price competition.[4]

Productivity, Weak Demand Leading Reasons for Subpar Employment Growth

Productivity gains and weak demand for goods and services were the leading reasons cited for the soft labor market, though about half of the respondents also identified corporate restructuring and globalization as reasons for the recent slow employment growth. The panelists noted that U.S productivity growth has not been observed elsewhere in the world. The clear consensus is that there are market, especially labor market, rigidities in other economies which discourage and impede productivity gains outside of the Untied States. A number of panelists also identified cost cutting in response to weak demand as a reason for the slow employment growth in the United States.

Currency Adjustment Should Lower Current Account Trade Deficit; China Potentially an Engine of Growth

Though not unanimous, the consensus was that the size of the U.S. trade deficit was not sustainable. Among the panelists that specified a trade deficit to GDP relationship, the belief was that the current account deficit would ultimately have to be brought down to 2.0 to 3.0 percent of GDP. The panelists

[4] The range of panelist forecasts of the CPI in 2004 is from 1.0 percent to 2.5 percent.

expect that the trade deficit would be reduced over time through currency adjustments—declining value of the dollar relative to other currencies, as well as expansionary or growth policies in other countries. Indeed, the median forecast has a steady decline of the dollar relative to the euro and the yen over the next year. The expected depreciation against major currencies depends on a number of conditions—such as interest rate differentials and limits on the desire of investors to finance our massive current account deficit. While the U.S. will continue to be the engine of world economic growth, Asia, especially China, was cited as the most likely alternative engine of growth outside of the U.S.

Treasury Market to Remain Volatile; Corporate Spreads Narrowing

Treasury market price volatility is expected to continue. The most common reason cited for heightened volatility is political risk. Another reason frequently given by the panelists is expectations about Federal Reserve policy. A number of panelists also consider the effect of dynamic hedging in the mortgage markets, the federal deficit, fluctuations in the foreign exchange market and changing views on economic growth as contributors to the volatility.

The consensus view is that corporate bond spreads will tighten some more as a result of economic growth, increasing corporate profits and improved cash flow. Those that expect spreads to stabilize believe that spreads already incorporate economic growth and corporate profit improvements. The general view is that we are still some time off from a credit-weakening phase of the cycle.

Value Can Be Found in Fixed Income Investments, Especially in Higher Yield Sectors

The Committee expects a continuation of the recent negative correlation between equity and bond prices. The panelists identified corporate bonds, especially higher yield bonds in the U.S., and emerging markets as offering the best value in the fixed-income markets and to be more attractive value propositions than Treasuries. Within the Treasury sector, the panelists considered shorter-term securities to be the better value based on interest rate expectations.

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The Bond Market Association Economic Advisory Committee Forecast – December 8, 2003

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

	2002	2003	2004
Real GDP(yr - to - yr)	2.4	**2.9**	**4.2**
Real GDP (4Q - 4Q)	2.9	**3.9**	**3.9**
CPI (yr - to - yr)	1.6	**2.3**	**1.8**
CPI (4Q - 4Q)	2.2	**2.2**	**1.7**
Personal Consumption	3.1	**3.1**	**3.6**
Nonresidential Fixed Investment	-5.7	**2.4**	**9.3**
Housing Starts (millions)	1.7	**1.8**	**1.7**
Real State & Local Gov't. Spending	2.8	**0.6**	**1.0**
Merchandise Trade Deficit (billions current $)	489	**532**	**563**
New Home Sales (millions units)	1.0	**1.1**	**1.0**
Existing Home Sales (millions units)	5.6	**6.1**	**5.6**
Unemployment Rate (cal. yr. avg.)	5.8	**6.0**	**5.8**
Federal Budget Surplus (FY, billions of $)	-158	-374	**-478**

Quarter-to-Quarter % Changes in Annual Rates

	2003				2004			
	I	II	III	IV	I	II	III	IV
Real GDP	1.4	3.3	8.2	**4.0**	**4.1**	**4.4**	**4.0**	**3.9**
CPI	3.9	0.6	2.3	**1.8**	**1.8**	**1.6**	**1.8**	**2.0**
Personal Consumption	2.0	3.8	6.4	**2.0**	**3.2**	**3.9**	**3.4**	**3.5**
Nonresidential Fixed Investment	-4.4	7.3	14.0	**9.9**	**9.5**	**8.9**	**10.4**	**10.4**

Interest Rates

(monthly average %)

	Dec. 03	Mar. 04	June 04	Sept. 04	Dec. 04
Fed Funds	**1.00**	**1.00**	**1.00**	**1.25**	**1.75**
2 Year Treasury Note	**1.90**	**2.00**	**2.30**	**2.63**	**3.00**
10 Year Treasury Note	**4.35**	**4.56**	**4.68**	**4.90**	**5.10**
30 Year Fixed-Rate Home Mortgages	**5.95**	**6.10**	**6.20**	**6.38**	**6.65**
Municipals (Bond Buyer GO Index)	**4.85**	**5.10**	**5.25**	**5.30**	**5.30**
Moody's Corporate Bond Index (A rated)	**6.15**	**6.20**	**6.30**	**6.40**	**6.50**

Exchange Rates

(monthly average)

	Dec. 03	Mar. 04	June 04	Sept. 04	Dec. 04
Yen/Dollar	**108**	**106**	**105**	**105**	**104**
Dollar/Euro	**1.18**	**1.20**	**1.22**	**1.22**	**1.23**