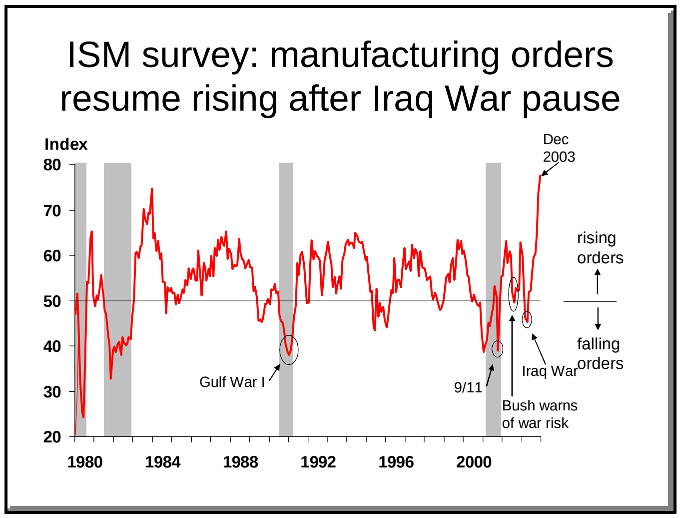
periods—such as before the late 1990s—profit growth typically leads investment growth and has a strong positive correlation after accounting for this leading tendency.

However, during the bubble years of the late 1990s, stock prices were so high that it was cheaper for companies to grow by investing in new capital than by buying out competitors at inflated prices. As a result of unusually high stock prices and excessive profit expectations, investment outstripped economic profits during the investment boom of the late 1990s when profit growth was faltering. Profitability plunged during the 2001 recession, on par with the 25 to 30 percent declines of deep recessions, like those of 1982 and 1974. Only after the Iraq War pause of the spring has profit growth notably recovered at a pace that is sustained and more in line with that seen in prior strong recoveries.

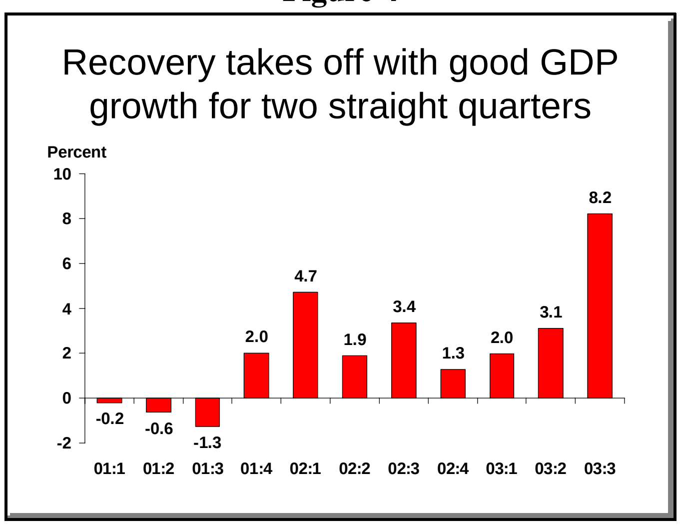
Another major headwind that has died down is geopolitical risk, which had induced pauses in spending by consumers and firms. The Institute for Supply Management (ISM) surveys purchasing managers in manufacturing about activity at their firms. Plotted in *Figure 3* is the purchasing managers' index of new orders, with a reading over 50, indicating that firms on net are seeing rising orders. This index typically plunges during recessions and historically has been a little faster to rise during recoveries than the broader purchasing managers' index. In an earlier episode of high geopolitical risk, new orders plunged following Iraq's invasion of Kuwait and during the first Gulf War.

Figure 3



The impact of geopolitical risk was very apparent in the last several years. After showing signs of recovering in the summer of 2001, new orders plunged following 9/11 and the index turned down following the president's warnings of a likely impending war with Iraq during the summer of 2002. After hopes of a peaceful resolution faded later that year, the index plunged again just before and during the Iraq War. Since then, new orders have soared to highs exceeding that of the 1983 recovery and not seen since 1950.

Figure 4



The Recovery Takes Off and the Outlook for Growth is Strong

As both the investment and geopolitical headwinds have died down, the recovery has gained momentum. As Dallas Fed President Bob McTeer has mentioned, it has only been since the second quarter of 2003 that we have seen two straight quarters of decent GDP growth (*Figure 4*). Although growth likely moderated from the

Conclusion

In summary, the recovery has picked up and the outlook for growth is strong because investment and geopolitical headwinds have died down; fast productivity growth will allow strong growth with low inflation; much fiscal and monetary policy stimulus is in train; and the rebound in profitability is stimulating investment and hiring.

The major upside risk to growth going forward is that profits and investment could continue surging. On the downside, a major concern is that consumption growth could fade quickly—however, an emerging job market recovery could temper the restraining effects from a possible slowdown in mortgage borrowing. Further declines in the dollar pose an unusual risk because an orderly retreat would be a plus for short-run growth, while a disorderly one might be a net minus if the impact of financial market disruption more than offsets gains in net exports. The key policy issues concern the speed of the recovery and how sustainable that growth rate is. The risks surrounding these questions warrant monitoring indicators of both aggregate supply and demand.

John V. Duca, Vice President
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