Hurricanes Katrina And Rita: Their Impact On The Economy And On Your Bond Holdings

The devastating loss of human life and property from Hurricanes Katrina and Rita have been staggering. In addition to the hundreds of lives that were lost across several states, the economic loss from the hurricanes is astounding. According to an assessment by Risk Management Solutions (RMS), Hurricane Katrina is estimated to have caused more than $125 billion in total economic losses, of which an estimated $40–$60 billion is covered by insurance. While RMS has not released a figure for Hurricane Rita's estimated total economic loss, it believes insured losses total $4–$7 billion. And while the hurricanes' effects will be felt in the Gulf Coast economy for some time, the destruction they brought has impacted the national economy as well.

Economy

The U.S. economy was relatively robust prior to the hurricanes. For example, the economy appeared to be growing at roughly a 3.5% annualized rate (in real, inflation-adjusted terms) prior to Hurricane Katrina as part of a broad-based expansion. However, as a result of Katrina and Rita's impact, most economists believe that third and fourth quarter real GDP growth will be reduced by about 0.5% to a level of 2.5%–3.0%, depending on how long energy prices remain at record levels.

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The policy response from the federal government will have a large influence on the national economy's growth and inflation trends over the next 1–2 years. The federal government may spend $150–$200 billion to rebuild the affected areas, including housing and infrastructure spending. History demonstrates that the construction sector is a primary beneficiary of rebuilding efforts. Thus, the mix of economic growth will be skewed toward construction and government spending and away from consumer spending. In fact, after Hurricane Katrina consumer confidence plunged to its lowest level since March 2003, at the outset of the war in Iraq.

Consumer Impact

Prior to the hurricane-related increase in energy prices, consumers were spending 3% of their overall personal income on gasoline, fuel oil, and other energy products (not counting what consumers spend on energy services, such as electricity and natural gas), the highest level in 20 years. The latest price increases will only add to household fuel expenses, forcing adjustments elsewhere. Consequently, consumer spending growth is likely to slow to 2.5%–3.0% over the next six months from 3.5%–4.0% over the past two years.

Interest Rates

The property devastation left behind by the hurricanes may prompt the Federal Reserve Open Market Committee to raise interest rates faster than it otherwise would have, since the Fed's greatest concern is managing inflation. The disaster in the Gulf of Mexico has raised the price of petroleum products. Further, the rebuilding effort will likely add to the price pressures already impacting the tight market for construction supplies and materials. In addition to these heightened inflation pressures, once the rebuilding effort gets underway, the Gulf region's economy will get a boost. Of course, initial economic activity in the region will suffer due to worker dislocations and inoperable factories, but ultimately rebuilding activity will enhance the rate of economic growth.

Bond Market

The prospective performance of the bond market is tenuous. The Federal Reserve had already embarked upon a

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Written and edited by Louis E. Conrad II, CFA.

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path of increasing interest rates to battle the inflation threat of an expanding economy. The devastation in the Gulf region only adds to current pricing pressures and economic growth through rebuilding efforts. The federal government's plan to spend as much as $200 billion in the region will result in a larger budget deficit. Bonds generally react negatively to prospects for accelerating inflation, increasing interest rates, and an expanding budget deficit.

Consequently, we continue to maintain a cautious stance with our clients' fixed income allocations, preferring to manage portfolios for reduced interest rate sensitivity (lower risk to rising interest rates). We also seek to add value at the margin, in such areas as high quality, international bonds and inflation-protected securities. If the federal budget deficit grows, the U.S. dollar is likely to come under pressure, which would benefit non-dollar denominated bonds. An acceleration in inflation will lead to appreciation in inflation-protected securities, commonly referred to as TIPS, and our clients' portfolios have representation to this subasset class too.

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COMPASS Investment Advisors, LLC
41 Forrester Street
Salem, MA 01970
Telephone: 978.828.5681
E-mail: info@compassinvest.com
Web Site: www.compassinvest.com

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