

Current Event - September 31, 2003

by *Tristan Walker*

The major players on Wall Street and Main Street are seemingly in a state of dismay, or confusion, about the state of the economy, on a macro scale and a micro scale, present and future. No one can easily comprehend the true state of the economy. Upon the Federal Open Market Committee's (FOMC) statements and various market indicators, one can say that the upside and downside risks (*pros and cons*) to attainment of economic growth are roughly equal.

On the *con* side, one must first take note of the FOMC's rhetoric concerning various geopolitical risks deterring the American economy from growing at a suitable rate. Terrorism, war in Iraq, Israeli and Palestinian conflict, and the North Korean missile program, have all helped to facilitate waning consumer sentiment, thereby weighing down the major market indexes.

The Fed also speaks of the threat of higher oil premiums as impeding upon economic growth. Recently the Organization of Petroleum Exporting Countries (OPEC) decided to cut oil barrel output by 900,000 to keep inventories below their ten-year average. Oil premiums have increased for this very reason. Their cutting supply could impede upon recovery because the reduction comes in the form of inflated energy bills for oil importing countries in the winter.

One can assert that the United States budget deficit, too, has assisted in destabilizing economic growth. With President Bush's \$350 billion tax cut on both dividends and capital gains, and his soliciting more money from Americans for foreign rather than domestic interests, the budget deficit can only be exacerbated. The tremendous budget deficit also comes at a time when the "baby boomer" generation will be filing for retirement, and pensions will have to be paid out to the respective persons, which could only make matters worse.

The threat of deflation, the general decline of prices of goods and services, also, has helped to weigh down the major market indexes this past summer, thereby strengthening the fixed income markets.* The FOMC, in each of its statements from January, has warned of this

threat; to stave off this threat the Fed has kept rates at record lows, around one percent, in hopes of getting corporations and consumers to spend at a lower rate than normal, so that the general level of prices can rise, which is a sure sign of economic recovery.

The worst of all lagging indicators has been the unemployment figure. When gauging an economy, one should always look at the unemployment rate. This rate, now 6.1%, peaked in the aftermath of the latest recession at 6.4%. The decline from 6.4% to 6.1% is not substantial enough to move markets to the upside. An unemployment figure above six percent is dismal. Outsourcing, where companies hire overseas rather than domestically for cheaper labor, one can say contributes the most to the miserable unemployment figure. Not until legislation could be passed barring some outsourcing mechanisms could the unemployment figure decline at a faster rate. *'Tis the downside.*

On the upside, on a macro scale, one must take note of the steady Gross Domestic Product (GDP) growth. For the past two economic quarters, GDP has beaten analyst expectations.⁺ The strong GDP figures were spurred by increased government spending, in the United States' financing the war in Iraq, and increased consumer spending from the summer when consumers helped to create a refinancing bubble, taking advantage of the low interest rates.[^]

Also, consumer sentiment data suggests expectations of the Fed's raising interest rates. Interest rates are raised to stabilize robust economic growth and rampant inflation. So, an expectation of increased rates signal consumer belief that strong economic growth is on the horizon. This consumer sentiment could be noted by the overwhelming June and July bond sell-off. Bond prices plummeted as investors sold bonds and pursued interests in the equity markets in expectation of higher interest rates. The sell-off has stabilized, however, as of late with investors belief that the sell-off was somewhat exaggerated.

On the micro scale, one can clearly assert that the market has been on a tear as of late. The technology-laden NASDAQ market

* The threat of deflation signals lower interest rates. Expectations of lower interest rates leads to an equities sell-off, which leads to an increase in demand for fixed income products (i.e. Treasuries, mortgage backed securities, asset backed securities, junk bonds, etc.)

⁺ 2nd quarter – 3.1%, 2.4% expected

^{3rd} quarter – 3.3%, 3.1% expected

[^] when interest rates decrease, consumers refinance their mortgages to take advantage of lower rates. The low interest rates also bring lower value demanders into the housing market, eventually leading to a housing market "bubble"

index reached an 18-month high on September 8th. The Dow Jones Industrial Average is in its seventh straight winning month and the broader Standard & Poor's 500 Index continues to ascent, up 26% from its March low. The NASDAQ's strength has been the most notable, however. The technology sector has been robust as of late. This strength in the tech sector shows that companies are increasing the supply of technological products. This increase in supply is a direct correlate of increased productivity.¹ If the high productivity gains continue, the economy will benefit tremendously, as the supply of jobs will increase to keep productivity at high levels.

Bush's tax cuts on capital gains and dividends can help spur economic growth, *on a micro scale*. The tax cuts make it cheaper for investors to invest in the market, thereby strengthening demand so as to move the economy to the upside.

So, as asserted above, the upside risks and downside risks are roughly equal. The combination of the threats of deflation, geopolitical risks, and an enormous budget deficit and a timid and ambivalent Fed chairman, in Alan Greenspan, can work to destabilize the economy on the macro side and the micro side. Greenspan acknowledges the downside risks, but he also recognizes the upside, detailing increased productivity and a firming in spending. With the sustained ambivalence of the Fed, offering no clear economic forecasts, the bemusement of Wall Street and Main Street market players will be prolonged...

My forecasts?...

Dow Jones Industrial Average: 10, 000 by the end of the year (9313.08 as of September 15th).

NASDAQ: 2,200 by the end of the year (1792.07 as of September 15th)

S&P: 1150 by the end of the year (996.85 as of September 15th)

Interest rates: Up 25 basis points by mid-2004

--Tristan Walker--
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¹ up 6.8%