Time for Crystal Ball gazing for 2005

(written on September 2004)

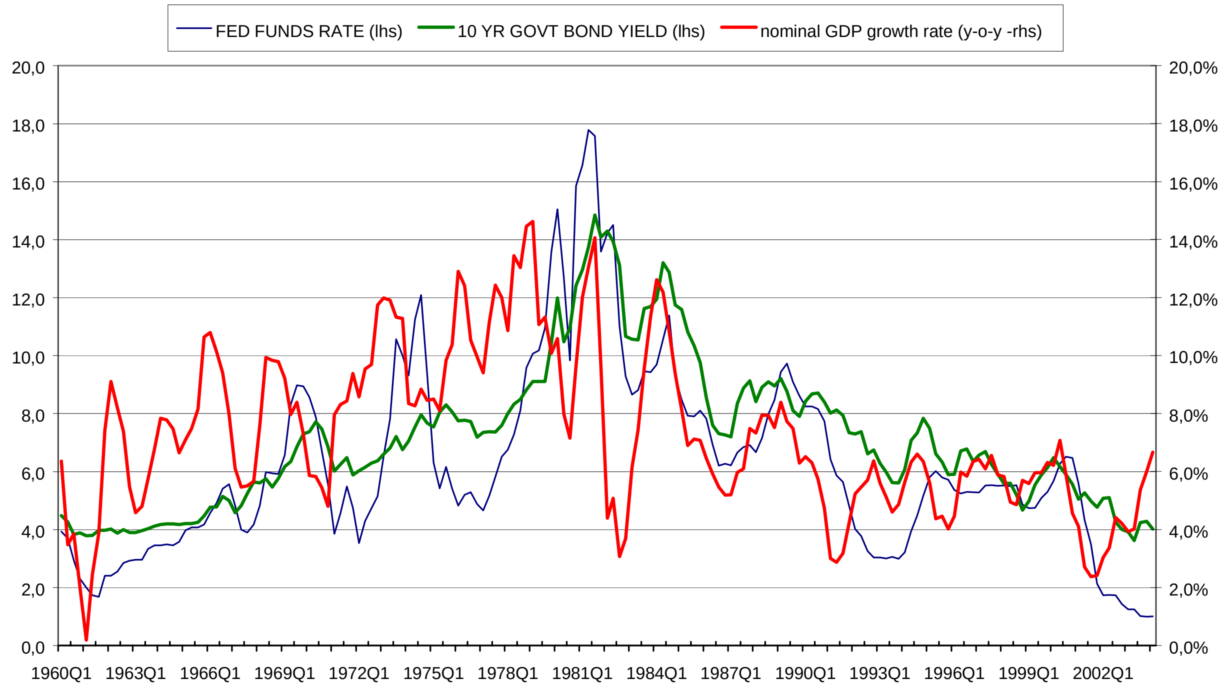
Back from holidays, everybody is looking at the 'guess-numbers' for next year. Budget, investment and other planning decision may depend on key assumptions on next year economic performance. TAC is no exception and we have worked intensively on the possible world scenario for 2005.

As most economic observers, we agree that the critical factors are concentrated on the US outlook. Not only is the US the leading engine of world demand and output growth, but the transmission from US financial markets to other centres is so strong that "contagion" is very likely through financial channels, be they interest rates, exchange rate or equity prices.

We will not disclose here the whole scenario that we have in mind, but we would like to draw the attention on the following "unfolding" of thoughts, supported by a couple of key charts:

1 – A long-term observation of the relationship between the US nominal GDP growth rate and the interest rate on 10-year US Treasury bonds (chart 1) reveals two interesting features: (a) There has been a clear break between the period of accelerating inflation (1960-1980) and the subsequent period of disinflation (1982-2003). In the first period, nominal GDP growth rates are consistently above both short and long-term interest in the US. In one sense, this has been used as a major explanation for the accelerating trend in inflation, and this is what former Fed Chairman Volcker broke with his 'punitive' monetary tightening at the beginning of the 80s. Since then, bond yield have stayed close to, but in general slightly higher than, the US nominal GDP growth rate. (b) The very last period (2003 and 1st half of 2004) is therefore clearly a temporary anomaly, where yields are significantly lower than nominal GDP growth. This anomaly is compounded by the peculiar level of short-term rates (here, Fed Funds): we have to go back to the 60s to find such a discrepancy between economic activity and the Fed's complacency… So, what does this tell for the next couple of quarters? Well, that markets are wrong on at least one variable, among real GDP growth, inflation, short-term rates or bond yield.

Chart 1 : Bond rates and nominal GDP growth in the US



2 – A second observation is derived from the past correlation between the yield curve (10-year US treasury bond, minus Fed Fund rates) and the real GDP growth (chart 2). Indeed, the yield curve has been a fairly good predictor of future GDP growth, with a lead-time of about 4 quarters. Based on this observation, the last points would suggest a stabilisation and moderation of US growth rate towards 3% to 3.5% in the second half of 2004 and next year. Here again, two comments are warranted: (a) The 1996-2000 period was a visible exception to that medium-term relationship, with an almost flat yield curve coinciding with high real US economic growth. The explanation may be related to the shift in economic paradigm (the positive side of the Internet / ITC bubble), but also to an exceptional period for commodity prices and therefore for undercurrent inflation pressure. Indeed, the third chart highlights the same ‘exceptional’ period when world GDP growth was not correlated to increases in overall commodity prices, and points towards a return to ‘normality’ in the recent period. (b) If this proves right, then the scenario may be less positive than usually expected, because of the following chain of events: higher world growth during the past 2 years is triggering higher commodity prices and stronger ‘undercurrent’ price pressures; this is in parallel with the expected ‘return to normal’ monetary policy in the US; either the tightening has to be much more significant in the coming quarters, and it would be enough to derail the growth process in the US and lead to sub-potential growth somewhere in 2005H2 (below 3.0%-2.5%); or the Fed reaction is more muted and the yield curve steepens significantly; however, in this scenario, the current sensitivity of the cyclical upswing to such a steepening of the yield curve (i.e. much higher bond yields), through household debt, real estate and mortgage situation, and through corporate investment, would then lead to a definite slow-down, maybe even at the same time that what would trigger a sharper US monetary tightening.

Chart 2 : US real GDP growth and spreads: 1970-2004

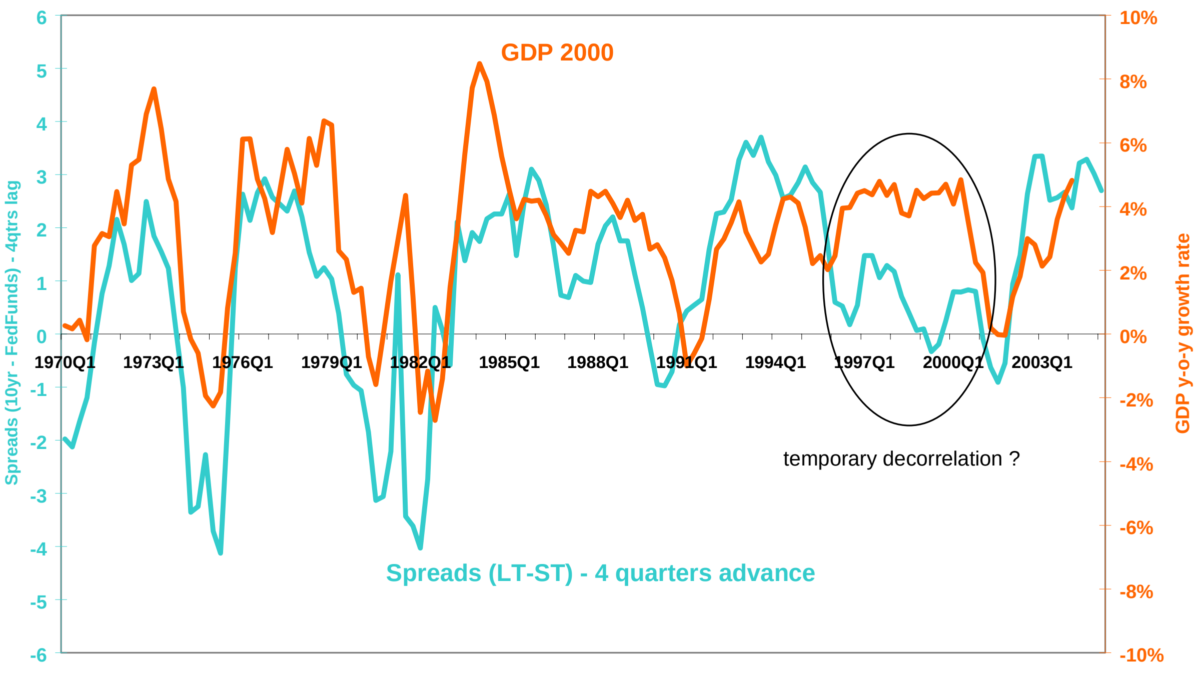
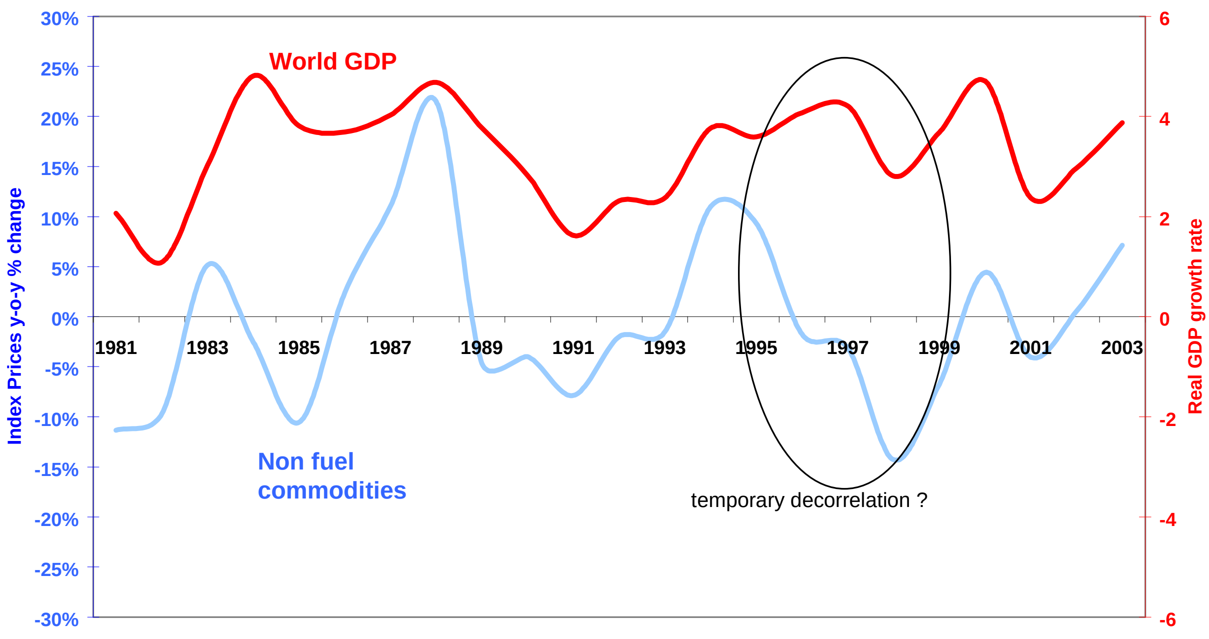


Chart 3 : World GDP growth rate and commodity prices: 1981-2003



The bottom line is that we consider that the last US recession (2001) was short and rather mild; that only the corporate sector has adjusted its previous financial and investment excesses; that the household sector has not yet initiated this required adjustment, and that US consumers may be therefore more vulnerable to less favourable monetary and interest rate conditions; and that this sensitivity will show its effect when short-term interest rates and long-term bond yield come in line with the levels implied by the current economic conditions.

The US economic growth may well slow down to around 3% in the next few quarters. After two years (2003-04) characterized by a very positive growth-acceleration convergence in most industrialised nations and an exceptionally soft monetary stance, and thus by a very favourable background for developing countries, 2005 will undoubtedly be less supportive, and the downside risks are quite important (US confidence, oil markets, Chinese hard landing, financial markets turbulences….).