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Musings & Amusings

Bob Hope

"He rules the country with an iron fist – the same way he plays the piano" on Harry Truman.

"Eisenhower admitted that the budget can't be balanced and McCarthy says the Communists are taking over. You don't know what to worry about these days – whether the country will be overthrown or overdrawn."

"Ronald Reagan is not a typical politician because he doesn't know how to lie, cheat, and steal. He's always had an agent do that."

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The Peek-a-boo Recession. For much of this year, the recession has been a "now you see it… now you don't" phenomenon. By August, jobs had declined for eight months in a row, but the total loss of 600,000 is small by recession standards. There's no doubt that auto sales, which have plunged by more than 25 percent, are in recession. The same holds true for housing where building activity, sales and prices have all dropped.

On the other hand, real Gross Domestic Product (GDP) slipped a little in the final quarter of last year but rose at a 2 percent annual rate during the first half of 2008.

As discussed previously, the familiar "two quarters in a row of real GDP decline make a recession" is only a rule of thumb and not the yardstick used by the National Bureau of Economic Research in dating business cycles.

Thus far, exports and consumer spending have been strong enough to offset the weakness in autos and housing plus the fallout from the credit crunch. Productivity explains the difference between GDP and jobs. Businesses are getting a little more output (GDP) while using a little less labor.

Where we go from here is far more important than whether this episode will ever be officially labeled as a recession. The economic malaise that started in the U.S. is spreading overseas, with Germany and Japan at the brink of recession. China is slowing. And the dollar exchange rate has been rising over the past few months. Taken together, these mean that exports are bound to slow.

Consumer spending got a boost during the second quarter from those rebate checks, but the most recent monthly data have been quite soft. Hence, GDP growth during the second half is likely to be flat or maybe even down. Under these circumstances, jobs will continue to decline.

Economic activity should start picking up during the first half of next year. By that time, most economists expect house prices to stabilize, reducing uncertainty and increasing the incentives to buy homes. Another positive will be the further decline in oil prices, which have already fallen from over $140 per barrel in July to about $100 in September. I'm predicting they'll drop another $20 or so by year-end.

But don't bet on a "rip roaring" recovery. Instead, the GDP pickup is likely to be modest, with little or no jobs growth for a while. Banks will have to be cautious in financing the recovery since many will have to work on replenishing their capital after the losses taken in 2008. Also, lots of potential borrowers will be repairing their credit records.

Inflation is not *the* problem. Many people, including a few members of the Federal Reserve's Federal Open Market Committee (FOMC), are worried that today's elevated inflation will persist or even worsen. Several FOMC members have dissented when the majority voted to lower rates and, later, to keep them stable. They think the Fed needs to tighten now to combat inflation.

My assessment is that these fears are way overblown. Sure, the Consumer Price Index (CPI) is now rising better than 5 percent – well above the 20-year average of 3 percent and the Fed's purported target of 1-2 percent. However, most of the bad behavior comes from food and energy. The so-called "core" rate of inflation, which excludes both, is up only about 2.5 percent. Actually, it's probably lower because only direct purchases of electricity, gasoline, natural gas and heating oil are excluded from the core. Still in the core is the indirect energy such as the higher jet fuel cost priced into airline tickets.

Looking ahead, as long as oil prices flatten out at recent levels, the CPI is likely to rise only about 2.5-3 percent during the coming year. That's because the core will increase only 2.5-2.75 percent, energy will be zero (or less) and food is expected to rise about 5-6 percent. You can do the arithmetic by using the weights in the table. This forecast is pretty much in line with the consensus of economists.

What happened during the past year was the rise and fall of a speculative commodities bubble. Sure, growth in China and India eventually will push oil and raw materials prices up, but there was no reason for oil prices to have doubled in price from mid-2007 to mid-2008 – just as economic activity was beginning to slow. No reason, that is, except speculation.

Anatomy of Inflation: CPI

	% of Index	% Change*
CPI	100.0	5.6
Core	75.4	2.5
Food	14.9	5.9
Energy	9.7	27.2

*July '08 vs July '07

Is there any other evidence for this rather optimistic view? As discussed in previous issues, a good measure of financial market inflation expectations can be gotten by comparing the yield on the 10-year U.S. Treasury coupon bond with the Treasury Inflation-Protected Securities (TIPS). Since the only major difference between these two is the inflation protection, this comparison tells you the rate of expected inflation. For several reasons, the yield on TIPS is boosted a bit because of things like their tax treatment. To get at a "true" expected inflation, we'd have to adjust the TIPS yield down somewhat, which would raise the expected inflation closer to 2.5 percent.

Expected inflation is not much different than my forecast and certainly not anything worth raising interest rates over. Furthermore, expectations have not increased despite the rise in the overall CPI. In Ben Bernanke lingo, they are "well-anchored." While future inflation may be above the unstated 1-2 percent target, the Fed will be quite content to see it slow to half what it is today.

	8/07	2/08	8/08
Coupon Note	4.67%	3.74%	3.89%
Minus: TIPS	2.44	1.41	1.68
Equals: Expected Inflation	2.23%	2.33%	2.21%

Postscript: The mother of all bailouts. Most of us won't soon forget the week of Sept. 19, which started with a plunge of nearly 1,000 points on the Dow Jones and ended with a rebound of the same size. It is not too extreme to say that the wheels almost fell off the U.S. financial system. The week began with the bankruptcy of Lehman Brothers and the government rescue of AIG. Then there were problems at the large money market mutual funds used by big corporations and institutions to park short-term cash. Later in the week, Fed Chairman Bernanke and Treasury Secretary Henry Paulson met with members of Congress to tell them that unless very prompt action were taken, the U.S. financial system could seize up and a deep recession would follow. Was it a coincidence that Sept. 21 also marked the 70th anniversary of the legendary hurricane of 1938, which hit and devastated parts of the Northeast?

Anyway, Bernanke and Paulson did several things to avert disaster. Using existing authority, they placed a temporary ban on short selling of financial stocks and temporarily guaranteed the assets of money market mutual funds. These actions seemed to help significantly.

However, they needed to ask Congress to authorize the "centerpiece" of their plan, which would permit the Treasury to buy something like $700 billion of impaired mortgage-backed securities from the financial institutions holding them. These are bundles of individual home loans, mostly sub-prime, that had been packaged within the past few years. Their value had plunged as home prices fell and foreclosures climbed. The losses associated with these were causing serious problems at a wide variety of financial institutions, including the failures of major firms as well as a serious tightening of lending activity. Bernanke and Paulson were no doubt convinced that what started as pain for Wall Street was about to harm ordinary people at home and possibly the rest of the world in a big way.

It is not clear yet that all this frenzied activity will work. As of late September, these bold and highly controversial actions seem to have helped stabilize financial markets. However, we don't yet know the details of the loan purchase program since Congress has yet to pass the legislation.

My assessment is that bold actions of this type were absolutely necessary to avert disaster. If all works out well in coming months, then the forecast outlined above of modest economic growth starting in 2009 is still a decent bet. However, we need to start soon on devising ways to keep such things from happening again.

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