



AMERICAN  
BANKRUPTCY  
INSTITUTE

# **Sunny Side Up, or Down?**

## **Breakfast with the Economists**

***Stephen B. Darr, Moderator***

Mesirow Financial Consulting, LLC; Boston

***Dr. Roger E. Brinner***

The Parthenon Group; Boston

***Hon. Louis H. Kornreich***

U.S. Bankruptcy Court (D. Maine); Bangor

***Dr. David Wyss***

Standard & Poor's; New York

# U.S. Economic Forecast

## Monthly Summary

### April 2008

#### **What I Tell You Three Times Is True**

By David Wyss

The third consecutive drop in payrolls implies that the economy has clearly moved into recession. We are raising the odds of recession to 80% from 70%. The data still suggest that the recession will be mild; we expect first-quarter real GDP to be only slightly negative. Even now, we expect the economy to improve in the third quarter, as rebate checks get spent. After the stimulus package ends, however, the economy will decelerate; the risk of falling back into recession remains high.

The Federal Reserve is responding to the evidence by not only cutting interest rates more aggressively, but also by being creative in trying to unfreeze financial markets. The problem is that every time markets seem to be calming down, more bad news surface and they slide back into recession territory. Various term lending facilities are being used (for example, \$38 billion in loans outstanding to primary dealers in the latest week), but spreads remain wide. Mortgage markets, in particular, remain tight; even the conforming mortgages are trading relatively high compared with Treasury yields. We now expect another 50 basis-point rate cut April 30, bringing the funds rate down to 1.75%.

Construction remains the major area of weakness. January and February housing sales were stronger than expected, but prices dropped more. This suggests that sellers are capitulating, realizing that price cuts are necessary to sell their homes. At the same time, lower prices and mortgage rates are attracting bargain-hunters, new entrants into the market.

#### **Weak Employment Leads To Weaker Spending [**

The payroll decline is a problem in itself, but is likely to lead to even bigger problems in the future. When consumers are worried about their jobs, they cut back their spending. Because higher fuel prices are already hitting incomes and falling home prices are cutting wealth, spending has to slow down. We do not expect consumers to stop buying, and we still expect that most of the rebate checks will be spent, but real consumer spending is likely to be reduced to a meager 1.2% in 2008 from 2.9% in 2007.

Auto sales are particularly hard-hit. Tighter credit conditions have made it more difficult for many Americans to buy a car, while higher gasoline prices make it more expensive to drive one. We expect light-vehicle sales to drop to 14.8 million units in 2008 from 16.1 million in 2007. This would make 2008 the worst year for car sales since 1993.

The soft housing picture also hurts consumer spending. Wealth is declining because of low housing prices. Stock prices are still below their 2000 peak. Although net worth remains high compared with the 463% average of disposable income between 1960 and 1995, it is well below its 618% peak in 1999, and we expect it to drop to a low of 508% in mid-2008. However, less wealth will mean greater saving. We have argued for the last few years that a major propellant of the low U.S. saving rate was the high level of wealth. The stock and housing markets were doing households' saving for them. Now, those markets have gone into reverse.

Sagging housing sales also cut retail sales directly, because many household purchases are tied to buying a house. Furniture and appliances are the obvious examples, but even sales of gardening supplies, lawn mowers, and tools increase when homes are bought.

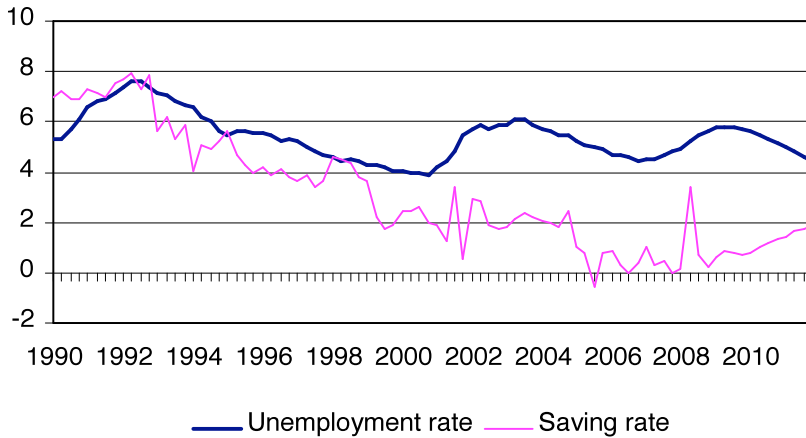
We still expect the tax rebate checks to be spent quickly. Americans may say that they are going to save the money or use it to pay down debt, but even those who do pay down their credit card balances are likely to build them back up rapidly. Analysis of the 2001 tax rebate suggests households spent about 60% of the rebate within 90 days. With this rebate concentrated in lower income brackets, it's reasonable to predict that more will be spent this round, but we think that only 50% will be spent.

The approaching retirement of baby boomers adds urgency to the wealth picture. Most baby boomers do not have enough wealth to retire on comfortably. Reliance on Social Security and Medicare will cause the federal deficit to balloon in coming years. With the leading edge of baby boomers hitting 62 this year, there is too little time to save. Will that result in a flurry of late saving or in a delayed retirement?

**Chart 1**

**The Saving Rate Rises With Unemployment**

(Saving as percent of disposable income and unemployment rate)



Source: BEA

Retirement shifts may distort the unemployment data. With so many approaching retirement, the drop in employment may result in declining participation rates as older workers decide to call it “early retirement” and take Social Security rather than unemployment benefits. The result may be more volatility in the participation rate, stabilizing the unemployment rate (and thus making it less useful as a measure of labor market pressure).

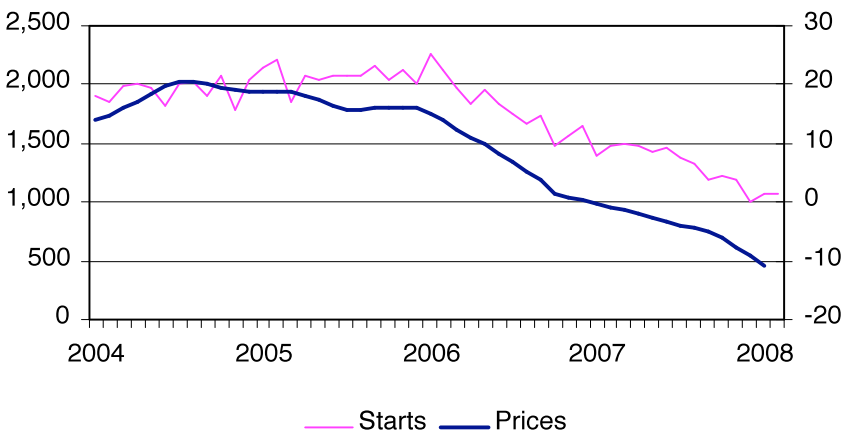
**Houses Continue To Slide**

Home prices continued to drop in recent months, with the S&P/Case-Shiller home price index for 20 major metropolitan areas down 10.7% from a year ago in January. On the bright side, sales and starts were slightly stronger than expected. The combination could imply that sellers are finally capitulating and accepting lower prices, while buyers are bargain hunting. On the other hand, the winter data are often misleading, and we shouldn’t get too excited until we see the March and April data.

**Chart 2**

**Housing Continues To Slide**

(Housing starts (thousands) and prices (12-month percent change, right))



Source: Census Bureau and S&P/Case-Shiller

We do not know whether any of the rescue bills in Congress will make it out. The House bill proposes to allow the Federal Housing Authority (FHA) to insure more subprime mortgages. That won't, of course, make the underlying mortgages any safer. It just means that the taxpayer rather than the investor will eat the cost. Homeowners are increasingly treating the mortgage as a put option on their houses. If the house price drops below the mortgage amount, they are mailing the keys back to the bank.

Many of these houses were bought as investments, not as places to live. When the value of the investment drops, people are living free in the house as long as they can, but are going back to renting (or living in another home that they own) rather than trying to keep the mortgage current. Web sites ask, "What if you could live payment free for up to 8 months or more and walk away without owing a penny?" and state, "Your lender WILL NOT be able to collect any deficiency or loss they may receive by you walking away!" (from [yourwalkawayplan.com](http://yourwalkawayplan.com)) The penalties to defaulting on a mortgage seem nonexistent.

We still expect housing starts and sales to continue to decline through midyear, and make a sluggish recovery thereafter. We expect housing starts to fall to 890,000 in 2008 from 1.34 million last year and a record 2.07 million in 2005. This year will have the lowest number of housing starts since World War II. Housing prices are not expected to hit bottom until early 2009, dropping another 10% from current levels.

### **Capital Spending**

Strong investment in nonresidential construction helped offset the weak housing market last year, but nonresidential construction is softening this year. Most of the reason is the weaker employment picture—fewer workers need fewer offices. An additional explanation reflects funding problems, as commercial mortgages and construction loans become harder and more expensive to get. The problems in the residential markets have hurt commercial-mortgage-backed securities (CMBS), although CMBS defaults remain very low. We expect nonresidential construction activity to drop 7.7% (fourth-quarter to fourth-quarter, 2000 chain-weighted dollars) in 2008, after rising 15.1% in 2006.

Equipment spending will also slow, as a weaker economy makes capacity additions less necessary and financing problems make them more expensive. Most large U.S. corporations are in very good shape going into this recession, having paid down debt to the lowest level relative to net worth (at historical cost) since the early 1980s. They also have near-record levels of cash on hand. But smaller companies—the ones who are doing the borrowing—are less well positioned. Debt is relatively high, and these expanding companies must invest to grow. The outcome may be that cash-rich larger companies will find these smaller ones ripe for takeovers. We expect capital equipment spending to fall 1.4% fourth quarter over fourth quarter in 2008 after rising 1.5% last year.

### **The Fed's Next Move**

The Fed seems to have accepted that the economy is in, or at least close to, a recession. In his testimony before Congress, Chairman Ben Bernanke talked about a potential contraction in early 2008. The minutes of the March 18 Federal Open Market Committee meeting show that the Fed's staff revised its growth forecast downward (negative in early 2008) and its inflation forecast higher.

The Fed will fight recession first, and worry about inflation later. We now expect a 50 basis-point rate cut April 30. After the April meeting, the Fed will wait to see the results of the rebate program before moving again (barring another major financial crisis). Because we expect the rebate checks to be spent quickly, the Fed should be done.

Inflation is likely to remain low during the recession. If history tells us anything, it's that recessions are good for bringing inflation down. Former Fed Chairman Paul Volcker proved that with the recessions of the early 1980s. This recession will be less effective than most, however, because it is relatively mild and the falling dollar will tend to raise inflation by raising import prices and providing a price umbrella for domestic competitors. After the recession, the Fed will be forced to revert more quickly than usual to inflation-fighting mode, raising rates sharply. The Fed believes that they erred after the 2001 recession in keeping rates too low for too long. We expect a rate hike beginning in mid-2009, bringing them back to a neutral 4.75% by mid-2010. After 2001, the Fed was still lowering rates 18 months into the recovery, and didn't start to tighten until after three years.

The Fed's other concern remains the financial markets' lending freeze. Lenders have gone from being totally oblivious to risk a year ago to paranoia, without stopping at rationality on the way. Our forecast implies a return to rationality, which means that spreads will narrow, but not nearly as tight as they were a year ago. In fact, the spreads in the corporate markets are similar to the last recession, and are probably appropriate for the current state of the business cycle.

Short-term risk premiums remain abnormally high. Although the various term lending facilities have helped reduce the spreads in term loans (especially LIBOR), they remain very wide by historical standards.

Copyright (c) 2008, by *The McGraw-Hill Companies*. S&P clients may reproduce this fax for use within their organizations.