What Lies Ahead for the U.S. Economy in 2006

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The economic growth that the United States enjoyed in 2005 will continue in 2006, as stronger business investment begins to pick up the slack on the part of consumers who will curtail the white-hot spending that has been a key factor in propelling the economy, according to Wharton faculty members and private-sector economists.

In addition, oil prices will remain high in 2006, but not much higher than they are now, the residential real estate boom will cool and American workers will be forced to deal with a volatile employment market, these experts say.

Finance professors Jeremy Siegel, Richard Marston and Nicholas Souleles agree that the pugnacity of the economy in the face of skyrocketing fuel prices was the most heartening development of 2005. "We had a real test this summer and fall in terms of the oil shock. The remarkable thing about the economy is how resilient it is," Marston says. "We have been growing at a reasonable pace since early 2003. The growth of corporate profits isn't as great as it was in the first 18 months of the recovery, but companies have been churning out higher earnings quarter after quarter."

Souleles says recently released figures on growth in gross domestic product and job creation represented the latest good news. GDP rose at an annual rate of 4.3% in the third quarter, according to the U.S. Bureau of Economic Analysis, and 215,000 new non-farm jobs were added in November, according to the U.S. Bureau of Labor Statistics.

"It looks like the economy has weathered both the hurricanes and the energy spike pretty well," notes Souleles. "The third-quarter GDP number was revised up from an already reasonably good number despite all the problems we have had. Without [the Gulf Coast storms and high oil prices], there might have been extraordinary third-quarter growth. So the good news we have going forward in 2006 is a lot of momentum."

Without question, says Siegel, the response to high oil prices has been the most surprising aspect of the economy's performance in 2005. "There has been much stronger consumer resilience to the high oil prices than expected. Most economists, including myself, would have thought consumer spending would have slowed significantly." Siegel says that once all the figures for 2005 are in, consumer spending may indeed show some slowing but it will not be a sharp decline. "Consumer spending is 70% of GDP," he adds. "If that falls significantly, there is very little chance the economy can do well."

Turning Down the Heat

Will consumers continue to be resilient? Yes, says Siegel, as long as oil prices do not rise above, say, $70 a barrel, which he does not anticipate. "The reason for saying this is that conservation of energy is going to be a major theme in 2006. We are going to insulate our homes better, businesses will run more efficiently, and we have already seen a shift to a preference for higher gas mileage in automobiles. So consumers will again respond to higher prices as economists have always said they should -- by cutting down usage and finding ways to improve efficiency."

In a report released on December 12, the U.S. Department of Energy predicted that crude-oil prices will remain above $50 a barrel for decades. In its forecast, the department said that oil will cost an average of $54 a barrel in 2025 and $57 in 2030, before inflation is taken into account. The price of oil briefly topped $70 a barrel in 2005 and has recently stood at $60 or $61.

Scott Anderson, senior economist for Wells Fargo Bank, predicts that the economy will witness slightly slower growth in 2006 -- 3.5%, compared with estimated growth of 3.7% for 2005. "Growth [in 2006] is going to be more balanced than in the past couple of years in that the manufacturing cycle is beginning to turn. I think inventory building, in particular, will be a major story in 2006. Businesses have let their shelves go bare, basically, and there will be a build-back of inventories."

Economists at Standard & Poor's expect GDP to increase by 3.4% in 2006, according to the December 14 issue of The Outlook, a weekly S&P publication. Inflation, as measured by the consumer price index, will remain muted at 2.4% in 2006, while the core CPI, which excludes volatile food and energy prices, will be 2.3% for the year. S&P says the projected $200 billion likely to be spent on rebuilding efforts in the wake of Hurricane Katrina will contribute to economic growth in the first six months of the year.

At the end of 2006, according to Wells Fargo's Anderson, economists will be able to look back over the previous 12 months and find "that the Federal Reserve successfully halted the advance of inflation that followed the energy price spike of 2005. But this success on the inflation front will be won at the expense of modestly slower GDP growth. The housing downturn, in part due to the Fed's actions, will become more pronounced as the year progresses, triggering a passionate debate regarding overall economic activity and the potential impact on credit quality and job creation."

Anderson says a "change in economic leadership" will take place in 2006, as consumers -- short of breath from their marathon buying binge fuelled by the wealth effect of rising real estate values -- finally ease up on spending. "Consumers will be coasting and the housing-market engine will be sputtering. This is going to be a long, drawn-out process. I'm telling people to get ready for Act One of a five-act play. The housing downturn will be more like hardening of arteries rather than a massive coronary. It will be the beginning of a slowdown. It will limit the ability of consumers to use their houses as an ATM machine. You will get lot a less refinancing activity, a lot fewer loans taken out, and that will weigh [on economic growth]."

Wharton’s Marston agrees. "The underpinning of the economy has been consumer demand, helped enormously by the real estate boom. There is a danger ahead that as real estate prices slow their rate of growth -- or, in some markets, maybe even backtrack -- consumer demand might start to correct. That’s what the Fed has to watch carefully in terms of any further action regarding interest rates." But Marston adds that business investment has picked up substantially in recent months, as corporations begin to employ the profits they have generated in the last two and a half years. This will help to prolong the continuing growth in GDP.

Souleles points out, however, that while a softening in residential housing costs may not sit well with the owners of those homes, its impact on consumer spending is less than clear. "It is really hard to say whether home prices have gone up too much. The strict definition of a bubble -- prices well above fundamental values -- is hard to show. You will always have debates. That said, prices have gone up a lot and consumers have extracted a lot of that equity to consume, which has supported the economy. With the increase in interest rates, those prices are going to slow down. But the question is, what’s going to be the effect on consumers?"

Souleles explains that researchers do not know exactly how consumers have been thinking about the appreciation of their housing wealth -- do they view it as a lot or just a little? -- and how their perceptions affect their decisions to spend. For example, some economists may assume that only if housing prices decline sharply will there be a negative effect on consumer spending. While certainly possible, that is not obvious, in Souleles’s view. It is also possible that if housing prices merely stop rising, consumers may feel poorer and decide to cut back on purchases.

The Fed’s Final Hike?

One thing that’s certain is that rising interest rates will make homes -- and other big-ticket purchases -- less affordable for many people. But it is not certain that rates will continue to rise in 2006.

On December 13, the Federal Open Market Committee, as expected, raised its target for the federal funds rate by one-quarter point, to 4.25%. It was the 13th consecutive quarter-point increase by the Fed, which has been waging a lengthy campaign since 2004 to keep inflation at bay. In an eagerly awaited statement accompanying the rate hike, the Fed noted that "possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures. The committee judges that some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable growth and price stability roughly in balance. In any event, the committee will respond to changes in economic prospects as needed to foster these objectives."

Siegel, a veteran Fed watcher, interprets the committee’s carefully worded missive this way: "It means the Fed does recognize that it is close to being done raising rates. It’s a statement that says, first of all, they have gotten to a level of tightness where interest rates are no longer stimulative. Second, it means they will look at the economy with respect to inflation and GDP growth for their next meeting on January 31."

Siegel believes it is likely that the Fed, given current conditions, will raise rates by one-quarter point on January 31 and then end its campaign of rate hikes. But he says it is possible the Fed will not raise the target rate another quarter point on January 31 -- if economic data that will be released just before that meeting shows the economy to be much weaker than it is now. "If inflation is about 2% or below, and if GDP growth falls under 3%, I think they will not raise the rate on January 31."

Fastest Growing Occupations

The unemployment rate currently stands at 5%, according to government statistics, and Anderson of Wells Fargo expects that figure to hold steady in 2006. As for job growth, Anderson expects it to slow slightly -- from 1.6% in 2005 to 1.5% in 2006.

According to figures in the winter 2005-2006 issue of the BLS’s Occupational Outlook Quarterly, released December 7, nearly all of the 20 fastest growing occupations between now and 2014 are related to healthcare or computers, including home health aides, network systems and data communications analysts. This projected growth reflects increased demand for medicine by an aging population and increased purchases of computer services and software, according to the report. During the same period, retail salespersons and registered nurses are expected to gain the most new jobs -- more than 700,000 each.

Wharton management professor Peter Cappelli, whose research expertise centers on labor issues, says it is becoming increasingly difficult to forecast employment trends. "What is probably fair to say is that the ability to predict where the jobs are going to be is much reduced because the economic changes are so much more frequent now. In a global economy where competitors are around the world, it’s harder to tell. In 1999 and 2000, people said the place to be was in information technology. Two years later, that market was dead because demand turned down and the supply shot up."

Workers can also expect to have to contend with continual restructuring across sectors of the economy. "Big companies continue to restructure all the time," says Cappelli, who is director of Wharton’s Center for Human Resources. "Pharmaceutical companies, which were once thought to be about as stable and safe as you could get, have been roiled by acquisitions. Anybody with experience in petroleum geology is being snapped up by the oil companies, but if oil prices turn down, that will stop. So it’s extremely difficult to predict. Industries we used to think of as safe aren’t safe anymore. No sectors are safe, not even government jobs."

Cappelli does say, however, that it is safer to be an employee of a "single-function" company than in a corporation. "You’re better off being an accountant in an accounting firm than an accountant in a corporation because the corporations are continually changing their mission and may decide to outsource. These single-purpose firms are ’portfolio players’ in that they have a huge mix of clients."

Good Year for Stocks

For 2006, S&P projects that the stocks in the S&P 500 index will produce a total return of 8.5%, as both the economy and corporate profits continue to show strength.

In addition, S&P predicts that the index will end 2006 at 1360, a 6.7% advance over the 1275 it forecasts for the end of 2005. "The projected advance is modest, in part, because the bull move that began in October 2002 is getting a bit long in the tooth," according to S&P. "Furthermore, corporate profits, though growing, are doing so at a slower pace." Still, the projected gain is only a bit below the 7.6% average annual gain that the S&P 500 has posted since 1929.

Wharton finance professor Marshall E. Blume also expects 2006 will be a solid, if not spectacular, year for stocks. At the moment, stocks seem reasonably priced, he says. The current multiple on the S&P 500 is 16.5 times S&P's estimate for 2005 operating earnings, which compares favorably with the 19.8 average P/E ratio on operating earnings for the period 1988 through 2004.

"I don't think there is going to be a lot of risk that price-earnings ratios will fall over the next year because they are already pretty normal," says Blume, who is director of Wharton's Rodney L. White Center for Financial Research. "If you don't have a reduction in the P/E ratio and if corporate earnings grow anywhere near [what S&P is forecasting], you will get a reasonable return on stocks next year."

Inflation could cause investors to get nervous, but Blume sees little threat from sharply rising prices. "It looks like we are on a steady course, and that's good for the market. It doesn't appear we will have much inflationary pressure over the next year or two regardless of what the Fed does. We are able to buy things abroad at very cheap prices because the dollar has appreciated, so it's even better for us."

Outside the U.S.

Even though the U.S. economy is expected to continue forward progress in 2006, Wharton's Marston would like to see other industrialized nations take steps to stimulate growth and accelerate global demand.

"The U.S. consumer cannot carry the load for the entire world; it creates imbalances internationally," says Marston. "It's far past the time that industrial countries outside the U.S. take on the burden of keeping world demand at a certain level. The signs of economic growth from Japan are encouraging. They have had false starts in the past, but the government is committed to reform more than at any time in the past 15 years." Prime Minister Junichiro Koizumi has such strong support in Japan's parliament that he should be able "to put forth just about any policies he wants."

Europe is a different story. "They don't seem to be getting their act together, either in pursuing genuine reforms or establishing short-term momentum," says Marston. "There isn't a single European economy. There are segments of the eurozone economy [the countries that use the euro as their common currency] moving in an optimistic direction. But if you look at the core countries [France and Germany], they have been poor in growth."

Wells Fargo's Anderson agrees that Asia's economies, particularly China's, will grow briskly in 2006, and he thinks Europe's growth prospects are becoming brighter. Says Anderson: "Japan is coming back and China is strong. We still see 9%-plus growth in China next year. Stock markets are rallying in Asia, and Asia will be a growth engine next year. We're more optimistic about Europe. They have been in a slump, but the strong dollar will help Europe's exports next year."

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