Economic Forecast for 2006 Trends
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By Claude Gruen

The bottom line, this 35th year we have had the hubris to make a forecast, is that 2006 will bring opportunities for good returns to value investors and developers as the U.S. economy stays vibrant. But my fingers falter as I write this, because like Scrooge's dreams on Christmas Eve, there are aspects of the current U.S. economy that evoke a ghost in the minds of economists – the ghost of Professor Irving Fisher. In the decades before and after World War I, this Harvard professor was widely respected for his prescient writings and forecasts. By 1929, he was broadly accepted as the country's leading authority on the business cycle. Then disaster struck. In 1929, just before the Black Friday market crash that ushered in the Great Depression, Fisher forecast that the economy was on a plateau of prosperity. His reputation never recovered, and the economy took 13 years and another world war to do so.

There is plenty to worry about in the U.S. economy. Outgoing Federal Reserve Chair Alan Greenspan often points out the dangers posed by two huge and growing U.S. deficits, one in trade and the other in the federal budget. Consumers' spendthrift ways, the aging Boomers' reliance on housing equity as their main nest eggs, our tangled and bureaucratically burdened health care system, and the constant pressure for changes posed to existing industries by the pace of technological change and overseas competition all work to put the economy on a tightrope where a few missteps could send it into free-fall.

Nevertheless, I bet on the ability of the American workforce and entrepreneurial decision-makers to continue their bruising, open field running of adaptation to the threats of trade deficit. Workers in once safe and high-paid, labor-intensive industries are seeing their jobs and pensions evaporate as China, where urban workers are paid an average of 95 cents an hour and rural workers earn an average of 41 cents per hour, becomes the world's manufacturing giant. But in spite of much personal hardship and struggle, U.S. industries have seen great productivity gains, moved up the value-added food chain and shifted jobs to services and industries that have comparative advantages not matched by low wage offshore sources. Much of this shift has been financed by the willingness of exporters, like China, to loan and invest the dollars they earn back into the United States. In effect, the construction industry, particularly housing, that provides a much higher proportion of U.S. jobs than was the case when our factories provided the cars and other goods we bought at Wal-Mart and car showrooms, has been financed by the dollars we lost to low wage foreign producers.

The ability of the housing and other real estate sectors to stay healthy depends on those who earn a trade surplus from the U.S. continuing to recycle the dollars. I am optimistic on this point since, to take China as an example, I can see no benefit to them of inducing a crash in the dollar. A rise in interest rates and falling dollar would stop the export boom that provides hope for the millions of Chinese who are flocking to their cities. At least for the time being, we appear to have lenders who are not motivated to stop lending.

In the U.S., rising incomes encouraged by productivity gains and interest rates that will not climb to break the back of housing demand will work to avoid a significant fall in single family housing prices. Immigrants, members of Generation Y, and a strong capital market will support apartment market growth in areas where employment growth is at or above the national level. I am much less sanguine about the ability of condominium and attached townhome products to avoid a drop in prices in those areas where investors, rather than occupants, make up a large share of on-going demand.

I predict an overall growth in Gross Domestic Product of between 3.4 and 3.8 percent. However, regional and local growth rates will vary significantly above and below this positive nationwide output. High tech employment will recover, particularly in areas that have been able to keep housing prices and, therefore, salaries, from skyrocketing, as Internet-using innovations, approval for biotech products and the ability of chemical firms to throw off the drag of high oil and gas prices add employees. The fastest employment growth will be in suburban and exurban locations where local firms have found they can operate with comparative advantages.

A wise new chair of the Federal Reserve will not choke off the capital supply, which will enable adaptive reuses, such as the replacement of obsolete shopping centers and the conversion and redevelopment or yesterday's industrial plants and offices, to succeed in sites that have strong reuse potential.

The political mood of the country is likely to remain contentious, if not schizophrenic. But I believe that the U.S. economy will remain buoyant in 2006, enabling me to fend off the ghost of Professor Fisher.

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