Both the U.S. and world economies are in a sustained economic expansion entering 2006. The world has been flooded with financial liquidity over the last several years in an environment that is much less inflation-prone than in past decades. The economic pessimists have focused on a moderate slowdown in the flow of new liquidity, but it is the ample existing stock of financial liquidity that is supporting the broad worldwide expansion. In the U.S., extremely easy monetary policy over the last several years created vast pools of excess liquidity. Symptoms of this ample liquidity were (1) the ease of refinancing weak borrowers, (2) tight junk bond spreads, (3) tight emerging market bond spreads, (4) easy credit availability in the Fed’s survey of senior loan officers, and (5) a strong appetite for risk among leveraged investors and speculators. In addition to excess financial liquidity in the U.S., Asian countries have maintained low real yields and ample financial liquidity.

A review of the economic outlook in major countries for 2006 indicates favorable odds of sustained economic expansion worldwide. Asian countries have been running expansionist policies. China’s macroeconomic policy includes low real interest rates and low exchange rates, with policies that stimulate strong growth of supply capacity helping to hold down inflationary pressures. Similar policies are in place elsewhere in Asia. While China and other Asian countries may see some slowing in the rate of growth of exports in 2006, the magnitude of any overall growth deceleration should be quite limited given their stimulative macroeconomic policies. Real interest rates and real exchange rates remain low throughout Asia.

Japan has finally made a fundamental exit from the decade-and-a-half hangover from the Nikkei bubble. The labor markets have strengthened and the financial condition of the banks has improved substantially. Japanese real yields have been falling as the nominal policy rate has stayed at zero while deflation has moderated. We expect continued economic expansion at a 2% to 3% pace in Japan in 2006.

Europe has been the caboose of the world economy, but economic indicators strengthened enough by late 2005 that the ECB felt comfortable in beginning to raise interest rates. We expect economic growth of 2% in Europe in 2006, which would represent an improved economic outcome after several years of sluggish growth.

Measured by quarterly GDP growth, the U.S. economy ends 2005 on a relatively weak note. Fourth quarter real GDP should be characterized by a stall in real consumption, widening real net exports and a rise in inventories. However, we believe that this will be a false dawn of economic weakness, attributable largely to the 2005 hurricanes. Inventories are rebounding towards normal after a sharp slowdown. Due to volatility in the auto sector plus the effects of Hurricane Katrina and the brief spike in gasoline prices it caused, real consumption was weak in August and September, at the end of the third quarter. When an economic variable is weak at the end of a quarter, much of that weakness may be reported in the quarterly growth rate for the next quarter. In this case, much of the weakness in the growth rate of fourth quarter real consumption will actually have occurred late in the third quarter. Katrina was also a major cause of the net export erosion as the volume of energy imports in the fourth quarter has been pushed up by the reduction in domestic energy supply. We do not believe that the weak final sales growth likely to be reported for the fourth quarter of 2005 will represent the onset of sustained economic weakness, especially since hurricane rebuilding will be financed by a Federal fiscal easing in 2006.
We expect U.S. economic expansion at about a 3.5% pace in 2006, despite a shift in growth away from interest sensitive sectors. The labor market remains relatively strong and reported inflation (including food and energy) has already begun a likely halving from its peak 4.7% 12-month rate of change in September 2005. The rebound in real income growth due to falling reported inflation should largely offset the impact of the likely stall in house prices. We expect strength in both capital spending and exports in 2006 to contribute to the expansion.

We agree with those analysts who argue that the outlook for housing prices is critical to the 2006 outlook. Where we differ from the pessimists is that we expect a stall rather than a plunge in nationwide owner-occupied house prices over the four quarters of 2006 and believe that the lagged benefit to consumer net worth from past price appreciation will help offset the early phases of the slowing in house price inflation.

The most vulnerable mortgages tend to be narrowly concentrated among the more aggressive mortgages issued in the last year or two, which are a minor proportion of the total outstanding stock of mortgages on owner-occupied homes in the U.S. With a relatively strong labor market nationwide in prospect for 2006 and Fed policy destined to be no tighter than moderately restrictive, we place low odds on the nightmare scenario for house prices in 2006. While house prices should be weak in 2006, a gradual rolling stall with pockets of decline seems the most likely scenario.

The Hurricane Katrina rebuilding will tend to add to the demand for construction goods and construction labor, holding up the supply price of new homes nationwide, thus squeezing builders' profit margins on new homes. As a result, a volume adjustment in the form of a substantial decline in housing starts should absorb some of the demand weakness, limiting downward house price pressures. We would expect substantial weakness in investor-owned housing, some weakness in areas where aggressive financing of owner-occupied homes was most intense and a more neutral house price outlook for most owner-occupied houses.

It is true that outstanding household mortgage debt in the most recent flow of funds accounts totaled $8 trillion in the third quarter of 2005, but it is also true that household net worth has risen $7 trillion from $44 trillion in 2003 to $51 trillion in the third quarter of 2005. Household liabilities have risen, but household assets have risen even more. Under these circumstances, a stall in nationwide house prices is likely to have much more limited consequences than would a plunge in house prices.

Our view of the housing market influences our view of Fed policy in 2006. In the absence of a sharp crack in the housing market, we expect the Fed to adopt a monetary policy of moderate restraint for an extended period of time. This policy would be dedicated to preventing core inflation from drifting higher, an objective that should be achieved more by the long duration of moderately restrictive policy than by its severity. While the Fed does not target asset prices, it is likely to monitor house price trends as it updates its economic forecasts for 2006 and 2007.

We place low odds on an early cyclical peak in rates and subsequent monetary policy ease for three reasons. First, we think expectations of a quick plunge in housing prices are overwrought. Second, capacity utilization has tightened in the goods and labor markets, raising the risk of an upward drift in core inflation. Third, with the new Fed Chairman so identified with the credibility benefits of inflation targeting, there is a reputation risk to the Fed if it tolerates an upward drift in core inflation or eases with core inflation near the upper limit of its perceived inflation target range.
For the securities markets, the combination of sustained economic expansion at a near-trend rate and an extended period of moderately restrictive monetary policy imply a moderate midcycle year. The midcycle precedent from 1994-1995 differed in important ways from the current cycle. The Fed’s tightening was a shock to the market in 1994 and drove long-term yields substantially higher. The relief rally in the stock market when the Fed stopped tightening and began to ease in 1995 was quite powerful. In this cycle, the Fed’s tightening was a surprise to no one and 10-year Treasury bond yields are currently less than 20-basis points above their average yield over the last two years. With monetary restraint so moderate, we believe that any easing is likely to be postponed until 2007. On the other hand, the limited intensity of the upward pressure on core inflation lowers the odds that the Fed will move to a severely restrictive policy. The outcome for the securities market is likely to be a muted midcycle year. We expect some further rise in long-term yields with 10-year Treasury bonds likely to eventually trade somewhat above 5%.

With profit growth decelerating and financial liquidity being gradually reduced, we would expect growth stocks, large capitalization stocks and high quality stocks to provide relative leadership within the stock market over the course of 2006.

*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.*