The world economy remains in a broad and powerful economic expansion. This reflects accommodative macroeconomic policies worldwide.

Over the last several years, the U.S. has pump-primed the world economy in two ways. First, U.S. monetary policy was stimulative for an extended period time. Second, rising import demand from a strong U.S. economy fostered export expansion overseas. As U.S. monetary policy shifts to neutral and the growth of U.S. imports slows somewhat, the U.S. economy will be less stimulative for the rest of the world. Fortunately, domestic sources of growth have strengthened overseas — in Europe, Japan, China and many emerging market countries. As a result, 2006 should be another year of strong economic growth worldwide.

Concerns that the major oil price upsurge would substantially weaken the world economy, as it did in 1973-74, 1979-80 and 1990-91, have not been validated. There were two reasons for this. First, oil price strength this time was more attributable to the strength of economic growth worldwide than to a supply disruption. Second, the world was very inflation-prone in each of the prior three occasions, requiring aggressively restrictive monetary policy to suppress the pass-through of energy inflation to broad inflation. In the prior oil price spikes, energy inflation created a major broad acceleration of wage and price inflation. Today, the world is less inflation-prone due to globalization and rapid growth of supply from low cost regions of the world. As a result of the limited pass-through of energy inflation to broader wage and price inflation to date, world macroeconomic policy has been able to remain broadly accommodative of economic expansion.

For nearly two years, U.S. monetary policy has been shifting from stimulative to neutral while easy monetary policy has prevailed elsewhere in the world. With the Fed raising the Federal funds rate one quarter of one percent about every six weeks, the result was a dollar rally during 2005, as interest rate spreads widened in favor of the dollar. Even though Europe has begun to tighten and Japan is on a slow-motion path to begin tightening, the interest rate spreads in favor of U.S. dollar investments remain high. In the near term, we expect the dollar to remain well bid. However, if and when the U.S. economic growth rate decelerates and other countries significantly increase their interest rates, the odds would favor a renewed dollar downtrend in 2007, perhaps beginning in late 2006.

You can prove anything with carefully selected statistics and that will be true of real GDP statistics in the U.S. The temporary weakness in the fourth quarter of 2005 (due to Hurricane Katrina and the timing of auto incentives) should be followed by temporary strength in the first quarter of 2006 (unwind of the prior quarter’s special factors plus the warmest January in a century). The underlying story is likely to be much less dramatic, as the pace of U.S. economic growth is likely to gradually decelerate from somewhat above-trend growth to near-trend growth.

Quarterly GDP growth rates were in the 3.3% to 4.3% range for each of the eight quarters ending in the third quarter of 2005. The four quarter growth rate of real GDP was a somewhat above-trend 3.6% to 3.8% for each of the five quarters ended in the third quarter of 2005. We would expect a real GDP growth rate averaging 20 to 30 basis points slower than that over the subsequent five quarters through the end of 2006, nearer to trend growth. The growth rate over the four quarters of 2006 will exclude the weak fourth quarter of 2005 and include the expected strong first quarter of 2006, so it should be within or close to the 3.6% to 3.8% range. For the four quarters of 2007, we would expect a deceleration to somewhat below-trend economic growth near 3%, reflecting the lagged impact of tighter monetary policy and weakness in housing.

We expect the slow emergence of a prolonged weakness in housing, the most interest-rate-sensitive segment of the U.S. economy. We believe the investor-owned condo market should weaken quickly as the aftermath of momentum speculation kicks in. In some regions, owner-occupied houses have also become
extended with a high proportion of recent purchases aggressively financed. These should also weaken. Nationwide, however, we expect more of a stall in the prices of owner-occupied homes. Neither of the two main fundamental triggers for severe housing weakness (sharply higher unemployment rates or sharply higher long-term mortgage rates) are features of today’s economy. As a result, we expect a gradual, moderate and prolonged weakness in housing. Given the lags involved, we would expect the greatest weakness in residential construction in the second half of 2006, continuing in 2007.

A volume adjustment should balance some of the weakness in demand and limit downside pressure on house prices. We expect a downtrend in housing starts and completions over the next 18 months. Demand for construction labor and building materials for federally subsidized hurricane rebuilding should keep the supply cost of new homes relatively high. With construction costs remaining high and demand cooling, a profit margin squeeze on builders should generate a decline in the volume of new homes.

We do not agree with the thesis that a weakening housing market will generate a major economic slowdown in 2006. The negative trend in residential construction is likely to coincide with a major deceleration in reported inflation. In an economy with a relatively tight labor market, that should underpin real income growth. The crest in energy prices at the time of Hurricane Katrina drove the 12-month rate of change in reported inflation to 4.7% in September 2005. With energy prices stalling, this reported inflation rate is likely to drop down towards 2% by the end of 2006. The resulting strength in real income growth should offset much of the effect of a weaker housing market in 2006.

There should be enough real income growth to accommodate both consumption growth at a somewhat slower pace and a modest rise in the savings rate. Recent data from the Federal Reserve’s “Report on Consumer Finances” reveals that much of the recent weakness in the savings rate has occurred among the higher net worth segments of the population, many of whom should face little difficulty in maintaining their spending.

Reported inflation (a key to real income growth) should trend down in 2006, but we expect core inflation (a key to Federal Reserve policy) to drift higher. This is a risk that also worries some at the Fed. Leading Fed officials agree on a “central tendency” forecast for core inflation for the four quarters of 2006 of about 2% (up from 1.50% to 1.75% forecast 12 months earlier and from 1.75% to 2.00% forecast six months earlier). However, their forecast range is now 1.75% to 2.50%, with some officials expecting core inflation to be one-half of one percent above the general consensus at the Fed.

Ben Bernanke is one of the most committed advocates of a pre-announced inflation target in the financial world. While we do not expect the Fed to announce any kind of official inflation target any time soon, we believe that the consensus of Fed governors for a long-term core personal consumption deflator inflation target is probably 1% to 2%.

Twice a year, the Fed holds a special FOMC meeting and then releases the “central tendency” and “range” of economic forecasts of all of the members of the Board of Governors and the Presidents of the Federal Reserve banks. We believe that the central tendency forecast for the core PCE inflation rate will be treated by the market as an unofficial short-term inflation objective, namely 2% for the four quarters of 2006 and 1.75% to 2.00% for the four quarters of 2007. It is extraordinary that every forecast of nearly 20 Federal Reserve officials for 2007 core inflation fell within a very tight 25-basis point range of 1.75% to 2.00%. In this context, any rise in the core PCE inflation rate significantly above 2% would raise Fed concerns about risks to their credibility.

We believe that there are basically four scenarios for Federal Reserve policy in the coming months: “long pause,” “pause and resume,” “straight up,” and “cycle peak and early ease.” Our view is that either a “long pause” or a “pause and resume” pattern is most likely, with a pause likely in the Federal funds rate at or close to 5%. A “straight up” pattern of another 100– to 150-basis point rise without a pause seems unlikely if housing indicators continue to weaken, as we expect. A “cycle peak and early ease” also appears
unlikely since resource utilization is relatively tight and Federal Reserve credibility could be weakened by a premature ease. Our view of the probability of these different scenarios reflects our judgments that (1) economic growth will persist at a near-trend rate later in 2006, with strong odds of above-trend growth early in the year, (2) financial liquidity is still ample, with the rise in the Federal funds rate reflecting a shift to neutral monetary policy rather than to tight monetary policy, and (3) core inflation will be under moderate upward pressure over the course of 2006 due to tighter labor markets and goods markets, despite a sharp deceleration of reported inflation as energy inflation stalls.

We believe that the key to the economic and market outlook is a correct interpretation of financial liquidity. Our view is that even after 14 tightenings by the Federal Reserve over the past 20 months, with an additional two increases currently anticipated, there is still ample financial liquidity. This is due in part to a legacy stock of financial liquidity that was created by an extended period of hyperstimulative monetary policy. With the exception of a few troubled industries (autos, airlines) and a relatively small proportion of the consumer sector, most financially weak borrowers have been successfully refinanced. This includes U.S. corporations, foreign corporations and emerging market countries. Risk spreads are very tight, which is consistent with the thesis that financial liquidity is easy.

The pessimists argue that we are in the ninth or tenth inning of the financial liquidity cycle and the odds of recession are high. Their logic is that the Fed has tightened many times and that this will ultimately generate major economic weakness, quite possibly a recession. We believe, however, that one needs to evaluate a three-stage process to judge the risk of future economic weakness: (1) central bank rate rises, (2) reduced financial liquidity and (3) economic slowdown. In this cycle, there has been a slippage between Federal Reserve rate increases and the tightening of financial liquidity. We believe that Federal Reserve rate increases have not yet tightened financial liquidity in any major way.

It is financial illiquidity, with the denial of credit to weak borrowers, which triggers the “cycle peak financial crisis,” generating economic weakness and a cyclical peak in interest rates. As a general rule, the final cyclical peak in interest rates does not occur until there is a major financial crisis.

Pessimists on the U.S. economy point to precedents of prior periods of substantial rises in the Federal funds rate. However, in contrast to past periods when the Fed shifted from a neutral policy to a tight policy, the Fed has only tightened from hyperstimulative to neutral so far in this economic expansion. In addition, world monetary policy remains easy. Japan retains a zero interest rate despite sustained economic expansion and an emerging transition from deflation to moderate inflation. Europe has only tightened 50 basis points so far, despite a strengthening economy. The most recent move by the Bank of England was towards ease and it appears to have entered a “long pause” after only 25 basis points of easing. China and other countries in Asia have strongly stimulative macroeconomic policies with low real interest rates, low exchange rates and subsidies or price controls to reduce the drag of higher energy prices. Low interest rates abroad have cushioned the impact of a rising Federal funds rate, as foreigners have been attracted to higher yielding U.S. investments, limiting the upward pressure on longer-term interest rates in the U.S. We continue to expect moderate upward pressure on long-term yields worldwide, with 10-year U.S. Treasury bond yields likely to eventually breach 5%. However, the upward cyclical pressure on bond yields is occurring within a longer-term context of moderate inflation and moderate real interest rates. The gradual nature of the cyclical rise in long-term rates is muting its restraining impact on the economy.

Some traditional measures of financial liquidity, such as monetary growth or the yield curve, show some signs of tightening. However, direct measures of financial liquidity remain easy: junk bond spreads are narrow, emerging market bond spreads are narrow, countries with a recent history of default are financing long term at favorable interest rates, private equity funds are making aggressive cash bids for corporations, and the Fed senior loan officers’ survey shows ample availability of credit. Throughout the financial system, the compensation for taking on risk is quite low so few borrowers are being denied credit or even forced to pay a high interest rate to get it. We believe the evidence is clear that financial liquidity is easy rather than tight so far.
The yield curve is now slightly inverted, with short-term yields above long-term yields. In the past, inverted yield curves have preceded economic recessions and profit recessions. There are two reasons for this. One is that the marginal profitability of extending credit by banks and other financial intermediaries tends to dry up as the yield curve inverts. Ex-Chairman Greenspan has argued that this effect may be muted in this expansion by the increased use of market-based financing which is not intermediated by the banks. We believe that this is likely to be true when the yield curve is only slightly inverted, but would be a weaker argument if the yield curve were substantially inverted. In that case, the credit supply from both the banks and the markets might be restrained.

The second reason why inverted yield curves are good forecasters of future recessions is that they embed the market expectations about future short-term rates. When the yield curve is inverted, it reflects a market consensus that short-term rates will be lower in the future than they are today, presumably due to expected economic weakness. While we would regard a severely inverted yield curve as a valid signal of a major economic slowdown in the future, slight inversions of a few basis points are likely to be consistent with only a mild future deceleration in the growth rate of the economy. We expect that the U.S. yield curve will be slightly inverted over the course of 2006, presaging somewhat slower growth in 2007.

Confirming evidence that financial liquidity remains ample is that high-risk financial assets have continued to outperform high quality financial assets despite more expensive valuation for many risky assets. We believe that the transition to quality leadership has been postponed precisely because the transition from easy financial liquidity to tight financial liquidity has been slow to emerge.

In an environment of ample corporate financial liquidity, many firms have unused financial capacity to borrow. The deleveraging of corporate America has probably run its course and the next stage is likely to be a gradual trend of releveraging corporate America. The mechanisms of releveraging are likely to differ between small and mid-cap stocks on one hand and mega cap stocks on the other hand. For small and mid-cap companies, leveraged buyouts are currently relatively easy to finance since junk bond spreads are so tight. Mega caps tend to be impervious to takeover, but may still choose to releverage by debt-financed stock repurchases or other means.

We believe that the relative performance of high-risk versus quality stocks and small cap versus mega cap stocks is likely to be sensitive to which of the four Fed scenarios prevails. The “early cycle peak and early ease” scenario might be consistent with even further outperformance by risky assets once the ease began to be discounted. The “pause and resume,” or “straight up” scenarios would tend to eventually favor high-quality assets as they would result in a tightening of financial liquidity and a significant slowing of profit growth. Relative performance under the “long pause” scenario is ambiguous, with relative valuation likely to be the dominant factor. We believe that the transition from outperformance of high-risk financial assets to high quality financial assets is likely to occur at some point this year as liquidity is slowly drained out of the financial system, the markets begin to discount slowing profit growth in 2007 and respond to the cumulative change in relative valuation which has occurred over the last several years.

Mr. Hoey's comments are provided as a general market overview and should not be considered investment advice or predictive of any future market performance.

Mr. Hoey's views are current as of the date of this communication and are subject to change rapidly as economic and market conditions dictate. Contact Dreyfus or your advisor for current information about Mr. Hoey's views of the economy and the markets.