



Quarterly Economic Report – 4th Quarter 2008

A Global Meltdown Leads to a “Great Recession”

Throughout 2008 we saw a chain reaction of plunging economies, failing banks and consumer fear and many of those trends will continue into 2009. Deterioration in employment and an unstable housing market will prolong the recession and sustain the risks to financial markets. However, some loosening credit conditions should slow the erosion later this year helped along by fiscal stimulus. The fiscal stimulus policies being introduced will catapult an already burdensome budget deficit and could bring further problems if not managed correctly.

The disruptions in the financial institutions have also brought major changes to the financial marketplace. Broker/dealers have become an endangered species. Changes at Lehman Brothers, Bear Stearns, Merrill Lynch, Bank of America, Goldman Sachs and Morgan Stanley will fundamentally change not only salaries, but bring major changes in regulations. Banks continue to merge or fail and 2009 will undoubtedly see more of this disruption (IndyMac, Countrywide, WA Mutual, and Wachovia). Even the mortgage juggernauts, Freddie Mac and Fannie Mae, have become wards of the state.

Globally the news is not good. 2008 brought several countries to the edge of default (Argentina, Hungary, Iceland, Russia, Pakistan, Belarus, and Egypt). The moribund economic situation in most countries has deteriorated trade, which continues to reignite financial difficulties and fear, and in less developed countries this is a notable stability risk. With the liquidation of hedge funds, technology development, trade absence and a global drop in auto sales, the balance sheet for both corporations and countries presents a critical challenge. Securitization has been an important source of credit for several years and as result we have seen the crisis spread from US housing across the globe. However, the rate of decline in areas such as housing and employment, are slowing year-over year and often month-over-month.

This is not, however, anywhere near the great depression touted by the media during the election frenzy. During the 30's, asset values dropped 70% making our losses pale by comparison. The events that created the debacle and the steps being taken to exit are quite different. Over the past year, the economy has lost 2.8 million jobs with 1.9 in the last four months, but even this loss represents only 1.6% of jobs and less than 4% of overall purchasing power. The wealth destruction has been widespread, but so too has been governmental action. Since mid-2008 money has been pumped into the banks and the Federal Reserve has been aggressive on providing liquidity. The past isolationism has not developed and currency actions have remained reasonable between countries (at least until Mr. Geithner's recent gaff). The drop in commodity prices has helped to loosen consumer purse strings. In September worker wages were 3% below the living rates but by April 2009 this should be back to equal.



Source: FRED Philadelphia, NBER

Housing and the securitization of mortgages was one of the fundamental building blocks of this meltdown and we saw a tidal wave of foreclosures until October 2008 as the waves started to flatten. Bringing back this sector will require major and multifaceted approaches because the consumer remains overleveraged, jobs are unstable, home prices are down and inventory remains high. This situation may lead to years of stagnation in housing even as inventories decline. It will require a new approach including loan modifications for existing mortgages, reverse mortgages and shared appreciation terms as well as lower rates.

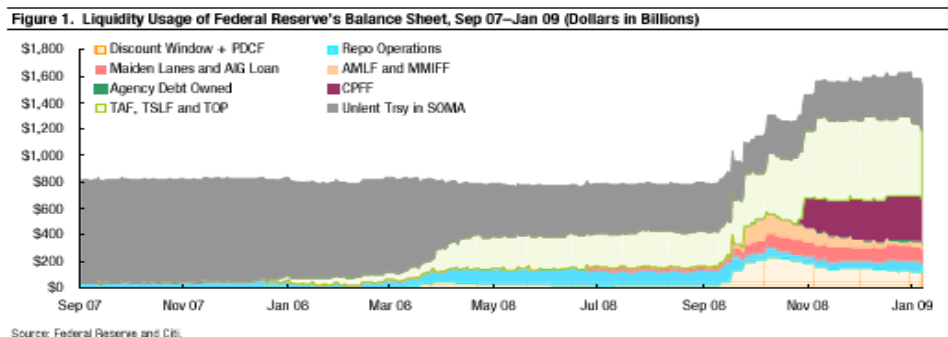
These areas need attention, but the focus for recovery is the banks. Most large banks' assets are down well over 20% from last year. Banks no longer trust their own ability to measure risk and are unwilling to take on more risk. The debt appetite of 2006-2008 outpaced the banks in an unregulated environment outside the banks. But the banks took on the securitized debt which was a high source of credit. Now that debt burden has effectively stopped lending practices. Now at least with the spread of the meltdown all banks in all countries are on the same level playing field, which should engender cooperation.

As regulator to the banks and primary arbiter of monetary policy, the Fed has done much to cushion the crisis within the limitations of unstable banking institutions which can not afford greater shocks. Although the effort was initially patchwork in nature because of the tsunami of failures since December, the Fed has been on focus with its unanimous vote for 0-25% rates. The focus has been on credit easing to improve bank reserves and the Fed has been creative in using all the tools at its command. Special facilities have been established and now the Fed will look to direct purchase of bad assets. We may see Fed bonds or a RTC type vehicle created too also. But the Fed is walking a *very* fine line. Flooding the banks and economy with funds creates a secondary problem. If they act too soon in removing the credit easing facilities, the economy could slip back into recession easily and quickly. If however they remove them too late, the inflationary risk is tremendous. Suffice it to say the government as a bank – and even the Fed as a lending bank – is not an optimal solution but one that has been forced on them at this point.

To work out of the recession we need improvement in several areas.

- (1) Liquidity must be available. Deleveraging will continue at all levels and hedge funds will unwind. Loan facilities will assist this process and lower mortgage rates will help.
- (2) Monetary policy must continue to focus on easing. Bernanke's "quantitative easing" (QE) with Fed Funds at 0% takes a great burden off balance sheets.
- (3) Fiscal policy is focused on stimulus and tax cuts and both are needed. The goal is confidence. There will be about \$2 trillion issued in 2009 of which only \$400 billion is replacement funds.
- (4) Banking will need regulators to ease loan loss reserves and potentially take bad assets off their balance sheets through purchases or "bad bank" creations.
- (5) Housing inventories must decline. Production and inventory have declined but sales have declined more. We now have nine months of inventory and it will take that long or longer to work through that inventory before construction can resume.
- (6) Employment losses and fear of job loss must decline.
- (7) Time.

Much hope is tied to the stimulus program, but this will take much more time than anticipated by many. The government has been working in this area since March 2008. We needed to open inter-bank lending and the Fed has done this. We needed a tremendous injection of capital and the Treasury has started that. Now we have to separate the survivors from the weak in banking and in industry. This is the most difficult and takes the most time. Little of the initial \$600 billion has been used yet. From banks to automakers, we have to save those that are viable and let the rest go. The automakers will lose \$40 billion in the 1Q. If they can not stem the tide they have to fail.



The challenge is to go fast and that means tax cuts, state and local government aide, and major infrastructure building because there is no private sector demand. None of these however will create actions until mid-2009.

Lying ahead are multiple challenges. It feels like a free fall but it is not. The bank market is anticipating much worse than probable reality and keeping rates at historic lows. The supply of Treasury issuance will raise rates slightly starting in 1Q. The trade balance has been reduced from \$57bb to \$40bb, 13% of which is the drop in oil. Climbing out will take time and be difficult with bank dysfunction and risk aversion, but the stimulus funds should bridge that gap. Deleveraging will continue but major deflation is unlikely. The rate of deflation has already slowed in 4Q from 20% to 2% month-over-month. If unemployment increases slow and inventories dry up, deflation is unlikely.

There used to be sharp differences between Keynesians and monetarists. Now both matter. The biggest ongoing discussion and decision will be the size of government and the level and nature of tax cuts. The stimulus program and its trillion dollars will improve the situation. The new difficulty will be in the required discipline after the stimulus has worked its magic in the economy.