# Surfing a Tsunami

## Annual Outlook Edition

*By Diane C. Swonk, Chief Economist and Senior Managing Director*

### More Than a Rip Tide

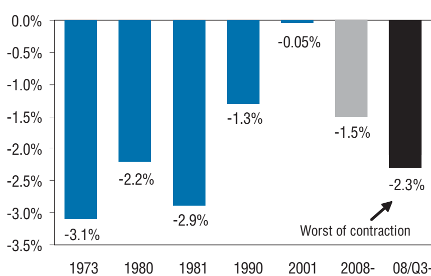
Last year, I spoke about the rip tide that we were in and how, if we were calm and swam with the current, the U.S. economy would be metaphorically "battered. . .but not defeated in 2008." I was wrong on two fronts. First, the turmoil that we faced was more severe than the rip tides that I feared as a youth playing on the shores of Lake Michigan. Instead, it was more of a tsunami of oceanic proportions. Second, instead of remaining calm, we panicked, which pushed us further into the heart of the wave that was hitting financial markets. We collectively fled anything that was associated with risk, including stocks and bonds, to the perceived safety of the U.S. Treasury market.

Indeed, the yield on the 3-month Treasury bill actually dipped below zero at the height of the credit-market seizure in October, which suggests that investors were more willing to pay the U.S. government for the privilege of lending it money and financing its debt, than run the risk of losing even more money elsewhere.

> "Wall Street is the only place where nobody seems to show up when there is a fire sale, and it may take more than a modest rebound in profits to restore market confidence."

CHART 1

**Peak to Trough Declines in Previous Recessions**




* National Bureau of Economic Research (NBER) states that the peak of the previous expansion was December 2007, and the start of recession was January 2008.
Source: Source: Haver Analytics/NBER

**For all charts/graphs:**
■ = Actual ■ = Estimate (e) □ = Forecast

My challenge this year is even harder. Not only are economic conditions going to get worse before they get better, but we have little foresight as to how bad they will get, given the aftershocks we are still feeling. This is to say nothing of the uncertainty about the speed and size of the next stimulus package, which could have a large impact on the depth and length of the recession.

The good news is that the Fed and the Treasury are still working hard to stabilize financial markets, adding another $800 billion to buy mortgage-backed debt issued by Fannie and Freddie, and increase liquidity for credit card, auto, and student loan issuers.

Separately, Obama has nominated a strong economic team, which is not only stellar in its composition, but includes Tim Geithner as Treasury Secretary, who worked closely with Paulson during the height of the crisis, which will ensure that there is no time lost getting him up to speed.

The remainder of this report takes a closer look at the outlook for 2009 with the humility of one whose vision is dramatically impaired. The National Bureau for Economic Research (NBER) has now "officially" decided that the expansion peaked in December 2007 and that the recession began in January 2008, which means that we are already a year into the pain. The worst of the losses are expected to be felt in the second half of 2008 and first part of 2009. (*See Chart 1*.) No matter how the data is cut, however, this will easily be the longest and most broad-based recession of the post-World War II period. Of course, most of us already know that. The pain is being felt from Wall Street to Main Street and from coast to coast.

### The 2009 Outlook

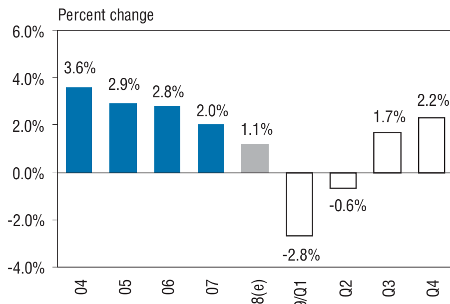
#### Emerging from Recession?

*Chart 2* shows the forecast for 2009. The economy is expected to remain in recession at the start of the year, and struggle to emerge from recession later in the year:

- Consumer spending is expected to continue to remain weak at the start of 2009, despite what will likely be a fairly aggressive tax cut and additional softness in energy prices. Rising unemployment is the primary culprit, as tax cuts can't do much to boost the spending of those who no longer have incomes. The credit

CHART 2

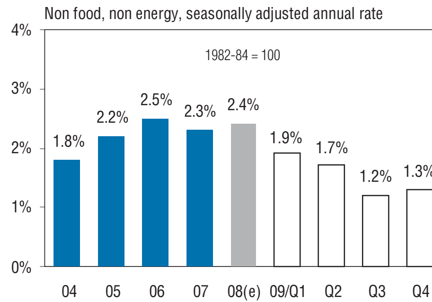
### Real GDP Contracts




Source: Bureau of Economic Analysis/Mesirow Financial

CHART 3

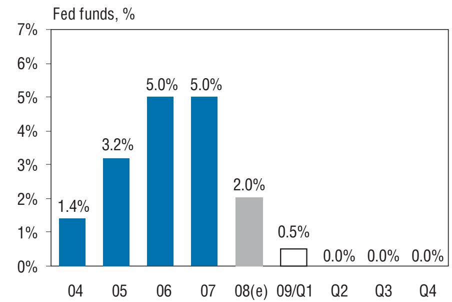
### Core Inflation Decelerates...Rapidly




Source: Bureau of Labor Statistics/Mesirow Financial

CHART 4

### Fed Funds Rate Drops to Zero




Source: Federal Reserve Board/Mesirow Financial

crunch is also expected to persist, as banks continue to consolidate and heal their balance sheets, but remain reluctant to lend into an economy that is continuing to deteriorate. The cutback in credit in October was particularly severe, as homeowners discovered that their home equity lines of credit had been lowered (or eliminated entirely), only after checks they wrote from those accounts bounced. This marks a sharp shift from 2001, when credit was more of a stabilizer, allowing stressed firms and households to buy time and wait out the worst of the recession by restructuring their balance sheets. Then there is household net worth, which has contracted in response to falling home and equity values. This is forcing consumers to save more and spend less to restore their retirements, and is curtailing spending across income groups. (Spending in Manhattan is expected to remain particularly weak, as New York is among the hardest hit by financial sector layoffs and a sharp drop in European tourism.)

- Housing is expected to hit bottom during the year, but not to bounce much until mortgages become more abundant. Recent Fed moves with Fannie and Freddie have reduced mortgage rates on conventional loans, which have helped trigger a new wave of mortgage restructuring. The hurdles to getting a new mortgage, however, are expected to remain fairly high. Indeed, sales and starts came to a virtual standstill in October.
- Business investment is expected to contract, driven by a sharp reduction in commercial construction activity. Much of what was in the pipeline in 2008 is about to be completed, and not much has been financed for 2009. (Commercial real estate financing has been all but nonexistent since the start of the financial crisis in August of 2007.) Prospects for equipment spending are not much better, at least at the start of the year. Durable goods orders collapsed in October, as firms pulled back and cancelled plans to expand in response to the credit crisis. A stimulus package, coupled with some healing of credit markets and pent-up demand will help later in the year. The lags on infrastructure spending by the government, however, tend to be fairly long.
- Inventories are expected to drain, given the ongoing stress in credit markets. Many retailers were forced to hoard cash and cut costs as short term inventory financing dried up in October.
- Government spending is expected to accelerate, as strong gains in federal spending provide some offset for constraints on spending at the state and local levels. Everything from another fiscal stimulus package, to the ongoing wars in Iraq and Afghanistan, to the increase in spending associated with broader economic weakness (unemployment insurance, food stamps, Medicaid, etc.), is expected to account for those gains. The details of the next fiscal package remain vague, but it seems clear that there will be some combination of tax cuts for the middle class (maybe even some incentives for vehicle and home purchases), and increased spending on infrastructure. Indeed, states are lobbying hard for infrastructure spending to go toward state and local projects, which were shelved because of a shortfall in real estate revenues.
- Finally, the trade deficit is expected to improve. Much of that "strength," however, can be attributed to a reduction in imports rather than additional gains in exports. Export growth is expected to slow in response to weakness abroad, particularly in Europe.

***Risks.*** The risk remains to the downside, especially in the first half of the year. Beyond that, much will be determined by the size and speed with which the fiscal stimulus package is passed. Hopes are high that Obama will have something to sign shortly after being sworn into office on January 20, 2009. The size of the package is uncertain, except that it will be large—rumors suggest that it could be anywhere from $500 billion to $1 trillion over the next two to four years.

Separately, growth abroad is weakening, which could cause further stress credit markets and slow the pace of exports even more than currently forecast. This, coupled with the recent depreciation of the dollar, could make the trade deficit more of a negative than a plus for the U.S. economy.

The primary upside of risk is oil prices, which could be significantly lower than forecast. This is especially important for the outlook for the second half of 2009, as the positive effects of lower oil prices tend to be cumulative over time. It also appears that we are overshooting on the downside in housing, which could set the stage for a stronger rebound later in the year.

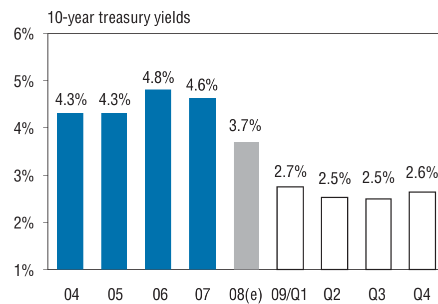
### Inflation Decelerates

*Chart 3* shows the forecast for core (non food and energy) inflation in 2009. Core inflation is expected to moderate fairly significantly over the course of the year:

- Weakness in the economy is expected to create slack and ease inflationary pressures in key sectors. Airfares have already dropped fairly significantly.

CHART 5

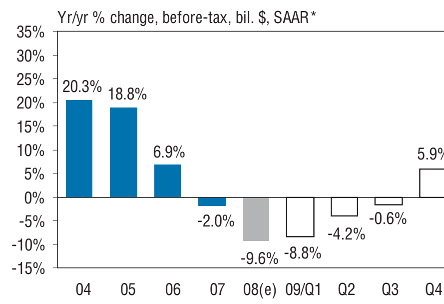
### 10-Year Treasury Bond Hits Bottom




Source: Federal Reserve Board/Mesirow Financial

CHART 6

### Corporate Profits Stabilize




*Seasonally adjusted annual rate
Source: Bureau of Economic Analysis/Mesirow Financial

- Much of the deceleration in core price levels associated with lower commodity prices (transportation costs, feed costs, etc.), has yet to work its way through the pipeline to consumer prices.
- And, the decline in housing prices, which make up about one-third of the consumer price index, has yet to show up in the "official" data. (It often takes at least a year for actual changes in home prices/costs to show up as a change in the survey of home prices in the consumer price index.)

***Risks.*** The risk is that prices will decelerate more than forecast. There is even some risk of deflation, given the rate at which the economy is deteriorating and the inability to stimulate the economy via easier monetary policy.

Why do we care? Because deflation is even worse than inflation. When prices are falling, consumers and businesses tend to hold off and wait for prices to hit bottom. This "pause" in economic activity only adds insult to injury in an economy that is already contracting. It not only deepens up front losses, accelerating layoffs and loss in incomes, but it elongates the recession, raising the risk of depression.

### Fed Moves Beyond Interest Rate Policy

*Chart 4* shows the forecast for monetary policy in 2009. The Fed is expected to lower the fed funds rate from 1% to 0.5% at their next meeting, which concludes on December 16. They are then expected to drop rates to zero in 2009.

The movement in rates, however, is less important than the actual actions the Fed takes to restore liquidity to credit markets. Chairman Bernanke has already shown his willingness to expand the Fed's balance sheet, and won't stop easing monetary policy just because it has hit the zero boundary on interest rates. The Fed could easily add municipal bonds, for instance, to the already broad portfolio of bonds it has purchased in the broader marketplace. If that fails, it may resort to "dropping money from helicopters," or revving up the printing press to re-inflate the economy.

***Risks.*** The risk is that the Fed takes the fed funds rate to zero, re-liquifies credit markets, and lenders still don't lend. If that were to happen, all bets are off.

### Bond Yields Bottom Out

*Chart 5* shows the forecast for the 10-year Treasury bond in 2009. If the Fed is successful, the flight to safety, which prompted investors to prefer Treasury bonds over almost any other type of credit instruments, should unwind. This should help limit the downward pressure on bond yields, even as inflation continues to abate and the Fed continues to ease.

The "risk premium," or the spread between Treasury yields and other types of credit instruments, should also narrow as credit markets begin to heal. This should help to bring down interest rates on everything from mortgages to commercial paper and municipal bonds.

### Profits, Stocks Stabilize

*Chart 6* shows the forecast for corporate profits in 2009. Profits are expected to rebound slightly after suffering severe losses at the end of 2008 and the start of 2009. Everything from a slight rebound in overall economic growth, to rising productivity and falling costs, will contribute to modest profit gains. The cost of capital is also expected to fall as credit markets heal. No one should expect business loans ever to be as cheap as they were at the height of the credit boom.

Small profit gains, in and of themselves, are not likely to be enough to boost equity prices. A better reason for a market rally is the overselling that we saw in 2008. That, coupled with some return of investor confidence, does justify a fairly substantial rally in the broader market indices.

***Risks.*** Wall Street is the only place where nobody seems to show up when there is a fire sale, and it may take more than a modest rebound in profits to restore market confidence.

### The Dollar Regains Its Reserve Status

The dollar is expected to remain strong in 2009, relative to 2008, and could appreciate even further against the euro and the yen. Prospects for a further appreciation of the dollar against the euro are particularly good. Europe will likely lag behind us in a recovery, since the European Central Bank is well behind the Fed in easing credit market stresses, and most governments in Europe have only just begun to think of using fiscal policy as a stimulus to their economies.

Indeed, one could argue that we have become a winner among losers, as the dollar is once again the uncontested reserve currency of the world. This marks a sharp reversal from just six months ago, when the members of OPEC were considering pricing oil in euros instead of dollars. This will allow us to run larger deficits without a reduction in our credit rating as a nation than would otherwise have been possible.

### Finding the Clarity in the Chaos

It is hard to find much good in an economy that will get worse before it gets better, except that it will eventually get better. Why am I so confident? Because we have seen a seismic change in policy over the last two months. Not only are the Fed, the Treasury, and Congress all focused on the same economic target, but we have reopened dialog and moved in coordination with policy makers abroad. This not only helps us avoid the mistakes of the past, when every country acted on its own, but helps us to leverage any policy shifts we do make, with the power of the world instead of that of the U.S. government alone. We are stronger as a whole than we are as the sum of our parts.

# Mesirow Financial Economic Forecast (Numbers as of December 8, 2008)

| | 2008 | 2009 | 2010 | 2008:3(A) | 2008:4 | 2009:1 | 2009:2 | 2009:3 | 2009:4 | 2010:1 |
|---|---|---|---|---|---|---|---|---|---|---|
| **National Outlook** | | | | | | | | | | |
| Chain-Weighted GDP | 1.1 | -1.6 | 2.9 | -0.5 | -6.2 | -2.8 | -0.6 | 1.7 | 2.2 | 3.5 |
| Personal Consumption | 0.2 | -1.0 | 2.3 | -3.7 | -5.0 | -0.8 | 1.4 | 1.4 | 1.5 | 2.5 |
| Business Fixed Investment | 2.2 | -8.8 | -0.4 | -1.5 | -14.1 | -10.9 | -12.3 | -6.1 | -3.9 | 0.5 |
| Residential Investment | -20.8 | -16.9 | 21.3 | -17.6 | -20.2 | -32.4 | -17.5 | 9.7 | 25.2 | 31.2 |
| Inventory Investment (billions) | -31.9 | -55.8 | 3.9 | -29.1 | -37.8 | -62.0 | -70.3 | -58.3 | -32.50 | -6.7 |
| Net Exports (billions) | -390.5 | -353.4 | -363.4 | -352.3 | -366.3 | -350.6 | -350.0 | -353.6 | -359.6 | -361.7 |
| Exports | 7.1 | -3.1 | 4.3 | 3.9 | -19.5 | -2.0 | -2.1 | 1.9 | 3.4 | 5.0 |
| Imports | -3.5 | -3.9 | 4.5 | -4.4 | -9.9 | -4.8 | -2.1 | 2.5 | 5.1 | 5.0 |
| Government Expenditures | 2.9 | 2.8 | 1.3 | 5.4 | 1.7 | 2.3 | 2.9 | 3.6 | 0.4 | -0.1 |
| Federal | 5.8 | 5.4 | 2.4 | 13.6 | 3.5 | 5.7 | 4.2 | 2.7 | 2.6 | 2.2 |
| State and Local | 1.2 | 1.3 | 0.5 | 0.8 | 0.7 | 0.3 | 2.1 | 4.2 | -0.9 | -1.4 |
| Final Sales | 1.4 | -1.3 | 2.4 | -1.4 | -5.8 | -1.9 | -0.3 | 1.2 | 1.2 | 2.6 |
| **Inflation** | | | | | | | | | | |
| GDP Deflator | 2.3 | 2.0 | 0.2 | 4.2 | 1.4 | 3.4 | 0.9 | 0.6 | 0.4 | 0.5 |
| CPI | 3.9 | -0.4 | 0.5 | 6.7 | -7.2 | -1.8 | 0.6 | 1.3 | 1.0 | 0.7 |
| **Special Indicators** | | | | | | | | | | |
| Corporate Profits* | -9.6 | 5.9 | 12.8 | -9.0 | -9.6 | -8.8 | -4.2 | -0.6 | 5.9 | 10.2 |
| Disposable Personal Income | 1.3 | 2.7 | 2.7 | -9.2 | 5.1 | 5.3 | 4.7 | 0.3 | 2.0 | 2.5 |
| Housing Starts (millions) | 0.93 | 0.72 | 1.07 | 0.88 | 0.74 | 0.64 | 0.67 | 0.75 | 0.84 | 0.96 |
| Civilian Unemployment Rate | 5.7 | 8.2 | 8.6 | 6.0 | 6.7 | 7.6 | 8.1 | 8.4 | 8.6 | 8.6 |
| Employment | -1.1 | -2.9 | 0.4 | -2.0 | -5.5 | -3.6 | -2.8 | -1.3 | 0.1 | 0.7 |
| **Vehicle Sales** | | | | | | | | | | |
| Automobile Sales (millions) | 6.8 | 6.5 | 8.5 | 6.8 | 5.2 | 5.8 | 6.3 | 6.7 | 7.3 | 8.0 |
| Domestic | 4.5 | 4.1 | 5.6 | 4.4 | 3.4 | 3.6 | 3.9 | 4.2 | 4.8 | 5.3 |
| Imports | 2.3 | 2.4 | 2.9 | 2.4 | 1.8 | 2.2 | 2.4 | 2.5 | 2.5 | 2.7 |
| Lt. Trucks (millions) | 6.3 | 5.4 | 6.8 | 5.5 | 5.3 | 5.3 | 5.4 | 5.5 | 5.5 | 6.2 |
| Domestic | 5.1 | 4.3 | 4.8 | 4.4 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 4.5 |
| Imports | 1.2 | 1.1 | 2.0 | 1.1 | 1.0 | 1.0 | 1.1 | 1.2 | 1.2 | 1.7 |
| Combined Auto/Lt. Truck | 13.1 | 12.0 | 15.3 | 12.3 | 10.5 | 11.1 | 11.7 | 12.2 | 12.8 | 14.2 |
| Heavy Truck Sales | 0.3 | 0.3 | 0.4 | 0.3 | 0.3 | 0.2 | 0.3 | 0.3 | 0.4 | 0.4 |
| Total Vehicles (millions) | 13.4 | 12.3 | 15.7 | 12.6 | 10.7 | 11.3 | 12.0 | 12.5 | 13.2 | 14.6 |
| **Interest Rates/Yields** | | | | | | | | | | |
| Federal Funds | 2 | 0 | $\frac{3}{4}$ | $1\frac{7}{8}$ | $\frac{1}{2}$ | $\frac{1}{2}$ | 0 | 0 | 0 | $\frac{1}{2}$ |
| 10-Year Treasury Note | $3\frac{5}{8}$ | $2\frac{1}{2}$ | $2\frac{3}{4}$ | $3\frac{7}{8}$ | $3\frac{1}{4}$ | $2\frac{5}{8}$ | $2\frac{1}{2}$ | $2\frac{1}{2}$ | $2\frac{1}{2}$ | $2\frac{5}{8}$ |
| Prime Rate | 5 | 3 | $3\frac{3}{4}$ | $4\frac{7}{8}$ | $3\frac{1}{2}$ | $3\frac{1}{2}$ | 3 | 3 | 3 | $3\frac{1}{2}$ |
| Corporate Bond AAA | $5\frac{5}{8}$ | $5\frac{1}{8}$ | $4\frac{5}{8}$ | $5\frac{5}{8}$ | 6 | $5\frac{1}{4}$ | $5\frac{1}{4}$ | $5\frac{1}{4}$ | $5\frac{1}{8}$ | $4\frac{7}{8}$ |
| **Exchange Rates** | | | | | | | | | | |
| Yen/Dollar | 104 | 98 | 104 | 93 | 97 | 96 | 97 | 98 | 99 | 100 |
| Dollar/Euro | 1.46 | 1.22 | 1.24 | 1.26 | 1.29 | 1.25 | 1.22 | 1.20 | 1.22 | 1.25 |

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was $10,989.5 billion in chain-weighted dollars.

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