

Economics

Recession Scenario for 2008

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Last week we presented our central forecast of slow-to-moderate growth for 2008. The forecast was predicated on a number of key assumptions, including a significant easing of the turmoil in the credit markets in the first half of 2008 and a continuation of the lack of spillover effects from housing to the consumer because of further growth in employment. This week we look at a *what-if* scenario—specifically, what if the economy slips into recession. At the outset, and for the reasons explained below, we need to say that we do not view this as a likely scenario—we would put the probability of recession in 2008 no higher than 20%. Nonetheless, the scenario is worth examining, particularly to explore the character of what a recession might look like. Not all recessions are created equal and the character of the recession will shape the nature of the Fed's response and the reaction of the bond market in terms of the level of yields, shape of the curve and the extent of spread widening.

Origins of Recession

We do not believe that economic expansions simply die of old age. Recessions have a specific cause, usually arising from a prior policy error by the Federal Reserve. Frequently, recessions resulted from inflation getting out of hand—itsself a product of overly easy monetary policy—resulting in a sharp tightening of policy to attempt to reverse the course of inflation. The recessions of 1969–70, 1973–75 and the back-to-back recessions of 1980–82 were all of this nature. These recessions tended to be relatively deep and often fairly long because inflationary expectations had to be reversed—a process that can take a considerable amount of time. Suppose, for example, that nominal GDP was growing at 9% (the average growth rate of the 1970s and 1980s) and inflation was running at 6% (and expected to remain at that rate) and real growth was running at 3%. If the Fed tightens policy so that nominal GDP growth slows to 6% but inflation expectations remain unchanged in the short run, real GDP growth will drop to 0% until inflation and inflation expectations decline.

The last two recessions were, in our opinion, somewhat different in character. The 1990–91 recession began as a prolonged slowdown—related to balance sheet restructuring in the financial system and Fed tightening—that tipped over into recession as a result of the Gulf War oil price shock. The Fed was easing into the recession, lowering the funds rate target by 175 bp before the onset of recession in July 1990. The Fed eventually cut the funds rate by 675 bp, to 3%, and kept the rate at that level until February 1994. The 2001 recession was entirely different in character again since it was a corporate spending generated recession. Corporations had been on a

tech-related capital spending spree that had the result of boosting productivity. However, the Fed had been hiking rates to head off an inflation problem that was predicted by its Phillips Curve model and overtightened, systematically reducing the pricing power of corporate America. The result was a profit squeeze and an unsustainable financing gap for corporations. Corporate America had to retrench, cut back sharply on capital spending and restore profitability. Price trends, as evidenced by sharp declines in gold and commodity prices, were disinflationary, which permitted the Fed to cut rates rapidly once it became clear that growth was stalling. The Fed cut the fed funds rate target by 475 bp in 2001 and by a further 75 bp over the following two years (in response to deflation concerns).

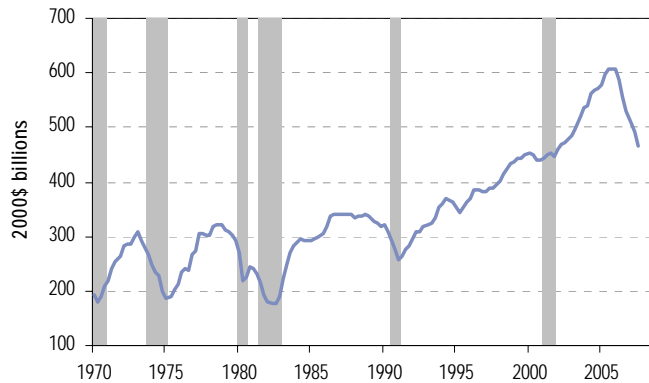
At the present time, it seems clear to us that the preconditions for a 1970s or 1980s style recession are absent. Inflation expectations are fairly contained (although beginning to rise)—at least as judged by TIPS or the University of Michigan—and the Fed's inflation-fighting credibility seems fairly high. By the same token, however, recent price trends and the high level of gold and commodity prices suggest that there are no disinflationary forces at work. The severity of the recessions of the 1970s and 1980s resulted from the incompatibility of the stance in Fed policy (tight) and inflation expectations (high and rising). The sluggishness of inflation expectations to adjust to the new policy stance resulted in sharp contractions in real economic activity. The failure of expectations to adjust to the new tight policy stance resulted in an excessive inventory build as real demand fell short of expectations, eventually prompting a sharp cutback in production to restore inventories to more normal levels. At the present time, inventories stand at almost a record low level in relation to sales and this is one of the reasons that we think a recession in 2008 is unlikely.

What Would a 2008 Recession Look Like?

We think that if the economy falls into recession in 2008 it would have the greatest similarity to the 1990–91 recession. The three factors that we see potentially driving the economy into recession are (i) the impairment of capital in the banking system if structured credit continues to deteriorate in price and new sources of capital dry up; (ii) a steeper than expected decline in home prices and a decline in equity prices that crimps consumer spending via the wealth effect; and (iii) energy prices continue to move higher, eating into real disposable income. The deterioration in the balance sheet of the banking system parallels events in the S&L system and the

banking system in the late 1980s. High energy prices were also a feature of the 1990–91 recession.

Figure 1. Real Residential Investment



Source: Commerce Department

We think any recession would be short and shallow, similar to the 1990–91 recession. Over the three recession quarters (1990 Q3–1991 Q1), real GDP fell by only 1.3%, with final sales down an even milder 0.5%. Residential investment had been contracting modestly since 1988 but the drop in construction intensified in late 1990 and 1991. With real residential investment already down 23.5% from its peak, we do not think that the pace of decline in housing construction will pick up. However, we would expect a further contraction

in residential investment of 11.6% in 2008. Such a decline would put residential investment by the end of next year at a record low of 3.3% of real GDP. In the recession scenario, consumer spending is seen slowing in the first quarter of 2008, before contracting in the second and third quarters. As the economy begins to contract, businesses cut back on investment spending and hiring, further depressing final sales and boosting unemployment, which is seen rising to 5.8% by the end of 2008 in this scenario. Imports contract in response to declining sales and the real trade gap is seen narrowing by over \$100 billion, to \$405 billion by the end of the year, which cushions the decline in GDP in 2008 by about 0.9 percentage points.

We do not believe, however, that a recession would lower core inflation, since we see inflation as a monetary phenomenon (and monetary policy is expected to be eased in any recession scenario) rather than a Phillips Curve phenomenon—hence, the rising unemployment rate does not put the brakes on rising core inflation. Headline inflation is seen running faster in the first half of 2008 on the assumption of higher oil prices, but then slows in the second half of the year as weaker demand growth leads to a reduction in oil prices. For the year as a whole, we would project headline CPI inflation at 3.1% and core PCE price inflation at an elevated 2.7%. Looking beyond 2008, however, we would expect that easing in response to a credit-induced recession would put upward pressure on inflation, in part the result of a likely significant further weakening in the dollar.

Table 1. GDP in the 2008 Recession Scenario

	2007*				2008*				2007+	2008+
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
	(percent)				(percent)				(percent)	
Nominal GDP	4.8	6.6	5.9	4.6	2.3	1.3	3.4	5.3	5.5	3.1
Real GDP	0.6	3.8	4.9	1.5	-0.4	-1.5	0.4	2.2	2.7	0.2
Real Consumer Spending	3.7	1.4	2.7	1.5	0.6	-2.0	-1.5	1.0	2.3	-0.5
Residential Investment	-16.3	-11.8	-19.7	-18.0	-17.0	-15.0	-9.0	-5.0	-16.5	-11.6
Nonresidential Investment	2.1	11.0	9.4	4.7	1.4	-3.7	-7.7	-3.3	6.7	-3.4
Exports	1.1	7.5	18.9	9.4	5.0	4.5	4.2	3.8	9.1	4.4
Imports	3.9	-2.7	4.2	2.0	2.0	-4.0	-7.0	1.0	1.8	-2.1
Unemployment Rate	4.5	4.5	4.7	4.7	4.9	5.3	5.6	5.8	4.6	5.4

* Values are either quarterly changes or quarterly averages

+ Values are either 4-quarter changes or yearly averages

Source: Bear Stearns; Labor Department, Commerce Department

Table 2. Inflation in the 2008 Recession Scenario

	2007*				2008*				2007+	2008+
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
	(percent)				(percent)				(percent)	
Chain-Weight GDP Deflator	4.2	2.6	0.9	3.0	2.8	2.8	3.0	3.1	2.7	2.9
Consumer Price Index	3.8	6.0	1.9	3.9	3.5	3.3	2.8	2.7	3.9	3.1
Core PCE prices	2.4	1.4	1.8	2.3	2.4	2.6	2.9	3.0	2.0	2.7

* Values are either quarterly changes or quarterly averages

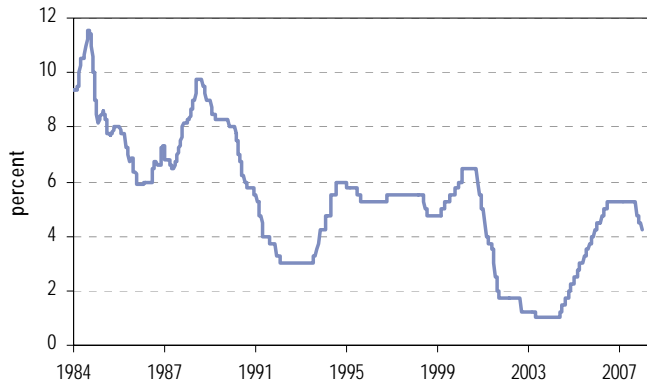
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Source: Bear Stearns; Labor Department, Commerce Department

The Fed in the Recession Scenario

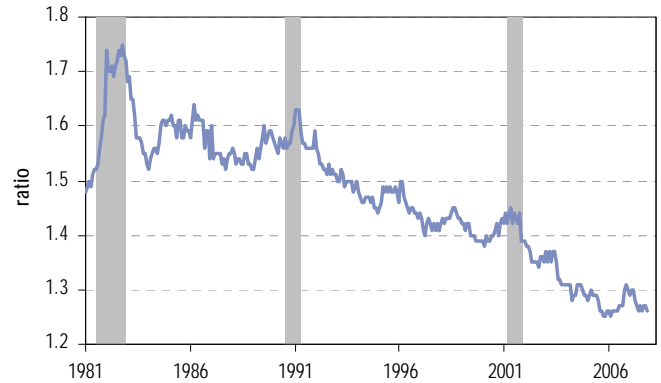
Despite inflation pressures, the Fed would likely continue to cut rates in a recession, on its reasoning that the rise in unemployment would eventually put downward pressure on inflation. We see the Fed cutting rates to 2½% by the end of 2008 in the recession scenario, which would put the real fed funds rate by the end of next year below -0.5%. As the Fed cuts rates, the yield curve steepens significantly, with the spread from 2-year yields to 10-year yields widening to 170 bp. Ten-year yields are seen rising modestly, to 4½%, on inflation concerns, while two-year yields follow the funds rate lower. Corporate spreads widen further with the spread of Baa corporates to 10-year Treasuries rising to 250 bp. We would expect corporate profits to fall by around 19% in 2008 and equity prices to fall around 15%. P-E ratios typically rise in a recession (i.e., equity prices fall by less than profits) and this magnitude of a decline in stock prices would be on a par with the 1990–91 recession.

Figure 2. Fed Funds Target Rate



Source: Federal Reserve Board

Figure 3. Inventory-to-Sales Ratio



Source: Commerce Department

The inventory drawdown in a recession in 2008 would be expected to be mild given the current low inventory-to-sales ratios. This would likely cushion the economy from a steeper drop in GDP. As the Fed cuts rates, the real economy is seen stabilizing as the drag from residential investment diminishes in the second half of the year. However, the combination of financial balance sheet rebuilding and lack of a sharp rebound in the inventory cycle would likely make the recovery a sluggish one in late 2008 and in 2009. Indeed, the last two recessions have both been short and shallow but the recoveries have been very subdued. For example, the growth rate of real GDP in the first four quarters of recovery was 1.9% following the 2001 recession and 2.7% following the 1990–91 recession. In contrast, the first-year growth rates following the 1969–70, 1973–75 and 1980–82 recessions were 4.5%, 6.1%, and 7.7%, respectively. As a result of a lukewarm recovery, the unemployment rate would likely continue to rise into 2009 and, since the Fed has never hiked rates following a recession until the unemployment rate has peaked, we would not envisage a rate hike until the middle of 2009. The steep yield curve would have the benefit of helping recapitalize the banks as it did in the recovery following the 1990–91 recession.

Table 3. Interest Rates in the 2008 Recession Scenario

	2007*				2008*				2007+	2008+
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
	(percent)				(percent)				(percent)	
Federal Funds	5.3	5.3	5.2	4.5	3.8	3.4	3.0	2.8	5.0	3.3
3-Month LIBOR	5.4	5.4	5.4	5.0	4.3	3.9	3.4	3.1	5.3	3.7
3-Month T-Bills	5.1	4.9	4.4	3.5	3.3	2.9	2.7	2.6	4.5	2.9
Two-Year Treasury Note	4.8	4.8	4.4	3.5	3.6	3.3	3.0	2.8	4.4	3.2
10-Year Treasury Note	4.7	4.8	4.7	4.3	4.2	4.3	4.4	4.5	4.6	4.4
Conventional Mortgage Rate	6.2	6.4	6.6	6.2	6.2	6.3	6.4	6.5	6.3	6.4
Moody's Baa Corporate Rate	6.3	6.5	6.6	6.5	6.5	6.7	6.9	7.0	6.5	6.8

* Values are either quarterly changes or quarterly averages

+ Values are either 4-quarter changes or yearly averages

Source: Bear Stearns; Federal Reserve Board