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# The Economic and Financial Outlook: An Energetic Economy

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*The McGraw-Hill Companies*



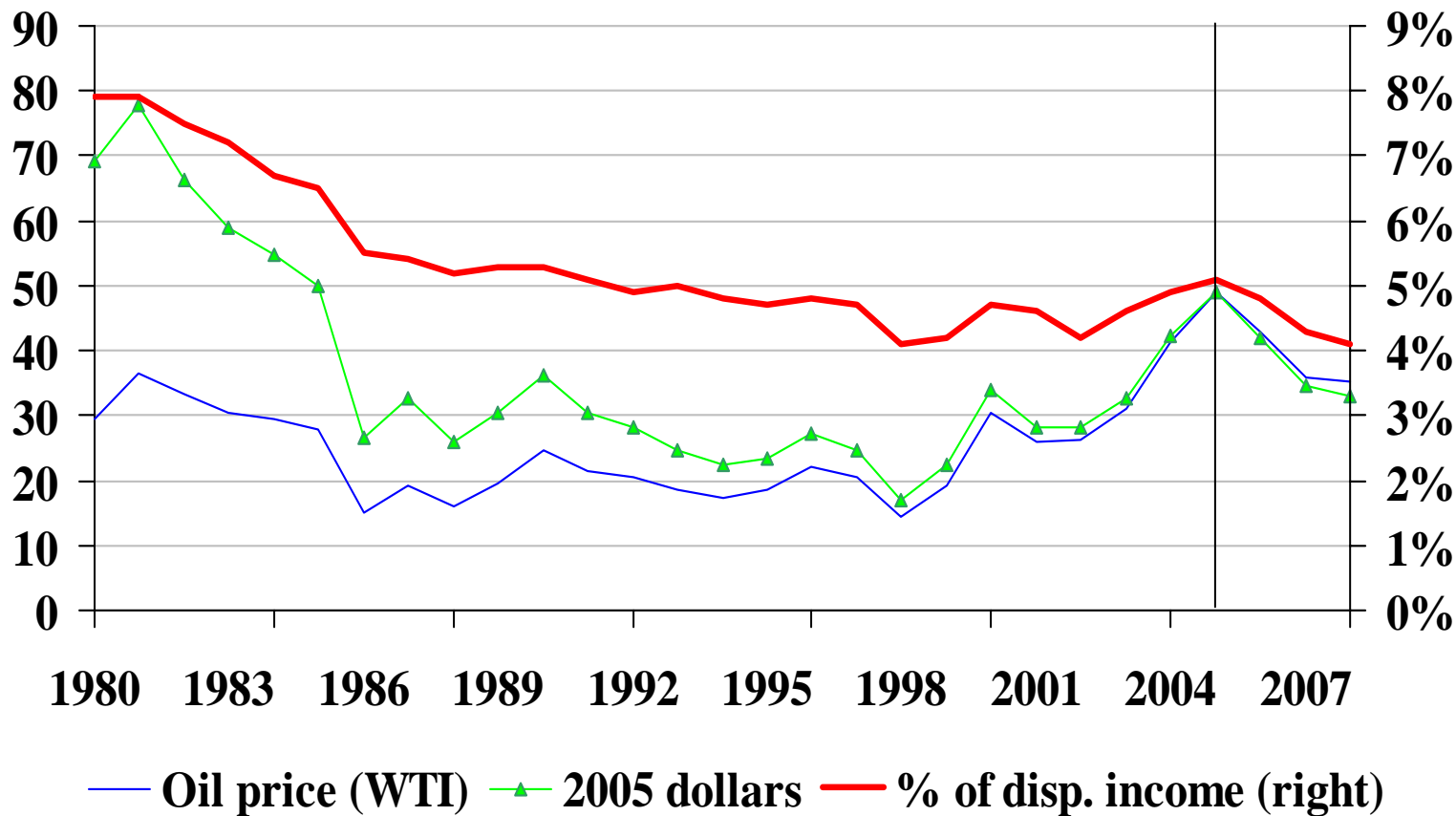
# The Recovery Is Finally Accelerating

- After two years of sluggish expansion
- Jobs are finally materializing
- Up to now, the recovery has run on two legs – consumer and government spending
- Now equipment spending is rising
- And nonresidential construction is starting to recover
- Higher interest rates will slow housing and consumer spending
- Tax cuts are over, and the saving rate is already low
- Federal deficits will come down slowly
- But higher oil prices could stall the expansion
- And world economic stagnation continues to widen the trade gap



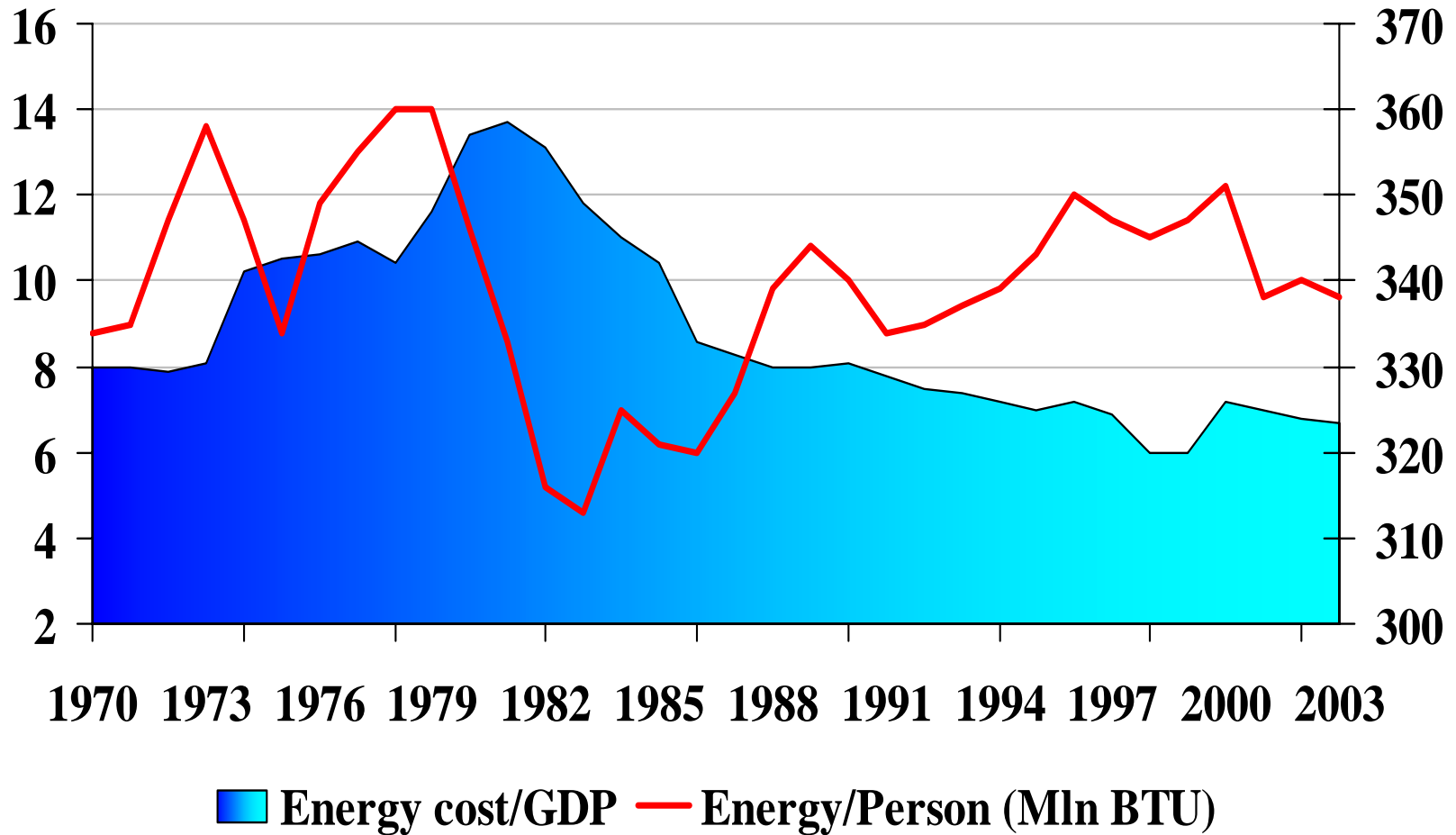
# Oil Prices Are Hitting New Highs

(\$/barrel, WTI and deflated by CPI;  
household energy purchases as percent of disposable income)



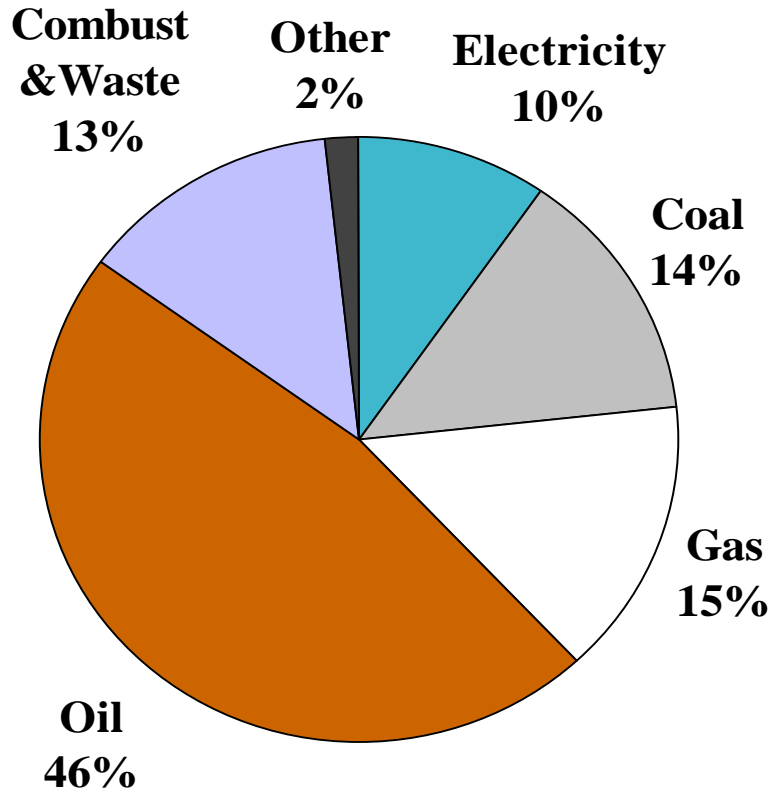


# Energy Consumption

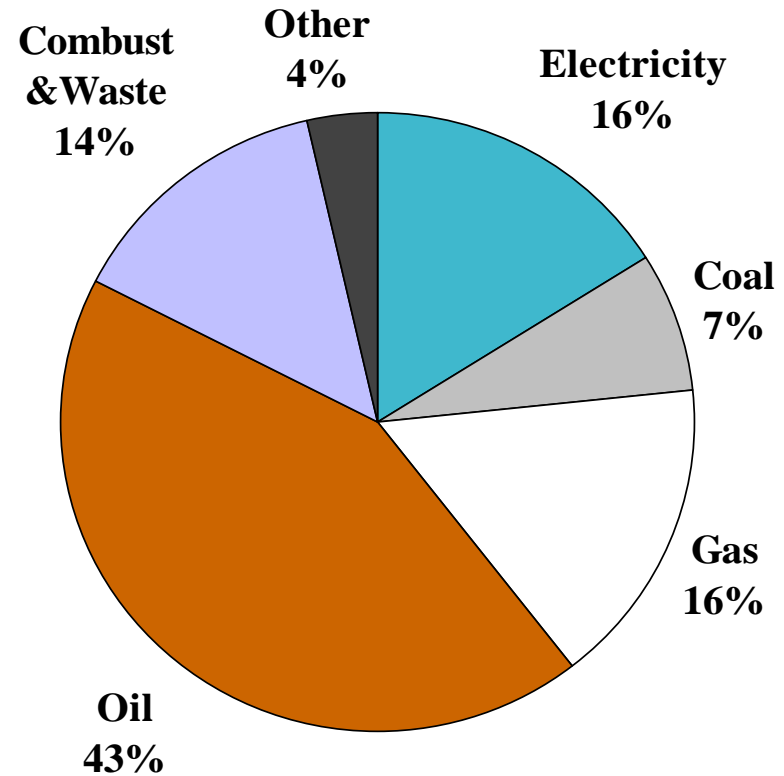




# World Energy Consumption



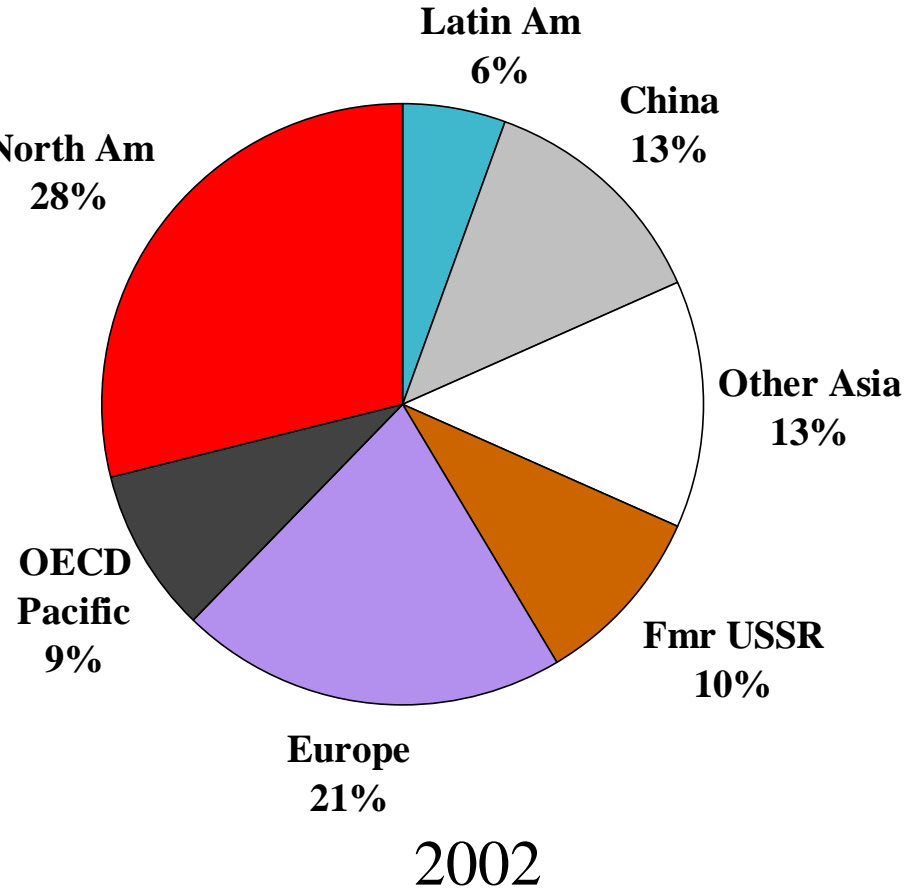
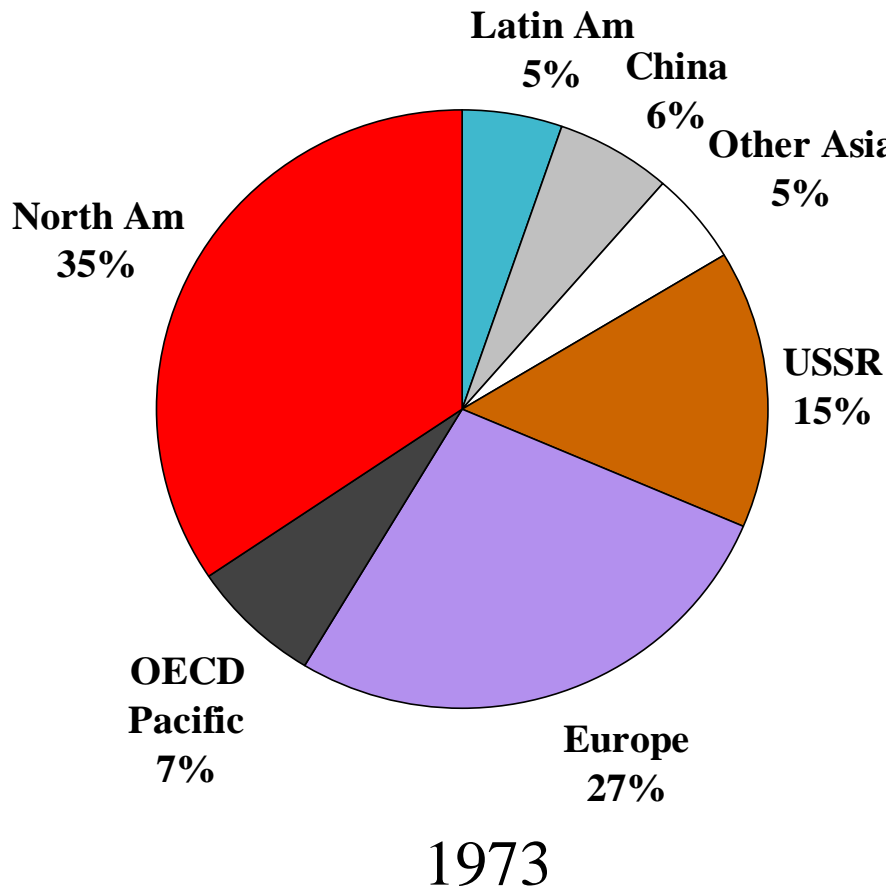
1973



2002

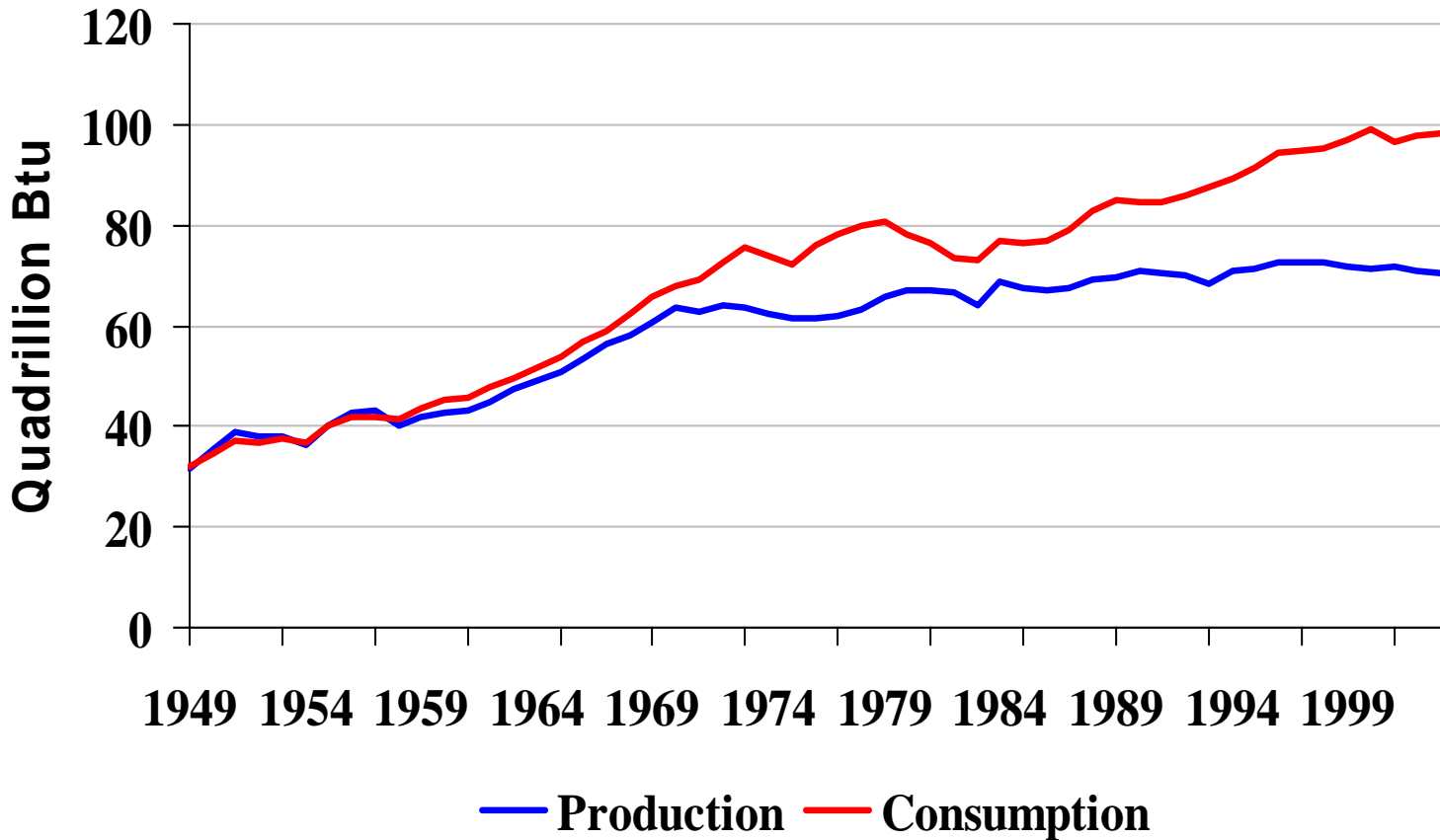


# Energy Consumption by Region



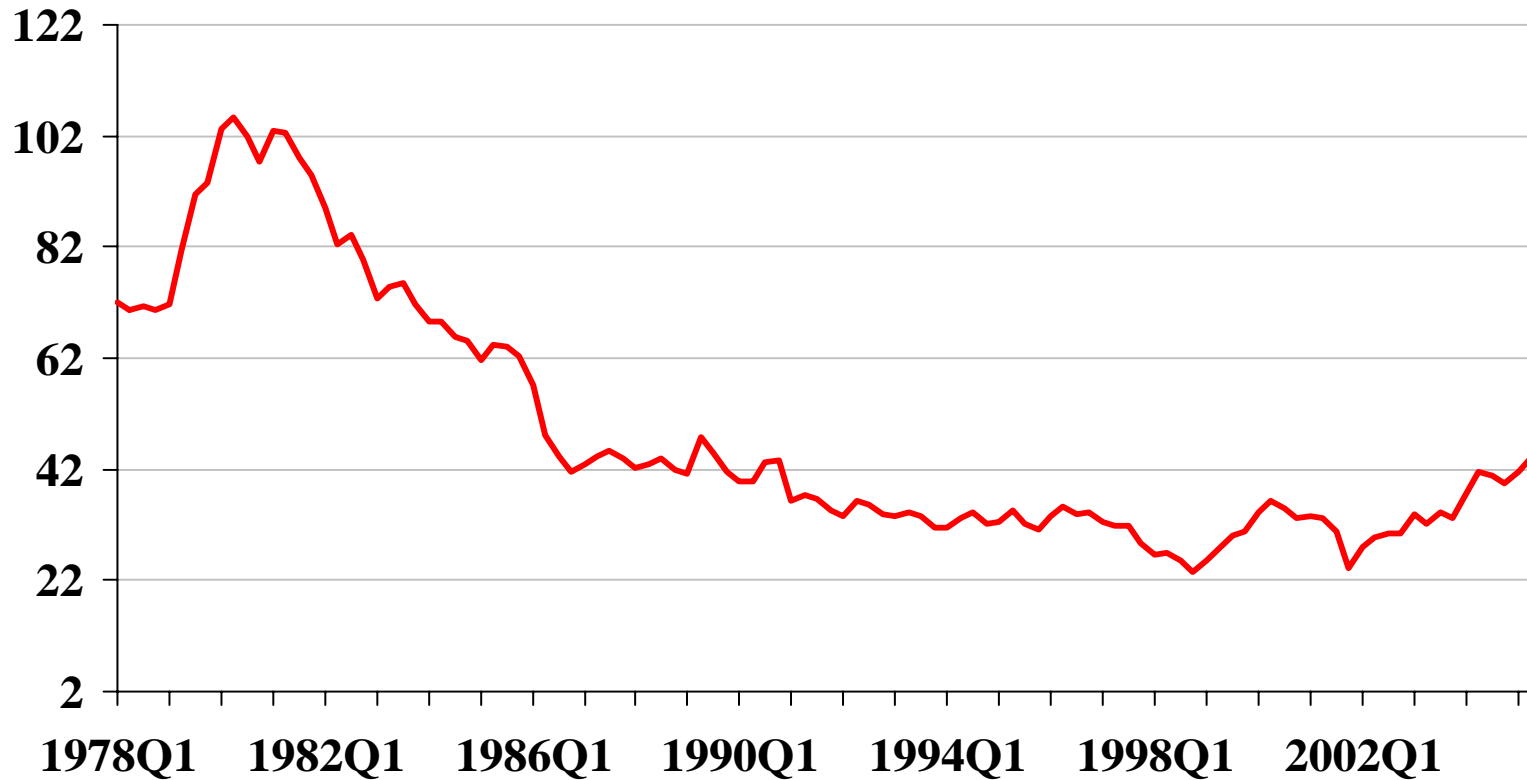


# US Was Nearly Self-Sufficient Until 1970



# How Long Do We Work to Drive 100 Miles in the Average Car?

(Minutes)

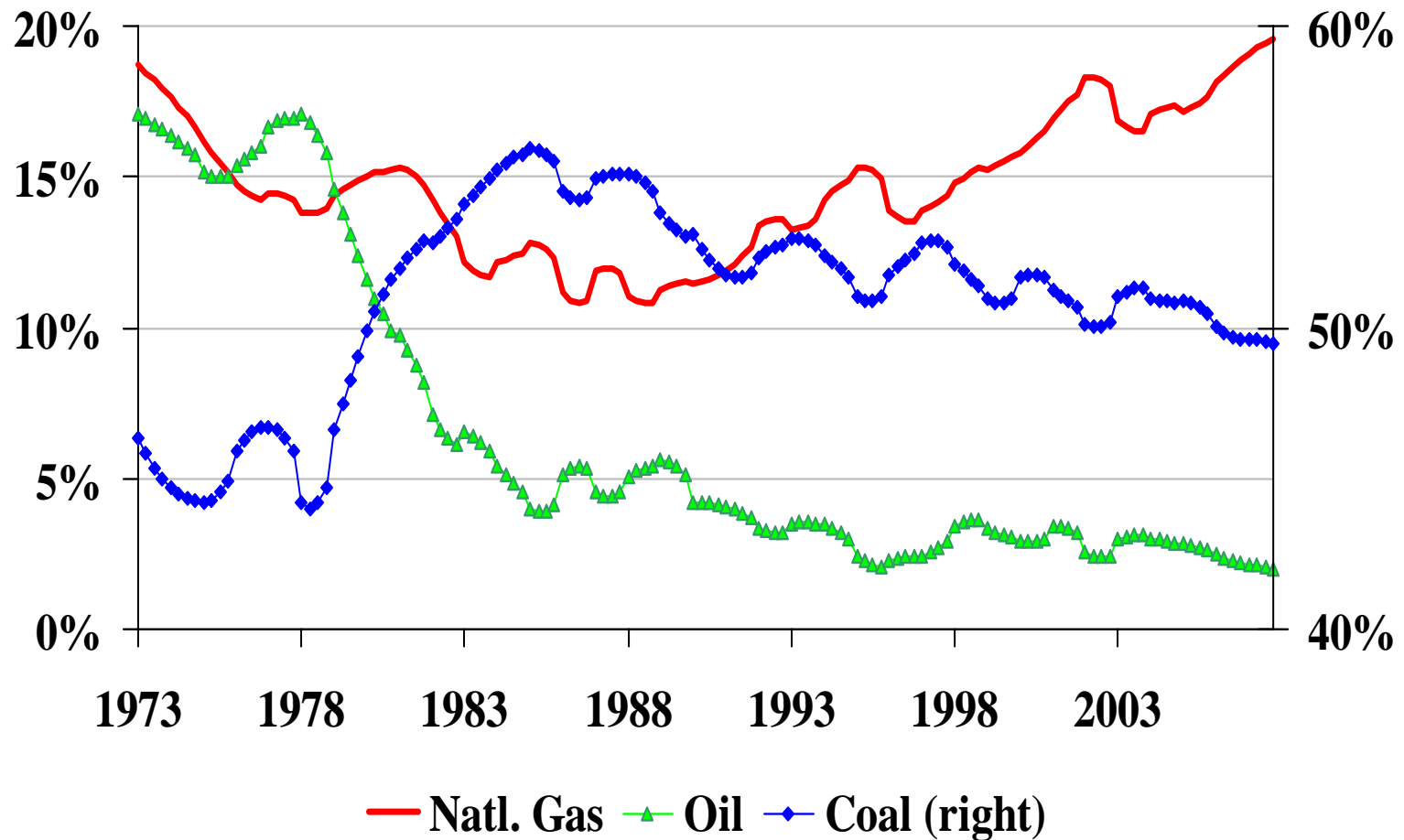






# Components of Electricity Fuel Use

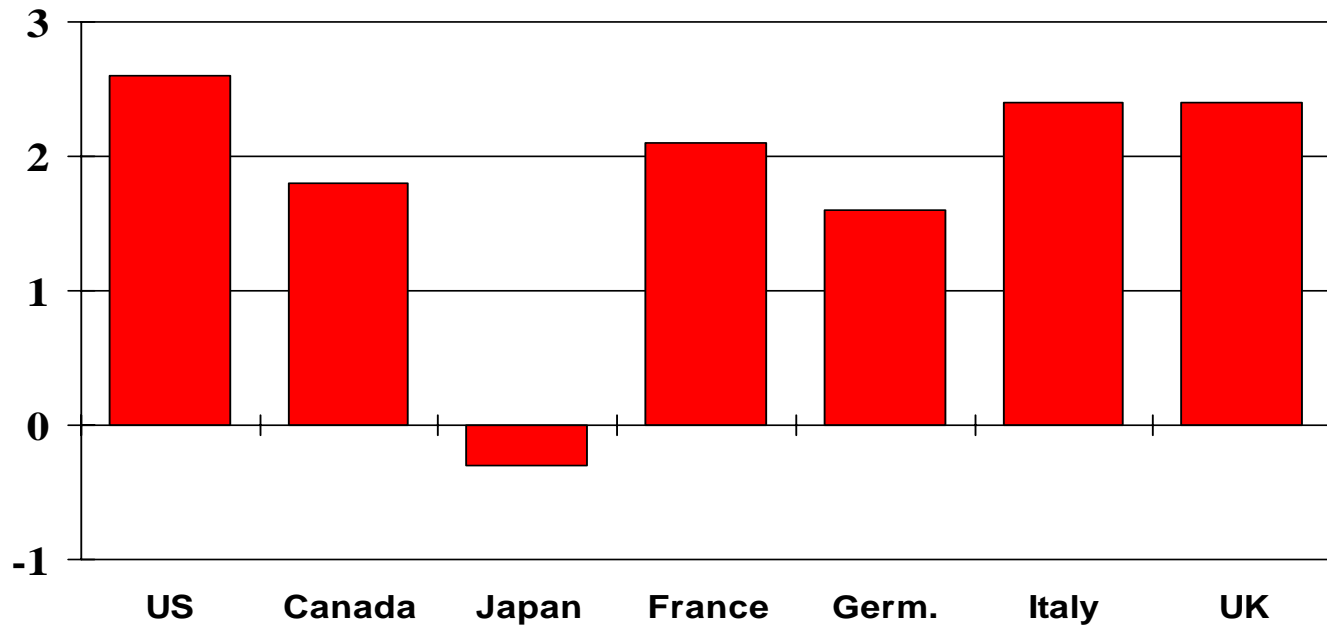
(Percent of total use)





# Inflation Remains Mild

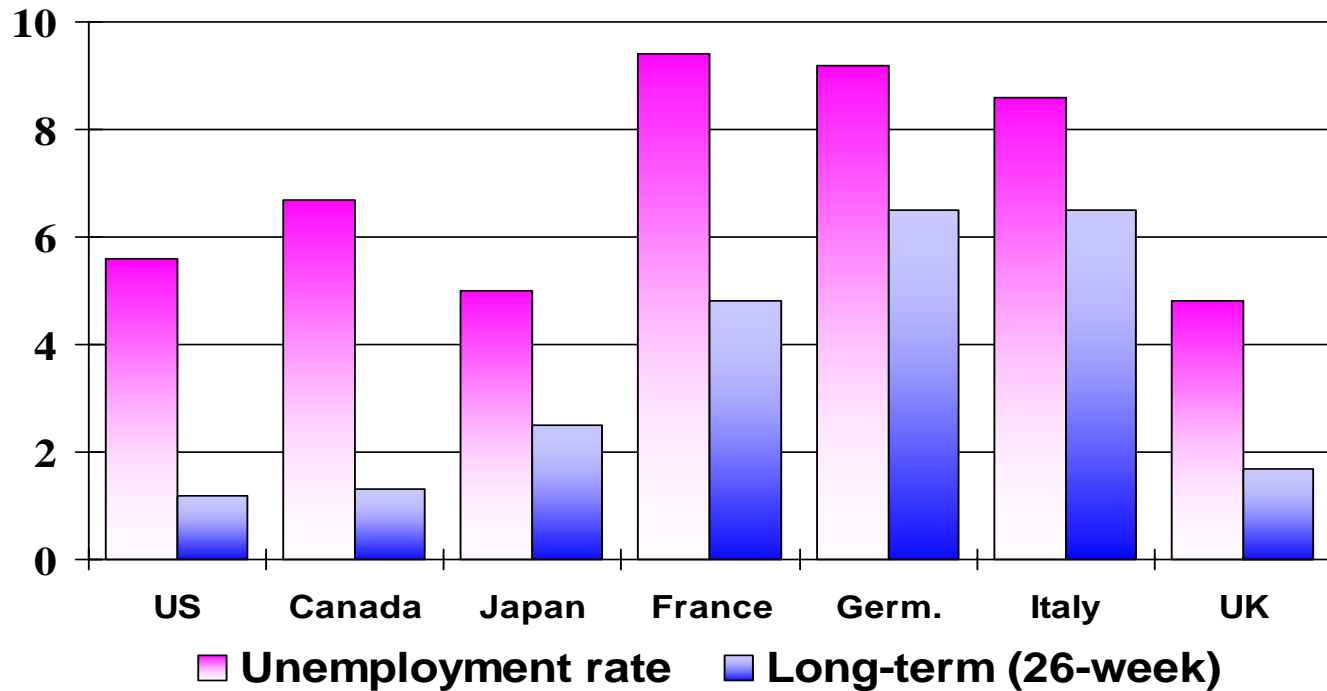
(Percent change in CPI)





# Unemployment Rates Are High

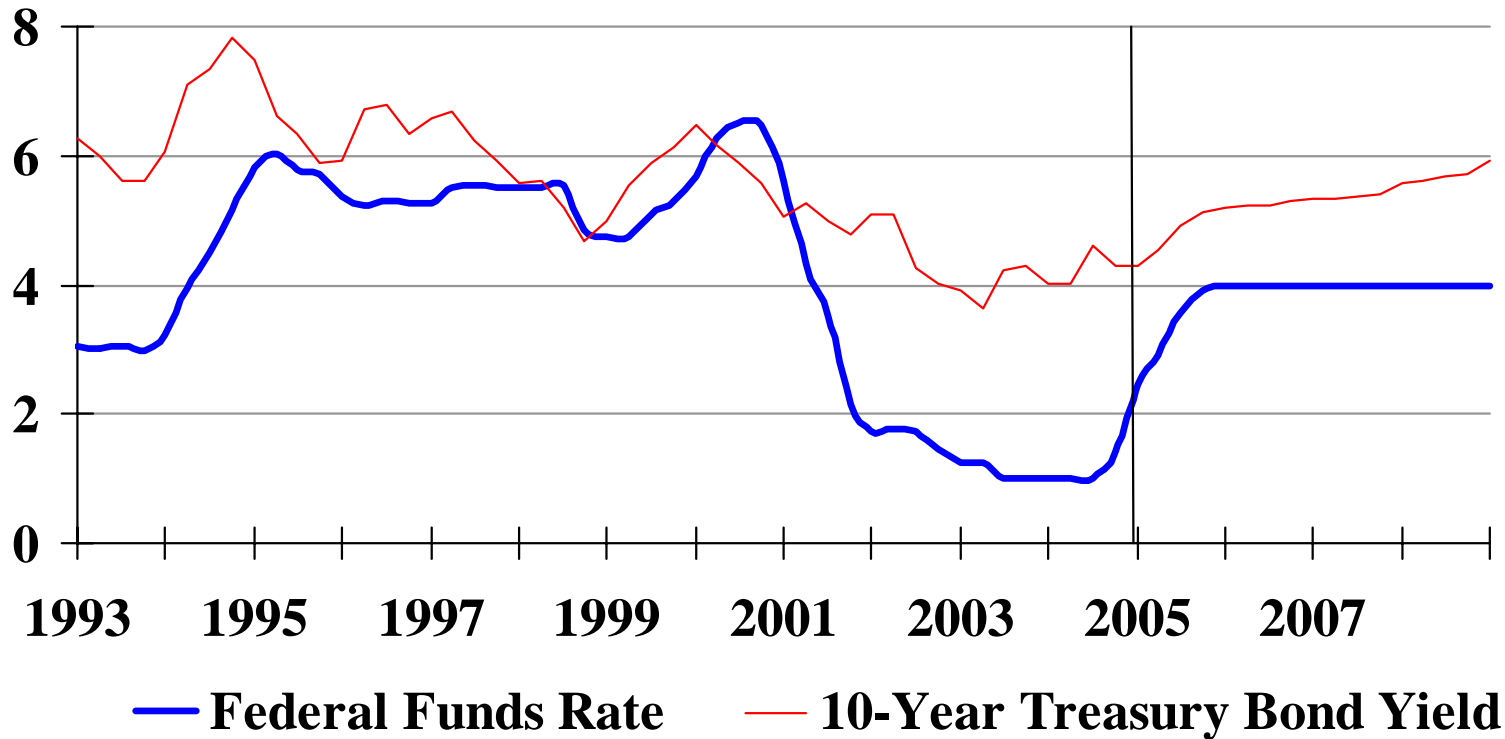
(Percentage of labor force, 2003)





# The Fed Is Moving Toward Neutral

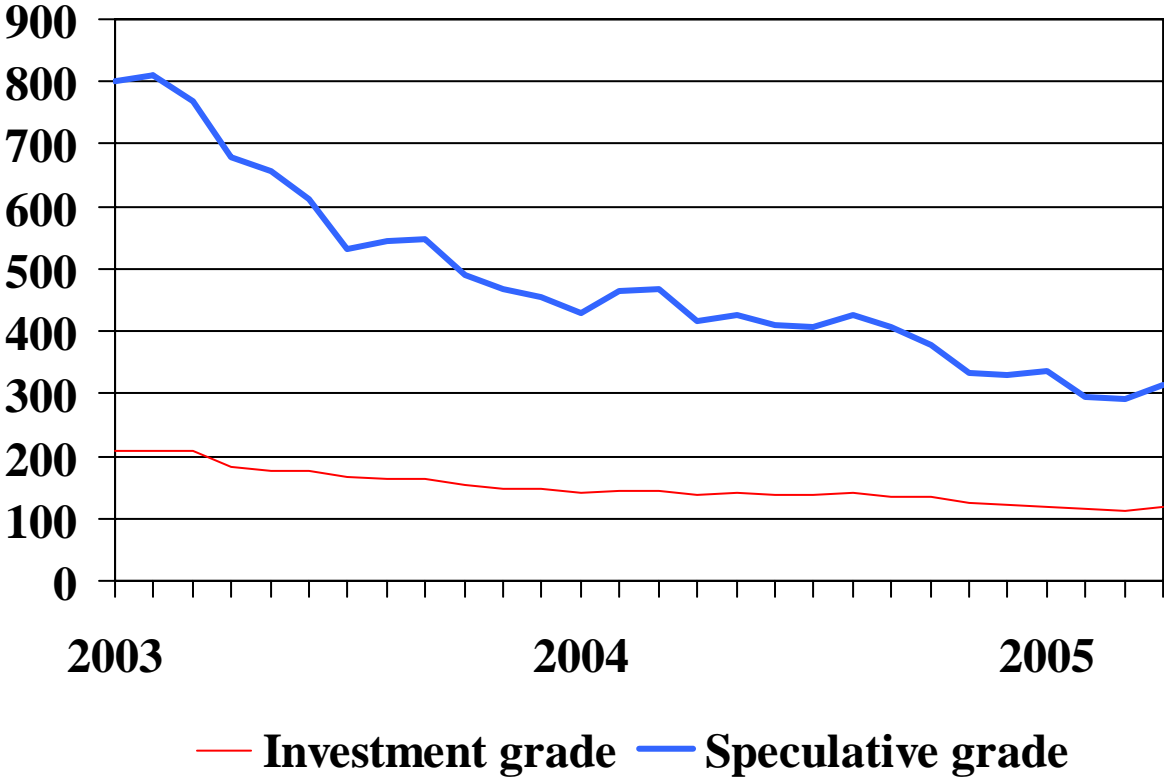
(Percent)





# Quality Spreads Grind Tighter

(Spread over Treasury yields, basis points)





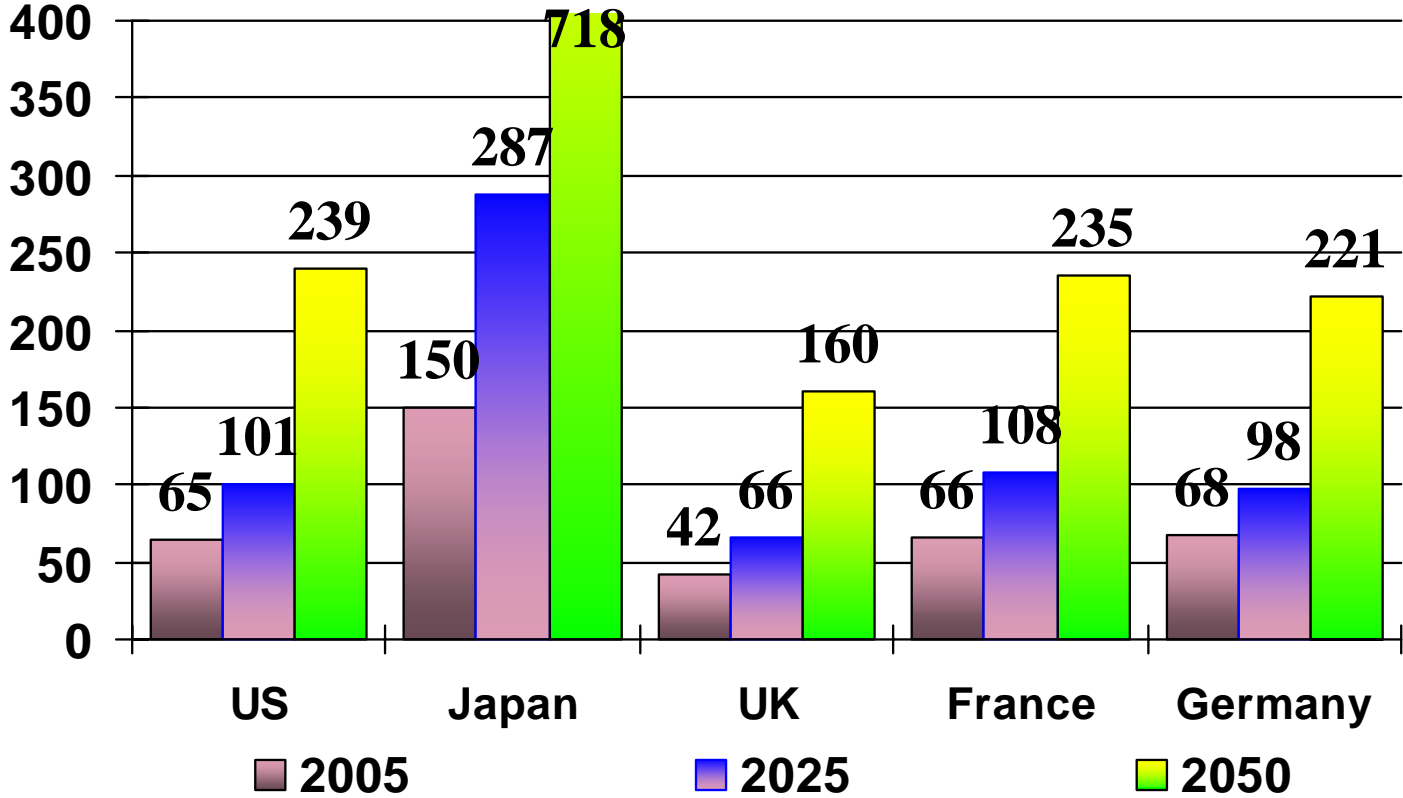
## Second-Term Policies

- Emphasis in second term will shift to controlling deficit
  - The current deficit is manageable (3% of GDP)
  - But few prospects for controlling it
- Creating an “Ownership Society”
- Social security reform is getting most attention
  - We have promised more than we have money to pay
  - Benefit cuts or tax increases
  - Partial privatization will be main Administration proposal
- Tax reform rather than tax cuts
  - Changes should be revenue neutral
  - More consumption-based taxation
  - Encourage saving
- Cut deficit in half by fiscal 2008
  - Requires tough control of government spending
  - Could be derailed by international events



# The Future Looks Bleak

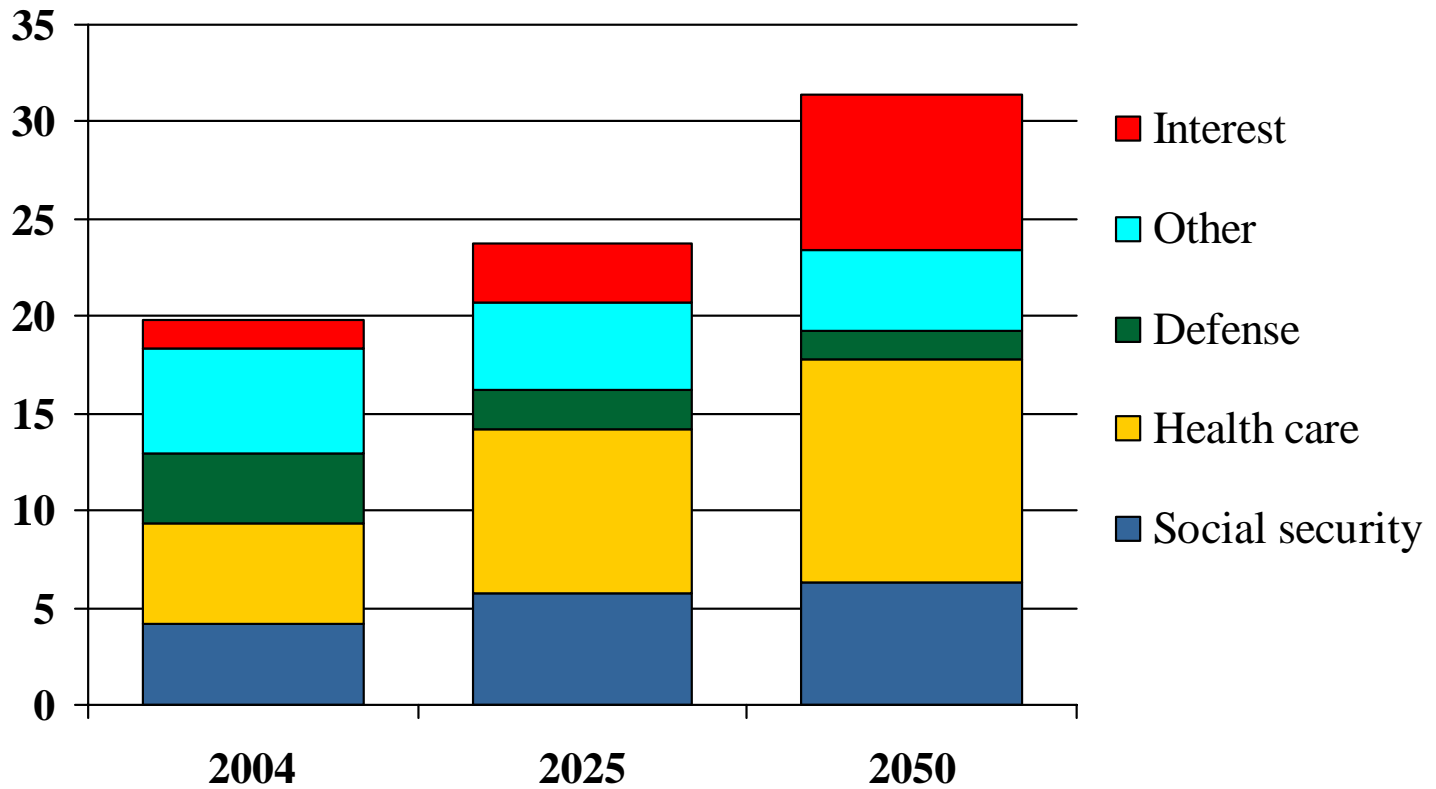
(Government debt as % of GDP)





# Where the Money Goes

(Federal spending, percent of GDP, CBO estimates)

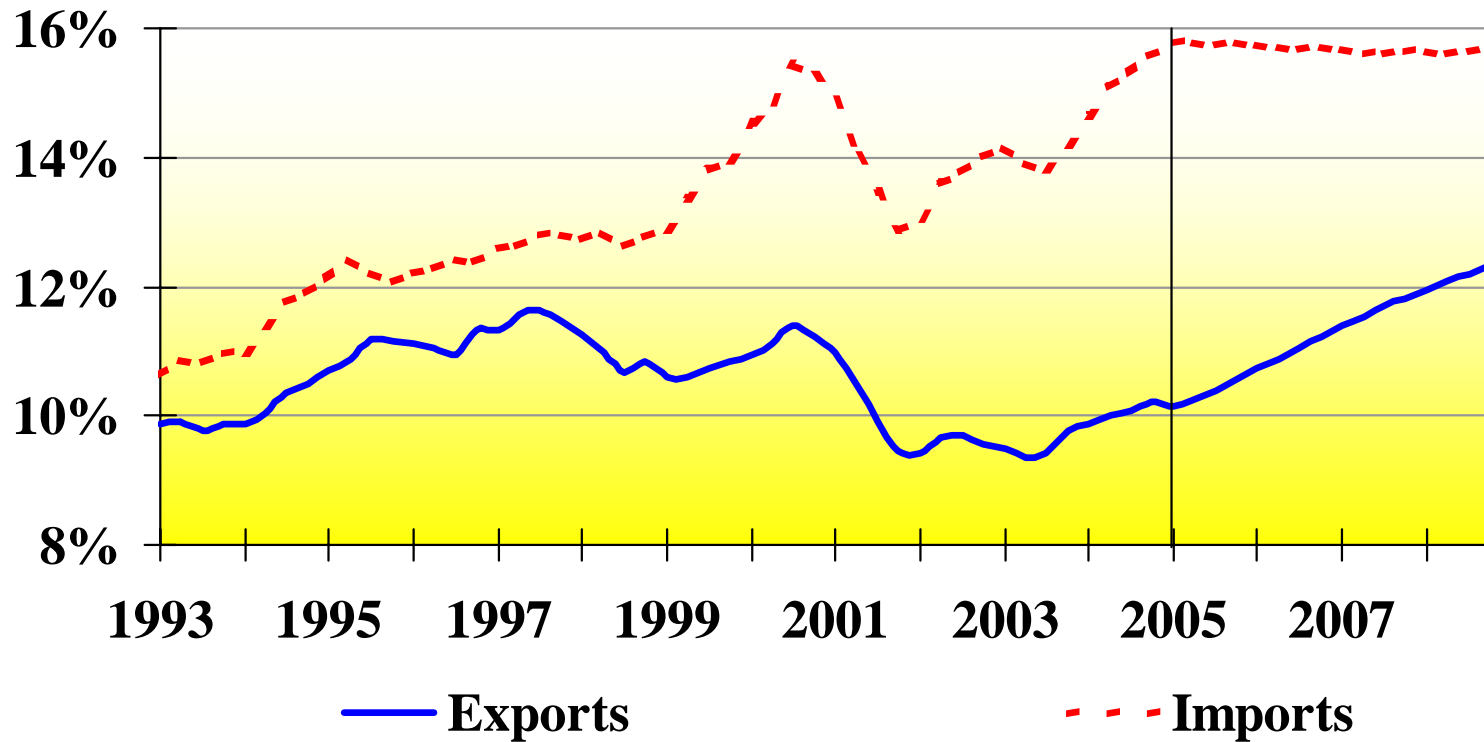






# The Trade Gap Yawns Wider

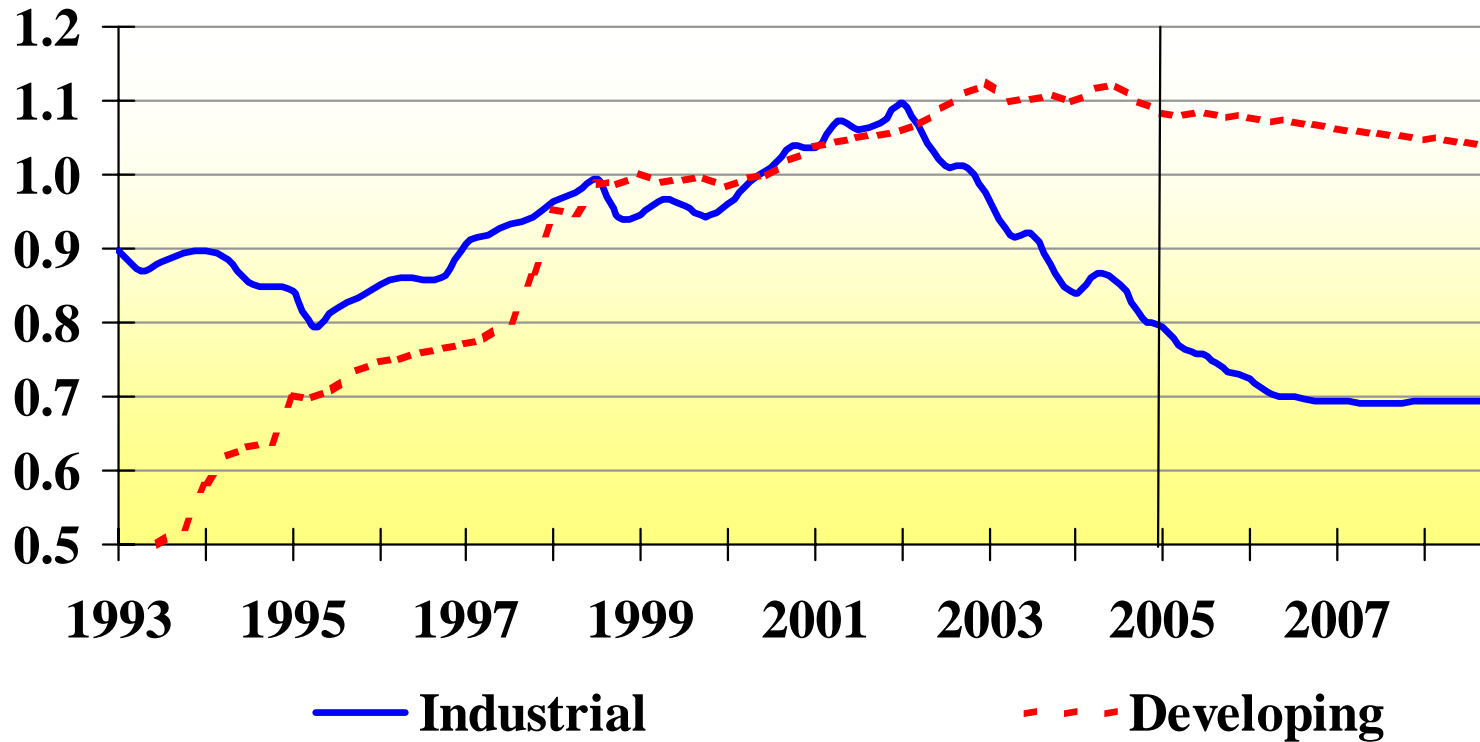
(Percent of GDP)





# Taking the Dollar Down

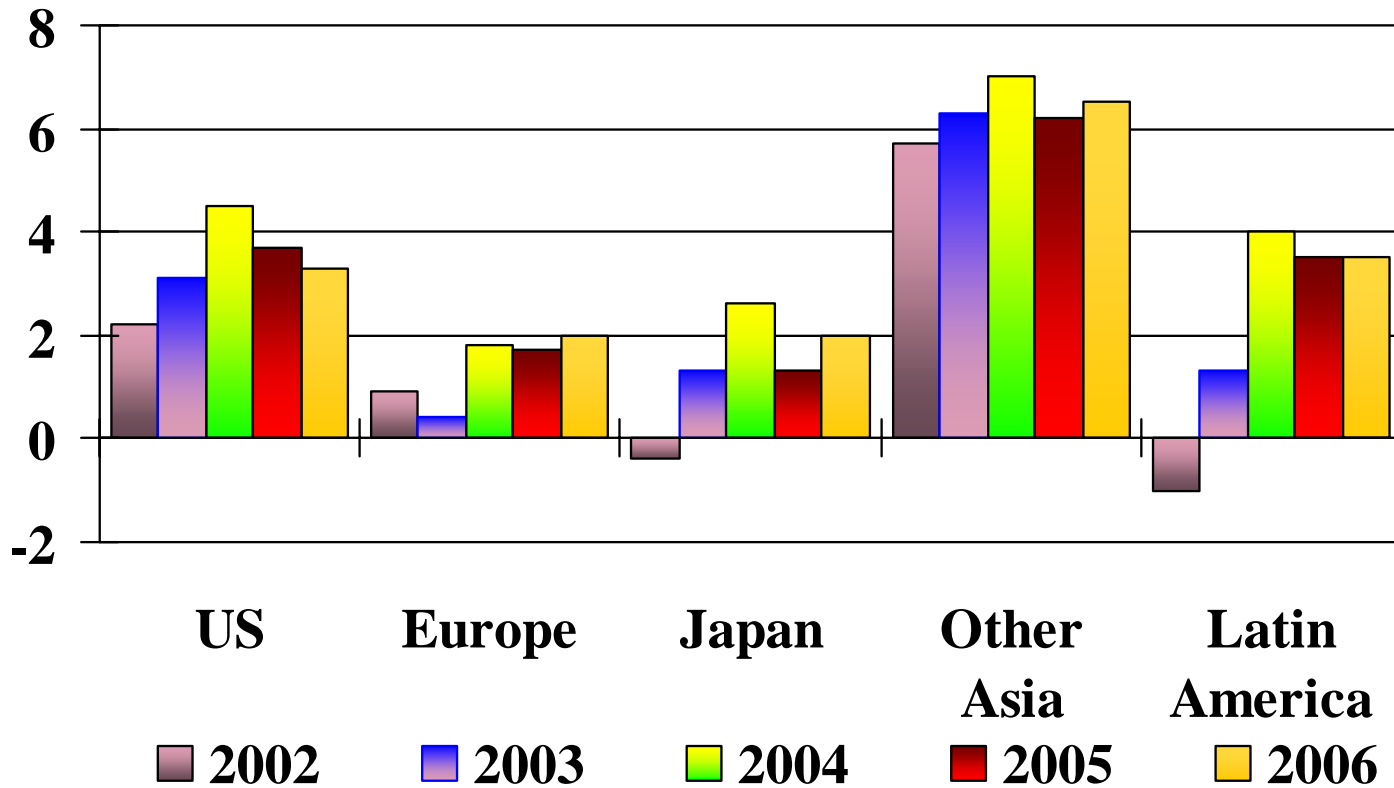
(Real trade-weighted dollar)





# World Growth Is Slowing

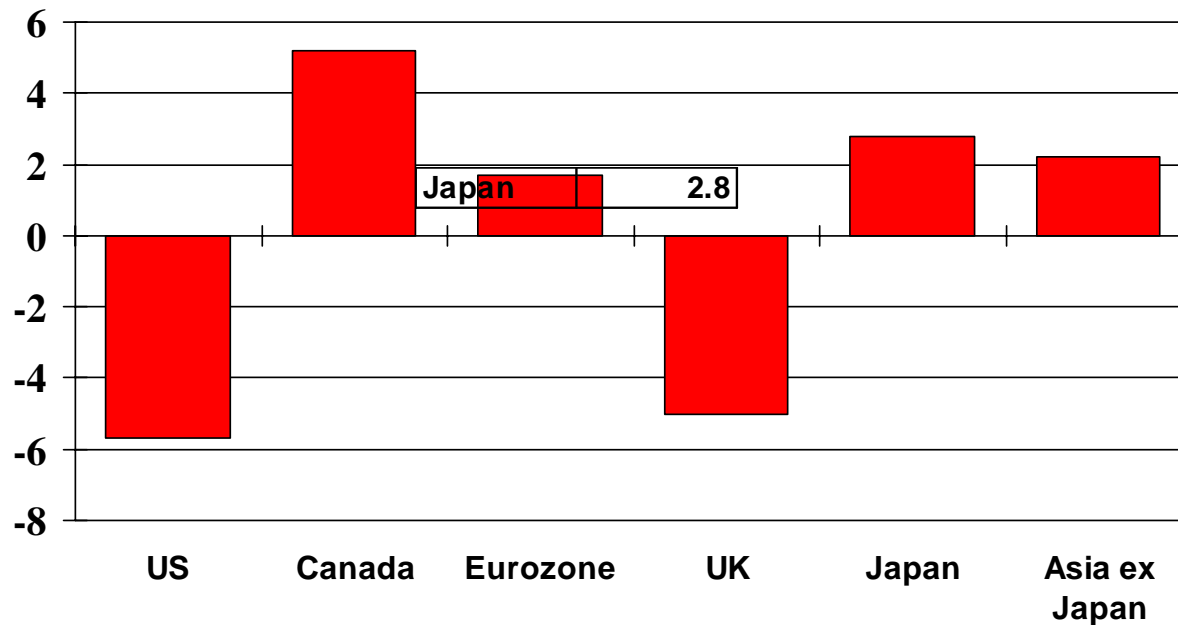
(Real GDP, % change)





# US Deficit Balances Other Surpluses

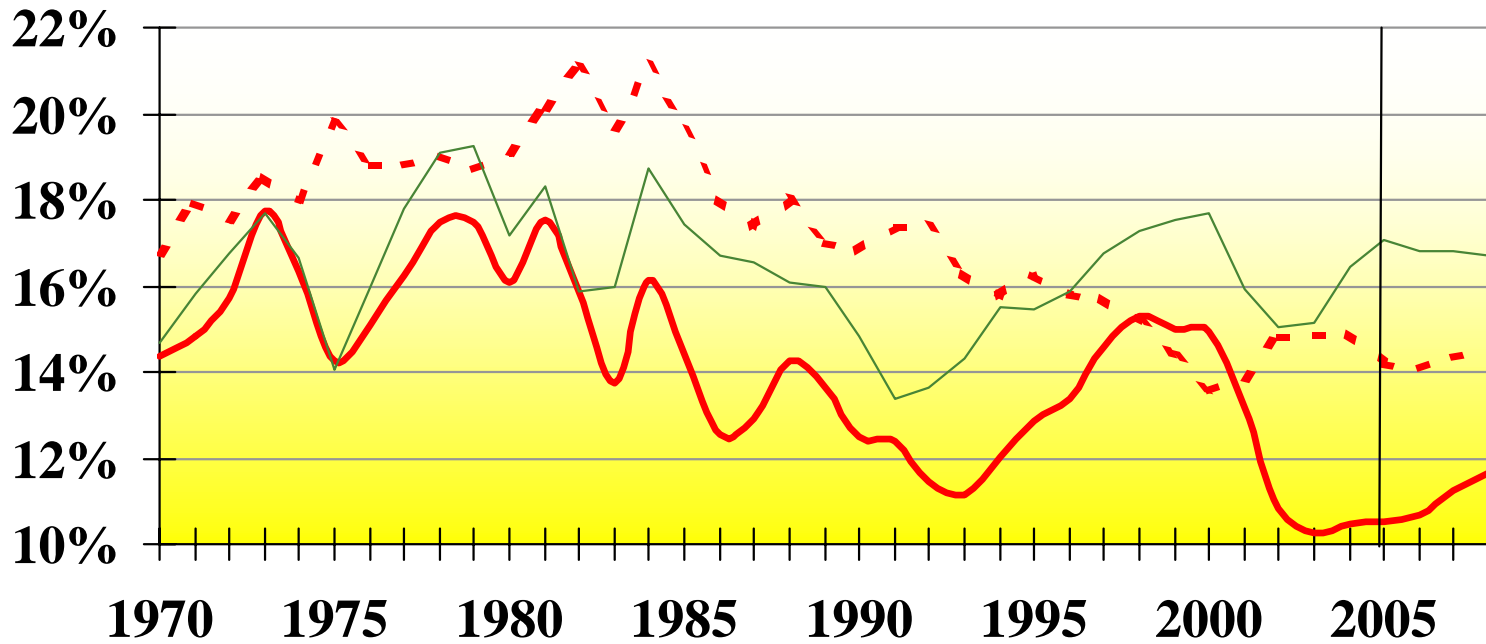
(Trade balance as percent of GDP, 2004)





# US Borrows From Abroad to Offset Weak Savings

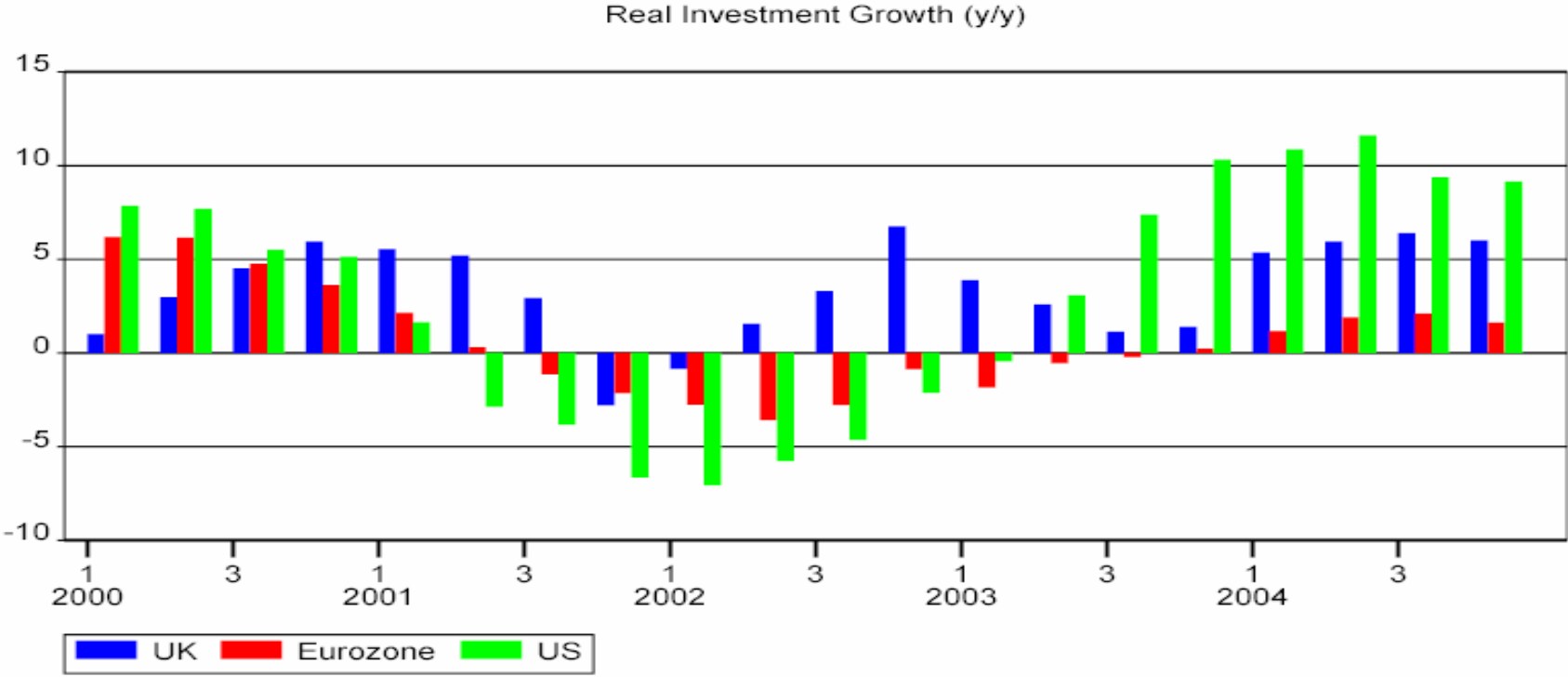
(Percent of GDP)



— Gross saving    - - - Private saving    — Private investment



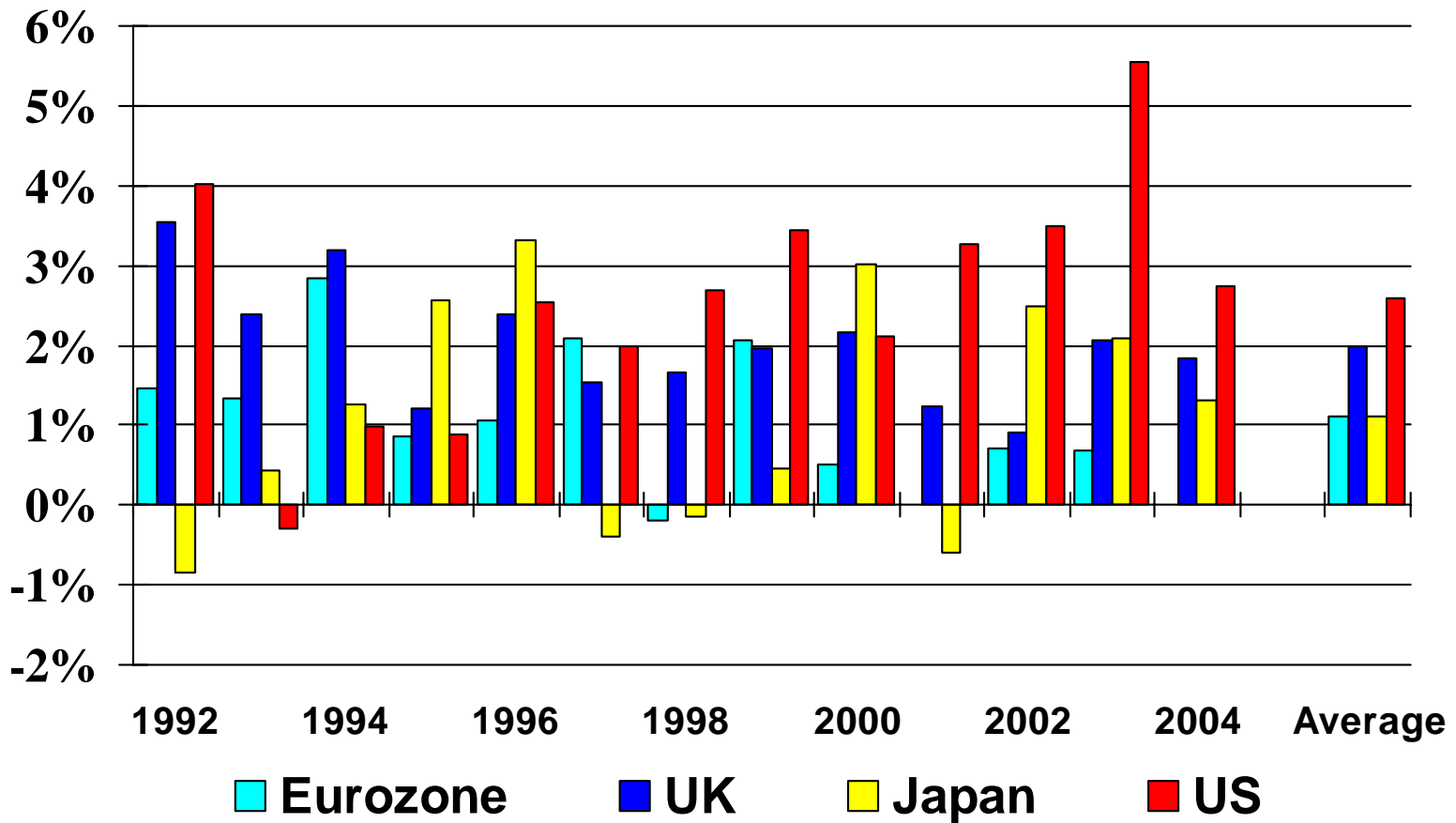
# European Investment Lags US and UK





# European Productivity Growth Trails

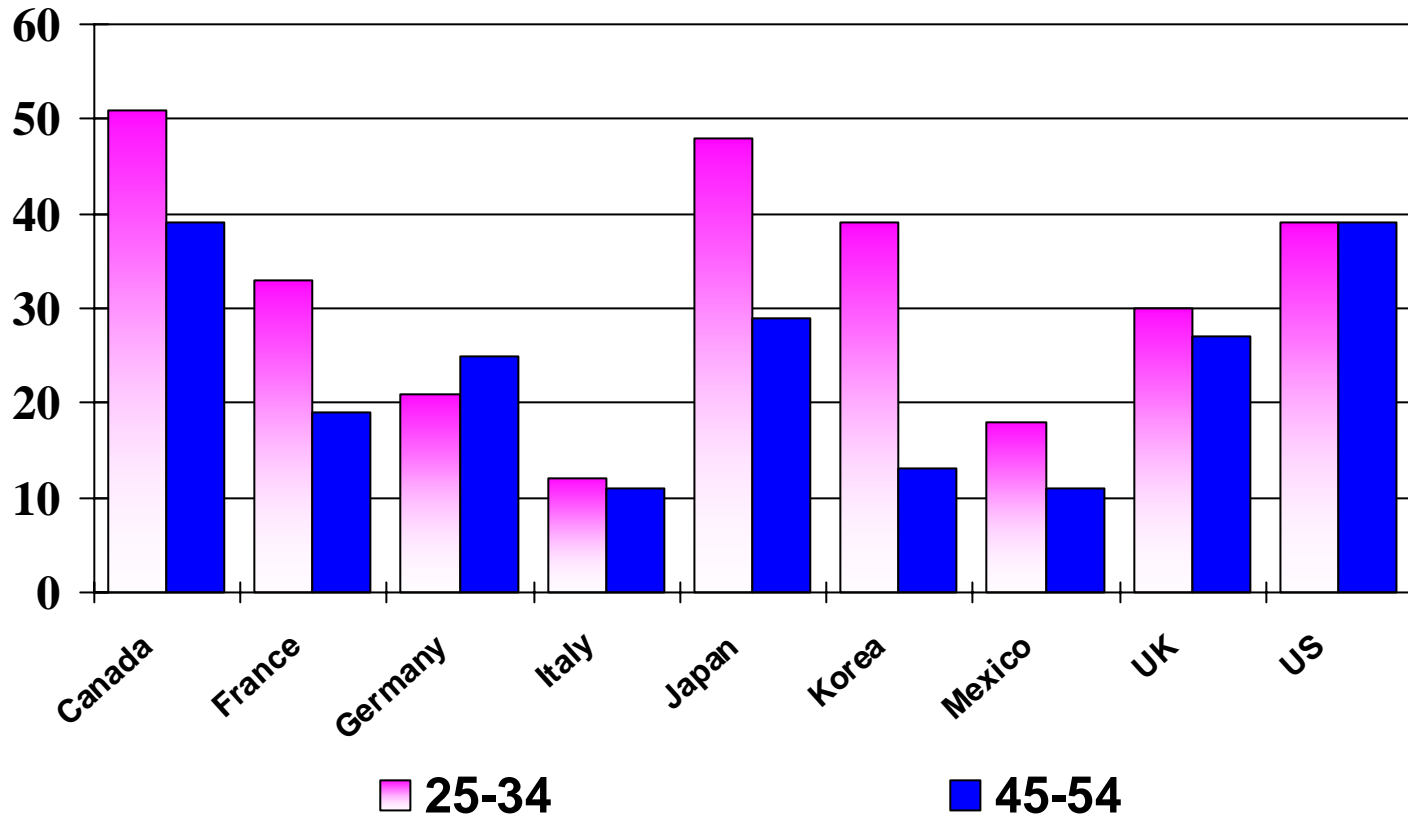
(Output per hour, percent change)





# Other Countries Are Catching Up

(Percentage of college graduates by age group)

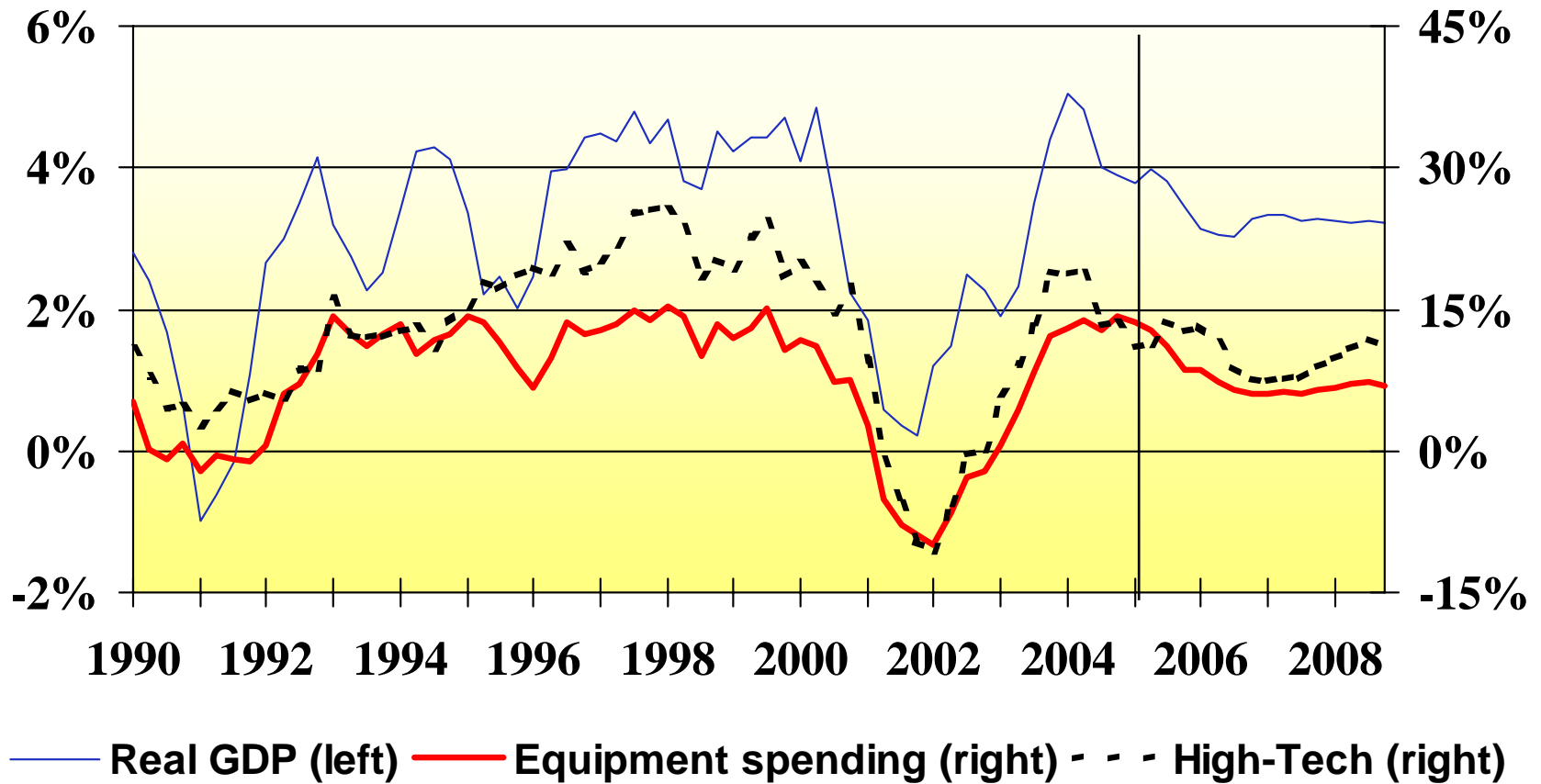






# Capital Spending Follows GDP

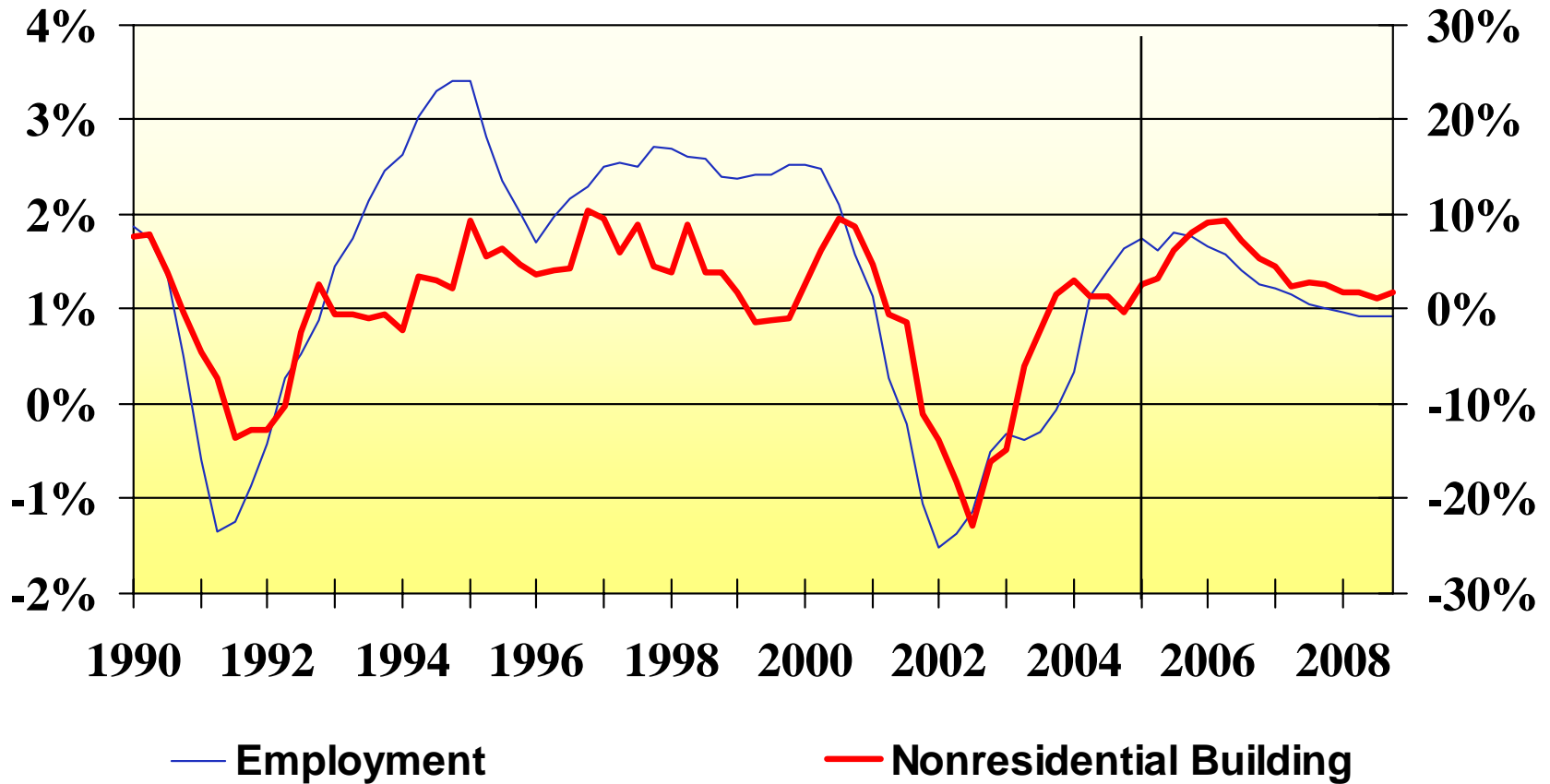
(4-quarter percent change)





# Weak Employment Means Weak Construction

(4-quarter percent change)



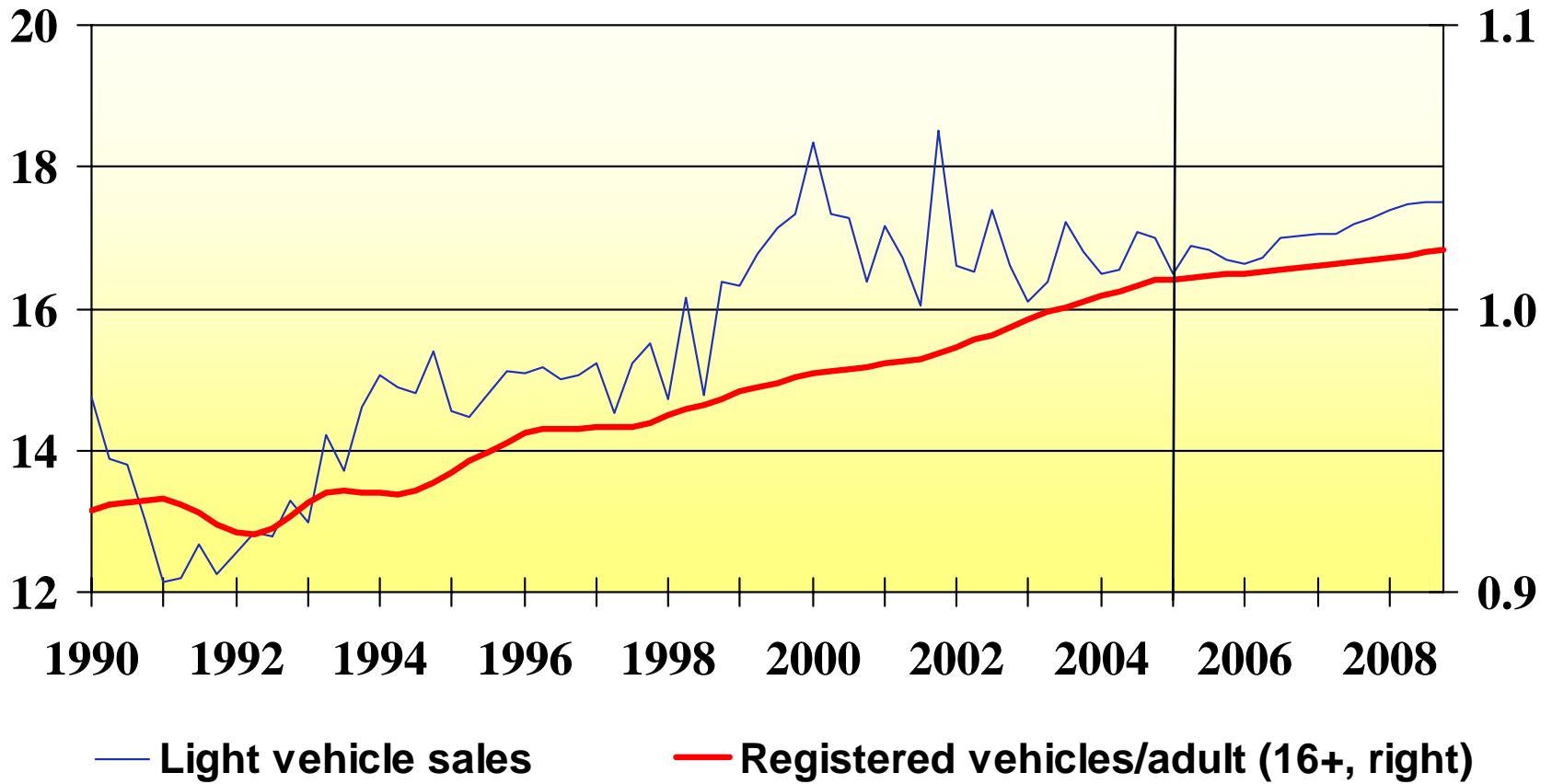


## Can the Consumer Keep Spending?

- Spending has led the expansion
- The tax cuts provided extra income
- Lower mortgage rates freed up funds
- Confidence is improving
- But the saving rate is low
- Tax cuts are over
- Interest rates are rising
- And gasoline at a record high
- Net result will be a slowdown, not a retreat
- But the saving rate will remain low



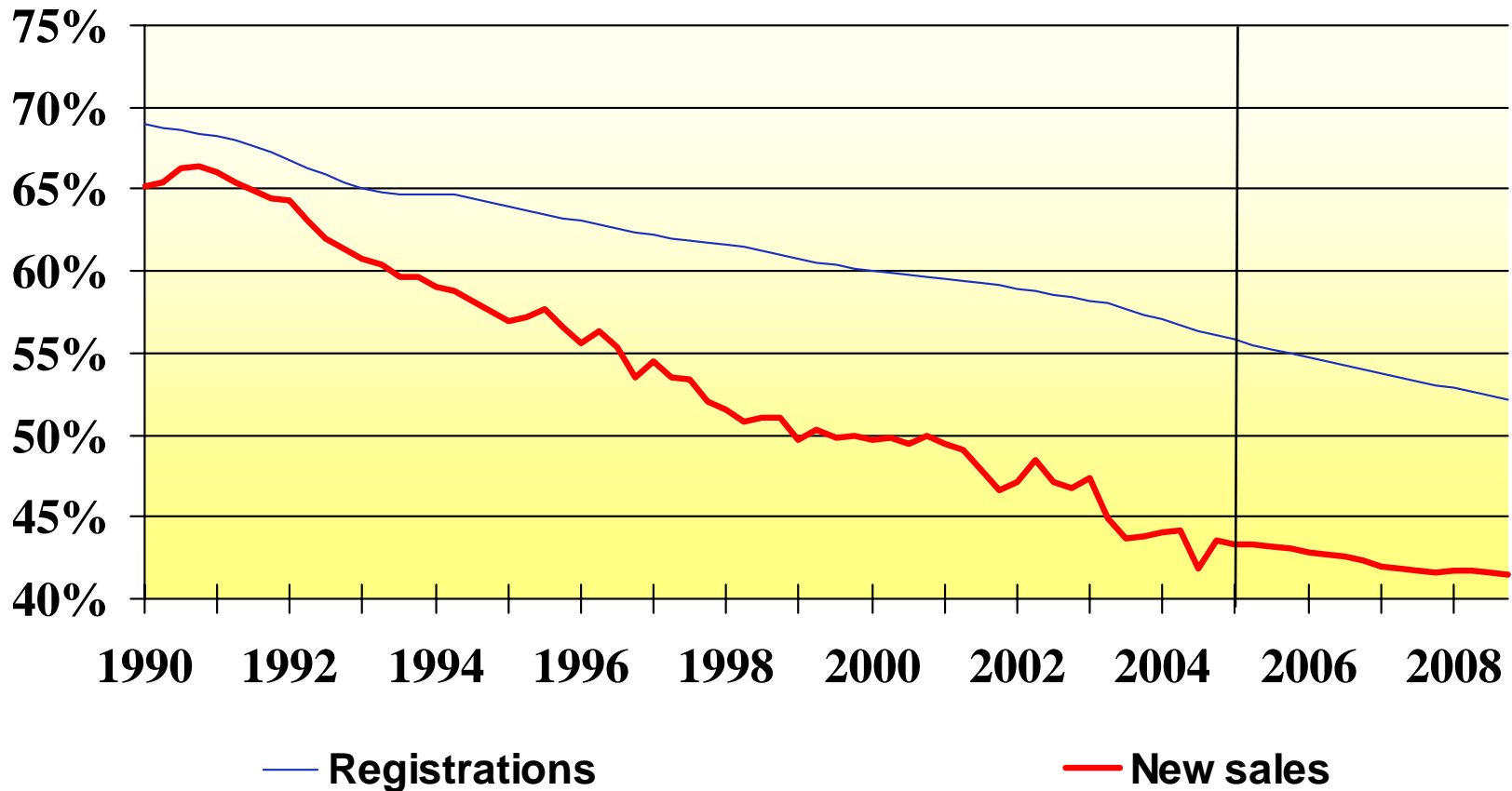
# Car Sales Remain Strong Despite Gasoline Prices





# Trucks Dominate New Vehicle Sales

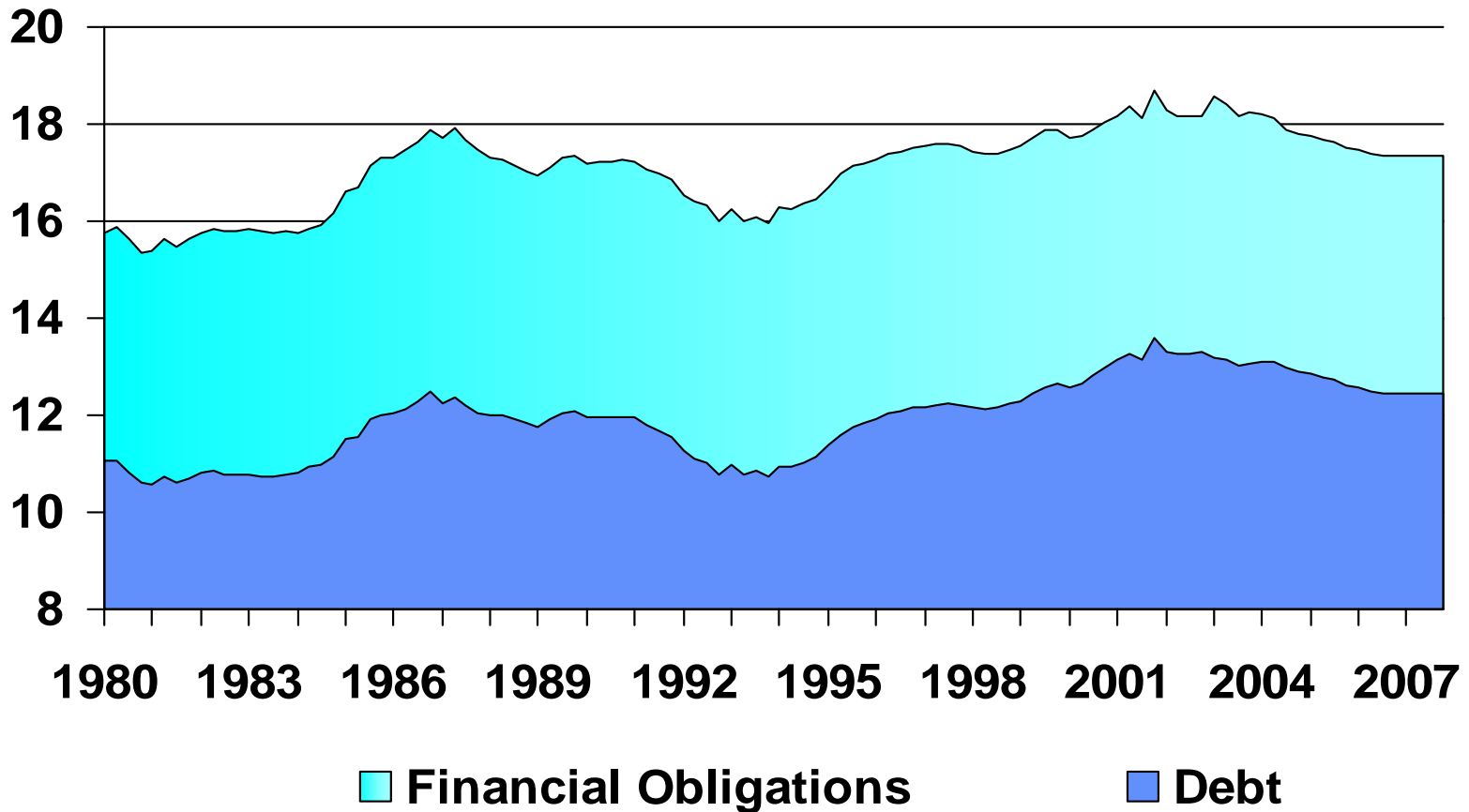
(Cars as percentage of total vehicles)





# Debt Service Now Above 1986 Record

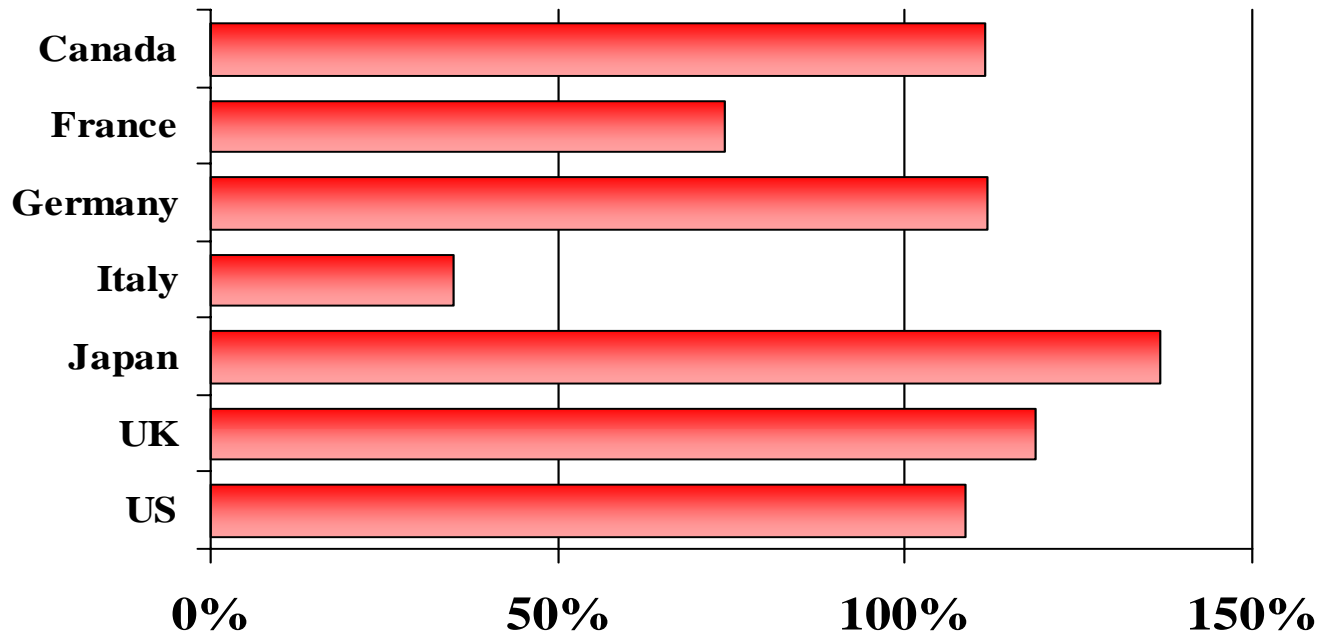
(Household obligations as percent of after-tax income)





# Household Debt By Country

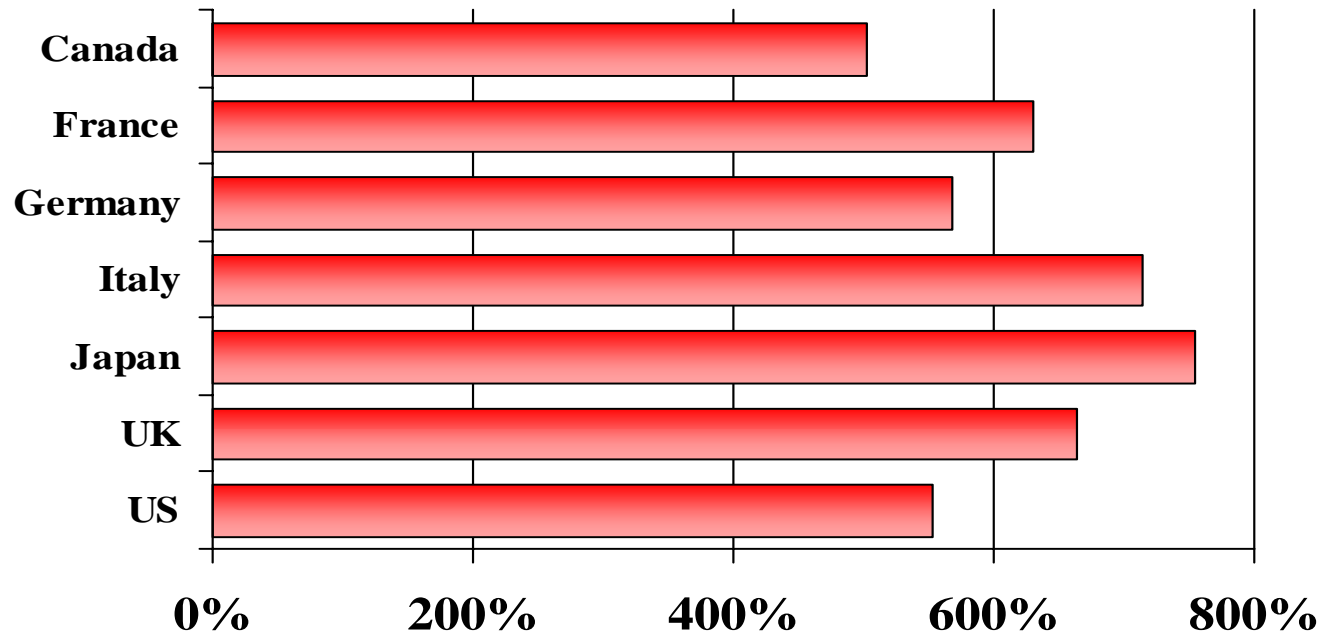
(Percent of income, 2001)





# Household Net Worth By Country

(Percent of income, 2001)

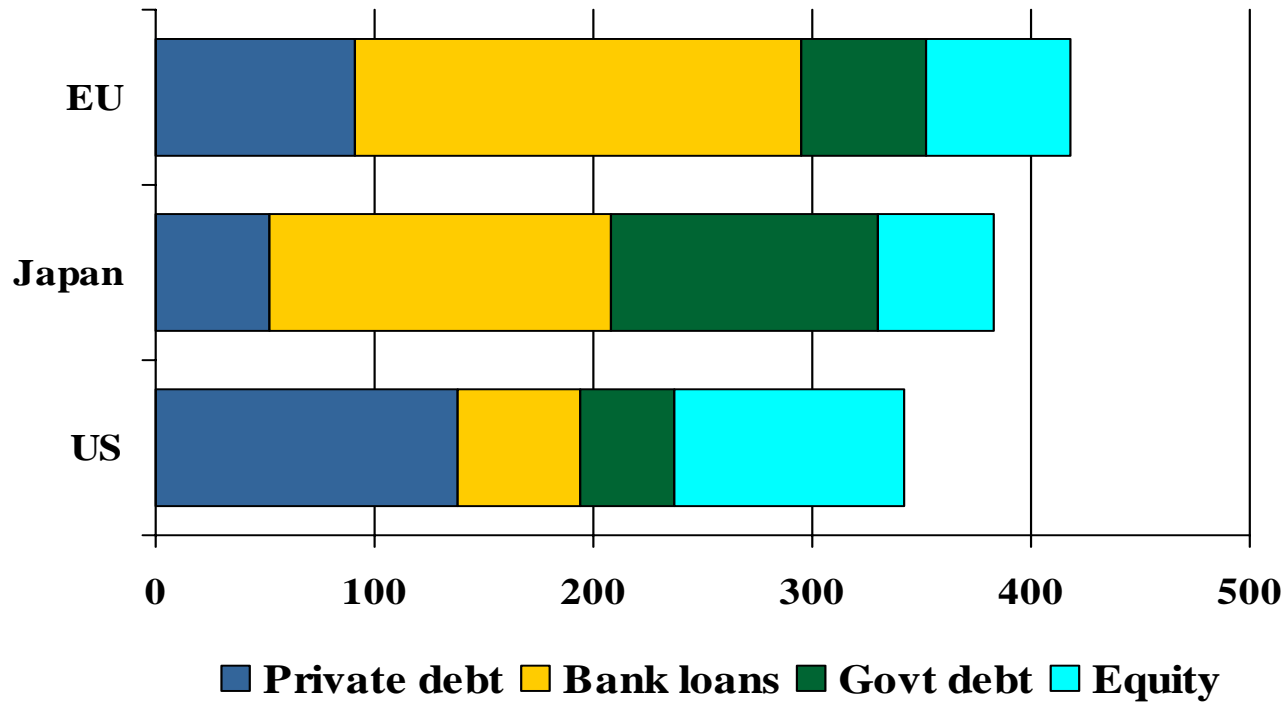






# US is Actually Low-Debt

(Assets as percent of GDP, 2002, source: IMF)



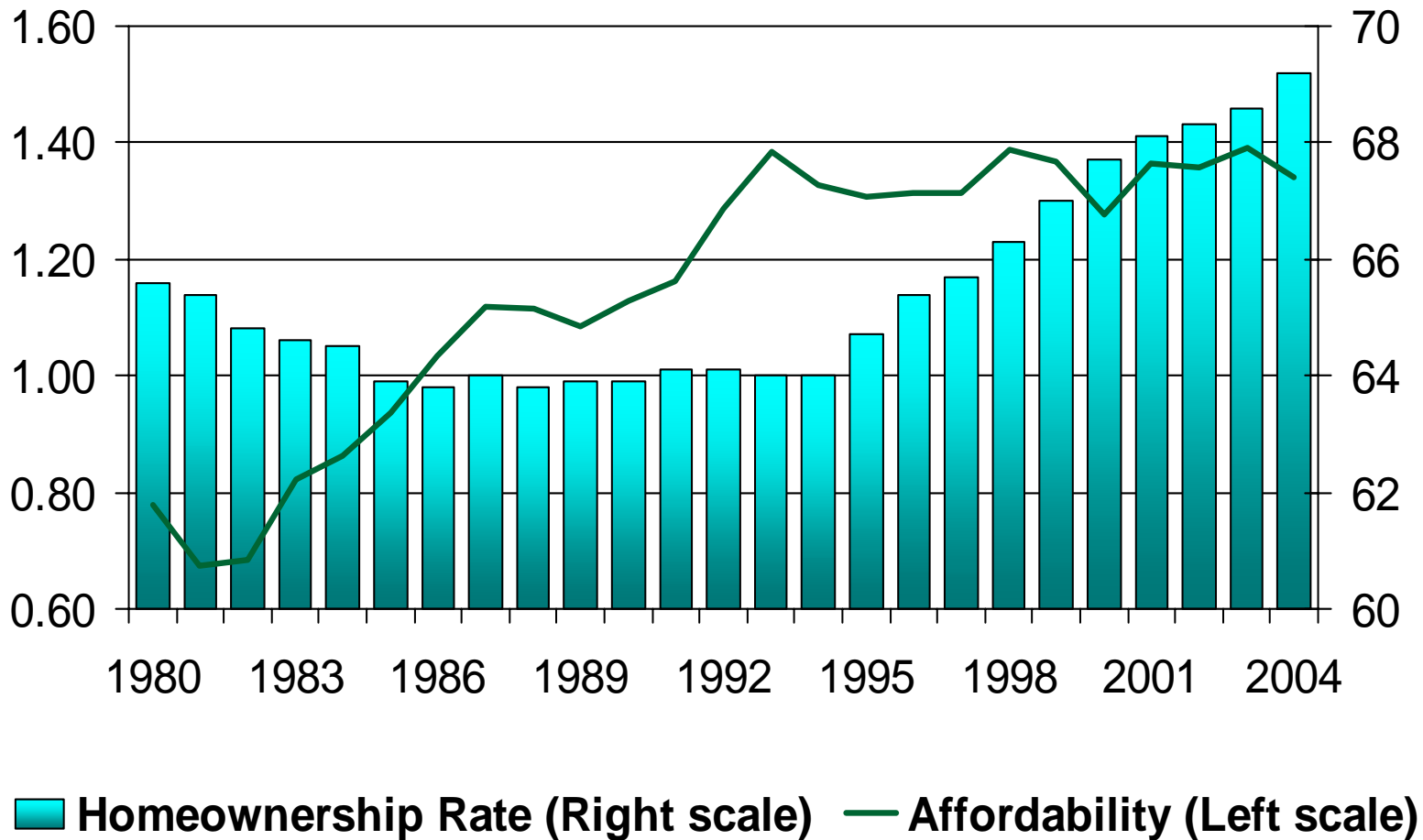


## A Housing Bubble?

- Housing is the most affordable it has been since the early 1970s
- Thanks to low mortgage rates
- Home prices have outpaced incomes
- But ratio of home price to income is only moderately high
- There are local bubbles
  - E.g., New York, Bay area, Boston, DC
- And higher mortgage rates will cause weakness
- But housing looks less overvalued than other assets



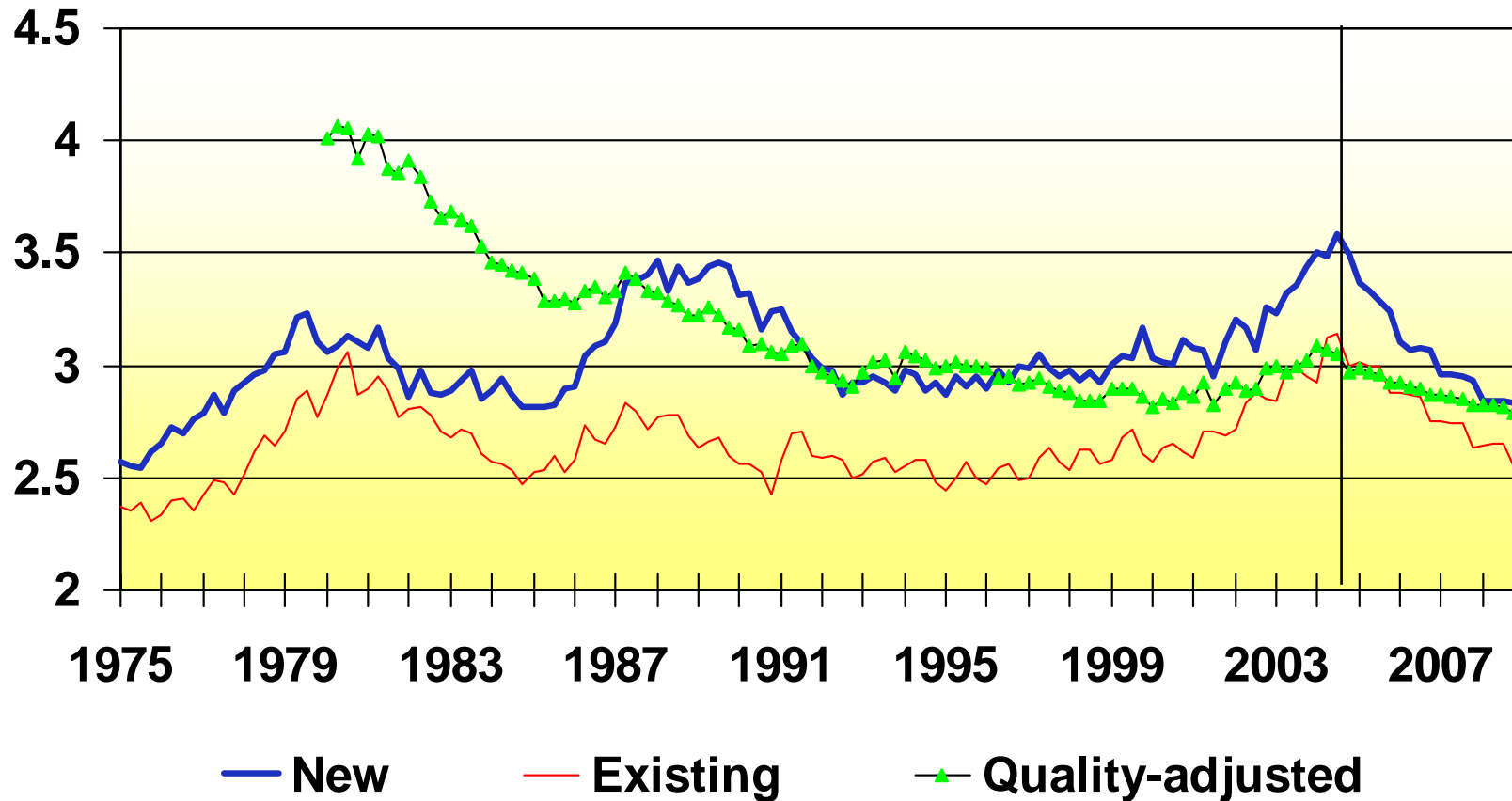
# More Affordable Housing Allows More Households To Own Their Home





# Home Prices Are High Relative to Household Income

(Ratio of average home price to average household disposable income)





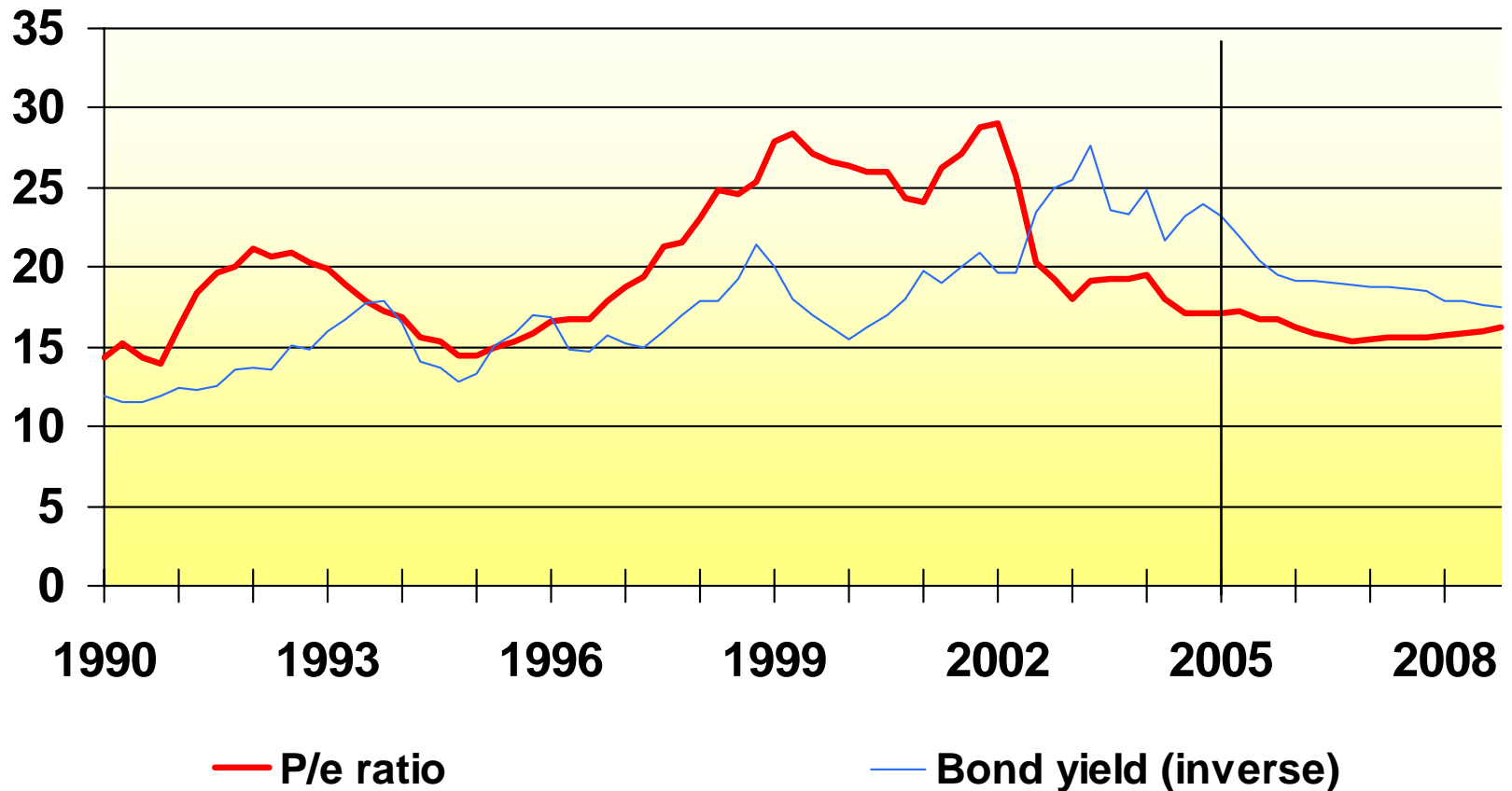
## The Stock Market Will Recover, But Slowly

- Market rose over 20%/year from 1995 -99
- But dropped from March 2000 through June 2003
- First three consecutive down years since 1939-41
- Biggest drop since 1929-32
- Profits cannot continue to outpace GDP
- Share prices cannot continue to outpace earnings
- As interest rates rise
- Stocks will thus yield less in the future than in the recent past.
- But a near-term rally is being spurred by earnings recovery and dividend tax change



# Stocks Aren't Overvalued Any More

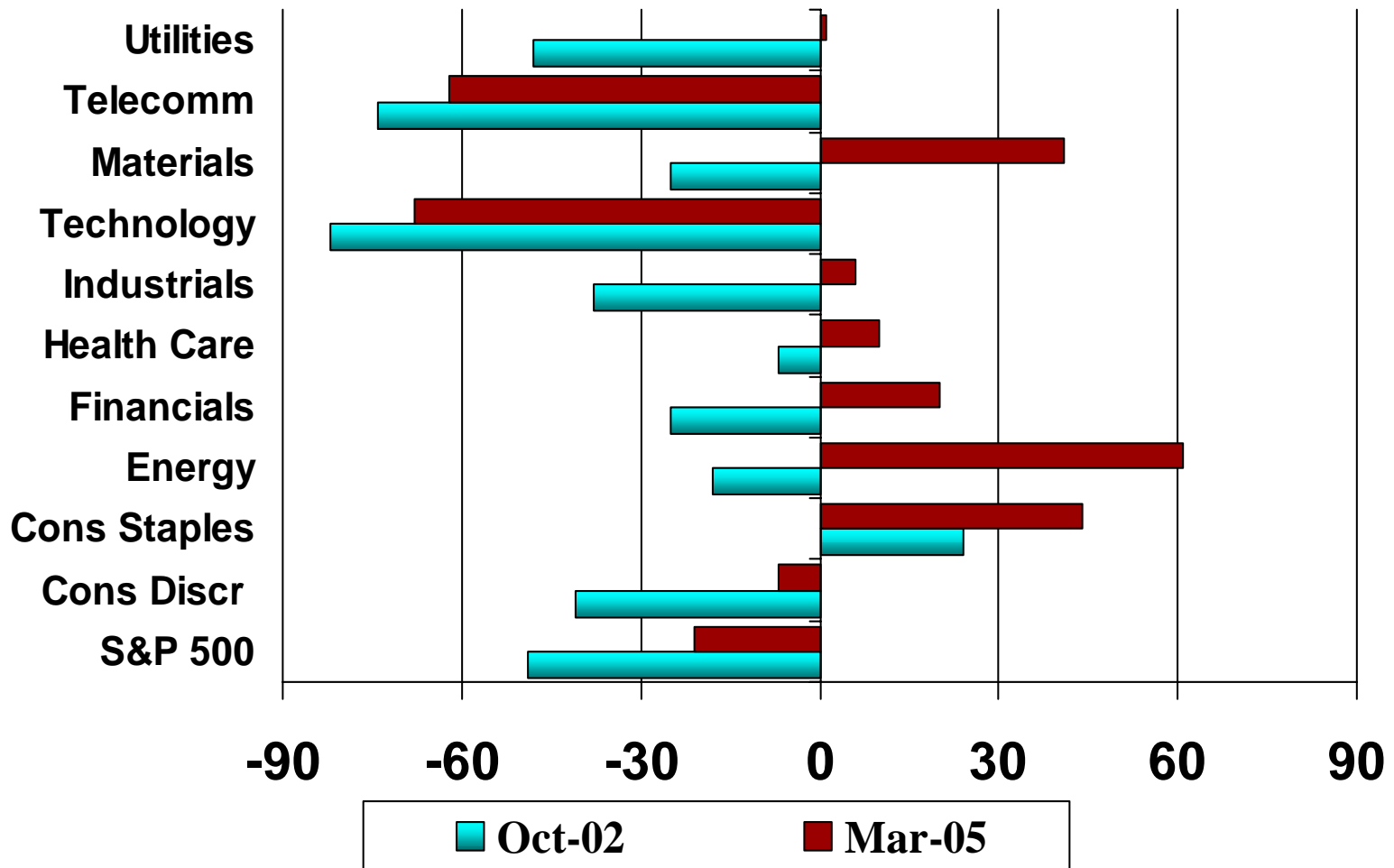
(10-year Treasury yield vs price/earnings ratio, S&P 500 operating earnings)





# Most Sectors Have Recovered from the Bear Market

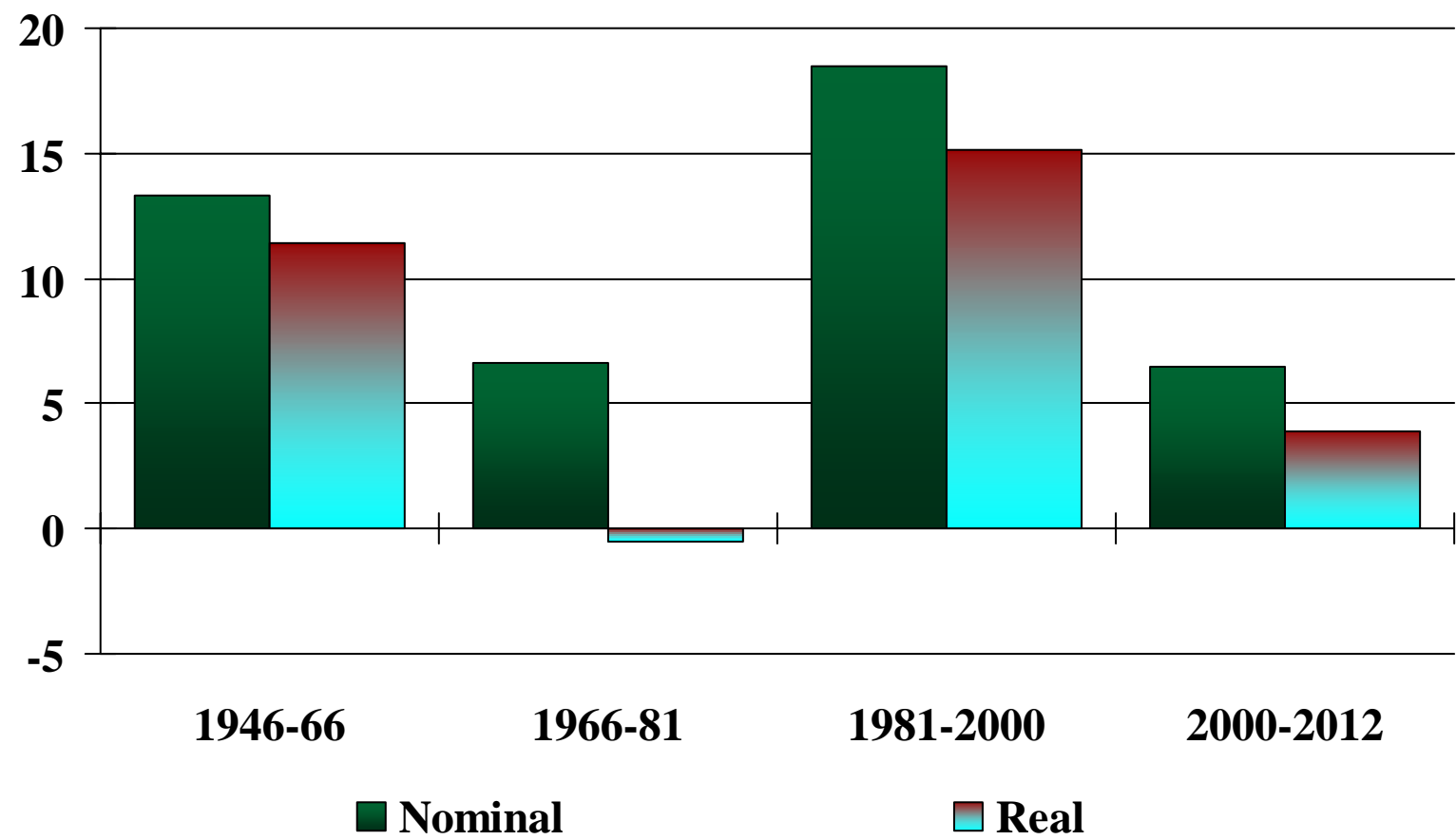
(Change in S&P 500 sectors since March 24, 2000 peak)





# Long Bull Markets Are Followed by Periods of Weakness

(Percent return on S&P 500 and corrected by CPI)

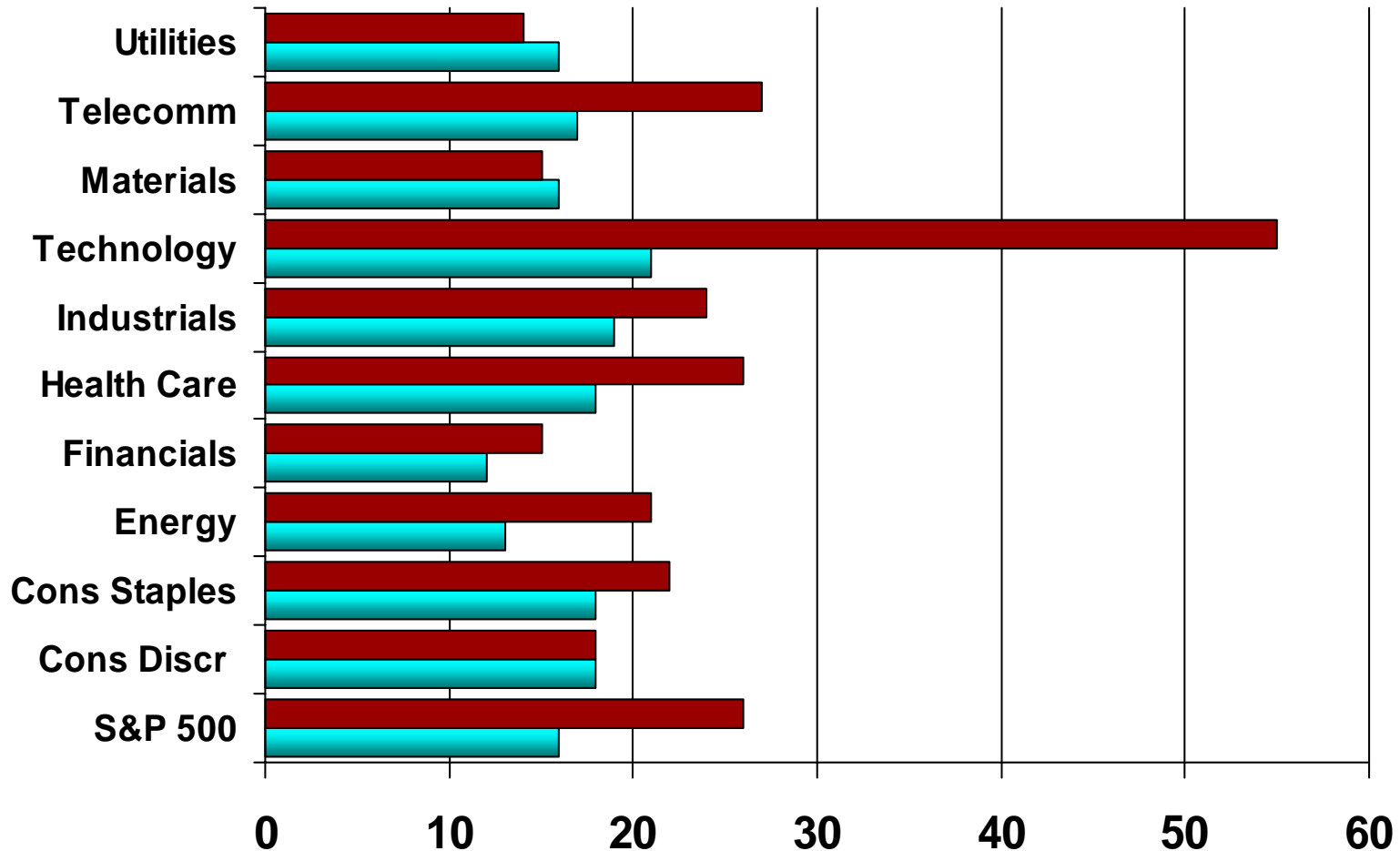






# High P/Es are Concentrated in Tech

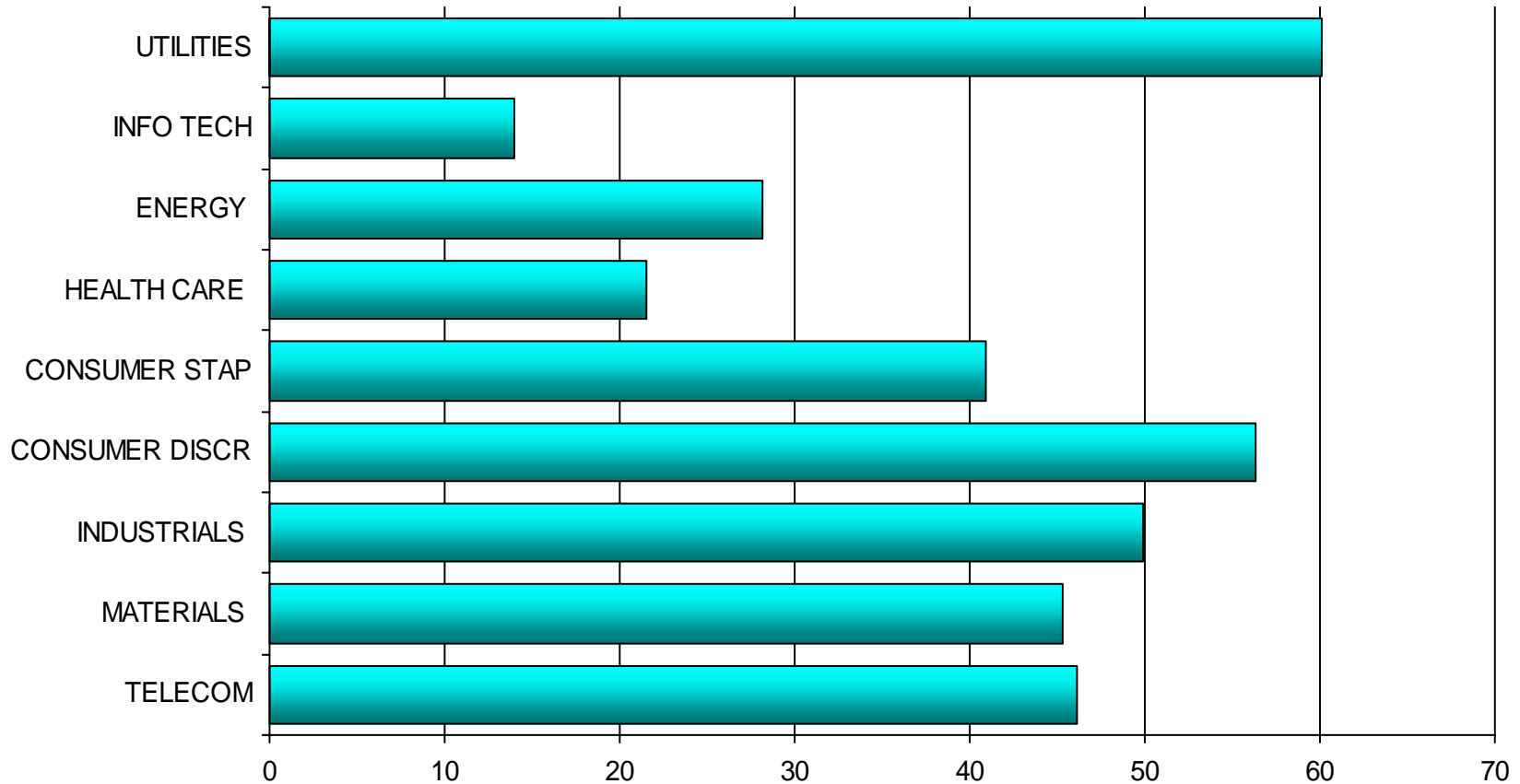
(Based on 12-month forward operating earnings, Today vs. March 2000)





# Highest Leverage in Utilities and Consumer Discretionary

(Debt as percent of market value in third quarter 2004)



Source: Compustat



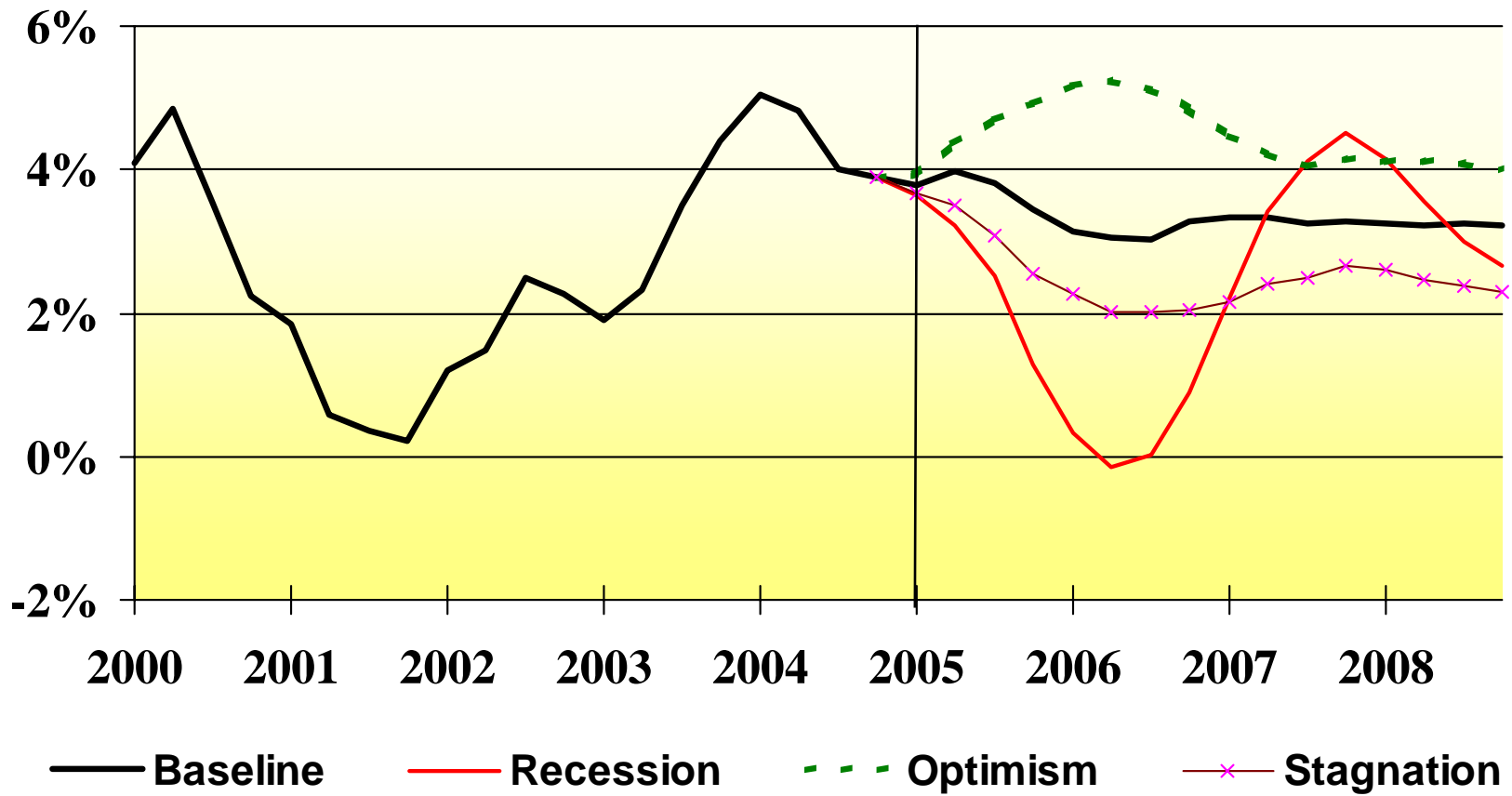
# Bottom Line: The Economy Recovers, But Slowly

- Consumers are spending near max
- Businesses will not take over the lead yet
- But strong stimulus from fiscal policy
- Interest rates rise gradually next year
- Housing prices and starts slow
- Weak recovery for stock market
- Risk of recession remains if:
  - Further terror attacks damage confidence
  - War disrupts oil supplies
  - World deflation sucks the US into slower growth



# Risks to the Economy

(Real GDP, percent change year ago)





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