

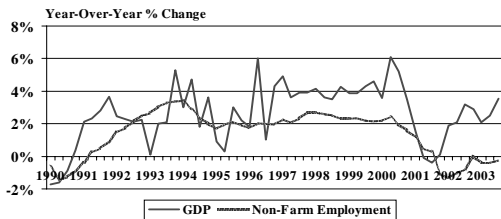
## UNITED STATES ECONOMIC CONDITION AND OUTLOOK

By Hugh F. Kelly, CRE

Let's pick up where we left off a year ago. The final clause of our economic outlook section for the 2003 edition of *Comparative Statistics* read: "We should be better off a year from now than we are today." For a while in 2003, that seemed to be an "iffy" forecast. First quarter GDP growth just eked out a 1.4 percent gain. The stock market plunged as we began to gear up military operations in Iraq. Employment, which seemed ready to improve at the end of 2002, suffered another six months of decline. Warnings of a potential "double-dip" recession started to stream out of the Wall Street newsletters. The Fed calmed nobody's nerves by informing us that deflation was not considered a significant immediate threat... but they were keeping their eyes on it anyway. For readers of tea leaves, things were looking murky at best, and the surprises all seemed to come on the side of trouble.

But as 2003 comes to a close, the positive assessment of the economic outlook was vindicated. Growth in GDP accelerated to 3.3 percent in the second quarter and soared to 8.2 percent in the third quarter—the fastest growth in twenty years. Smoothing out the quarterly volatility, real GDP was up 3.6 percent on a year-over-year basis by the end of the third quarter, putting the economy well within reach of the 4.0 percent growth target we established in last year's report for the year as a whole. As economic indicators streamed out of Washington during the fourth quarter, all the signs pointed to a solid year of economic expansion—once 2003 is tallied up—and considerable momentum going into 2004.

## Non-Farm Employment and GDP



Sources: U.S. Bureau of Economic Analysis; U.S. Dept. of Labor

The third quarter gains had a strong lineup of contributing elements. Consumption, which had been the bulwark of the economy through the past several troubled years, increased by 6.4 percent, a solid gain but no longer the factor leading all others. Business fixed investment was up by 14 percent, led by equipment and software gains of 18.4 percent. The housing boom continued, with residential fixed investment surging forward 22.7 percent. Our enormous trade deficit eased ever so slightly, as exports increased by 11 percent, much faster than the 1.5 percent increase in imports. That is a positive thrust for GDP. Interestingly, the government contribution to growth was negligible, despite spending on the military, with a net increase of just 1.3 percent.

Two questions must be considered. First, are the gains of the third quarter sustainable? And, what about jobs? Both issues are critical to the outlook for 2004.

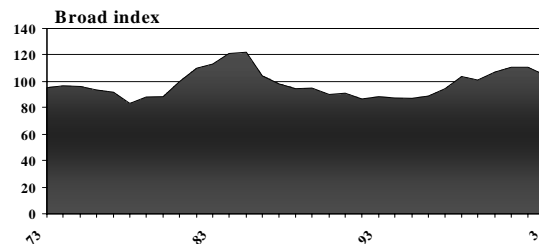
Let's tackle the GDP outlook first. It is easy to say that we won't see a full year of 8.2 percent growth, and so the third quarter numbers were unsustainably high. But what about a second year of real gains of four percent or more? That's not such a hard argument to make at this point. In the government sector, the hurdle for measuring an acceleration is not that high, especially in the non-defense sector. Remember that 2004 is a presidential and congressional election year, and incumbents will be using the power of the purse to maximize their reelection odds. So it is entirely reasonable to see this component growing more quickly in the coming year.

How about the trade situation? One of the results of the spectacular U.S. growth from 1994 through 2000 was a steady climb in the value of the dollar, a trend that makes imports cheaper and exports more expensive to the final consumer. While the dollar did not reach the peaks seen in the mid-1980s, by 2002 it had risen to a

level that was clearly damaging to our ability to export goods... with depressing effects on our manufacturing industries. As in the 1985 Plaza Accord, the central bankers of the major trading economies have agreed to coordinate efforts to gradually move the dollar down. The Federal Reserve Bank publishes a variety of indexes on currency rates, but its broadest measure is already showing the results. The exchange value of the dollar, versus a basket of world currencies, is down by almost nine percent December 2002 to December 2003.

Some have been viewing with alarm the decline of the dollar versus the Euro, but such concerns have not been very thoughtful regarding their economic impact. A rising Euro actually disadvantages the EU members, as it makes their exports more costly on world markets. And trade counts for the EU even more than it does for the USA, as a component of GDP. So the prospects for a sustained positive contribution to U.S. growth in 2004 and thereafter from some decline in the trade deficit must be rated fair to good. At minimum, this deficit will not be increasing the drag on growth as it has in the past several years.

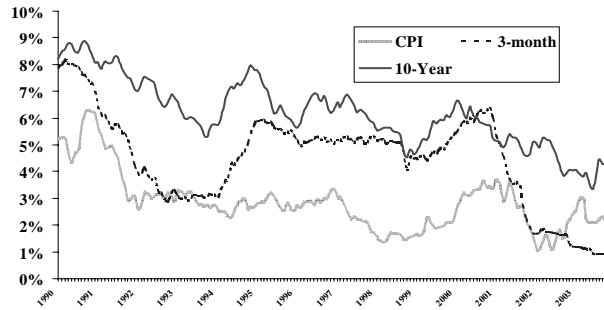
## Value of the U.S. Dollar



Source: Federal Reserve H 10 Summary

Business fixed investment depends upon corporate profits, more than any other variable. When profits are under attack, investment halts and layoffs begin as managers seek to defend the bottom line through aggressive cost cutting. But as economic prospects improve, the keys to improved profitability become increased market share and higher productivity. That depends upon renewed investment. Corporate profits were down 7.2 percent in 2001, but rebounded in 2002 by a nearly equal 7.6 percent. During 2003, the first three quarters showed an upward trend with a strong 9.9 percent improvement in the second quarter eclipsed by an 11.8 percent gain in the third quarter. While it is probably too much to expect that businesses will return to the investment patterns of the late nineties, when

## Interest Rates and Inflation



Sources: U.S. Dept. of the Treasury; U.S. Census Bureau

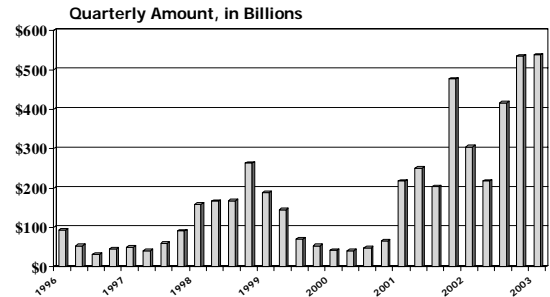
double-digit increases in equipment and software spending were the norm, gains in 2004 and 2005 could well be in the eight to 10 percent range as corporations play catch-up after several weak years of investment behavior.

Housing investment, together with consumption, has been the driver of the economy since 2000. Both engines have been running on a single fuel—low interest rates. As inflation remains tame, the Fed has been willing to hold short-term rates substantially under the contemporary CPI measure to jumpstart growth. Risks in interest rates are clearly on the upside for 2004, but those expecting a substantial tightening at the Fed are likely to be frustrated. For one thing, the October minutes of the FOMC (the Fed’s Open Market Committee) are unusually clear in suggesting the central bank is bias toward a loose monetary policy (low rates) in the coming year. Secondly, the Fed is loathe to move rates substantially during election years, lest it be accused of influencing the political climate. Some might argue that standing pat has its own influence, but the inclination to hold a “steady as you go” course is likely to make any changes in 2004 modest in scale and gradual in timing.

Longer-term interest rates, however, could be subject to upward movement, implying a steeper yield curve as the year goes on. The stunning increase in the Federal budget deficit is bound to push long rates up as the Treasury goes to market to borrow the shortfall. And businesses are not likely to fund investments out of current profits, but will go to the corporate bond market for debt financing. Profits will be targeted to increased dividends, as favored by changes in the income tax code, and to spur stock price increases through the P/E measures.

Even so, it looks like the rate environment will remain favorable for housing. Demography dictates that we

## Home Refinancing Volume



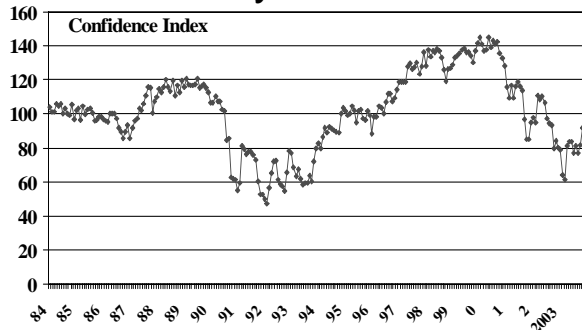
Source: Mortgage Bankers Association

must produce about 1.3 million residential units per year, and we have not strayed far from that number in the recent past. So, while there is little “pent-up demand” to spur rapid growth in housing, there is certainly no sign that this important sector will be putting on the brakes next year.

The linkages between low interest rates and the extraordinary staying power of consumers cannot be stressed too strongly. Even as the nation has struggled on the employment front, consumer expenditures have been robust. With 68 percent of all U.S. households now homeowners, many have elected to unlock the equity in their homes to preserve household liquidity during the jobs downturn. The numbers are staggering. The scale on the graph above is in billions of dollars, indicating that recently quarterly refinancing volumes have exceeded half a trillion dollars.

But there are limits to the pool of refinance opportunities, and most of the households prone to take advantage of this source of cash probably have done so by now. For 2004, an increase in personal consumption expenditures will have to be driven primarily by improvements in earned income. In the aggregate, that depends upon increases in employment. A year ago, we projected a gain of two million jobs for 2003. In actuality, from year-end 2002 to November 2003, the nation lost 24,000 jobs. For six consecutive months from February through July, employment totals were down, not up. Since July, we have made up most of the lost ground, with a net increase of 260,000 jobs over the past five months. But that’s the amount of job gain we will have to see every month for the coming year if we are to get back to the January 2001 level of employment by the time Election Day 2004 arrives. It is a tall order. And that is a big reason why the Consumer Confidence Index has yet to push above its benchmark level of 100.

## Consumer Confidence Is Turning Up...But Has a Long Way To Go



Source: The Conference Board

What spoiled the jobs forecast for 2003? And why should we expect 2004 to actually be the year of the employment turnaround?

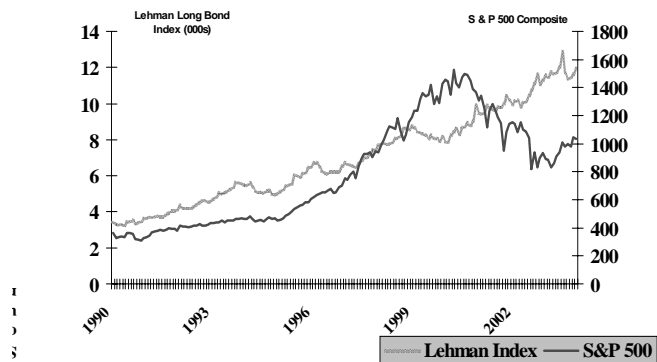
In a complicated economy, it is almost never so simple that a single cause can be ascribed to major variables like employment. But this year, there is good reason to suggest that the Iraq invasion derailed a job recovery that was ready to commence a year ago. Certainly the stock market got the jitters as war became imminent, and poor stock performance put corporations right back into cost control mode—with weak business investment matching the layoff trends in the first quarter of 2003. Another factor is the changed structure of the military personnel profile today. Many of those sent to the Middle East have been reservists, citizen-soldiers who expect to return to their normal jobs when hostilities cease. Employers are reluctant to commence new hiring in large numbers, knowing that the reservists must be reintegrated into the labor markets on their return to the States.

Nevertheless, all is not as bleak on the employment front as the national statistics might suggest. As of October 2003, 27 of the 50 states, plus the District of Columbia, had returned to job expansion on a year-over-year basis. The jobs recovery is working its way west to east, and south to north. Southern California is doing well, though the Bay Area still suffers and Oregon is also troubled. Significantly, Nevada is the first state to

“go gold,” achieving employment gains of more than three percent, in this cycle. The Mountain states have solidified their gains in recent months, with only Colorado lagging. The Great Lakes are the most troubled region, but South Carolina is the state that has lost the most ground in employment over the past year. The common story: these areas experienced a weak export market for key their products. Elsewhere in the Southeast, Georgia is seeing a tremendous turnaround and Florida is posting consistently solid job numbers. Gains are spreading up the East Coast though New Jersey, and three of the six New England states are now in the plus column for jobs. The national statistics mask the important story of regional differences, and these are critical to real estate markets.

All in all, the elements seem to be falling into place for another very good year in terms of GDP statistics, then. The stock market certainly seems to believe this, and there is a long-standing theory that the stock indexes are a good leading indicator of the economy as a whole. It is unlikely that the job recovery will lag indefinitely, and it is entirely possible that the BLS benchmarking revisions next March will revise the 2003 numbers upward. The fundamentals are moving in the right direction to support improved employment. And nothing would prove a better tonic for commercial real estate demand in 2004 and the years ahead.

## Trends in Stocks and Bonds



Sources: Standard & Poors; Lehman Brothers

