THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist & Managing Director

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Houston…we may have a REAL problem!!

By the end of this week, we expect Congress will pass and the President will sign the largest the bailout package ever crafted. But this is not a time for celebration, not on Wall Street nor on Main Street. The reason is no one is sure whether this historic rescue deal will even work! The Emergency Economic Stabilization Act of 2008 certainly initiates a process that is designed to cleanse the banking system of failed mortgage-related securities and restore some health to their balance sheets. The ultimate goal is to get banks and other financial companies to lend again --- to each other, to consumers and to businesses. Only then will we know for sure that we've dodged the depression bullet. Unfortunately, we may not be able to judge the plan's success until the middle of 2009, at the earliest.

Here's why. This emergency package has two goals: We believe 60% is to bolster confidence, while 40% is to begin cleaning up bank balance sheets. To a significant degree, the success of this package will largely depend on whether global investors and financial institutions perceive this plan as effective. If so, we could begin to see banks free up loans by early next year, with the economy coming back to life in the second half of 2009. But if the rescue package is viewed as the wrong measure or falling short of what is needed, the probability increases we'll see a deeper market crash and a complete shutdown of the US and world economy.

The response to the bailout plan has so far has been tepid. Indeed, the stock and bond markets initially gave a thumb down to the formal rescue plan. The Dow plummeted more than 300 points this morning, 3-month LIBOR surged to 3.88%, the highest level since mid-January, and the LIBOR-OIS spread, which reflects the scarcity of cash in the banking sector, rose to a record. (The spread widened to 220 basis points. In contrast, the spread averaged just 8 basis points in the year before the credit crises erupted in August 2007.) Plain and simple, this is not the kind of endorsement the US Treasury or Congress hoped to see.

What does all this mean for the economy and the markets? Our high probability forecast has not changed. We expect to see the recession continue through the first half of 2009, followed by a modest rebound in housing and economic activity in the second half of next year, with growth accelerating between 2.5% to 3%. Unemployment could approach 7% by mid-year and remain around this level for the next two years. Growth will stay subpar (average GDP will be below 3%) through 2011. Our outlook is based on the view that banks have been so traumatized by events this past year that they will remain extremely risk aversive as they deleverage their balance sheets. The restructuring and consolidation in the financial sector has only begun. For the next 12 to 18 months, bank officers will continue to tighten their lending standards. Indeed, capital will cost more the next two years.

In the meantime, businesses, worried about having access to credit, will be under pressure to conserve their cash and cut back on investment plans. The result: more job losses and a greater cutback in consumer spending. We got a taste of the latter this morning when the government released data on personal income and spending. Consumer expenditures were flat in August, after rising a barely visible 0.1% in July. Households were clearly not in any shopping mood all summer. But who’s to blame them? The job market has gotten much worse. In addition, take home pay, which is disposable personal income, plunged by 0.9% in August, after falling 0.8% in July, and dropping 1.8% in June. So we now have had three consecutive months where take home pay has declined. The erosion in pay is even greater after adjusting for inflation. The economic downturn has also led to a decline in the standard of living for Americans. Income on a per capital basis fell steadily, from $36,458 in May to $35,105 in August. This deterioration, combined with rising unemployment, the collapse in home values and stock prices, and the difficulty in accessing credit, virtually assures this holiday shopping season will be the worst in perhaps two decades.

What bothers us, too, is the fact that come January, a whole new team of less experienced players will arrive in Washington and we wonder how much this will slow the machinery of rescuing troubled financial institutions. This change in dynamics represents yet another major uncertainty for investors.

Asset allocation strategies are not particularly challenging in this environment. The primary goal is to preserve investment capital, and this means reducing risk and staying as liquid as possible. Given the uncertain outlook for the financial sector and the weakness in the economy, we believe this is a time to seek shelter in Treasuries, gold, and even bank CDs. Our asset allocation recommendation breaks down as follows: 60% cash, 10% gold, 20% US defensive (recession-proof) equities, and 10% exposure with emerging countries, such as Brazil's energy stocks. (We're staying away from Europe and Asia for now.)