THE BOND MARKET ASSOCIATION

EconomicOutlook

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The Economic Outlook: Sustained Growth in a Higher Rate Environment

Members of the Bond Market Association's Economic Advisory Committee predict in their mid-year forecast survey that the U.S. economy will sustain the recent trend of GDP growth, and that last year's deflationary threat is a distant memory. The median forecast for real GDP growth calls for a 4.7 percent rate for full-year 2004, and for inflation to rise to 2.6 percent.[1] Still-stimulative fiscal and monetary policies and the cyclical dynamics of recovery set the stage to propel economic growth through the end of the year. A significant increase in capital spending and still-healthy growth in consumer spending will pace the rise. As mortgage rates start to move up from their lows during the coming year, panelists expect some moderation in the housing sector. Nevertheless, they expect that housing activity will remain strong by historical standards.

The panelists' moderate inflation outlook no doubt reflects their view that the Fed will raise rates through 2005. The Economic Advisory Committee panelists unanimously expect that the Federal Reserve will begin with a 25 basis point increase on June 30. Most think that Fed officials believe that the pace of economic growth is sustainable and low inflation implies that they can move policy toward neutral from ultra-accommodative in "measured" steps. They also note that the Fed will respond more aggressively if inflation threatens to rise more quickly.

Forecast Highlights

THE ECONOMY The median forecast calls for GDP growth of 4.7 percent[2] in 2004 and 3.9 percent in 2005, compared to 3.1 percent for full-year 2003. The committee's median forecast is 4.3 percent quarter-over-quarter annualized growth rates for each of the next three quarters. The median forecast is for 4.4 percent growth for 2004 compared to 4.3 percent for 2003, and 2.9 percent for 2002 measured fourth-quarter to fourth-quarter[3].

The panelists expect business investment—nonresidential fixed investment—to lead the expansion, growing by an impressive 9.9 percent during 2004. Supported by the recent fiscal stimulus and historically low interest rates, the business investment expectations are based on increasing aggregate demand resulting from economic growth. Other factors influencing business investment include growth in inventories, the availability of internally generated funds resulting from increased corporate cash flow, and rising rates of capacity utilization.

The median forecast calls for consumer spending to continue to rise at a 4.0 percent rate in 2004, above the 3.1 percent in 2003. The projected median forecast for the average unemployment rate for 2004 of 5.5 percent, compared to the 6.0 percent in 2003, is expected to contribute to the projected growth in consumer spending.[4] Despite higher

[1] The survey was conducted the week of June 13-20, prior to the downward adjustment of Q1 GDP to 3.9 percent. The forecasts discussed in the text and appearing in the accompanying data table are medians of the 25 individual members' submissions.
[2] The panelists' estimates for 2004 GDP growth ranged from 4.4 to 5.1 percent.
[3] All growth rates are inflation adjusted, and annual comparisons are measured fourth quarter to fourth quarter.
[4] The range of individual panelists' forecasts for the average unemployment rate for 2004 ranged from 5.3 percent to 5.6 percent.

mortgage rates, based on the panel's median forecast, total housing sales—both new and existing housing sales—will reach 7.3 million units (6.2 million existing housing sales) in 2004 actually above the 7.2 million units (6.1 million existing housing sales) last year, slipping to 6.8 million units in 2005.

This year's inflation uptick has come as a surprise to many forecasters and to the Fed. Yet panelists expect that inflation measured by the "headline" consumer price index, or CPI, to rise only modestly this year, although they do see upside risk to that view. The median forecast has 2004 CPI at 2.6 percent and 2.4 percent next year compared to 2.3 percent in 2003. On a fourth-quarter over fourth-quarter basis, the CPI is expected to increase by 3.1 percent.[5]

The consensus is that the Federal deficit will peak this fiscal year at $425 billion, and decline to $375 billion in FY 05.[6] The improvement stems both from a cyclical increase in tax revenues and from a more restrained rate of growth in federal spending as expenditures in Iraq and defense spending subside. The panelists identified the principal long term fiscal challenges as restoring discipline and the growing future structural deficit arising from Social Security and other entitlement programs.

INTEREST RATES As noted, beginning with the June 29–30 FOMC meeting, the Fed is expected to move rates up at a steady though moderate pace towards a "neutral" Fed Funds rate. Panelists think that the Fed will say that the "measured" pace of tightening is contingent on its inflation forecast, which will give the Fed flexibility to raise rates more aggressively should circumstances warrant. With respect to the FOMC's assessment of risks, the panelists were split between a balance between growth and price stability and risks more heavily weighted towards price stability. The risk assessment is most likely to be affected by changes in risk on the upside, including a faster than expected rate of growth, a higher rate of core inflation or unit labor cost increase, while noting a drop in consumer confidence could also affect the risk assessment.

The median forecast has the Fed funds rate up at least another quarter of a point by September and up to 2.00 percent by the end of the year. Looking ahead to 2005, the median expectation is that the Fed funds rate will be at 2.5 percent in March and about 3 percent next June.

The committee's median forecast has the yield on the 10-year Treasury note rising from about 4.7 percent as of June 23 to 5.0 percent at the end of September and 5.2 percent by December[7] to 5.3 percent by March and 5.6 by June of 2005. As would be expected at this stage of the rate cycle, the consensus forecast calls for a continuation of the flattening of the 2-year to 10-year yield curve. The presumption is that the long end of the curve has largely anticipated the rate hikes and would only rise dramatically if there were an inflationary "shock." The median projection has the 2-year rising from around 2.7 percent to 3.2 percent at the end of September, to 3.5 percent at year-end and 4.2 percent a year from now. Based on the median forecasts, the implied 2-year to 10-year spread would decline from today's 200 basis points to 170 basis points by year-end and 140 basis points a year from now.

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 60 basis points and corporate yields by 40 basis points from September 2004 to September 2005. Median forecasts for the 30-year fixed-rate mortgage are 6.6 percent at year end and 6.7 percent a year from now, about a 35 basis point increase from current levels.

[5] The range of individual panelists' forecasts for the 2004 CPI increase ranged from 2 percent from 3 percent, and from 1.6 percent to 3.3 percent for 2005.

[6] The range of individual panelists' forecast for the FY 04 federal deficit ranged from $375 billion to $475 million and from $300 billion to $506 billion for FY 05.

[7] The individual panelists end of 2004 forecast for the 10-year rate at the end of 2004 ranged from 4.6 percent to 5.75 percent and from 5.55 percent to 7.25 percent for the 30-year fixed-rate mortgage.

Fed Expected to Reach Equilibrium Short-Term Interest Rate in the Next 12 to 18 Months

The general consensus is for the Fed to bring short-term interest rates into equilibrium within the next 12 to 18 months with some believing it could spill over to 2006. The consensus view was that the equilibrium short-term rate could be between 4 and 5 percent based on 2.5 percent real rate—which may edge upward based on higher productivity levels—and 2 percent price inflation measured by the PCE (Personal Consumption Expenditure) price deflator.

Higher Interest Rates Not Expected to Materially Affect the Consumer

The consensus view is that the anticipated rise in rates will not have a significant adverse affect on the consumer sector, though some panelists did express concern should the Fed raise rates too quickly. Most mortgages are fixed-rate and thus interest costs generally are immune to rate movements over the life of the mortgage. Furthermore, some adjustable rate mortgages are hybrids which will not reprice for several years. With respect to interest rate exposure, many consumers used mortgages to pay down higher rate and rate sensitive credit cards. During the low-rate environment of recent years, consumers shored up their balance sheets. As rates rise, yields on interest bearing assets may also rise, offsetting the impact of higher interest expenses of financial asset holding consumers.

Productivity Growth Moving to a Sustainable Level

Although the trend in productivity growth has improved in the past decade, part of the recent large productivity gain was cyclical. Following a surge in hiring until the slowdown early in the decade, the comparatively slower rate of employment creation contributed to the rise in productivity. The panelists' view is that we are moving towards a more normalized and sustainable productivity rate. The long-term productivity rate estimates ranged from about 2 to 3 percent and the view is that a number above 3.5 percent is not sustainable. There are a number of factors affecting productivity—foreign competition, flexible labor markets, education and a favorable business investment environment.

Risks to GDP Growth, Inflation Forecast

The consensus view of the panelists is that the potential long-term growth rate is around 4.5 percent. Taking into account recent increases in capacity utilization and other measures showing reduced slack in the economy, the dominant view is that there will continue to be some slack in the economy for at least another 12 to 18 months.

The panelists identified a number of factors that could drive GDP growth above the median forecast. The most frequently mentioned upside risks were stronger than expected growth in capital spending, including inventory build up, and lower energy prices. Other upside risks identified were stronger than expected personal income and consumer spending growth, and a slower than expected rise in interest rates. The dominant "downside" risks to the panelist growth forecasts were excessive monetary tightening, growth in energy prices and a geopolitical or terrorist event. Other downside risks identified were declining housing prices, slowdown in productivity and an adverse effect on consumers of rising interest rates.

The panelists commented that, while the rate of inflation is expected to be moderate, the risk of higher inflation should not be discounted or ignored. The leading risk factors, which could cause accelerated inflation are rising energy costs, higher labor costs, a slow reaction from the Federal Reserve, and expanded global economic growth. The risks that could precipitate slower than expected inflation include greater than expected slack in the economy, lower commodity prices due to slow global economic growth, a geopolitical event, and declining energy prices.

Oil Prices Expected to Subside Over the Next Year

The consensus view is that oil prices will hover around $35 in the near term, though others panelists expect oil prices to remain in the upper $30 per barrel range with some putting the number lower. The longer-term (five-year) view is that per barrel oil prices will stay around the mid $30s range or decline further, though there will be seasonal spikes. While acknowledging that there are risks that prices may rise above the forecast, the expected lower prices reflect both the build up of inventories and increased production levels. At those levels, the effect on economic growth will be neutral to positive while lowering the inflation threat.

Non-U.S. Private Investors and Governments Will Continue to Be Net Purchasers

The panelists agree that the non-U.S. investors and governments will continue to be net buyers of U.S. Treasuries though the pace of buying could moderate and the percentage of non-U.S. ownership may level off. The current account deficit creates a supply of dollars offshore. From the non-U.S. government perspective, holding of dollar-denominated assets helps foreign central banks implement currency strategies and intervene in the foreign exchange markets. Private non-U.S. investors are likely to pick up any slack in foreign government investment in government securities as U.S. investments offer attractive returns in a stable market environment and are considered to be a "safe haven," especially to the degree that the dollar stabilizes. (The median forecast calls for a stable 1.2 dollar to the euro exchange rate throughout the forecast period.) Though the consensus view was that there will not be a significant effect on rates, the net effect of non-U.S. net purchases will be to limit or cap rising Treasury yields.

Replay of Recent Tightening Episodes Considered Unlikely

The consensus view is that the current round of Fed tightening will be distinctly different from the recent episodes, especially the 1993–94 episode. The 1993 economic environment was different – higher resource utilization, including commodity prices, employment level and inflation. The Fed today is better positioned to respond because it has greater credibility due to the market's experience of the earlier periods and has communicated its intentions more clearly. The bond market, especially at the long end of the maturity spectrum, has incorporated the anticipated higher rates, portfolio durations have been adjusted and negative convexity worked through, suggesting that less of a sell-off is expected in the current cycle. Furthermore, there are more tools today to hedge in a rising-rate environment.

Fixed-Income Buying Opportunities May Begin to Emerge

While the committee offered a range of opinions about fixed-income market investing, most suggest that attractive opportunities are beginning to emerge, especially relative to a few months ago. The rising rate environment favors shorter dated instruments. At the same time, the Treasury market, especially at the long end, seems to have priced in a good deal of the anticipated rate hikes. Within the higher interest rate environment surrounding economic growth expectations, pure rate products such as Treasuries and swaps are the most vulnerable. Spread products may offer value, though any geopolitical threat will adversely affect lower rated bonds.

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The Bond Market Association Economic Advisory Committee Forecast - June 29, 2004

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

	2003	2004	2005
Real GDP(yr - to - yr)	3.1	**4.7**	**3.9**
Real GDP (4Q - 4Q)	4.3	**4.4**	**3.8**
CPI (yr - to - yr)	2.3	**2.6**	**2.4**
CPI (4Q - 4Q)	1.9	**3.1**	**2.4**
Personal Consumption	3.1	**4.0**	**3.5**
Nonresidential Fixed Investment	3.0	**9.9**	**8.8**
Housing Starts (millions)	1.9	**1.9**	**1.8**
Real State & Local Gov't. Spending	0.5	**0.7**	**2.2**
Merchandise Trade Deficit (billions current $)	588	**613**	**594**
New Home Sales (millions units)	1.1	**1.1**	**1.0**
Existing Home Sales (millions units)	6.1	**6.2**	**5.8**
Unemployment Rate (cal. yr. avg.)	6.0	**5.5**	**5.3**
Federal Budget Surplus (FY, billions of $)	-374	**-425**	**-375**

Quarter-to-Quarter % Changes in Annual Rates

	2004				2005			
	I	II	III	IV	I	II	III	IV
Real GDP	4.4	**4.3**	**4.4**	**4.3**	**3.9**	**3.7**	**3.9**	**3.9**
CPI	3.6	**4.5**	**2.5**	**2.0**	**2.2**	**2.3**	**2.4**	**2.4**
Personal Consumption	3.9	**3.5**	**3.5**	**3.3**	**3.4**	**3.3**	**3.4**	**3.3**
Nonresidential Fixed Investment	5.8	**11.4**	**11.3**	**12.5**	**7.7**	**8.0**	**8.2**	**8.2**

Interest Rates

(monthly average %)	Sept. 04	Dec. 04	Mar. 05	June 05	Sept. 05
Fed Funds	**1.6**	**2.0**	**2.5**	**2.9**	**3.3**
2 Year Treasury Note	**3.2**	**3.5**	**3.9**	**4.2**	**4.4**
10 Year Treasury Note	**5.0**	**5.2**	**5.3**	**5.6**	**5.7**
30 Year Fixed-Rate Home Mortgages	**6.4**	**6.6**	**6.8**	**6.7**	**6.8**
Municipals (Bond Buyer GO Index)	**5.2**	**5.4**	**5.6**	**5.8**	**5.8**
Moody's Corporate Bond Index (A rated)	**6.5**	**6.7**	**6.7**	**6.8**	**6.9**

Exchange Rates

(monthly average)	Sept. 04	Dec. 04	Mar. 05	June 05	Sept. 05
Yen/Dollar	**109**	**107**	**107**	**106**	**104**
Dollar/Euro	**1.20**	**1.20**	**1.20**	**1.20**	**1.20**