

2008 OUTLOOK

The extraordinary events in the credit markets last year will likely impart lingering ramifications for the U.S. economy through at least the first half of this year. In addition to the drag on the economy emanating from the sharp contraction in residential construction, the tightening in lending standards alluded to in our 2007 Review will likely curtail sales of other big ticket items, most notably autos. In comparison, both housing starts and auto sales were two of the principal engines of the recovery of the U.S. economy following the end of the last recession in November 2001.

Adding to the economic malaise will be the continuing effects of relatively restrictive monetary and fiscal policy that remained intact through most of 2007. Typically a reversal of policy requires 12 to 18 months before becoming effective. On this basis, a broad policy-induced recovery of the U.S. economy could be expected sometime in the latter half of the year.

Domestic economic policy, however, is now only part of the story in an increasingly global economy. Serving to mitigate the effects of the 2007 credit turmoil is the recent decline in the value of the U.S. dollar. Dollar-driven export growth has led to a significant decline in the trade deficit during this past year. More importantly, economic theory suggests that demand for U.S. products will continue to grow should the dollar find a more sustainable level.¹ The recent growth in exports has contributed to a dramatic pickup in activity in export-related industries, as well as in those businesses that support these industries. This activity, when coupled with the domestic policy steps already taken, should improve the chances for a recovery on an accelerated timetable. Given the likelihood of a recession, we expect the U.S. economy to grow on the order of 1% for the year. This would be significantly below the estimated long-run growth potential of the U.S. economy of 2.5% to 2.75%.

The inflation rate is one aspect of the outlook that will likely prove troublesome. Normally a forecast of below-trend GDP growth would be consistent with some easing of inflationary pressures. The substantial decline in the dollar, however, renders a benign outcome unlikely. As a result, the year-over-year core rate of inflation is likely to tick up from a level of just over 2% at the end of last year to perhaps as high as 2.5% by the end of this year. The combination of an anemic economy, combined with a steady uptick in inflation, suggests that the broad fixed income market, as represented by the Lehman Brothers Aggregate Bond Index, will fail to earn its current coupon of 5% this year. The return from cash, meanwhile, will likely lag behind at under 3%.

While the outlook favors higher interest rates over the course of the year, the opportunity for generating excess return in fixed income may be the best since duration-adjusted excess returns were first calculated in 1988. By way of comparison, the negative excess return of the Lehman Brothers Aggregate in 2007 was 2.1%; the next-worst performance was in 2000, when the Aggregate produced a negative excess return of 1.6%. Our demonstrated expertise in the so-called spread sectors could serve our clients particularly well in 2008. The degree of yield spread compression that should commence once the economy finds its footing is likely to be unprecedented. This should work to the advantage of those investors adroit enough to properly manage their exposure to spread product. ■

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Endnotes

1. That the decline in the value of the U.S. dollar may have run its course is supported by the dramatic changes in the "Big Mac" index published by The Economist magazine. In the seven years ending mid-2007, the relative price of a McDonald's "Big Mac" sandwich rose 31% in Canada versus the United States and 27% in Euroland, respectively.



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