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ECONOMIC NEWS UPDATE

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Volatility and Slow Growth are not a Recession

It seems that share and commodity prices move in more than one direction – a fact that has shocked some investors, but not a bad thing, it turns out. Investors have been reminded that there is something called risk out there, and that the prices they pay for the assets they want to add to their portfolios should reflect a realistic appraisal of that risk.

Some risks, of course, do not lend themselves to precise quantification. President Bush might decide not to leave it to his successor to cope with a nuclear-armed Iran, even at the risk of interrupting the steady flow of Middle Eastern oil. Islamic radicals might overthrow the House of Saud, and have such a preference for caves over palaces that they shut down the Kingdom's oil production. Even Alan Greenspan, brave enough to assign a one-in-three possibility to a recession this year, wouldn't try to assign a probability to those scenarios.

In making sense of what is going on in the US economy, it is important not to confuse the gyrating market for shares with the underlying economic fundamentals. Almost exactly 70 years ago, John Maynard Keynes surveyed the US economic scene, and drew a distinction between the economy and the markets. He expressed the view that a slump was unlikely, and that should a recession occur it “would probably appear to the future historian as merely an incident in the upward movement.”

But Keynes, a successful investor despite some major misjudgments along the route to material comfort, went on, “On the other hand,...I am much less optimistic of the markets....They will need continual fresh stimulus, if they are to go higher....The errors the market will make will definitely be of pessimism and ... prices will be often lower than the underlying situation really warrants...”.

Which brings us to the present-day “underlying situation.” It is no news

that the housing market is in the doldrums. Inventories of unsold houses are high; builders are pulling back on construction and offering incentives to prospective buyers; home prices are softening, and speculators who stocked up on Florida condos find their investments under water, if I may be permitted a pun.

More important, institutions that made mortgages available to buyers whose credit-worthiness was questionable, are wishing they hadn't. HSBC, which is to write off \$11 billion in uncollectible loans to low-income families, is not the only lender that has had its fingers burned in the so-called sub-prime mortgage market, which is now in melt-down as lenders scurry for the exits.

Nor is it any news that the economy is slowing. But there is a big difference between slower growth and a recession. The recent survey by the Federal Reserve Bank of Kansas found "modest expansion" around the country, with "steady growth in retail sales", "generally positive" tourism activity, "steady or expanding manufacturing activity", agricultural conditions "generally improved", and tight labor market conditions. Some areas -- most notably Boston and Dallas -- seem to be slowing more than others, and auto sales are weak in most places around the country. But, all in all, at least for the present, the economy is doing exactly what the Fed wanted it to do when Greenspan began ratcheting up interest rates -- it is cooling. The "froth" is off house prices, investors are realigning share prices with more reasonable expectations of risk and growth, and people who shouldn't be lending to people who shouldn't be borrowing are writing down the value of their

enterprises. All of these are arguably in the long-run interests of a healthy economy.

The worrying question is the one raised by Greenspan -- will slower growth morph into a recession? Fed chairman Ben Bernanke doesn't think so, and is sticking to his projection of "moderate growth in the US economy going forward". Fed governor Kevin Warsh believes there is sufficient liquidity to permit financial markets to continue to function well in the face of higher volatility. Treasury Secretary Hank Paulson says that the economic fundamentals are sound. And the president of the Federal Reserve Bank of Chicago says "the underlying economic fundamentals are conducive to a pickup in growth as we move through 2007 and 2008."

They would say that, wouldn't they, argue cynics who say that it is the job of central bankers and Treasury Secretaries to calm markets, regardless of the health of the economy. With growth in corporate profits due to fall from the double-digit levels of recent years, auto sales slow, the weakness in housing and manufacturing seeping into the service sector, and durable goods sales down, Greenspan's one-in-three odds might seem too low. Unless you are impressed with the facts that growth is picking up around the world and with it our exports, consumer confidence is high, jobs are plentiful (almost 100,000 new ones in February), average hourly earnings are rising, and investors were confident enough to pour \$29 billion into volatile markets in the week ending March 6. Note, too, that unit labor costs are rising rapidly. In which case worry about inflation, not recession.

Perhaps the public knows more than the economic experts. Americans are relaxed. Over 70% say their finances are “very” or “fairly” secure, and 90% say they are “not too likely” (33%) or “not at all likely” (57%) to lose their jobs. That might explain the relative buoyancy of retail sales, and the unwillingness of Americans to get depressed by the painful realization that their homes are no longer ATM machines.



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