Economic Review

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The art of buying low and selling lower

Market correction:
The day after you buy stocks

Cash flow:
The movement your money makes as it disappears down the drain

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Ask Doctor Nick:
Occasionally, I like to devote an entire newsletter to the questions that arise in my travels. Here goes.

Q. When will the recession end?

A. As I mentioned in the last issue, it all depends on what you mean by *end*. The official start of the recession was December 2007. And I'm still pretty confident that GDP will stop falling and start rising before 2009 ends. However, jobs and unemployment won't improve until next year. Most economists agree with me.

There is, however, considerable downside risk. We have no modern precedents for a global financial crisis that has produced a worldwide recession. The Great Depression of the 1930s unfolded against a very different backdrop: adherence to the gold standard, the passage of the Smoot-Hawley Tariff Act in 1930, President Hoover's belief that the system would right itself, etc. We also don't know what the bankruptcy of major auto firms or another major financial institution might entail.

Q. How high will unemployment go?

A. By March, the unemployment rate had already reached 8.5 percent – up from a low of 4.4 percent in 2007. And I'm forecasting that it is likely to get very close to 10 percent later this year or early in 2010. By the way, this would be the highest since late 1982 when employment reached 10.8 percent following the back-to-back recessions of the early 1980s. However, it is nowhere near the 25 percent reached at the depths of the Great Depression in 1933 when there were no unemployment compensation and no Food Stamps. There was also no federal subsidization of medical insurance for unemployed workers, as was included in the stimulus package enacted earlier this year.

Q. When will the stock market recover?

A. It already has started recovering from the lows hit this past March. By late April, the Dow Jones was up more than 20 percent. This is a very good sign because the stock market typically begins to improve less than half a year before the GDP comes out of recession. Not only does the equity turnaround reflect a belief that the recession's end is not that far away, but it actually helps the economy pick up! Higher stock prices mean there's more wealth (larger 401Ks) and more confidence for businesses and consumers. In a very real way, the stock market has the ability to help make its forecast of economic recovery come true. The progress is usually uneven and setbacks are common.

However, I have no idea how long it will take for the Dow Jones average to fully recover to the 14,165 peak reached during October 2007. It is more likely to be years rather than months.

Q. Are there any other signs that the economy will stabilize later this year?

A. I like to say that we are now in the "pre-recovery" phase of the business cycle. Mathematically, we're at a point of inflection where the rate of decline is no longer accelerating and is starting to get smaller.

Here's some evidence. New layoffs are still very large, but they don't seem to be getting bigger. This is shown by initial claims for unemployment insurance, which have been running about 650,000 per week for the past two months. If you look at the seasonally adjusted monthly sales figures, car sales are very low but no longer falling. Consumer confidence has started to improve. There's more, but you get the point.

Q. Should I worry about deflation or inflation?

A. Yes! The near-term risk is for deflation. The entire global economy is weak enough that it is possible for prices and wages to spiral downwards in many nations. This would be very difficult to counteract. I don't think deflation will happen, but it is a threat.

However, looking out a couple of years, inflation becomes a threat if the Federal Reserve doesn't start draining some of the money it has recently pumped into the economy and if those federal budget deficits don't start getting smaller.

Q. What condition are the banks in?

A. The recent "stress testing" of the 19 largest banks showed than a number need major capital infusions. How much will have to be provided by the government will become clearer in coming months.

However, many banks are in quite decent shape since they were much more conservative in recent years than the bigger institutions. By the way, Webster Financial Corporation exceeds all the regulatory criteria needed to be classified as "well capitalized."

Q. Will the economy and financial system need even more help from the Feds?

A. Yes! The losses by financial institutions are estimated to be in the trillions of dollars. As a result, the capital at these institutions is shrinking dramatically. And this affects us all because reduced capital means less lending for households needs and business expansion.

While the $800 billion price tag on the recently passed stimulus package sounds like a lot, it is spread out over two years. By way of perspective, the U.S. GDP is currently a bit more than $14 trillion per year.

Failure to act decisively early on in terms of dealing with bank losses and stimulative fiscal packages helps explain why Japan suffered from what has been called the "lost decade" and "slow motion depression" in the 1990s.

Q. When will house prices stop falling?

A. The most recent *Wall Street Journal* survey of economists says sometime next year (I am included in the *Journal* survey). One of my best students at Yale (Aaron Greenberg '09) just completed a research project that utilizes a number of economic indicators to predict house prices. He's forecasting stability around the middle of next year. I agree. I've been saying for a while that home sales and construction will start to improve before then since people will begin to think there's some light at the end of the tunnel. This seems to be happening.

Q. What about the regional economy?

A. Over the past 12 months, jobs have declined at about the same pace as the nation for Connecticut and Massachusetts and somewhat faster in Rhode Island. The Connecticut losses were especially large in February and March. However, I think these will abate since the number of advance notices of layoffs has gotten much smaller in recent months. The region's labor markets will start recovering a bit later than the nation, sometime after the middle of next year.

Q. Where are interest rates headed?

A. I'm quite sure that short-term rates will stay very low for at least another year. Think about it: the Federal Reserve really can't start raising rates until jobs stop falling. However, longer term rates will start moving up sooner as financial markets come to believe that recovery is at hand and the financial crisis is ending. All that borrowing needed to finance those large budget deficits will also help push bond yields up.

Q. Will the dollar exchange rate rise or fall?

A. It will rise (strengthen) somewhat further in the near-term because much of the rest of the world is behind us in the current economic malaise and will probably lag us in recovering. Among other things, this makes the U.S. a safer haven than most other financial centers. However, my forecast is that the dollar will weaken once the rest of the world starts recovering and attention turns to the financing of those massive trade deficits we're still likely to have for some time to come.

Q. Am I supposed to spend or save?

A. You're supposed to do what is best for you and your family! The spend vs. save question is a macroeconomic issue. Right now, we need enough people to spend in order to help lift us out of the recession. That's why taxes were cut effective April 1. Longer term, which isn't that far away, people must save more. This is necessary to provide for financing the education of their children and their retirements. It is also essential to help reduce our national dependence on borrowing from foreigners.

Q. Are any lasting financial changes likely when we get out of this mess?

A. One sure bet is that there will be much more government regulation of financial institutions, ending the long era where many regulations were dismantled or simply disregarded. The days of the behemoth banks are numbered. Not only have we had to contend with "too big to fail" but we are rapidly recognizing that many of these are "too big to succeed." Economies of scale, which are elusive, seem to be more than offset by the extreme difficulties of control and risk management when institutions become gargantuan.

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