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The U.S. economy is in trouble!



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Job growth is faltering, consumer confidence plunging. The fallout from the worst housing slump in a quarter-century grows. Wherever you look, the signs are unmistakable that the US economy is in trouble.

The drumbeat of bad news since last fall has caused PYTHEAS to consider a recession more likely now. The US economy entered into a recession path in December and it will pull out of the downturn in June, aided by the rebate checks that begin going out in May. If problems worsen for the financial industry, hard hit by the housing downturn, then Washington will rush through a second rescue measure because nervous politicians will not want to be seen as dawdling before the November elections.

A recession in an election year represents a problem for incumbents, i.e. why the first stimulus package got passed so quickly and that is why we expect more of a policy response before this is all over.

It is PYTHEAS opinion that GDP will expand by 1.8 percent this year, which would be the weakest growth in five years. That compares with an estimate of 2.5 percent growth for 2008 made in our previous survey, in November. The new estimate is in line with a downgraded forecast from the Federal Reserve this past week. The forecast reflects the expectation that the economy will grow only sluggishly or actually contract from January through June. Then it is seen starting to expand more strongly in the second half of the year. Helping accomplish that is a \$168 billion federal aid plan, with its rebate checks for millions of families, and aggressive interest rate cuts from the Fed.

In November, we expected the Fed would keep a key rate, the federal funds rate, at 4.5 percent through all of 2008. That rate, the target for overnight bank loans, already is at 3 percent, after significant cuts by the Fed in January. Fed Chairman Ben Bernanke has indicated that further rate cuts will be coming if the economy fails to rebound. We predict the funds rate will end this year at 2.5 percent.

Inflation is expected to moderate greatly this year as the weak economy cools price pressures. Inflation shot up by 4.1 percent in 2007, the biggest jump in 17 years. The Consumer Price Index is forecast to rise by 2.5 percent. That is based in part on Fed's view that demand will weaken for oil and the barrel price will drop to about \$84 by December. The current trend, however, is up; crude oil jumped to all-time highs above \$100 per barrel over the last week.

The weaker growth will mean higher unemployment. PYTHEAS predicts that the jobless rate for 2008 will average 5.2 percent, compared with 4.6 percent last year.

Although the economic aid plan signed by President Bush should make the downturn a mild one, we worry that the economy could falter again next year. There is a danger that this could turn into a double-dip recession. Once the rebate checks are spent, the US economy could go back down again.

The latest PYTHEAS forecast, however, shows the economy continuing to grow in 2009. It predicts a modest GDP increase of 2.7 percent for the whole year, compared with the 1.8 percent expected this year and the 2.2 percent actual GDP growth in 2007.

Wall Street will face a slew of data in the coming weeks: on Americans' spending, inflation at the producer level, home sales and manufacturing.

So far this year, economic data has been mixed, but overall worrisome, and that has made for a turbulent stock market. And investors are bracing for more of the same — for some time to come.

Last week, the Dow inched up 0.27 percent, the Standard & Poor's 500 index rose a modest 0.23 percent and the NASDAQ composite index dipped 0.79 percent. The three indexes are all



down sharply for the year, and there's no sign yet of a true rebound in the stock market. And it can fall further; particularly troubling news could easily push the S&P back under the 1,300 mark, a level it briefly sunk below in January. It's possible for the stock market to end the year with decent returns but to say we are getting a bottom here might be premature.

Stock markets generally fall 30 percent, peak to trough, during a recession, so it's quite possible, depending on how weak the economy gets this year, for stocks to fall another 15 percent.

The housing market, the biggest drag on the economy, so far, saw a further slip on home sales by about 1 percent in January from December.

Wall Street is concerned with not only sales, but inventories, which are at very high levels because demand is so weak. The housing market can only start bouncing back once inventories start edging lower — something that many analysts don't expect to happen for a while.

But a cash-strapped consumer is also a problem. The government releases its readings on consumer spending and income in four days on Friday, with both expected to rise by 0.2 percent. Anything below those levels could raise red flags for investors.

And inflation worries remain — the consumer spending report's inflation measure is forecast to come in at 2.2 percent, year-over-year, which is above the Federal Reserve's unofficial comfort zone. And last week, the Labor Department's consumer price index showed higher-than-expected upticks.

On Tuesday, the Labor Department issues its reading on prices at the wholesale level. The Producer Price Index is expected to have risen by 0.3 percent in January after falling by 0.1 percent in December, and the core index, which excludes food and energy, is expected to have risen by 0.2 percent, the same as the prior month.

While the consumer is struggling, businesses are having a hard time offsetting that weakness. Wednesday, the Commerce Department reports on orders of durable goods, which are expected to drop by about 3.5 percent after rising by 5.2 percent in December. And the Chicago Purchasing Manager's Index — considered a precursor to the Institute for Supply Management's U.S. manufacturing report next week — is expected to show that activity was flat, perhaps even contracting, in February.

What Fed Chairman Ben Bernanke implies the central bank's monetary policy during his testimony to Congress on Wednesday and Thursday could provide some short-term direction. But doubts about the effectiveness of interest rate cuts in the tight credit markets — not to mention the gloomy tone Bernanke adopted during his last congressional appearance — could keep investors on edge for a while. Although rates have come down fairly sharply, banks have become less willing to lend and housing demand is low. Simply, you can make money cheap. You can't necessarily make people take out mortgages, or have institutions want to lend that money!

Opinion: It is Pytheas opinion that near-term, the US economy remains extremely vulnerable to further contraction because business sentiment has deteriorated further and the aggressive Fed easing to date has been partially offset by tighter financial conditions. This means the Fed is going to have to cut rates further!

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