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WHERE IS THE U.S. ECONOMY HEADED UNDER BUSH OR KERRY?

How will the U.S. economy perform over the next year? How might that change depending on who wins the presidential election – President George W. Bush or Senator John Kerry? These topics were addressed by Dr. Allen Sinai at the Fourth Annual Venture Capital Summit on October 19, 2004. Allen Sinai is the Founder, President and Chief Global Economist of Decision Economics, Inc., a global economic information and financial advisory firm serving numerous major financial institutions, corporations, governments and individual investors. What follows are some of the highlights of the speech given by this adviser to both Republican and Democratic presidential administrations.

Overview

Dr. Sinai predicted that over the next twelve months:

- The economy will slow, but still perform well, with economic growth – as measured by gross domestic product (GDP) – running slightly above 3%.
- If the economy does not perform as described above, it's likely to perform worse, particularly if oil prices climb even more from current levels.
- If enacted, the Bush-Cheney campaign's economic policy proposals would help the U.S. economy and stock market. This compares favorably with the Kerry-Edwards' neutral impact on the U.S. economy and a negative impact on the stock market.
- Regardless of who wins the presidential election, it will take more than a year for new policies to impact the economy. Financial markets will react initially, anticipating actions of a new administration. Legislative changes take time to enact and then there are lags in the impacts on the economy.

Pre-Election Economic Outlook

U.S. economic growth is likely to slow, but remain above 3% over the next twelve months. Consumer and capital goods spending will be solid, but not so strong as before. Why? For starters, the amount of already legislated new stimulus from tax cuts is less in the second half of 2004 and will decline somewhat further in 2005. Moreover, the ability of tax cuts to increase consumer spending fades over time.

Next, the price of oil has risen above \$50 a barrel as a result of strong demand versus supply that is threatened by geopolitical factors in Iraq, Nigeria and elsewhere. This pinches consumers' purchasing power and raises businesses' operating costs, restraining spending and slowing economic activity.

Likelihood of Different Economic Scenarios

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Dr. Sinai places a 65% probability that the U.S. economy will experience the solid growth described above. However, there is a significant risk that the economy will not perform that well, particularly if oil prices rise into the \$60 to \$70 dollar a barrel range. That creates a 20% probability of a weak economy with high inflation, or a kind of “stagnation.” Less likely is a “fizzle out” economy with lower growth as policy stimulus fades after the election. A “something better,” much more robust economy has very low odds of occurring.

Pre-Election Financial Markets Outlook

The Federal Reserve believes the economy is in good shape. Accordingly, it will raise the federal funds rate from 1.75% ultimately to a more normal, or “neutral,” level of 4%. As long as inflation remains subdued, the Fed can take until some time in 2006 to reach that level. It’s likely to raise rates to 2.0% or 2.25% by the end of 2004 and to 3.0% by the end of 2005. Long-term interest rates, which are not controlled by the Fed, are also likely to rise.

This year the stock market has been hurt by uncertainty about the outcome of a presidential election that is too close to call. There may be a relief rally after the election.

Kerry-Edwards vs. Bush-Cheney Economic Policy

The key Kerry-Edwards economic policy is to raise taxes by some \$860 billion and to spend almost all of that for socially desirable goals, mostly health care and education. Taxes would rise for families earning more than \$200,000. The lower 15% tax rate on capital gains would end for those households, as would the lower 15% tax on dividends. The elimination of the estate tax would not occur. If enacted, the Kerry-Edwards campaign’s economic policy proposals would have a neutral impact on U.S. economic growth and a negative impact on the stock market, due to increased taxes on capital gains and the market’s dislike of government transfers to health and education.

Bush-Cheney economic proposals combine significant new tax cuts with somewhat increased spending on areas such as defense. If enacted, the Bush-Cheney campaign’s tax cuts and spending would help the U.S. economy and the stock market. They would also create more jobs than the Kerry-Edwards approach. But, a negative by-product would be higher federal budget deficits and possibly higher interest rates.

Election’s Impact on 2005 Economy

It takes time for new economic policies to be implemented following an election. This is particularly true when the race is so close that a winner may not be declared for 24 hours or more after the polls close. If Kerry is elected, he’ll probably face a Republican Congress or, at best, a Democratic Senate and Republican House of Representatives. It will be difficult for him to push through policy initiatives.

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With a Republican Congress, Bush could move more aggressively than Kerry. However, it takes time for legislation to impact the economy. It's unlikely that either presidential candidate's new policies could influence the economy much before 2006.

In conclusion, it's important to note that neither campaign has proposed a detailed plan to deal with the federal budget deficit. This is a lack which will hurt the economy, perhaps before the end of the next president's term. Neither is either candidate really coming to grips with the increasingly difficult problem and risk to the economy from rising oil and energy costs.

Do you have questions about this article? Contact John Packowski of Boston Private Bank at 617-912-4204.

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