# Financial Forecast

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The Dow Jones Industrial Index hit a record high in October by crossing over the 12,000 threshold, yet investors are not wildly celebrating. Part of the reason is that the Dow does not denote the "stock market," since the thirty stocks comprising the index are not fully representative of the entire market. For example, the broader S&P 500 Index reached a high of over 1,527 in March 2000 and currently stands at only 1,377. More discouraging, the current NASDAQ Index for smaller, over-the-counter stocks is at 2,350, less than one half of its record of 5,048 also set in March 2000. These broader indexes clearly suggest that many investors retain bitter memories of the bursting stock market bubble and indicate that the markets have a long way to go before recouping their realized losses.

After the stock market collapse, many investors shifted to real estate speculation fueled by low interest rates, double-digit price increases, and intense baby boomer participation. Unfortunately, the real estate market has recently cooled, with the August median sales price for an existing home down 1.7 percent from a year earlier, the first yearly drop in over a decade. As investors search for the next hot investment, they never seem to heed Kin Hubbard's advice, "The safest way to double your money is to fold it over once and put it in your pocket." Since consumer spending continues to grow, investors are not putting money in their pockets and they certainly are not saving it—the U.S. savings rate on a national income account basis is now -1.7 percent, down from 12 percent in the early 1980s!

Of course, there are some notable bright spots in the financial picture:

- Energy and commodity prices are now dropping, providing welcome material and psychological relief to consumers and businesses.
- The Fed appears to be finished with interest rate increases.
- Corporate income and balance sheets remain strong.

With this as a backdrop, the question on everyone's mind is, "What does the future hold?"

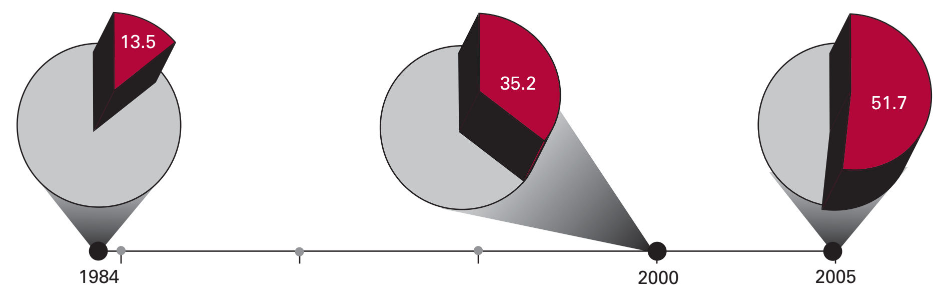
## Interest Rates

The new Federal Reserve Chairman, Ben Bernanke, continued the Greenspan initiative of increasing the short-term federal funds rate until August 2006, ending with 17 consecutive 25 basis point increases to a level of 5.25 percent. Such increases are likely to be finished if the economy's core inflation rate has moderated and the Fed no longer sees its main job as fighting inflationary pressure. We believe that job is completed and that the federal funds rate will remain at 5.25 percent for most of the year, with a possible increase later in 2007.

Since short-term rates have risen much more than long-term rates, the yield curve is now downward sloping, with short-term interest rates above long-term rates. Historically, the spread between long and short-term rates is a predictor to economic activity and the currently observed negative spread is generally followed by a downturn in the economy. In fact, each of the six previous recessions were preceded by an inverted yield curve.

However, we do not think the current inverted yield curve is indicative of an upcoming recession because it is as much a creature of foreign holdings of U.S. Treasury debt as it is investor expectations. The percentage of outstanding Treasury bonds held by foreigners has increased from 13.5 percent in 1984, to 35.2 percent in 2000, to 51.7 percent in 2005 (see **Figure 1**). In particular, Japan and China have purchased massive quantities of Treasury bonds to forestall the dollar's depreciation against their currencies. This strategy protects their export industries

**Figure 1**
**Percentage of Outstanding Treasury Bonds Held by Foreigners**




Source: U.S. Department of the Treasury

by keeping the price low for U.S. consumers.

Our forecast of inflation at about 3 percent for the upcoming year implies that short-term real interest rates will approximate 2.25 percent, which is within historical norms. The anticipated small decrease in inflation we are projecting suggests that ten-year Treasury yields will remain at the current 5 percent level, inching up to around 5.25 percent by the end of 2007. Corporate interest rates will exhibit similar small increases by the end of the year. However, the prime rate is expected to remain stable at a level of 8.25 percent. On the other hand, we anticipate mortgage interest rates to remain at current 6.3 to 6.4 percent rates for awhile and then creep up to the 6.7 percent level by the end of the year as borrower credit quality diminishes.

> *"The continual increase in health costs and fringe benefits will push profit growth down to the 6 percent to 8 percent level in 2007, less than half the growth rate for 2006."*

## Corporate Profits

Corporate profits have had a historic run, with S&P 500 operating profits showing double-digit yearly gains for a record seventeen quarters. We expect that the run will end this year. Rising costs of inputs, including material, energy, and labor, plus the continual increase in health costs and fringe benefits will push profit growth down to the 6 percent to 8 percent level in 2007, less than half the growth rate for 2006. Since productivity growth will fall to a level of 1.65 percent in 2007, it is not enough to offset these rising costs. Productivity will be hurt by slower growth in the economy and the limited opportunities to cut costs since they have already been pared to the bone in most organizations. Global competition remains fierce in virtually all markets, but the continued weakness in the dollar will help U.S. exporters remain competitive. Although we see very few reasons to expect a major business slowdown at this time, we also do not see a major upturn either.

The U.S. automakers, however, will be relatively hard hit as General Motors, Ford, and DaimlerChrysler have recently announced large production cutbacks to get their inventory levels back in order. In spite of closing facilities and buying out employment contracts with white-collar and blue-collar employees, the domestic producers are still struggling to get their labor costs in line. For example, General Motors' old SUV plant in Arlington, Texas, had total labor costs (including benefits) of $81 per hour, whereas Toyota's total labor cost at its new truck plant in San Antonio is estimated at $35 per hour—even though the factory is 40 percent smaller than the old GM facility. Furthermore, higher gasoline prices have hurt the sales of the profitable truck and SUV segments of U.S. auto companies.

Corporate balance sheets are strong with plenty of cash and borrowing power available to fund capital investments, which are expected to grow in line with the economy. Some of this financial muscle will be used to fund merger and acquisition activity as some firms adjust their strategies. The mountain of funds in private equity firms will add to the deal flow activity. In addition, a quantity of the cash flow will be dedicated to increased dividends or share repurchases.

## Stock Market

The stock market enjoyed an excellent October, rising 3.5 percent for the month, and, as of this writing, the Dow Jones Industrials were up 12.8 percent in 2006. The results throughout the year were all over the map—up, down, and sideways. The slow growth in the economy that we envision suggests that the stock market will continue to make gains. Some sectors (such as energy) will outperform others (such as autos), but the overall trend is up. If corporations disperse their cash hoard by paying increased dividends or buying back stock, the market will benefit. There is also some evidence that real estate and gold speculators are returning to the financial markets. Lower commodity prices are helpful to the market since empirical evidence suggests that price-earnings ratios are inversely related to commodity prices. Lumber prices are down to their lowest level in three years, and gasoline actually sells for less than it did last year, the first year-to-year drop since 2002. In the long run, we expect the stock market will offer returns of 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 during the bubble in the late 1990s. As always, prudent investors should continue to diversify their portfolios to guard against excessive exposure to any individual stock, market, or asset category. It may not be exciting, but one can sleep well at night by avoiding major losses.

## Summary

The financial markets will mirror the slowly growing economy with relatively stable interest rates and normal increases in valuations in face of the global and domestic challenges outlined above. As always, there will be ups and downs along the way. Recall what Mark Twain so wisely noted, "There are two times in a man's life when he should not speculate: when he can't afford it and when he can."