year, resulting in lower profits. Easy corporate cost-cutting measures taken in the past to raise profits are virtually exhausted, and the economic environment we project for 1999 does not lead to higher profits.

Of course, lower corporate profits generally lead to declines in stock prices. Damage to the overall stock market already occurred in late summer and is continuing for some individual firms that do not match up to earnings expectations. This is a particular problem now for the banking sector. The lower interest rates we forecast will help offset the decline in profits for all firms, including banks, indicating that the stock market will drift sideways next year. Also helping the market overcome the profit decline is the lower probability of a recession occurring this year. This probability was much higher earlier in the summer.

Market Risk and the Flight to Quality

A big determinant of stock market direction in 1999 will be investor perception of risk. Because the market has been a powerful wealth creator for investors over the past few years, most investors are sticking with it after the late summer sell-off. If many decide to leave the market because it is viewed as too risky, buying support could weaken and stock prices will fall.

A number of factors influence the risk of the market. Interest rate uncertainty, global crises, banking failures, negative profit surprises, and political upheaval could all lead to a judgment of more risk in the market. Higher risk perceptions would lead to stock price declines greater than we currently expect.

In our opinion, the market is fragile right now concerning risk. We have weathered the collapse and rescue of the Long Term Capital Management hedge fund, impeachment proceedings against the president, numerous international problems, and some poor earnings reports from important companies. Unfortunately, more could happen. In particular, a severe crisis could occur in the Japanese banking sector because the banks in Japan continue to sit on bad loans that need to be written off. Given the importance of those banks in funding Japanese business, a banking crisis there could be very harmful to its economy and the others in Asia. Further, such a crisis would hasten the Japanese to sell U.S. government bonds to raise liquidity. Such a move would put upward pressure on interest rates in the United States. Although there is always a chance of such a crisis, we do not see it developing.

Summary

To sum it all up, we expect financial markets in 1999 to drift sideways, with a modest reduction in interest rates. Inflation will be under control and, with a bit of luck, we will avoid the international crises that could negate this forecast and put all of us in a bad mood.

International Trade and Foreign Investment

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The Asian crisis that began in the latter part of 1997 ushered in a global financial crisis in 1998. It affected not only stock markets and exchange rates in Asian countries, Russia, and Brazil, but also a broad spectrum of the world's economic conditions. Tremendous fluctuation in economy and business—a repeated theme everywhere these days—will likely continue in 1999. The Dow Jones Industrial Average has gone through several near-record ups and (mostly) downs thus far this year. The Japanese yen appreciated from ¥145/$ to ¥110/$ in a couple of months and had a record daily gain recently. Our trade deficit reached an all-time high, and foreigners have amassed their investments in the U.S. at a record pace. The prediction of international trade and foreign investment for 1999 has naturally become more difficult in this tumultuous period. A good prediction is all the more important, because global trade and foreign investment now play a greater role in our economy than ever before.

At the end of second quarter 1998, the accumulated four-quarter U.S. merchandise trade deficit was a record $220 billion, compared to $197 billion a year ago. After continuous increases in our merchandise exports, we had two consecutive quarters of decline in the first half of 1998. The second-quarter merchandise exports were $165 billion, $9 billion less than the figure for fourth quarter 1997. On the other hand, our imports steadily increased from $224 billion to $230 billion over the same period. Exports in services were flat in the same period at around $65 billion, whereas service imports increased slightly with the second-quarter figure of $45 billion.

A broader measure of trade, the current account balance (which includes merchandise, services, investment income, and unilateral transfers), had a deficit of $186 billion—an all-time record—over the same four-quarter period. We will likely have a larger deficit in 1998, followed by another record in 1999, although the change from 1998 to 1999 is not expected to be as large as that from 1997 to 1998. This record-setting pace of foreign trade is nonetheless dwarfed by the enormous changes in foreign direct and portfolio investments.

A year ago, Larry Davidson wrote in his outlook for 1998: “Should currency crises occur in 1998, one result would be massive capital inflows to the U.S. and a higher value of the dollar.” Massive inflows, indeed! At the end of 1997, U.S. assets abroad were $5 trillion (all assets are in market values), among which our direct investments abroad were $1.8 trillion. On the other hand, foreigners’ assets in the U.S. were $6.3 trillion, including $1.6 trillion in direct investments. At the end of 1997, the latest actual figures available, the net investment position of the U.S. was –$1.3 trillion, compared to –$744 billion at the end of 1996. Our net investment position decreased by $679 billion in 1997. The figures for 1998 are expected to be even larger. The U.S. economy has been very good: healthy growth, relatively high returns from investments, and low inflation. Foreign capital, especially due to the Asian turmoil, found its way into the U.S. for high, safer returns. Recent stock market movements, cuts in the short-term interest rates, and slower economic growth will likely contribute to reducing the rate of capital inflows.

Capital inflows, as measured by the capital account balance, were $255 billion in 1997. (The difference between this and the current account balance of $155 billion, –$100 billion, is due to the so-called statistical discrepancy.) The value for 1998 will be in the neighborhood of $300 billion. We predict capital inflows to be only a little bit larger in 1999 from the 1998 level, because our economy will grow weaker and the problems in Japan and other Asian countries in 1999 will not be as severe as in 1998.

Without the fast-track authority, the administration will be ineffective for any new serious negotiations with other countries for international trade and investments. As imports rise, some industries will likely seek trade protection by following the lead taken by recent antidumping petitions from steel producers. Because many developing countries try to grow their economies by exporting more to developed countries in general and to the U.S. in particular, there is a potential danger of competitive exchange rate and commercial policies around the world. Business managers should pay closer attention to the nature and the outcome of new rounds of negotiations, such as the recent talks between the European Union and Japan and between the EU and several Latin American countries. We do not, however, expect any major trade negotiations that would greatly affect our economy.

The trade-weighted value of the dollar has also been fluctuating wildly. Up until the middle of August, mainly because of the healthy U.S. economy, the demand of the dollar had been steadily increasing, although the rate of increase was not large. Since September, however, the value of the dollar has taken a nosedive. In fact, the Japanese yen appreciated against the dollar by 8% in a single day. From a high of ¥145/$ in August, the exchange value is now as low as ¥110/$. Less dramatically, though, the German mark has been appreciating against the dollar as well. With the introduction of the euro on January 1, most European countries will make sure their new currency is not overvalued against the dollar. The effective exchange rate in 1999 is therefore expected to be only slightly lower than what it is now.

So far, Indiana has been doing better than the nation in exporting manufactured goods. The state’s manufactured exports in the second quarter reached a new record of $3.59 billion. Indiana managed two consecutive increases in quarterly exports in 1998, in stark contrast to consecutive declines for the nation. In the first two quarters, it exported $7.1 billion, compared to $6.7 billion for the same period in 1997. That increase places it among a small group of high-performing states this year. The *Indiana Quarterly Export Report* (second quarter 1998) wrote that, out of the 25 largest exporting states, 11 states exported less during the first half of 1998 than they sold in the first half of 1997. Only six states performed better than Indiana. It should be noted, however, that the rate of increase in Indiana’s exports in those periods was much smaller than growth in the last few years. Thus, Indiana is suffering from the high dollar exchange rate in 1997 and early 1998 as well as the global financial crisis, though less severely.

What is in store for 1999? International trade and foreign investments depend on the economic conditions of the rest of the world as well as the United States. Recently, the World Bank cut the predicted value of the growth rate of world output in 1999 almost in half, from 3.5% to 2%. Only six months ago, the rate had been predicted to be close to 4%. Fortunately, the U.S. economic growth rate we forecast is only slightly below that of the rest of the world. The top two destinations of Indiana’s manufactured exports, Canada (by far) and the U.K., are relatively less affected by the Asian crisis so far than other countries. Yet Japan (the third destination) is still in a recession that will continue in 1999. The severity of the recession in most Asian countries will be much reduced in 1999. In fact, some of those countries will begin to record positive growth rates, especially in the second half of the year, although 1999 is probably too early for their full recovery. We predict our current account deficit will be substantially larger in 1999 and still larger in 2000.

Until the global financial crisis is resolved, capital will continue to flow into the United States. With a slower growth rate and lower interest rates than before, however, the rate of capital inflows will be slower. Many U.S. firms are reportedly finding new ventures in countries that are severely affected by the Asian crisis. Many old joint ventures have been changed into wholly owned subsidiaries. Real estate prices have been dropping and affected countries are now welcoming more foreign direct investment (FDI) than ever before. We believe there will be a large change in U.S. exports and FDI in those destinations. Because our lower savings rate appears to have bottomed out, and because we are going to have a budget surplus again in 1999, our current account deficits and capital inflows will become smaller, but only after the first half of 2000. In the meantime, there will be a large increase in risks as well as opportunities in 1999, in both international trade and foreign investments.

Housing Markets

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It has been a good year for housing. The home building industry is enjoying one of its best periods, driven by a strong economy, low mortgage rates, and robust employment growth. Housing starts and home sales reached record levels this year. Privately owned housing starts in August were at a seasonally adjusted annual rate of 1,613,000, which is 17% above the August 1997 rate of 1,383,000 (see **Figure 1**). During the first eight months of this year, 1,074,800 housing units were started, compared to 977,300 for the same period in 1997—about a 10% increase.

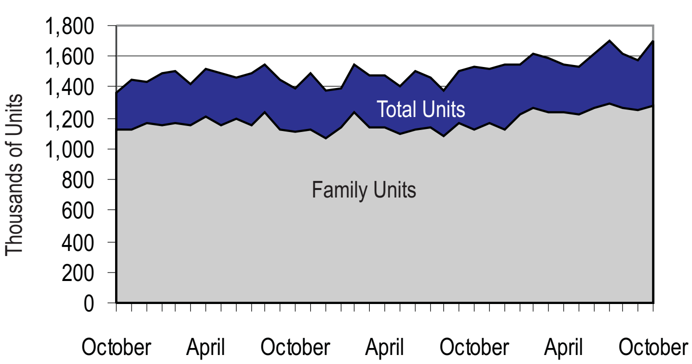
Building permits issued during the first half of 1998 were up 11% from the first half of 1997 and surpassed the first-half record set 21 years ago. The increase in permits in Indianapolis was exactly the same as the national average of 11%. Mortgage Bankers' chief economist David Lereah predicted record highs this year for existing home sales, new home sales, the U.S. home ownership rate, and mortgage originations.

Sales of new one-family houses in August 1998 were at a seasonally adjusted annual rate of 838,000, according to estimates released recently by the U.S. Department of Commerce's Bureau of the Census and the U.S. Department of Housing and Urban Development (see **Figure 2**). This is 5% above the August 1997 rate of 799,000. Through August of this year, 618,000 houses were sold, compared to 564,000 during the same period last year—an increase of about 10%.

Mortgage Interest Rates at Record Lows

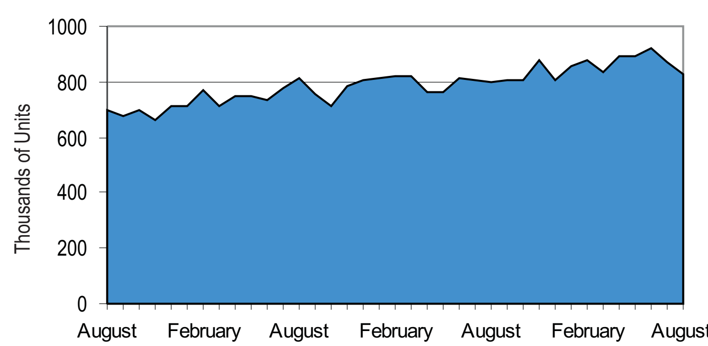
Interest rates for 30-year fixed-rate mortgages dipped to about 6.5% in October, the lowest level in about 30 years. They rose toward the middle of October, but that was before the most recent reduction in interest rates by the Fed (see **Figure 3**). The rate for one-year adjustable-rate mortgages also dropped in October (see **Figure 4**). The spread between the rate on adjustable-rate mortgages and fixed-rate mortgages has

Figure 1
Housing Starts



October 1995 to October 1998
Seasonally Adjusted annual Rate

Figure 2
Single-Family Home Sales



August 1995 to August 1998
Seasonally Adjusted Annual Rate