

Global Indicators

U.S. Financial Markets
January 2005



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Prepared by

William C. Handorf
Professor of Finance
Department of Finance, School of Business

Lisner Hall 540, 2023 G Street, NW, Washington, DC 20052
Tel. (202) 994-1414 *Fax* (202) 994-5014 *Email* whandorf@gwu.edu

School of Business
The George Washington University
710 21st Street, NW, Suite 206, Washington, DC 20052
www.business.gwu.edu

A searchable faculty experts database is available at www.gwu.edu/media.
For media assistance, contact Robert Moll, Director of GWSB Communications,
at (202) 994-2492 or rmoll@gwu.edu.

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ANNUAL FINANCIAL MARKET HIGHLIGHTS

JANUARY 2005

- *The Federal Reserve increases the trading range of federal funds for the fifth time since mid-year 2004.*
- *The financial futures' market project the central bank will increase interest rates by another $\frac{3}{4}$ of one percent within the first half of 2005 as monetary policy turns neutral.*
- *The yield curve flattens as the market believes economic growth will remain modest but inflation will not accelerate to intolerable levels.*
- *Corporate bond yields continue to decline as the market seeks yield over safety and confirms expectation of sufficient growth for firms to pay interest and repay principal on debt on a timely basis.*
- *Inflation spread widens a little as the market projects average annual inflation of 2.6 percent over the next decade, which is consistent with recent experience.*
- *Households continue to take on debt at near double-digit levels and state/local debt balloons quickly.*
- *Both broad and narrow money supply growth slows to 5.5 percent from eight to ten percent allowed during the recession of 2001 and slow recovery of 2002/03.*
- *Commodity markets exhibit no clear consensus regarding inflation but gold prices jump over ten percent from year-earlier levels.*
- *Industrial production continues to increase and capacity utilization rates increase modestly but still remain 2.5 percent below the historical average.*
- *Purchasing managers within the manufacturing sector remain optimistic as production, new orders and employment opportunities all increase.*
- *Equity markets exhibit strong appreciation since the presidential election as investors apply lesser price-earnings multiples to higher earnings.*
- *The economy continues to add sufficient new jobs to offset population growth and reduce unemployment rate to 5.4 percent.*
- *Consumers spending increases 6.0 percent over the past year but income grows by 4.8 percent; the savings ratio falls to near zero level.*
- *Housing market begins to show signs of easing after torrid pace of past three years; the median price of existing homes sold increase nine percent in past year.*

ANNUAL FINANCIAL MARKET TRENDS

Federal Reserve Raises Rates Again

Monetary Policy Remains Accommodative

The Federal Open Market Committee (FOMC) of the Federal Reserve increased the trading range of federal funds another .25 percent to 2.25 percent in their mid-December meeting. The central bank has increased rates five times since mid-year 2004. The FOMC believe that policy accommodation can be removed at a pace that is likely to be measured. The financial futures' market project the central bank will increase interest rates another .25 percent by the February 2 meeting and assign an 80 percent probability that rates will increase to 3.0 percent by May. The *Beige Book* prepared prior to a meeting of the FOMC showed that 11 of the 12 Federal

Reserve districts reported expansion; Cleveland was the only district that did not show growth. Most of the districts indicated that retail sales were mixed but business investment and service sales were strong. The central bank must contend with slowing productivity, depreciation of the U.S. dollar, sharply higher and volatile energy prices and preliminary evidence of accelerating inflation. Real or inflation-adjusted interest rates on federal funds are now positive as monetary policy accommodation moves toward a more neutral stance. Not all interest rates increased during the past year.

Table 1
Annual Interest Rate Trends

| Money Market (Three-month) | IV Quarter 2004 | | IV Quarter 2003 | |
|--|-----------------|--------|-----------------|--------|
| | Rate | Spread | Rate | Spread |
| US Treasury Bill | 2.19% | 0.00% | 0.88% | 0.00% |
| Commercial Paper | 2.43% | 0.24% | 1.03% | 0.15% |
| Certificate of Deposit | 2.46% | 0.27% | 1.09% | 0.21% |
| Capital Market (20 to 30 Years) | | | | |
| US Treasury Bond | 4.70% | 0.00% | 4.91% | 0.00% |
| Corporate Bond | | | | |
| High-grade (Aa) | 5.53% | 0.83% | 5.77% | 0.86% |
| Medium-grade (Baa) | 5.83% | 1.13% | 6.17% | 1.26% |
| Low-grade (B) | 6.76% | 2.06% | 7.60% | 2.69% |
| Mortgage-backed Security | | | | |
| Fannie Mae (FNMA) | 5.11% | 0.41% | 5.25% | 0.34% |

Sources: *The Wall Street Journal* and *Merrill Lynch Indices*

Table 1 illustrates the **annual** change in U.S. interest rates for key short-term money market, and long-term capital market instruments. Interest rates respond to shifts in the global supply of and demand for funds, and to perceptions of inflation. Short-term money market interest rates increased about 1.25 percent during 2004, which is consistent with the change in the trading range of federal funds approved by the Federal Reserve.

Long-term US Treasury bond yields decreased given expectations of continuing expansion at a moderate pace. Gross domestic product (GDP) increased by a revised annual rate of 3.9 percent in the third quarter of 2004. The Organization of Economic Cooperation and Development (OECD) lowered their forecast of growth in the United States during 2005 to 3.3 percent given the expected drag of high energy costs. The OECD also reduced their forecast of GDP growth for the 12-country euro-zone to 1.9 percent. Corporate bond yields also declined in

2004 as investors believe the recent expansion will continue for the next year and are comfortable with the ability of firms to pay interest and repay principal. Table 1 also illustrates the annual shift in interest rate spreads; a spread reflects the difference in yield between a corporate or agency security and a U.S. Treasury instrument of comparable maturity. Interest rate spreads mostly change in response to perceptions of default risk and tolerance for credit risk by investors and traders. Credit spreads for short-term money market instruments increased from very low levels in 2003 as corporate working capital increases and related demand for bank loans shows signs of increasing. Capital market credit spreads narrowed, especially for low-grade corporate debt, as market optimism pervades the debt market. Investors have sought higher yields in the low-grade bond market given the low yields still available in the money market, nervousness in the equity market and expectations of continued expansion of GDP.

Table 2
Annual Interest Rate Spread Trends

| Spread | IV Quarter 2004 | IV Quarter 2003 |
|------------------------|------------------------|------------------------|
| Yield Curve | 1.99% | 3.37% |
| Medium-grade Corporate | 0.30% | 0.40% |
| Low-grade Corporate | 1.23% | 1.83% |
| Inflation | 2.58% | 2.38% |

Sources: *The Wall Street Journal* and *Merrill Lynch Indices*

Several interest rate spread relationships, to include the yield curve spread, corporate bond credit spreads, and the U.S. Treasury Note/Treasury Inflation-protected Security spread provide information that may be used to project future economic conditions, and to

confirm recently-released information about trends within the U.S. economy. Although individual indicators may provide false indications of strength or weakness, the composite spreads provide a reasonable representation of market expectations. Table 2

illustrates the annual trend for each of the key interest rate spreads.

- **Yield Curve Spread** -- The yield curve provides a graphical relationship between the yield and the remaining term of a U.S. Treasury security. The yield curve spread is the difference in yield between ten-year U.S. Treasury notes and three-month U.S. Treasury bills. The slope of the yield curve partly reflects expectations of interest rates in the future. A less positive slope suggests the market expects interest rates to increase by a lesser amount and/or rate hikes will be further into the future. The yield curve spread decreased by a very large 140 basis points in 2004 as short-term interest rates increased and ten-year rates changed little. The yield curve spread is approaching the historical average, which is approximately 180 basis points over the past 20 years. The bond market believes the Federal Reserve will raise interest rates in measured steps, inflation will not accelerate to intolerable levels and economic growth will be good (e.g., three-plus percent) but not exceptional. If the yield curve spread declines to below 120 basis points, the probability of a recession in the United States increases within the next year.
- **Corporate Credit Spreads** -- The corporate credit spread reflects the difference in yield between corporate securities of comparable maturity but different asset quality. The low-grade corporate bond spread provides an especially good gauge of the market's perception of and tolerance for credit risk in the market. The yield spread between low-grade (e.g., BB, B and CCC credit ratings) and high-grade (e.g., AAA and AA ratings) corporate debt declined another 60 basis points in 2004 to a very low 120 basis points. The low-grade spread had exceeded 600 basis points at the end of 2002. Clearly, the market is comfortable with credit risk

and project continued expansion.

Meanwhile, the spread between medium-grade (e.g., A and BBB ratings) and high-grade corporate bonds also decreased from a low 40 basis points to a very low 30 basis points. The corporate bond spread decreases when traders believe the economy will expand and investors seek higher yields rather than retreat to safety.

- **Inflation Spread** -- The popular price indices illustrate historical price trends. The financial markets can be interpreted to identify future inflation expectations by focusing on the difference between the nominal yield for 10-year U.S. Treasury notes, which were used to derive the U.S. Treasury yield curve spread, and the real rate for 10-year Treasury Inflation-protected securities. The inflation spread increased by 20 basis points or .2 percent during the last year; the spread increased from about 2.4 percent a year ago to 2.6 percent as of year-end 2004. The financial markets have long been more concerned with accelerating prices than the FOMC. The U.S. dollar has depreciated 8.5 percent against the euro, 3.0 percent against the yen and 10.7 percent against the pound sterling during the past twelve months. The cost of imported goods increases as the U.S. dollar loses value and exporters have an opportunity to increase the price of their goods given the increase in value of other key trading partner currencies. During the past year, import prices jumped 9.3 percent while export prices have increased 4.3 percent.

The FOMC recently stated, "The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal." The central bank also indicated, "Inflation and longer-term inflation expectations remain well contained."

Inflation Indices Increase Given Earlier High Cost of Oil

The popular price indices reflect earlier sharp increases in the cost of oil.

- The Producer Price Index jumped by .5% in November and is 5.0% higher than one year ago. The core rate of inflation for wholesale goods, which removes volatile energy and food costs, increased a more modest .2% in the past month and is just 1.9% over that posted last year.
- The Consumer Price Index increased .2% in November; consumer prices are 3.5% higher than one year ago. Core consumer prices

also increased .2% in the past month yet are just 2.2% higher than a year ago.

- Inflation, as measured by the Personal Consumption Expenditures Index for the month ended October, increased by 2.4% during the past year while core prices have increased a modest 1.5%.

Firms soon will attempt to pass on higher cost energy prices and still escalating health care costs as capacity utilization rates increase above current levels.

Table 3
Commodity Cost Trends
(Percentage Change)

| Commodity | December 2004 | Past Year |
|------------------|----------------------|------------------|
| Food | 2.3% | -9.6% |
| Industrial | -1.3% | 9.9% |
| Gold | 4.1% | 11.0% |
| Oil | -12.5% | 30.3% |
| All-commodity | 1.8% | -1.3% |

Source: *The Economist*

Table 3 illustrates the monthly and annual trend in the percentage cost of key goods traded in the commodity market. The commodity markets continue to provide no consistent perspective of likely inflationary pressure; some prices are declining while others are rising by sizable percentages. Gold prices, which provide a harbinger of inflation, increased by another four percent in the past month and are 11 percent higher than a year ago. The cost pressure on gold partly reflects global terrorism and regional wars in addition to concerns regarding the threat of the high cost of oil working their way into the inflation indices on a more permanent basis. The

all-commodity cost index increased almost two percent in December but is more than one percent lower than a year ago. Food prices have declined by almost ten percent in the last year but increased over two percent in December. Although industrial commodity costs declined again in December, they are almost ten percent higher than a year ago as the manufacturing sector recovers from its prior three-year slump and global demand for goods remains strong. Oil prices plummeted over ten percent in December but remain 30 percent higher than a year ago.

Purchasing managers within both the manufacturing sector and the service sector surveyed by the Institute for Supply Management uniformly indicate their firms are facing higher costs of goods and services purchased. Companies need not pass on higher cost of goods if management is willing to accept lower gross profit margins or operate more efficiently. Productivity in the U.S. slowed significantly in the third quarter of 2004. After increasing at an annualized rate in excess of three percent for the past year, productivity

slowed to 1.8 percent in the third quarter. The financial markets concur that inflation is accelerating given the increase in the inflation spread previously discussed. The market expects average annual inflation of 2.6 percent over the next decade, which is consistent with recent inflation indices. The FOMC clearly indicates its concern with inflation, "Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to price stability."

Less Government Stimulus

Federal government spending still exceeds revenue growth. The federal deficit equaled US \$58 billion in November relative to a deficit of \$43 billion posted a year ago. The Congressional Budget Office project the fiscal deficit will equal \$331 billion for 2005 compared to the nominal dollar record of US \$412 billion in fiscal year 2004. Continued economic growth, coupled with growing indications of fiscal restraint by the administration and Congress, will pare the large governmental demand for funds.

The Federal Reserve Board of Governors recently released the most recent *Flow of Funds* that depict annual growth rates in debt by various sectors. Table 4 illustrates the percentage

change in debt on an annualized basis for selected sectors in the third quarter of 2004 versus 2003. Debt continues to expand at an accelerating rate in the U.S. financial markets. Although the rate of increase for federal debt declined from 8.2 percent in 2003 to 4.9 percent in 2004, state and local debt ballooned at a 14.2 percent pace this year. Business is borrowing relatively more quickly this year to finance investments in equipment and software. Households have shown little desire to slow down debt financing as their debt still grows at a nine percent annualized pace. Personal income is not keeping step with the growth rate for net new consumer and mortgage debt. Refinancing activity has been replaced by consumers drawing down home equity lines of credit.

Table 4
Quarterly Growth in Debt by Sector
(Seasonally adjusted Annual Rates)

| Sector | III Quarter 2004 | III Quarter 2003 |
|--------------------|------------------|------------------|
| Total | 7.4% | 7.0% |
| Federal Government | 4.9% | 8.2% |
| Households | 9.1% | 9.4% |
| Business | 5.1% | 3.5% |
| State Government | 14.2% | 7.2% |

Source: *Flow of Funds Accounts*, Federal Reserve Board of Governors.

After allowing the money supply to expand at an eight to ten percent rate between 2001 and 2003, the Federal Reserve is restricting monetary growth. Both the narrow money supply, M1, and the broad money supply, M2, have increased by approximately 5.5 percent in the last year. Total reserves in the banking system have increased by a little over two percent. Free

reserves (excess reserves minus reserves borrowed) exceed US \$1.7 billion and have increased by over \$500 million in the past year. The banking system has access to sufficient liquidity to support the economic expansion projected by the OECD and capital market participants.

Equity Market Buoyed by Bush Victory

Industrial Production Exhibits Continued Growth

Business investment in equipment and software increased at an annualized rate of 17.2 percent in the third quarter of 2004 and the rate of expansion has equaled approximately 13 percent during the last year. The index derived from the monthly survey of purchasing managers with manufacturing firms increased to 57.8 in November compared to 56.8 posted in October. A reading above "50" suggests expansion. The survey showed that manufacturers were reporting higher new orders, enhanced production, more employment opportunities, and new export orders consistent with a lower value of the U.S. dollar. Other indicators are consistent with the survey.

- Industrial production increased by .3% in November and is 4.2% higher than a year ago.
- Capacity utilization increased .1% to 77.6% in November and is almost 1% higher than a year ago. However, capacity utilization averaged 81% over the past 30 years so firms will continue to have some difficulty passing on higher costs to consumers.

Interest rates remain low by historical standards. Financing is readily available. It is still uncertain how the phase-out of bonus depreciation that has been allowed through the end of 2004 will impact new investments going forward. The housing market can not maintain its frantic pace of 2004. Consumer income can not keep pace

with the recent growth in debt and household spending will decelerate. Business investment is critical.

After languishing for the first ten months of the year, the equity market increased nicely in the last two months of 2004. Table 5 illustrates the annual trend in key indicators related to the broad-based Standard and Poors 500 Index. Stock prices are up over ten percent in 2004 with most of the increase posted since the reelection of George W. Bush in November. Merrill Lynch recently released a study that shows GDP tends to expand by 4.3 percent in an election year, 3.8 percent for the first year in office, 2.5 percent the second year and 2.7 percent for the third year. Investors anticipate continued growth in corporate earnings but reduced the price-earnings (PE) ratio applied to future earnings; the PE ratio fell from 17.8 times earnings in 2003 to 16.6 times projected earnings this year. Many firms have increased dividend payouts in 2004 given the favorable tax change related to dividend receipts for individuals and equity dividend yields have increased from 1.63 percent to 1.95 percent. Dividend yields are consistent with money market yields. Higher stock prices will increase federal, state and local income tax receipts in 2005 and mitigate some pressure on fiscal deficits at both the federal and state/local level. Higher stock prices also enhance consumer confidence, household wealth and spending.

Table 5
Annual Equity Market Trends
(Standard and Poors 500)

| Standard & Poors 500 | IV Quarter 2004 | IV Quarter 2003 |
|----------------------|-----------------|-----------------|
| Index | 1,182.8 | 1,059.1 |
| Price-earnings Ratio | | |
| Trailing Year | 19.8x | 26.7x |
| Next Year | 16.6x | 17.8x |
| Dividend Yield | 1.95% | 1.63% |

Source: *BusinessWeek* and *Standard and Poors Corporation*

Housing Market Cools but Retail Sales Remain Respectable

The U.S. economy added 112,000 new jobs in November as the unemployment rate inched down .1 percent to 5.4 percent. Employment growth has averaged 180,000 new jobs each month over the past four months. The economy needs to create at least 110,000 new jobs monthly to meet population growth. Jobs are key to confidence and spending.

- Personal income increased .6% in October and spending increased by .7%; as a result of spending again rising more quickly than income personal saving fell to just .2%. Personal income is up 4.8% in the past year while spending increased 6.0%.
- Retail sales increased .1% in November and are 7.2% higher than a year ago.
- Selected stores are reporting very strong growth; J.C. Penney indicated sales were 12.0% above year-earlier levels as of November while upscale Neiman-Marcus posted 8.4% growth.
- Consumers continue to rely on debt to support spending; revolving credit is 1.8% higher than a year ago while non-revolving debt has grown by 6.0%.

Given the very low savings rate exhibited by households, expectation of rising interest rates that make home equity loans more expensive and lack of substantive tax relief projected in the second term of President George W. Bush, the household sector is not expected to propel economic growth at the four percent or higher level on a sustainable basis.

Long-term fixed-rate mortgage loan rates declined from almost 6.0 percent a year ago to 5.7 percent this year. Low interest rates have sustained the housing rally.

- Sales of existing homes declined by .1% in October to annualized unit sales of 6.75 million. Home sales are 5.6% higher than a year ago. The median price of a home sold increased 8.8% to US \$187,000. The inventory of existing home available for sale fell from 4.6 months to 4.3 months.
- Sales of new homes fell in October to annualized unit sales of 1.23 million. Despite the monthly decline, October sales were the third best month since the statistic was published.

- Housing starts plummeted by 13.1 percent in November to 1.77 million annualized unit starts. Although building permits fell by 1.5% to 2.00 million annualized units, building permits are 3.5% above year-earlier levels.

The housing market should set a record for 2004. The rate of growth is not sustainable as mortgagors look to innovative and higher risk loan products such as floating-rate interest-only loans to support rapidly rising costs applicable to housing units.

Summary

Fiscal policy has been stimulative while monetary policy accommodative over the last three years. The governmental actions provided a catalyst for current growth. The upward sloping yield curve and low corporate credit spreads indicate market traders project economic growth in excess of three percent consistent with that now expected by the OECD. The housing market has been torrid given low long-term mortgage interest rates and rising home prices. The economy is adding new jobs and the high unemployment rate of a year ago is much lower. Industrial production is up and capacity utilization rates are increasing. The equity market cheered the reelection of President Bush given almost all of the appreciation in 2004 followed the election.

There are political and economic risks going forward in 2005. The FOMC will continue to increase interest rates; the increase will be quick

if inflation accelerates. The administration and Congress will grapple with alternatives to reduce spending and/or increase taxes. The war in Iraq continues, casualties mount and no clear exit strategy has been articulated. The key domestic questions are whether business investment in equipment, software and real estate will be sufficient to offset lesser housing activity and more moderate consumer spending, and whether the economy can create at least 150,000 new jobs per month. The key international question is whether investors in Asia and Europe will continue to buy U.S. dollar-denominated debt from the U.S. Treasury, agencies and corporations given the inability of consumers or government to save. Best wishes for 2005 and Happy New Year as we learn answers to the critical questions facing the market over the next half-year.

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