

Econ 101

BY DR. ALBERT W. NIEMI, JR.

Your Economic Forecast

The Dallas economy has enjoyed sunny skies. But the clouds on the horizon have **the potential to rain on everyone's parade.**


TWO RECENT AND SEEMINGLY unconnected events—one occurring locally and one on the other side of the world—illustrate well the tenuous and complex business of economic forecasting. On October 11, JCPenney CEO Mike Ullman spoke at an SMU Cox event in Dallas sponsored by Ernst & Young. Ullman stated that the Plano-based retailer expects to open 150 new stores over the next three years—the company's greatest expansion since James Cash Penney opened his first store in 1902. Only days before Ullman addressed an audience of several hundred local business people, North Korean leader Kim Jong-il announced to the world that his country had performed its first nuclear detonation tests.

In order to project a 2007 forecast for the U.S. and Dallas economies, one needs to first make sense of the current economic state of affairs in the United States in light of recent economic trends—and then make some assumptions regarding the near-term stability of global affairs. This first activity poses few challenges, as it's fueled by cold, hard, readily available data. The latter activity, on the other hand, can prove as difficult as making a long-term weather forecast.

RELATIVE STRENGTH

To put 2006 in perspective, it helps to look at other recent periods of economic growth as well as record periods of expansion in our nation's history. The recent U.S. economic expansion compares favorably with the expansion we witnessed in the 1990s, which was the longest peacetime expansion in U.S. history and one of the strongest ever. The real rate of growth in the '90s averaged 3.6 percent. Since the current expansion began in

KEY U.S. ECONOMIC INDICATORS (Estimates by the author)



Indicator	2006	2007
Real Gross Domestic Product	3.4%	2.7%
Unemployment Rate	4.7%	4.8%
Consumer Price Index	3.5%	2.6%
Interest Rates: 3-month Treasury	4.8%	4.8%
Interest Rates: 10-month Treasury	4.8%	4.9%
Housing Starts	1.85 MILLION	1.70 MILLION

November 2001, the real rate of growth has averaged 4 percent, making this the strongest period of economic expansion since the 1960s. This is good news.

» THE TAKEAWAY

- 1 The economic expansion of the past few years will continue next year, albeit at a slower pace.
- 2 Home equity loans have fueled consumer spending, but the party can't last.
- 3 Educating our region's high school students, Hispanic and African-American students in particular, is key to our economic success.

HOUSING

The housing market has remained strong throughout the current economic expansion, driven primarily by a tremendous housing boom. Two-thousand five represented the best year in American history for single-family housing starts. If we include single- and multi-family houses, 2005 was the second greatest year in terms of overall construction.

Recently, observers have seen signs of weakness in the housing sector, and in the third quarter of this year, median house prices fell for the first time since 1995. However, overall, 2006 will be a very good year for home builders, and construction will continue to drive the economy forward.

CONSUMER SPENDING

In addition to the housing boom, consumers are continuing to spend, and this,

too, is propelling the economy. While the aforementioned example of JCPenney's anticipated expansion speaks in part to the company's own financial strength and business strategy, from a broader perspective it illustrates the solid footing on which the U.S. retail industry, in general, now finds itself.

TRADE DEFICIT AND GLOBAL STABILITY

On a more sobering note, the U.S. trade deficit continues to grow and has more than doubled since 2000. [See table at right.] Our deficit with China is currently more than \$200 billion, and China has now become our second-largest trading partner, which could become problematic.

In putting together my 2007 economic forecast, I make what economists like to call the "peace in the world" assumption. I assume that the current level of turmoil in the world will not escalate in 2007. If North Korea attacks South Korea, or the war in Iraq spreads to Iran, you can take anyone's economic forecast and throw it out with last month's magazine.

I also assume no major disruptions in the economies of our major trading partners, especially Canada, China, Japan, and Mexico. The fate of the U.S. economy is particularly intertwined with these four nations because of our strong trade relations. For example, if the Chinese economy overheated and created problems for their banking system, this could destabilize the U.S. economy. Similarly, if the Chinese government revalued the yuan, this could trigger an inflationary spiral in the United States.

GIVEN THE CURRENT STATE OF THE U.S. ECONOMY AND the two stated assumptions, I expect the U.S. economy will slow down in 2007. For the first time since the early stages of the current expansion, real growth will fall below 3 percent based on the projections in the table on page 24.

The U.S. economy showed some signs of weakness in late 2006, and there is less consensus among leading economic forecasters for the 2007 outlook than at any time since this economic expansion began in November 2001. Bear Stearns, Prudential Equity, and Morgan Stanley see a continuation of real growth at a rate of 3 percent or more in 2007. Merrill Lynch, on the other hand, is calling for real growth of less than 2 percent. This divergence of opinion is to be expected when an expansion lasts for more than five years.

A number of clouds are gathering on the horizon with the potential to rain on the current U.S. economic expansion:

CONSUMER DEBT

While the strong rate of consumer spending is fueling the economy, the record-high levels of consumer debt will eventually stall spending. How have consumers been financing their spending? Home equity loans. In 2001, home equity loans totaled \$550 billion; today they are over \$900 billion. I'm also worried about the large number of adjustable-rate mortgages (ARMs) that exist. If interest rates spike upward, this could spell disaster for many home owners. Another reason for concern is the types of mortgage loans currently being made. In 2005, 70 percent of all mortgage

loans in California were interest-only loans in which payments go only toward interest, not principal, and customers build no equity in their properties.

GLOBAL COMPETITION

The United States continues to lose manufacturing jobs to low-cost nations offshore. In 2004, Bain did a survey of all companies based in California, and 36 percent of those companies said they had plans to close their U.S. operations and move offshore to find cheap labor.

GM's experience is an example of what other U.S. manufacturers will face in the years ahead. Thirty-five years ago, GM had 57 percent of the U.S. car and truck market. Today, its share is approaching 25 percent—and in five years it's likely to be as low as 15 percent.

It's not just competition from China and Southeast Asia that worries me. We are also seeing unprecedented competition from India in high-wage, high-skilled white-collar jobs in finance, consulting, and other service sectors. Global competition will intensify in the future and exert greater pressure on the U.S. economy to provide meaningful jobs to its citizens.

TAXES

If you look at our tax burden as a percentage of gross domestic product (GDP), the U.S. position, roughly 25 percent, is good compared to Europe's average of 35 percent. But compared to most of Asia, we are excessively taxed, and this is driving business away from the United States.

MINORITY EDUCATION

In recent years, the U.S. economy enjoyed one of its greatest productivity explosions in our nation's history. In the future, our productivity and economic competitiveness will be determined by how well we prepare our growing minority population to compete in the global economy. High school dropout rates are near 50 percent for young Hispanics and young African-Americans. By 2040, projections indicate that more than 50 percent of America's high school students will be Hispanic or African-American. So our future competitive position in the world

U.S. TRADE DEFICIT

[2000]
\$380
BILLION

[2003]
\$519
BILLION

[2006]
\$800
BILLION

(2006 figure estimated by the author)

DFW POPULATION GROWTH

[1980]
3.0
MILLION

[1990]
4.0
MILLION

[2000]
5.2
MILLION

[2006]
6.0
MILLION

SOURCE:
U.S. CENSUS BUREAU

depends upon our ability to educate these minority groups.

IN ORDER TO BE COMPETITIVE IN the future, regional economies need to have some combination of the following factors:

- **Low cost of doing business**, including costs associated with land, energy, labor, and tax structure.

- **Pro-business attitude.** Businesses will continue to choose locations where they feel wanted. Tax incentives, low levels of bureaucracy, and strong community support are critical to recruiting businesses and industry.

- **High quality of life.** People who make decisions about where to relocate companies look at the quality of schools, housing, retail, the arts, and recreation. Climate is also important. The migration of baby boomers as they retire will be one of the greatest driving economic forces in America during the next 20 years.

- **Air transportation.** Transportation has written the urban history of America, and in a global economy you need a major international airport.

DALLAS ECONOMIC OUTLOOK

Dallas-Fort Worth has been one of the fastest-growing metropolitan areas in the United States since the 1960s. [See table at left.] Earlier this year, DFW passed Philadelphia to become the fourth-largest metropolitan area in the country behind New York City, Los Angeles, and Chicago.

Dallas will continue to do well and grow in the coming years. Our cost structure is attractive. Our government officials and chambers of commerce are effective recruiters. We enjoy a wonderful quality of life that is going to be significantly enriched by the spectacular investments in the arts district. And DFW International Airport is one of the world's great airports.

Of the four clouds gathering on the horizon, Dallas is well-positioned to deal with two. The absence of a state income tax and Dallas' pro-business climate and corporate tax incentives minimize for local residents and businesses the heavy tax burden felt in other parts of the country. And the city's diverse, services-based

economy protects it from some of the pressures posed by cheaper manufacturing labor in other parts of the world.

However, rampant U.S. consumer debt knows no geographic boundaries. And Texas' growing Hispanic population intensifies the need to provide good high school and college education for minorities throughout the metropolitan area. In the

coming years, Dallas-based businesses and residents will have ample opportunities to make choices about the future of our metropolitan area. How we nurture and educate our young people will ultimately determine Dallas' success or failure. **D**

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