

NEXT QUARTER IN THE U.S. ECONOMY

July 2009

The Economy

Signs of an upturn are accumulating. Auto sales are well off their earlier lows. Most regional purchasing managers' reports are consistent with an economy finally coming up for air. Government purchases are adding a percentage point to GDP growth. Additionally, fiscal stimulus is adding to transfer payments. But a greater proportion of income is being saved not spent. Initial unemployment claims need to fall further before we can be confident of recovery.

Inflation

Except for monetary stimulus, the fundamentals point to exceptionally low inflation the next couple years. The Fed will have to start extracting excess liquidity next year.

Interest Rates

With unemployment high, the Fed will be reluctant to tighten. Fed funds rate flat until next summer. Market rates will move higher. Mortgage rates at 6% in a year, and 6.6% in early-2011.

America's Watershed

Every cloud has a silver lining.

There is much misgiving about this recovery. Experts are uncertain about when the recovery will start and what the economy will look like a year from now. In reading the viewpoints expressed in the media by individuals and prominent organizations, I'm struck by a curious phenomenon. You might call it "boxed in." It shows up in various guises. Here's an example. The Bank for International Settlements (BIS) in Basel says world bankers may not have done enough to stimulate the global economy to bring about a sustained recovery. Emphasis on the word "sustained." Yet they say withdrawing stimulus too soon may cause the recovery to sputter and die a year or so down the road. Isn't this curious? We might not have spiked the punch bowl enough for the party to even get going, yet already we have to start thinking about taking the punch bowl away. (The BIS is

saying don't do that.) It's like the economy is balanced on a high wire with virtually no leeway on either side. This same sense of having to walk a tightrope appears in the media almost daily regarding Fed policy. We hear that if the Fed doesn't start unwinding its balance sheet soon, it is setting the stage for an inflation that will be hard to eradicate. The Fed increased the monetary base from \$832 billion last August to \$1,770 billion in May. In normal times this would lead to a doubling of the price level within two or three years. In other words – hyperinflation. Yet a majority of forecasters at primary dealers believe the Fed won't raise the funds rate until 2011, because if they do they'll risk aborting the recovery. The Fed seems to be boxed in. The theme is there's only a narrow path authorities can take to avoid calamities waiting on both sides like the mythical sea monsters Scylla and Charybdis.

(continued next page)

Hagerbaumer Economics
10106 Tarpon Springs Road
Odessa, Florida 33556
813 792-7624

It's a watershed

What are we to make of this quandary? First, there is much more than the usual uncertainty about the future at this turning point. Exceptional uncertainty is understandable in that during the past year we witnessed a near financial collapse, and now the consumer spending core of the economy is straining under a mountain of debt. Second, so many parts of the economy are in flux – when housing will bottom, where delinquency rates are going, maintaining solvency in the banking system, keeping the US dollar the world's reserve currency, peaking of global petroleum production, what to do about global warming, and so on. With so many loose cannons, it's only natural to want to tie policy down at both ends. And thirdly to the heart of the matter, the global economic system has undergone a profound shock that has dislodged its tectonic plates. The plates are still moving. We are never going back to the old way. The world is in a different place now. It is in the process of shifting, making us uncomfortable. China is rising, America's is breaking off its love affair with credit, and Wall Street has imploded. The political winds have for a time shifted to an era of more involvement by big government. Much as when the prime rate hit an astounding 21% in 1981, we're experiencing a watershed moment. This watershed is far more fecund with unknown than that one was. Then it was concern about inflation and the price of credit; today the concern is about change and it's closer to the bone. The moorings have come loose. From the rail on one side, the voices are adamant: "Reel in the stimulus or consequences will be dire." Yet as loudly from the other side you hear: "Don't reel in yet,

though, or you'll snap the line."

Any solid middle ground?

Having escaped deflation and depression, we must now guard against setting off inflation and winding up with too much federal government intrusion and too large a national debt. Yet even the middle ground feels shaky. This is because two things are happening: an ordinary business cycle is turning and deeper and more profoundly we are in the midst of a wrenching structural break with the past. We're leaving behind the era of expanding credit and entering an era of credit contraction. Until the future becomes clearer, it's time to focus even more intently on executing the basics.

The recovery

Leading indicators started signaling the cyclical recovery in April. That recovery is slow in coming. The level of initial unemployment claims is a tipoff. Claims haven't fallen enough yet. Personal income (less government transfer payments) and manufacturing and trade sales have turned up. But industrial production and payroll employment are still falling. So we are in the midst of a turning point but not yet through it. Fiscal stimulus is the force that will lift the economy up. The beneficial effects of lower energy costs will help too. The price of crude was over \$100 per barrel most of last year. The run-up to \$147 was part of what brought the economy down. Now lower energy prices will help the economy recover.

The consumer

Auto sales evidently hit their low in February, climbing from a 6.3 million unit annual rate to around 7.2 in June. Auto sales may never fall this low again. Consumer sentiment pushed to a 16-month high in June. These are encouraging

signs. The consumer portion of the recovery will be anything but a barnburner, though. The Survey Research Center in Ann Arbor reports that in the months ahead consumers expect the smallest income gains ever recorded in the history of the survey.

Home prices

After 7 straight months of falling at an annualized rate of 20% or more, the Case-Shiller home price index slowed its rate of descent to 12% in April. It looks like we've reached the inflection point. A rough estimate is for home prices to fall another 6% on a national basis, bottoming sometime next year. Higher-priced homes will fall proportionately more. Given the way investors have snapped up fire sale foreclosures, the lowest tier of the market may have already bottomed. Of the 20 largest cities, prices rose in Denver, Washington, Cleveland, and Dallas. The last few months have evidenced a notable stabilization in housing permits, housing starts, and new and existing home sales. So the earliest stage of a long shallow recovery in housing seems to be getting underway.

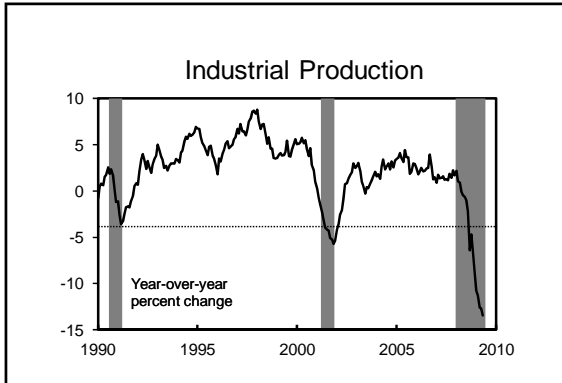
Fiscal stimulus

Stimulus is the main driving force. Enabled by all the liquidity from the Fed, it's what will pull the economy out of recession. Christina Romer, who heads the Council of Economic Advisors, says the administration didn't expect much impact from the stimulus package in the first 5 or 6 months, that the big impact starts from now on. (That the administration did not sufficiently front-load the stimulus package was evident even before passage by Congress.)

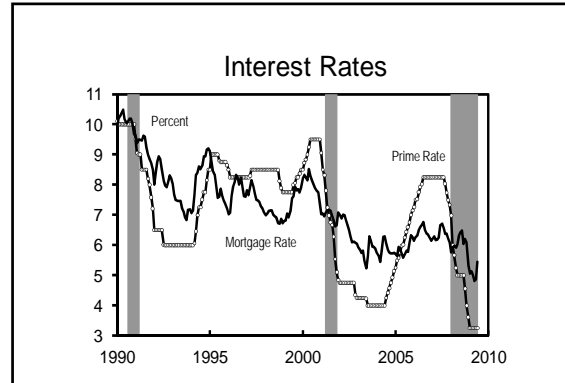
(continued next page)

KEY ECONOMIC INDICATORS

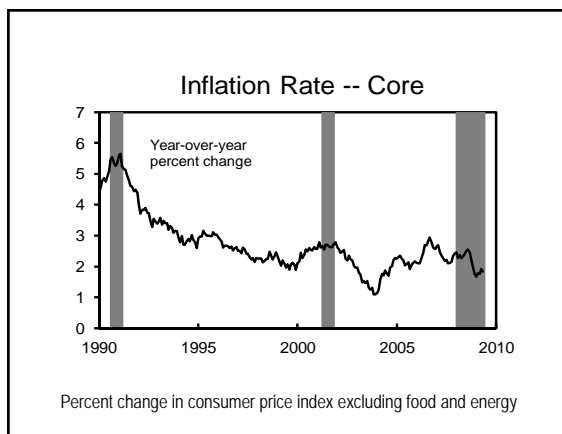
NEXTQUARTER



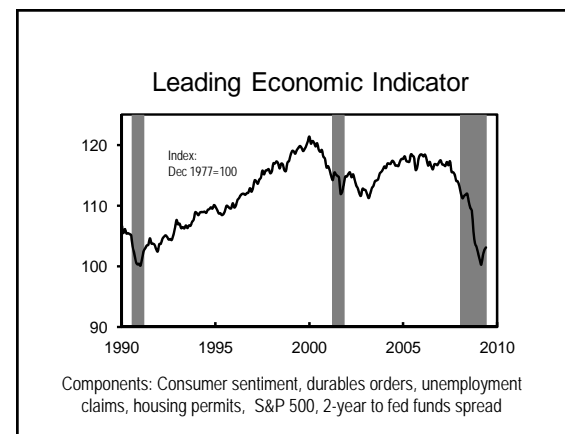
Manufacturing output is still dropping. June purchasing manager data look better.



Mortgage rates have clearly bottomed. And will rise only slowly from now on.



Recent increases should be reversed.



Three months up adds credence to the case for recovery.

Protracted stagnation

In its just-released annual report, the BIS warns that until the banking system heals – by rebuilding capital ratios and disposing of bad assets – there’s a significant risk that monetary and fiscal stimulus will lead to only a temporary recovery, with protracted stagnation to follow.

Unemployment rate

The unemployment rate will exceed 10½% next year. **By 2010, lack of job creation will re-**

soundingly be the nation’s number one problem. The administration and the forecasting consensus are calling for a peak in the unemployment rate next year and then a decline. But unemployment will stay tenaciously and surprisingly high in the slow growth environment, with the bulk of that growth coming from productivity. The Fed will remain on hold longer than otherwise and jobs will be “the” issue in mid-term elections.

Fed funds hike when?

Never in my forecasting career has the confidence interval around when the Fed will hike been so wide. Charged by Congress with promoting maximum employment – and certain to be staring at a double-digit unemployment rate – the Fed will hold off as long as it can. Yet there’s a real risk that growth in the early stages of the global recovery may trigger a scare about inflation (signaled by higher bond yields) that the Fed

(continued next page)

THE OUTLOOK

NEXT QUARTER

	Actual	Forecast				2010
	Q1	Q2	Q3	Q4	Q1	
	percentage change at annual rate					
Gross Domestic Product (\$2000)	-5.5	-1.5	2.1	1.8	2.7	
Consumption	1.4	0.6	2.2	2.8	3.0	
Durables	9.5	-5.9	6.8	8.9	8.9	
Nondurables	-0.4	-2.2	1.0	1.6	2.1	
Services	0.9	1.5	1.8	2.0	2.1	
Plant and equipment	-37.3	-17.5	-14.9	-12.5	-10.5	
Housing	-38.8	-24.3	3.5	9.7	10.8	
Government purchases	-3.1	4.1	5.6	-5.0	-0.9	
	millions of units at annual rate					
Auto & truck sales (domestic)	6.8	7.2	7.5	8.0	8.6	
Housing starts	0.53	0.51	0.52	0.54	0.56	
	percentage change at annual rate					
Consumer Price Index (all items)	-2.4	2.0	2.1	2.1	2.1	
	percent per annum					
Prime rate	3.3	3.3	3.3	3.3	3.3	
Fed funds rate	0.2	0.2	0.2	0.2	0.2	
2-yr T-note	0.9	1.0	1.2	1.3	1.5	
10-yr T-note	2.7	3.3	3.7	4.0	4.3	
Mortgage commitment rate	5.1	5.0	5.4	5.6	5.8	

Note: Forecasts are for calendar quarter averages and are subject to continuous and substantial revision.

will not be able to ignore. All the more so because the funds rate is at an unsustainable low level. Balancing all this puts the likelihood of the initial rate hike around June next year.

Market interest rates

The 10-year Treasury yield zoomed from 2.54% on March 18th to 3.95% by June 10th. March 18th was the day the Fed announced they would be buying \$300 billion of long-dated Treasuries directly from the market. The stock market had begun its rally the week before. Stocks and

bonds were driven to those extremities by fears of an interminable and deep recession. It had been huge flight-to-safety. After the markets turned in March, they gathered momentum with each new sign of impending recovery. For bond yields, the pendulum reversed direction on June 10th. The Dow topped two days later. Bond yields have been driven lower by strong bidding at Treasury auctions. This cannot last. As more concrete signs of recovery emerge, yields will turn back higher. □

July 2, 2009
 Jim Hagerbaumer, Ph.D.
 hagerbm@tampabay.rr.com