

Themes on the Economy

Darkest before the Dawn

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

The Worst of Times?

*"Why don't we just call it what it is,
A DEPRESSION!"*

-Ravings of a pharmacist—January 2008.

The economy is clearly in bad shape, regardless of whether or not we actually see the requisite of two consecutive quarters of negative growth in the data to "officially" declare it a recession. (Frankly, we probably won't know if we were technically in a recession in the fourth and first quarters until benchmark revisions to the GDP data are released in July, which will be too late to matter.) Calling it a depression, however, is outright offensive, especially to those of us who have actually experienced significantly worse economic times. (I came of age in Michigan in the late 1970s and early 1980s, when unemployment crossed 20%. One of the worst hit areas was Flint, Michigan—where hope for many all but evaporated.)

Last month's edition of this report laid out several reasons why some consumers might be feeling worse than their recent benchmark—the 1990s—but not nearly as bad as they would if we were experiencing an actual depression. The data could be wrong and the economy could be even weaker than is being reported. Indeed, employment was revised down for 2007 as a whole last month, with the bulk of the weakness occurring in the second half of the year. And, income inequalities have worsened, causing more people to feel left behind, even when *overall* economic conditions are improving. Now those same consumers are feeling even worse, given the havoc that the housing market bust and

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higher gas prices have wreaked on their personal balance sheets.

This report takes a closer look at consumer balance sheets, the damage that has been done, whether or not shifts in monetary or fiscal policy can fix any of those problems, and what it all means for the outlook for consumer spending. Lower interest rates and tax rebates can't fully cure the ills associated with falling home values and higher debt burdens. They will, however, limit the collateral damage associated with the housing market bust—additional credit delinquencies and foreclosures—and could even create a bit of extra cash to spend for households that are able to refinance going forward.

Separately, the shifting outlook for housing will be discussed. The collapse in subprime mortgages and collapse in the mortgage-backed securities market last summer clearly accelerated the contraction. The question remains whether or not recent changes to monetary and fiscal policy can do much to reverse those losses.

Damages to Consumer Balance Sheets

Charts 1-3 lay out the deterioration that we have seen in consumer balance sheets over the last year:

A Better Second Half

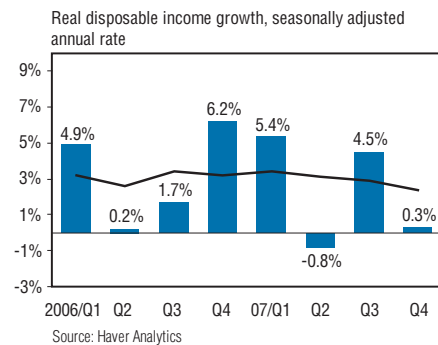
Real GDP growth came in at 0.6% in the fourth quarter, with rapidly worsening conditions in the housing market and a sharp drawdown in inventories mostly offsetting a descent gain (2%) in consumer spending, continued strength in business investment, and a modest improvement in trade. Moreover, recent data suggest that the initial fourth quarter data estimates will be revised down, not up.

Preliminary data on the first quarter is not any better. The housing market continues its downward spiral, while consumer spending has come to a virtual standstill. The only bright spots are business investment and trade, which are both benefiting from the weakness in the dollar. On net, real GDP is forecast to rise an insignificant 0.2% in the first quarter.

Prospects for the second and third quarters are better. Mortgage restructuring will increase cash flow and rescue some homeowners from foreclosure at the same time that rebate checks will show up in the mail. Separately, equipment spending is expected to get an extra lift from an acceleration in the depreciation rate of new equipment purchases. Real GDP is forecast to rise 1.8% and 3.2% in the second and third quarters, respectively.

The Fed Continues to Ease. The Fed is expected to lower the fed funds rate another three quarters of a percent to a low of 2¼% by the end of April. An additional ease is possible, but not likely, given the prospects for a mid-year rebound. It will not take long, however, for the Fed to reverse course and tighten. (They will not want to repeat the excessive easing of 2003.) The fed funds rate is forecast to end 2009 at or above 4%.

CHART 1

Incomes get Pinched

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

CHART 2

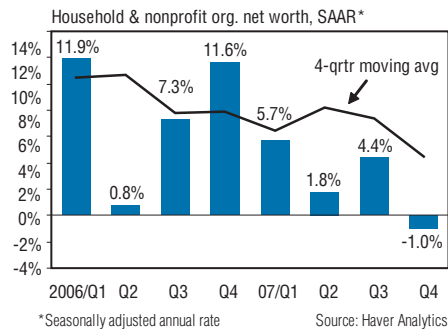
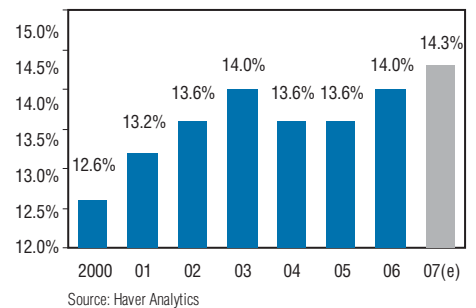
Net worth Erodes

CHART 3

Debt Service Burdens Rise

- Real disposable income growth has trended down, especially on a moving average basis, in response to higher inflation (largely food and energy) and a slowdown in employment. Indeed, payroll employment actually contracted in January which, depending on how high inflation comes in, could set the stage for a decline in real income growth in the first quarter.
- Household net worth has hit a plateau and is likely to retrench in the very near term, as falling home values and recent stock market losses make their way through 401(k) plans and onto consumer balance sheets.
- Debt burdens rose to unsustainable highs as adjustable rate mortgages began to reset at higher rates, and consumers shifted to more expensive credit card debt to keep their spending going over the last two years.

Some consumers collapsed under the weight of their own debt. Delinquencies surged over the last year, first on mortgages and, more recently, on credit cards (*See Chart 4*). The rise in “early” mortgage defaults—those that were in default within the first six months of their origination—was particularly disturbing, as it suggests that many subprime borrowers never should have been given a mortgage in the first place. (Indeed, anecdotal reports from Chicago suggest that many families that are now facing foreclosure, were evicted from their apartments for delinquencies just five or six years ago.)

Conditions are likely to get worse for consumer balance sheets before they get better, given the sheer volume of subprime foreclosures in the pipeline, as well as the downward pressure on income growth in

the near term. By November, about 20% of subprime adjustable-rate mortgages (ARMs) were more than ninety days in default, which is twice the level of the year before. Foreclosures were started on about 171,000 of those loans. This is an addition to the 1.3 million foreclosures already in progress.

This is to say nothing of prime borrowers who have yet to default, but are likely to walk as home values fall even further. The deep discounts that home builders are offering new buyers on unsold properties in California and Florida are particularly risky, as they are forcing existing owners in their developments to take as much as a 25% to 35% hit on their equity position in their homes over night. For example, builders in the Modesto, California area are offering up \$100,000 discounts on homes that were sold for \$400,000 just a year ago.

A Turning Point

There is, however, a light at the end of the tunnel:

- Short-term interest rates have plummeted in response to recent Fed easing, which has lowered the reset rate for the remaining pool of ARMs.
- The rate on 30-year fixed mortgages has dipped to its lowest level in four years, which has reopened the window on mortgage restructuring. Mortgage applications jumped more than 40% from a year ago in January—more than 60% of those applications went to refinance existing loans (*See Chart 5*). This will not only alleviate the pressure to default on adjustable-rate mortgages, but will also increase cash flow for those who locked in at a lower fixed rate.
- The Term Auction Facility (TAF), which was launched by the Fed in

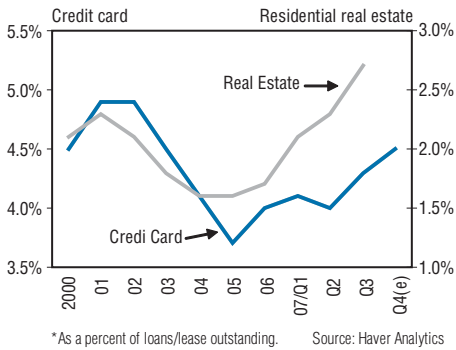
December to shore up liquidity in the banking sector, is effectively providing short-term lending to banks where credit markets have failed.

- The LIBOR or inter-bank lending rate has fallen in recent weeks, which means that banks are finally lending to one another again.
- Sovereign wealth funds are recapitalizing bank balance sheets, which should eventually help banks increase their lending capacity.
- The yield curve has reestablished itself, which should eventually boost the return that banks earn on loans.
- Subprime lending has come to a standstill, which will put a cap on foreclosures going forward.

Moreover, the Fed is not finished cutting rates, and the bulk of the payoffs from earlier monetary easing are still ahead of us. It takes about six to twelve months for shifts in monetary policy to work their way through to consumer balance sheets, which means that the first wave of real stimulus associated with recent Fed easing is likely to start affecting the economy in March. (The Fed's first move to lower the fed funds rate occurred in September.)

This is to say nothing of the fiscal stimulus plan, which made its way through Congress to the President's desk in record time. (Election year politics make for strange bedfellows.) Some \$168 billion in rebate checks, credits for children, and accelerated depreciation for businesses on new equipment purchases should be in the mail by May. Discounters are expected to do particularly well, as those who earn the least are more likely to spend rather than save their rebate checks.

CHART 4

Loan Delinquencies* Soar

Separately, the limit on jumbo mortgages for Fannie and Freddie has been increased. This should help ease recent restrictions on jumbo loans, and grease the rusted wheels of the housing market.

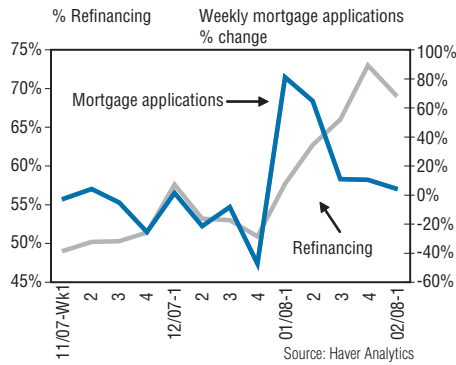
Stop and Go Consumer Spending

On net, consumer spending is expected to come to a virtual standstill, and could even dip into negative territory in the first quarter. Vehicle sales plummeted, while retailers reported their worst year-over-year gains in same-store sales in five years in January.

Chart 6 shows the forecast for consumer spending for the remainder of the year. Prospects for growth are significantly better than the first quarter:

- Real disposable income is expected to jump, initially in response to tax rebates, but later in response to a modest pickup in employment and slight moderation in inflation.
- Net worth is expected to stabilize and could even pick up a bit, as rising stock prices later in the year provide some offset to declining home values.
- The service burden on debt is expected to fall as incomes pick up, mortgages reset or are refinanced, and the interest charged on other consumer loans comes down. (The interest on most credit cards is tied to the prime lending rate, which moves in tandem with the fed funds rate.) Work done at Mesirow Financial suggests that the service burden on debt could drop as much as a full percent over the next six to twelve months, or its lowest level since 2004. This would go a long way toward alleviating the pressure on consumers to default.

CHART 5

Home Owners Rush to Refinance

- Credit market conditions are expected to ease, especially for new mortgages, once the secondary market for mortgage-backed securities starts to come back. The increases in what is considered a jumbo mortgage by both Fannie and Freddie should go at least part of the way toward reestablishing a secondary market for jumbo loans, which was hit along with the subprime loans when the credit market unwound last summer.

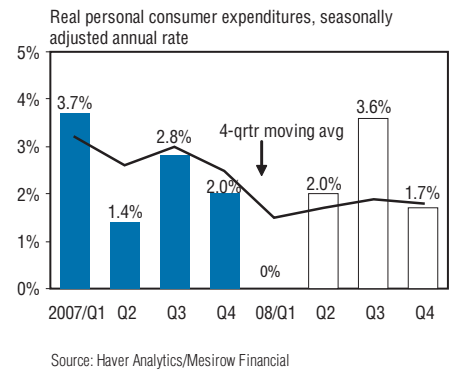
Indeed, the current forecast for a reacceleration in consumer spending is relatively conservative given the historical relationships between consumer spending, the monetary easing, and the fiscal stimulus coming our way. Consumer spending growth should be at least a percent higher in the second half of the year than currently forecast.

A Bottom for Housing?

An easing of credit will also help stem the bloodletting in the housing market. Housing affordability has soared in recent months as both mortgage rates and home prices have moderated. The index of housing affordability dipped to its lowest levels since 2004 in the fourth quarter, and that was before recent declines in mortgage rates. This, coupled with an increase in the limit on jumbo mortgages, should create a floor for home sales.

The recent drop in mortgage rates could also dampen the decline in home values. A record overhang in both new and existing inventories, however, suggests that the direction in home values will remain slightly negative for some time to come. The downward pressure on home values in the overbuilt coastal markets, where hurricanes are a problem, is expected to

CHART 6

Consumer Spending Regains Some Force

remain particularly intense. Hurricane insurance has all but disappeared, which has made all but the cheapest real estate prohibitively expensive in those areas.

On net, housing is likely to hit some sort of bottom in the second half of the year. (The current forecast has housing starts hitting a bottom in the third quarter.) We could even see a bit of a dead cat bounce as increased affordability brings some buyers back to the game. The losses in housing are likely to cumulate, even as the drag that the housing market places on overall growth dissipates.

The Bigger Picture

Everything from lower short-term interest rates to fiscal stimulus will be working in favor of consumer spending by spring. An abating of the headwinds associated with housing will also help alleviate the downward pressure on growth in the second half of the year. Some sort of a pick up in growth is virtually guaranteed.

Historically, an easing of the magnitude we have seen by the Fed would give us at least one quarter of nearly 5% growth before the year is over. The current forecast is much more conservative, however, as the monetary easing is expected to limit but not correct the fundamental problems with consumer balance sheets.

These are neither the best nor the worst of times. They are, however, the worst of times for this cycle, and have clearly left their scars, regardless of whether the economy "officially" slips into recession or not. The first quarter has been particularly painful. The good news is that we are close to a new dawn, and are all but assured a better second half.

Mesirow Financial Economic Forecast (Numbers as of February 12, 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	1.9	2.9	4.9	0.6	0.1	1.8	3.3	2.8	3.0
Personal Consumption	2.9	1.7	2.5	2.8	2.0	0	2.0	3.6	1.7	2.1
Business Fixed Investment	4.8	5.5	5.8	9.3	7.5	1.9	2.7	5.1	10.3	4.6
Residential Investment	-16.9	-18.9	1.8	-20.5	-23.9	-26.7	-17.5	-5.7	0.8	4.6
Inventory Investment (billions)	8.3	10.6	27.0	30.6	-3.4	9.9	16.9	5.2	10.4	23.7
Net Exports (billions)	-560.0	-501.4	-498.3	-533.1	-521.0	-513.0	-506.3	-492.1	-493.9	-492.8
Exports	7.8	6.8	6.2	26.2	2.4	3.2	4.6	8.3	4.3	6.0
Imports	1.8	2.3	5.3	4.8	0.3	2.3	2.6	3.5	4.8	5.2
Government Expenditures	2.1	2.4	1.6	3.8	2.6	2.1	1.7	1.7	1.8	1.8
Federal	1.7	3.5	2.0	7.1	0.3	6.2	1.7	2.1	2.3	2.1
State and Local	2.3	1.7	1.4	1.9	4.0	-0.1	1.7	1.5	1.6	1.6
Final Sales	2.5	1.9	2.8	4.0	1.9	-0.4	1.5	3.7	2.6	2.5
Inflation										
GDP Deflator	2.7	2.3	2.4	1.0	2.6	2.5	2.7	2.1	2.3	2.6
CPI	2.9	3.3	2.3	1.9	4.3	3.5	2.9	2.4	2.4	2.3
Special Indicators										
Corporate Profits*	5.1	5.5	3.3	1.8	5.1	2.7	-1.4	2.7	5.5	8.1
Disposable Personal Income	3.1	2.5	2.4	4.5	0.3	1.1	9.1	1.7	-2.9	4.4
Housing Starts (millions)	1.34	0.99	1.07	1.30	1.15	1.00	1.00	0.99	1.01	1.03
Civilian Unemployment Rate	4.6	5.2	5.2	4.7	4.8	5.1	5.2	5.4	5.3	5.3
Employment	1.0	0	0.8	-0.2	-0.4	-0.6	0.3	0.2	0.9	1.1
Vehicle Sales										
Automobile Sales (millions)	7.6	7.7	7.9	7.3	7.8	7.3	8.0	7.7	7.8	7.8
Domestic	5.0	5.1	5.2	4.9	5.2	5.0	5.1	5.2	5.2	5.2
Imports	2.5	2.4	2.6	2.4	2.5	2.3	2.4	2.5	2.6	2.6
Lt. Trucks (millions)	8.6	8.4	8.4	8.6	8.4	8.3	8.3	8.4	8.4	8.4
Domestic	7.1	6.9	6.8	7.2	6.9	6.9	6.8	6.9	6.9	6.8
Imports	1.5	1.5	1.6	1.4	1.5	1.4	1.5	1.5	1.5	1.6
Combined Auto/Lt. Truck	16.1	16.0	16.3	15.9	16.2	15.6	16.3	16.1	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	15.9	16.7	16.5	16.6	16.6
Interest Rates/Yields										
Federal Funds	5	2½	3¼	5⅛	4½	3	2¾	2¼	2¼	2⅝
10-Year Treasury Note	4⅝	3⅞	4¼	4¾	4¼	3⅝	3½	3½	3⅝	4
Prime Rate	8	5½	6¼	8⅛	7½	6	5¾	5¼	5¼	5⅝
Corporate Bond AAA	5⅝	5¼	6	5¾	5½	5¼	5¼	5¼	5¾	5¾
Exchange Rates										
Yen/Dollar	117	108	114	118	112	107	107	108	109	112
Dollar/Euro	1.37	1.47	1.33	1.38	1.45	1.47	1.49	1.48	1.45	1.40

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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