New York Life Investment Management LLC

Snap Shots (Year-end 2008)

- Yield curve should get steeper with cuts – 10 year treasury hovers around 4% until mid year.
- Large Cap growth will still be in favor through first half of 2008.
- Tech is poised to remain the top industry sector as the weak dollar supports sales and revenue overseas for the first half of 2008. Second half of '08 expectation is that domestic orders build.
- Financials and Consumer Discretionary sectors will become attractive at some point in the first half of 2008.

As a result of lower rates and lower prices, consumer activity and business investments should pick up midway through 2008, likely avoiding an actual recession.

2008 Economic Forecast

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Slowdown? Yes. Recession? Not likely.

We will see the ill effects of the housing market in earnest next year, as it will continue to slow the economy in 2008. Although it's only about five percent of the entire U.S. economy, housing has already provided a one percent drag on growth over the last six quarters. I believe it will continue to be a damper on the economy for the next four to seven quarters. If you assume potential growth for the U.S. at about three percent, the one percent housing drag becomes a significant negative to overcome. Some other market factors would have to exceed expectations to counter the hole in growth. Right now, trade is the economy's only significant help, adding one percent to growth within the last couple of quarters. But will that be enough to avoid recession next year?

If there is a housing spill-over to the consumer—and we are seeing signs that consumers are slowing spending—will business expenditure make up the difference? Right now it doesn't seem so. Small firm confidence has not been very good and we have not seen business activity picking up significantly. I think part of that is just that small businesses see the slowdown on the domestic side and they don't usually participate as well on the international front. Clearly, larger corporations have to pick up the slack. When you look at new orders for durable goods and the Institute of Supply Management (ISM) manufacturing Purchasing Manager Index (PMI), we're not seeing willingness for corporations to invest.

I think the market is currently forecasting a gloomier outcome than is probably going to occur. People in the market tend to close their eyes to actual economic specifics. We are concentrating on the sub-prime credit market turmoil, which is not going to be the end of the world. With that said, you have market participants who are embroiled in the situation and therefore think it bleeds over into everything else in the world, and that's not necessarily the case. So although I predict we're going to have a slow-down in 2008, it will not necessarily mean a recession.

Housing will be a wreck for a while; as a result, consumer spending and business investments will slow until some of the economic uncertainty clears. In response to the slowing economy and overall uncertainty, the Fed will continue to lower interest rates.

Commodity prices, particularly oil, will fall as a natural result of the contraction in demand that results from slowing growth. As prices retreat, a fall-off in speculative investments in commodities should hasten their price decline. As a result of lower rates and lower prices, consumer activity and business investment should pick up midway through 2008, likely avoiding an actual recession.

Misconceptions of a Weak Dollar

A weak dollar can actually be pretty good for the economy. If you look at U.S. export numbers, they are doing great. For example, if you poll an audience posing the question, "Do you know who the biggest exporter in the world is?" Everybody in the room says, "China." But they are all wrong. It is still the United States.

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The weak dollar is great for exports and the world has got the excess dollars to buy. So right now, that is what counterbalances the drag that housing has had on the economy. Sure, it's awful if you're trying to take a vacation, but perfect for people traveling to the United States. Tourists want to buy our consumer goods at cheap prices. The next phase is going to be asset sales to large buyers, which will be divisive when it occurs—it always is—as you may recall in the mid to late 80s, with Japan. So this time around, the headline grabbers will be the Middle East and Chinese buyers. We have already seen capital infusions to troubled financial companies and a few smaller mergers. This is just the tip of the iceberg.

Exports will be important for the U.S. for some time to come. There is no doubt that, globally, income equalization—rich versus poor—has never been better than it is today. Most Americans don't really worry that the dirt farmer in China now has a factory job and increased their standard of living several times over. This phenomenon is being repeated throughout the developing world. Emerging markets are 30 percent of global GDP, but they are 85 percent of the world's population. This is good for the U.S. because not only can we import cheaper manufactured goods, but this also means that there will be an ever increasing market, for some time to come, for the goods the U.S. exports.

The Mantra of Oil

In any article you read, any presentation you see, three things are mentioned as to why oil is expensive: (1) the dollar's going down, (2) supply is low and (3) demand is going through the roof, particularly from China. But how does the dollar come into play? There has never really been any proven correlation between the dollar and the price of oil, save for some extreme instances. But even if you take that as gospel, the dollar's down about ten percent on a trade weighted basis globally, and oil is up sixty percent, so it certainly does not account for oil's entire move.

Is supply down? No it's not. OPEC is releasing greater volume to the market, you have non-OPEC production ramping up, the rig count is through the roof, and the former Soviet Republics are getting close to where they were before the breakup of the Soviet Union in terms of production. Right now, OPEC supposedly has an excess capacity of over 3 million barrels a day, and that would more than meet any sort of global demand increase.

At some point soon, look for speculators to retreat from today's lofty prices and retreat quickly. I believe the price of oil will slide back down meaningfully in 2008, probably testing $70 a barrel.

Is demand up? Developed world demand is at best flat and probably down in the last year. Emerging market demand is not living up to previous expectations; there has not been a spike in demand since 2004. Chinese demand grew seven to eight percent that year—growth there has never been that high since—and now it's difficult to estimate China's actual demand because it's adding to its strategic petroleum reserves. So while it looks like Chinese demand is growing at five percent, it's really more like three percent, when you exclude additions to the strategic reserve.

OPEC knows what happens when the price of oil goes too far too fast. The danger is that oil could be the tipping point to push not only the U.S., but much of the world into recession. We have already discussed U.S. weakness. Japan may be in recession right now and there is a huge deceleration of growth in Europe. Compound the slowdown with high oil prices and currency strength—Japan and Europe are very export dependent, and the strong currency slows exports—and you have a majority of the developed world with slowing growth, if not on the brink of recession, and oil may upset the balance. The short-term gain of $90 or $100 per barrel may not be worth it to OPEC if price declines precipitously due to a global recession that they helped cause. And on the margin, higher prices also spur the development of alternatives, for example, people start buying more fuel efficient cars, putting solar panels in their homes, etc. Oil producers don't want to provide that impetus, because they want to make us happy buying oil.

I see the Fed cuts continuing in the first half of 2008, with the Fed Funds rate settling at 3.5 percent and perhaps as low as 3 percent if the economy does touch recession-levels.

The fourth and likely main reason why oil has gone up so much this year is that speculative demand has gone through the roof. An oil analyst at ISI Inc. estimates that the paper-traded value of exchange traded futures and options on energy is 13 times the nominal value of daily consumption in the U.S.

Hedge funds have been increasingly attracted to the market during the recent run-up, and now retail investors are piling in too as new investment vehicles, such as ETF's, make the market more accessible. The result: record levels of open interest by speculative buyers of all stripes. Commercial entities—those who actually produce oil and gas—are selling what they produce as quickly they can. These associations are saying, "OK, we'll sell you whatever you want at this price. Keep running it up, we're happy to sell it to you."

We have seen weakness in the energy markets over the past few weeks after the unsuccessful assault on $100 per barrel of crude oil. Now that the speculators have had one misstep, look for greater recognition of market fundamentals, something speculators ignored with triple digits in sight. That is, supply and demand aren't so bad. At some point soon, look for speculators to retreat from today's lofty prices—and retreat quickly. I believe the price of oil will slide back down meaningfully in 2008, probably testing $70 a barrel.

Conclusion

Of course, the presidential election in November may be one of the larger wild cards in factoring the 2008 economic forecast. Campaign rhetoric will gyrate wildly as housing worsens and the economy weakens in the first half of the year. As the first half swoon heads through the spring, I believe the economy will firmly supplant the war in Iraq as the number one issue for American voters.

As a result, tax cuts likely will be discussed as stimulus and the Republican candidate will likely pull even—or perhaps ahead—in the polls with the then-decided Democratic nominee. Whichever party wins the blame game over the economy very well may determine who wins the Whitehouse in November. Signs of a return to economic growth before the election will slightly favor the Democrats, given their current control of Congress.

As always, the Fed's activity—or lack thereof—will impact the year ahead and beyond. I see the Fed cuts continuing in the first half of 2008, with the federal funds rate settling at 3.5 percent and perhaps as low as 3 percent, if the economy does touch recession-levels. Given the lower rates, anticipated increase in business activity, and the predicted drop in prices (food, oil, etc), 2008 will have a slowdown in growth. On the other hand, we'll avoid recession as these factors above take root and demonstrate signs of economic expansion in the third quarter.

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