

Financial Forecast

have come in at a life support level around 1 percent. That the rate was more than 1 percent reflects several positive influences. First, the international trade picture improved. While this was partly due to a weak dollar, it is also driven by very good growth (the best ever, in fact) in the rest of the world. Second, business investment in structures and in high-tech equipment has been strong. Finally, consumption spending by households weakened, but did not collapse.

We expect a continuation of this basic pattern—solid trade numbers, adequate investment, and consumption at a level that is sufficient to maintain forward momentum in spite of continuing declines in the housing sector and pressure from energy prices. Some details:

- We expect output to grow about 2.5 percent in 2008. That will be slightly below 2007, and also below the long-run potential of the economy. Growth will be slower in the first half of the year, with some acceleration after mid-year.
- Employment will expand by about 1.1 million. Unemployment will rise early in the year, reaching perhaps 5 percent, and then will stabilize.
- Inflation will moderate from 2007, with assistance from relatively stable energy prices. The consumer price index will increase about 2.6 percent.
- The Federal Reserve, which lowered its target for the federal funds rate to 4.50 percent in September and October (from 5.25 percent), will cut the rate at least another 25 basis points.

This is a relatively optimistic scenario. It rests on some improvement from the 2007 experience in three areas.

1. We expect oil prices to moderate from their recent peak. Although the average for the year will at least match 2007, the upward trend will end.
2. The world economy will continue to be strong, allowing exports to be a solid support for the economy. Further depreciation of the dollar will contribute to this outcome.
3. While housing will continue to weaken, the extent of its drag will lessen as the year proceeds. More importantly, troubles in this sector will not lead to a major retrenchment in consumption.

For each of these three, a less favorable scenario can by no means be ruled out. Energy prices have a substantial speculative element, and the political situation in the Middle East continues to exhibit significant instability. A crisis in that area could easily drive prices into totally uncharted territory. This would be bad for both the domestic economy and the world economy as a whole. The extremely strong growth in East Asia probably cannot continue

indefinitely in any case. Finally, the very weak demand in the housing market could have more impact on housing prices than we foresee. If so, there could

be a severe impact on consumer confidence.

We think that 2008 will be another year in successful survival mode. The crucial household sector will face pressures from several directions, but will not collapse. While there are definitely risks, there are enough positive signs to sustain moderate economic growth. ■

“The crucial household sector will face pressures from several directions, but will not collapse.”

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The financial markets performed quite well for the first half of 2007, with the Dow Jones Index crossing the 14,000 threshold on July 19. Then the subprime mortgage mess hit, reminding all investors that investments are indeed risky and must be priced accordingly. This marked the end of a big party in real estate—one that was reflected in popular “flip this house” TV shows and incredible speculation by amateur real estate investors who did not have the resources to weather a downturn in the market. It all seemed so easy: put a small pre-construction down payment on a property in a new development, wait for the price of the yet-to-be-built property to soar, wait again until the property is complete with yet another price increase, and, finally, sell to another “investor” for a sizable gain without ever occupying the real estate. It became clear to all: a house was no longer a home ... it became a financial asset with windows!

All of the real estate market participants had to come together to make this possible: lenders, buyers, real estate agents, and investors. Lenders supplied low interest rate financing to the developers to get the projects underway and then provided generous credits to low-quality buyers. Little or no loan documentation was required from these buyers to qualify for a substantial adjustable rate mortgage with an unrealistically low initial payment stream. Real estate agents guided homebuyers and speculators through the process with visions of ever-increasing fees. Foreign and domestic investors displayed a voracious appetite to purchase the subprime mortgages that lenders, with help from their friends on Wall

Street, repackaged into collateralized debt obligations (CDOs) with varying slices, or tranches, of risk/return characteristics that catered to the investors' portfolio needs. The credit agencies complied by assigning the highest rating possible to the CDOs to assuage the investors' fears of default. Once the CDOs were sold, the lenders had the cash to start the process anew and years of frenzied growth ensued. However, as the dates for resetting the payments for the underlying adjustable rate mortgages were reached, payments dramatically increased. Such increases were required to cover the initially low teaser payments and to reflect the interest rate increases orchestrated by the Federal Reserve to cool the economy and fight inflation.

As the growth in housing prices stalled, new financing on the property could not be arranged to bail out the borrower. Borrowers had no recourse except to try to sell the property at distressed prices or walk away if the amount owed was greater than the property was worth. If foreclosed, the mortgaged property was auctioned off, further depressing real estate prices. In the end, interest rates spiked up (especially for lower credit quality loans); real estate prices fell as speculative fever waned; realistic expectations of risk/return tradeoffs returned to the market as the prices of existing CDOs collapsed and the market for new CDOs disappeared; and residential construction slowed to a crawl in many parts of the country.

In addition to this subprime mortgage mess, investors are also concerned about oil price uncertainty,

the continuing wars in the Middle East, and political gridlock in Washington. With this backdrop, the markets are re-pricing risk and reassessing the future.

Interest Rates

When faced with his first financial crisis caused by the subprime mortgage debacle, Federal Reserve Chairman Bernanke acted on August 17 to cut the discount rate charged to bank borrowers by a substantial 50 basis points. Previously, the Federal Reserve injected \$43 billion of liquidity into the system, the European Central Bank \$191 billion, and the Bank of Japan \$8.4 billion. These coordinated efforts were meant to establish liquidity in the market, stabilize exchange rates, and calm credit markets. Although they did restore a measure of confidence to the markets, the London Interbank Offered Rate (LIBOR) rose to its highest level in seven years, indicating that the markets were still unsettled. On September 18, the Fed also cut the federal funds rate by 50 basis points to 4.75 percent. On October 31, the Fed celebrated Halloween by lowering both the federal funds rate and the discount rate by another 25 basis points.

We expect the Fed to continue with this calming influence and reduce the federal funds rate to 4.25 percent by the end of 2008. Evidently the Fed no longer sees its main job as fighting inflationary pressures but rather one of maintaining calm in the markets. We expect the budget and trade deficits to continue and the value of the U.S. dollar to slide even more. A key question in this

scenario is whether foreign investors will continue to purchase the massive amounts of government bonds as they have in the past. In particular, China and Japan have supported U.S. trade by propping up the dollar from even greater declines with substantial debt buying. If this buying dries up, the dollar could fall precariously.

We expect that short-term rates will be lower than long-term rates for the year. Thus, the yield curve will remain at its normal upward sloping shape. Our forecasted inflation of 2.6 percent for the upcoming year implies that short-term real rates of interest will be below 2 percent, which is at the lower end of historical norms. The decrease in inflation we are projecting suggests that ten-year Treasury yields will remain near the current 4.6 percent level, perhaps inching up to the 5 percent range by the end of 2008. However, we expect the prime rate to remain stable at a level of 7.5 percent, and we anticipate fixed thirty-year mortgage interest rates to remain in the current 6.1 percent to 6.2 percent range. Clearly, as lenders demand a premium for credit risk, rates for low-quality loans will be higher—perhaps a level of 6.7 percent by the end of the year. Very risky subprime borrowers will likely be unable to get credit.

Corporate Profits

Rising costs of inputs took their toll on corporate profits last year. Such inputs included materials, energy, and labor, plus the continually increasing health costs and fringe benefits. Profits rose only 7 percent in 2007, the lowest growth rate since 2001. **Figure 1** shows the most recent data for corporate profits. We forecast a similar performance for next year with corporate profits growing in the 6 percent to 8 percent range. Although productivity growth will increase to a level of 2.2 percent next year, this growth will not be enough to offset the rising costs, particularly energy costs. Global competition

“A subprime loan is a loan made to someone who does not qualify for a more favorable rate because of low credit scores. These loans have higher interest rates and fees than prime loans.”

—For a more detailed explanation, see the housing article on page 8

remains fierce in virtually all markets, but a continued weak dollar will help exporters remain competitive and will produce some trade gains. Real gross domestic product (GDP) growth of 2.5 percent suggests a steady business climate for next year.

The U.S. automakers have been renegotiating their contracts with the UAW and progress has been made in controlling labor and health care costs for the domestic companies. This will marginally help their competitive positions in the long run. It is important to note, however, that Toyota has overtaken Ford as number two in the U.S. auto market and is quickly gaining on General Motors.

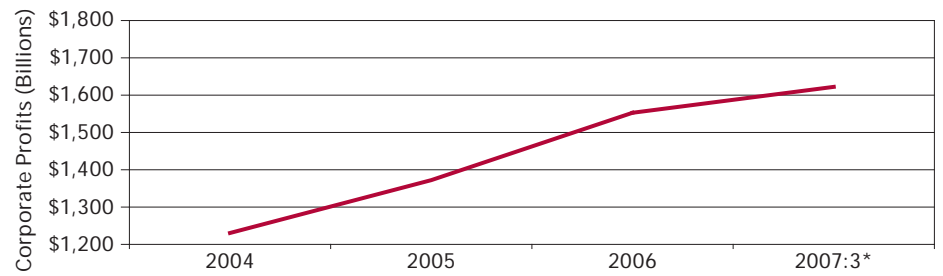
Of all the sectors, the financial sector will be reporting the weakest profits in the coming months as it writes off the losses from its subprime activities. Large commercial and investment banks, as well as some hedge funds, will be particularly hard hit. For example, Merrill Lynch just wrote off \$8.4 billion, a bigger-than-expected write-down on the values of its subprime mortgages and collateralized debt obligations. Barclays and Citicorp have also written off over \$10 billion each.

Corporate balance sheets remain strong with plenty of cash and borrowing power available to fund needed capital investments. Merger and acquisition activity will slow from its torrid pace last year as the private equity firms absorb the deals they have consummated and as they re-price the risks inherent in their strategies. Dividends and share repurchases are expected to increase as companies share their success with investors.

Stock Markets

After hitting its high in July, the Dow dropped below 13,000 on August 15 and the S&P 500 crossed into negative territory year-to-date. Similar drops occurred in virtually every market in the world, with Brazil and Korea being particularly hard hit. Large

Figure 1
Corporate Profits



*Data for the third quarter of 2007 are preliminary and seasonally adjusted at annual rates
Source: Bureau of Economic Analysis

daily drops became common: for example, the Korean market dropped about 7 percent in one day. The largest daily drop by the S&P 500 was 50 points on February 27, as a result of the growing subprime crisis.

Overall, the stock market through September was up for 2007 with the Dow Jones Industrials up 12.7 percent and the broader S&P 500 Index up almost 10 percent. The period was especially good for small stocks, with the NASDAQ up 14.7 percent. Thus, the subprime mess was only a temporary setback for the markets.

The steady economic growth we envision suggests the stock market will continue to make gains in 2008. While steady growth will continue, some sectors will do better than others. For example, gold speculators are returning to the financial markets, with the price of gold reaching \$800 per ounce on October 31. This is the highest gold has been since the high inflation year of 1980. However, the big run-up in energy stocks is likely over, banks and other financials will be hurt by the subprime mess, and the consumer goods sector depends on the consumer confidence and the strength of the Christmas selling season. Additionally, on August 14, Wal-Mart (considered a barometer of the health of the U.S. retail sector) reported lower-than-expected second quarter profits and cut its projected full-year earning forecast. Wal-Mart plans to discount heavily in the months ahead, which would cause further damage to margins.

Increased dividends and stock buybacks will provide support for the market. In the long run, we continue to expect the stock market to offer returns of 6 percent to 8 percent above treasury bonds, which is in line with the market's historical average performance since 1926. As always, prudent investors should continue to diversify their portfolios to guard against too much risk 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, especially as the market continues to re-price risk.

Summary

We predict that the economy and financial markets will exhibit growth in 2008. The results will be choppy over time but investors will be appropriately rewarded for the risks inherent in their investments. The good news for investors is that the markets are re-pricing the risks in line with historical experience. The bad news is that some investors will always be tempted to reach for return and pay too much to speculate. We've seen it all before: tulip mania in Holland in the seventeenth century, the South Sea bubble in 1720, the roaring twenties, the Japanese bubble economy of the late eighties, the Internet bubble in the nineties, and now subprime mortgages. The lesson is clear—don't be tempted to speculate with your hard-earned dollars. ■