An Overview of the U.S. Economy

Presented by Daniel North, Euler Hermes ACI, June 9rd , 2010

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The Overview, June, 2010

- Good News

- Bad News

- News from the Future

The Overview, June, 2010

- Good News
  The Recession is Over

- Bad News
  Inflation is on the Way

- News from the Future
  Change

The Overview, June 2010

Good News - The Recession is Over

- How we got in / out
- What the data says

Bad News - Inflation is on the Way

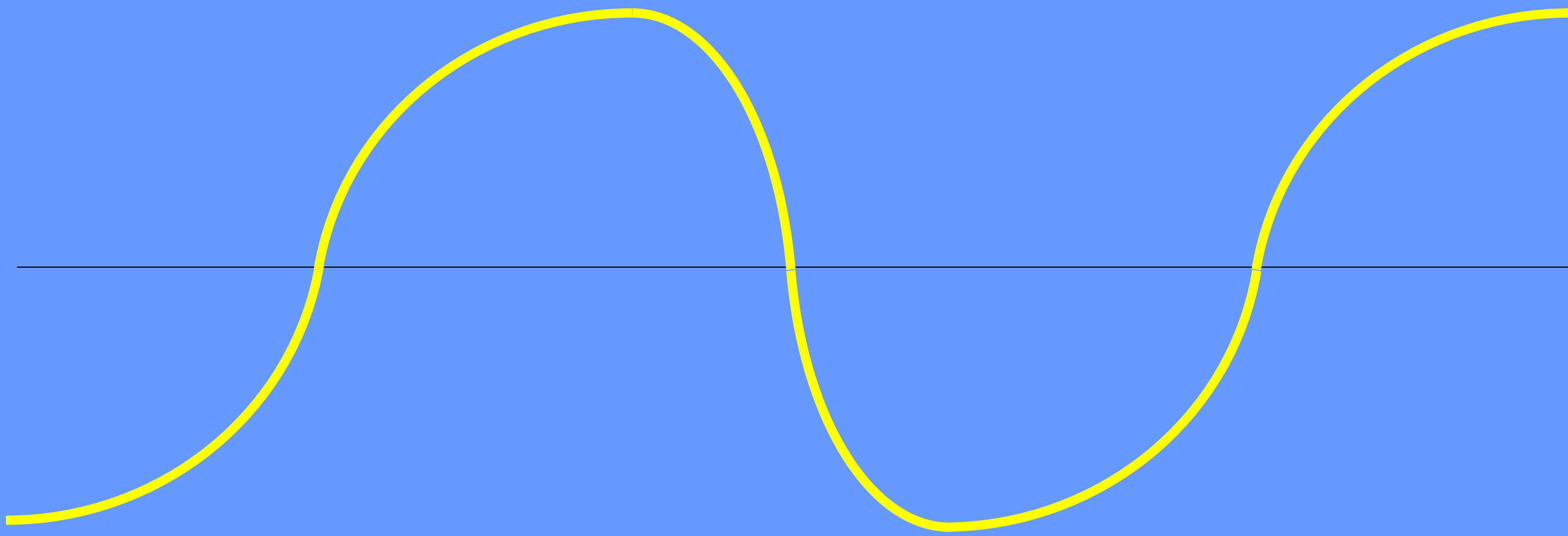
- Monetary and Fiscal policy
  - Consumer prices, interest rates, oil, bubbles
- Deficits and Debt

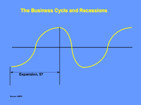
News from the Future

- Change

Not around here pal.

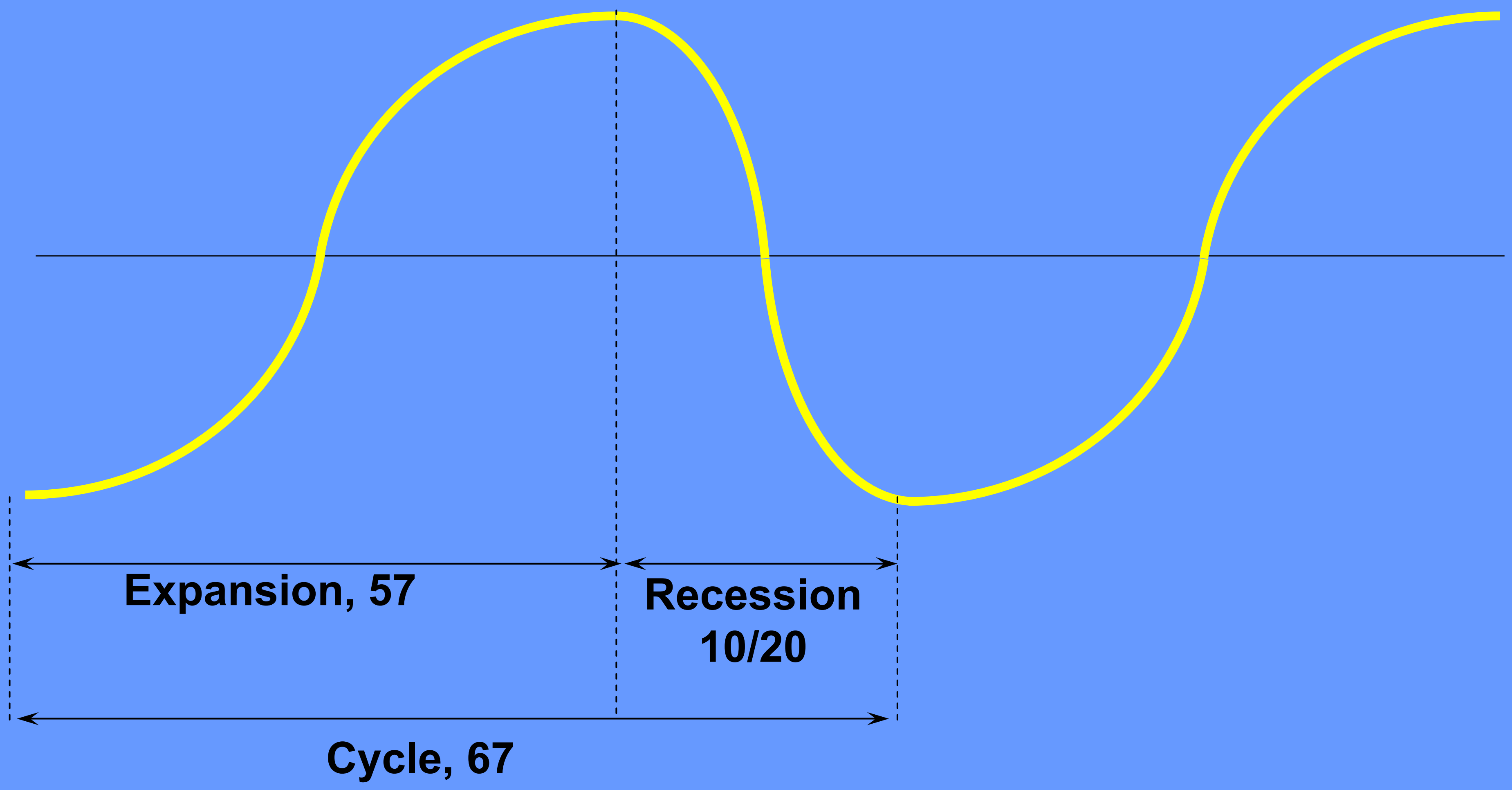
The Business Cycle and Recessions





Source: NBER

The Business Cycle and Recessions



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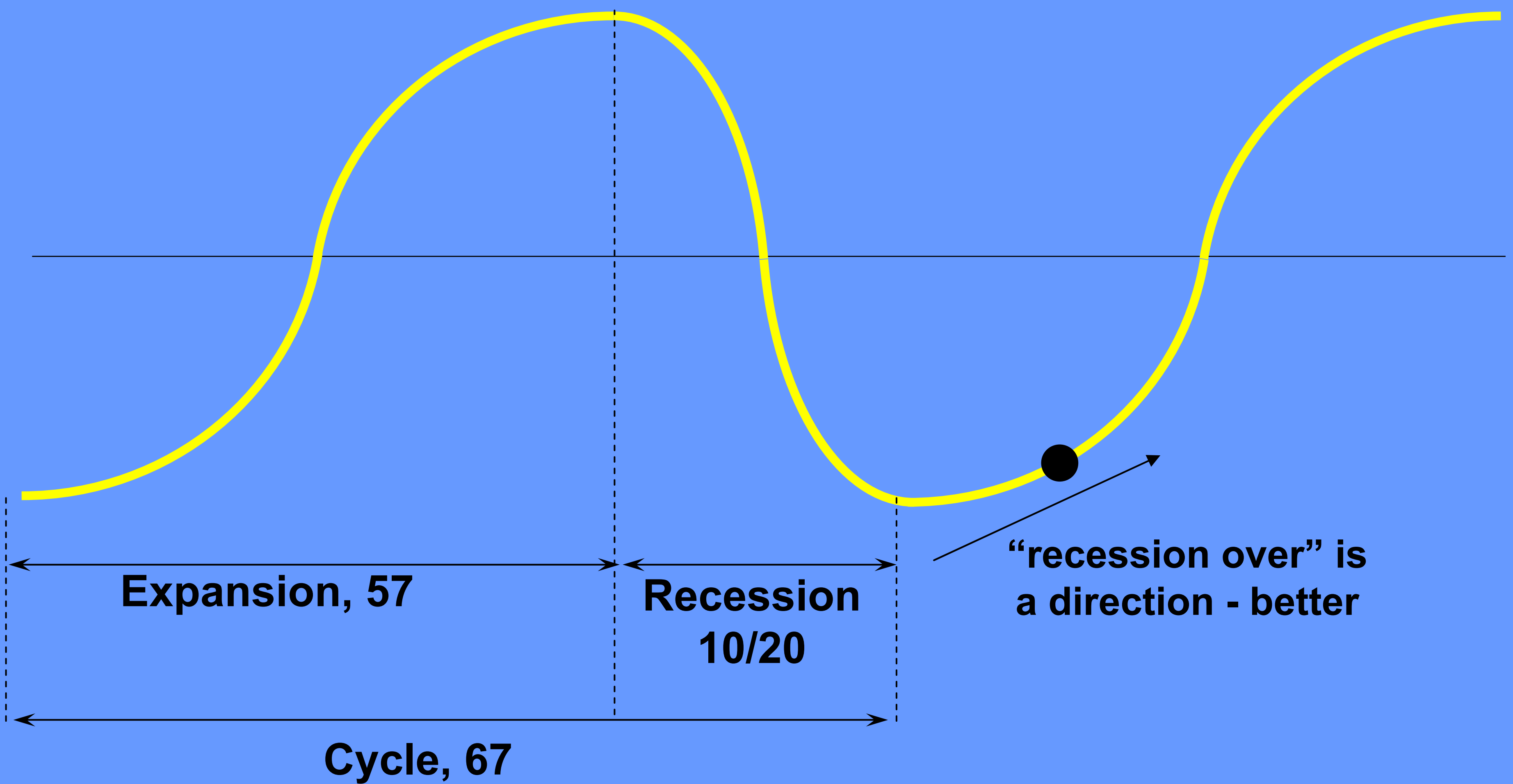
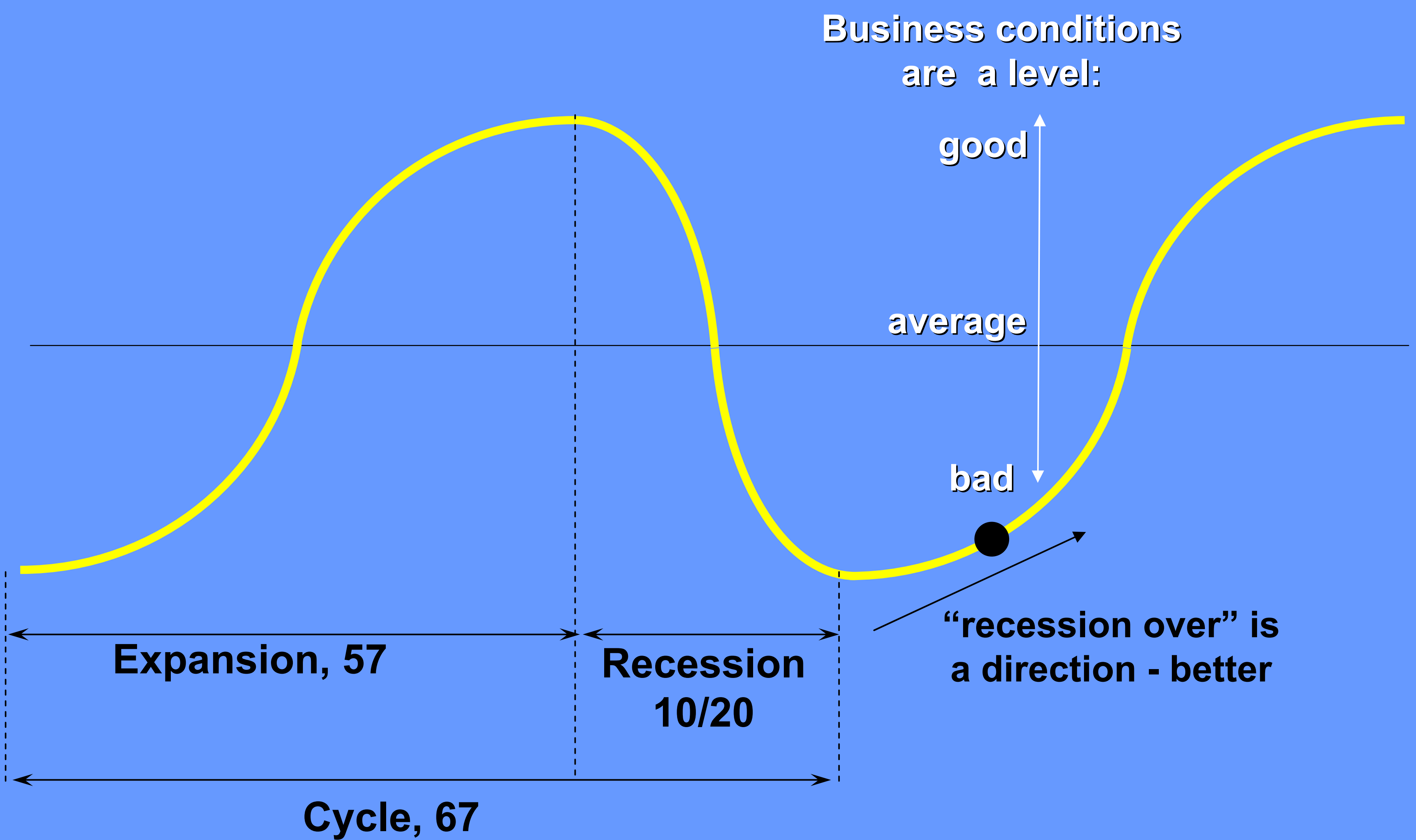
The Business Cycle and Recessions



Source: NBER

The Business Cycle and Recessions



Source: NBER

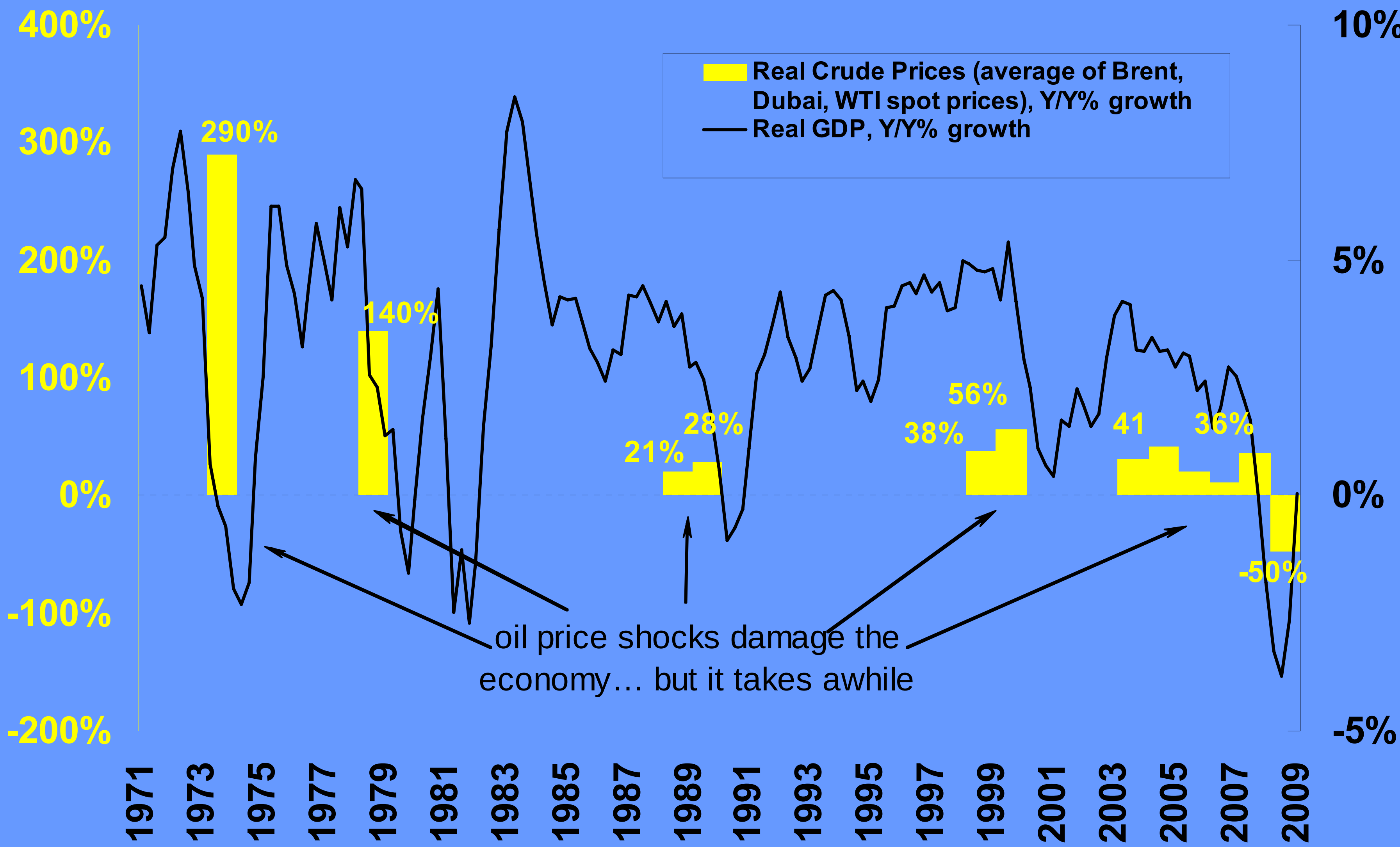
- “The recession is over.” = “Most measures of economic activity are getting better.”
- But the unemployment rate is still high – it lags - and that’s why it feels like we’re still in a recession.
- Feel better: for the unemployment rate to improve, the recession must end.
- And it has.

The Overview, June 2010
The Recession is Over

- Forces starting and ending the recession:
  - Oil
  - Housing
  - Fed policies
  - Fear

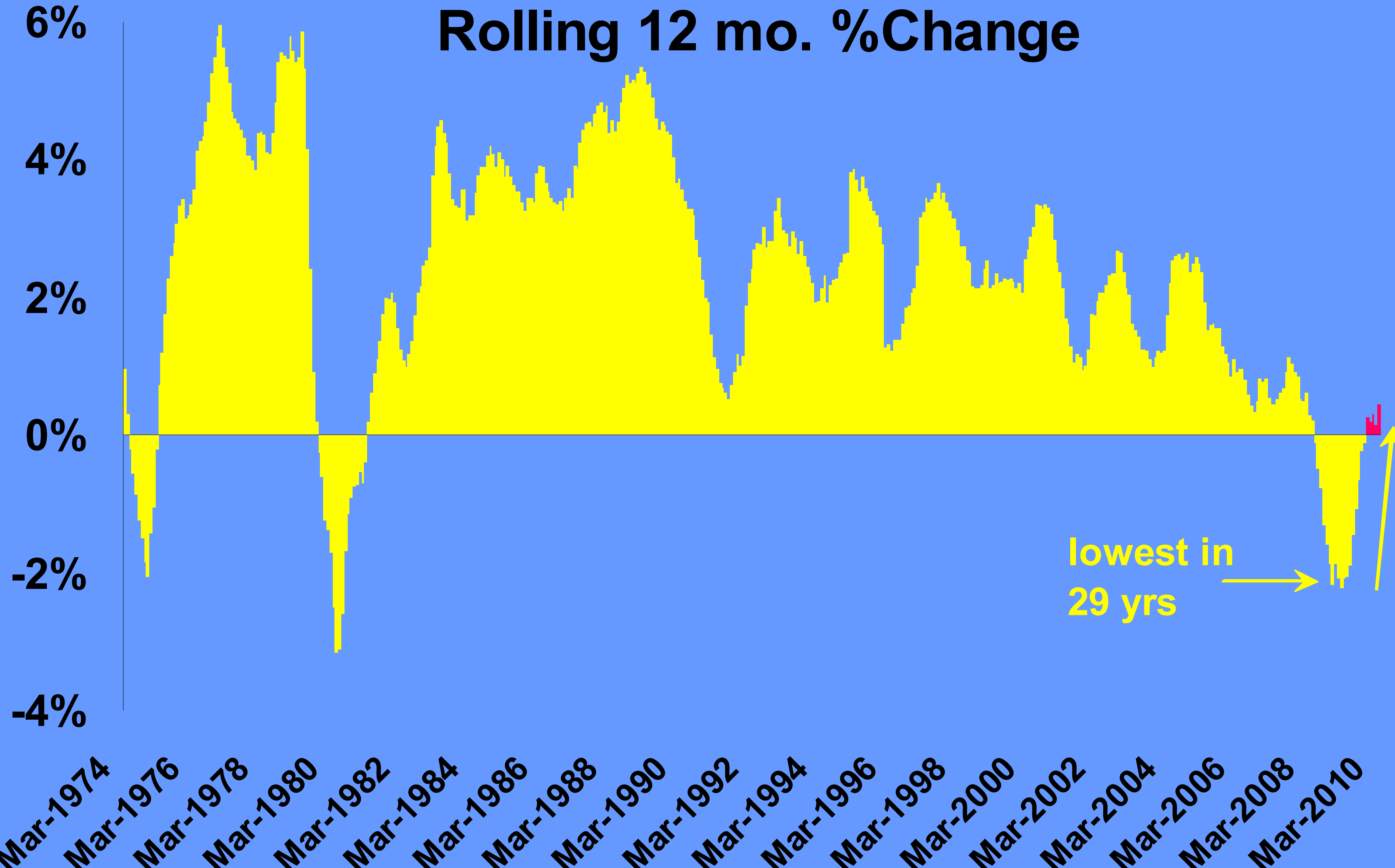
- GDP: $14T, 3.3% ave. growth

Oil Price Shocks and the Economy



Source: Dept. of Commerce, Dept. of Labor, World Bank, EHACI

HIGHWAY MILES DRIVEN
Rolling 12 mo. %Change



source: Federal Highway Administration

house price

The Housing Market

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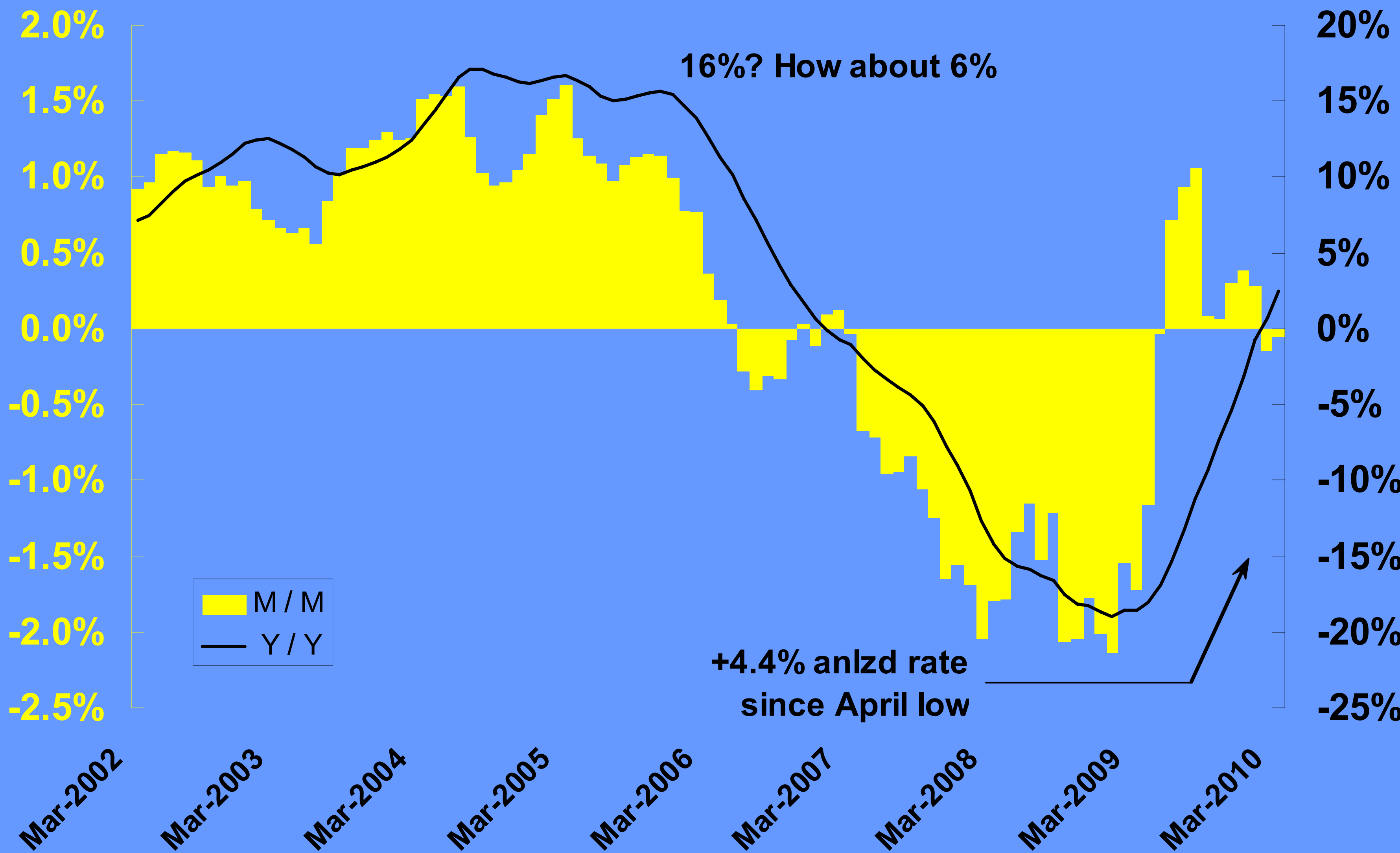
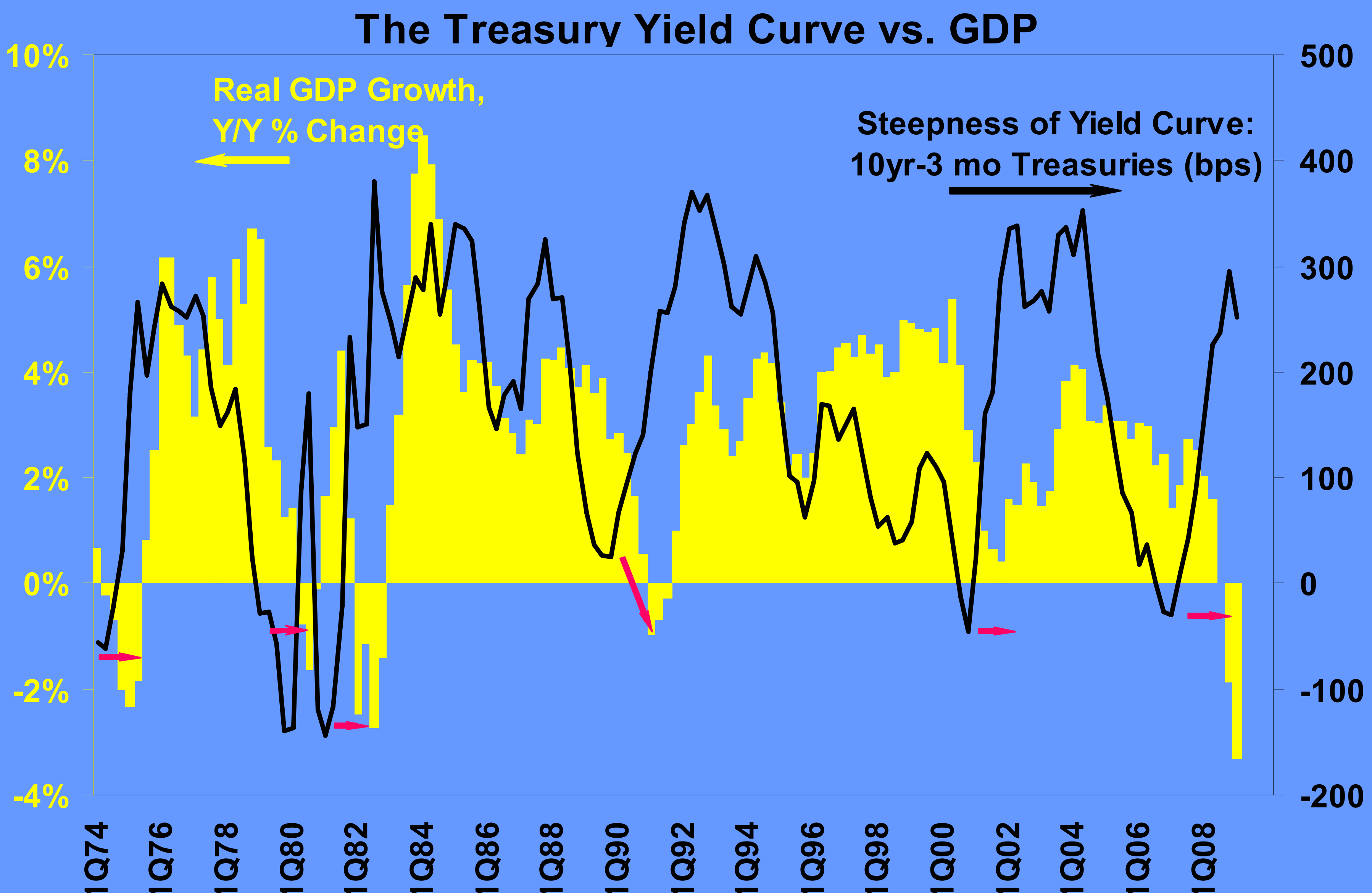
Case - Shiller Home Price Index, % Change



S&P/Case-Shiller

The Housing Market: More strong data

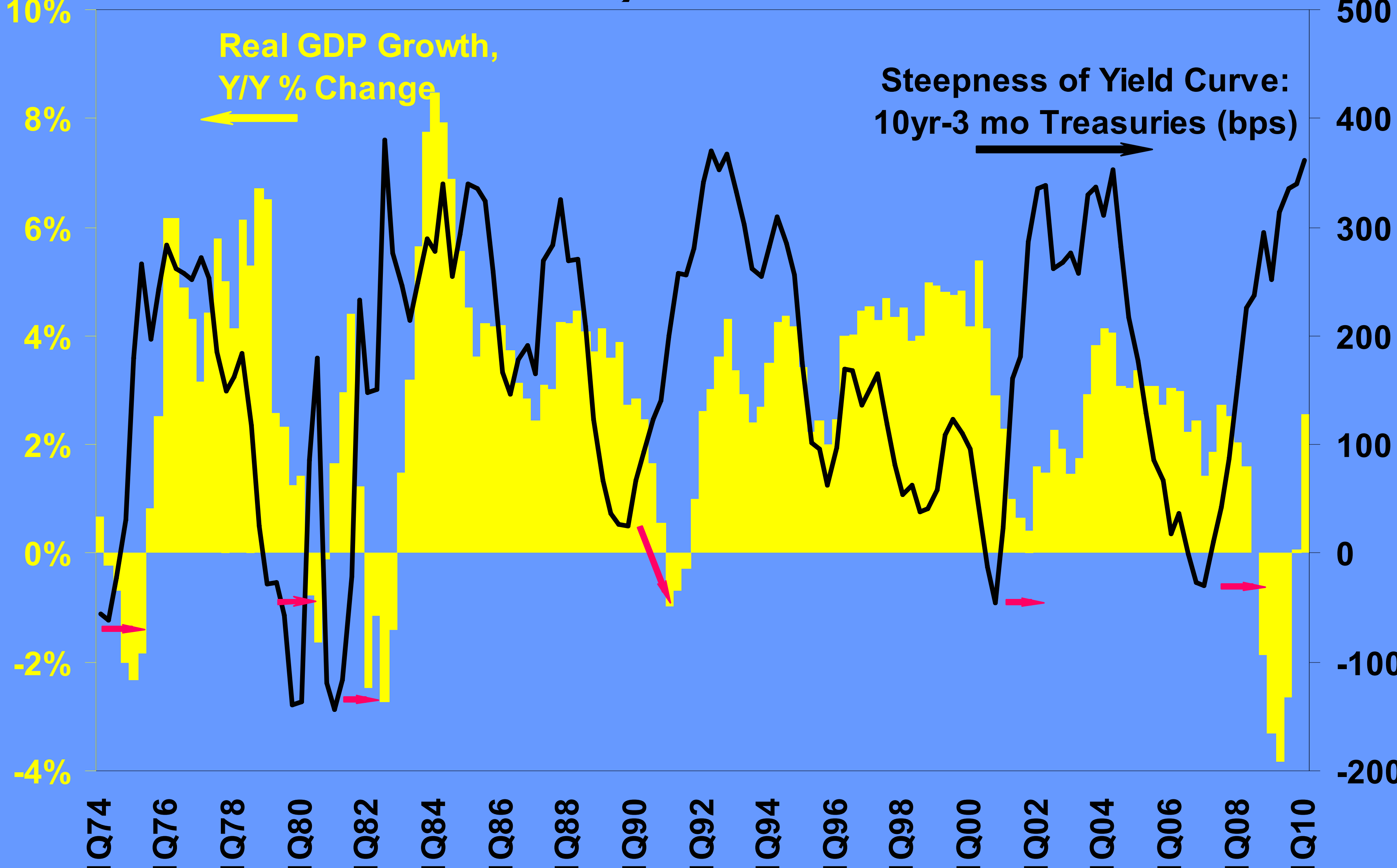
- Existing 1 family home sales up 21% y/y
- New 1 family home sales up 48% y/y
- Months supply of existing homes down 25% to 8.4 from 4/08 high of 11.2
- Months supply of new homes down 59% to 5.0 from 1/09 high of 12.1
- Starts up 41% y/y, permits up 17%



Source: Census Bureau, Federal Reserve

fear

The Treasury Yield Curve vs. GDP

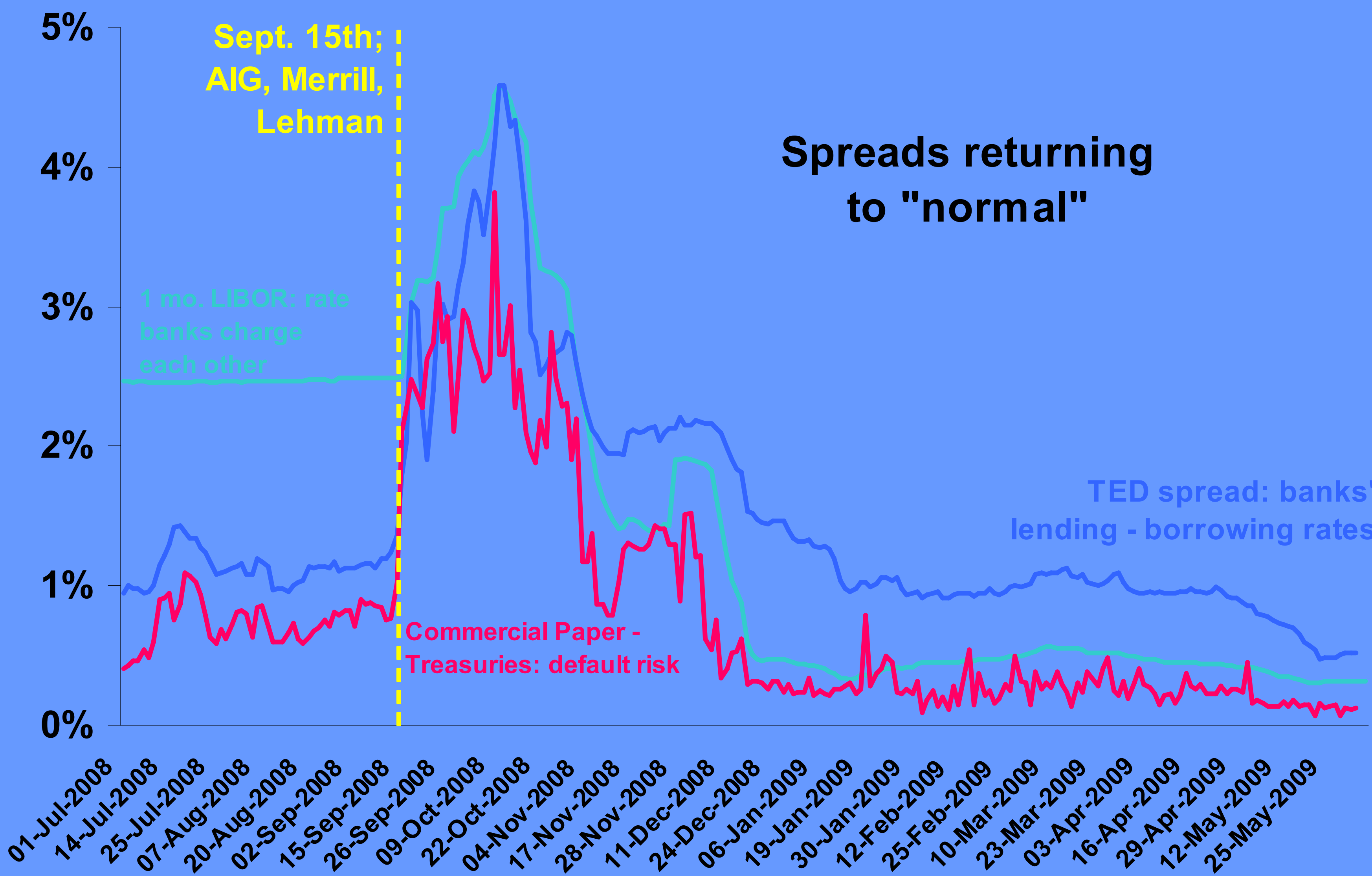


Source: Census Bureau, Federal Reserve

How we got here - fear

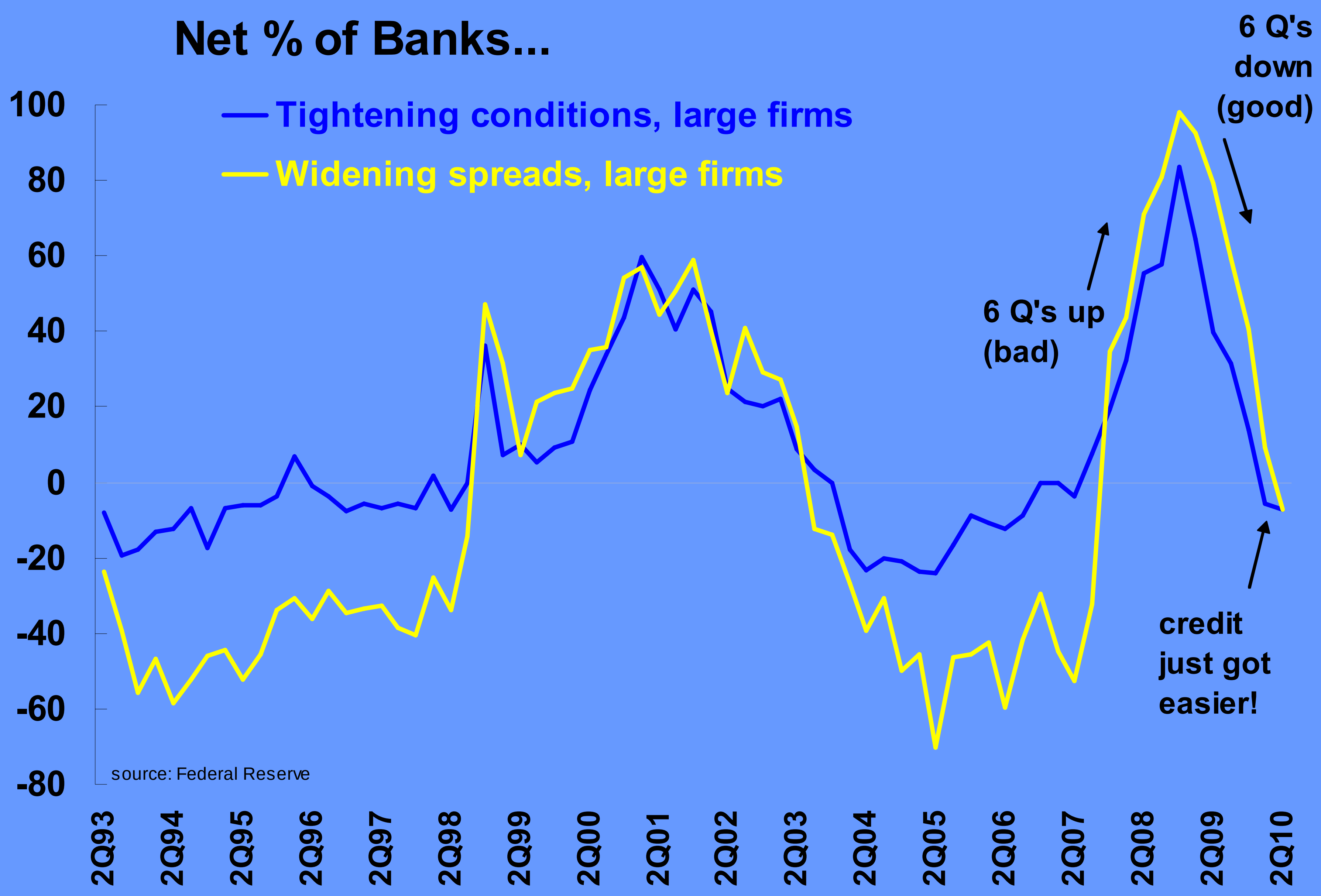
RISK MEASURES IN THE CREDIT MARKETS

source: Financial Times,Merrill Lynch,Federal Reserve



Fed

How we got here - fear

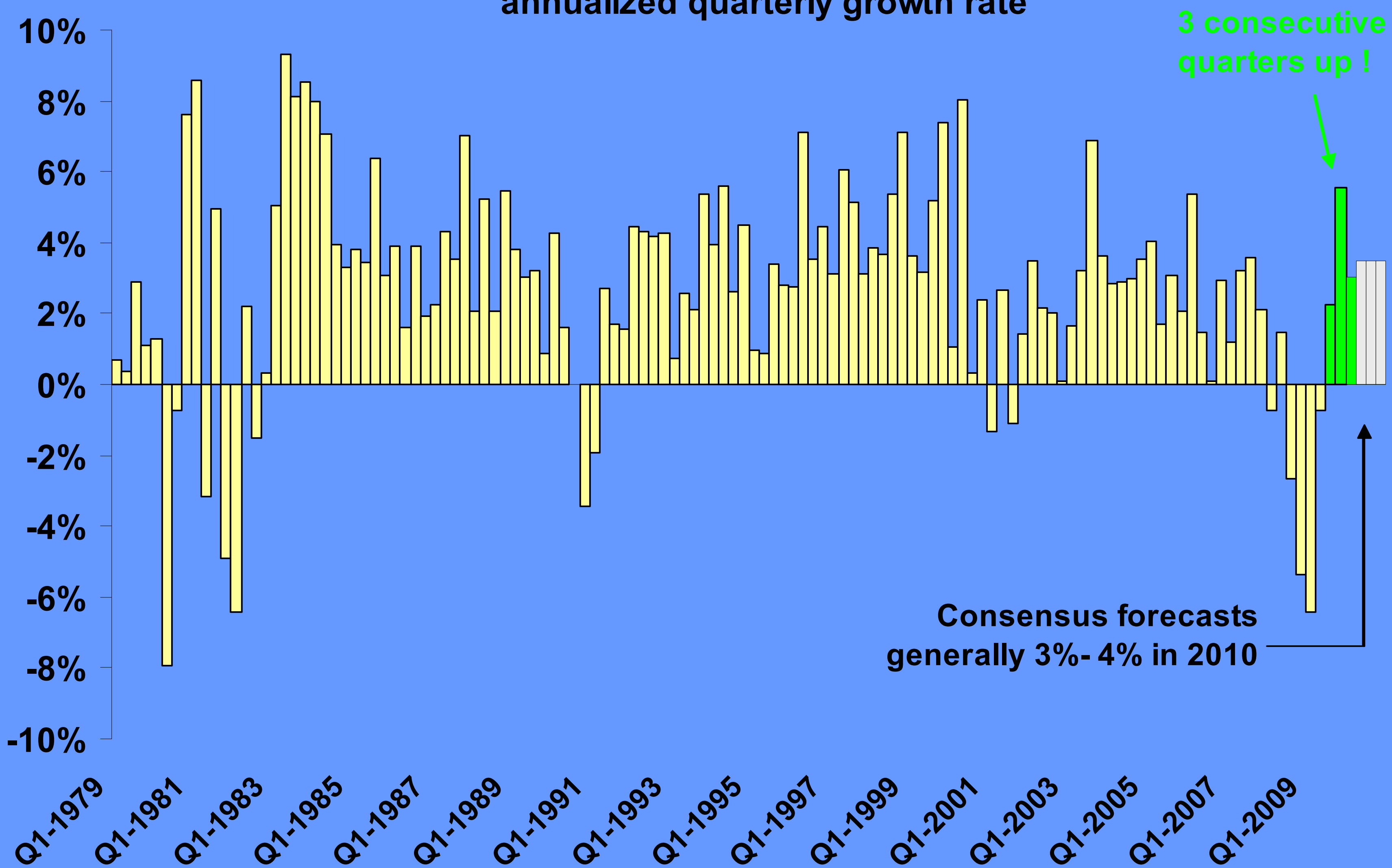


OK, fine, 4 forces working for us…

..but what are the results?

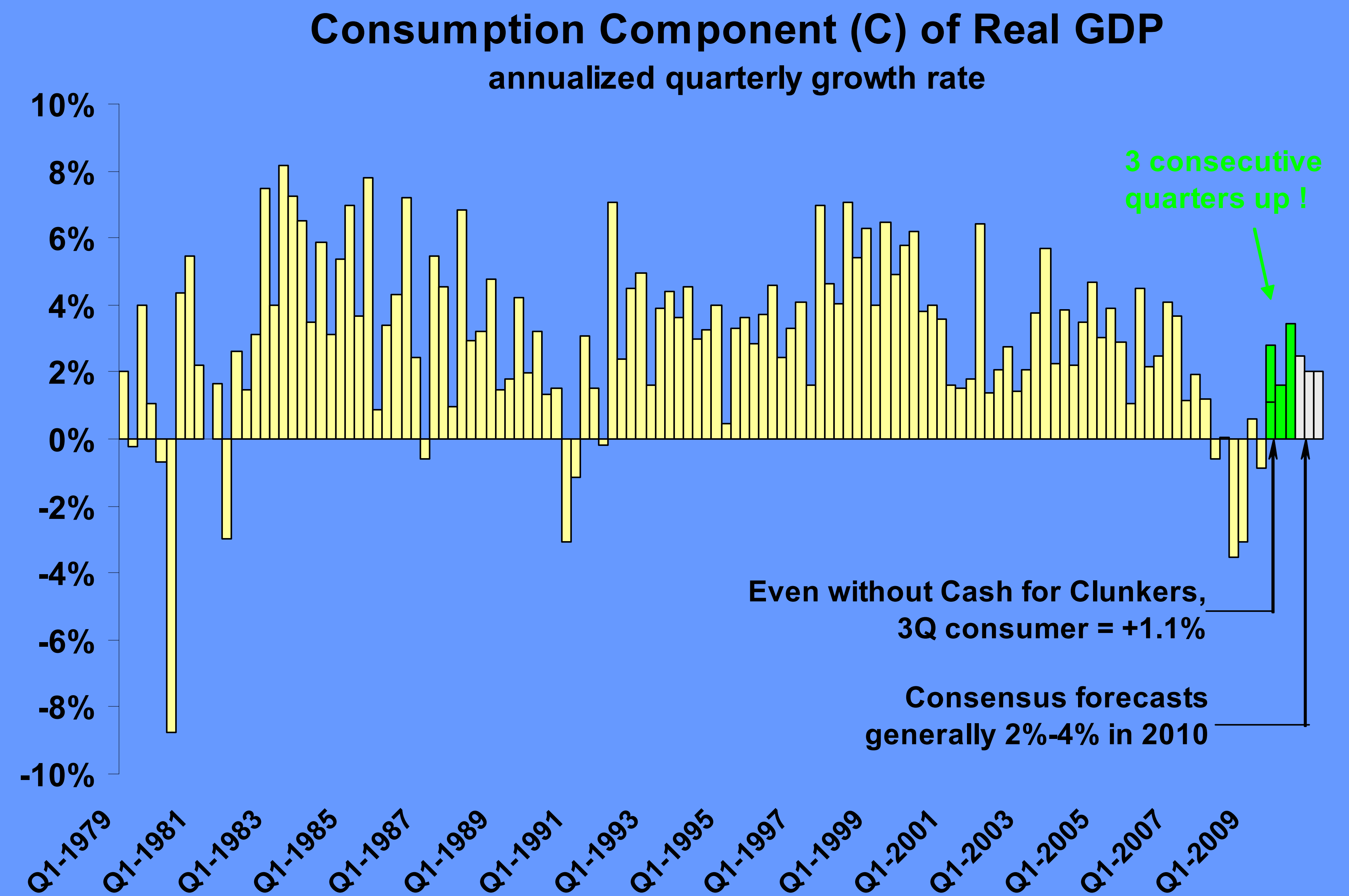
Real Gross Domestic Product (GDP)

annualized quarterly growth rate



source: BEA

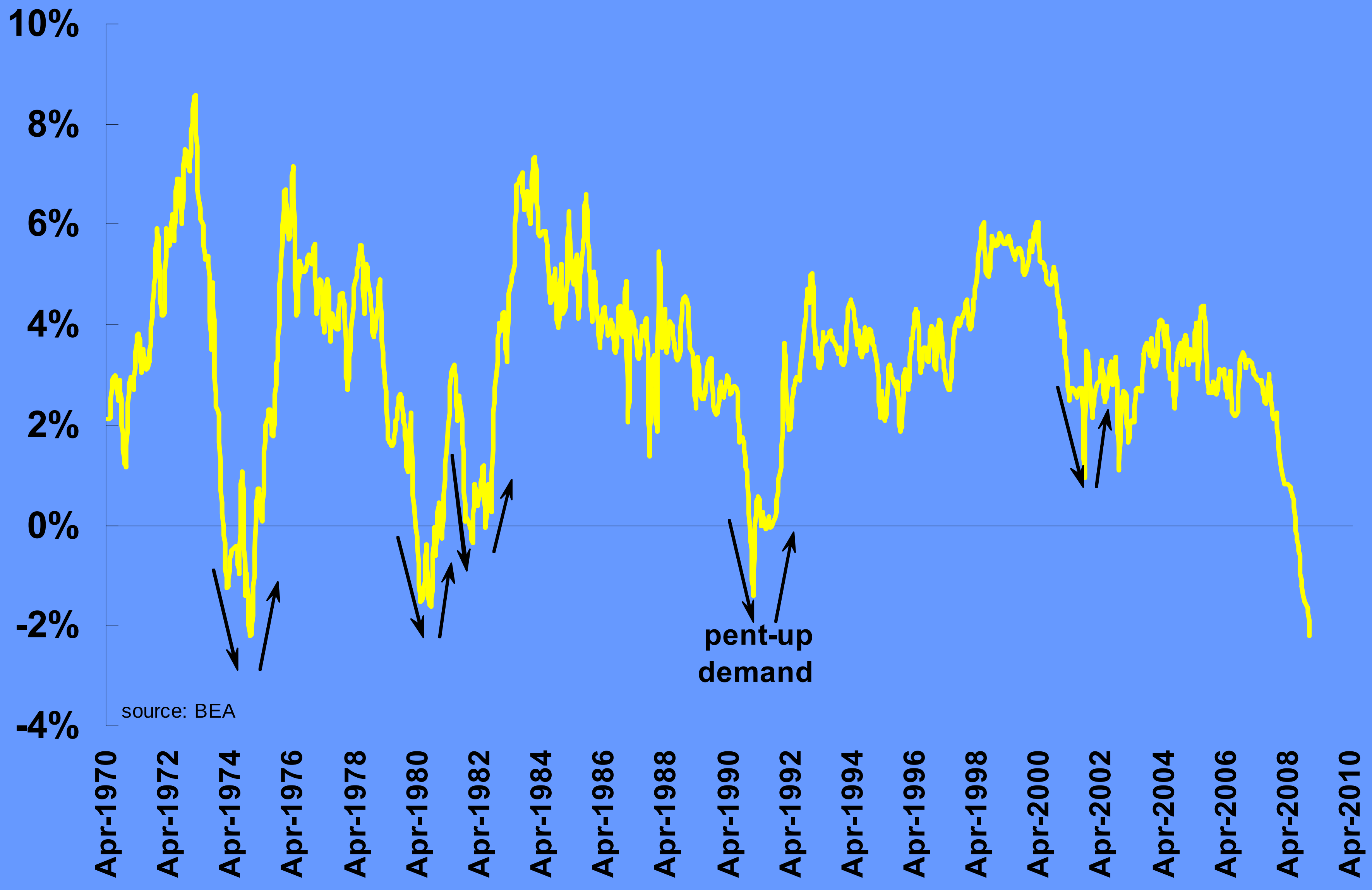
Consumer



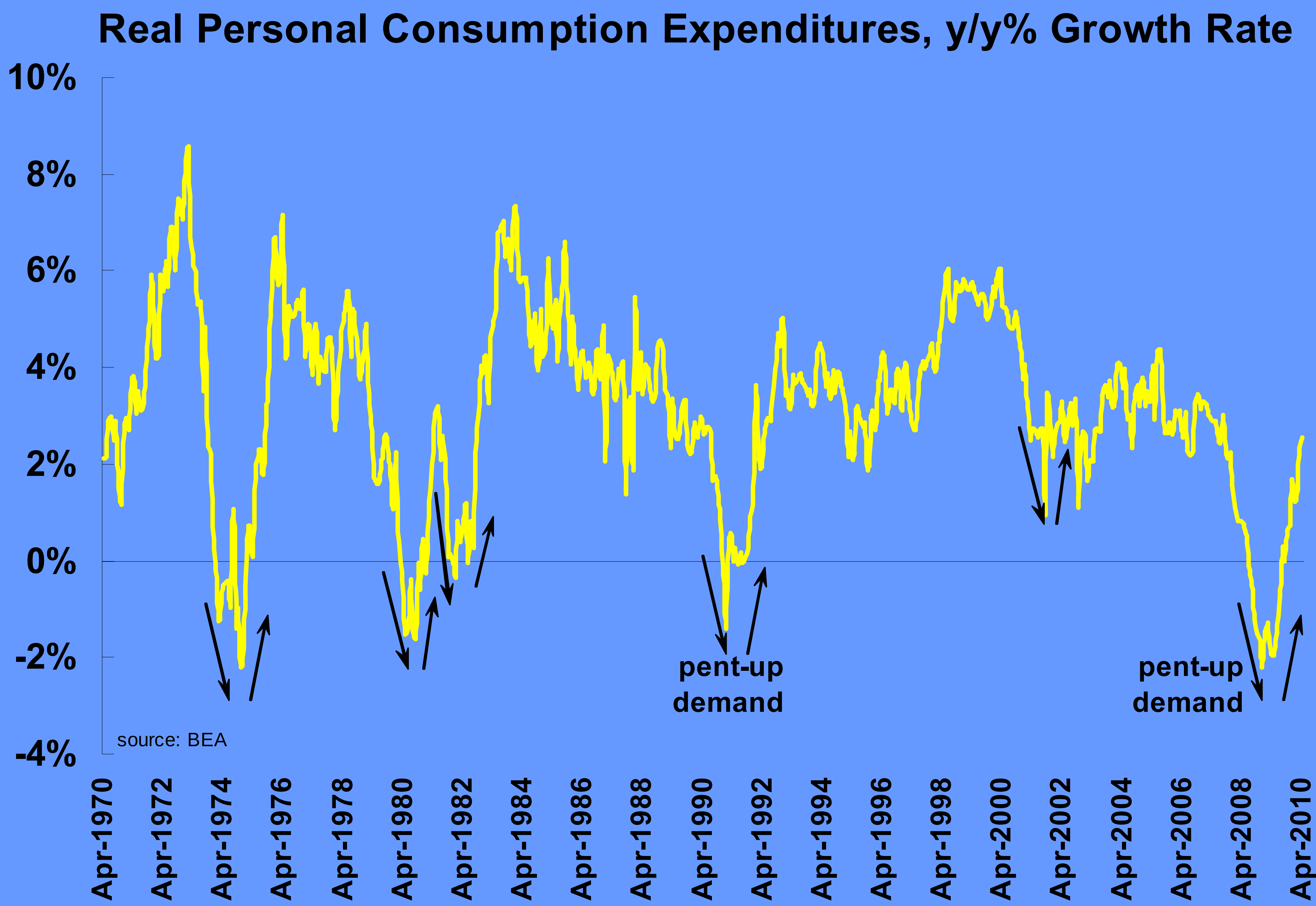
source: BEA

Consumer

Real Personal Consumption Expenditures, y/y% Growth Rate

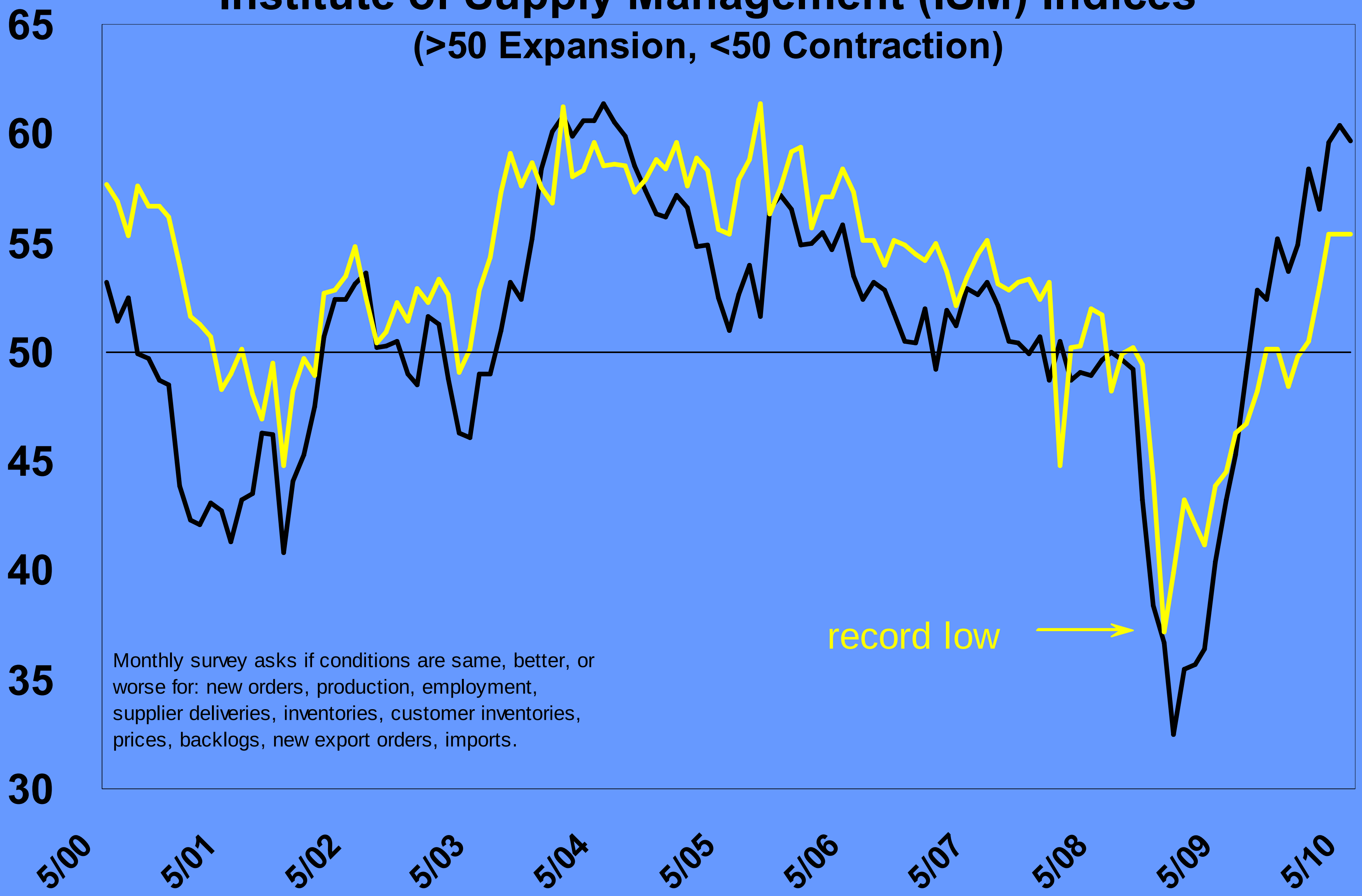


Consumer



Real Personal Consumption Expenditures, y/y% Growth Rate
10%
8%
6%
4%
2%
0%
-2%
-4%
source: BEA
pent-up
demand
pent-up
demand
Apr-1970
Apr-1972
Apr-1974
Apr-1976
Apr-1978
Apr-1980
Apr-1982
Apr-1984
Apr-1986
Apr-1988
Apr-1990
Apr-1992
Apr-1994
Apr-1996
Apr-1998
Apr-2000
Apr-2002
Apr-2004
Apr-2006
Apr-2008
Apr-2010

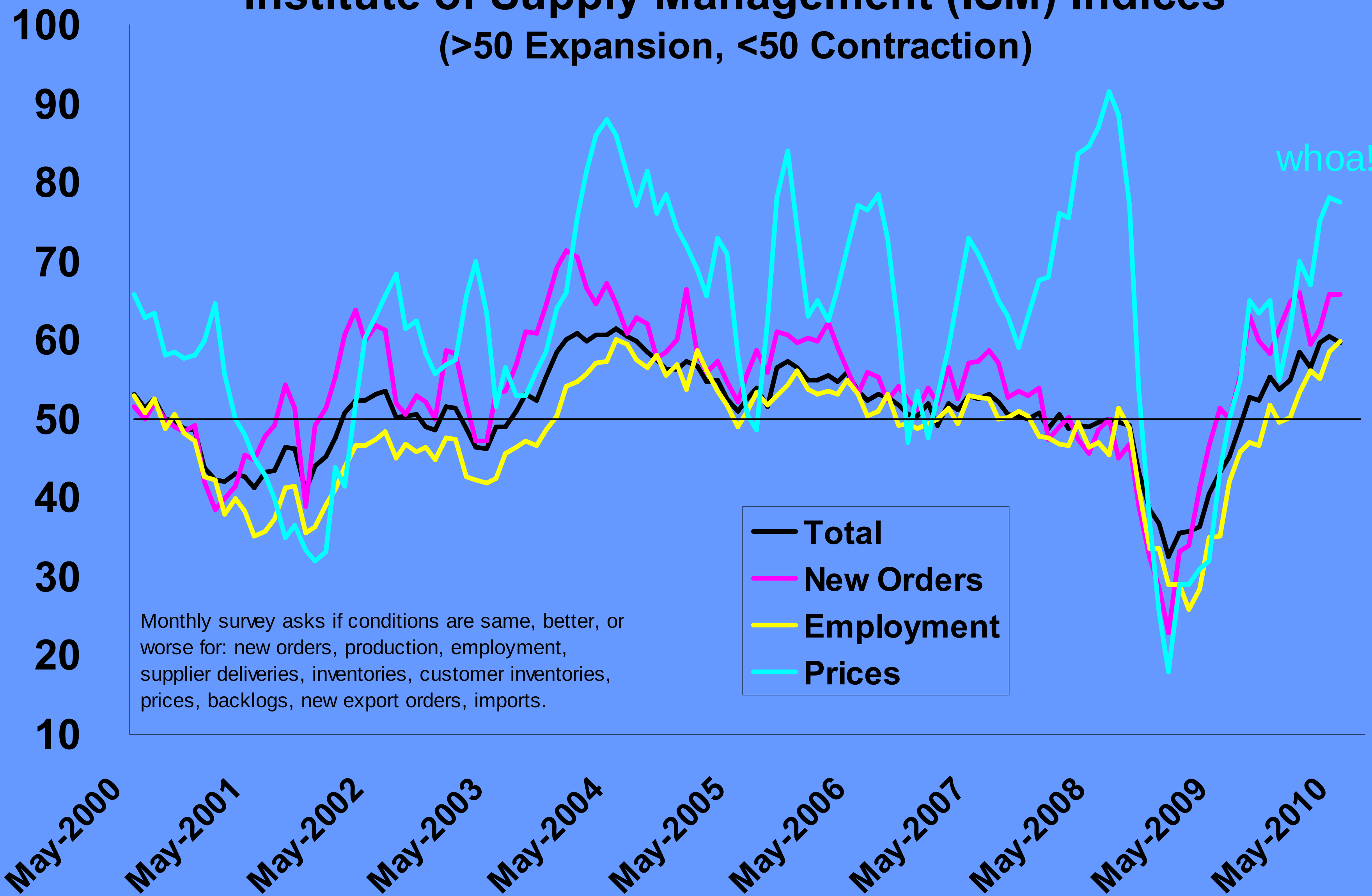
Institute of Supply Management (ISM) Indices



Fed

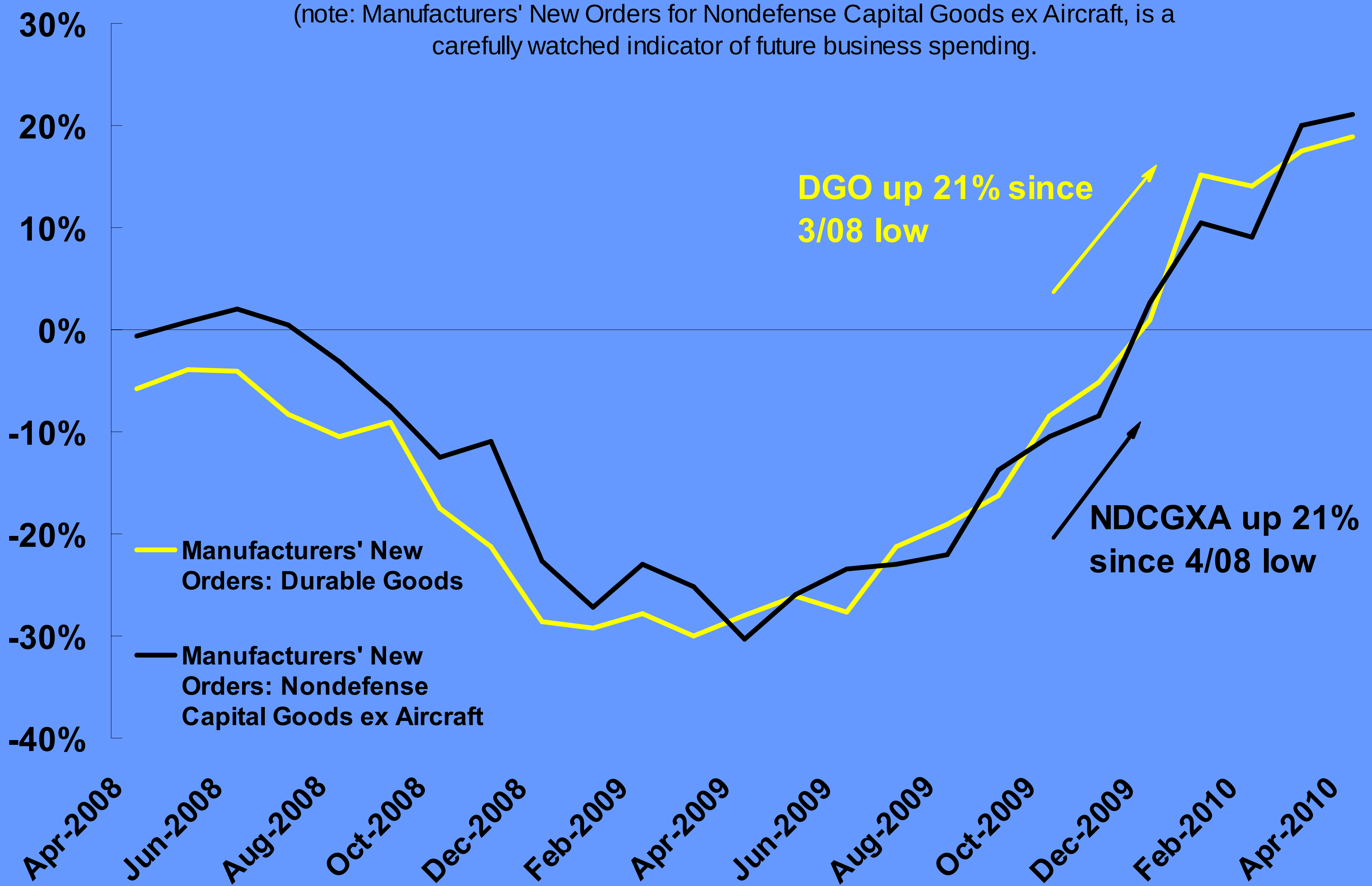
Institute of Supply Management (ISM) Indices

(>50 Expansion, <50 Contraction)



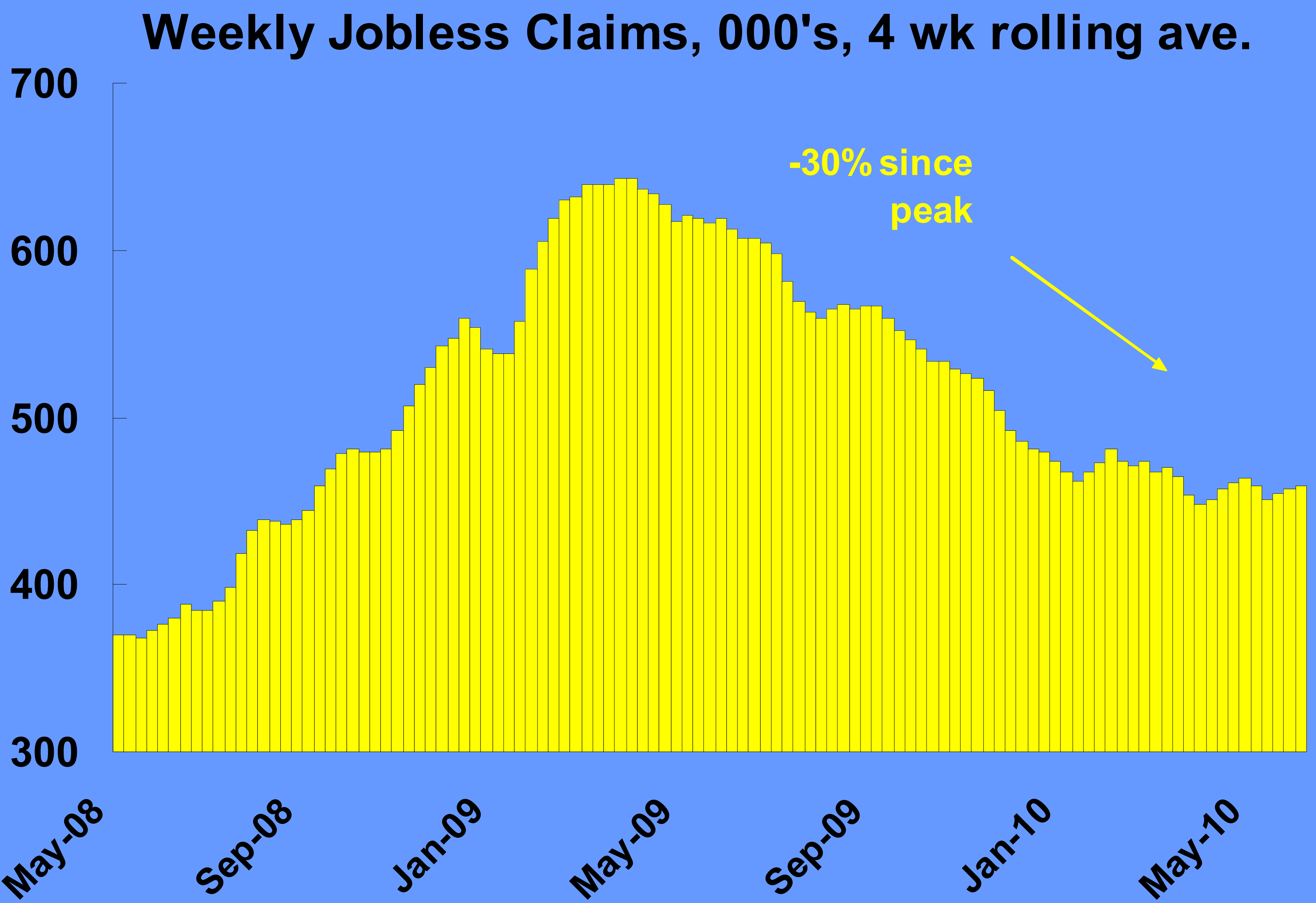
Durable Goods Orders, y/y % Growth

(note: Manufacturers' New Orders for Nondefense Capital Goods ex Aircraft, is a carefully watched indicator of future business spending.



source: Census Bureau

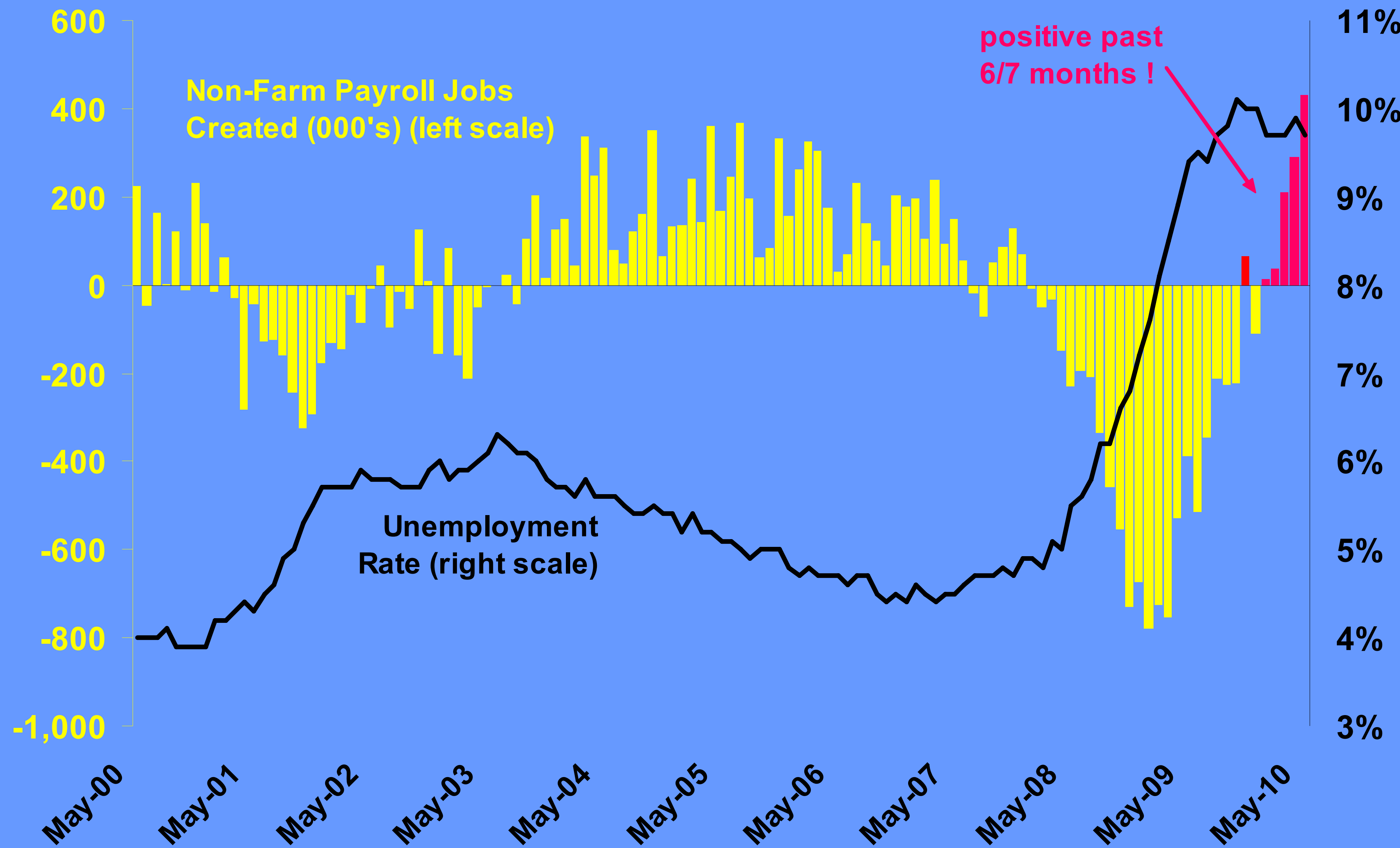
Employment



source: Labor Dept.

Employment

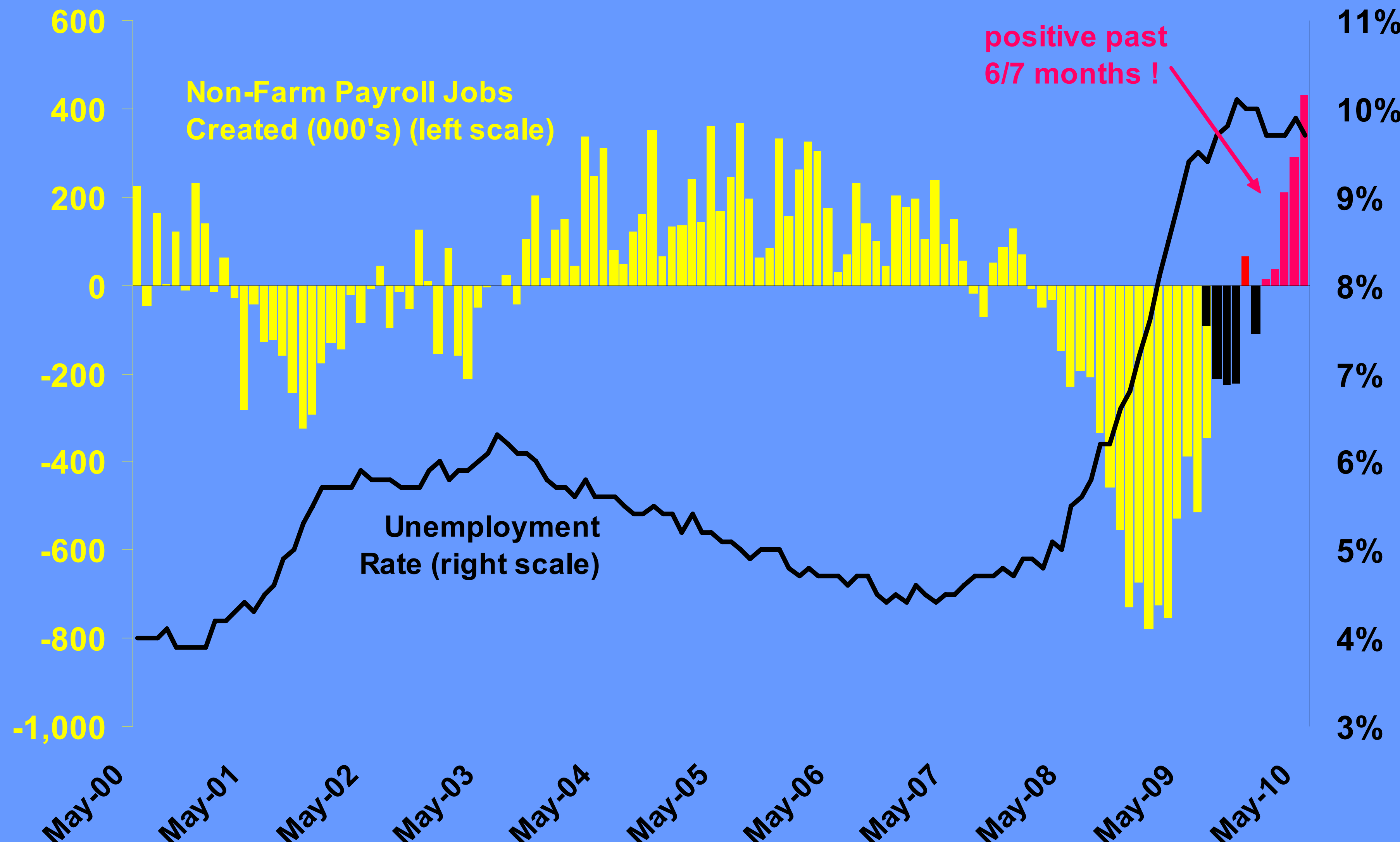
Jobs Created and The Unemployment Rate



source: Labor Department

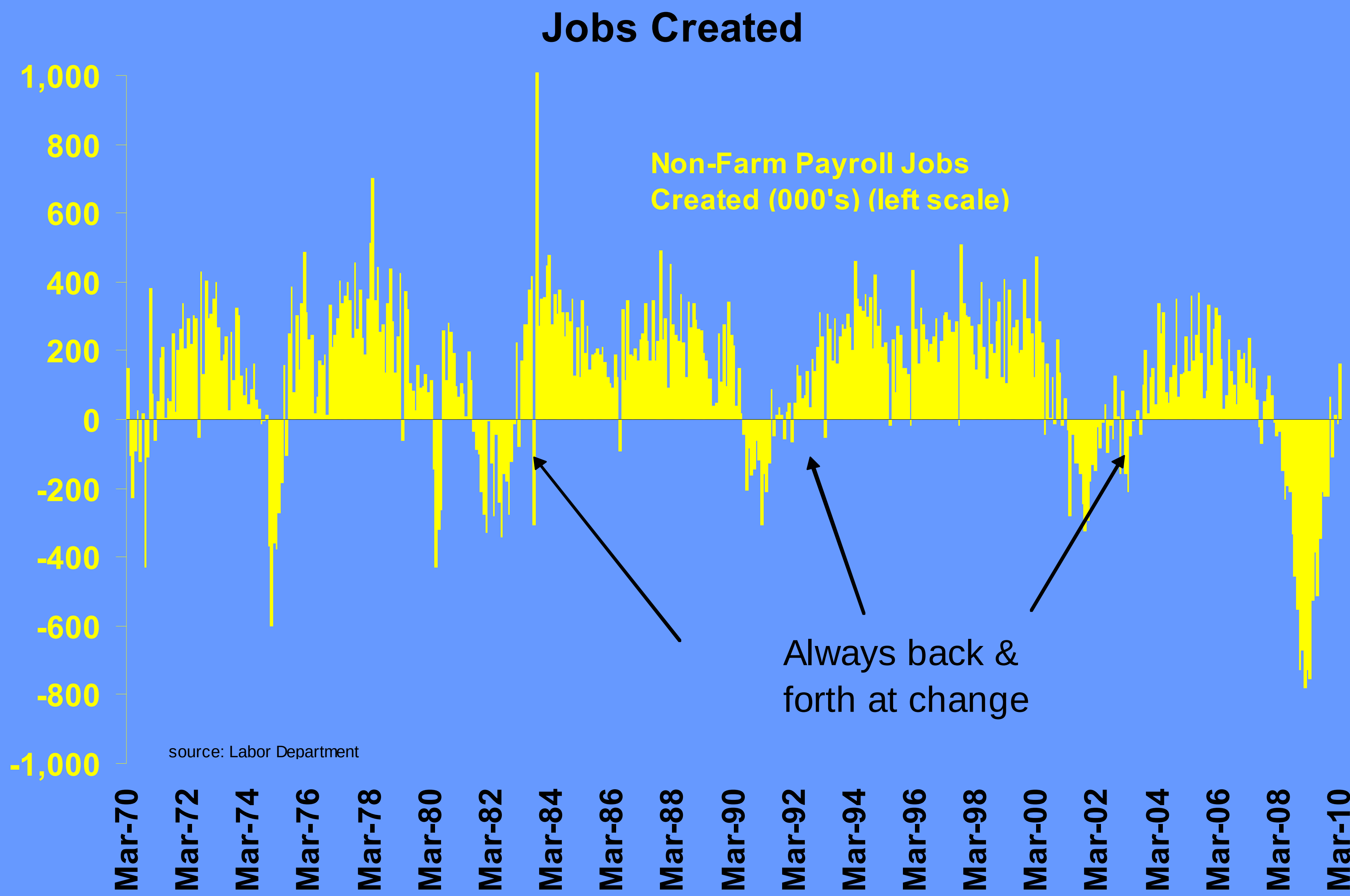
Employment

Jobs Created and The Unemployment Rate



source: Labor Department

Employment



Jobs Created
1,000
800
600
400
200
0
-200
-400
-600
-800
-1,000
Non-Farm Payroll Jobs Created (000's) (left scale)
Always back & forth at change
source: Labor Department
Mar-70
Mar-72
Mar-74
Mar-76
Mar-78
Mar-80
Mar-82
Mar-84
Mar-86
Mar-88
Mar-90
Mar-92
Mar-94
Mar-96
Mar-98
Mar-00
Mar-02
Mar-04
Mar-06
Mar-08
Mar-10

Employment

We are right on the cusp of steady job growth

- The pattern, and the trend, are right
- Weekly jobless claims approaching 450k level which would indicate job growth
- ISM employment index now >50
- Unemployment peaked at 10.1% in Oct, now 9.7%-temp. gets worse as unemployed job seekers re-enter job force
- 6/7 mos. had positive job growth
- Fed signaling

Bankruptcies also lag

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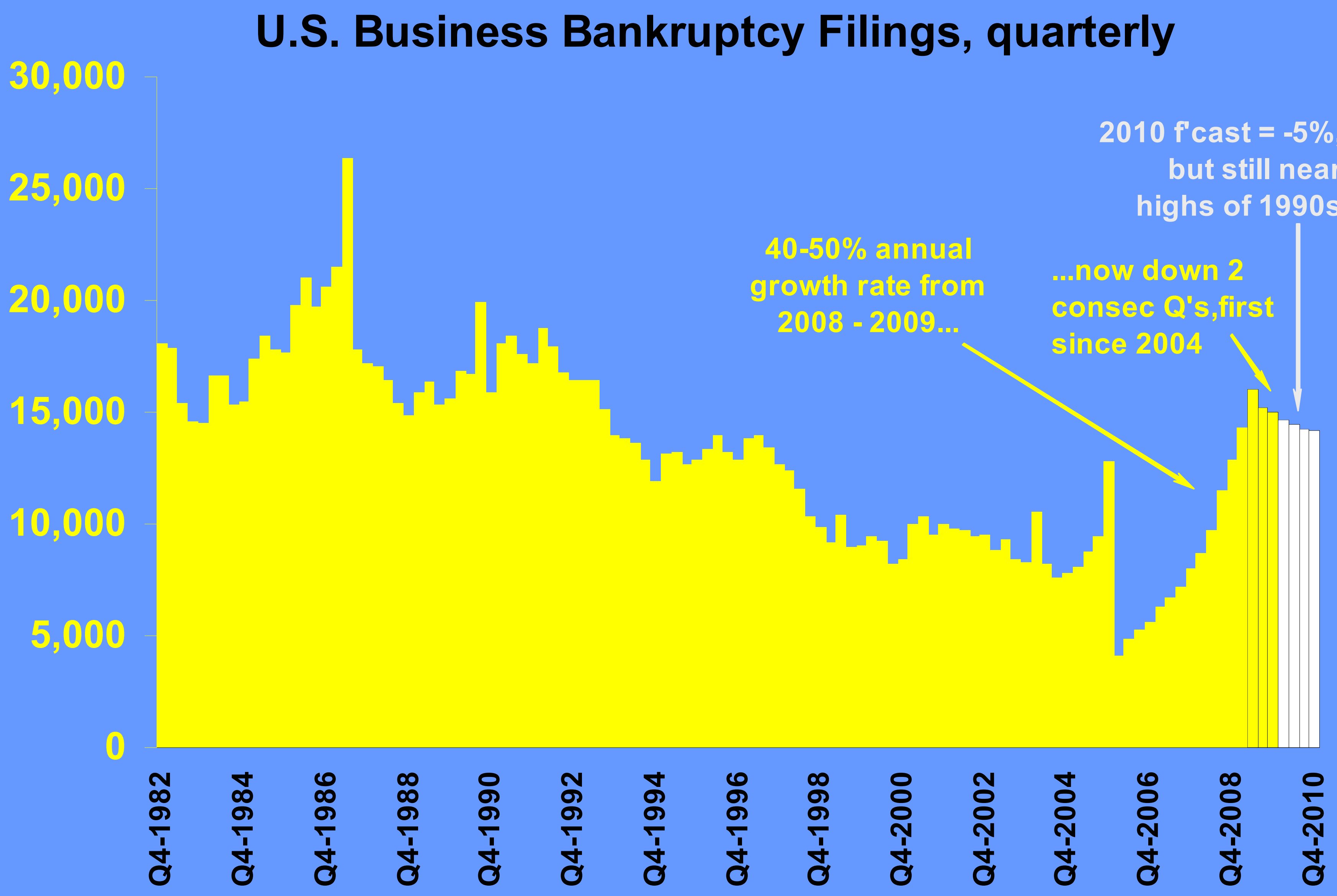


recap

Recap

- 4 forces caused recession, now helping recovery
- Consumer, manufacturing sectors positive and improving
- Employment lagging but getting better
- Bankruptcies lagging but getting better
- On to Inflation, the future, conclusion

INFLATION

Inflation

Simple example

Today:
Lend $1 @10%. Loaf of Bread costs $1

Inflation goes to 20%

A Year later:
Creditor gets $1.10 back.
But now loaf of bread costs $1.20.

Creditors lose.
Debtors like the U.S. government, win.

Inflation

Several types of inflation:

- Consumer price inflation - bread
- Money price inflation - interest rates
- Commodity price inflation - oil
- Asset price inflation - stocks, houses

No inflation now, but tremendous inflationary pressures in pipeline

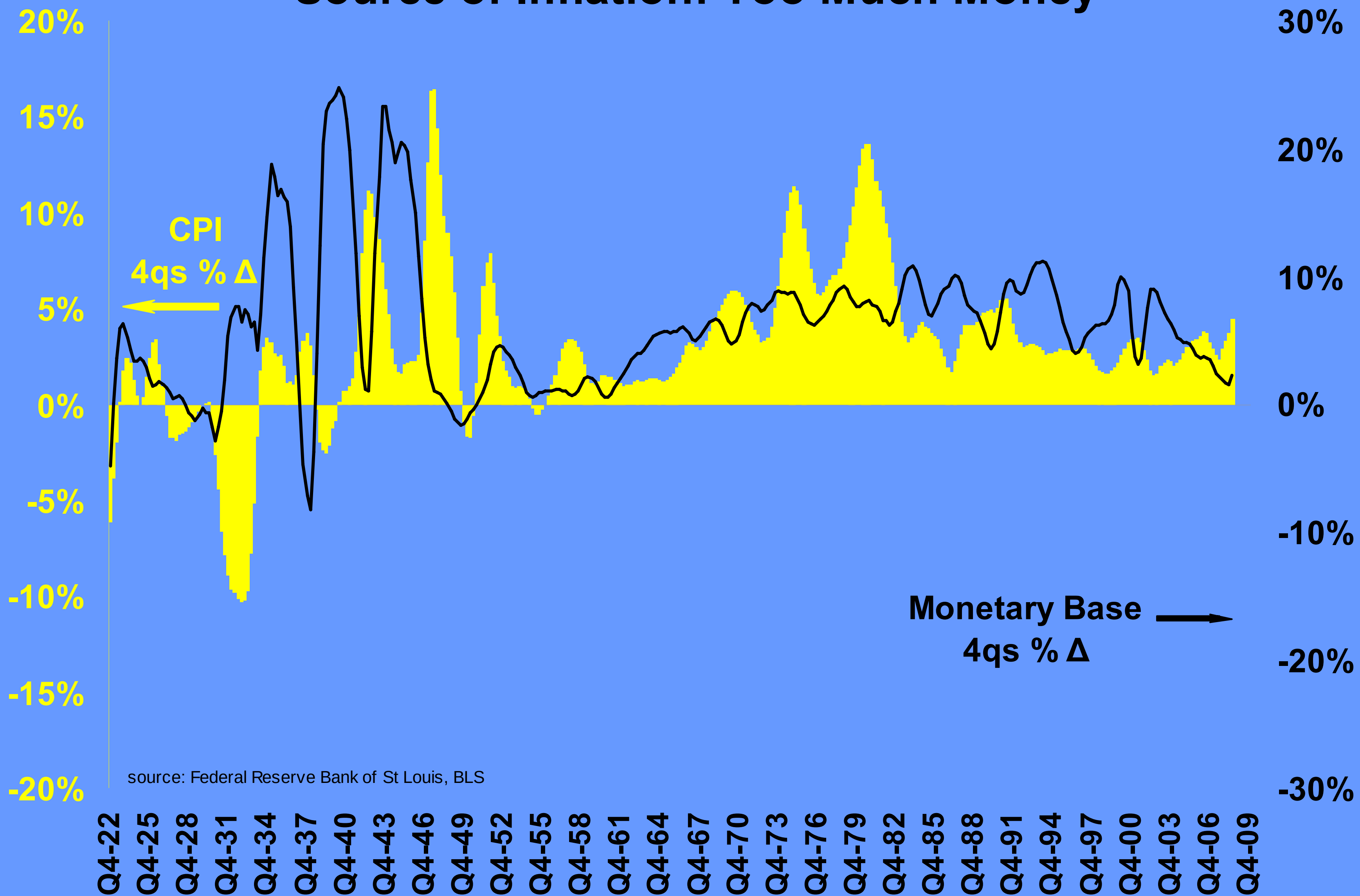
Monetary policy (Takes 3-5 Q's to work!)

- **Bernanke is student of the Great Depression - move big and move fast**
- **Slashed FF rate to 0%**
- **Invented many schemes to create liquidity**

Fiscal Policy

- **$150B stimulus in 2008: tax rebates**
- **$787B stimulus: lower taxes, increase spending – can work.**
- **But it's a terrible sham - 75% will be spent <u>after</u> the recession! Inflation, deficit, debt.**

Source of Inflation: Too Much Money



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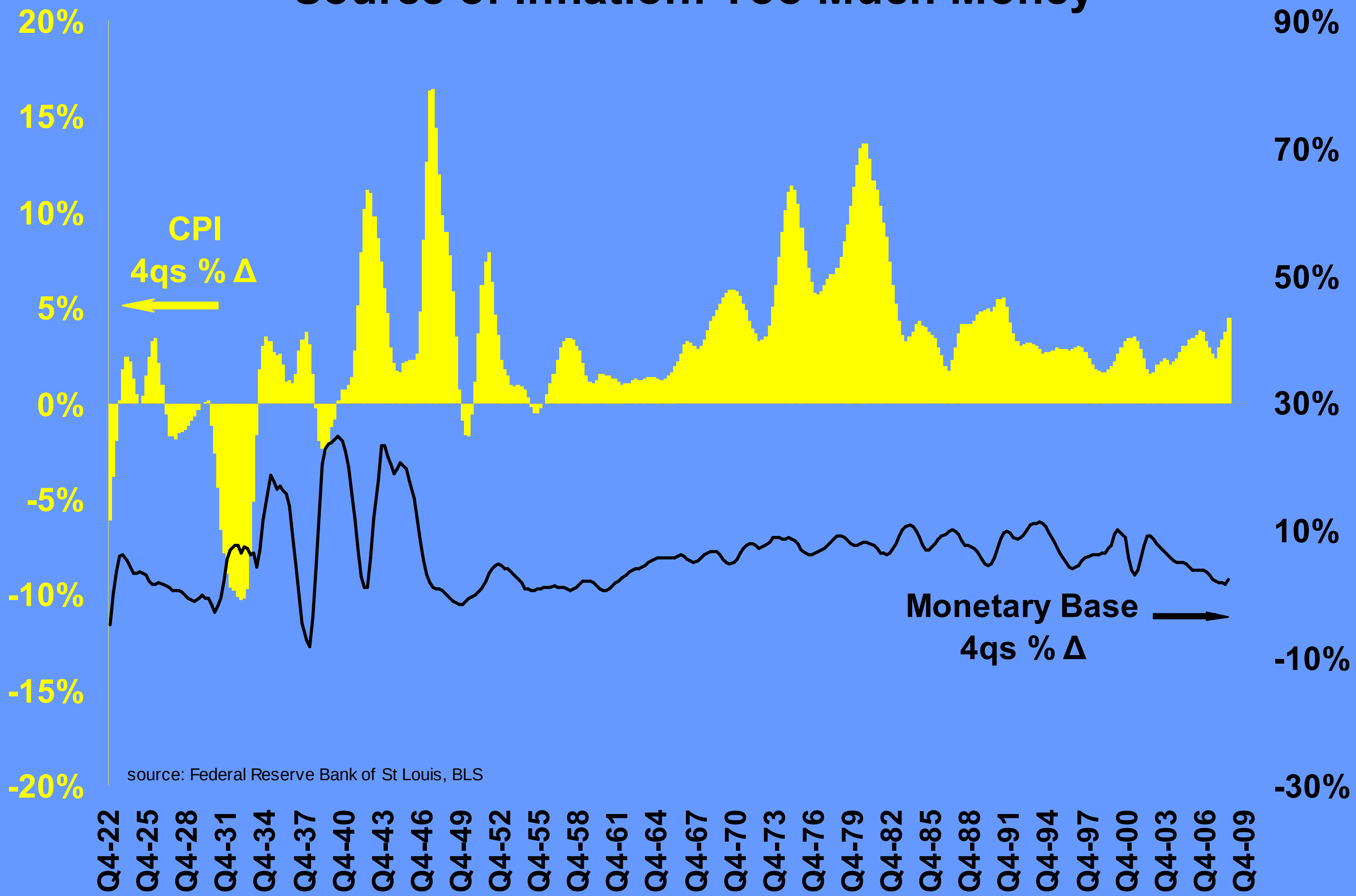

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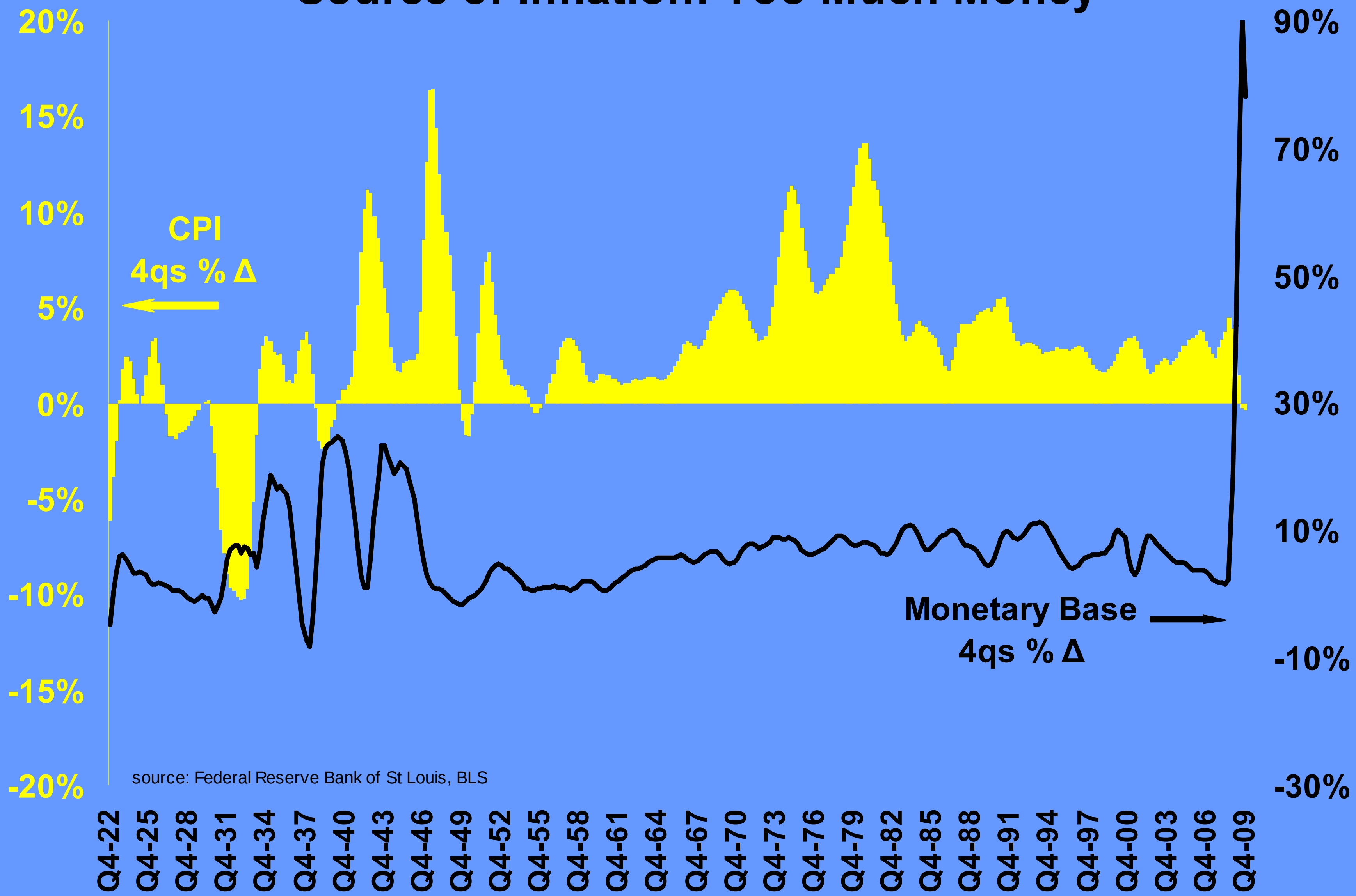

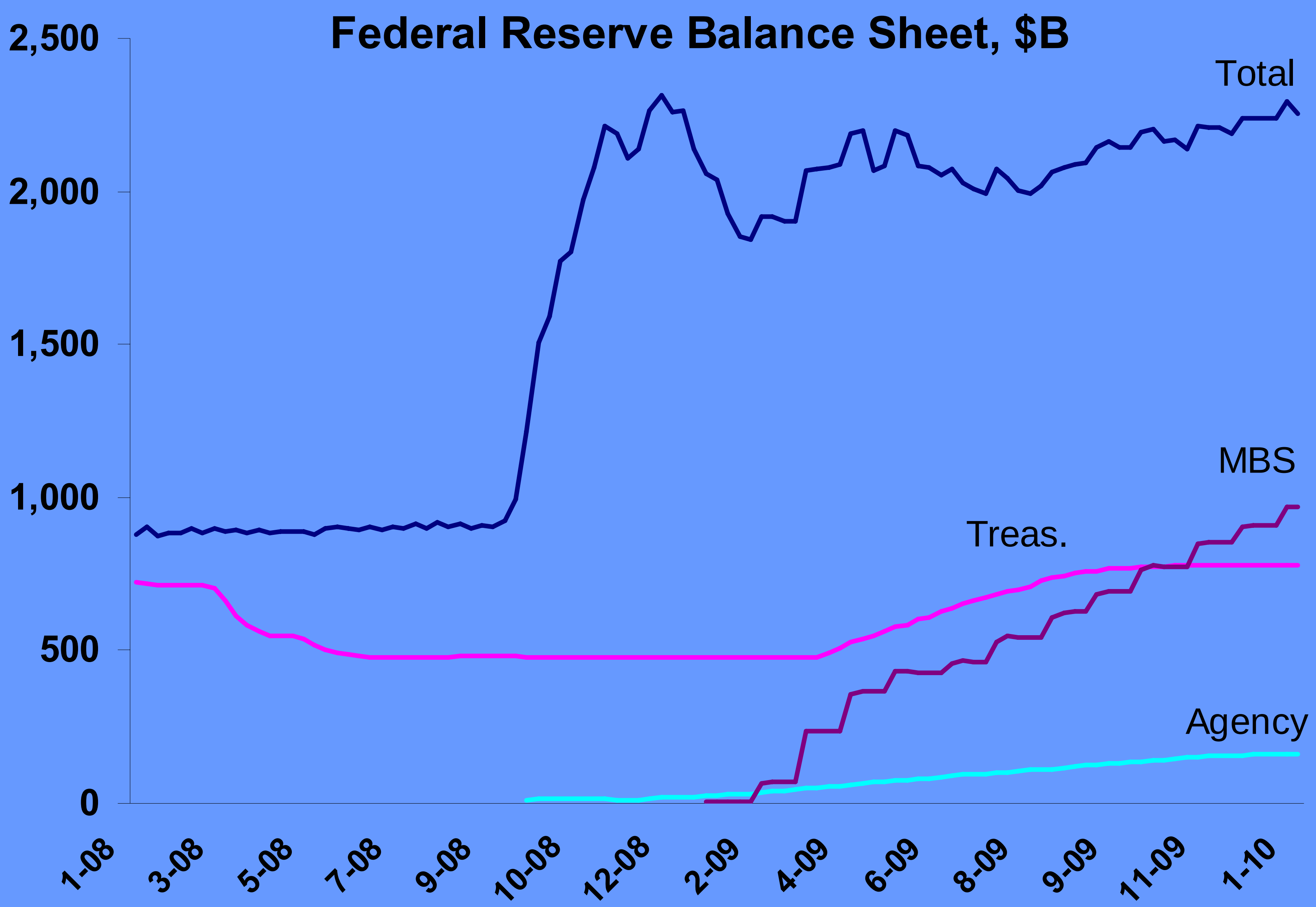
Federal Reserve Balance Sheet, $B
Total
MBS
Treas.
Agency
2,500
2,000
1,500
1,000
500
0
1-08
3-08
5-08
7-08
9-08
10-08
12-08
2-09
4-09
6-09
8-09
9-09
11-09
1-10

Subtle Signals

August FOMC meeting: "…important to continue communicating that the Fed… has the tools and willingness to begin withdrawing monetary policy accommodation…"

•Late September: mention reverse repos
•Late October: "It's only a test.."
•November FOMC: reducing agency debt purchases
•December: Time Deposits
•February: Interest on Deposits, Discount window, Treasury program

So the tightening will happen because…

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Here's what happens if you print a bit too much money:

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6

German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6
Jan 1923	2,785
July 1923	194,000
Nov 1923	726,000,000,000

Zimbabwean Hyperinflation

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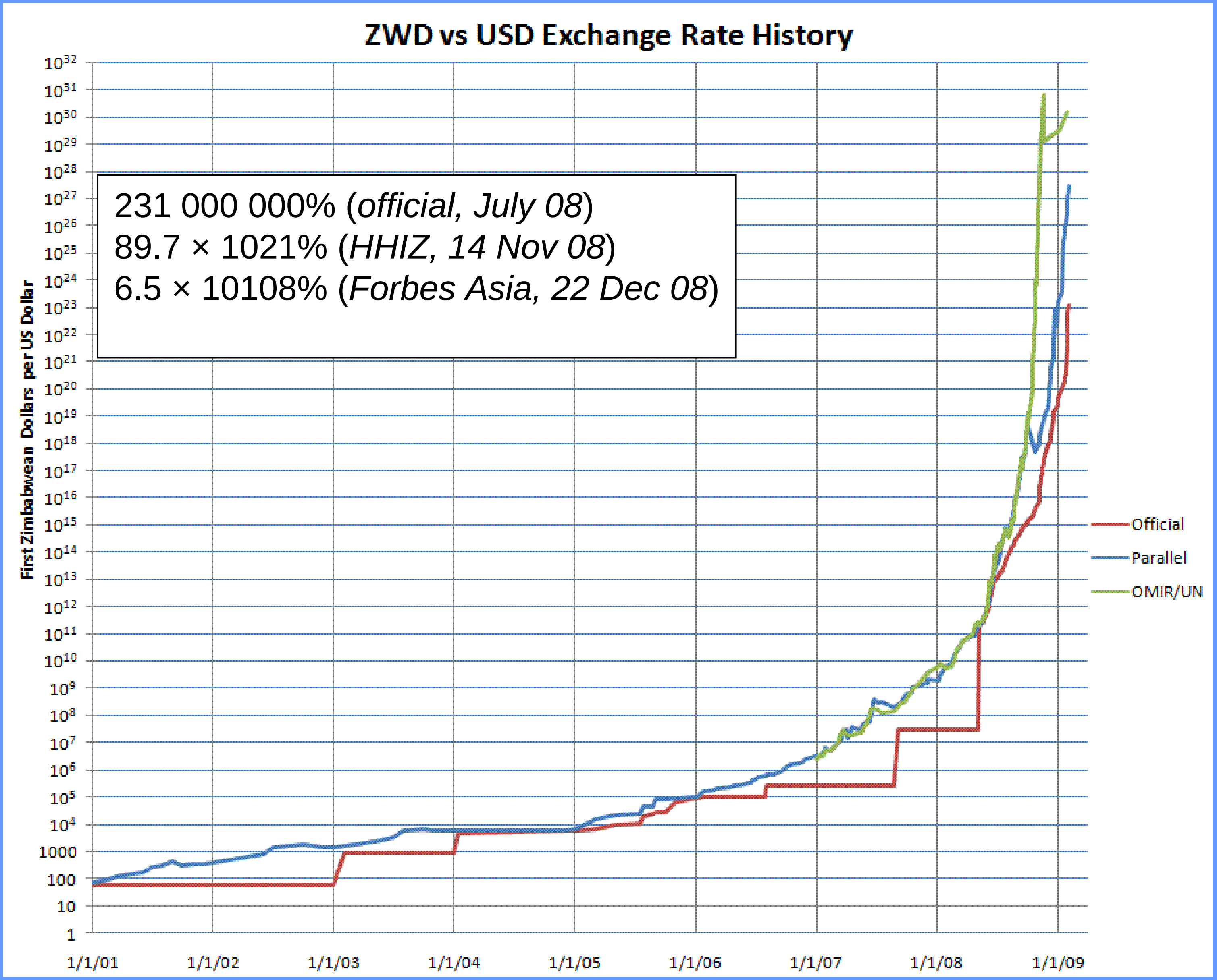


$250,000,000

The Fed is unlikely to let that happen.

So change in balance sheet and public statements are starting to signal gently that it WILL have to come

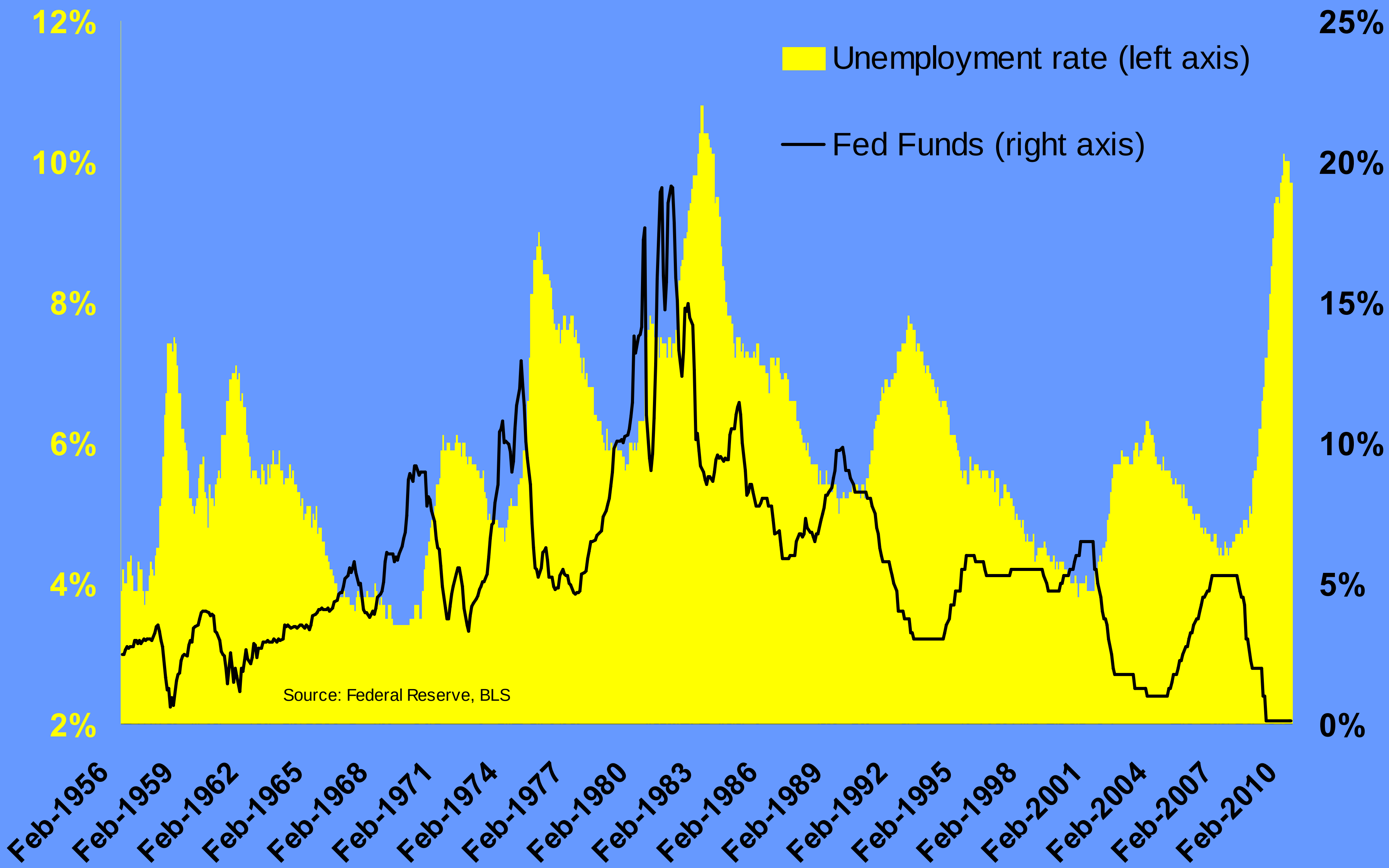
"But there's no sign of inflation and unemployment's high!"

Of course there isn't! That's not the point!

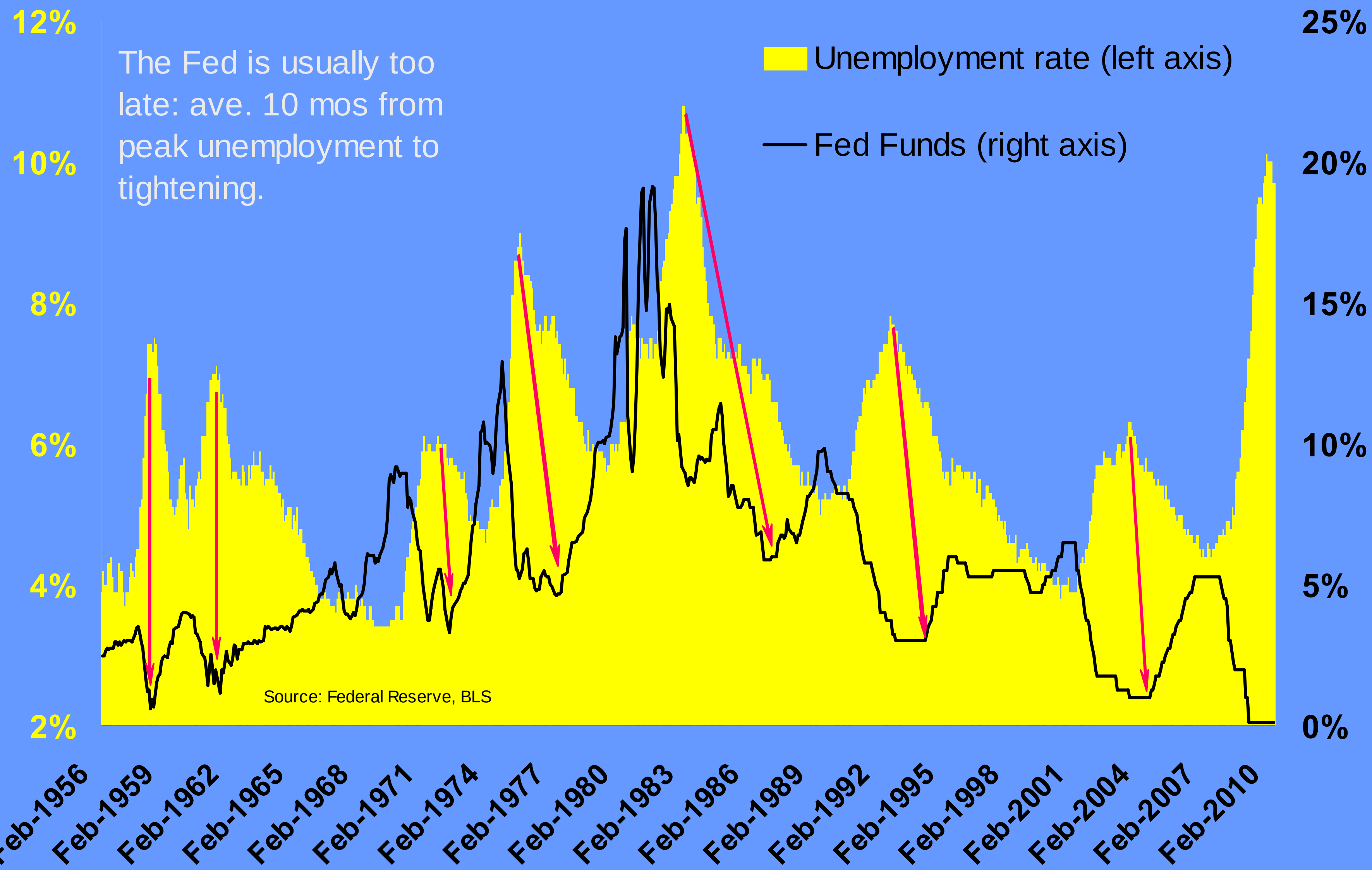
The point is that inflation gets out of hand easily, and it takes a really long time for changes in monetary policy to have full effect; 3-5 Qs.

First note that unemployment peaks around 1-2 Qs after recession ends… about right

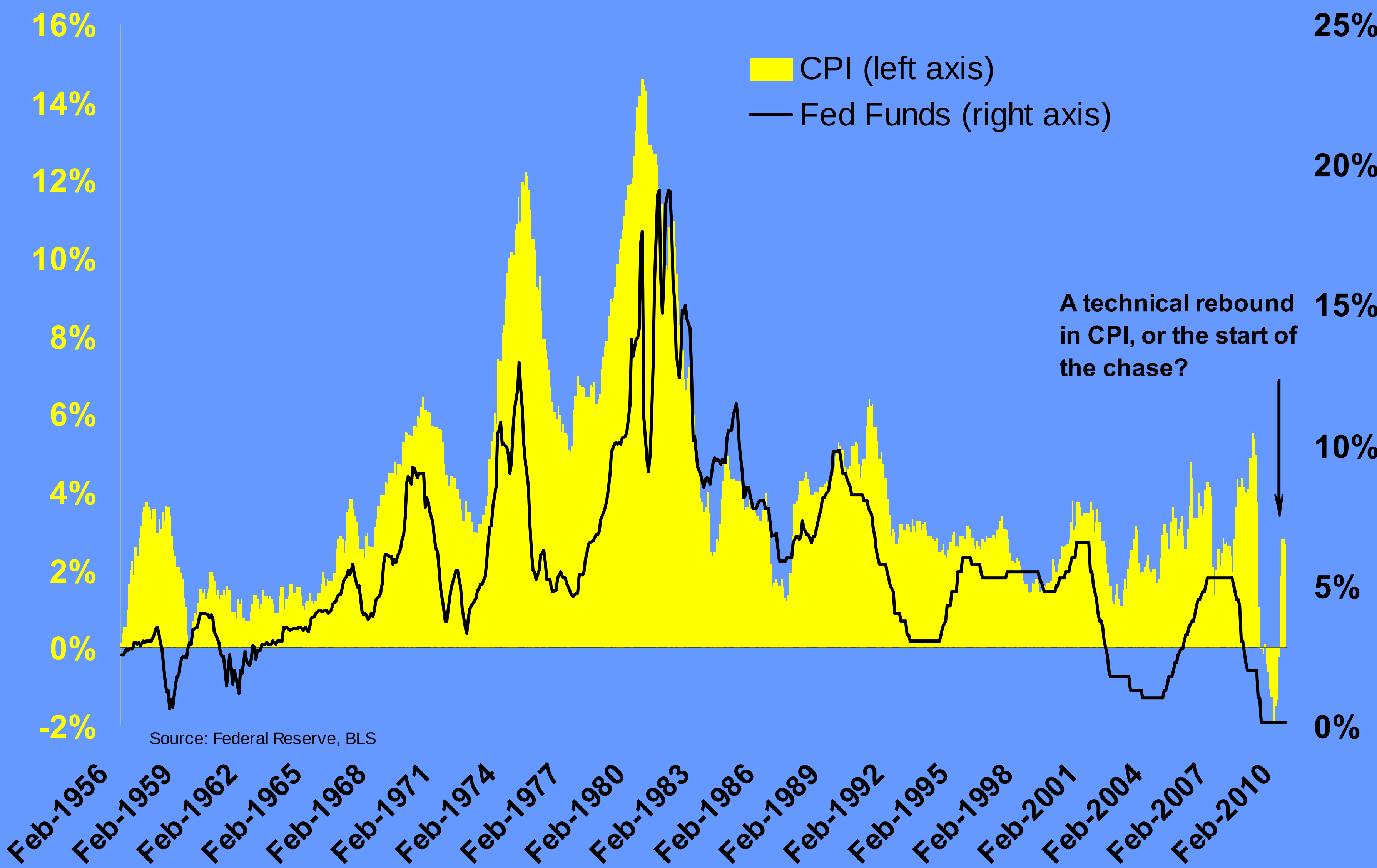
Federal Funds Rate vs Unemployment



Federal Funds Rate vs Unemployment



Federal Funds Rate vs Inflation



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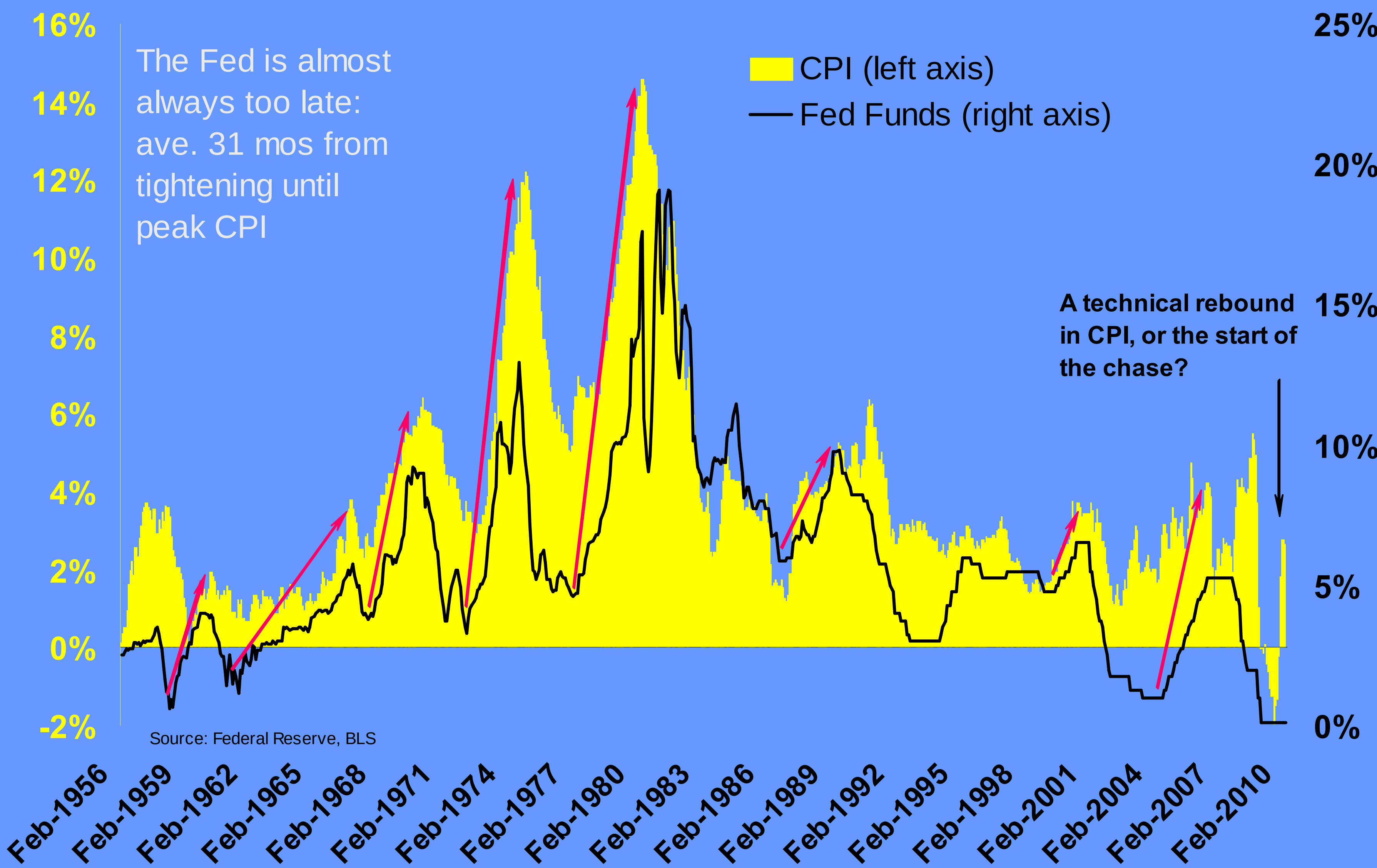

Fiscal Policy

The Federal Reserve Bank at least has a plan to reduce spending and mop up liquidity.

The Federal Government's plan is to spend more, to effectively increase liquidity, and to increase the debt burden.

Spending, Deficits and Debt

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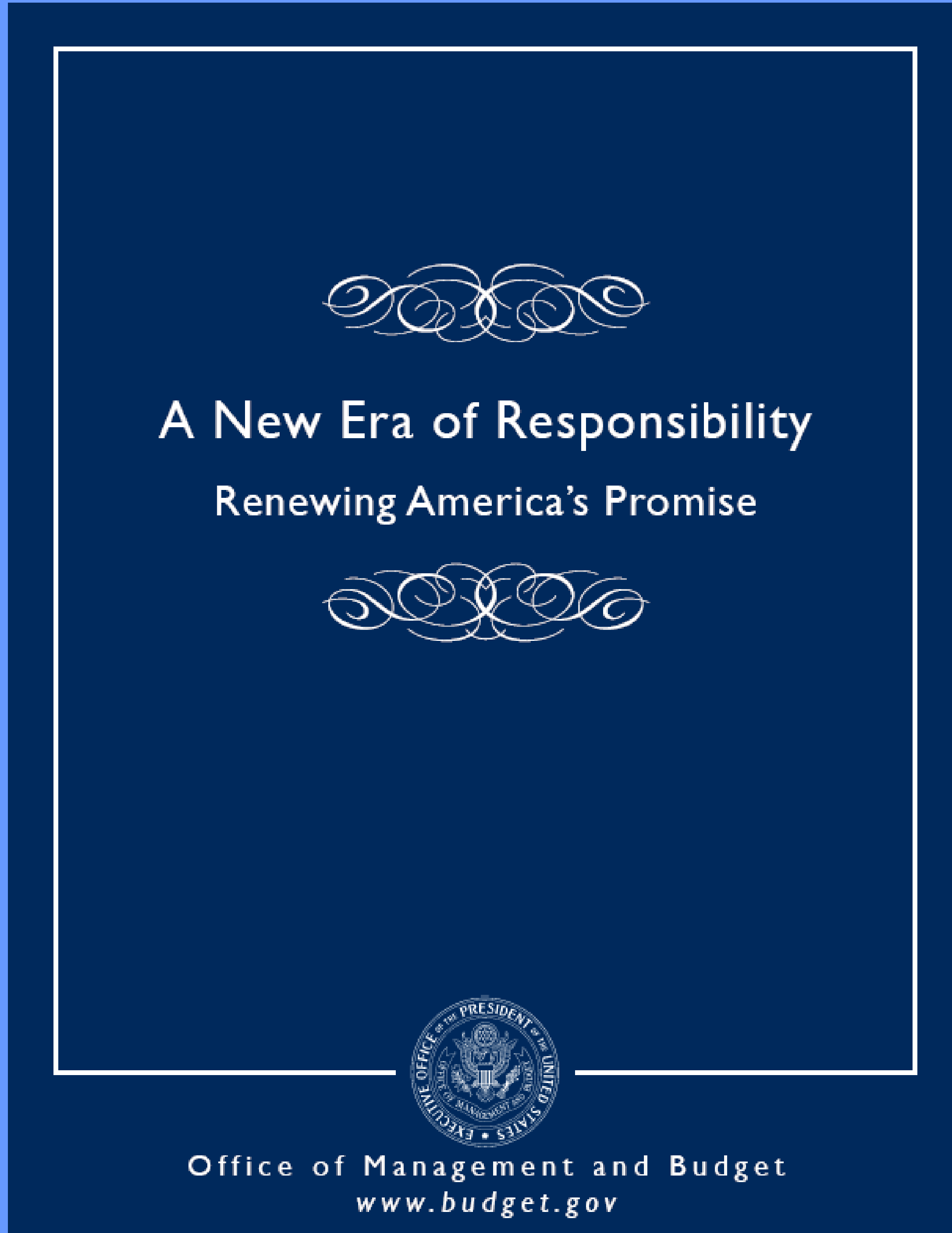
Gov't spends	$120
<u>Gov't gets tax revenue</u>	<u>$100</u>
Deficit	$20

- Treas. gets loan, issues $20 notes/bonds
- Not a Ponzi scheme, no intent to deceive, return is fixed, debt retired, revolving credit



A New Era of Responsibility

Renewing America's Promise

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Budget

of the U. S. Government

Fiscal Year 2011

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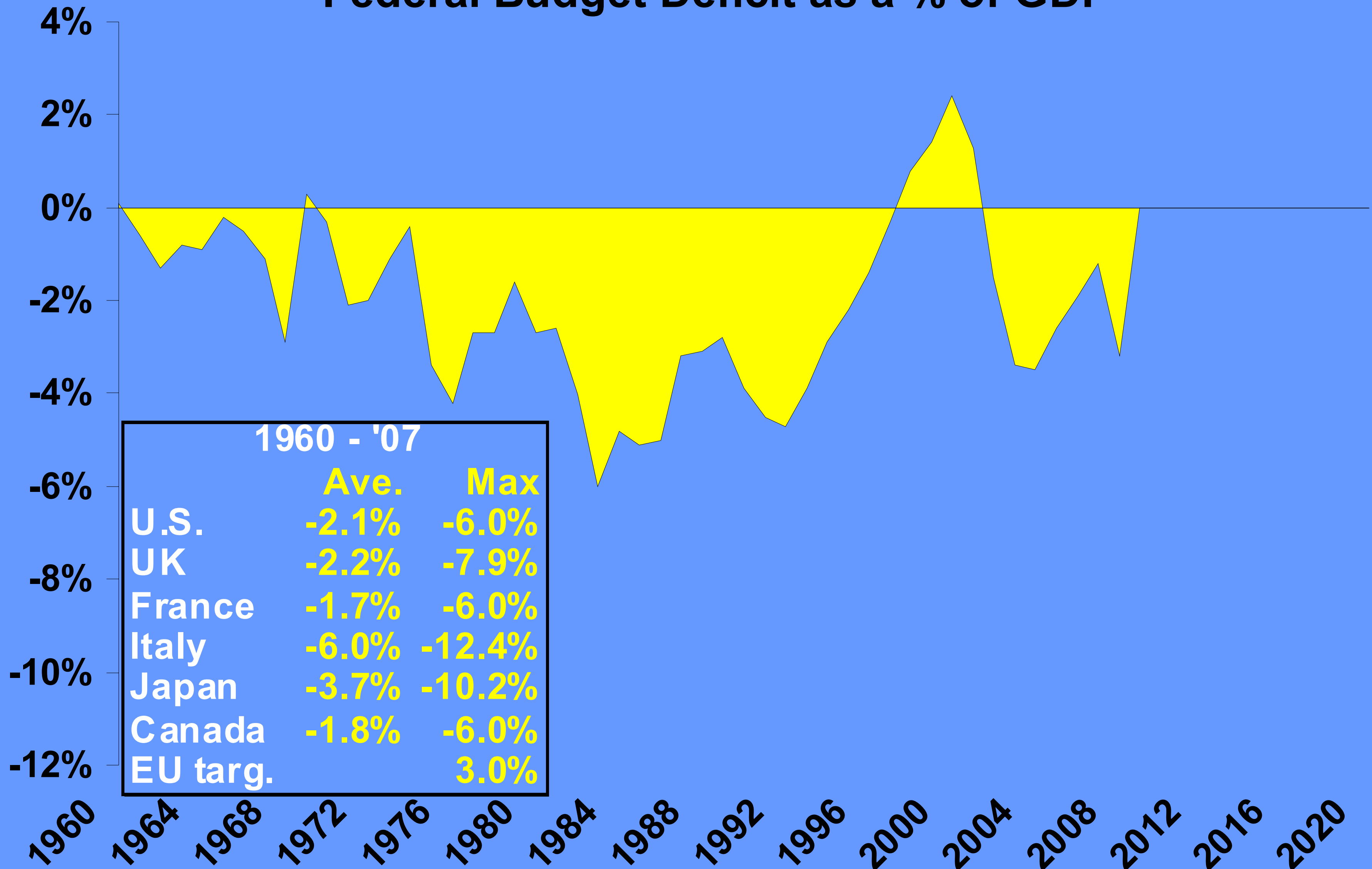
Federal Budget Deficit as a % of GDP



1960 - '07	Ave.	Max
U.S.	-2.1%	-6.0%
UK	-2.2%	-7.9%
France	-1.7%	-6.0%
Italy	-6.0%	-12.4%
Japan	-3.7%	-10.2%
Canada	-1.8%	-6.0%
EU targ.		3.0%

Sources: The Federal Reserve. Congressional Budget Office

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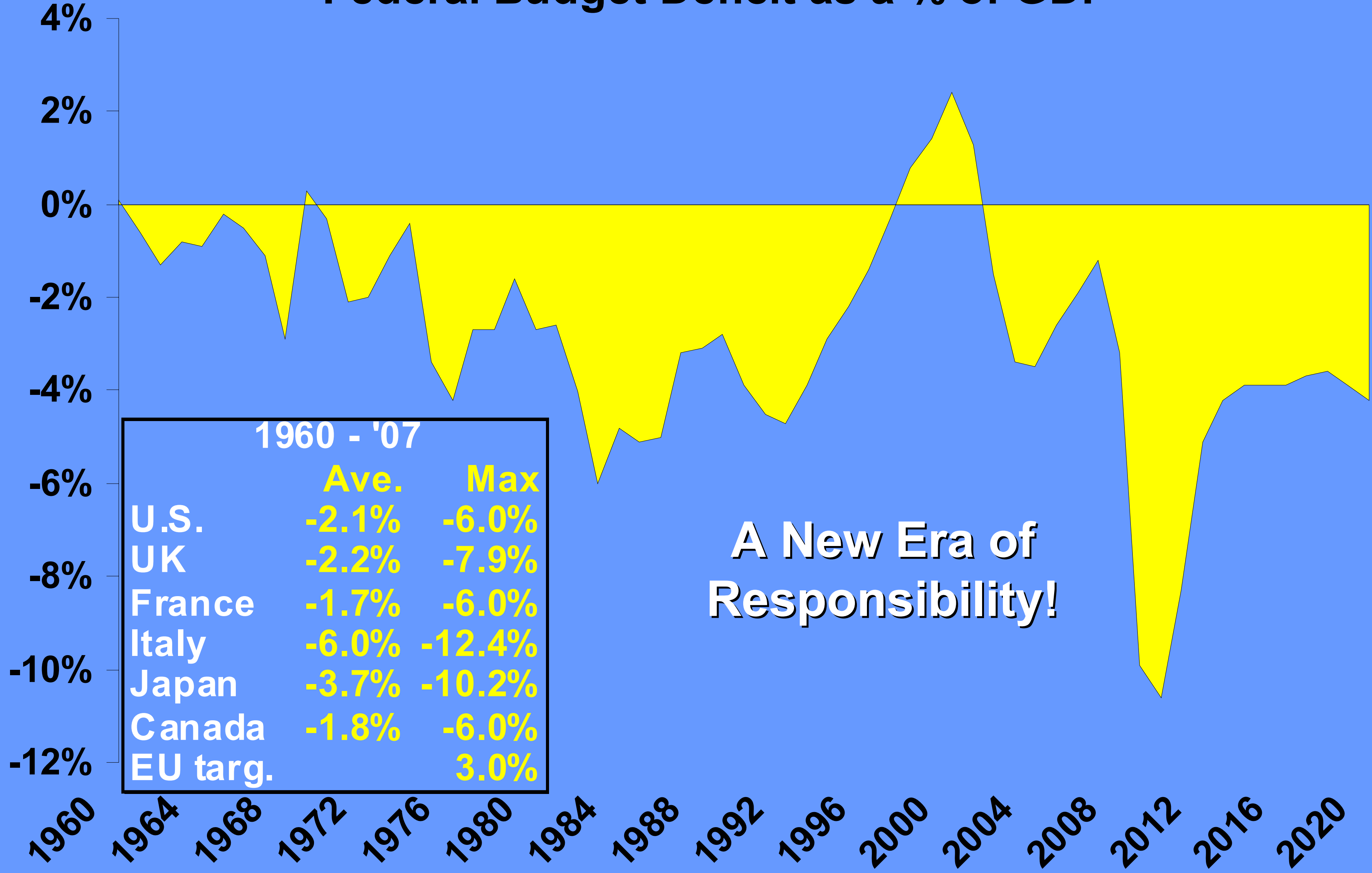
Federal Budget Deficit as a % of GDP



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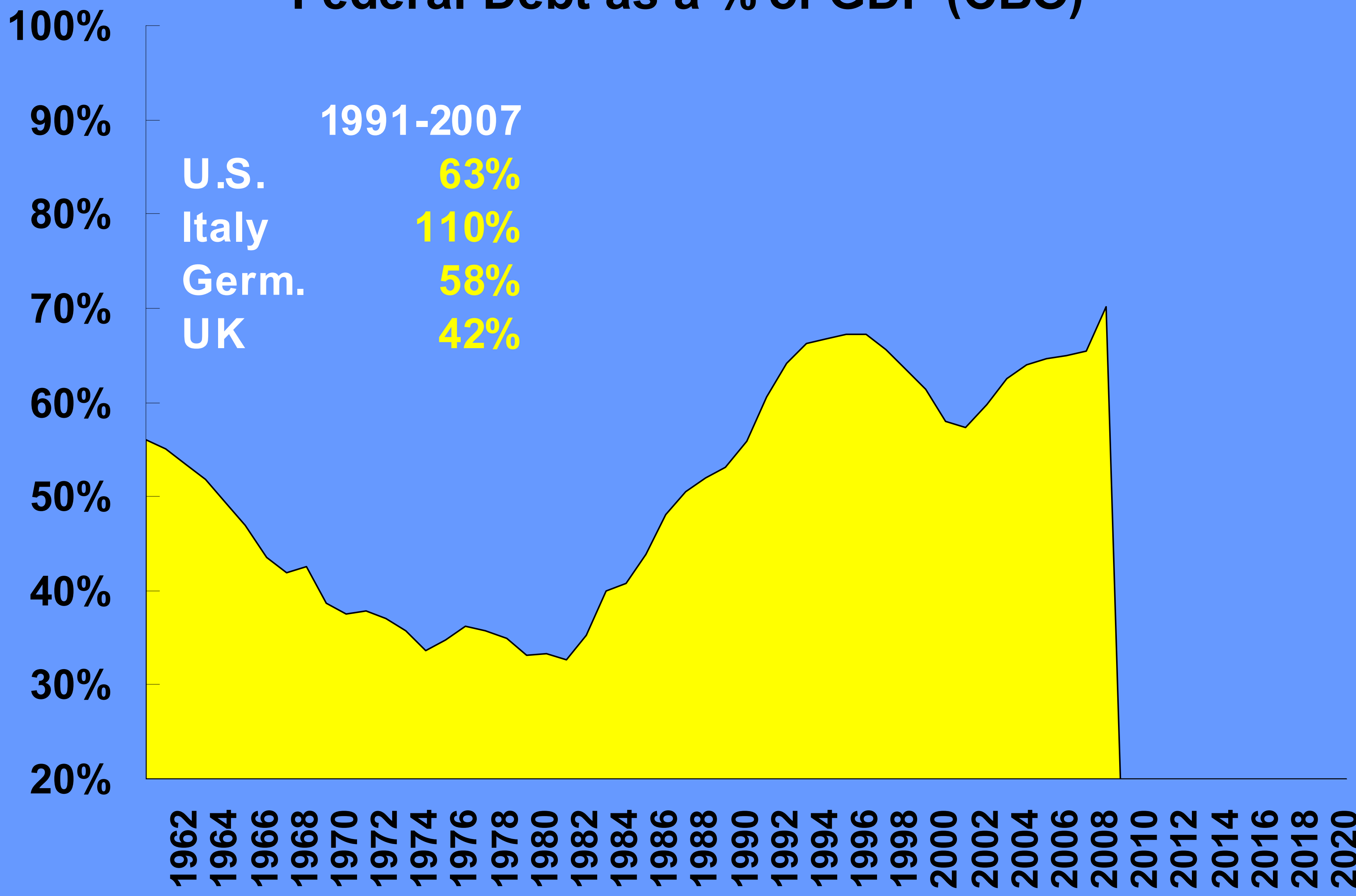
Sources: The Federal Reserve. Congressional Budget Office

Federal Debt as a % of GDP (CBO)



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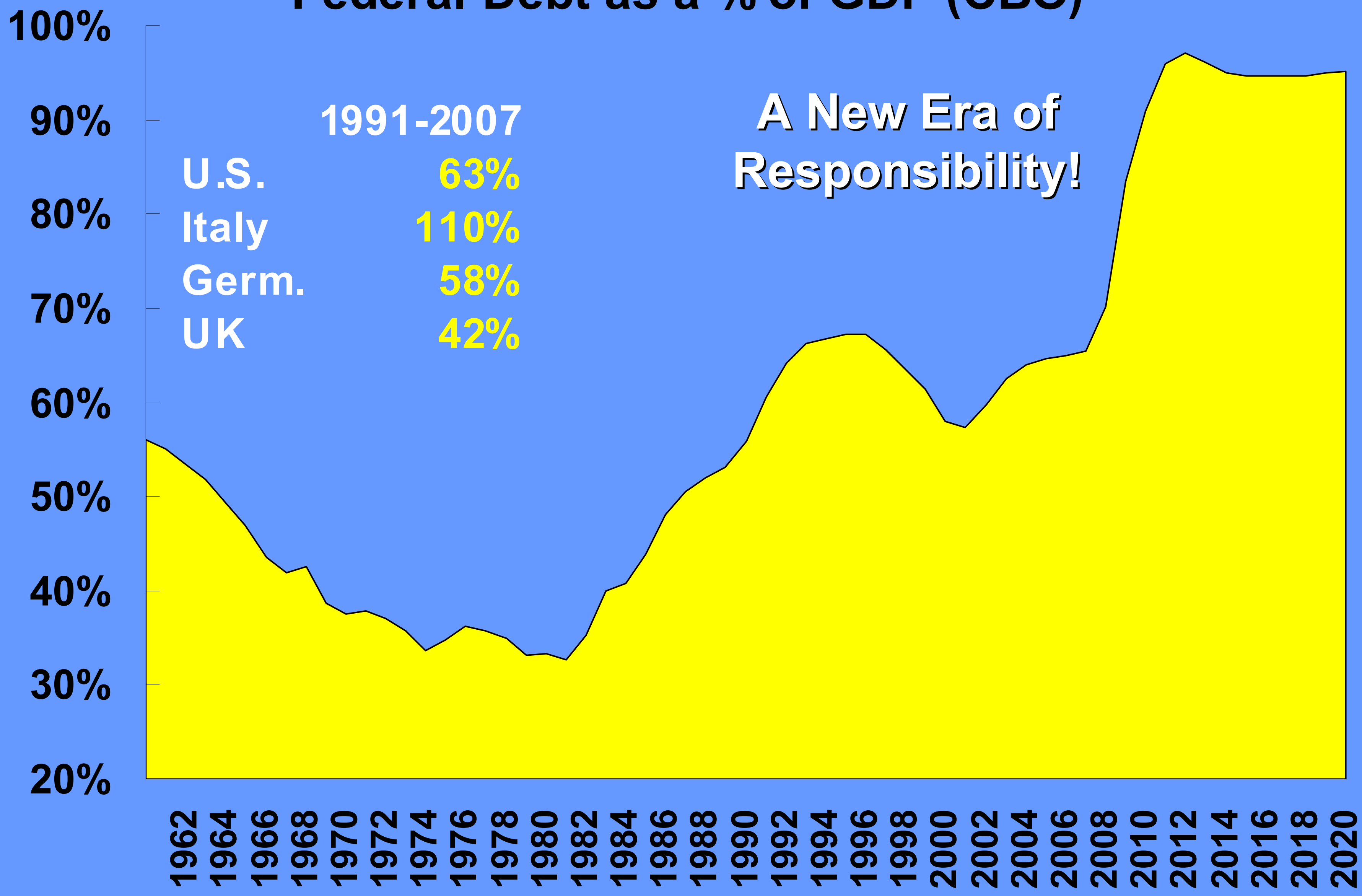

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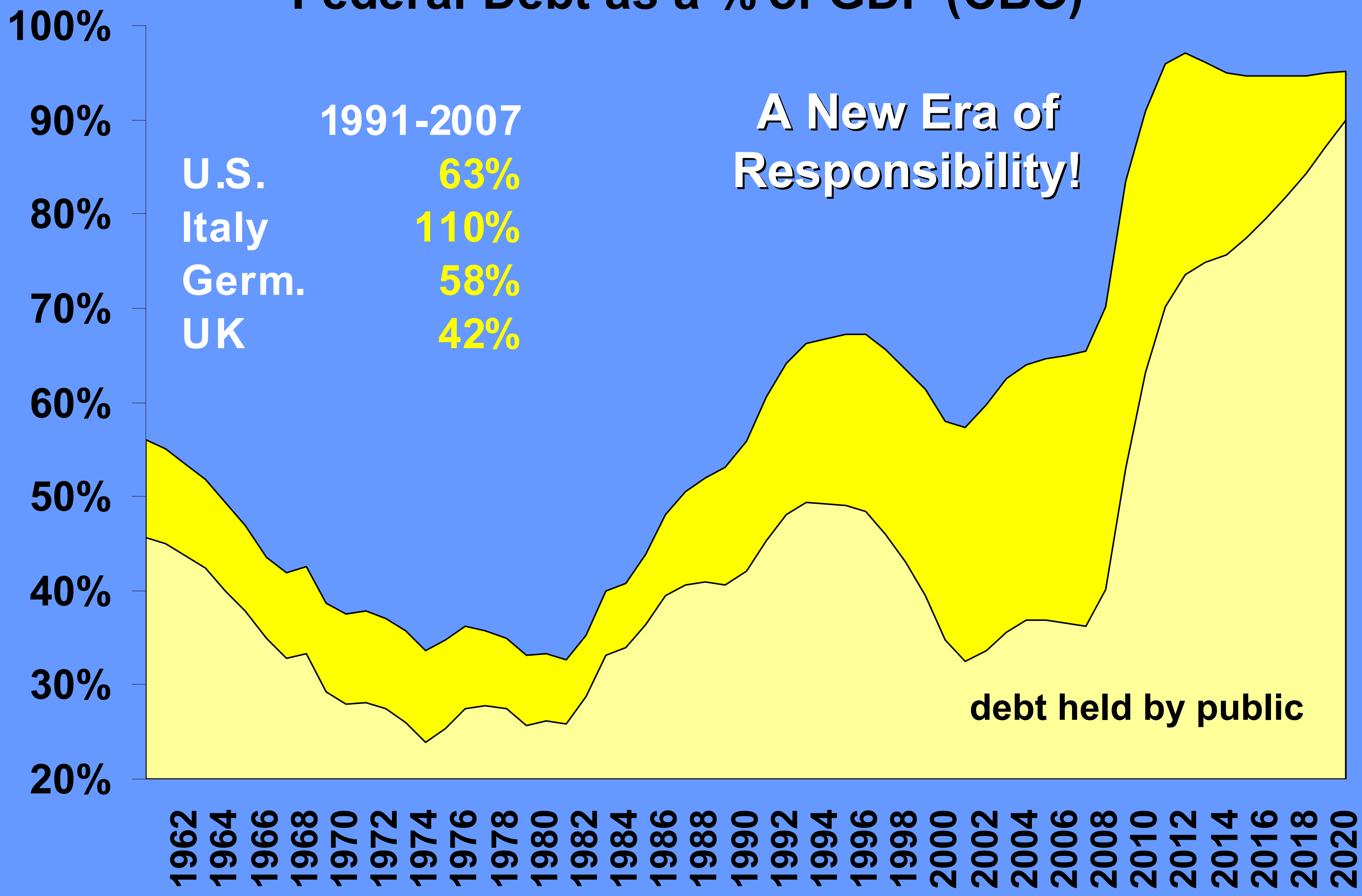
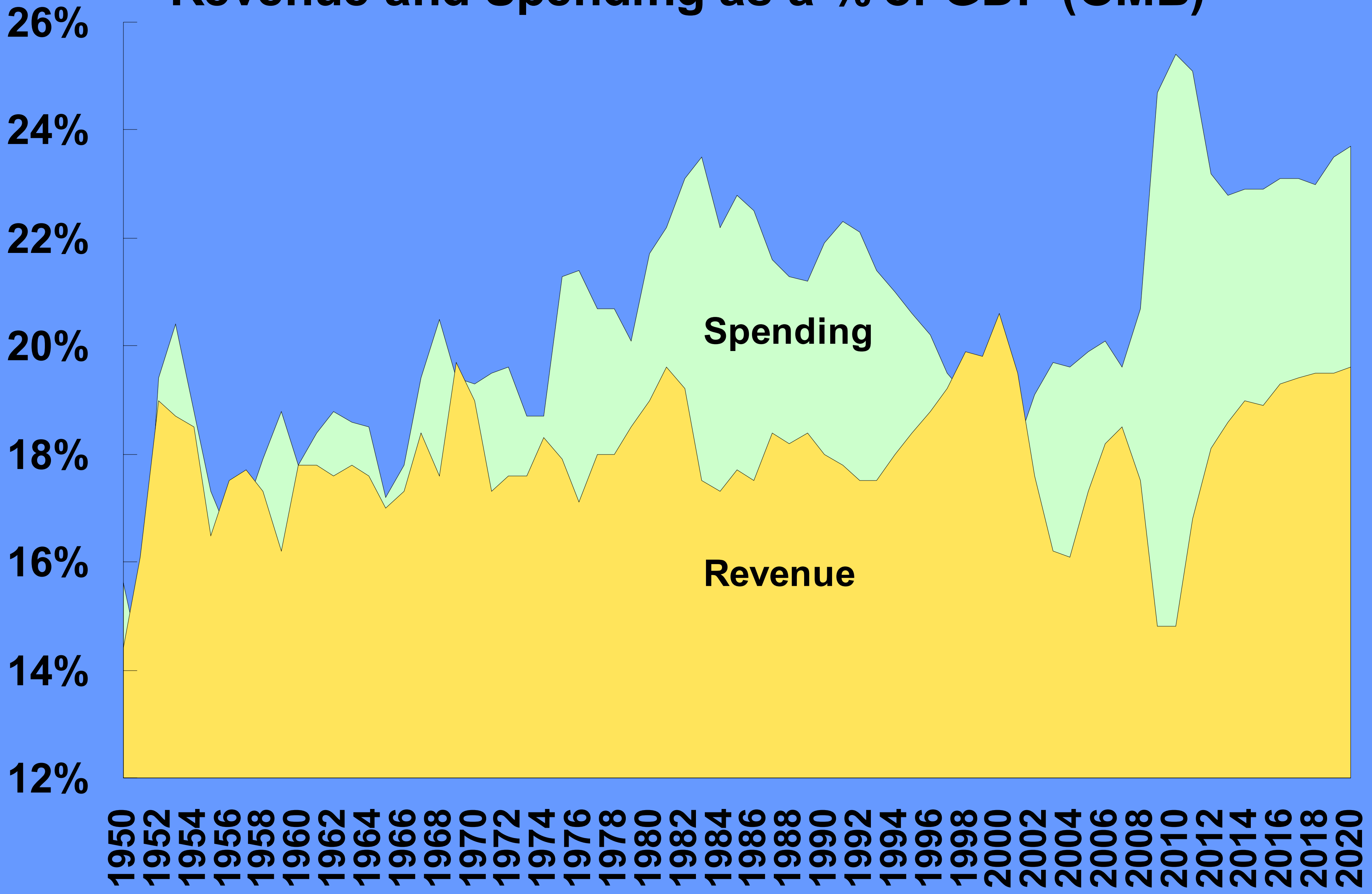


Revenue and Spending as a % of GDP (OMB)



The Fiscal Stimulus

- $787B stimulus spending: several more years, only $333 (42%) has been "obligated", only 35% has been "spent"

- $150B "Jobs Bill"

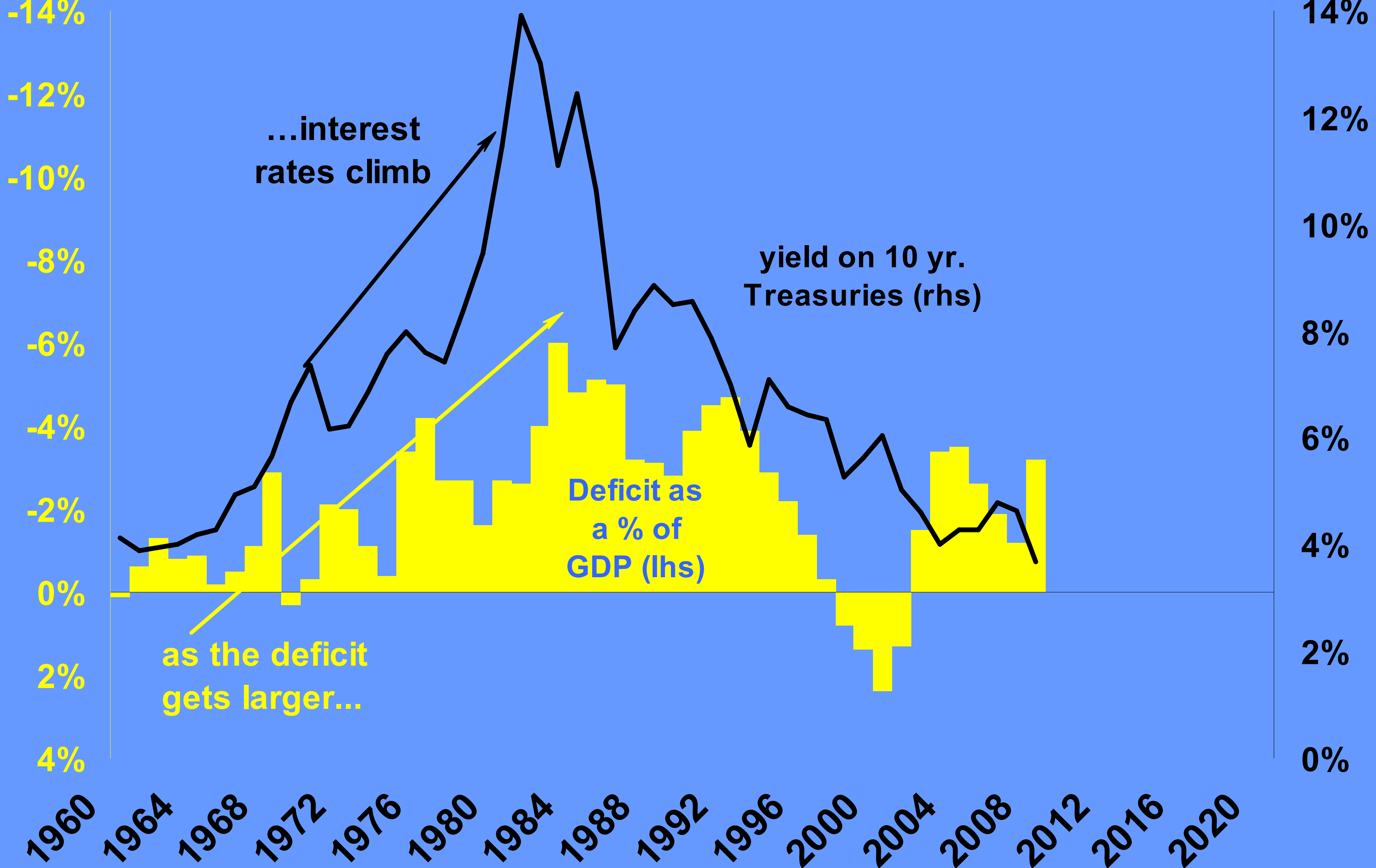
- $25B to state govts to prevent layoffs

- Health Care!

- Note to Congress…

- **Deficit will contribute to Inflation of Consumer Prices**
- **And will really contribute to Inflation of Money Prices; Interest Rates**

"Crowding Out:" The Budget Deficit vs. Interest Rates



Sources: The Federal Reserve. Congressional Budget Office

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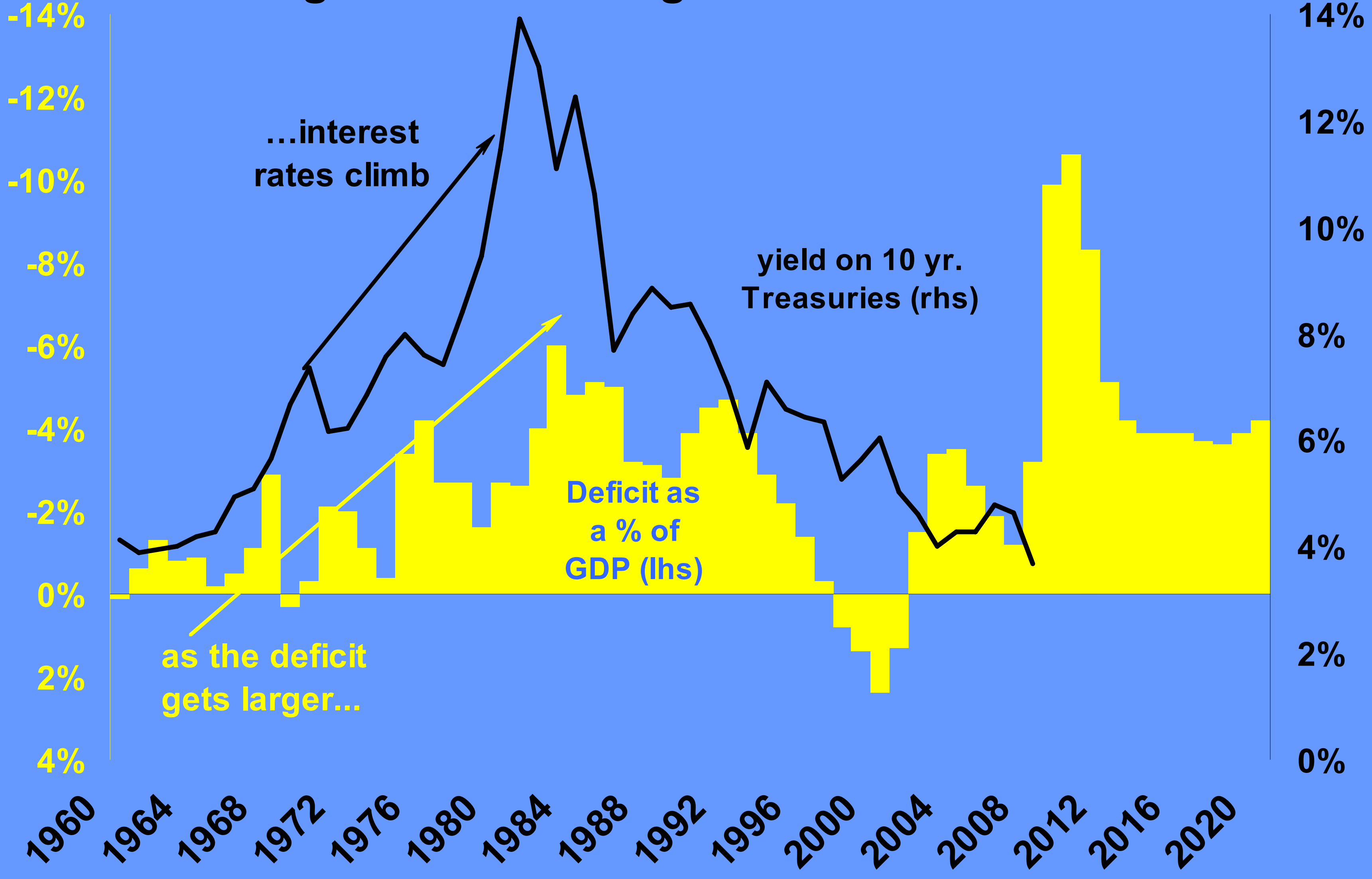

Sources: The Federal Reserve. Congressional Budget Office

Deficits

- Do usually cause money price inflation (interest rates) as just shown

- In this case, massive deficits also likely to cause FX$ inflation – “weak” $...

- Which will lead to commodity, particularly OIL price inflation

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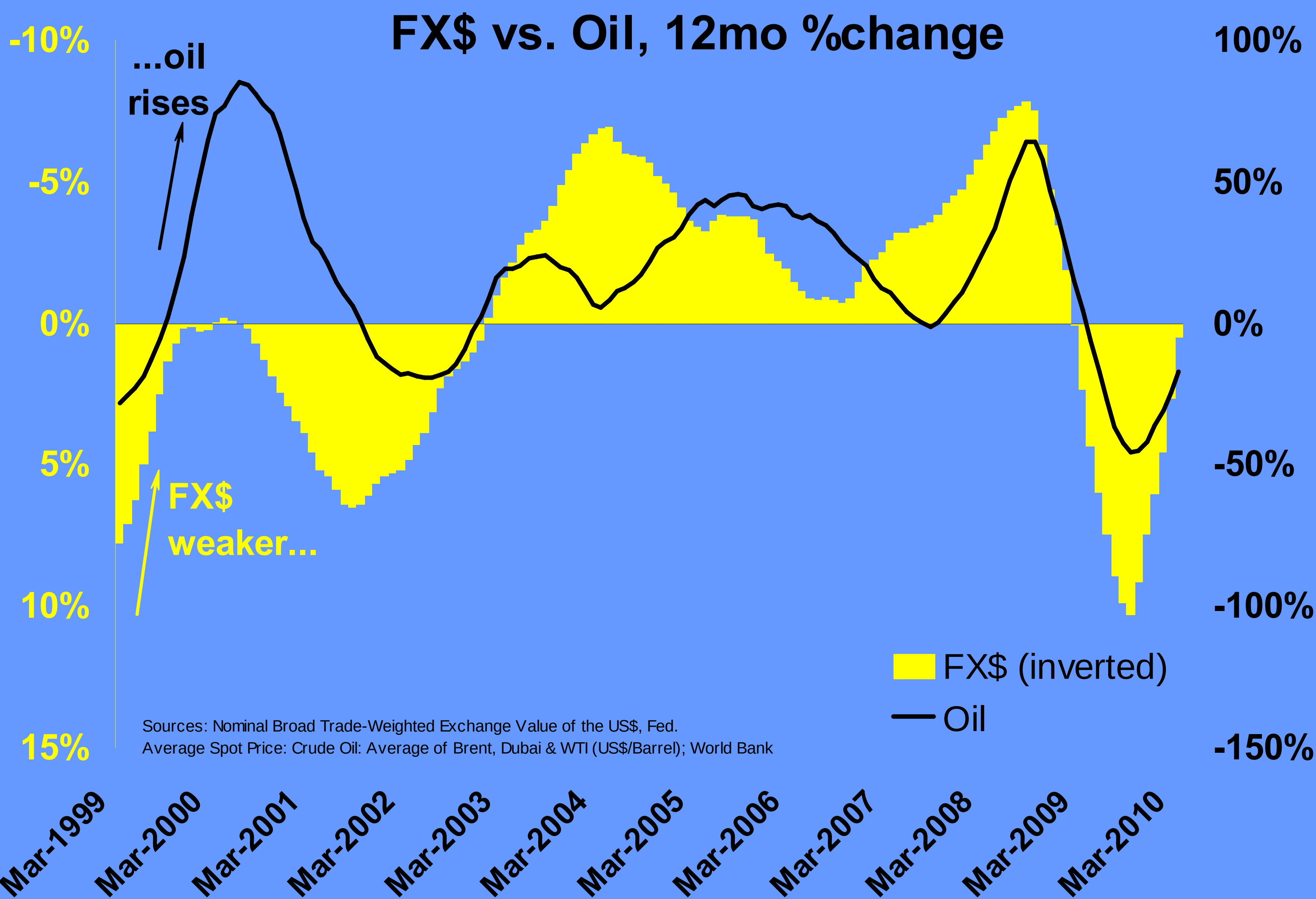


The Trouble With Oil is…

- It may soar on deficits and $FX, but it is probably more likely to soar based on fundamentals
- Its daily supply is fixed but its demand is ever-growing
- It's denominated in US$
- Its use is pervasive
  - $1B/day in US, or around 3% of GDP
  - 85 million bbls produced / consumed daily worldwide. You used 2 gallons of oil today – 1.3 gallons came from foreigners
  - In 1973 we relied on foreigners for only 19% of our oil, but OPEC embargoed us, and drove us into recession. Today, we rely on foreigners to provide 66% of our oil. The outside world could easily crush us.
  - Drilling would be great, but it's a bit out of fashion at the moment.

- So we've seen consumer, interest rate, and commodity inflation.

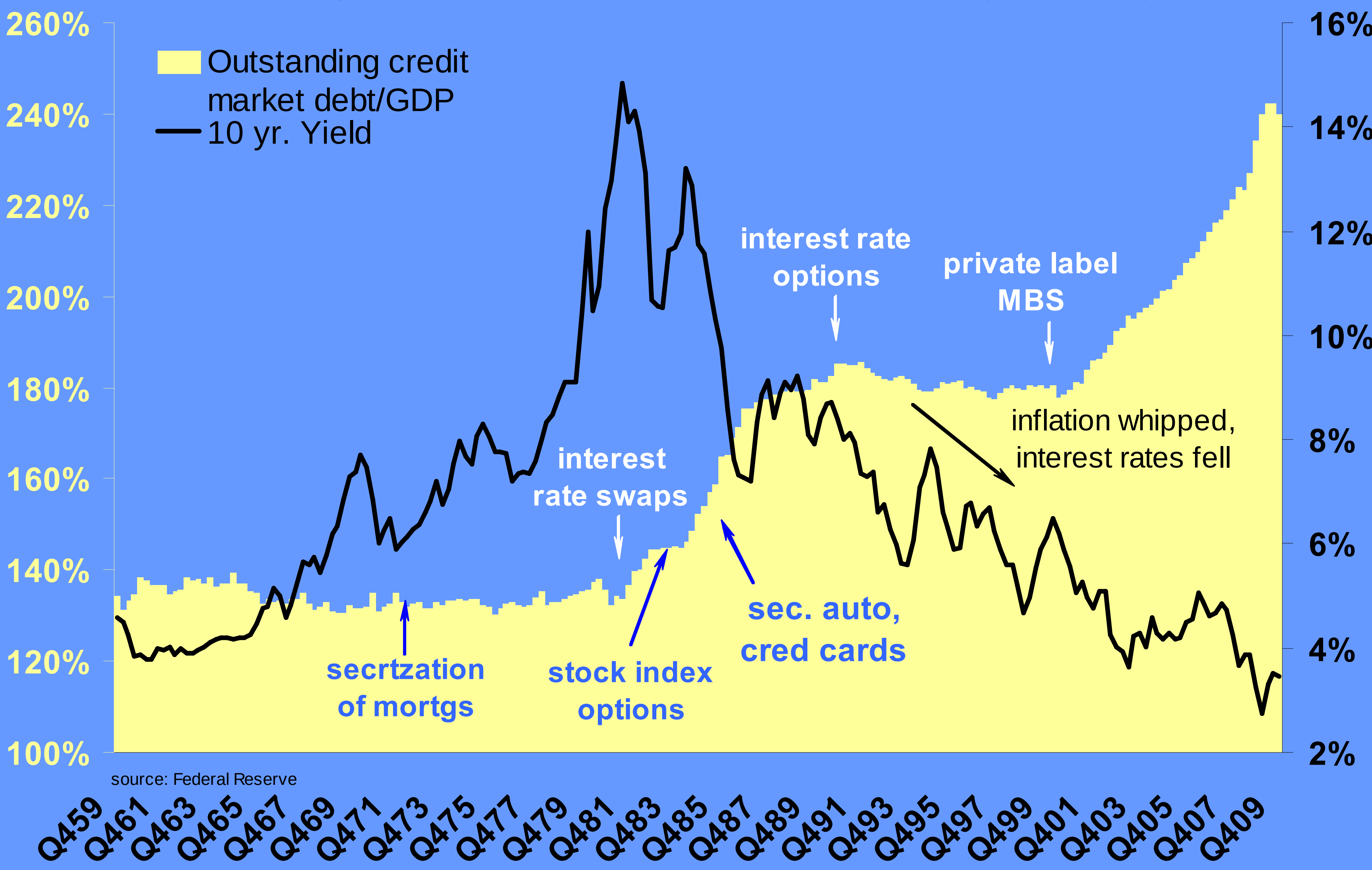
- Final Form of Inflation: Bubbles

- How did that mess just happen?

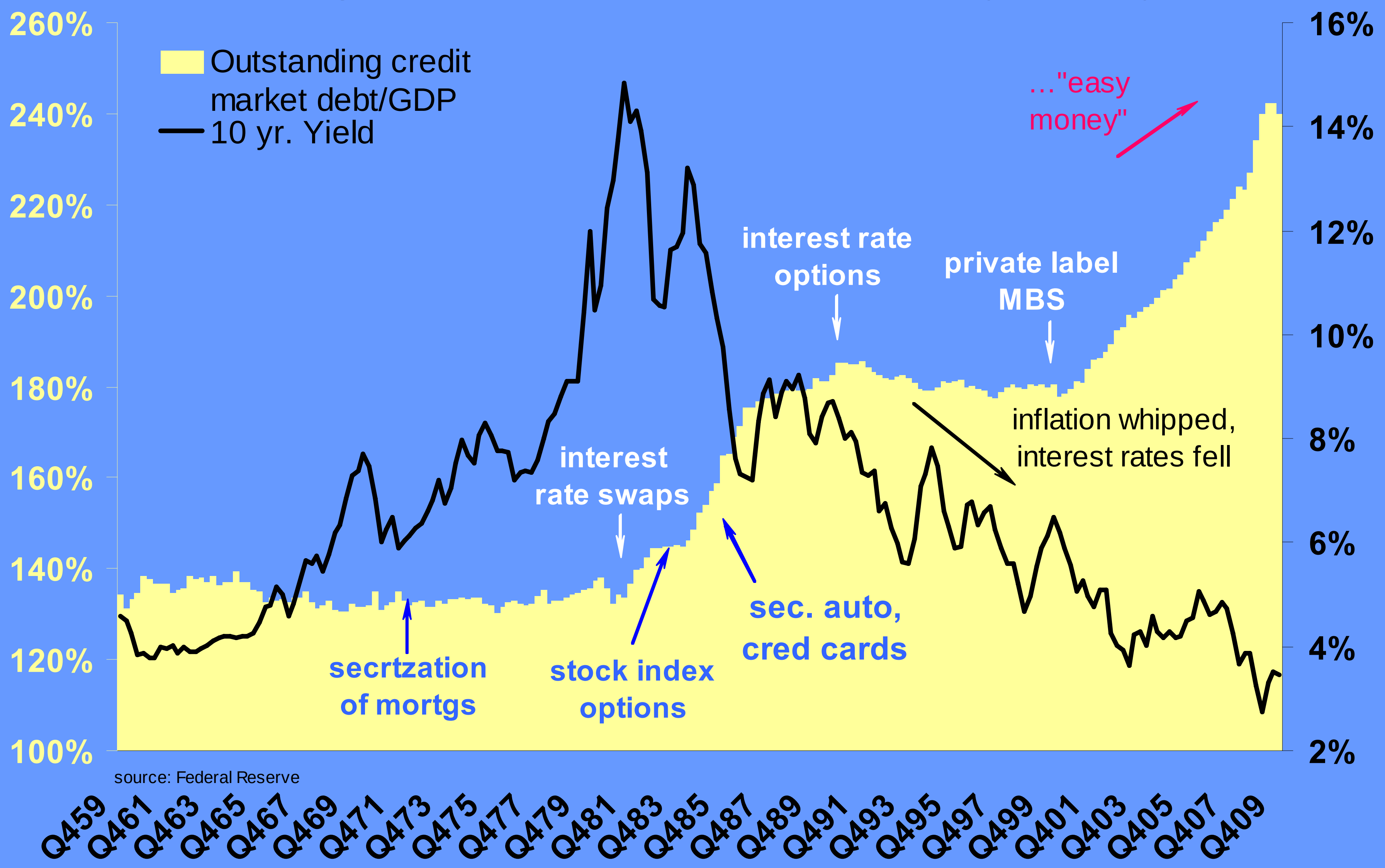
- How did that bubble form?

- How about the one before that?
    - (and China now, and Australia now)

The Big Picture; the Evolution of Easy Money



The Big Picture; the Evolution of Easy Money



But really, who's to blame for the financial crisis?

- Community Reinvestment Act for promoting risky loans
- Mortgage bankers and brokers for making those loans
- People for taking those loans when they shouldn't have
- Fannie / Freddie for providing a market for those loans
- Rating Agencies for being lulled
- Regulators for not paying attention
- Foreigners for lending us too much money
- Investors for creating too much "spec" housing
- Investors for seeking too much risk in MBS

But really, who's to blame for the financial crisis?

- Investors for panicking and paralyzing banks
- Alan Greenspan for inflating the housing bubble
- Ben Bernanke for bursting the housing bubble
- Paulson, Geithner, Bernanke, etc. for bailing out all those banks
- Paulson, Geithner, Bernanke, etc. for <u>not</u> bailing out that one bank
- Congress for not passing TARP
- Congress for passing TARP

- **And most importantly…**

But really, who's to blame for the financial crisis?

•…the Human Condition.

• Humans will always strive to improve their status, and will always take risks to do it.

• That will never change, and no amount of regulation can't stop the need to take risks.

• So this is <u>not</u> the last financial crisis you will ever see.

(Sorry).

A final word on inflation

We've seen <u>pressures</u> on consumer, interest rate, and commodity inflation, but…

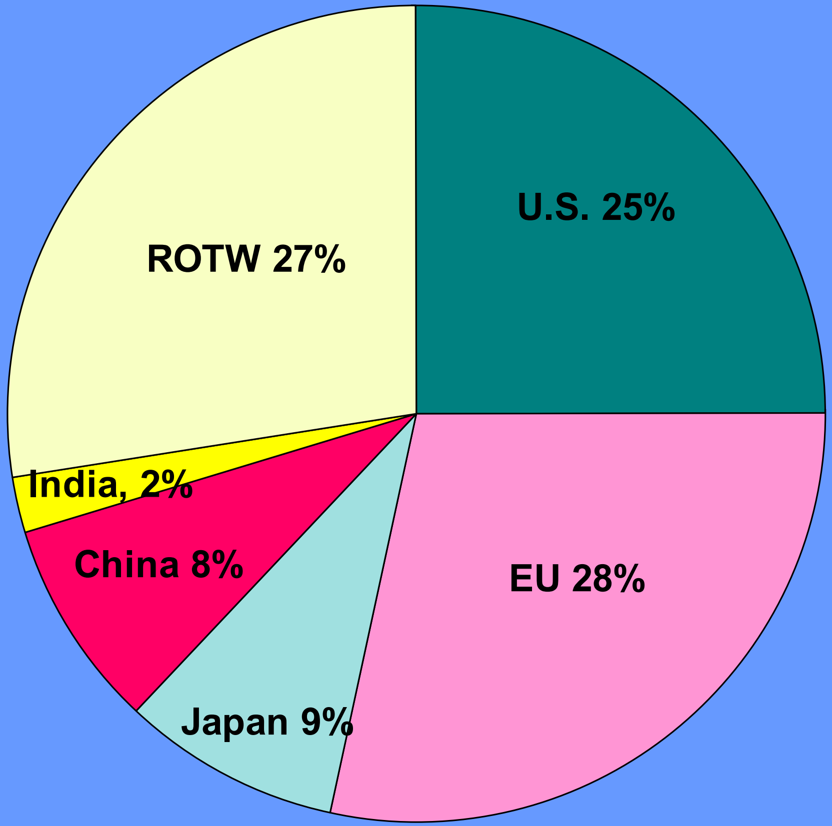
…other countries are already <u>feeling</u> it, preparing for it:

- **Canada – raised once**
- **Australia – raised six times, 1.5%**
- **India – raised twice for 50bps, f'cast 5.5% inflation**
- **China – put restrictions on lending to prevent bubble**

News From the Future

The World is Going to Change: World GDP

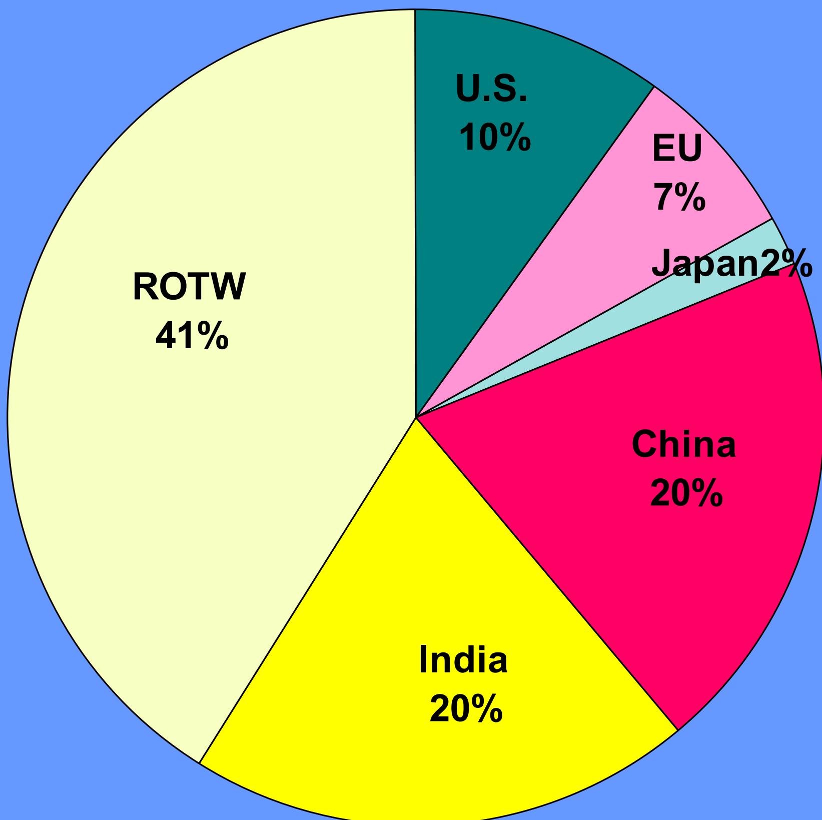
2009



Source: IMF, Prof. Jeremy Siegel

The World is Going to Change: World GDP

2050



Source: IMF, Prof. Jeremy Siegel

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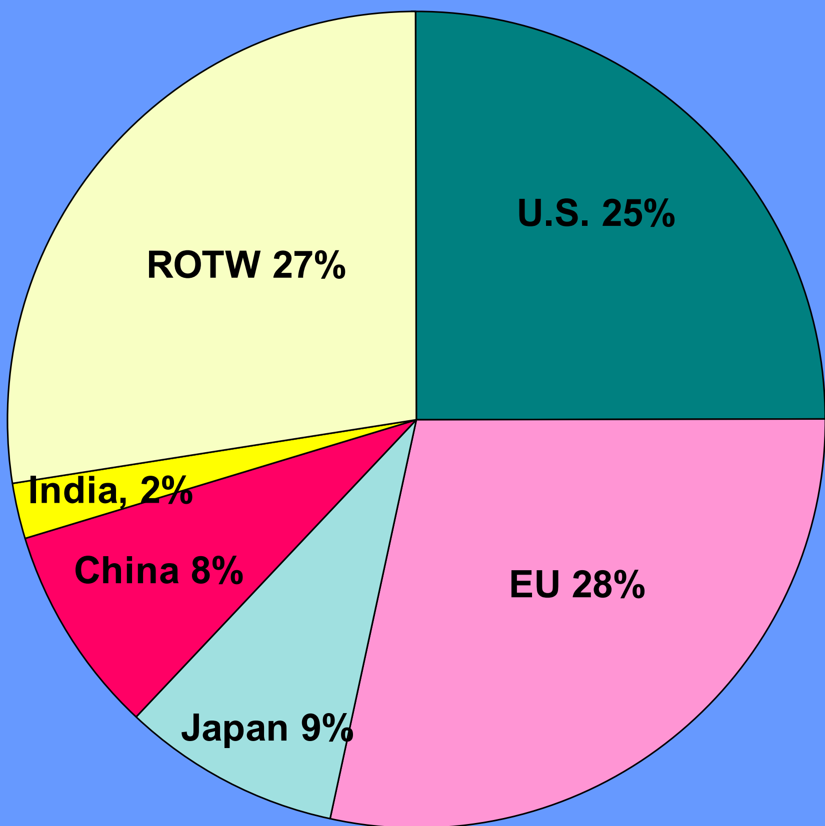
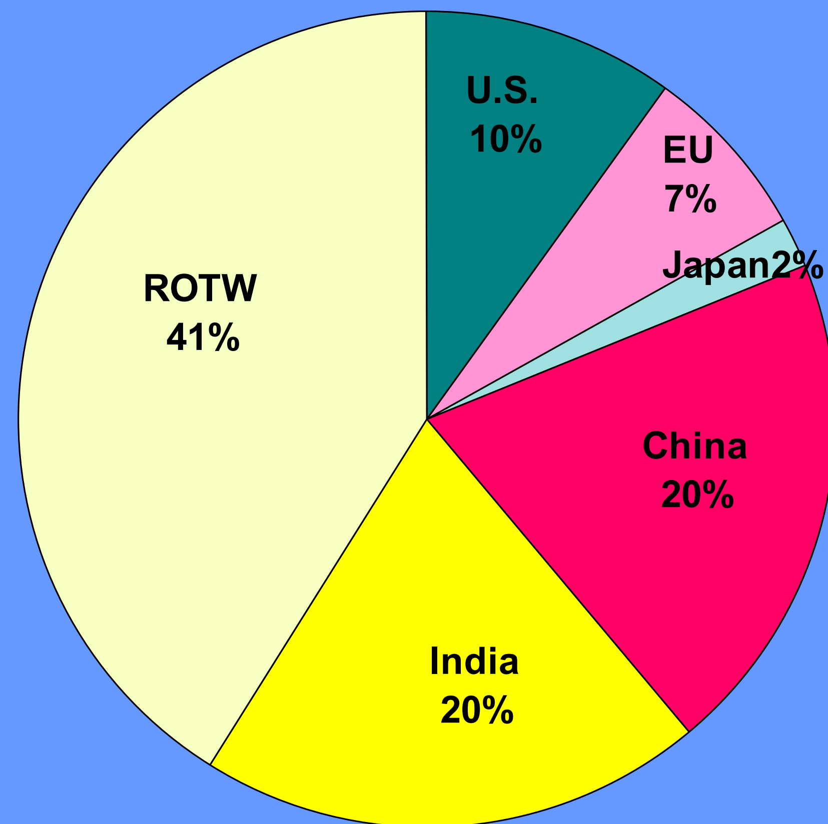
Business insured. Success ensured.

The World is Going to Change: World GDP

2009



2050

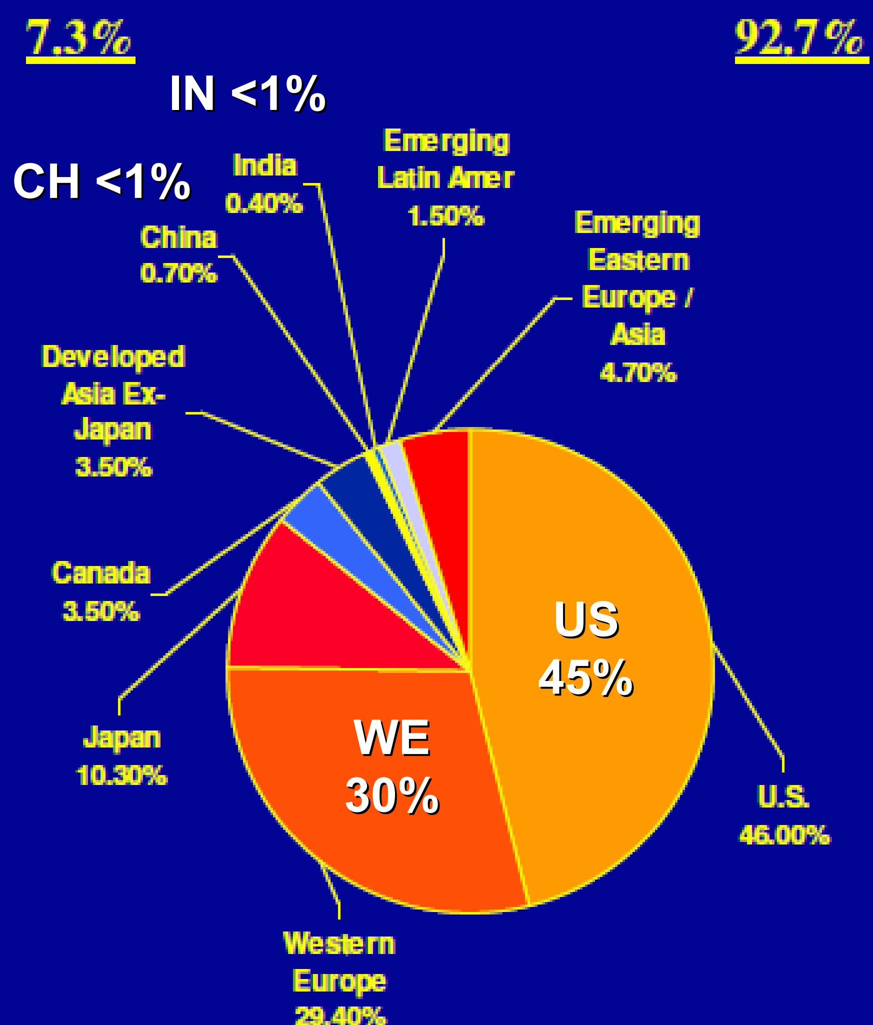


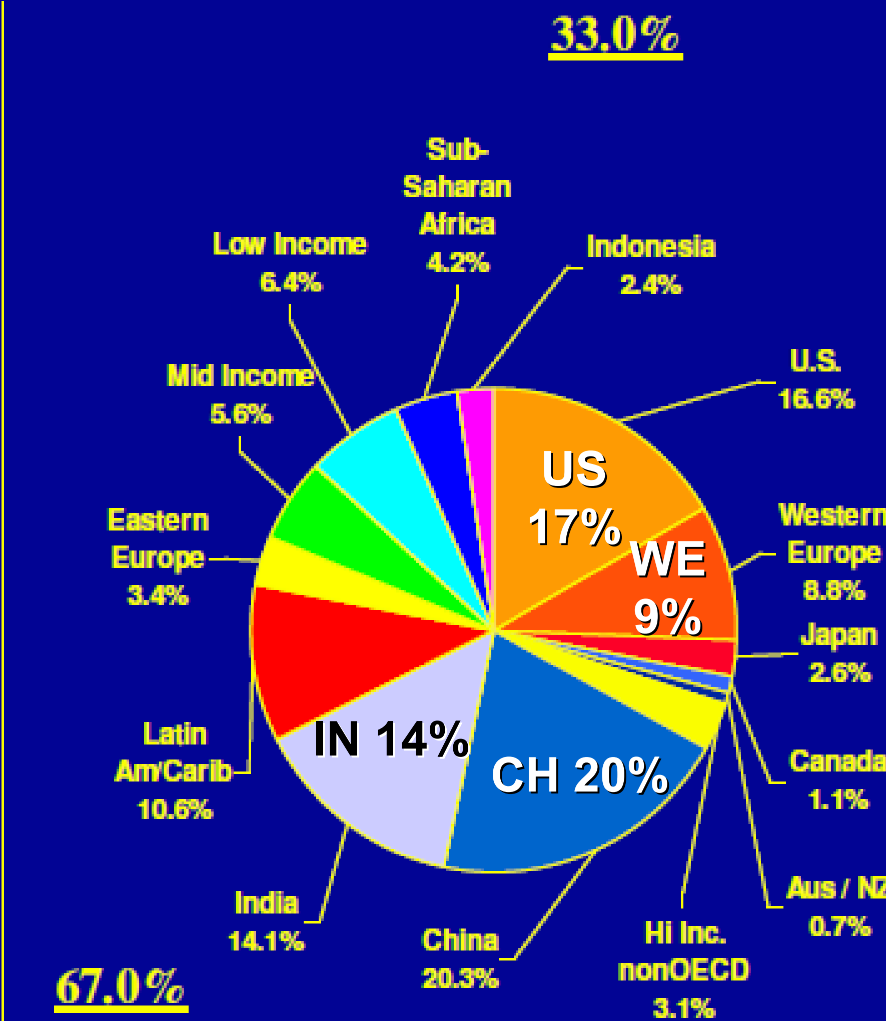
Not mis-management

Source: IMF, Prof. Jeremy Siegel

Stock Market Capitalization 2006

Stock Market Capitalization 2050





The World is Going to Change

Implications:

- Protectionism will no longer be an option
- Teach our children Chinese and Hindi, not Spanish and French
- It is 8x as many people, growing with 2nd mover advantage (phones, airports).
- It is <u>not</u> doomsday. It does <u>not</u> mean the end of U.S. prosperity, freedom or global importance, but it puts us more at risk…

China says to the U.S.,

“Get your house in order.”

China says to the U.S.,

"Get your house in order."

Moody's: … doubt

Recap

- 4 Forces
- Recovery
- Inflation
- Debt, deficits
- Future
- Risks
- Conclusions

Risks

- PIIGS damage the euro-zone
- Double Dip – weak consumer + something else bad sends us back into recession
- Housing market collapses / foreclosures
- Commercial real estate
- State budgets broken
- More waste
- Oil prices spike
- Increasingly divisive politics, populism / protectionism
- Global growth stagnates

Conclusions

- Recession over thanks to oil, housing, interest rates, and lack of fear. Expect GDP growth of around 3% over next few years
- On brink of creating jobs, unemployment rate is near the peak but will take years to come back down, hurting those in office.
- Inflation likely on the way, 2011 and beyond
- Interest rates up soon, and then continuing next 2-3 years
- Monetary policy was great and is getting mopped up, but it was too much to avoid consumer inflation
- Fiscal policy of huge deficits will cause money inflation (interest rates)
- Will also likely cause FX$ inflation, and oil price inflation
- Oil prices are problematic in several ways
- Bubbles are caused by "easy money" which will come around again some day as the credit cycle eases…

Finally, please, remember, this is a mostly <u>positive</u> presentation!

• The economic news is <u>very good</u> right now.

• We know about inflation ahead of time so it's <u>less of a problem.</u>

• Our fiscal situation is scary but it does <u>not</u> have to be doomsday – it can change.

• We know about 8x as many people ahead of time so it's <u>less of a problem</u>

• The economic news is <u>very good</u> right now.

Thank you
for your attention.

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