



Economic Update

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We agree with the view that this is the greatest global financial crisis since the Great Depression. The global economy was in freefall in the fourth quarter of 2008 and this should continue in the early months of 2009. This has created fears of a global depression. However, we expect a severe global recession rather than a depression. The key to our view is that policymakers have a correct diagnosis of the severity of the financial crisis and should continue to be proactive in responding aggressively to it. This contrasts with the experience of the 1930s and the Japanese stagnation after the Nikkei bubble.

However, even after the recession is over, we do not expect a strong economic rebound in the early quarters of recovery. Such a strong initial rebound has occurred in past business cycles dominated by inventory cycles rather than by serious systemic financial crises. Instead, we expect a subpar recovery in the initial phase of this economic cycle. The financial system is on a path of gradual recuperation and much of the credit available will be utilized to refinance existing debt rather than finance new spending. This is not just an issue of the supply of credit. The demand for borrowing for new spending (as opposed to refinancing) is also likely to be weak. The major erosion in consumer net worth should limit the demand for new consumer debt. In the corporate sector, excess capacity should tend to restrain capital spending.

A lake of liquidity is being backed up behind a dam of risk aversion, creating a drought of credit availability. We expect that this liquidity will be slowly released over the risk aversion dam as government actions lower the fear of an intensified systemic financial crisis.

The U.S. is in what is likely to be the longest recession of the Postwar period, the combination of

two distinct recession phases: (1) a pre-Lehman borderline recession and (2) a post-Lehman waterfall economic decline. Combining the borderline phase of the recession and the waterfall phase of the recession, we expect an economic decline lasting roughly a year-and-a-half. The peak-to-trough decline in the 2007-2009 recession should roughly equal and possibly exceed the 1973-1975 recession and the 1981-1982 recession. Economic activity should be lower in 2009 than in 2008 in nearly all developed countries and the overall global economy should be roughly flat in 2009, well below potential trend growth. The result should be a substantial rise in unemployment rates worldwide and rising protectionist pressures.

It has been more than a generation since the U.S. economy has experienced a recession with anything near the severity of the current recession. We expect the recession trough to occur close to mid-2009 in response to monetary ease, fiscal stimulus and an end to inventory liquidation. A recession trough occurs when the economy stops declining and begins to rise, irrespective of whether that rise is weak or strong. The end of actual economic decline is unlikely to be regarded as the beginning of prosperity. Instead, we expect a "post-recession pre-prosperity phase" in late 2009 and in 2010. While a few months of sharp rebound is conceivable when inventory liquidation ends, we expect a subpar recovery in the first few quarters after the economic trough with a rise to a peak U.S. unemployment rate in the 8.5% to 9% range in the early phase of recovery. Whereas recessions dominated mostly by the inventory cycle are likely to have a V-shaped bottom, recessions dominated by a burst bubble of asset prices and systemic financial crises are not. The end of economic decline by mid-2009 is likely to be followed by several quarters of subpar recovery, and then by a somewhat better recovery in 2010.

World industrial production dropped at an extraordinary pace in the fourth quarter of 2008, which should continue into the first half of 2009 as financial stresses have been slow to improve and substantial excess inventories need to be liquidated worldwide. The global economy experienced a “negative recoupling” in late 2008 as a half-decade of global boom has given way to a serious global recession, with many key economies currently dropping at a very rapid rate. There has been a globalization of economic cyclicality first to the upside and now the downside. The closest precedent to this cycle would be the global recession of 1973-1975. In that cycle, an oil shock and commodity inflation was followed by falling commodity prices and an intense inventory liquidation at the end of the recession.

The severity of the current financial crisis and global recession is undeniable. The issue is how quickly stimulative policy can contribute to an end to the recession and reflate demand. The good news is that policy is powerful, policymakers have a correct diagnosis of the situation and their ability and willingness to be proactive in adopting stimulative monetary and fiscal policies is quite high. The bad news is that economic declines linked to systemic banking crises and house price busts have a history of being prolonged, so a very aggressive policy response is required in order to achieve a long recession rather than a more prolonged decline.

The financial system has not yet normalized but there are early signs of improvement. Over the years, Chairman Bernanke has analyzed in various speeches and articles the multiple unconventional policies that the central bank could adopt once the Fed funds rate approached the “zero bound.” As a result, the adoption of a variety of new liquidity programs has been relatively rapid and is beginning to show some traction. Many of the alphabet soup financial support programs have offset contractive forces in the private financial sector, acting as backup generators where the private sector financial system has not functioned well. Some recent improvements in financial stress indicators are

reflections mainly of central bank and government support programs, but there are also early signs of improvement in non-supported markets. Spreads on A2/P2 commercial paper have dropped, the junk bond market is no longer making new lows, spreads have dropped on unsupported non-financial corporate bonds and a calendar of new issues has emerged in the corporate bond market. It is notable that when the financial stock indices broke to new lows in early 2009, most stress indicators in the credit markets did not revisit their worst levels. We view this “positive non-confirmation” as an indication that, while the financial crisis is still severe, the Fed’s policy of “credit easing” is beginning to work. This conforms to the thesis in our December 2008 report that the markets would transition from disorderly deleveraging to semi-orderly deleveraging. We expect an eventual transition to orderly deleveraging.

U.S. consumer prices have been in a temporary deflation in recent months following the peak in oil prices in July 2008. We expect that the 12-month rate of deflation in the headline Consumer Price Index should be about minus 3% by the summer of 2009 as the high inflation readings from early 2008 roll out of the calculation period. With the Fed funds rate effectively at zero, that implies that one measure of the real Fed funds rate would be positive by about 300 basis points, appropriate for an economy in a strong expansion, not one in a severe recession. However, five-to-ten year inflation expectations in the University of Michigan Survey have risen back up to 3%, implying that among U.S. consumers a breakdown to long-term deflationary expectations has not yet occurred. As long as consumers view consumer price deflation as temporary, the zero Fed funds rate should eventually have a substantial stimulative effect.

The Fed’s actions have succeeded in generating a rapid growth in the money supply. This is a desirable outcome when consumer prices are deflating and financial stresses are contributing to a fall in velocity. Desired liquidity has risen in a context of severe financial stress and if the Fed did not accommodate that rise, the contractive forces in

the financial system and the economy would intensify even further.

Rapid growth in the money supply can help prevent an inflection point to long-term deflation expectations. We regard it as appropriate in the current context. Just as an upside breakout in long-term inflation expectations in a period of cyclical inflation can be destabilizing, a downside breakout to long-term deflation expectations can be destabilizing in a period of cyclical deflation. Central banks prefer that long-term inflation expectations remain “anchored” and stable. When they are, they increase the effectiveness of monetary policy.

How and why will the recession end? Some factors are automatic, such as the end of inventory liquidation. However, there needs to be a set of policy contributions from (1) conventional monetary policy, (2) unconventional monetary policy and government support for the functioning of the financial system, (3) fiscal stimulus, and (4) government policies to avert a “house price overshoot.”

The sharp drop in global spending has generated excessive inventories worldwide. There is now an intense global inventory liquidation underway as production is dropping below even the new lower level of demand. This helps explain the intensity of the global economic decline in late 2008 and early 2009. Weakness from an inventory liquidation is unstoppable as long as it persists, but all inventory liquidations are temporary. Later in 2009, the inventory liquidation will be over, permitting some rebound in production from extremely depressed levels.

In the midst of a serious recession, the U.S. economy needs a fiscal stimulus that is fast, large and well designed. Fiscal stimulus is neither a free lunch nor the Tooth Fairy. The resulting increase in the budget deficit will need to be financed by a massive increase in the Treasury calendar. In addition, some taxpayers will adjust behavior in anticipation of future tax increases. However,

timely fiscal stimulus can help break the momentum of a vicious cycle feedback loop during a serious recession. We regard fiscal stimulus as a time-shifting policy, shifting spending into the current period of deficient spending at the cost of somewhat weaker spending in the future. The fall in spending is not the cause of the recession, it is a symptom. The causes of the recession include global imbalances, payback for too tentative a pace of Fed tightening in the last expansion, a widespread mispricing of risk two to three years ago and debt-financed spending by the private sector in the past. But continued declines in spending can feed back to further house price declines and also to higher estimates of future loan losses in the financial system. Since the Federal government is able to borrow money relatively easily at a time when it is hard for the private sector to borrow, it can successfully mitigate that feedback loop by a time-shifting fiscal stimulus.

In our opinion, the election gave President Barack Obama a clear mandate to act in response to the severe recession. We expect a fiscal stimulus that will be both large and fast. The economic policymakers in the new Administration are quite experienced, but the jury is still out on how well designed the final version of the bill that actually passes Congress will prove to be. The design of the fiscal stimulus bill should have an important impact on the long-term growth rate of the U.S. economy in the coming years. In any case, the short-term impact of the fiscal stimulus bill should cushion the severity of economic weakness in 2009.

One key to the longer-term economic outlook is “expectational stability.” Uncertainty about the financial crisis, the recession, current deflation risk, future inflation risk and the policy outlook has tended to motivate companies and individuals to accelerate contractive decisions and postpone spending. In this context, clarity and consistency in the policy regime can be just as important as the details of the policy itself. We are hopeful that there will be a clarification of the future policy regime in the coming weeks. This should contribute to continued financial recuperation.

House price deflation is still generating a negative shock to the financial system and the economy. It is doubtful that there was any way of preventing house prices from correcting their boom-time overshoot and returning to long-term fair value relative to income and rents. In 2009, house prices should begin to approach their long-term equilibrium value in many areas. The U.S. population is growing over time and the Federal Reserve is dedicated to generating a moderately positive inflation rate once the cyclical deflation has ended. Tax policy remains very supportive of home ownership.

A reduction in the “house price overshoot risk” is critical to stabilizing the economic outlook. There is still a substantial risk of a downside overshoot in house prices since excess inventories of vacant houses and condos remain quite high. To date, government policy to reduce the vacant housing inventory has been quite tentative. Aggressive government policies could help prevent a painful overshoot in house prices, now that they are beginning to approach equilibrium. We expect a succession of government actions to incentivize housing purchases and limit foreclosures. A rebound in house prices is not required. Instead, it is confidence that nationwide house prices would stop going down at some point in 2009 that would aid the transition from recession to recovery.

In the years prior to the current financial crisis, the “originate and distribute” securitized sector of the financial system grew to roughly the same size as the regulated commercial banking system. The growth of the securitized sector of the financial system via increased leverage expanded the total credit capacity of the overall financial system. During the financial crisis over the last year-and-a-half, the securitized banking system has contracted sharply. The severe contraction in securitization in recent quarters reduced the total credit capacity of the private financial system at a time when the risk budget of the commercial bank sector was strained by loan losses. The resulting reduction in the capacity of the financial system helps explain why the central bank has needed to dramatically expand

the Federalized component of the financial system. Some analysts, such as James Bianco of Bianco Research, argue that the contraction in the securitized financial system has resulted in a private financial system too small to effectively finance the economy. Credit provided through financial intermediaries requires much more capital than credit provided through securitized channels that distribute loans directly from borrowers to lenders. That is especially true to the degree that they are distributed to unleveraged lenders and moderately leveraged lenders rather than to highly leveraged lenders.

At a time when the risk budgets of financial intermediaries are strained, it is difficult for them to fully replace the credit capacity of the damaged securitized sector of the financial system. Many liquidity programs of the Fed are designed to temporarily replace that credit capacity. Longer term, however, it would be desirable to rebuild a better regulated and more transparent private securitized financial system. That would tend to limit the required size of continuing Federal life support or increased equity capital that would be needed by financial intermediaries if they are to permanently replace the credit capacity of the shrunken securitized financial system. If confidence in the U.S. financial system and economy is to be rebuilt, the private financial system needs a “path back” from Federal life support to a private financial system with enough credit capacity to easily finance economic expansion. We believe that rebuilding a simpler, sounder securitized sector of the financial system is one key to that “path back.”

Only the government and central bank can insure against generalized panic-risk. When there is uncertainty about that implied insurance, risk aversion will create behaviors that tend to cause the financial system to contract. More recently, confidence is gradually being rebuilt in the commitment of the Federal government and the central bank to prevent an intensification of the systemic financial crisis. A notable aspect of the new liquidity support programs from the Fed and

the Treasury is that they have often relied on explicit guarantees. As the financial system shifts from ambiguous implicit guarantees to clearly defined explicit guarantees, the result is likely to be a decline in uncertainty. This should assist in the recuperation of the financial system.

We agree with the view, expressed in “A Global Perspective on the Great Financial Insurance Run” by Richard Caballero, an Economics Professor at MIT, that only the authorities can provide effective insurance against a generalized panic-risk:

The core aspect of the crisis is a collapse in all forms of (explicit and implicit) financial insurance ... As long as the government becomes the explicit insurer of generalized panic-risk, we can in the medium run go back to a world not too different from the one we had before the crisis (aside from real estate prices and

the construction sector) ... The essence of a solid recovery should build not from deleveraging and a forced and brutal contraction of the financial sector. Rather it should be built on the explicit and systemic provision of insurance against further negative aggregate shocks to the financial sector’s balance sheet that might be caused by panic or predatory actions ... trimming the (lower) tail-risk offers the biggest bang-for-the-buck.

Despite the severity of the financial crisis, the global recession and the U.S. recession, we believe that confidence that the governments and central banks will prevent an intensification of the financial crisis is returning and the financial sector is gradually recuperating. As a result, we believe that the most likely case is a recession trough around mid-2009 followed by a subpar economic recovery.



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