

What's Next?

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As we begin 2003, it's uncertain as to where the economy is headed. The final numbers are not yet out on the holiday season just past and they will largely tell the tale. But shoppers were out in great numbers and, despite the deep discounts offered by most sellers, they appeared to have surpassed 2001 in their spending. The question is whether the number is 2.5 percent higher as predicted by most analysts or not. If it falls short, the working assumption will be that there will be another recession in 2003. We also do not yet know whether or if there will be a hot war in Iraq and what that will do to the economy. The Gulf War had little impact on the economy, but that may have been because it was so short. This one will probably be longer, so its impact is uncertain.

Clearly, in forecasting the future, the professional must rely on Rule #2: Your guess is as good as mine. Even if we don't know what's happening, we can certainly enumerate the forces that will shape the economy in the next twelve months:

Wealth Erosion. I think we're all familiar by now with the impact of the decline in equity values. Since April 2000, the stock markets have fallen by nearly half. With many more Americans owning stock through retirement programs (and increasingly reluctant to open their monthly account statements) this decline has touched a greater portion of the population than ever before. Most of these price declines have little direct effect, since they show up only in retirement savings, and may in fact have reversed themselves by the time most people reach retirement age. But they do inhibit current spending, since the only way to make up for the losses is by saving more. There is another, lower profile wealth erosion that is going on, however. As the housing market has boomed, funds have flowed out of the market and into real estate, increasing prices and equity. In many cases, consumers have drawn on this equity to maintain their spending levels in the face of a worsening economy. Thus, real estate wealth is also lower. And while the drop in equity prices is now largely reflected in the economy, we have yet to feel the impact of the decline in real estate wealth. We are in a race between job creation (that would maintain consumer spending) and wealth erosion.

Corporate Profits. The recession of 2001 was driven by a decline in business investment, which in turn was caused by a decline in corporate profits. Corporate profits are now up, but the signs of recovery are still insufficiently strong to generate more investment. On top of this, the accounting scandals that have rocked the corporate world, from Enron to Tyco to AOL Time Warner, have cast doubts on the accuracy of reported earnings. This means the market is discounting reports more heavily and will thus not necessarily respond well to seemingly good news. And, of course, continued stock price stagnation shows up in consumer spending (see above.) During 2003, we should see a turnaround in both reported earnings and the Street's acceptance of them. If that happens, it would spur economic growth.

Public Policy. It is generally believed that some form of fiscal stimulus is necessary to nudge this economy back onto a solid growth path. The administration will opt for a tax cut of some sort. If that cut takes the form of making permanent the cuts introduced as temporary measures in 2001, the needed stimulus will not occur. Any tax cut that will be successful in boosting the economy in 2003 must focus on putting additional spending power into the hands of consumers. For example, a suspension of income tax withholding for three months immediately raises the disposable income of consumers. A suspension of FICA would do the same and allow employers more spending power. Each would have a more powerful impact than would the tax rebates of 2001, which are generally credited with moderating the economic downturn. But the other provisions of the Bush tax cuts are focused on the wealthy, and thus would have little impact on spending and help little in averting a double dip recession.

All these aspects are crystallized in confidence about the economy. This means both consumer confidence, reported each month is virtually all business news outlets, and investor confidence, as expressed in the broad based stock indices. Tracking these will give you a feel for where the economy is going.