Mesirow Financial

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Recession Risks, Income Inequalities and Prospects for a Rebound

By Diane C. Swonk, Chief Economist and Senior Managing Director

> "The economy has looked better on paper than it has felt to the majority of Americans for the bulk of the expansion. It's not going to feel any better now that growth is slowing."

Wrong Questions

Are we in a recession? Are we headed for one?

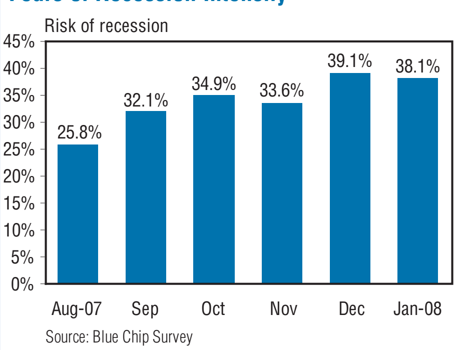
Those are probably the most common questions asked of economists these days. Perhaps a better question is: *Why do things seem so bad for so many, when the economic data still says we are in positive territory?*

The answer could be that the data is wrong, and that the economy is actually weaker than is being reported by the government. This wouldn't be the first time. The Bureau of Economic Analysis missed the recession as it was occurring in 1990. Or, another answer could be that the current slowdown is even worse than what is currently being reported, which would make the debate about whether or not we call it a "recession" more an issue of semantics than reality.

Bad data and decelerating growth alone, however, can't explain the growing sense of unease and lagging confidence that we have experienced in recent years. Indeed, widening income inequalities have left millions with the feeling that they are being left behind, even though the economic aggregates continue to grow.

CHART 1

Fears of Recession Intensify



Source: Blue Chip Survey

For all charts/graphs:
■ = Actual ■ = Estimate (e) □ = Forecast

Those who read this monthly report know that the integrity of the economic data and income inequalities are of great concern to me. Without quality data, we can't make quality policy decisions; and with growing income inequalities, we risk losing ground on market reforms and free trade—to some extent, we already have. China has usurped Japan as our scapegoat du jour, while changes in our immigration policy since 9/11 have limited the number of legal immigrants who can work here. Indeed, we seem absurdly content to educate the world's best and brightest only to send them home to make their fortunes and pay taxes abroad instead of here.

This report takes a closer look at the risks of recession, whether or not the data is leading us astray and prospects for a rebound later in the year. Special attention will be paid to the role that income inequality is playing in coloring our perceptions of the economy. All the stimulus in the world is not likely to close the income gap that has resulted from an economy that disproportionately rewards only the most educated workers.

Recession Risks

Recession is defined as two consecutive quarters of negative real GDP. The risks of a recession have clearly increased in recent months, with most economists moving up their risk estimates from about 25% before the credit market crisis to almost 40% in recent weeks. Our own estimates for recession have also moved up, from about 30% to 45%. (*See Chart 1.*)

Moreover, the Blue Chip Survey—the best measure of the economic consensus—was taken two days ahead of the December 2007employment report, which showed a sharp deceleration in job creation and a jump in the unemployment rate. Indeed, a couple of Wall Street economists have revised down their forecasts, and are now predicting a recession. It should be cautioned, however, that Wall Street economists have a long history of being too pessimistic during times of financial turmoil. (It gets pretty tough to see the forest through the trees when the trees at your end of the forest are burning.) On a

CHART 2

Consumers Become More Cautious

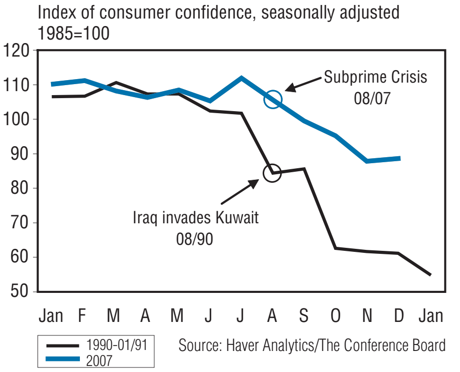


CHART 3

Unemployment: Higher, but Still Low

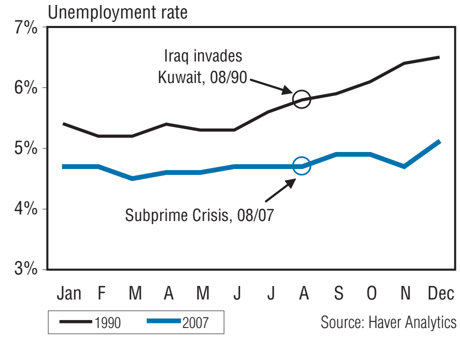
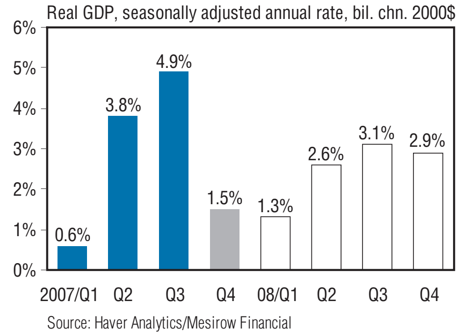


CHART 4

2008 Outlook



more positive note, Wall Street economists also tend to underestimate the subsequent rebound in growth created by monetary stimulus.

Economists Larry Summers and Martin Feldstein (who was one of Larry's professors at Harvard), for instance, are on the darker side of the outlook. Marty was pounding the gavel and scolding the Fed for not doing more at the Kansas City Fed's Jackson Hole, Wyoming meeting in late August. Larry has recently called for tax cuts to avoid what he fears could be a deeper recession.

That said, it is not clear that any of us really know much about assessing recession risks. Most recessions are surprises driven by shocks to the system, which are either external or hard to time. The economy fell through the ice in 1990 after Iraq invaded Kuwait and oil prices skyrocketed. It contracted again in 2001, after the tech bubble burst and investments imploded in the wake of the run up in spending associated with Y2K.

Our biggest obstacle, however, is the economic data itself. At their best, government reports on the economy are little more than a flashlight in an increasingly dense forest of global economic information. At their worst, they are downright wrong—this was the case during the 1990-91 recession. Only upon revisions in 1992 did we see the real depths of the recession, by then it was too late to avert it.

The 1990 Data Debacle

The initial estimates of growth in the fourth quarter of 1990 and first quarter of 1991 showed that the economy was still growing, albeit somewhat anemically. This allowed former Fed Chairman Alan Greenspan to hold off on additional monetary easing over the summer, and push (some would say blackmail) the White House and Congress to ratify the "1990 Budget Accord." The hope was to impose some sort of external control on fiscal policy, and narrow the federal budget deficit, which had become unsustainably large by the start of 1990.

The problem was that by the time Greenspan realized how weak the economy was, the Fed was already behind the curve in terms of easing. Then, as if to add insult to injury, the 1990 Budget Accord kicked in. The White House and Congress were forced to raise taxes and cut government spending during the worst months of the recession. Not surprisingly, President George Bush's approval rating plummeted, despite his perceived success in the first Gulf War, and a somewhat unknown Governor from Arkansas named Bill Clinton got his job.

Are We in the Same Data Predicament Today?

Parallels between 2008 and 1990 are easy to find:

- Oil prices are skyrocketing, much like they did in 1990.
- Credit markets are in turmoil, this time because of an overextension of loans in the housing market instead of in the commercial real estate market. (Remember the S&L crisis and the subsequent collapse in commercial construction activity. At one point, real estate experts were estimating that Chicago had at least an 80-year supply of office space to liquidate before another building went up.)
- Consumer confidence has softened.
- Labor market conditions are weakening.
- Many argue that the Fed is once again behind the curve.

A closer look at those similarities, however, suggests that they are more superficial than material in nature:

- Oil plays a much smaller role in the economy today than it did in 1990, which has made the economy much less sensitive to oil price increases.
- The pipeline on commercial construction remains fairly strong, despite some problems in credit markets, which will help blunt the blow to construction activity created by the collapse in residential activity.
- Consumer confidence is still well above—more than 40%—the lows hit in the wake of Iraq's invasion of Kuwait, and consistent with the early stages of this expansion. (*See Chart 2*.)
- With the exception of December, the unemployment rate (which is not subject to major revisions) has been remarkably stable. (*See Chart 3*.) Indeed, unemployment claims and the number of people out of a job are still running well below the thresholds that we would expect to see in a recession.
- The real fed funds rate, which more accurately assesses the stance of monetary policy, is currently about twice as stimulative as it was prior to the recessions of 1990 or 2001.

Moreover, anecdotal reports are significantly more upbeat than we saw during previous recessions. Small businesses still have access to credit, are hiring, and remain cautiously optimistic about their prospects for 2008. Meanwhile, the ISM manufacturing index remains consistent with positive growth, despite some slippage in December.

This is to say nothing of the momentum that we saw in the economy ahead of the crisis, which was significantly greater than we had in either 1990 or 2001. Real GDP growth came close to 4% and 5% in the second and third quarters, respectively. This is helping the economy to absorb the shocks associated with the meltdown in the housing market.

On net, the economic data is far from perfect, but doesn't appear to be the problem it was in 1990. The economy hasn't slipped into a recession yet. It has, however, slowed considerably from the breakneck pace seen earlier in the year. Preliminary data suggest that real GDP grew at about a 1.5% rate in the fourth quarter. Some of that weakness can be attributed to a give back to earlier gains. The rest reflects a genuine weakening of economic conditions, both in and related to housing.

Still in the Game

At the start of the expansion, the consumer carried the baton on growth via spending and home buying, even as business investment and trade were dragging us down. The consumer is still walking, but no longer able to run in the face of headwinds created by the collapse in housing and higher energy prices. Income growth, which remains in the black, is now the primary driver of economic expansion. Recent data on consumer credit also suggests that households are tapping into their unused credit card lines to keep spending going.

The real news, however, is in business investment and trade, which are both back in the game and running:

- Equipment spending remains strong, driven by everything from rising commodity prices (increased spending on mining and agricultural equipment) to the upgrades being made to computers because of Vista. (Microsoft finally fixed what was wrong with the system, which opened the door for more widespread adoption.) Even the auto industry, which was entirely out of the game last year, has plans to increase investment this year. It seems everything is easier for the automakers now that they have put their UAW contracts to bed.
- Investment in new structure is being supported by a fairly strong backlog of business. The pipeline on hotel and office construction is particularly strong.
- And, the trade deficit continues to narrow. Strong growth abroad and a weak dollar are the primary reasons for strong exports. Imports, however, have also slackened a bit with moderating consumer spending over the last year.

Prospects for a Rebound

The result should be positive, albeit somewhat weak growth, during the first half of the year. *Chart 4* shows that the prospects for the second half are considerably better:

- It takes anywhere from six to twelve months for a shift in monetary policy to work its way through the economy, which means that much of the stimulus associated with the recent monetary easing is still ahead of us.
- It takes up to two years for the full effects of a shift in the dollar to work its way through trade contracts, which means that the bulk of the improvement in trade is still ahead of us.
- The White House and Congress are now considering tax cuts that could put more cash into consumers pockets as soon as this spring. Most are betting that they can't get it done. However, this is an election year, and everybody loses if the economy is still weak in November.

Overshooting by the Fed

The Fed is expected to cut rates further, moving the fed funds rate down another half percent to 3-3/4% by their next meeting on January 30th. Indeed, the Fed is more likely to over- than under- stimulate at this stage of the game.

In order to understand where the Fed is, however, it is useful to take a step back to see why they must continue to ease. One could rate the Fed's performance over the last several months much like you would rate the performance of an Olympic skater. "Technically" the Fed would probably score a 9 out of a possible 10 for cutting the fed funds rate a full percent since September. However, the Fed's score for its execution or "artistry" in communicating those moves, however, is probably closer to a 3, which would knock even the most technically competent of skaters out of the running for a medal.

What went wrong? With the exception of September, the Fed's message regarding policy has been anything but clear. Dissent, waffling and open debate regarding the direction of policy in their public statements left market participants dazed and confused. Moreover, they continued to make mistakes in how their message was perceived right through the end of the year.

In response, Chairman Bernanke has finally taken the bull by the horns and concentrated power back where the financial markets want it to be during a crisis—in the Chairman's office. On January 10, he all but promised a half-percent reduction in rates by the Fed's next meeting, and opened the door to additional easing if necessary. This should effectively limit uncertainty and help restore investor confidence, which has been badly lagging.

A Tough First Term

The economy has looked better on paper than it has felt to the majority of Americans for the bulk of the expansion. It's not going to feel any better now that growth is slowing.

Moreover, if the problems that we face are more due to the distribution than the level of income this economy generates, then a reacceleration in growth will not do much to cure them. The temptation will be to move more toward populist, rather than market-oriented solutions. Free trade is already under attack from both sides of the political aisles.

This, coupled with the challenges already being created by the pending retirement of the baby boomers, a broken health care system, a further loss of manufacturing jobs, and the ongoing conflict in the Middle East, will only work to further complicate the job of the next President relative to that of the last.

Add to that, the expiration of the Bush tax cuts, which will no doubt trigger a class war, makes me wonder why anyone would want the job of President in the first place. My hat goes off to those willing to run, but I can't say that I am optimistic that anyone, regardless of how well they do, will be able to make it to a second term.

Mesirow Financial Economic Forecast (Numbers as of January 11, 2008)

	2007	2008	2009	2007:3(A)	2007:4	2008:1	2008:2	2008:3	2008:4	2009:1
National Outlook										
Chain-Weighted GDP	2.2	2.5	3.0	4.9	1.5	1.3	2.6	3.1	2.9	3.1
Personal Consumption	2.9	2.1	2.5	2.8	2.8	1.5	1.7	2.4	2.4	2.8
Business Fixed Investment	4.7	6.0	5.0	9.3	6.5	3.8	5.4	6.1	4.6	4.5
Residential Investment	-17.0	-15.0	3.9	-20.5	-26.0	-17.4	-9.3	-2.0	0.9	4.6
Inventory Investment (billions)	12.0	23.5	34.1	30.6	11.3	13.4	21.5	27.9	31.4	30.6
Net Exports (billions)	-563.7	-510.9	-500.1	-533.1	-535.6	-528.0	-512.2	-503.7	-499.8	-497.8
Exports	7.7	8.4	8.2	26.2	0.9	7.4	7.8	8.0	8.2	8.3
Imports	1.9	3.2	6.2	4.8	2.3	4.1	1.8	4.6	6.0	6.4
Government Expenditures	2.2	2.8	1.9	3.8	4.8	1.7	1.9	2.0	2.2	2.1
Federal	2.2	4.0	2.1	7.1	8.5	1.7	2.2	2.2	2.3	2.3
State and Local	2.2	2.0	1.7	1.9	2.7	1.6	1.7	1.9	2.1	2.0
Final Sales	2.5	2.4	2.9	4.0	2.2	1.3	2.3	2.9	2.8	3.1
Inflation										
GDP Deflator	2.7	2.0	2.1	1.0	2.4	2.3	1.7	2.1	2.2	2.4
CPI	2.8	2.7	1.9	1.9	4.2	2.8	1.6	1.9	2.1	1.9
Special Indicators										
Corporate Profits*	7.4	9.0	1.9	1.8	7.4	7.1	3.8	8.4	9.0	8.7
Disposable Personal Income	3.1	2.1	3.4	4.5	0.1	2.6	2.4	2.5	2.8	4.5
Housing Starts (millions)	1.35	1.10	1.18	1.30	1.19	1.12	1.10	1.09	1.10	1.13
Civilian Unemployment Rate	4.6	4.9	4.7	4.7	4.8	4.9	4.9	5.0	4.9	4.9
Employment	1.3	0.8	1.2	0.8	0.9	0.7	0.6	1.1	1.2	1.4
Vehicle Sales										
Automobile Sales (millions)	7.6	7.8	7.9	7.3	7.8	7.6	8.0	7.7	7.8	7.8
Domestic	5.0	5.1	5.2	4.9	5.2	5.1	5.1	5.1	5.2	5.2
Imports	2.5	2.6	2.6	2.4	2.5	2.5	2.5	2.6	2.6	2.6
Lt. Trucks (millions)	8.6	8.3	8.4	8.6	8.4	8.3	8.2	8.3	8.4	8.4
Domestic	7.1	6.8	6.8	7.2	6.9	6.8	6.7	6.8	6.9	6.8
Imports	1.5	1.5	1.6	1.4	1.5	1.5	1.5	1.5	1.5	1.6
Combined Auto/Lt. Truck	16.1	16.1	16.3	15.9	16.1	15.9	16.2	16.0	16.2	16.2
Heavy Truck Sales	0.4	0.4	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4
Total Vehicles (millions)	16.5	16.4	16.7	16.2	16.5	16.2	16.6	16.4	16.6	16.6
Interest Rates/Yields										
Federal Funds	5	$3\frac{5}{8}$	$4\frac{1}{4}$	$5\frac{1}{8}$	$4\frac{1}{2}$	$3\frac{7}{8}$	$3\frac{1}{2}$	$3\frac{1}{2}$	$3\frac{5}{8}$	$3\frac{7}{8}$
10-Year Treasury Note	$4\frac{5}{8}$	4	$4\frac{3}{4}$	$4\frac{3}{4}$	$4\frac{1}{4}$	4	$3\frac{7}{8}$	$3\frac{7}{8}$	4	$4\frac{1}{2}$
Prime Rate	8	$6\frac{3}{4}$	$7\frac{1}{8}$	$8\frac{1}{8}$	$7\frac{1}{2}$	$7\frac{1}{8}$	$6\frac{5}{8}$	$6\frac{1}{2}$	$6\frac{5}{8}$	$6\frac{7}{8}$
Corporate Bond AAA	$5\frac{1}{2}$	$5\frac{1}{4}$	$5\frac{7}{8}$	$5\frac{3}{4}$	$5\frac{1}{2}$	$5\frac{3}{8}$	$5\frac{1}{4}$	$5\frac{1}{4}$	$5\frac{1}{4}$	$5\frac{5}{8}$
Exchange Rates										
Yen/Dollar	117	110	114	118	112	113	109	107	110	112
Dollar/Euro	1.38	1.47	1.39	1.38	1.45	1.44	1.47	1.49	1.47	1.42

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was $11,049 billion in chain-weighted dollars.

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For more information, contact:

Diane Swonk
Chief Economist
312-595-7122
dswonk@mesirowfinancial.com

Olga Camargo
Director of Economic Communications
312-595-7128
olcamargo@mesirowfinancial.com