



What Economists are Forecasting for the First Half of 2005

Each January and July, about 50 economists and assorted pundits participate in the Wall Street Journal's semi-annual economic forecasting survey. The January 2005 survey hit the papers earlier this month. Alongside current forecasts were those made on July 2, 2004. These folks are supposed to be the country's most influential economists (an oxymoron?), so it can be useful to analyze what they are telling their bosses and clients.

Short-term Interest Rates - In our youth, a wide open lay-up in basketball was called "a duck". You didn't want to miss a duck. July's forecast for December '04 T-bill rates was a duck. All you had to do was count up the remaining Fed meetings in 2004, multiply by +25bps (the Federal Reserve's definition of "a measured pace"), and add the result to 1.25%. That got you to a best guess year-end Fed Funds rate, with T-bills a lock to be in the same neighborhood. And so it was, as the 2.08% forecast for Dec '04 just missed the 2.21% actual. If the Fed keeps raising the target Fed Funds rate at the same measured pace, it will be at 3.25% by the 4th of July. This compares to the median T-bill forecast of 3.04% (and high-end of 3.40%). Seems like the economists can still read Greenspan's lips, loud and clear.

Long-term Interest Rates - The July consensus was for the 10-year Treasury bond yield to continue rising for the rest of the year, from its 4.59% starting point on June 30th, to 5.14% at year-end. How hard was that to foresee, with rising short-term rates already a lock? Turns out plenty. In 2004's biggest surprise to investors, long-term T-bond yields fell during the second half of the year, right back to the 4.22% level of *last January*. The current median forecast is for the long bond's yield to rise just 60 bps in the first half of 2005, to the 4.8% range.

Real GDP Growth - Economists have been steadily ratcheting down their quarterly forecasts in this area, but were still overly optimistic compared to actual results throughout 2004. The initial estimate of 4Q growth is due out in late January. The "official" forecast is still at 4.2%, but the whisper number has been reduced to 3.8%.

The current median forecast of real GDP growth in 2005 is rock steady at 3.6% for each quarter. Lower than the past two years, but slightly above the long-term average. Perhaps more telling are the most optimistic guesses, which top out at 4.7%. Last July, they ranged up to 5.3%.

Consumer Price Inflation - Forecast at midyear to hit 2.9% on a trailing year-over-year basis, the actual November '04 figure was instead an unexpectedly high 3.5%. That compared unfavorably to the Nov '03 level of 1.8%, and last May's 3.1% figure. Price increases simply did not moderate from May to November, with the big three - energy, food, and health care - all up. Undaunted, the average economist forecasts this May's CPI to be up only 2.5% year/year, which will require a slowdown in price gains during the first five months of 2005.

Value of U.S. Dollar - The final miss of last July's forecast related to F/X rates. At 103, the Yen gained almost 5% versus the US\$ in the second half of 2004, compared to a median forecast of no change. The Euro ended 2004 at \$1.36, up over 11% since June, compared to a forecasted *decline* of 3%. Even the most bearish economist didn't foresee such a € rise. Current median F/X guesses are for the Yen to appreciate 1% during the first half of 2005, and the Euro to decline 2.2%.

Unemployment Rate - It is projected to decline very modestly during the first half of 2005, to 5.3% (current level is 5.4%). This implies continued growth in the number of people employed, but nothing earthshaking.

Our Take on This? - The overall consensus forecast clearly sees a smooth sailing, "steady as she goes" economic environment, at least for 2005. In effect, it suggests we've already absorbed much of the consequences of our nation's huge trade and budget deficits - even though the deficits themselves have only increased. That seems to us like a big stretch. We're most worried about higher long-term interest rates, a weaker Dollar, and higher inflation (in that order).



-- First Half 2005 Forecasts -- (as of January 3, 2005)

| | 3 month T-Bills @ JUNE '05 | 10 year T-Bonds @ JUNE '05 | GDP 1 st Qtr 2005 | GDP 2 nd Qtr 2005 | GDP 3 rd Qtr 2005 | GDP 4 th Qtr 2005 | CPI Yr/Yr Chg. @ MAY '05 | ¥en / \$ Spot rate @ JUN '05 | \$ / Euro Spot rate @ JUN '05 | Unempl. Rate @ MAY '05 |
|---|----------------------------------|----------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|-----------------------------------|------------------------------------|-------------------------------------|------------------------------|
| Survey Average | 3.04% | 4.79% | +3.5% <i>(was 3.7%)</i> | +3.6% <i>(was 3.7%)</i> | +3.6% | 3.6% | 2.5% | 102 ¥/\$ | 1.33 \$/€ | 5.3% |
| Survey Range * | 2.40 – 3.40 | 4.25 – 5.50 | 2.2 – 4.5 | 2.5 – 4.6 | 2.8 – 4.6 | 2.7 – 4.7 | 1.9 – 3.3 | 95 - 115 | 1.20 – 1.45 | 4.9 – 5.6 |
| ACTUAL 6/30/05 <i>(actual 12/31/04)</i> | ??? | ??? | ??? | ??? | ??? | ??? | ??? | ??? | ??? | ??? |
| | <i>(2.21%)</i> | <i>(4.22%)</i> | | | | | <i>(3.5%)</i> | <i>(103 ¥/\$)</i> | <i>(1.36 \$/€)</i> | <i>(5.4%)</i> |

-- Second Half 2004 Forecasts -- (Posted on July 2, 2004)

| | 3 month T-Bills @ DEC '04 | 10 year T-Bonds @ DEC '04 | GDP 3 rd Qtr 2004 | GDP 4 th Qtr 2004 | GDP 1 st Qtr 2005 | GDP 2 nd Qtr 2005 | CPI Yr/Yr Chg. @ NOV '04 | ¥en / \$ Spot rate @ DEC '04 | \$ / Euro Spot rate @ DEC '04 | Unempl. Rate @ NOV '04 |
|---|---------------------------------|---------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|-----------------------------------|------------------------------------|-------------------------------------|------------------------------|
| Survey Average | 2.08% | 5.14% | +4.4% <i>(was 4.1%)</i> | +4.2% | +3.7% | 3.7% | 2.9% | 108.2 ¥/\$ | 1.20 \$/€ | 5.3% |
| Survey Range * | 1.40 – 2.50 | 4.53 – 5.60 | 3.2 – 6.0 | 3.1 – 5.6 | 2.8 – 5.3 | 2.8 – 5.3 | 2.0 – 3.6 | 96 - 120 | 1.08 – 1.33 | 4.7 – 5.8 |
| ACTUAL 12/31/04 <i>(actual 6/30/04)</i> | 2.21% | 4.22% | 4.0% | ??? | ??? | ??? | 3.5% | 103 ¥/\$ | 1.36 \$/ € | 5.4% |
| | <i>(1.32%)</i> | <i>(4.59%)</i> | | | | | <i>(3.1%)</i> | <i>(108.8 ¥/\$)</i> | <i>(1.22 \$/€)</i> | <i>(5.6%)</i> |

* Excluding outliers

Sources:

“The Wall Street Journal Forecasting Survey for 2004 and 2005”, 7/2/2004

“The Wall Street Journal Forecasting Survey for 2005”, 1/3/2005