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Whither the Economy?

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I said, "whither," not "wither." But you wouldn't know it by the way things are going. If there is one place I would rather not be at this moment, it is right here, attempting to decipher the economy's next moves. It—the economy—and I are both in limbo. Stuck. Don't know whether the next move is up or down. Like that other limbo, the game, the question once again is, "How low can we go?"

As I write this column, the United States continues to press for a diplomatic solution in Iraq, but…; the Dow tantalizes with "suckers' rallies" every couple of days but…; West Coast ports are open once again but no one knows the extent of economic damage from the work stoppage and slowdown; consumers finally appear hesitant about the future; and most interest rates—certainly government securities and mortgage rates—are bouncing along a floor that is lower than most people have ever experienced.

No Double Dip

Last month, a "Double Dip" recession was not inevitable. It's still not. There is an economic expansion underway, but it is weak and will remain weak. Economic growth will remain below the rate that corresponds to the economy's full potential for at least the remainder of the year. The evolving scenario is an extended period of below trend growth—like now—rather than imminent contraction. That brings with it corresponding threats, of which deflation—an extended period of

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widely falling prices throughout the economy—may be the worst. Deflation would be harmful to consumers and businesses with extended credit loads. We aren't there yet, but it is one reason the Fed's next move is being watched so carefully—lower interest rates may or may not be what it takes to jumpstart the economy, but they could also encourage consumers to extend their shopping spree on credit. That could be problematic in the future. Of course, with so many external forces also likely to influence the US economy over the next several months—Iraq and oil prices being at the top of the list—not even the Fed knows its next move, right now.

Interest rates are near the bottom

Looking forward, our forecast sees government interest rates near the bottom, with movement over the next month likely to be volatile and, in light of uncertainty, slowly creeping up. Short rates should remain effectively flat or bounce up no more than 15 to 25 bps. Long rates will not bounce quite as much, perhaps 10 to 20 bps. The 10-year Treasury remains near the middle of the range. Residential mortgage rates are also near the bottom. Refinancing activity will continue to outstrip new purchases, especially as we head toward winter. Economic conditions do not merit an extended or steady increase in interest rates, but the onset of cooler weather and the volatile situation in oil-producing portions of the Middle East, provide enough impetus to anticipate the short-term rise in rates.

Overall, the economy will continue to perform as it has—growing sluggishly, with interruptions along the way. That won't dissuade the pessimists from looking for further declines, while it will temper most claims relating to expansion. I suppose that limbo wouldn't be so bad if it was just a game played on beaches in the Caribbean. No such luck. Stay tuned—

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