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ECONOMIC NEWS UPDATE

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A Look Ahead

Now is the time to try to determine what the rest of the year will look like. For three reasons. First, traders, investors, politicians and executives are back at work, either refreshed or wearied from their summer vacations. Second, as Gerry Baker pointed out in *The Times* last week, “September is the cruelest month”: since 1929 share prices have declined on average in September by more than any month. Third, to borrow from Don Rumsfeld, there are now things we know we know that we did not know at the beginning of the past summer.

The most important is that we will have to live with a high degree of political and economic uncertainty until we ring out the

old and ring in the new. The presidential election on November 4 might, but will not certainly resolve the political uncertainty. Ted Olson, the lawyer who successfully argued George W. Bush’s case before the Supreme Court when all those chads were hanging in Florida in 2000, tells me that armies of lawyers have been recruited by both parties to contest the results in any states in which the vote is very close. And even if the result of the election is clear by the night of the election, we won’t know the shape of the corporate and personal tax structure until the new president meets with the new congress to haggle over the important details. Corporate taxes might go down (McCain), personal taxes of high

earners might go up (Obama); trade unions might be on the march and free trade in retreat (Obama), development of domestic oil reserves and construction of nuclear plants might be stepped up (McCain).

The economic uncertainty is also likely to be unresolved. After all, even the Federal Reserve Board's gurus are quarreling after peering into their separate crystal balls. Fed chairman Ben Bernanke sees a future in which the strains on the financial system are more worrying than the possibility of a renewed burst of inflation, and so is holding interest rates down and shoring up the balance sheets of financial institutions.

Janet Yellen, president of the Federal Reserve Bank of San Francisco agrees, "Lenders have been hit by a shock so severe that they are contracting and withdrawing from private sector lending." She is said to want a further rate cut by the Fed. No, says Charles Plosser, president of the Federal Reserve Bank of Philadelphia, "If we don't reverse our accommodative stance sooner rather than later, we will face rising inflation ... and ...a risk to the Fed's credibility...".

Still, some things are reasonably certain. The first is that the jobs market is unlikely to improve during the final months of this year. The unemployment rate

soared to 6.1% in August, from 5.7% in July, and is at its highest level in five years. The number of long-term unemployed (out of work for more than 27 weeks) is 589,000 higher than it was twelve months ago.

From that it follows that consumer spending is not likely to recover after falling in recent months. It won't fall off a cliff -- consumer sentiment is showing signs of recovering from recent lows -- but a weak job market will make consumers cautious about swiping those credit cards in the nation's malls and shops with the good, old-time alacrity. Indeed, retailers are reporting that consumers are tending to resort to a long-forgotten means of payment -- cash.

That makes it virtually certain that the economy will not continue to barrel ahead at the 3.3% annual rate it recorded in the second quarter. The strengthening dollar will begin to bite into the export sales that have been offsetting the drag created by continued woes in the housing market. Throw in the weakening of the Euroland and UK economies (business confidence in Germany is at its lowest level in three years), the likelihood that China will at least tap the brakes to prevent overheating, and it is a good bet that worldwide sales of made-in-America goods will slow

by year-end after 70 months of solid growth. Visiting foreigners who have been picking the shelves of America's shops clean will find that the bargains just aren't what they were a few months ago.

Worse still, credit markets remain under strain. The list of troubled banks has increased from 90 to 117, and is predicted to grow further, putting a strain on the resources of the Federal Deposit Insurance Corporation (FDIC), which guarantees deposits up to \$100,000. Banks such as Merrill Lynch, Goldman Sachs, Wachovia and HBOS will have to raise a total of almost \$800 billion to cover debt that is coming due this year and next, according to J.P. Morgan Chase. Institutions such as Lehman Brothers will continue to struggle. And the sovereign wealth funds that have seen some of their investments in financial institutions decline in value will be more cautious. Finally, Freddie Mac (a client) and Fannie Mae, which are supporting some 75% of the mortgage market, have a long way to go before they recover their pre-collapse luster.

But as is always the case, there are contradictory signs. The first is that the housing market is beginning to touch bottom. "It appears that existing home sales have stabilized..., a surprise to many forecasters, ourselves

included," report economists at Goldman Sachs. Banks are aggressively unloading foreclosed properties, sales of new homes are now exceeding housing starts, and house prices are no longer on a hiding to nowhere -- prices are up recently in more cities than in which they continue to drop.

The second bit of cheer is that several of the banks that need to replace debt that is coming due have reported that "debt repayment is business as usual" (HBOS), can be comfortably (Goldman) or "seamlessly" (Wachovia) handled, or met from customer deposits (Merrill).

Meanwhile, Tamasek, the Singapore sovereign wealth fund, has expressed satisfaction with its investments in Merrill and Barclays, and Freddie and Fannie report more-than-adequate liquidity.

All is not for the best, and we are not living in the best of all possible worlds. But the world can come to an end only once, and there are several signs that that event just isn't likely to occur.

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