Current U.S. Economic Outlook

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Looking back on the state of the US economy over the past several years, a number of experts would come to the same conclusion that despite the self-serving reports released by the government, actual consumption hasn't shown any discernible increase. Although most indexes may indicate 2.5 ~ 3.5% nominal annual growth on average, the actual consumption seems to have noticeably moved neither up or down. Any one that spent the decade of 1990's in the U.S. would agree that there is a considerable difference between the states of the economy during that period and the period afterwards. Oil price has soared through the roof coupled with rise in interest rates amidst concerns about inflation that is not clearly backed up by perceivable evidences economic boom. What about the mortgage interest rates that are not quite moving in tandem with the change in fed funds rates being used as the most favored instrument of monetary policy by the Federal Reserve? What's the link between the worsening U.S. trade balance and all these other factors? What big picture would emerge if all these variables were put together systematically for analysis?

Overview of the U.S. Economy in the 1990s

Let's first take a close look at the so-called boom of the 1990's and the factors that contributed to it. It is estimated that the U.S. economy grew at an average rate of 7~8% per annum during this period. Considering the size and the scale of the U.S. economy, this is a remarkable growth tantamount to a two-digit growth rate for a select group of fast-growing industrializing economies. The prime mover of such a record growth was unarguably the unprecedented productivity gain across the board brought about by the explosion of the IT industry referred to as the Silicon Valley. Such a record growth in productivity even resulted in oversupply in the economy by the early 2000s, which even stirred up the scare about deflation. The most apparent and direct beneficiary as well as the vanguard of such an economic boom was the stock market. During this period, the average annual growth for the U.S. stock market reached a hefty 15~20% range.

Behind this scene of jubilee lurked the ultimate product of bubble such as Enron, which eventually busted the dot-com bubble and brought an end to the continued trend in the bull market signaled by the crash of Amazon.com in summer 2001. Amazon.com in particular, the forerunner of the dot-com legend, was trading at the record high of $110 per share before the crash. After the crash, however, it was worth no more than a sheet of tissue paper at one point. Then, what is bubble? Or from what level of overvaluation, to be more exact, is considered bubble? And what causes the bubble?

[1] All analyses, discussions and forecasts are based on the economic conditions as of the 2nd quarter of 2006.

To answer these questions, one needs to review the basics of security valuation while still refraining as much from math and technical language as possible although it is practically difficult to do so. However, one may sum it up as the present value of the all the future stream of income (dividends and capital gains) from holding a security adjusted by appropriate cost of capital. This would be the intrinsic value of the security, the basis of the market value, which may not necessarily be the same as the book value computed from the financial statements of the firm[2]. Therefore, the bubble may be defined in principle as any part of the security price over and above this rationally expected price. What the former FRB chairman Alan Greenspan warned against as the "irrational exuberance" in the early 2000s may also be understood in this context.

Back to the discussion about Amazon.com again, one would then subsequently wonder "What was the extent of its bubble?" and "What was the extent of average bubble in the stock market in general at the time?". As far as I can remember, Amazon's financials looked extremely bad at the time. The company had a huge debt out of its capital structure, which translated into a high financial distress cost. On top of all that, the company was fast expanding beyond its means, thereby using up all its resources in paying off debt, aggressively securing high quality employees and acquiring capital assets. That being the case, then what would explain Amazon's overpriced stock?

The Basics of Security Valuation

Among the most frequently quoted security indexes in the Wall Street are the EPS (Earnings per Share) and P/E (Price/EPS) ratio. Due to the mathematical relations between these two variables, any change in EPS is bound to cause a subsequent change in P/E ratio. If i) P is extremely high regardless of the level of EPS or ii) EPS is extremely low regardless the level of P, P/E is bound to be high by its mathematical construct. It goes without saying that the higher the EPS, the better it is, and therefore, will lead to a higher stock price. On the other hand, however, even with mediocre EPS, if some other conditions such as speculation, noises, and rumors – even deliberately fabricated favorable to a firm – still keep the stock price irrationally buoyant, the ratio will still be abnormally high regardless of its actual fundamentals.

The root cause of all evil was that a good number of overoptimistic investors put too much frothy confidence in the myth that the growth firm's P/E is supposed to be high due to inevitably high expenditures essential for fast expansion and aggressive marketing, as in Amazon's case, that would eventually lead to higher future returns – only under normal circumstances. However, as with anything, good things don't last forever, and the unprecedented decade of uninterrupted growth and prosperity of the 90s lost steam at the turn of the new millennium. As the overheated economy that came to a screeching halt could not support Alan Greenspan' now acclaimed classic quote – "irrational exuberance", the bubble busted, and with this economy-wide reality check many dot-com ventures crashed. And the stock market went into a phase of correction that was long overdue.

[2] This is obtained by dividing the total equity value by the number of shares outstanding.

If ever the US economy escaped any hard landing despite the severe blow of the busted bubble in the stock market, it would be thanks to the boom in the housing market that continued to support the post-2000 US economy even after most of the solid manufacturing sector left the US soil for outsourcing. Although the slowdown in the economy and in the overall rate of return in the stock market may have contributed in most part to the flow of the funds into the housing market, it would take more in-depth analysis to understand that the general housing market boom has a lot to do with the US trade deficit.

The Flip Side of the U.S. Trade Deficit

As often pointed out, the balance of trade between the US and its major trading partners is tipped in favor of its trading partners – especially China. As of this writing, the current US trade deficit stands at about $65 billion[3], most of which was run against China. The competitive advantage of the Chinese imports arising largely from the cheap labor must be one of the major factors that contributed to the continued extravaganza of continued growth in consumption even during the slowdown in the post-2000 US economy.

What would China, the major beneficiary of this economic *status quo*, be most afraid of? It would obviously be afraid of anything that might topple this current *status quo*. What, then, are the factors that could topple it? The primary factor, of course, would be the Dollar/Yuan exchange rate. It is also a well-noted fact that Yuan is disproportionately undervalued despite the fast growth in the Chinese economy that has raked benefit of the *status quo* in the balance of trade between the two countries, which in turn constitutes a feedback loop that only reinforces this status *quo*. Hence, China would have all the reasons to defend this loop, whereas the US would have all the reasons to break it. It would also be ironical, however, that it is not entirely in the best interest of the U.S. to break the loop. The rationale for this conflicting message will be discussed later, but for now, I would like to focus more on what efforts China has made to maintain this loop.

As was the case with South Korea during the 70s and 80s, the countries that pursue export-driven growth generally hoard foreign reserves earned through exports to acquire capital assets essential to economic growth from overseas. In other words, this is an indispensable part of investment process for growth. China, however, has been spending a significant proportion of its hard-earned foreign reserves on buying US Treasury securities. Of course, it would not be such a bad idea considering that there are no less risky investment instruments than US Treasury securities, but it still seems like an obsession when considering the fact that the Fed Funds rate had remained barely at 1% level for a good period of time even until a year ago as of this writing[4], the Treasury yield level that is in turn linked to the Fed Funds rate, and the overall interest rates in the US.

The truth of the matter is that China needs to buy US dollars to buy US securities, and since it must sell the amount of Yuan equivalent to the dollar amount it wishes to buy, the

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[3] This is only about 0.5% of the US GDP in 2005. The significance, however, is more in the cumulative effect over the years.
[4] As of this writing, the fed funds rate has soared to 5% from the historical low of 1% even a year ago in May 2005.

greater the demand for US dollars, the greater the amount of Yuan China must sell, and therefore, the Yuan exchange rate is bound to go up (depreciate) against the US dollar. This in turn feeds back into the loop of trade surplus for China or trade deficit for the US. Therefore, the demand for US Treasury securities raises their selling prices, which consequently lowers the Treasury yield, which in turn lowers the US interest rates linked to the Treasury yield.

Throughout the early 2000s, the US economy was awash with the dollars pumped back into the system through the sale of Treasury securities to China, and the resulting low interest rates, therefore, gave the finance and banking industry no other choice but to dramatically increase lending. And what better market to lend than the housing market in the murky US economic landscape abandoned by the solid manufacturing industries and overshadowed by the stock market ailing with mediocre returns in the aftermath of the bubble bust? The housing market was the only fail-safe sector attractive enough to be still viewed as the goose that lays golden eggs, in which at least their investments can be protected by foreclosures and repossessions in case the borrowers default.

The annual growth in the real estate market during this period averaged around 10%, which served as the main workhorse that helped the overall economic growth to stretch its linger around 2.5%~3.5% range during the same period. This situation puts the US government in dilemma when it comes to actually taking any strong position to flex muscles over the Chinese government to revalue Yuan while talking tough under the heavy lobbying from their constituent business communities that demand real actions. The US government knows well what ramifications the Yuan revaluation might bring to the US economy, so it's in no position to wish for more than just a symbolic gesture for revaluation from China.

The Increase in Money Supply in the US Economy

It boils down, then, to the question of "Why has the Fed (FRB) raised the interest rate by almost 4% over the past one-year period?". While the tight money is usually the policy taken to curb the inflation and to cool off the overheated economy, one cannot help but question whether there has been any perceivably significant inflation. The FRB has maintained that their rationale behind the raise in interest rate is the concern about possible inflation "arguably" looming over the horizon, but the actual growth in price level in the US has averaged around 1.5%~2.5% per year during this post-2000 period, which is only about the historical average of the US or slightly below. Besides, this means that the real economic growth has barely been only about 1%~1.5% ahead of the inflation each year. Has there really been any significant overheating that warrants the countermeasure for inflation?

Of course, it is true that a good proportion of the US population has been feeding their spending frenzy with low interest rates, low mortgage rates, and low home equity loan rates while the overall US consumer spending has been exorbitantly high even to the point of dissaving. Also, with the current unemployment rate standing at about 4.5%, roughly the natural rate of unemployment for the US[5], it may not be entirely incorrect to

[5] This means that almost everyone in the labor force, willing and able, is employed.

argue that the consumer spending has been supported by this near-full employment. However, this allegedly low unemployment rate is computed in such a way that excludes from the calculation those discouraged job seekers who were forced to give up on job search due to the continued structural failure.[6] Consequently, this unemployment figure is inevitably underestimated. Also, considering that those workers laid off from the downsizing and exiting manufacturing industries are now mostly under-employed in service sectors or barely holding minimum wage jobs, it will be a far-fetched claim to maintain that the consumer confidence is keeping the spending going strong, much less to worry about the inflation stemming from the overheated economy.

Perhaps, a better defense for inflation argument would be the concern that the rising oil prices might bring in the stagflation or cost-push inflation. Or better still, it may be viewed as a preventive measure to the possible hard landing of the economy that can be triggered by the crash in the housing market if the bubble in the limited number of metropolitan areas bursts such as New York, L.A., Houston, Atlanta…etc. Therefore, it may only be logically concluded the excess dollars in the U.S. economy from the trade deficit with China is feeding into the concerns about inflation.

Disparity between Fed Funds Rate and Mortgage Rate

Whatever the reason they may contend, it is obvious that the 4% rise in the fed funds rate over the past one-year period certainly dampened the overheating, if any, in economy. However, it is curious that the mortgage interest rates have not quite caught up with the rise in fed funds rate during the same period. In early 2005 when the FRB started raising the fed funds rate gradually by ¼%, which was standing at its historical low of 1% at the time, the mortgage rate that was standing at about 4.5% level at the time rose only 1.5% to 6% as of this writing. Considering that the fed funds rate and the yield on short-term Treasury bill, also closely linked to the fed funds rate, constitute the bottom line for all the interest rates in the US that layer up on them, it would only make sense that the general interest rate level would rise by as much as the rise in fed funds rate. How, then, could only the mortgage rates be free from this overall trend? The answer to this question can also be found again in the excess money supply from the trade deficit with China. In order to put this influx of dollars to good use, the banking sector has no choice but to increase lending, which makes it inevitable to lower the lending rate even in the face of rising overall interest rates.

It will be another ball game entirely to assess how much crucial impact this influx of dollars from the $65 billion-a-year trade deficit would have on the overall US economy of $13 trillion, let alone the cumulative effect. But coupled with the fact that the US depends on the cumulative effect of even what little excess money supply to fill in the

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[6] It is a well-noted fact that over the latter part of the 20th century, the global industrial capitals opted for divesting away from the manufacturing sector fraught with innate labor issues that cannot easily be resolved by simply exiting as the high level of fixed costs is sunk in physical assets, which was the main reason for the relative job security in the manufacturing sector. Therefore, they have moved on to the service or the knowledge-based industries that are less prone to such issues and thus, present higher capital mobility to the industries and markets with higher return whenever the ROI drops. Such is only the nature of the beast.

current budget deficit of about $500 billion (amounting to 4% of the US GDP in 2005), it may not be entirely paranoid to be wary of possible inflation from this excess money supply. Then, with little to no perceivable real growth in the economy, inflation can truly be an issue of only money supply and nothing but money supply, as Milton Friedman once so aptly pointed out. And it won't be a surprise at all that the FRB, the ultimate bastion of the monetarists, believe in this fundamental monetarist tenet and accordingly take policy measures to raise interest rates despite weak real growth.

Current Outlook for the US Economy

What will be the outlook for the US economy for the rest of 2006 then? First, unless there are changes to the exogenous variables such as oil prices, the economy will continue to grow about 3.5% in 2006. The unemployment will remain at 4.5%~4.6% while inflation will be held at around 2.5%, which is not considered too shabby by any standards. The baseline interest rate is expected to remain at around 5% level, as the 1-year T-bill yield will be about 4.85% while the 10-year T-bond yield is expected to be about 5.06%~5.08%. Mortgage rates are not expected soar above 7%, which, although still lower than the historical average of 8%, may still keep the market in freeze for a while. However, the weak demand due to higher mortgage rates will also fizz off the bubble in some overheated local markets, and eventually bring it to the much needed correction. The budget deficit will stand at about $400 billion, and is expected to be gradually brought under control by 2010 to about 1.3% of the GDP. Trade deficit is expected to stand at about $70 billion level. Consumer confidence, measured against 1966 as 100, is estimated to be 99, indicating that the FRB's fear of inflation is not entirely due to overheated consumer spending as I have pointed out.