2008 Economic and Market Forecast

by Jeremy J. Siegel

The economic forecasts for 2008 are now split down the middle. Almost all prognosticators see a marked slowdown in economic activity in the first half of this year. But about one half (and that includes me) believe that the U.S. economy will skirt a recession and that growth will pick up in the second half of the year; the other half see falling home prices and a credit squeeze that finally will pound consumers, precipitating a short but mild recession. (There are always a few who think this is the "beginning of the end," but I'll ignore them.)

As I see it, the U.S. economy has more to fear from rising oil, food, and gasoline prices than it does from the credit crunch. As far as the housing crisis goes, I believe the actual number of foreclosures this year will be below what the market predicts; I believe investors have overreacted to the mortgage crisis. Yes, far too much money was lent on far too easy terms, which caused the housing market to experience a boom/bust cycle. But a lot of those foreclosures were for second and investment properties that many speculators were hoping to flip in a hot market. The vast majority of the homeowners who received subprime mortgages are current with the payments, and lenders are willing to work out terms with those who run into difficulties.

The Economy and Stocks

That said, the impact of the subprime crisis on the psychology of consumers and businesses will leave its mark. I predict that GDP growth will slow in the first half of this year to about 1% and rise in the second half, as conditions in the credit market ease. Overall, I expect 1.5% to 2.5% GDP growth in 2008.

I believe the stock market will do better in 2008 than it did in 2007, when it chalked up a 5.5% return, the fifth year in a row that the market went up. Year-ahead forecasts for the stock market are notoriously difficult, but I believe that a 10% to 12% gain is possible, on the heels of a recovering financial sector. Financial stocks plummeted almost 20% last year, and this was the reason why the market had a mediocre year. Outside of financials, the S&P 500 Index had double-digit returns. A revival of financial stocks would spur good market gains this year.

Interest Rates

What does all this mean for interest rates? The Federal Reserve cut the Fed funds rate to 4.25% on December 11, but it will have to do more this year. I believe that the Fed will get rates down to 3.5% before ratcheting them upward in the second half of next year as the economy improves.

U.S. government bonds did very well in 2007, as interest rates on top-rated securities plunged in response to the credit crisis. But as the risk premiums recede, money will flow away from government bonds and their interest rates will rise. I recommend investors cash in governments and top-rated corporate bonds now—you got a nice ride in 2007 that you won't get this year.

Oil

There are always events (or "risks," as Wall Street calls them) that can upend these forecasts, and the price of oil is one of them. If oil surges well past $100 a barrel, we will be in trouble. Three-dollar gasoline did not prove to be the tipping point for the consumer in 2007. But with a weak housing market, I believe $4 gasoline would do considerable damage to consumers' pocketbooks in 2008. And $4 gasoline will be a reality if oil rises to $120 a barrel or higher.

Politics

Of course, 2008 is a presidential election year. Although the primaries appear up for grabs now, with Barack Obama and Mike Huckabee making a good run, I believe that the Democrats will finally settle on Hillary Clinton after a great run by Obama, but that the Republican race will go down to the wire with McCain, Giuliani, and Romney, with McCain eventually receiving the Republican nod. After a hard-fought battle, Clinton will pull through, as the electorate seems ready for a new party to govern from the White House.

Honestly, anything can happen in the presidential race, but it is easier to predict Congress. I believe that the Democrats will keep the House and Senate. If the Democrats also take the presidency, this will send some nervous flutters through Wall Street. But Clinton will prove to be as moderate on economic issues as her husband was. If the Dems control Congress, taxes will rise on dividends and capital gains, when the current rates expire in 2010, regardless of who is president. But I think the increases will be moderate, and Wall Street will be relieved.

In the meantime, have a healthy and prosperous new year!
