

Financial Forecast

John A. Boquist

Edward E. Edwards Professor of Finance,
Kelley School of Business, Indiana University,
Bloomington

Robert Neal

Professor of Finance, Kelley School of
Business, Indiana University, Indianapolis

William L. Sartoris

Professor of Finance, Kelley School of
Business, Indiana University, Bloomington

As usual, the condition of U.S. financial markets is bipolar. The optimistic side is that the financial markets have been able to absorb tremendous shocks during the past three years: the trauma of 9/11; declining stock market returns from the incredible highs of 2000; the bankruptcies of Enron, Worldcom, United Airlines, and others; sweeping legislation to reform corporate governance practices at companies; and unrelenting global competition. The depressed side is that many new challenges now face the markets: the war in Iraq, massive budget and trade deficits, and record high oil prices. Given these new challenges it is easy to see why financial markets are on edge with investors wondering which direction the markets will go. Fortunately, there are some notable bright spots:

- ▶ Housing demand remains strong and families who own their own homes have seen rapid increases in value in many markets.
- ▶ Relatively low interest rates have helped sustain the markets, particularly real estate.

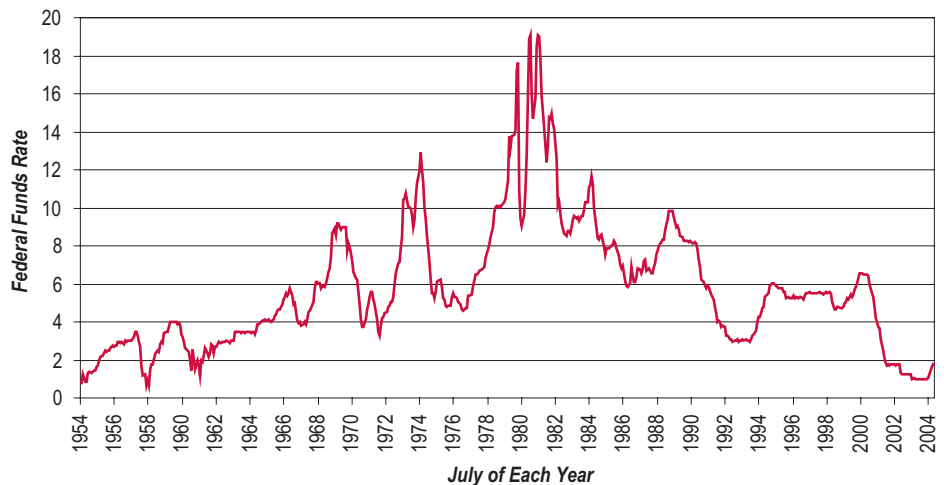
The question on everyone's mind is what does the future hold?

Interest Rates

Interest rates have generally fallen for the past twenty years, due in large part to wringing inflation out of the economy. In addition, foreign governments have been buying Treasury securities to shore up their currencies, and domestic investors have been improving the quality of their portfolios in the face of erratic stock market returns. Since short-term rates have fallen much

Figure 1

Monthly Federal Funds Rate over Time, July 1954 to October 2004



more than the long-term rates, the yield curve continues to be very steep. Historically, the spread between short- and long-term rates is a precursor to economic activity and the currently observed high spread is generally followed by an expansion and rising interest rates. Also, the Federal Reserve has been increasing interest rates in small steps to combat inflationary pressures in the economy. We expect this policy to continue and, as a result, we expect the short-term Fed Funds rate will rise to 2.75 percent by the end of 2005 (see Figure 1). Since we forecast inflation to be 3 percent in the upcoming year, the implication is that short-term real rates of interest will be negative or close to zero, which reduces the effective cost of the use of debt to the borrower. The anticipated inflation will carry long-term Treasury yields up from the current 5 percent level to the 5.5 percent range by the end of 2005. Corporate interest rates will exhibit similar increases next year. Mortgage interest rates bottomed out at about 5.25 percent last year, and we expect that mortgage rates will also rise over the next year to 6 percent. The prime rate is expected to be near 5 percent by the end of the year.

Corporate Profits

In the four quarters ending in June, the government reported that corporate profits increased by 18.5 percent, reaching a level of \$876.7 billion, or 7.7 percent of gross domestic product (GDP). This is the highest profit percentage since 1966 and

indicates a positive force for future growth. Corporate profits and cash flows continue to be adversely affected by high oil prices, high commodity prices for inputs like steel and copper, and rising costs of health care and pensions. These forces, along with higher interest rates, will dampen corporate profit growth next year. As the economy continues to grow (albeit at a slow 3 percent real rate), we expect corporate profits to rise only about 8 percent during 2005, less than half the rate of growth in 2004. Global competition remains fierce in virtually all markets, but the continued weakness in the dollar will help exporters remain competitive. In addition, a productivity increase of 1.9 percent will offset the small gains in labor compensation.

The weak but positive outlook for 2005 will encourage firms to expand capital investment and employment to meet the expected increase in demand for goods and services, as well as replenish reduced inventory levels. Unfortunately, these increases will be modest because current capacity utilization is 77.3 percent, which is below the 82 percent to 84 percent that is normally considered to be full capacity utilization. Although we see few reasons to expect a major business slowdown at this time, we also do not see a major upturn either. The recently passed American Jobs Creation Act of 2004 contains provisions that should help many manufacturing companies (broadly defined). The act includes provisions to repeal the tax exclusion for extraterritorial income (which is offset by a lower tax rate

Housing

Jeffrey D. Fisher

Director, Center for Real Estate Studies and Charles H. and Barbara F. Dunn Professor of Finance and Real Estate, Kelley School of Business, Indiana University, Bloomington

of 3 percent for domestic manufacturers), to increase the small business expensing limit to \$100,000 through 2007, and to initiate a one-year tax holiday to repatriate foreign profits at a 5.25 percent tax rate. Such a low tax rate may encourage as much as \$500 billion in undistributed overseas earnings to find its way back to the United States.

A major wildcard in the business sector is what corporations will do with the massive hoards of cash they have amassed. At the end of the second quarter, the Commerce Department estimated that U.S. corporations (not including farming and financials) held \$1.27 trillion in liquid assets, representing 10.9 percent of GDP. This is the highest percentage since 1959. At this point, companies are very cautious in spending the hoard on capital investment or hiring until economic uncertainty is resolved. Furthermore, special accelerated depreciation allowances enacted in 2002 are set to expire at the end of the year, diminishing a tax incentive for capital spending. If corporations are reluctant to spend the money, the imperative of shareholder value suggests that the cash will likely be dedicated to increased dividends or share repurchases.

Stock Market

The best way to describe recent stock market activity is “choppy”—up, down, sideways. As the economy slowly continues to improve, we expect the stock market to also continue making gains. If corporations divest their cash hoard by paying increased dividends or buying back stock, the market will benefit. In the long run, we expect the stock market will offer returns 6 percent to 8 percent above Treasury bonds, which is in line with the market’s historical average performance since 1926, but well below the returns investors were experiencing in the 1990s. As always, prudent investors should continue to diversify their portfolios to guard against too much exposure to any individual stock, market, or asset category.

Summary

The financial markets will mirror the economy—slow growth in valuations because of the global and domestic challenges outlined above. Unfortunately, it will be a bumpy ride. ◀

Because interest rates have remained at unexpectedly low levels during 2004, it appears that housing starts for 2004 will be slightly higher than we forecasted last year. Rates are expected to rise slightly during 2005 as the economic recovery continues, but there should also be continued job recovery. The thirty-year fixed-rate mortgage should gradually rise to 6.4 percent in the fourth quarter. The average rate for all of 2004 is expected to be 6.1 percent, only modestly above 2003’s 5.8 percent.

While rising interest rates tend to dampen the demand for housing, job growth increases the demand. On balance, we expect housing starts to fall slightly for 2005 to a level of 1.85 million units, down from the 1.93 million units expected for 2004. This is still quite strong by historical standards. The single-family component of housing starts is likely to set a record during 2004. Multi-family is not quite as strong because more families can afford to own rather than rent.

Existing home sales have been strong during 2004, after setting a record of 6.1 million in 2003, and should also remain strong during 2005. The National Association of Realtors (NAR) forecasts existing-home sales to rise 5.7 percent in 2004 to 6.45 million. New-home sales should also hit a record, increasing 10.8 percent to 1.20 million in 2004.

Expenditures for home additions and alterations are expected to be strong because homeowners’ equity has increased with rising home prices. High oil prices could produce a further rise in prices for certain building materials.

Low interest rates and the strong housing market during the past year put upward pressure on home prices. The median

existing-home price will continue to show above normal appreciation, rising 7.3 percent in 2004 to \$182,400. The median new-home price should increase 8.3 percent this year to \$211,100. The rising cost of building materials has been partly responsible for upward pressure on home prices.

The low mortgage rate environment has also led to a strong demand for condominiums (condos) by people who might otherwise rent because they could not afford a home mortgage—especially first-time homeowners. In many areas of the country, condo converters have been buying apartments at unprecedented prices and converting them into condominiums.

Primarily due to low mortgage interest rates, housing has been relatively affordable, with the NAR Housing Affordability Index at 127. This means a family at the median income level is earning 27 percent more than needed to qualify for the median-priced home.

Interest in commercial real estate by investors has also been unusually strong during 2004 and is expected to continue during 2005. Investors who have been disappointed with the performance of the stock market and have a renewed appreciation for the importance of diversification are looking to commercial real estate as a way to balance their portfolios. This can be done in a number of ways, including direct real estate investments or purchasing shares of publicly traded real estate companies, such as real estate investment trusts (REITs). The share price of REITs like Simon Property Group, which owns malls, and Duke Realty, which owns office and industrial properties, has risen significantly over the past year. ◀

Housing starts should fall slightly to a level of 1.85 million units, down from the 1.93 million units expected for 2004. This is still strong by historical standards.