# U.S. and Global Economy and Financial Market Prospects: Picking Up Steam*

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## Global Economy Position—2006

The U.S. and global economy are looking very good. I want to give you some sense today of where we think the U.S. and global economies are in the business cycle expansion that began a few years ago. I want to talk about the nature of financial market trends and tendencies at this particular stage in the expansion. I want to take you on a quick trip around the world, as we see it; the relative strengths and weaknesses of different parts of the world, to some extent highlighting Asia, because in our view, it is the dynamically growing region of the world. We think it will continue that way. I can't not talk about Federal Reserve policy and the U.S. with a change in chairman coming, especially since I got lucky last year on the federal funds rate forecasts. It's going to be harder this year.

And, we should look at Japan. What is likely to happen there is an end to the quantitative easing in a Japanese economy that for the first time in a decade looks to be in a real live sustained and sustainable economic upturn. Then, the risks and, of course, the currency picture, to what I think is a bright prospect for the global economy. The U.S. is losing some of it's steam but still growing nicely for a fifth year of expansion, depending on when you date the beginning of the expansion. But, much of the rest of the world is picking up steam, particularly Asia. The global economy always has problems, but basically looks very healthy.

Although as time goes by the U.S. economy will be less and less decisive in calling the tune on the global economy, it is still very important. So let us take a look at where the U.S. is in this cyclical expansion.

## The U.S. Business Expansion

We date the beginning of the U.S. expansion functionally as the middle of 2003.

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Statistically, according to the National Bureau of Economic Research, the well-known NBER, recovery began in November 2001. But the U.S. economy didn't really get going until the middle of 2003. The reasons for the delay had to do with the overhang from the collapse of business capital spending, the huge declines in the U.S. stock market, a bubble bursting, and a number of geopolitical events that held back the U.S. stock market and delayed the functional pickup of the economy. Those, of course, were the September 11th attack in New York, the War Against Terrorism, the Afghanistan War, and the War against Iraq.

What lifted the U.S. economy up and, in turn, through trade flows gave tremendous upward push to the world economy were two main factors.

One was the very low interest rate environment in the U.S. engineered by the Federal Reserve that supported and prevented the U.S. economy from declining like the Japanese economy did when it's stock market bubble burst. The support was mainly through housing and consumption; that's what the low interest rates did in our view.

The second factor was the liftoff that came from the Bush Administration tax cuts. The biggest was in May 2003, actually the third of five tax-reduction programs from the Bush administration over the 2001-2004 period. The tax cut fiscal stimulus and increased federal government spending provided the push that lifted the U.S. economy up, and that, in turn, helped revive the world economy. Functionally, the U.S. and global upturn started about the same time, well over two years after the Federal Reserve started taking down interest rates.

This assessment is very controversial. I would say the catalyst was a very old fashioned Keynesian fiscal stimulus in a depressed U.S. economy, with extremely low interest rates as accommodation. This fiscal stimulus, yes deficit-financed fiscal stimulus through tax cuts and increased government spending, provided the push from a stimulus point-of-view that changed the path of the economy and started it higher. That fiscal stimulus was, and is, not without potential side effects of large deficits, deficit financing and rising debt-to-GDP ratios for the U.S. federal government, which someday may come back to haunt the U.S.. But, in the practice of policy for an economy that really wasn't moving or responding except in a cushioned way to those low interest rates, the fiscal stimulus of tax cuts was the only choice available. The deficits that came from those fiscal initiatives are a problem for another day. It's a little like triage, you take care

of the biggest problem first, and even though there are negative side effects and byproducts, deal with them later, because if you don't deal with the big problem first, in this case a moribund U.S. economy, the economy wouldn't have been lively enough to deal with the deficit problems later.

If we look at the functional pickup in the U.S. economy as beginning in the middle of 2003, with the timeline for a U.S. business cycle expansion, and similarly the global economy, five-to-seven years, 2008-2010 is the central point, or window, when the next recession might come. We no longer have inventory cycles. The technology of inventory production and transport, just-in-time inventory production, the planning that goes on in production and use of inventory is such that large swings in inventories no longer occur to take the whole economy down or up. 2008-2010 is beyond the horizon of the talk today because we're looking at 2006-7. It is always possible, even on this timeline, that there can be surprises that could shorten that timeline. But, at the moment, the major categories of what brings an expansion to an end, though there are some signs that some of these are around, do not yet appear as decisive.

What brings on recession are any of four categories of factors.

*One can be negative external shocks* like the Gulf War (1990-91) or Iraq War, which in the case of the U.S. either brought about, or intensified, recessions that were already in-place. Both those wars made the U.S. economy worse than would have been the case otherwise. You can have other external shocks such as sharp rises in crude oil prices, pushed up by prices set in oil-producing countries, and those will depress growth and profits, and can cause an economy to move into recession.

*Second are imbalances* that are unsustainable and thus eventually must be removed. We have some of those around in the U.S.; very large trade and current account deficits likely to rise in the next few years, also federal budget deficits. These are structural and the U.S. can't continue them forever. People have been saying this for years, but the day of reckoning has not yet come. In the case of Asia, we have huge surpluses, growing surpluses on trade and current account for China, and huge accumulations of foreign exchange reserves in China and Asia. The uses of the reserves are a major factor in the markets and world economy. That imbalance largely has come about on undervalued Chinese and Asian currencies and will someday have to be corrected. And when those imbalances, whatever they are in any business cycle expansion, get pronounced and if

policy doesn't fix them, those imbalances can cause an economy to go down. The imbalances are not yet extreme enough, in our judgment, to expect the U.S., China, or Asia's economies to go down.

*A third category is capacity constraints.* That is, an economy can run up against full employment, and when that happens, inflation picks up and the Federal Reserve raises interest rates. The combination of the full employment constraint, higher inflation and higher interest rates slows the economy, changes the dynamics of the business cycle and gets the next downward turn in process. Of the various factors, this one most often brings about recession-like conditions. This one, for the U.S., is the one we are most sensitive to at this point. U.S. inflation looks quiet and the U.S. economy is in very good shape, but close enough to full employment that we are sensitive to running into the full employment constraint, inflation getting higher than the Federal Reserve wants, and they, in turn, raising interest rates more than will be forecasted here today, bringing negative effects on the economy. We do seem to be far enough from this situation so that it shouldn't be decisive in 2006.

*The final category is policy errors*—monetary and fiscal policies mistimed, misused, misdone. I must say that monetary policy in the U.S. for many years now has been A to A-; it has been superbly executed. And, in our view the fiscal policy stimulus of the Bush Administration, the tax cuts, were almost perfectly timed in terms of when those tax cuts came into the economy to lift it off. I have never seen tax cuts so well-timed. It was amazing how the administration managed to push those tax cuts through in order to get them in place.

The underlying conditions of the U.S. and world economies suggest that we are somewhat beyond the middle of this business expansion with still some time to go. The factors that start the clock ticking on the next recession, or recession-like situation, show some signs of being around, but seem pretty far away. So far, a large number of external shocks—the War Against Terrorism, the continuing confrontation in Iraq, other geopolitical risks, lately Iran and its effect on oil prices, in some sense an external shock, the hurricanes and weather problems that the U.S. economy went through in late summer and early fall—have buffeted the country. But, the U.S. economy and the world economy have shaken off these shocks and gone on to move ahead and up. That's what economies do when they are in the middle of an expansion, when they are not yet fragile in the real economy or in the financial system and when imbalances have not

gotten too extreme. That performance and our look at the data and the processes that are going on in the U.S. and world economies suggest they are somewhat past the midpoint of expansion and that there are a couple, or two-three years, to go.

U.S. financial markets in the middle of business expansions are pretty predictable, at least qualitatively, in terms of tendencies. In the middle of an expansion or even beyond it, the U.S. stock market cycle historically has been pretty clear; an equity bull market. And, it is at that time in the business cycle—the second leg of the equity bull market—where profits are still growing strongly, interest rates are beginning to rise, that awareness of some of the risks that may lead to recession later come into play. The stock market thus has an irregular pattern, but generally moves up.

We have thought, and continue to think, that the second leg of the equity bull market in the U.S. is still in process. However, we have never thought this would produce strong returns. Certainly, nothing like the 1990s. The operative phrase for the stock market cycle in the U.S. is that it is a muted bull market. Total returns on the U.S. equity market we have thought would range from 3% to 9%. Last year we did about 5%. This year we are hopeful for an 8% to 9% total return.

We are much more optimistic on equity markets outside the U.S. The DE global asset allocation in an all-equity portfolio has been, and remains, underweight the U.S. and overweight non-U.S.

The overweight is 60% non-U.S. The U.S. weight is 40%. And in the non-U.S. equity portfolio, the strongest overweight is Asia. For the U.S. and world stock markets, our view is that stock prices, on average, will go up nicely this year.

Interest rates go up in expansions because central banks start to raise their key rates. They do that because inflation starts to pick up, a natural part of a business cycle expansion. As resources are used up and if demand stays strong, inflation, on average, tends to rise and central banks will tend to lean against the rising inflation and raise interest rates. This stage of the interest rate cycle doesn't really derail the activity side and, at such a time, central banks don't try to take down the economy to take down inflation because inflation hasn't gotten bad enough yet.

The big question is when and whether inflation will get too high, when central banks

have to get tough and really have to raise interest rates to slow things down. Why does inflation in most business cycle expansions get too high? I think it's a natural result of the mixed free enterprise system and the energy in the system itself. Incentives to hold down prices and to keep inflation down don't really exist. When you are in business, it is for profits and sales and if there is pricing power, that's a plus. The business of business is not to cut prices. And, if workers get in short supply, they will ask to be paid more. Lenders want to lend, borrowers will want to borrow, and spenders want to spend. The energy of the system in the normal business cycle produces a tendency for inflation to rise. Somewhere in that process central banks step in, and the U.S. Central Bank has stepped in, with short-term interest rates up 3-1/4 percentage points since June 2004.

This time the U.S. interest rate pattern has been different. The U.S. started with abnormally low interest rates purposely to cushion housing and consumption, which it did. What we have seen so far is a renormalization of the federal funds rate to the 4-1/4% that closed out the year. This level of interest rates really is not punitive, maybe biting on the U.S. economy some, particularly in housing.

The reason is that U.S. inflation really hasn't gotten high enough for the Federal Reserve to be worried enough to slam on the brakes, to stop growth so that inflation gets reduced. The Federal Reserve is trying to cut the risk that inflation will get too high even before the reality of too high inflation sets in, which is a better way to run monetary policy than to wait until after inflation is in place and then to try catching up by raising interest rates a lot. At that point, it's too late.

There is a reasonable chance of going through these hikes in interest rates with the U.S. economy falling into some kind of balance, the central bank then stopping, not having to take rates up to really take the U.S. economy down. There is a reasonable chance of the U.S. finessing the problem of those capacity constraints that I mentioned before, the rises in inflation that typically come about, then higher interest rates, credit restriction, and a downturn. That is probably the biggest question for 2006. Will we finesse the business cycle? In the 1990s, the U.S. did and the expansion lasted 10 years.

For currencies, there is really no predictable pattern. Currencies depend on all sorts of factors including, for example, geopolitics and domestic elections, i.e., non-economic factors, and so the normal business cycle patterns that I've described for the stock market and interest rates can't be applied to currencies. There is no predictable

qualitative path or pattern for the dollar or Korean currency against the Yuan, e.g., that we can find in normal business cycles. But stock market cycles, interest rate cycles, and credit cycles are very clear and indeed for us structured in a very large-scale model of the U.S. economy of about 900 equations.

## A Global Economy Trip

Now, let me take you through the global landscape as we see it, the strengths and weaknesses throughout the world as the 2006 U.S. and global economies appear to us at this time.

Our expectation is for a pickup in economic growth for the world economy, a picking up of steam, but with striking differences in the pace of growth and business activity depending on the country and region. For the U.S., we expect continuing expansion, but at a diminishing rate, 3% fourth quarter-to-fourth quarter on GDP growth. This compares to an estimated 3.5% last year and 4% the year before.

That expectation is below the consensus of forecasters in the U.S.. The Business Week Survey had growth at 3.5%. The Wall Street Journal Survey had it at 3.3%. The comments of various members of the Federal Reserve, though they haven't made their forecasts yet, suggest a 3-1/4% to 3-1/2% range.

Why the slower growth? We think housing in the U.S. is softening and will be soft. The U.S. has had a tremendous real estate boom, so much so that the word "bubble" has been used numerous times for housing in terms of prices of residential real estate. I have to say that a lot of the anecdotal evidence on how rich Americans are getting on real estate reminds me of how it sounded in Japan in 1985 when I would go to Tokyo. I remember asking some of my Japanese friends, "aren't you worried that there might someday be a problem?" And the reply I heard the most was, "the government has never let us down". Well, the government did let the Japanese down—some five years later.

In the U.S., learning from the Japanese experience, the bursting of the stock market bubble was handled very differently.

Chairman Greenspan and his colleagues felt they couldn't stop the stock market bubble,

because in disinflating a bubble the economy might have been taken down. This would run counter to objectives, so tactically the Federal Reserve chose to wait and see if stock prices did collapse, choosing to deal with it after.

The stock market did collapse and the Federal Reserve quickly took the federal funds rate to 1%, the lowest short-term interest rate level since the 1930s. It was a very 1930s-like situation on the business side of the economy. And, even the abnormally low rates didn't really revive the economy, but simply shored up housing and supported housing prices. Then, U.S. financial institutions very cleverly invented many new lending instruments and borrowers flocked to these instruments to extract equity from previously untapped equity in residential real estate. Americans, rich and poor, have made heavy use of the new instruments to borrow on equity in real estate and, of course, as long as real estate prices moved up lenders preferred real estate as asset collateral and so concentrated lending around that asset. Borrowers love real estate as an asset, too, because of the ability to borrow and buy and buy and borrow. This is scary because the pattern resembles lots of other past bubbles in the U.S. and other countries and poses a big risk; one of the risks that in a surprising way could take down the U.S. economy. Right now we think housing will soften and are not using the words weak or bubble, but are watching the situation very closely because of bubble-like characteristics in the ways I described and thus the possibility of a bust.

Decision Economics, Inc. (DE) has gone a step further, looking at what has happened in the last five or six years in housing, real estate and real estate financing and have quantified, we think in a way that no one else has, how the real estate channel and housing boom worked in the economy. We have taken data on cash-out financing and mortgage debt, interest rate data, and looked at how that has affected consumption, residential construction, and business investment. And, we have found very significant effects for the whole channel and way housing and mortgage finance have evolved and how that has affected the economy.

I would summarize by saying that the U.S. economy has never been so levered on residential real estate as it is now. The quantitative effects, as we estimate them, if housing activity were to go down big time and home prices tumble, on consumption, business investment and residential construction will be much larger than in any previous episodes where we have had troubles in housing. Right now, the way we see it for this year is softness. That means home sales and housing starts diminishing 5%-15%,

housing prices not going up anymore on the published indices for existing and new homes, and significant declines in actual transactions prices. Asking prices won't be obtained and will actually decline, not always showing up in the measured data. And, as a balance sheet item, the value of residential real estate on household balance sheets will soften and not grow very much this year.

This is part of why we are looking at the economy and thinking that it will be weaker than the Consensus view, because the effects on consumption along with higher interest rates, high-energy costs, and higher inflation will constrain consumer spending. Growth in consumption spending will be below its historical trend of 3.4% per year over the last forty years.

We are projecting 3% growth for the U.S. economy in 2006 after adjusting for inflation.

What the consumer does is a very big deal for this year. The momentum of American consumer spending is critical, and you are familiar with this, the U.S. culture of spending, borrowing, and credit. The savings rate in the U.S. on one measure is negative now. That is unsustainable and so eventually consumer spending will slow down enough to bring about some sort of recession. Our judgment is that this year will not be the year and that we will just see somewhat below trend growth.

Weaker consumption spending has implications for what the U.S. buys all around the world and for exports to the U.S. of consumer-related items, ranging from cars to electronics. All the goods the U.S. buys from everywhere should be softer.

In the business sector, spending looks like it will be quite strong, that is capital spending and inventory building. Hiring is solid and it is the hiring and incomes generated and balance sheet strength of households that should keep spending by the consumer at 3% or a little more.

At 3% growth we would expect the unemployment rate in the U.S. to come down some; it is currently 4.9%. We are expecting 4-½% by summer and that would represent essentially full employment in the labor market. On 3% economic growth, capacity utilization rates will move higher, the economy will press its capacity limitations and as a result inflation will irregularly but, on average, creep up and the Federal Reserve will keep on raising interest rates. But, inflation should not get so out-of-hand that the

central bank has to clamp down and really put the brakes on the economy.

This scenario has to be watched very carefully to see how inflation plays out around-the-world. Because of globalization and competition and the low-cost production of so many goods that are bought all over the world, the inflation result could be different this time. A lot of goods come out of Asia and a lot comes out of China. For services, there is global competition from India in programming and software and intellectual capital. Global technology allows companies anywhere to buy from anywhere in the world and to ship anywhere. Technology itself, through the Internet, is a force to keep inflation down. If all of this were not going on, I would be talking about much higher inflation in the U.S. and probably talking about the Federal Reserve raising interest rates a lot more than in the current scenario.

In non-U.S. areas, we must start with Asia because that is where the most dynamic growth is going on. There is dynamic and robust growth in China and in India strong growth is likely to continue. We expect China to have another year of near 9% growth. All along we have not thought that the Chinese economy would slow down much. We continue to think that for 2006. This is a dynamic, burgeoning economy bursting at the seams and somehow inflation is low and so there is not a problem for the central bank. China is the number one trading partner now of Japan and of South Korea and I am almost tempted to say that as China goes so will go the Japanese and South Korean economies—at least on exports. I don't think we are quite there yet but the point I would make is that the U.S. economic prospect is no longer as important for Asia as is the Chinese economic prospect. The sands are shifting on which countries count most for Asia and so even if the U.S. economy slows down, Asia can still do better. Of course, if the U.S. were really strong and booming, Asia would do better. But, Asia's tail is not wagged by the U.S. dog anymore.

In this part of the world, Japan's pickup is solid and striking. Japan is in a real upturn and will add to the growth of Asia in general. We are projecting Japan to grow at 3%-to-4% this calendar year and next. That is above trend growth for Japan and probably higher than most other private forecasters think. What we observe in Japan is, of course, strong exports, part of the strong trade of Asia. Business capital spending has been solid. But, now the consumer is finally beginning to let loose after years of holding back. Bonus payments were very strong this year and corporate profits are strong. It looks like the real thing in Japan; sustained and sustainable growth. Deflation, on one measure,

will go away soon and we expect to see the Japanese central bank end quantitative easing. Emerging Asia, which includes China, India, Indonesia, Malaysia, the Philippines and Thailand, should grow about 8% in 2006. That's not far from what the growth rate was in 2005. In 2007, the expectation is still a strong 7%.

These figures indicate why Asia can be singled out as the strongest growth area anywhere in the global economy. The developed Asian economies of South Korea, Taiwan, Singapore, and Thailand collectively should show about 5% growth and South Korea will approach 6%. As we monitor the Korean economy, we detect some pickup over the last half-year.

Second on the growth ladder is Latin America—near 5% growth this year. Again, another group of less developed countries is second highest on the parade of growth in the global economy, where developing countries are contributing more. In Latin America, the improvement is thanks to firm commodity prices, higher oil prices, improved trade flows, and some internal adjustments. This region is not as solid as Asia, but pretty good growth on the order of 5% can be expected.

Even the Eurozone will pick up a little in economic activity; after 1-1/2% growth in 2005, 2% in 2006. Consumers are starting to spend more and we expect that the trade flows that relate to Germany, a lever for the region, will do better. For the Eurozone and Europe as a whole, 2006 will be a better year, but in terms of other countries and regions lagging in growth.

The Canadian economy looks very strong, benefiting from strength in the U.S., rising commodity prices helping exports and from the Asian boom, to grow about 3-1/2%.

The Israeli economy is picking up, with the country very much a technology exporter. Despite geopolitical problems and tensions, the Israeli economy is doing better.

For the global economy as covered by our organization, some 45 countries, the forecast is 3-1/2% growth this year. Last year, growth was just a little over 3%. A pickup in steam is in prospect for the global economy, but not for the U.S., with a major risk to the global economy from the U.S., part of a long list of risks, which we think are manageable in 2006.

## Financial Markets and Monetary Policy

Let me turn to the financial markets and monetary policy in the U.S. and Japan, where striking changes are in process, in turn very important to stock markets and currencies.

In the U.S., we think that the Federal Reserve has moved to a different stage. Stage I was taking a 1% federal funds rate and getting it back to normal for an economy that was up-and-running. The Federal Reserve knew that they had taken the funds rate to an artificially low level, and their experiment of shoring up the economy through housing and consumption worked. Housing not only was prevented from becoming part of the downturn in the U.S. economy, but it became a leader in growing the U.S. economy, along with consumption. The U.S. economy boomed after the Bush Administration tax cuts came into place. In fact, from the exceptionally easy monetary policy it may be that a good thing was overdone, with an unintended consequence excesses in housing and residential real estate.

I don't think anyone could've predicted the responses of the financial institutions and the subsequent awareness of American homeowners that they could extract previously untapped equity out of their homes, out of that asset, and then have that money to spend.

In the U.S., if you give consumers any way to get money to spend, they will get it and spend it. For Americans, it's just the way we are.

The U.S. has the highest consumption standard-of-living in the world, and in a way that's how I think Americans measure their standard-of-living, not as putting money away for the future.

What the December 13 Statement on the FOMC Meeting basically said was that the Federal Reserve recognizes they've done most of the work in restoring the federal funds rate to normal. But, in setting short-term interest rates in relation to the goals of price stability and maximizing sustainable economic growth, the game now is to find the federal funds rate that balances the risks around price stability. Of the Fed's goals, the economy is fine but price stability must be kept in-line.

Religion for all central banks is price stability first. Central banks have done a great job

over the past 10 to 15 years of keeping inflation rates low, and indeed the world economy has benefited. In the U.S., normalization of the key federal funds rate was straight up, starting at 1%, headed toward a range within which the funds rate, the economy and inflation would be balanced. But now, the central bank is in the region of the "right" federal funds rate and now needs to "grope" for the "right" level and to watch and see if the risks around price stability, or inflation, get balanced. And, when the Federal Reserve sees that they will declare the funds rate level at that point to be the "right" funds rate. At the moment, there is more upside risk than downside risk to inflation. The Federal Reserve will essentially have to grope now in a range to simultaneously get the funds rate balanced with inflation and the economy. To get that balance is a juggling act, but I think that's one way to look at the Federal Reserve and where they are going.

What the Federal Reserve said in the December 13 Statement and in comments after the December FOMC Meeting is that they do not have a lot more to go in finding a resting point for the federal funds rate. And, they do have to do some further policy firming. We interpret some further measure policy firming to be a minimum of a cumulative 50 basis points higher on the federal funds rate, 1/4 point each time, up to a maximum of 1 or 1-1/4 points. That's not a lot more. What results is a range of possibilities for the federal funds rate and not a precise number. A minimum of 50 basis points cumulatively would take the federal funds rate to 4-3/4% and a maximum of 1-1/4 percentage points would take the funds rate to 5-1/2%.

What is not easy to figure out is the pace of further increases. An automatic quarter percentage point per meeting rise no longer can be expected. What the Federal Reserve will do on January 31 is fairly easy; the Fed will raise the federal funds rate a quarter percentage point. Some further firming means at least two more hikes. That's a judgment based on the Fed sensitivity to inflation and what they are saying about how they are reading inflation. March 28 will be the first meeting for the new Chairman and we are not so sure a hike will occur. But our probabilistic assessment is seven chances-in-ten. A pause is expected in May but a little better than 50/50 odds is assessed on a 5% rate by the end-of-June. In the second half of the year, one more hike to 5-1/4% is expected and then the Federal Reserve should stop. Long-term interest rates, the 10-year U.S. Treasury yield, given where we are on inflation and the economy, should go up but a lot less than short-term rates. The yield curve, which is now flat, eventually will fully invert. First, from 2-years to 10-years where it is now essentially flat, then through the

curve later on. An inverted yield curve does not necessarily imply a coming recession. Its position this time is a result of the way the Federal Reserve is running monetary policy and the way inflation is behaving in this particular episode. Our economic forecast path says the inversion is a sign of slowing growth but not recession.

The "sea change" in U.S. monetary policy is the Federal Reserve going to a slower pattern of interest rate rises as they get to the right level. The experiment is to balance economic growth against inflation. This has never been done successfully in the history of U.S. monetary policy. And, lots of things are going on. Oil prices are moving around; the economy is moving around, so is the world economy. The odds of the Fed getting it exactly right are probably pretty low. We will just have to see what happens.

The path for interest rates expected by Decision Economics, Inc. is higher than the Consensus view and the futures markets and is tied to the global inflation pattern. A classic cyclical inflationary process appears in evidence which, on average, will produce irregularly rising inflation for the U.S. and global economies. Eventually, central banks will have to step in and stop and slow inflation. What we see on commodity prices is classic demand-pull in origin. Commodity prices around the world are firm and well bid, which is very good for commodity-exporting countries. Gold prices should continue to rise. Gold is also being bought as a hedge against the dollar. The dollar prospect, when one looks out two or three years, is not attractive. Gold is one item in an asset class, precious metals, which has a part in asset allocation. If you inflation-adjust gold prices, and do the same for crude oil, to the last peak which was 1981, the price of gold in today's dollars would be $1700 an ounce. At $559 this morning U.S. time, gold looks cheap. The forecast for gold coming into this year was $600 by the middle of the year and that is still the projection. Going to $600 from $500 is only 20 percent, not a very large move in a commodity price. Frankly, going from $560 to $1000, though $1000 sounds awfully high, if the inflation-adjusted figure is $1700, is not much. We are not making that forecast yet, however, only $600 by June.

If you inflation-adjust crude oil to its previous peak, $90 to $100 would be the figure. What tends to happen to prices in most economic expansions is the surpassing of previous peaks. On crude oil, our working assumption is $65 plus or minus $5. We can only make an assumption but the notion is for higher crude oil prices, not lower. If wrong, probably that assumption will go to $70 plus or minus $5. The global demand for oil and energy in a solid expansion can be quite large. It's not just China and India,

but really the whole world economy.

And, the supply of oil, though activity around increasing supply is beginning to pick up, still will lag demand for a long time. There is a three-to-five year lag time and so ex-geopolitical issues, e.g., the Iran situation, which has pumped up the price of oil by probably $5 a barrel in the last week, oil and energy prices likely will move higher. That has negative implications for oil-consuming countries and positive implications for oil-supplying countries.

On Japanese monetary policy, we are quite sure that quantitative easing will end very soon. Our expectation is that last item of deflation holding back the Bank of Japan will very soon, perhaps in the next month or two, turn positive enough so they will in advance tell us that they are going to end quantitative easing. Two stages are contemplated, first withdrawal of the excess reserves from the financial system, those huge reserves that have been put in. Then, second the BOJ will start to raise interest rates but only a tiny bit at a time. The key-lending rate of Japan could be close to 1/2% by the end of this year against the zero that now exists. We are not expecting 10-year JGB yields to go way up though. Remember, Japan is starting from an abnormally low interest rate position just like the U.S. did. There is still a lot of excess capacity in Japan to absorb and inflation at 1/2% or 7/10% year-over-year will still be very low. So then can be interest rates. Of course, we are very positive on the equity markets of the Asian countries, including the NIKKEI and South Korean stock market. The Japanese central bank has in this regard already stated publicly that they will be transparent and try to follow the U.S. example. This means that they will telegraph in advance what they're planning to do.

Let me close with some perspectives on the dollar. The view we have is negative to neutral, near-term. One of the fundamentals, which so supported the dollar last year, was interest rate differentials. The U.S. central bank was raising short-term interest rates straight up. There was no thought nor expectation that the Bank of Japan and European Central Bank (ECB) would be raising rates. Relative growth rates also favored the U.S. The U.S. was growing very strongly, Japan's growth was still in doubt, and, of course, Eurozone growth was also in doubt then. And those two fundamentals, particularly the interest rate differential fundamental where U.S. interest rates were so much higher, are where the dollar got its support.

Once the Federal Reserve made the sea change in policy that I've described, the pattern suggested on the funds rate is that rises do not have a lot more to go, and that the path may be flatter over time. The Bank of Japan will start raising rates this year. The ECB has already raised rates, and as we watch them we think they'll raise rates again in March and maybe one or two times more this year. Inflation, including energy, in the view of the European Central Bank, is an issue. The Federal Reserve will try to keep inflation at 2% or less which means that they will probably raise interest rates and may sacrifice some growth to keep inflation down. So, the interest rates differential dynamics that supported the dollar aren't really there now to the extent before. We think U.S. economic growth will slow down, Japanese growth pick up, and the Eurozone pick up some.

When the U.S. current account and budget deficits also are accounted for, it's very hard to objectively think positively about the dollar, especially so long as the U.S. has not found a way to fix those problems. I am sorry to say that I see no signs that the U.S. is coming to grips with the deficits. It isn't really federal government spending or the tax cuts that are busting the budget in the outyears. It is the aging population having to be supported by Medicaid and Medicare, which are uncontrollable or mandatory. Scholars who look at this see nothing but extraordinarily high deficits with this as the major source.

The second source of the large federal budget deficits is runaway federal government spending. We have a Republican President who has never vetoed a spending bill. The tax cuts are third on the list.

With tax cuts, you get something back, because they stimulate growth. You get some tax receipts back—they don't really pay for themselves but they do pay for some of themselves. But, how will the U.S. pay for the aging population, more beneficiaries, very expensive healthcare, and healthcare inflation that rises at nearly triple the rate of average inflation. This is not just a U.S. problem, but exists in other parts of the world as well. At this point, I cannot say to you that in the political or societal process in the U.S. we are beginning to tackle this problem. As a result, our view of the outyear budget deficits in the U.S. is very bleak. The current account deficits still look to keep rising. So the vulnerability of the dollar now that the interest rate differential positive fundamental has shifted becomes significant. Risks to the dollar from deficits, debt and rising debt service are on the radar screen and thus also for the stock market and long-

term U.S. interest rates. This whole imbalance situation, along with a cofactor of possibly less support from near-term fundamentals, makes us sensitive to this risk as one of the things that could go wrong with the future prospect, especially if inflation gets too high, the Federal Reserve has to tighten more than I have described, and housing and consumption weaken from the Federal Reserve raising interest rates more than I have described.

Despite these risks, which must be watched and monitored, the prospect for the U.S. economy is very good. However, from my comments, I think you can see why we are allocated in equities more to non-U.S. than U.S.. And, from the way I have described the landscape of the world, though you may not share our more optimistic view on Korea, you should be able to see why we are so bullish on Asia, both in terms of economic activity and stocks. From the point of view of the sweep of history, looking out over 10, 15, 20 years, I think were in the middle of a seismic shift in relative strength for the regions of the world, the likes of which we have not seen for a long time.

## Questions & Answers

Question: Especially after the financial crisis in Asia, the level of investment in this region has come down and remained lower. We are wondering why this is the case. Is this because of the short terminism of the American management, which has come into the Korean stock market, or is it because investment levels were too high before the crisis?

**Answer:** I think of the alternatives that you presented, investments were too high before the crisis, and there were flags. But investments are shifting as we speak and more will be coming back towards Asia. A year from now you'll see quite a different picture. It's just a lag effect of how these things flow. You know stock market monies into Japan, for example, have been mainly non-Japanese, and they have lagged in other parts of Asia. But, I don't think that will be the case this year.

There is a tendency to get upside surprises in situations like what now surrounds the Asian economies and part of it is the tight trade flows and all the businesses around trade and transactions that operates. This tends to give a lift to the cyclical upturns in Asia because of the tight ties in trade. The data recently on many countries have been

producing upside surprises. It will be interesting to see if the pattern repeats itself, more upside surprises than downside surprises. We have seen this many times before. For example, the Japanese economy maybe would be stronger rather than weaker, and China's economy, which we monitor very closely, was supposed to slow down last year but didn't. The Indian economy is growing faster. The Consensus view on South Korean is 5% growth. If that is wrong, that is 5% is wrong, its probably going to be 5-1/2% to 5-3/4% to as opposed to 4-1/2% to 4-3/4%. What systematically goes on in so many situations like this and particularly in the case of Asia is that economies turn out to do better than you think.