What’s the outlook for the economy, the dollar, oil prices, inflation, the Fed, the bond market, profits and the stock market?

For the economy, we believe that the main development is the transition from above-trend economic growth to near-trend economic growth. We interpret this as a transition to midcycle economic dynamics, with little risk of a full-scale recession. There are always short-term subcycles of faster and slower growth, but we believe that the growth rate around which these subcycles will occur is now near-trend growth, a somewhat slower pace than has occurred over the past two years. If our expectations are correct, there will be short subcycles of below-trend and above-trend growth around a near-trend average. We may well be entering a spring soft patch of below-trend growth. Both the deceleration to near-trend growth and the prior period of above trend growth actually fulfill the policy objectives of the Federal Reserve, which now desires a slower pace of expansion as the excess capacity in the goods market and the labor market has been reduced.

For investors, the most crucial question is whether the signs of slowing over the last month merely indicate a phase of slowing within a long multiyear economic expansion or are the first signs of serious recession risk. Among the reasons we believe this is a slowdown within a long cycle is that (1) the inflation uptrend is occurring within a relatively low inflation environment, (2) the Fed has tightened early enough to avoid the need for a recession to halt an inflation upsurge, and (3) a vast pool of financial liquidity has been created by past monetary stimulation. Corporations are flush with financial liquidity and thus problems in one corporate sector may not easily spread to the entire economy. The consumer has less financial liquidity but fortunately the unemployment rate has fallen. We expect sluggish consumer spending but not a decline.

What about the dollar? We argued in our recently released State of the Debate report entitled “The Dollar Debate” both that (1) the dollar should be in a stabilization this year now that U.S. real interest rates have risen relative to foreign real interest rates, and (2) any future downtrend (possibly in 2006) would tend to be orderly. Please see our dollar debate report for details. Given that the Fed is concerned about the updrift in inflation, a period of dollar stabilization or rally is supportive of their objective of holding down core inflation.

What about oil? We believe that the multiyear trading range of crude oil prices has shifted from the $10 to $30 per barrel range to the $25 to $60 per barrel range due to increased demand from Asia and slow supply growth. If this is correct, the $58 crude oil price on April 4, 2005 may prove to be the peak. Our expectation has been that oil prices would begin to drift down as the rate of growth in the U.S. and world economies decelerated and we believe that this process has begun.

Economists sometimes talk about the nonlinearity of the effect of oil prices on the economy. What this means in plain English is that a move way below or way above the prevailing range may have a proportionally bigger impact on the economy than changes inside the prevailing trading range for oil. A short-hand way of thinking about this is to examine the spread between the current oil price and a two-year or four-year moving average. At $58, crude oil prices were $20 above their two-year average of about $38 and $25 above their four-year average of about $33. At $40, crude oil prices would be only $2 above their two-year average and $7 above their four-year average. We believe the odds of a gradual easing of the oil shock are relatively good. We have a much easier time believing that oil prices could average $40 over the next year than that they could average $60, given the prospect of a more moderate pace of growth worldwide. Even Chinese oil demand could cool if coal-based electricity supply improves and there is a reduction in the use of high cost generators, which create demand for energy imports.
It is also important to recognize that oil prices impact the economy with a lag. The biggest impact usually occurs four quarters after the change in oil prices. Oil prices first rose above $40 about this time last year. The normal time frame for the high oil prices of the past year to be reflected in some slowing of demand is right now.

The Federal Reserve remains on a measured tightening path, but it has shifted its description of the logic of its tightening. The tightening is no longer merely a shift to neutral in the aftermath of a very accommodative policy. The Fed has now added recognition of the evidence of upward pressure on inflation. Our view is that the Federal funds rate will reach 3.5% to possibly 4% by year-end 2005. The pessimists have argued that an even higher level is likely based on the Fed's anti-inflationary comments. While we expect a continuation of an upward drift in core inflation, the magnitude of that rise should be moderate, perhaps another 50 basis points. We put some weight on the cooling in the interest-sensitive sectors of the U.S. economy, which should both limit inflationary pressure and moderate the Fed's hawkish views.

We continue to believe that there are good odds of a “pause and resume” pattern for the Federal funds rate in 2005 and 2006. The earlier the Fed pauses in its tightening in 2005, the more likely is an eventual resumption of tightening in 2006.

Stimulative Federal Reserve policy in 2003 helped generate a strong recovery in the economy and corporate profits. This in turn improved the finances of many high-risk companies and high-risk countries. The price of high-risk assets rose to the point where there was little compensation for risk. It is cyclically appropriate for that appetite for high-risk assets to cool in response to tighter monetary policy and slowing profit growth. Despite the short-term turbulence, the correct pricing of risk raises the odds of a long economic expansion, while mispricing of risk assets is a threat to the sustainability of the economic expansion. We thus regard the return to a more normal pricing of risk as strengthening the case for a long cycle of economic expansion, despite short-term volatility.

We believe that bond yields will fluctuate around an upward drifting moving average. So far, the uptrend has been slight. While short-term interest rates have risen substantially, long-term interest rates have risen only a small amount. The yield on 10-year Treasury bonds is currently only about 10 basis points above its two-year moving average. The center of gravity for 10-year Treasury bonds has been near four-and-one-quarter percent over that period.

Alan Greenspan labeled the failure of long-term interest rates to rise substantially a “conundrum.” There are a variety of explanations. One is that there are technical factors holding down bond yields. The U.S. Treasury, after selling 30-year Treasury bonds for most of the 20-year downtrend in interest rates, halted issuance in 2001. This has created a scarcity of long duration bonds at a time when there is the prospect of regulatory changes that might cause pension funds to increase their purchase of long-term bonds. Foreign central bank buying has also been cited. Another explanation is that despite the recent upward drift in core inflation, inflation remains relatively low due to the effect of globalization on pricing in the goods and labor markets.

However, it is actually real yields (yields minus inflation) that are low relative to the past. In his April 14, 2005 speech entitled “The Global Saving Glut and the U.S. Current Account Deficit,” Fed Governor Ben Bernanke cites the worldwide savings/investment balance as one explanation for low real yields. We believe that his argument that high savings rates in Asia may have contributed to the lower real yields in America makes sense.

Finally, some bond market optimists believe that the Fed has the wrong economic forecast, while the bond market has the right economic forecast. They expect that both inflation and real growth will be lower than the Fed fears. Recent evidence provides support for the case for slower economic growth near term, but not yet for the thesis that the upward drift in core inflation is over.
Our basic view is that the cyclical low in bond yields was reached in mid-June 2003 at 3.07% on 10-year Treasury bonds, and that yields should trace out a pattern of higher highs and higher lows, with the moving average of yields moving gradually higher into 2006. On a multiyear basis, we would expect 10-year Treasury yields to have a center of gravity in the 4% to 5% range. We expect 5% Treasury yields by late 2005 or 2006, but not any time soon.

As we have been expecting, profit growth has begun to slow. It is more accurate to regard this as a stall in profits at a very high level than as the beginning of any significant downturn. However, when profit growth slows, there is a clear differentiation between strong business franchises and weak business franchises. Companies with weak business franchises may only be able to deliver rising profits when overall profits in the economy are rising at a rapid pace. Thus profit declines among high-risk companies become more common when overall profit growth slows. That has been a major reason why we have stressed “quality for the midcycle.” Quality stocks have declined less than risky stocks in the recent correction, but we continue to believe that it is the quality stocks that offer the best tradeoff of potential reward against potential risk. Our advice is to stay with “quality for the midcycle.”

We reiterate the “behavioral logic of quality.” As we wrote in our Midyear 2004 State of the Debate report entitled “Quality for the Midcycle,” “We believe that there are much higher odds of maintaining a long-term strategy without costly whipsaws if the core of a portfolio is invested in high-quality assets.”

We view the stock market outlook as moderately attractive at current prices because we believe that the U.S. economy is in a long cycle of economic expansion. However, the outlook is sufficiently muted that it makes most sense to be valuation sensitive by taking a more positive stance whenever the market sells off and a more skeptical stance whenever the market rallies sharply.

*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.*