THE BOND MARKET ASSOCIATION

EconomicOutlook

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The Economic Outlook: Economy Primed for Stronger Second Half

Members of the Bond Market Association's Economic Advisory Committee predict in their mid-year forecast survey that the U.S. economy will accelerate through the balance of the year and into 2004. Respondents see four key drivers behind the expected upswing: Stimulative fiscal policy, including the recently enacted Jobs and Growth Tax Reduction and Reconciliation Act (JGTRRA), a deflation-fighting monetary policy, a favorable domestic financial market environment, and a weaker dollar. Panelists forecast significant growth in capital spending, along with higher levels of consumer spending and a continuation of record level housing sector activity. They believe lower oil and other energy prices, especially once Iraq production steps up, will also help fuel the rebound.

Respondents unanimously expect that the Federal Reserve will continue to support economic growth in response to post-bubble economic headwinds and a potential, though remote, deflation threat. About two-thirds of the panel expects the Fed to cut the target fed funds rate by 25 basis points, and the remaining third predict a 50 basis point cut at the upcoming June 24-25 meeting. As important, none expect the Fed to reverse course on monetary policy soon, given the low inflation backdrop.

Forecast Highlights

Panelists expect the economy to improve on the 1.9 percent annualized first quarter growth rate by summer. Following 2.0 percent growth in the second quarter, the median of panelists' forecasts is for an annualized 3.5 percent growth in the second half of the year. The median forecast is for 2.9 percent in 2003, measured fourth quarter to fourth quarter,[1] with 2004 GDP growth expected to reach 3.6 percent, measured fourth quarter to fourth quarter. Respondents expect that the JGTRRA will boost GDP growth over the year beginning with the third quarter of 2003, with a majority expecting the JGTRRA to boost GDP growth by at least 0.5 percent in 2003 and by more in the following year.

Committee members expect a turnaround in business (nonresidential fixed) investment following the contraction in the first quarter. The median prognosis is for steady if unspectacular acceleration, with a 3.1 percent in the second quarter, increasing to 5.3 percent in the third quarter and 6.3 percent in the fourth quarter. Consumer spending is forecast to remain at the first quarter growth rate of 2.0 percent, increasing to 3.1 percent in the third quarter and 3.3 percent in the fourth quarter.

Committee members believe that the fiscal stimulus will quickly boost the federal budget deficit. The median expectation for FY03's deficit is $400 billion, followed by $433 billion in FY 2004. Panelists expect that the deficit will peak in either FY 2004 or 2005, and no surplus is likely within the next five years. Respondents believe that the lower taxes and higher spending associated with the deficit will spur near-term economic growth. Conversely, however, they are concerned that persistent deficits and rising Federal debt in relation to

[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 22 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**.)

	2002	2003	2004
Real GDP(yr - to - yr)	2.4	**2.3**	**3.4**
Real GDP (4Q - 4Q)	2.9	**2.9**	**3.6**
CPI (yr - to - yr)	1.6	**2.2**	**1.8**
CPI (4Q - 4Q)	2.2	**1.8**	**2.0**
Personal Consumption	3.1	**2.5**	**3.3**
Nonresidential Fixed Investment	-5.7	**0.6**	**7.2**
Housing Starts (millions)	1.7	**1.7**	**1.6**
Real State & Local Gov't. Spending	2.8	**0.6**	**1.1**
Merchandise Trade Deficit (billions current $)	489	**520**	**524**
New Home Sales (millions units)	1.0	**1.0**	**0.9**
Existing Home Sales (millions units)	5.6	**5.8**	**5.6**
Unemployment Rate (cal. yr. avg.)	5.8	**6.0**	**5.9**
Federal Budget Surplus (FY, billions of $)	-158	**-400**	**-433**

Quarter-to-Quarter % Changes in Annual Rates

	2003				2004			
	I	II	III	IV	I	II	III	IV
Real GDP	1.9	**2.0**	**3.5**	**3.5**	**3.6**	**3.6**	**3.5**	**3.5**
CPI	3.9	**0.6**	**1.5**	**1.7**	**1.9**	**2.0**	**2.0**	**2.0**
Personal Consumption	2.0	**2.0**	**3.1**	**3.3**	**3.4**	**3.3**	**3.3**	**3.4**
Nonresidential Fixed Investment	-4.8	**3.1**	**5.3**	**6.3**	**7.6**	**7.6**	**8.2**	**7.9**

Interest Rates

(monthly average %)	Sept. 03	Dec. 03	Mar. 04	June 04	Sept. 04
Fed Funds	**1.00**	**1.00**	**1.00**	**1.25**	**1.75**
2 Year Treasury Note	**1.35**	**1.50**	**1.75**	**2.00**	**2.29**
10 Year Treasury Note	**3.50**	**3.63**	**3.95**	**4.50**	**4.63**
30 Year Fixed-Rate Home Mortgages	**5.40**	**5.65**	**5.75**	**6.00**	**6.20**
Municipals (Bond Buyer GO Index)	**4.55**	**4.77**	**4.82**	**5.16**	**5.31**
Moody's Corporate Bond Index (A rated)	**5.90**	**6.08**	**6.13**	**6.45**	**6.73**

Exchange Rates

(monthly average)	Sept. 03	Dec. 03	Mar. 04	June 04	Sept. 04
Yen/Dollar	**117**	**117**	**116**	**116**	**117**
Dollar/Euro	**1.20**	**1.22**	**1.23**	**1.25**	**1.23**

GDP could hamper growth by raising interest rates and discouraging investment, especially if there is no credible commitment to reduce it.

Although panelists believe that the Fed is on hold until sometime next year, they generally expect interest rates to move higher over the next six quarters. The median forecast projects the Federal funds rate to remain at 1.0 percent through March of 2004, steadily rising to 1.75 percent by September of 2004. The yield on the 10-year Treasury note is expected to rise to 3.50 percent by September of this year and 4.63 percent by September of 2004.

Home mortgage rates and yields on municipal and corporate bonds are also expected to increase. Municipal and corporate yields are projected to increase by approximately 80 basis points between September 2003 and September 2004. Median forecasts for the 30-year mortgage rate are 5.40 percent in September of this year and 6.20 percent in September of 2004. Despite the higher projected mortgage rates, committee members do not expect a significant adverse effect on housing demand; they forecast existing and new home sales to exceed the totals in 2002.

Deflation Unlikely

Committee members generally do not consider deflation to be a significant threat or risk to the economy, partly because they believe that the Fed has and will act appropriately to fight it. The committee is forecasting the headline CPI to increase by 1.8 percent in 2003 and 2.0 percent in 2004 on a fourth quarter to fourth quarter basis. Deflation can have a devastating effect on the economy by increasing the corporate debt burden, discouraging business investment and consumer spending, reducing asset values and making monetary policy less effective.

Despite fears that today's low short-term interest rates limit the Fed's ability to fight deflation and boost growth, members believe the Fed has a number of other effective policy tools at its disposal. The Fed has committed publicly to fight deflation, and can purchase longer term Treasury securities to target bond yields close to the rate of inflation.

Housing Remains Strong, Has Not Peaked

A majority of the committee believes that growth in the housing sector has not peaked, especially considering the current mortgage rate environment. Importantly, in their view, any adverse effect of a rising mortgage rate environment is likely to be counterbalanced by rising income and employment. While home price appreciation is expected to subside, committee members do not expect a "bust" in housing prices, and think that a U.S. housing " bubble" is extremely unlikely.

Capital Spending Recovery

Three factors are at work behind panelists' median view that capital spending will accelerate: Debt restructuring and improved profit margins will boost corporate cash flows, stepped up tax incentives in JGTRRA will bring spending forward into 2004, and companies' need to replace depreciated equipment. Low capacity utilization and continuing geopolitical uncertainty serve as constraints on capital spending, according to many panelists. Ultimately, they think that the pace will depend on business confidence and aggregate demand.

A falling cost of capital will help, however, and a majority of the committee expects corporate bond yield spreads to continue to narrow, reflecting improved corporate profitability and credit quality, and the flows into corporates from yield-hungry investors. The balance of the committee expects corporate spreads to stabilize around current levels. That view holds that most of the likely good news is now in the price.

Dollar Will Decline but Not Crash

Panelists generally believe that value of the dollar will continue to fall, by more against the euro than the yen. But they strongly doubt that the dollar will "crash," or decline abruptly. The expected depreciation against major currencies reflects interest rate differentials that favor other currencies and the waning desire of investors to finance the nation's sizeable current account deficit on current terms. The pace of the decline will also depend on growth and recovery in other economies, and policies of other central banks, including foreign exchange market intervention.

Risks that May Affect the Economic Forecast

Committee members cited three general risks to the outlook. First is a discreet event, such as a terrorist attack, expansion of SARS, increased tension the Middle East or a new significant corporate scandal. The second risk cited is that businesses would be slower to step up business investment and/or hiring than anticipated. In turn, that could reduce growth in consumer spending and thus aggregate demand. It's worth noting that panelists don't expect dramatic improvement in labor markets; the median unemployment rate forecast is 6.0 percent in 2003 and 5.9 percent in 2004. The third risk is a further deterioration in global economic conditions.

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