



The Economic Outlook for 2005

Published : January 12, 2005 in [Knowledge@Wharton](#)

Investors, consumers and businesses have had a fair share of concerns in 2004: high fuel prices, less-than-stellar job growth and volatile swings in the stock market, which remains well below the highs set four years ago. But by many measures the year is ending well. Oil prices dropped in December, hiring has picked up, and the Standard & Poor's 500, thanks to a string of gains in the fall, returned nearly 8% from the start of the year through mid-December.

Will the good news continue in 2005? The smart money says the coming year will probably bring decent, but not terrific, gains in economic growth and stock prices, according to four Wharton professors. But they do see hazards in the deepening federal and current-accounts deficits and the falling dollar.

"I think it looks reasonably good," said Wharton finance professor [Jeremy Siegel](#), referring to the economy and stock markets. "I think we can have 3½% to 4% real growth [in gross domestic product], with very moderate inflation - 2 ½%."

Corporate leaders recently polled by the Business Roundtable survey have similar expectations, forecasting 3.5% GDP growth in 2005. Similarly, [Anthony M. Santomero](#), a Wharton professor on leave to serve as president of the Federal Reserve Bank of Philadelphia, has forecast 3.5% to 4% GDP growth in 2005, compared to the 3.75% he expects for 2004.

Wharton finance and economics professor [Richard Marston](#) says he, too, expects GDP to grow 3.5% to 4% in 2005. "That's a healthy economy in its middle stage of expansion." Corporate profits, he added, are not likely to grow as fast on a percentage basis as they have this year, because 2004's strong profits provide a higher base for comparison. In 2004, it was comparatively easy for businesses to show big gains over the weak earnings of 2003.

Siegel predicts the stock market will produce average gains next year. "I can see returns in the normal range of 6 to 10%." Bond prices could well fall, he cautioned, if the Federal Reserve continues to raise interest rates, as expected. "I think the Fed will continue to raise rates and probably will get to something like 3½% by the end of [2005]." On December 14, the Fed ordered its fifth hike of the year, lifting short-term rates to 2.25%, up from 1% last summer.

Siegel expects the yield on the 10-year Treasury note to rise to 5%, from the current 4.14%, by the end of 2005. That will push mortgage rates up ½ to 1 percentage point. Marston agreed, arguing that a Fed Funds rate of 2.25% is not high enough to head off rising inflation, now at about 2% (or 3.2% with food and energy costs included). The Fed rate needs to be above 3%, he said, adding that he remains "positive. I think the economy's under control. It's not expanding at a pace where [Fed chairman Alan] Greenspan is getting worried. I think the economy is healthy and people are starting to get jobs."

Not Many Surprises

According to Wharton finance professor [Marshall E. Blume](#), although investors are unlikely to enjoy



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsiintl.com P. (212) 221-9595 x407.

1990s-style gains in stocks in 2005, they probably won't suffer the deep plunges that have characterized the markets in recent years. "What you're looking at for the future - for the next year or so - is slow, steady growth. The risk levels in the market are low. What that means is there's probably not going to be a lot of volatility. There are not a lot of surprises out there."

The price-to-earnings ratio of the S&P 500 has fallen to a relatively safe level in the high teens or low 20s, depending on which earnings accounting is used, he said. That makes stocks a lot safer than when they were trading at 30 to 40 times annual earnings a few years ago. In addition, investors' assessment of risk is evident in premiums, or prices paid, for stock options. Those prices have fallen considerably, indicating less perceived risk, Blume noted.

"Equity markets have really come a long way in such a short period of time, with the S&P 500 up 6.1% since the November election and 12.9% since the recent August 12, 2004 lows," Howard Silverblatt, chief stock analyst for S&P, wrote in a Dec. 14 report to investors. "As a result, some profit taking can be expected in the near-term." The long-term outlook, he said, "still remains positive, but slow and most likely bumpy." He said S&P forecasts a 10.5% gain in operating earnings for S&P 500 companies in 2005, with that index returning 10.1%. Silverblatt forecasts returns averaging as high as 12% a year through 2009.

Siegel predicts job growth will average a fairly healthy rate of about 200,000 jobs a month next year. The economy added about 112,000 jobs in November, disappointing economists who had forecast twice as many after some 300,000 jobs were created in October. The economy must add 100,000 to 150,000 jobs a month just to keep up with growth in the labor force.

Analysts say high prices for oil and other commodities made companies reluctant to hire in November. Oil has since fallen to around \$41, from around \$55 in late October. Another positive sign for job seekers came in a recent Labor Department report that worker productivity in the quarter ended Sept. 30 grew at the slowest rate in two years, at an annual rate of 1.8%, versus 3.8% in the previous quarter. As employers lose their ability to squeeze more production out of their workers, they will be forced to hire if they are to increase production.

Possible Derailment

Despite the positive economic signs and market gains of the fall, several problems could derail the recovery next year.

For example, while Fed interest rate hikes are meant to slow borrowing and reduce spending to curtail inflation, a spike in rates caused by bond-market jitters could reduce consumer and business spending too much. In addition, in recent years the vibrant housing market has helped sustain the economy. But economists at the University of California, Los Angeles, recently forecast a drop in housing starts next year, due to high prices and rising interest rates. Millions of Americans have taken adjustable-rate mortgages on their homes; they will see their monthly payments rise in tandem with the Fed moves, leaving those households with less spending money.

Wharton finance professor [David Musto](#) said higher mortgage rates, falling home prices, or both, could have ripple effects that are not well understood. People stuck with homes that are not worth as much as they owe, and people worried about the high payments they would face with new mortgages, might opt to stay put rather than take new jobs. "People migrating to their most productive use is, of course, good for the economy," he said. "If they are not doing that ... we will see if that turns out to be a serious thing."

Beyond the other obvious hazards - a worsening situation in Iraq or a major terror attack on the U.S. - Marston worries about the danger that the dollar will continue falling against foreign currencies.

A low dollar helps American companies sell goods and services abroad by making them cheaper to foreign buyers. But the U.S. also relies on foreigners for loans, in the form of Treasury bond purchases, which make American deficit spending possible.

As the dollar becomes less valuable, foreign investors, including governments in China, Japan and elsewhere, could worry that they are losing money on Treasuries. Should they reverse course and start selling Treasuries, the dollar would fall further. To attract investors, Treasury-bond yields would then have to rise, causing interest rates for mortgages and other loans to go up as well, dampening U.S. economic growth. "I think the dollar is a concern," Marston said.

The fate of the dollar is tied to two worsening deficits. The federal budget deficit results from the government spending more than it is taking in. The current account deficit is caused when Americans - their government included - spend more than they earn, financing the difference with loans from foreigners.

To avert a damaging slide in the dollar the government must tackle the two deficits, and the key to that is to reduce the federal budget deficit, Marston said. The current level of foreign financing of U.S. debt is "not sustainable," heightening the risk of a depreciation in the dollar. Now that the U.S. is in economic recovery, "the government ought to straighten out this fiscal deficit."

Greenspan also has argued the budget deficit must be tackled. President Bush promised during the campaign to cut the deficit in half in four years, but he also has proposed further tax cuts as well as making permanent the temporary cuts enacted in his first term. His proposal to let workers invest part of their Social Security contributions in personal accounts could force the government to borrow trillions to meet obligations to people in or near retirement.

Most analysts are also keeping a close eye on oil prices. Another surge in oil would increase business expenses, undermining profits and thus hurting stock prices. High gasoline and heating oil prices can cut into consumer spending, hurting corporate profits and economic growth. Indeed, Wal-Mart and some other large retailers have reported disappointing holiday sales as consumers pay around \$2 a gallon for gasoline.

In a Nov. 16 speech at Carnegie Mellon University, the Fed's Santomero said that "the underlying fundamentals of long-run supply and demand will keep oil prices from declining substantially for the foreseeable future. And, given the many sources of instability in the countries that supply much of the world's oil, we must recognize the possibility of another spike in oil prices as a significant risk."

Finally, there is, as always, the prospect for unanticipated events to upset all the experts' forecasts - natural disasters, political crisis, war. As Siegel noted: "Very rarely do we see these things coming."

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.