



# Fed Optimistic

Current Climate Favors Equities, Bond Outlook Remains Uncertain

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In his recent annual testimony to Congress, Federal Reserve Chairman Alan Greenspan provided an unusually clear roadmap for the financial markets. Although he attached a list of uncertainties and risks, he reinforced the fact that the economy is on solid footing. As a testament to the solid growth outlook, the Fed increased short-term interest rates to 3.5% at its August meeting.

The Fed expects real gross domestic product (GDP) to grow 3.5% for the rest of 2005 and 3.25% to 3.5% for 2006. Healthy labor markets should accompany the economy's growth, with an anticipated unemployment rate of 5% through 2006. The Fed increased its inflation forecast by 25 basis points, to a range of 1.75% to 2% through next year.

Given the current profile for growth, with healthy labor markets and inflation remaining below 2%, many observers are calling this a "Goldilocks" economy — not too hot, not too cold.

### Rates Need to Move Higher

To promote its positive outlook, the Fed will have to continue raising interest rates. Examining the financial conditions, bond market and interest rates, credit spreads, equity markets and currency markets, it's easy to see why the Fed describes the current climate as accommodative. Each factor is more positive now than when the Fed started its current tightening campaign, and each continues to stimulate growth.

Some observers believe the Fed could start loosening monetary policy early next year.

Given the market climate and Greenspan's roadmap, we believe that's highly unlikely. We expect to end the year with the federal funds rate at 4% to 4.25%, and we believe a neutral federal funds rate likely will start with the number four.

### Forecast Includes Uncertainties

The Fed's forecast does contain some uncertainties and risks, including higher unit labor costs. Although the economy has recently gone through an excellent productivity cycle, there has been some slowing of late. Recent data on national accounts income suggest stronger growth, which may support encouraging productivity numbers. But if they don't, unit labor costs may creep higher.

Energy costs also remains an uncertainty. There is considerable

political risk associated with the production and cost of oil, and this will increase the variability of oil prices and cause periodic supply interruptions.

Another element of risk is the behavior of long-term interest rates. Encouraged by stable economic growth and financial markets, some investors are reaching for longer time horizons and betting on lower volatility, which has led to low interest rates and narrow risk premiums. This probably is not a permanent situation, and pressure likely will develop on interest rates.

### Bonds Face Hurdles

We are concerned about limited rewards and significant risks in the bond market. The 10-year Treasury yield remains remarkably low, but it faces some hurdles, including continued economic growth, the Fed's continued tightening policy and rising inflation. In addition, the revaluation of China's currency may cause central banks to curtail their purchasing of U.S. dollars.

At the corporate level, businesses remain risk averse, rebuilding liquidity and solvency and taking a cautious approach to investing. Such behavior has been a positive influence on the bond market by contributing to tighter credit spreads. But there's a change underway, as corporations become more aggressive about satisfying their equity investors. This action may conflict with the interests of bond investors.

Given these risks, we believe bond returns, at best, may equal

coupon income, or possibly less, if the yield on the 10-year Treasury backs up toward 5%.

### Stocks Poised for a Stronger Second Half

We anticipate a stronger second half for the stock market. Corporate performance remains excellent, as the majority of companies have reported higher-than-expected second-quarter earnings. In addition, estimates for full-year earnings continue to advance.

For 2005, the annual earnings estimate for the S&P 500 Index is greater than \$75 per share, a gain of approximately 12% versus the prior year. For 2006, analysts estimate another 10% gain, and on a 12-month forward price/earnings basis, the market currently is selling at an attractive 15.5 times earnings.

Based on this data, the market is fair to slightly undervalued, which is encouraging in light of how well business is performing. Our confidence in these metrics is higher because, in addition to strong earnings, corporations have been achieving record profitability and continue to generate substantial free cash flows.

Furthermore, profitability has generated rapid dividend increases. Share buybacks, which often accompany dividend increases, are prevalent.

Growing mergers and acquisitions activity is also enhancing shareholder value. We expect more mergers and acquisitions as corporations move from their risk-averse, a "rebuild the balance sheet" perspective to a focus on growth.

### Fundamentals Drive Stock Market

We've been particularly pleased with the recent breadth of the equity markets' advance. The S&P 500's year-to-date performance (through the end of July) brings it to a four-year high. At the same time, the S&P MidCap 400 and the S&P SmallCap 600 hit all-time highs.

This breadth and strength — and the underlying fundamentals that support them — give us confidence that our longstanding target for the S&P 500 to reach 1300 by year end appears more probable, as does the market's reaction to recent terrorist attacks. The ability to rally in the face of negative events is a characteristic of a positive equity environment.

### Deficit, Housing Market Pose Challenges

Despite our positive outlook for equities, the financial markets face some risks and uncertainties. In particular, the U.S. current account deficit is now more than 6% of GDP. For a large industrial country, this is unsustainable on a long-term basis (more than 12 months). Three factors likely will lead to resolution:

- A higher national savings rate. The government and corporate sectors are showing improvements on this front, but consumers continue to add debt and maintain minimal savings rates.
- Greater U.S. currency flexibility and less savings in the Far East. We believe the market correctly interpreted as positive the recent revaluation of China's currency, because it represents the

beginning of a necessary correction of our current account deficit.

- Faster growth from Japan and Europe. We continue to hear of potential rebounds in Japan, but in Europe GDP growth rates and forecasts continue to decline. There are some encouraging trends, particularly in Germany, where confidence is building in anticipation of the September elections.

If negative trends continue, they most likely will be reflected first in the bond market and interest rates. The dollar will weaken and inflationary pressures will emerge. As a result, interest rates will start to back up. That's why, in addition to focusing on equities, we suggest a slightly higher-than-normal liquidity allocation.

The housing market represents another risk to the financial markets, as real estate investments, driven by second-home purchases and risky financing techniques, are causing values in many regions to get ahead of fundamentals. The mechanism for correcting this problem is an increase in real interest rates. Although the Fed denies it will keep increasing rates to deal with the housing situation, it has acknowledged the need to monitor the situation.

### Risks Validate Equity Overweight

The major risks to our favorable outlook are factors that generally translate into nervousness about interest rates and bond prices. Therefore, we remain comfortable with our overweight in equities and an overweight toward cash. ■