

Are Things Really Getting Better?

Christopher Thornberg of Beacon Economics is one of the featured speakers at the SSA's Fall Conference & Trade Show in Las Vegas. Here is an excerpt from his recent Beaconomics US Forecast Report.



What is perhaps most amazing about this past economic downturn isn't that it happened—that was inevitable. What is far more shocking is how many economists continued to argue that the economy was fine as late as the middle of 2008, even as things started to implode. By 2007 asset prices had risen to ridiculous levels, American consumers had stopped saving, and the U.S. economy was running a trade deficit that as a share of GDP was twice as large as ever before, and in absolute terms was the largest ever of any nation. It was inevitable that the U.S. economy (and therefore the world economy) was going to go through a painful period of recalibration when the bubble finally popped.

Perhaps most impressive is the rebound in the financial markets. Even with the recent contraction in the market, equities are still way up from last year at this time. But the bounce is deeper than seen in the major indexes. After hitting record high levels in the midst of the crisis in late 2008, risk premiums have come way down. The so-called TED spread¹ has dropped to almost nothing, as has the record spread between seasoned Baa and Aaa corporate bonds. Recent troubles in Europe have sent this up somewhat, but still at historically normal levels.

And while sovereign debt issues are worrying bond markets, they have become quite fond of the private sector again. Companies in need of refinancing outstanding debt are finding the process easier than they thought. In the middle of 2009, as the economy swooned, many bond experts predicted that 2010 was going to be one of the worst years ever for corporate bond defaults. Instead, given the data on loan problems to date, this year will end up being a below-average year for bond defaults at worst, and at best may be close to record lows.

While we are bullish in the short run, we are becoming increasingly worried about 2011 and 2012. Although having growth return in the short run is clearly a good thing, it has not occurred because the U.S. economy has moved beyond the issues that plagued it at the start of the recession two years ago. Rather it is due primarily to fiscal and monetary policy. Consider some of the actions put into place.

The Federal Reserve has reduced short-run rates to near zero. The Fed has also embarked upon an aggressive plan

to lower long-run rates through quantitative easing—a fancy term for printing money. The Fed has added almost \$1.3 trillion to the monetary base—one of the most aggressive expansions on record.

The Treasury has been involved in many direct support programs—from bailing out AIG and the GSEs (government-sponsored entities), to managing the spectacularly underperforming PPIP (the Legacy Securities Public-Private Investment Program), and of course TARP. It has also been running the HAMP programs that are designed to encourage the modification of mortgages for delinquent homeowners.

Congress and the Obama administration have also been involved, with a nearly \$1 trillion stimulus program that does everything from cut taxes to backfill state welfare systems, direct spending on various infrastructure projects, and provide a tax credit for home purchases. A controversial change in the FASB rules has also been passed, addressing how banks and other financial institutions value loans.

The FHA, which after years of being more or less pushed out of the home lending market, has come back with a vengeance, insuring home purchase mortgages at a record pace.

While these actions have done what they were intended to do—namely, stabilize the economy—they come with a cost. The potential consequences of these interventions are clear. According to the CBO, net Federal debt levels will rise to 70% of GDP within 5 years, while gross levels will be well above 100%. It will likely get there more quickly given that much of the bailout tab has yet to be fully recognized on the public books. As for the Fed, there is the issue of the monetary base expanding by 150%. If the velocity is held constant, this implies that prices in the U.S. economy should also rise by 150% within the next five years—a rate of inflation that makes the 1970s look tame. Such an inflationary spell is a ways off, and can be easily prevented—but doing so will send rates up sharply.

Of course, the challenges raised by these interventions are worth it if these actions get the economy moving again. But there's the rub. Even though the economy is currently expanding, the problems in our economy are still profound. As the stimulus is unwound, it remains to be seen whether the momentum of current growth will allow us to take these problems in stride. If not, the economy will quickly tumble back into a recession.

¹ The difference between the 3-month T-bill interest rate and the 3-month LIBOR interest rate

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Are There Any Bright Spots?

With all the risks on the horizon, one might wonder if there are any bright spots. The answer, as always, is “yes.” In the short-to-medium run the export market may continue to shine. With the world economy starting to expand again (particularly the developing world), and with a weaker dollar, firms who sell products to these parts of the world may find themselves doing quite well. Of course troubles in Europe have put some upward pressure on the value of the dollar in the short run, but it still remains at a relatively low level. The one worry is that a deepening sovereign debt crisis could cause a worldwide flight to safety. This would not be unlike what happened in the second half of 2008 when the export surge that occurred at the start of the year—and that somewhat offset the decline in domestic demand—was put to a quick end.

Another bright spot in the short term will continue to be business spending. Real net investment dropped to a near all-time low level during the downturn. The catch-up effect should keep growth in the sector decent if not spectacular. Similarly, a state and national policy push for alternative energy should create new possibilities.

The best-case scenario is that the Federal Reserve and the Obama administration manage to draw down the public

bubble slowly, a possibility that private bubbles typically don't share. In this situation, they manage to pull back on the stimulus slowly (the Fed gradually withdraws the excess liquidity, the Federal government is able to close the budget deficit slowly, the FDIC manages bank failures on a gradual basis, etc.) as the economy heals and meets the ongoing challenges. But this will require a delicate touch, to say the least—one unfortunately not normally associated with congressional politics. In such a scenario, the 2010 boom will be followed by a period of slow growth, perhaps for two years or more.

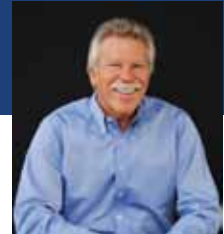
The worst-case scenario is that the bubble pops rapidly, putting the economy squarely back into another recession—the double dip.

So enjoy the rest of 2010—it should be a good year. But don't overextend. The one thing you can count on is that economic volatility will be the watchword for the next few years. The U.S. economy is surely in a better place than it was two years ago, but we are not yet in a position to enjoy another extended expansion. And this shouldn't be a surprise. The problems that put us here built up over more than a decade. It is going to take time to work our way out of them.

In the meantime, count your blessings—because even an unstable U.S. economy offers its citizens one of the highest standards of living in the world, something that Americans too often forget in uncertain times. ♦

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