Financial Forecast

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How times have changed. The new mantra from Wall Street is that sex, drugs, and rock and roll have now been replaced by the three P's: pensions, Porsches, and a place on the beach. As college professors, our dean ensures that we don't get paid enough to buy a Porsche—much less a place on the beach. But everyone is concerned about pensions and investment performance, so let's turn our attention to the financial outlook.

The year 2005 has been interesting. We've had everything from the White Sox to oil shocks. We've had bankruptcies in airlines and auto parts and huge losses from hurricanes. We've had creeping inflation and soon we'll have a new Fed chairman.

Despite all of this, the economy is like the Energizer Bunny®: it keeps going and going. Since our forecast a year ago, gross domestic product (GDP) has increased at an annual rate of about 3.6 percent. This was on the high end of our forecast range and has translated into strong earnings growth. From the third quarter of 2004 to the third quarter of 2005, earnings for the S&P 500 were up 15 percent.

The equity markets have followed suit, albeit a bit more cautiously. Over the past twelve months, the S&P 500 is up about 7.5 percent and the NASDAQ Composite is up about 6 percent. On a year-to-date basis, however, the stock market has been essentially flat, so all the gains over the past twelve months came from November and December 2004.

Two factors have contributed to this lackluster performance. Over the past year, the federal funds rate has risen from 1.75 percent to 4 percent (see **Figure 1**), and the prime rate has increased from 4.75 percent to 6.75 percent. Higher interest rates make it more costly for firms to finance their expansions, and higher discount rates reduce the value of future earnings. The long-term rates have also risen, but at a slower rate. The yield on the benchmark ten-year Treasury bond rose from 4.1 percent to 4.6 percent and the average rate on thirty-year mortgages increased from 5.7 percent to 6.3 percent.

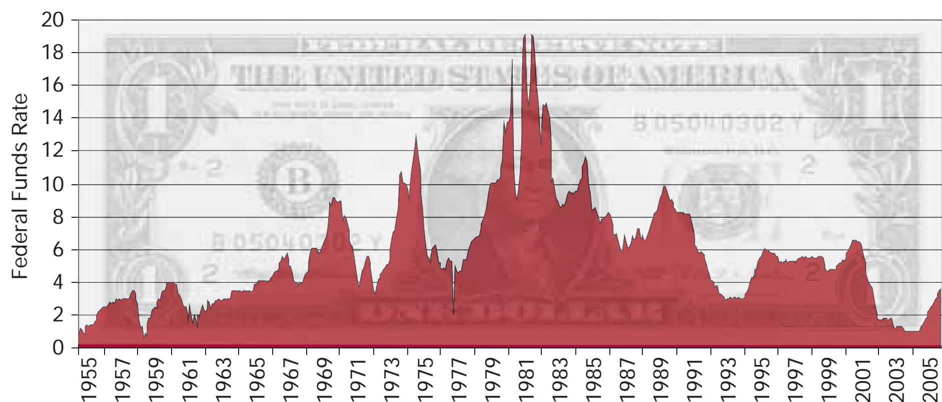
Another factor is compression of the price-earnings (P/E) ratio, which measures the price an investor needs to pay to acquire $1 of company earnings. Firms with high P/E ratios have strong growth prospects. A decrease in the P/E ratio means that investors are less optimistic about future growth or have become more risk averse about the stock market in general. From the third quarter of 2004 to the third quarter of 2005, the P/E for the S&P 500 declined from 19.3 to 17.8. This is above the long-term historical average of about 16, but below 24, the average over the last fifteen years.

Outlook for 2006

Our projection is that the stock market will provide a decent return this year, although less than the historical average of about 12 percent. Several factors lead us to this projection for 2006.

We expect that short-term and long-term interest rates will rise in 2006. The Fed increased short-term rates by 25 basis points at the December 2005 Federal Open Market Committee meeting. We expect at least one additional increase in 2006, bringing short term rates to 4.5 percent and the prime rate to 7.5 percent. Increases beyond this will depend on rate of inflation. The Fed seems to have a comfort zone of 1 percent to 2 percent for inflation. We are currently close to the 2 percent boundary, and if our inflation forecast of 3 percent is realized, then we will see additional increases in the federal funds rate. An important factor for inflation is the price of energy. In the past two years, oil has risen from about $28 per barrel to about $65 per barrel. If this trend

Figure 1
Monthly Federal Funds Rate over Time, July 1954 to September 2005



Source: Federal Reserve

continues, inflationary pressures are unlikely to abate.

The long-term Treasury bonds have shown strong resilience to the rise in short-term rates. Over the past year, the federal funds rate has risen by 225 basis points, while the yield on the benchmark ten-year Treasury only increased by 50 basis points. This has caused the yield curve to become flatter, which may depress economic growth in 2006. Historically, steeper yield curves have been associated with higher growth rates of GDP.

While the muted reaction of the ten-year bond to the rise in inflationary pressures suggests the market believes that inflation is not a long-term problem, there is uncertainty about the new Fed chairman. Lost in the discussion of the positive reaction to the Bernanke announcement was that long-term bonds sold off and the yields rose by about 20 basis points.

On the earnings front, we anticipate a decent year for corporate earnings. Earnings projections from Wall Street firms suggest a 10 percent to 12 percent growth in earnings in 2006. This is down from the 15 percent growth over the past year, but greater than the 10 percent annual earnings growth over the past fifteen years. One of the unusual characteristics of corporate earnings is that firms have a tendency to lower expectations about their earnings so their announced earnings will exceed the diminished target. While this process is well known on Wall Street, the earnings announcements do provide some good news. In recent months, there has been a greater than average tendency to exceed their targets, which bodes well for 2006 earnings. Firm revenues are expected to grow 8 percent to 10 percent in 2006 and productivity is expected to increase 2 percent to 3 percent, which remains strong by historical standards.

Much of the earnings strength in 2005 came from the energy sector, where earnings increased 45 percent. Excluding this sector, overall earnings fall to a more modest 11 percent. At this date, it is still unknown how consumers will react to higher energy prices. Since consumer spending generates about 60 percent of corporate profits, an energy-related slowdown in consumption could have a large adverse impact on 2006 earnings. Another source of strength in 2005 was the housing sector, as home sales and housing starts continued strong through the third quarter. Recently, however, signs of weakness have developed. Thirty-year mortgage rates are up to 6.3 percent and mortgage applications have declined. The ability to use home equity to pay for consumption items has also diminished as fewer household are using refinancing as a means to realize the price appreciation of their home. A third source of earnings uncertainty comes from hurricanes Katrina and Rita. Many economists believe the impact of the storms will shift GDP from the last half of 2005 into the first half of 2006. While 400,000 jobs disappeared and the property damage may exceed $100 billion, there is likely to be a massive government-led rebuilding effort. In turn, this will trigger hiring, increased spending, and ultimately corporate profits.

Prudent investors should always diversify their investments. For 2006, many analysts are recommending an asset mix that contains slightly less stock and slightly more bonds than the average recommendation. We expect the stock market performance in 2006 to be similar to 2005: choppy, with total returns in the 6 percent to 10 percent range. One important step investors can take to improve investment performance is to monitor the total fees paid to mutual funds and investment advisors. Fund expenses, management fees, and inefficient trading for taxable accounts can reduce total returns by 4 percent per year. ■

Housing

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The national housing sector has benefited significantly from low long-term interest rates in recent years. The Fed's hikes in short-term rates after mid-2004 did little to dampen housing demand. There has been talk of a housing bubble in many areas of the country as home prices have risen considerably compared to historical levels. Prices have also risen much faster than rental rates, analogous to having a high price-earnings ratio for houses. Average national home prices have not dropped since the Great Depression but the recent frenzy in the real estate market has investors wondering if the market can maintain this pace. Housing prices have risen and popped in past years. Texas collapsed in 1986, Southern California in 1989, and Massachusetts and Connecticut in 1991. But the debate continues over whether a nationwide bubble has materialized.

Some compare today's coastal housing market, where prices increased the most, to the investment craze that led to the technology stock crash a few years ago. Home prices in some regions have more than doubled in the past five years, leading to concerns that the speculative bubble might burst. There have also been record levels of conversion of apartments into condominiums in many areas of the country as demand for homeownership has also led to increased demand for condominiums. Investors can earn a greater profit by selling apartments as condos rather than renting apartments. In markets like Miami, where the condo market has been particularly hot, some units have even changed hands the same day as speculators have been buying many of the condos.