

**NABE OUTLOOK SPEECH--September 26, 1999**  
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IN OCTOBER, THE US EXPANSION WILL REACH 103 MONTHS, ALMOST A YEAR LONGER THAN THE REAGAN-ERA EXPANSION OF THE 1980S, AND JUST FOUR MONTHS SHY OF BREAKING THE RECORD OF THE 1960S:

- THE DOW JONES INDUSTRIAL AVERAGE IS NIBBLING BETWEEN 10,000 and 11,000 (depending on which day you look), MORE THAN 30% ABOVE THE CRISIS-SUPRESSED LEVELS OF A YEAR AGO.
- UNEMPLOYMENT HAS DROPPED NEAR 30-YEAR LOWS. (Unemployment in Madison, Wisconsin has dropped to almost 1%.)
- WELFARE ROLLS ARE DECLINING. PEOPLE WHO THOUGHT THAT THEY WOULD NEVER GET A JOB AGAIN ARE WORKING IN THIS ECONOMY (which seems obvious every time that I walk into a fast food restaurant), AND
- WE ARE NOW DEBATING HOW TO SPEND A SURPLUS RATHER THAN CUT A DEFICIT ON THE EVE OF AN ELECTION YEAR. (We have come a long way over the last decade.)

ARE WE LIVING ON BORROWED TIME? IS IT ALL ABOUT TO COME TO AN END? OR, HAVE WE ENTERED A NEW ERA, WHERE PRODUCTIVITY GROWTH CAN CONTINUE TO ACCELERATE, AND INFLATION IS DEAD?

WE ASKED THOSE QUESTIONS AND MORE TO OUR NABE PANEL, AND AS IS THE CASE WITH MOST TOUGH QUESTIONS, THE ANSWER IS SOMEWHERE IN BETWEEN.

EXPANSIONS DON'T DIE OF OLD AGE. THEY DIE OF IMBALANCES, TYPICALLY INFLATION, AND THE FED'S EFFORTS TO CURTAIL THEM. THE LONGEVITY OF THE CURRENT EXPANSION, THEREFORE, IS ROOTED IN AN UNDERSTANDING OF INFLATION. AS A GROUP, WE BELIEVE THAT THE ECONOMY DID BECOME FUNDAMENTALLY MORE EFFICIENT IN

THE LATE 1990S THAN IT WAS IN THE PAST. **AN OVERWHELMING 93% OF OUR PANEL BELIEVES THAT THE TREND RATE OF PRODUCTIVITY GROWTH HAS MOVED UP.**

THE ASIAN CRISIS, AND THE DEFLATIONARY EFFECTS THAT IT HAD OF COMMODITY PRICES, ALSO CONTRIBUTED TO THE GOOD NEWS ON INFLATION THAT WE HAVE SEEN IN RECENT YEARS.

THERE IS A SENSE, HOWEVER, THAT THE ECONOMY HAS REACHED A SUBTLE TURNING POINT. INFLATION IS EXPECTED TO EDGE UP FROM A LOW OF 1.8% IN 1998 TO THE MID-2% RANGE IN 2000, DESPITE THE FORECAST FOR A SLOWDOWN. A HIGHER RATE OF PRODUCTIVITY GROWTH IN THE US ECONOMY HAS SHIFTED, BUT NOT ERASED, THE THRESHOLD ON INFLATION.

A TURNAROUND IN THE SITUATION IN ASIA HAS ALSO, NO DOUBT, CONTRIBUTED TO OUR OUTLOOK FOR INFLATION NEXT YEAR. **ALMOST 95% OF OUR RESPONDENTS BELIEVE THAT RECOVERIES IN ASIA ARE HERE TO STAY.**

TODAY, I WILL TALK ABOUT NABE'S CONSENSUS VIEW OF THE ECONOMY, PAYING SPECIAL ATTENTION TO THE ROLE THAT THE CRISIS OF THE LAST TWO YEARS HAS PLAYED IN SHAPING THAT VIEW. I WILL ALSO TALK ABOUT WHAT WE THINK IT MEANS FOR INFLATION AND FED POLICY. AND, FINALLY, I WILL WRAP UP WITH OUR FEELINGS ABOUT FINANCIAL MARKETS.

AS A GROUP, WE BELIEVE THAT THE EXPANSION WILL EASILY CROSS THE TURN OF THE YEAR TO BECOME THE LONGEST OF THE POST WORLD WAR-II PERIOD. THERE IS SIMPLY TOO MUCH MOMENTUM TO STOP THIS TRAIN NOW. WE ARE ALSO FAIRLY CONFIDENT THAT IT WILL CROSS 2001.

WE SEEM TO HAVE LEARNED FROM THE LAST SEVERAL YEARS, AND ARE MORE OPTIMISTIC ABOUT GROWTH THAN WE ONCE WERE AS A GROUP. WE ARE NOT, HOWEVER, READY TO ABANDON THE ECONOMICS THAT GOT US THIS FAR. THERE ARE REAL REASONS THAT THE ECONOMY PERFORMED SO WELL OVER THE LAST SEVERAL YEARS, NOT THE LEAST OF WHICH INCLUDES LUCK. THE FEELING IS THAT THE BEST NEWS ON INFLATION AND INTEREST RATES IS BEHIND US. THE ENVIRONMENT THAT EMERGES WILL BE MORE DIFFICULT FOR FINANCIAL MARKETS.

### **THE NABE OUTLOOK**

OUR NABE PANEL IS FAIRLY BULLISH ABOUT THE OUTLOOK FOR GROWTH IN THE NEAR-TERM. GROWTH IS EXPECTED TO REBOUND IN THE SECOND HALF, AS PRODUCERS WHO, ACCORDING TO OUR PANEL, WERE SURPRISED BY THE STRENGTH OF THE ECONOMY IN THE FIRST HALF, ARE FORCED TO REBUILD INVENTORIES. (Most producers were making their plans for the first half of 1999 during the height of the financial market crisis last fall.)

EFFORTS TO HEDGE AGAINST POSSIBLE Y2K-RELATED DISRUPTIONS COULD ALSO CONTRIBUTE TO AN END OF THE YEAR RISE IN INVENTORIES. EARLIER NABE SURVEYS SUGGEST, HOWEVER, THAT Y2K-RELATED EFFECTS WILL BE EXTREMELY SMALL.

THE DRAG FROM TRADE IS ALSO EXPECTED TO DISSIPATE, AND DOMESTIC DEMAND IS EXPECTED TO REMAIN RELATIVELY ROBUST. GROWTH FOR THE YEAR IS EXPECTED TO AVERAGE 4%, SLIGHTLY AHEAD OF 1998.

THE MORE INTERESTING STORY CAN BE TOLD ABOUT THE OUTLOOK FOR 2000. **GROWTH IS EXPECTED TO SLOW, WITH AN UNWINDING OF THE ASIAN CRISIS.** BEFORE WE TURN TO THAT, HOWEVER, IT MAY BE USEFUL TO TAKE A STEP BACK AND TRACE THE EFFECTS THAT THE CRISIS HAD ON THE ECONOMY.

IN THE FALL OF 1997, AND AGAIN IN 1998, A COLLAPSE IN INVESTOR CONFIDENCE TRIGGERED CAPITAL FLIGHT AND RECESSIONS ABROAD. INTEREST RATES IN THE US PLUMMETED AS INVESTORS SOUGHT THE RELATIVE "SAFETY" OF THE U.S. TREASURY MARKET, THE DOLLAR APPRECIATED, AND COMMODITY PRICES PLUMMETED. (Oil prices dropped more than 50% between the start of 1997 and the finish of 1998.)

THE MOST OBVIOUS EFFECT WAS THE IMPACT ON TRADE. EXPORTS TO ASIA WERE PARTICULARLY HARD HIT. AFTER RISING AT A DOUBLE-DIGIT RATE DURING MUCH OF THE 1990S, EXPORTS TO ASIA WERE NOW DECLINING AT A DOUBLE-DIGIT RATE. IMPORTS ALSO PICKED UP (ALTHOUGH MUCH OF THAT STRENGTH COULD BE ATTRIBUTED TO A RISE IN DOMESTIC DEMAND), AND THE TRADE DEFICIT DETERIORATED AT ITS FASTEST RATE IN HISTORY.

THE FLIP SIDE OF THE ASIAN COIN, HOWEVER, WAS THE COIN THAT FELL INTO THE POCKETBOOK OF THE TWO-THIRDS OF THE ECONOMY THAT BELONGS TO THE U.S. CONSUMER. THE DROP IN INTEREST RATES AND FALL IN IMPORT AND COMMODITY PRICES BOOSTED PURCHASING POWER IN THE U.S. MORTGAGE APPLICATIONS AND MORTGAGE REFINANCING SURGED, REAL WAGES JUMPED (at their fastest pace since 1952), AND HOUSEHOLD SPENDING ACCELERATED....EIGHT YEARS INTO AN ECONOMIC EXPANSION.

THE EFFECTS WERE SO POWERFUL THAT HOUSEHOLD SPENDING ACCELERATED IN THE WAKE OF THE WORST STOCK MARKET CORRECTION IN A DECADE LAST FALL. THIS IS PROBABLY WHY WE SAW SUCH A LARGE DISPERSION IN OUR ANSWERS TO QUESTIONS OF THE STOCK MARKET'S IMPORTANCE IN THE ECONOMY.

NOW, THE CRISIS APPEARS TO BE OVER. INTEREST RATES HAVE RISEN WITH A REVERSAL IN THE FLIGHT TO SAFETY AND RENEWED FEARS OF INFLATION. THE DOLLAR HAS DEPRECIATED FAIRLY SHARPLY, COMMODITY PRICES HAVE BEGUN TO FIRM (some more than others), AND EMERGING MARKETS HAVE BEGUN TO RECOVER.

TRACING BACK OUR STEPS... ALMOST 95% OF OUR RESPONDENTS BELIEVE THAT THE RECOVERIES IN ASIA WILL HOLD. THERE IS SOME CONCERN THAT CHINA WILL DEVALUE NEXT YEAR, BUT THAT WAS NOT ENOUGH TO DERAIL A FAIRLY BULLISH OUTLOOK ON EXPORTS. EXPORTS ARE EXPECTED TO RISE AN AVERAGE 6.3% NEXT YEAR, ALMOST DOUBLE PACE EXPECTED FOR THIS YEAR. IMPORTS ARE ALSO EXPECTED TO MODERATE, AND THE DRAG FROM TRADE IS EXPECTED TO DISSIPATE. **THE WORST THAT THE ECONOMY HAD TO ENDURE OVER THE LAST TWO YEARS WILL BE BEHIND US.**

THE BOOST TO PURCHASING POWER CREATED BY THE CRISIS, HOWEVER, HAS BEGUN TO PLAY OUT. **THE NABE PANEL BELIEVES THAT SPENDING IN THE TWO-THIRDS OF THE ECONOMY THAT BELONGS TO THE US CONSUMER WILL MODERATE. HOUSEHOLD SPENDING IS EXPECTED TO SLOW FROM ABOVE 5% IN 1999 TO SLIGHTLY BELOW 3% IN 2000.** THE HOUSING MARKET IS PARTICULARLY VULNERABLE, GIVEN THE RECENT RISE IN MORTGAGE RATES, AND RESIDENTIAL INVESTMENT IS ACTUALLY EXPECTED TO POST A SLIGHT DECLINE IN 2000.

BUSINESS INVESTMENT ALSO MODERATES, BUT REMAINS A DRIVER OF ECONOMIC GAINS, AND GOVERNMENT SPENDING HOLDS CLOSE TO THE PACE THAT WE SAW IN 1999.

ON NET, THE US ECONOMY IS EXPECTED TO SLOW TO SLIGHTLY LESS THAN 3% IN 2000, AND THE UNEMPLOYMENT RATE IS EXPECTED TO STABILIZE IN THE LOW 4% RANGE.

## **IMPLICATIONS FOR FED POLICY AND INTEREST RATES**

WHEN QUERIED ABOUT OUR VIEWS ABOUT FED POLICY, OUR PANEL IS FAIRLY PLEASED WITH THE COURSE OF POLICY TO DATE. NEARLY TWO-THIRDS OF RESPONDENTS SUPPORTED THE FED'S RECENT MOVES TO TIGHTEN. IN MANY WAYS, THIS IS JUST ANOTHER ASPECT OF THE ECONOMY'S UNWINDING FROM THE ASIAN CRISIS.

**THE SURVEY RESULTS SEEM TO SUGGEST THAT A PRE-EMPTIVE STRIKE BY THE FED WOULD BE DIFFICULT AT THIS STAGE OF THE CYCLE.** AS MENTIONED EARLIER, THE PANEL HAS GOTTEN MORE OPTIMISTIC ABOUT PRODUCTIVITY GROWTH, AND REVISED UP THEIR ESTIMATES OF POTENTIAL GROWTH. ANOTHER UPSIDE SURPRISE IN PRODUCTIVITY GROWTH WOULD FURTHER DELAY THE ONSET OF INFLATION.

THE ACCELERATION IN INFLATION, ROOTED IN BOTH TIGHT LABOR MARKETS AND AN END TO THE ASIAN CRISIS, IS ALSO EXPECTED TO BE *GRADUAL*, WHICH WOULD SUGGEST THAT THE FED WOULD HAVE AMPLE TIME TO CATCH INFLATION ONCE IT BEGINS A MORE MEANINGFUL ACCELERATION.

**THE MEDIAN FORECAST CALLS FOR NO CHANGE IN THE FED FUNDS RATE NEXT YEAR.** OUR OUTLOOK FOR BOND YIELDS SUGGEST, HOWEVER, THAT **THE RISKS ARE BUILDING ON THE UPSIDE ON BOTH INFLATION AND INTEREST RATES.** THE TOP 10% OF RESPONDENTS HAVE THE FED TIGHTENING BY AS MUCH AS THREE-QUARTERS OF A PERCENT NEXT YEAR, AND THE YIELD ON THE LONG BOND NIBBLING AT 7%.

FINALLY, A TWO-THIRDS MAJORITY OF THE PANEL BELIEVES THAT THE FED WILL RAISE RATES NEXT YEAR IF ELECTION-YEAR POLITICS RESULT IN A SIGNIFICANT TAX CUT OR INCREASE IN FEDERAL GOVERNMENT SPENDING.

## **EQUITY MARKETS**

THE PANEL'S FEELINGS ON EQUITY PRICES ARE MORE MIXED. MORE THAN 40% BELIEVE THAT THERE IS SOME "BUBBLE" IN CURRENT STOCK PRICES; A SLIGHTLY SMALLER 32% BELIEVE THAT THERE IS NO "BUBBLE"; AND A LARGE 24% MINORITY BELIEVE THAT ECONOMIST'S CAN'T ESTIMATE A "BUBBLE". IT IS WORTH NOTING THAT OUR SURVEY WAS TAKEN IN THE SECOND WEEK OF SEPTEMBER, WHEN THE DOW WAS SIGNIFICANTLY HIGHER THAN IT IS TODAY.

AS A GROUP, PROFITS ARE EXPECTED TO SLOW, PRESUMABLY DRIVEN BY SOMEWHAT SLOWER ECONOMIC GROWTH AND THE UPSIDE RISKS ON INTEREST RATES. LABOR MARKETS ARE ALSO EXPECTED TO REMAIN RELATIVELY TIGHT, AND WITH A SLIGHT EROSION IN PRODUCTIVITY GROWTH, THOSE PRESSURES COULD TAKE A TOLL ON PROFIT MARGINS.

IT IS WORTH NOTING, HOWEVER, THAT PROFITS ARE DISTRIBUTED OVER A WIDE RANGE. SOME ANALYSTS ARE SHOWING DOUBLE-DIGIT GAINS IN PROFITS. The upside risks on profits in the outlook seemed to coordinate with more bullish attitudes on productivity and exports.

## **WRAP UP**

NABE HAS FINALLY TURNED A LITTLE MORE BULLISH. IT BELIEVES THAT THIS EXPANSION IS FAR FROM OVER...THERE IS A SENSE, HOWEVER, THAT WE HAVE HIT A SUBTLE TURNING POINT, AND THAT THE NEXT PHASE OF THE EXPANSION WILL NOT BE QUITE AS EASY AS THE LAST. THE ROAD AHEAD COULD BE SIGNIFICANTLY SLOWER FOR FINANCIAL MARKETS. WHEN WE FINALLY CLOSE THE BOOKS ON THE 20<sup>TH</sup> CENTURY, WE WILL LIKELY LOOK BACK ON THIS PERIOD IN THE LATE 1990S AS THE "GOOD OLD DAYS". THE MORAL OF THE STORY IS TO "ENJOY IT WHILE IT LASTS."

