





An Overview of the U.S. Economy

Presented by Daniel North,
Chief Economist, Euler Hermes A.C.I.
March 10th, 2010



The Overview, March, 2010


- Good News
- Bad News
- News from the Future

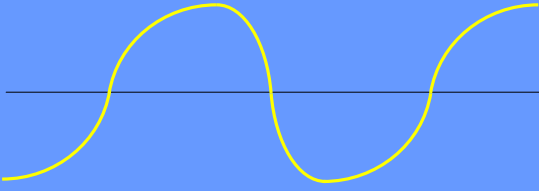


The Overview, March, 2010


- Good News
The Recession is Over
- Bad News
Inflation is on the Way
- News from the Future
Change

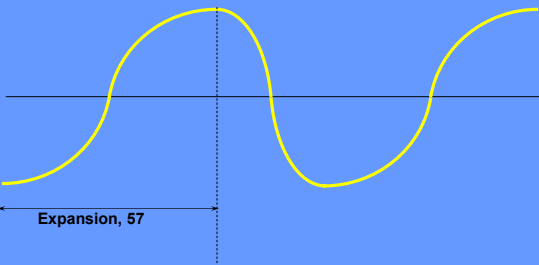
 **Not around here pal.**

 **The Business Cycle and Recessions**



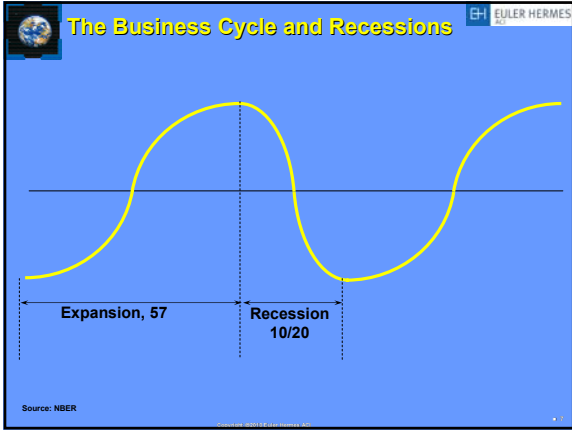
Source: NBER

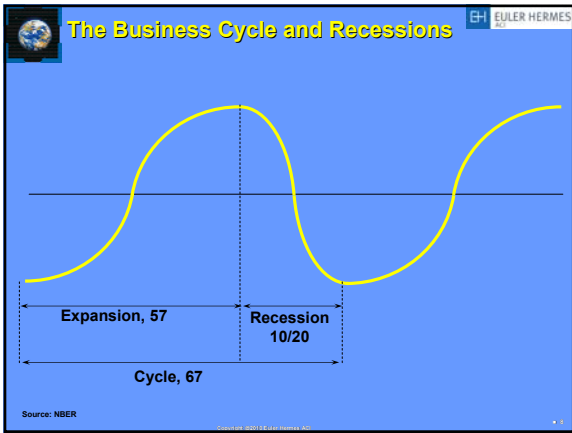
 **The Business Cycle and Recessions**

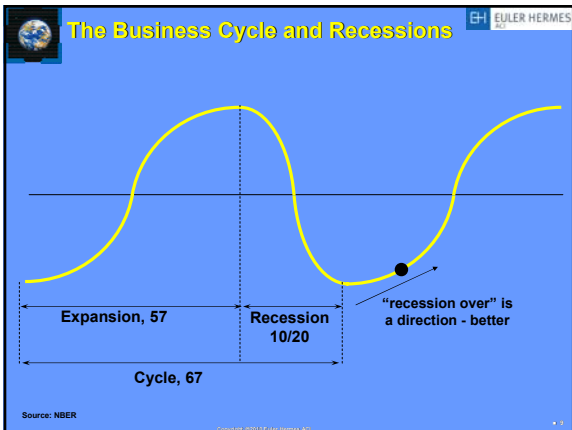


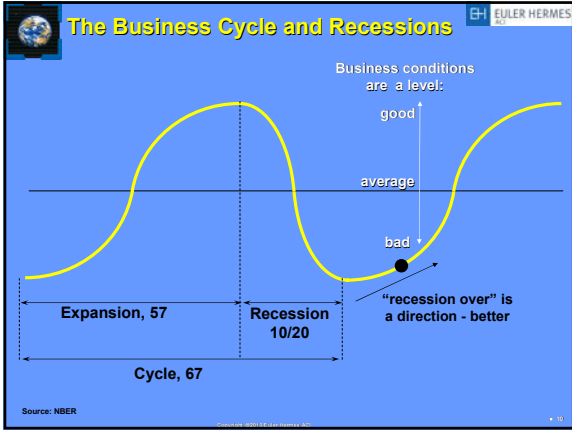
Expansion, 57

Source: NBER



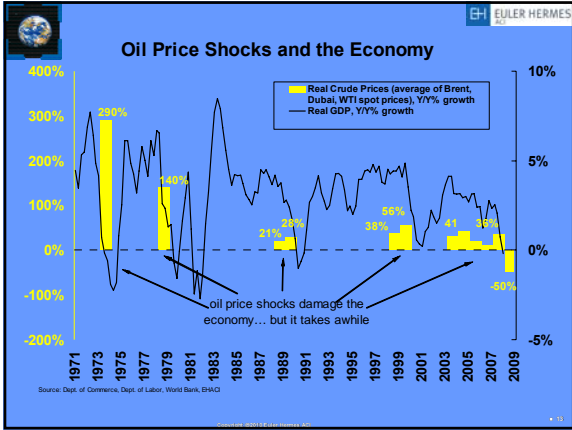


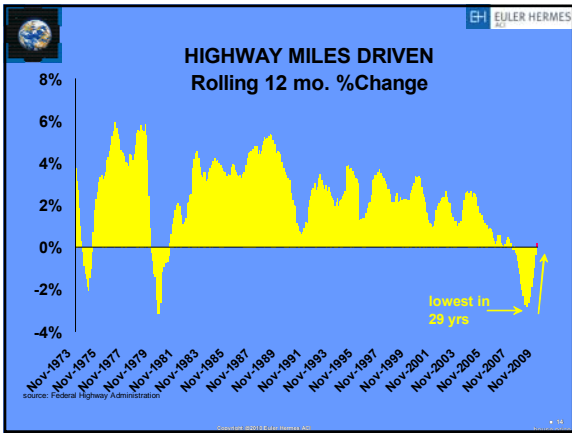


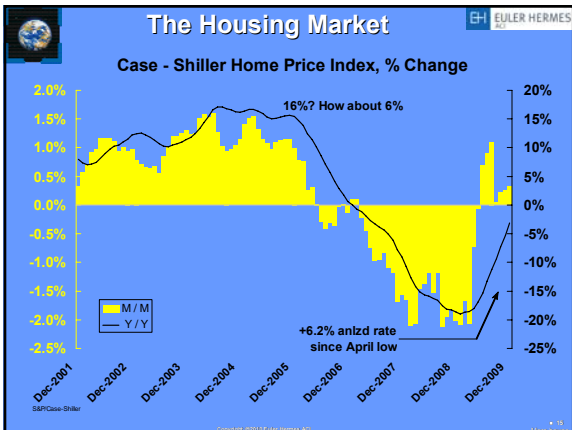


- "The recession is over." = "Most measures of economic activity are getting better."
- But the unemployment rate is still getting worse – it lags - and that's why it feels like we're still in a recession.
- Feel better: for the unemployment rate to improve, the recession must end.
- And it has.

- ### The Overview, March 2010 The Recession is Over
- Forces starting and ending the recession:
 - Oil
 - Housing
 - Fed policies
 - Fear
 - GDP: \$14T, 3.3% ave. growth







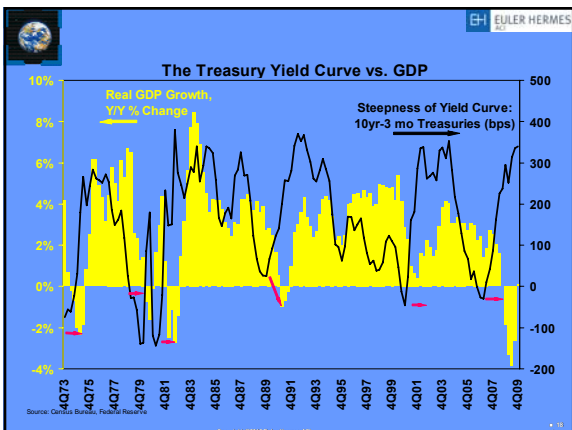
**The Housing Market:
More strong data**

- Existing 1 family home sales up 20% annualized rate since Jan low
- Starts up 32% 'zd from April low, permits up 34%
- Months supply of existing homes down 36% to 7.2 from 4/08 high of 11.3
- Months supply of new homes down 27% to 9.1 from 1/09 high of 12.4

**Monetary Policy
Fed Overtightened**

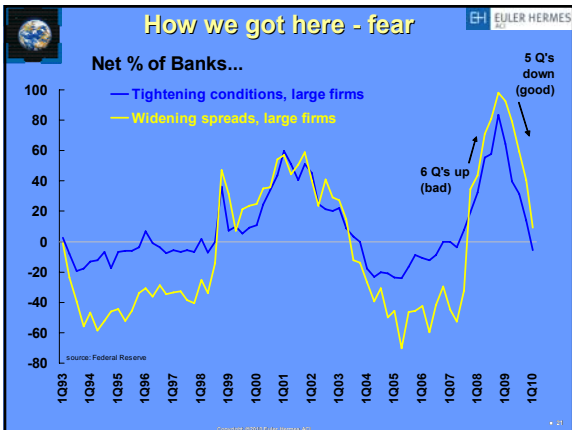
Demonstrated by the Yield Curve


- shows interest rates, reflects Fed policy
- very good forecaster of the economy

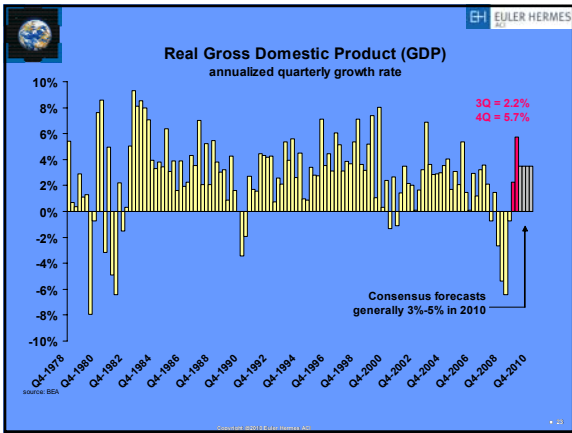


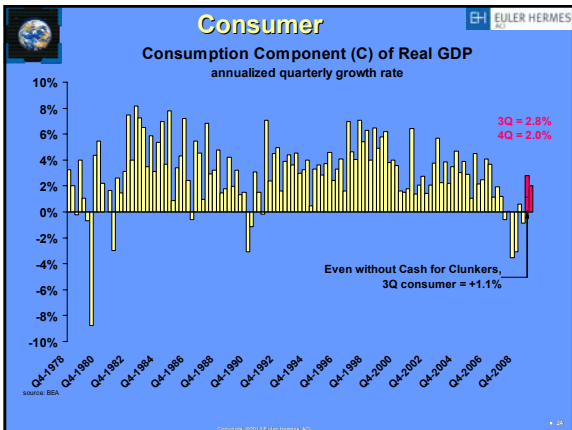


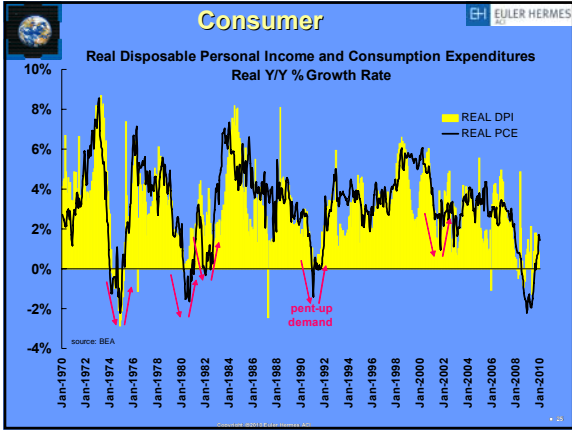


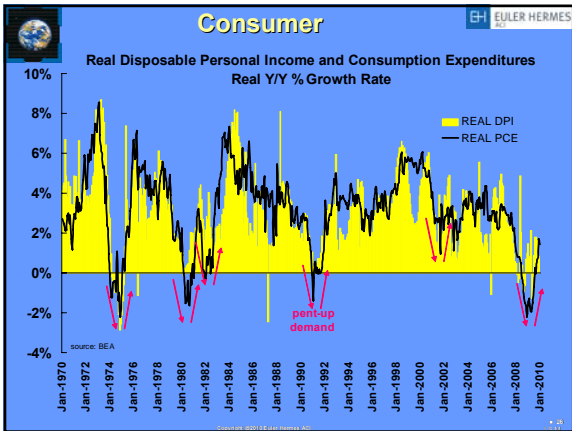


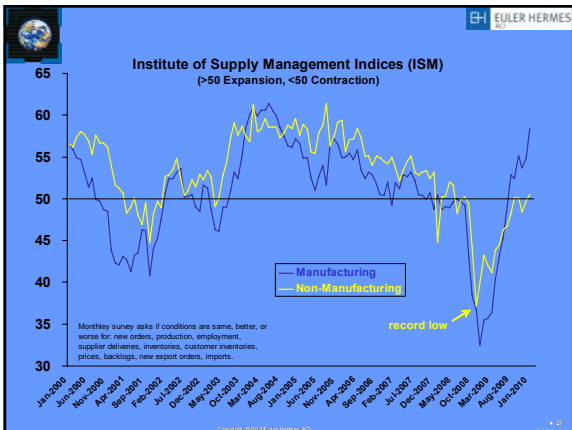
 OK, fine, 4 forces working for us...
..but what are the results?

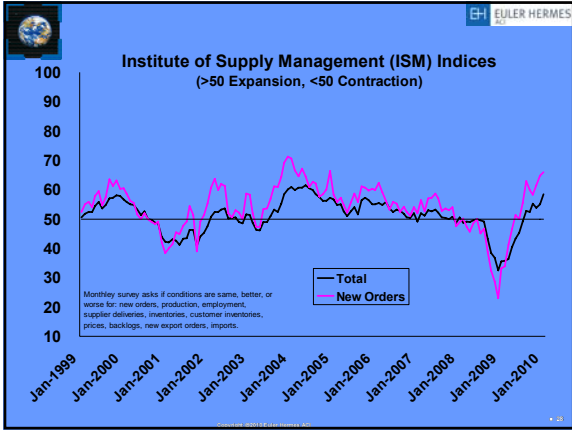


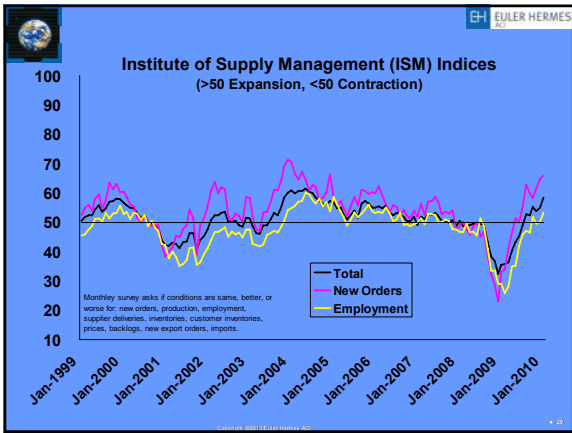


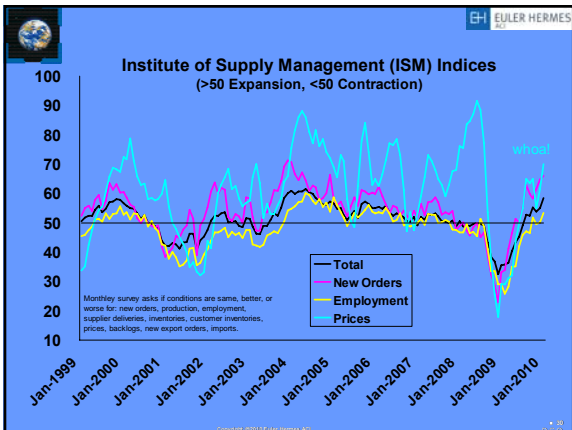


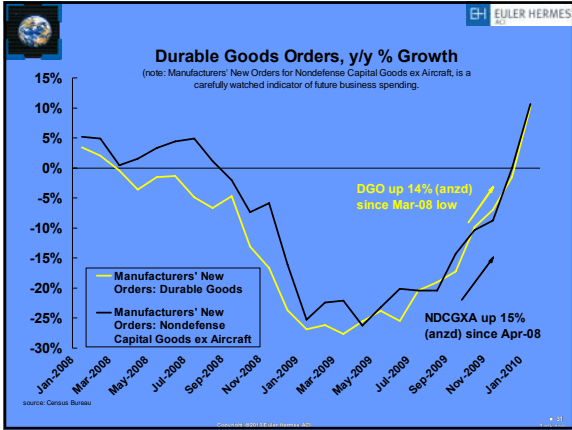


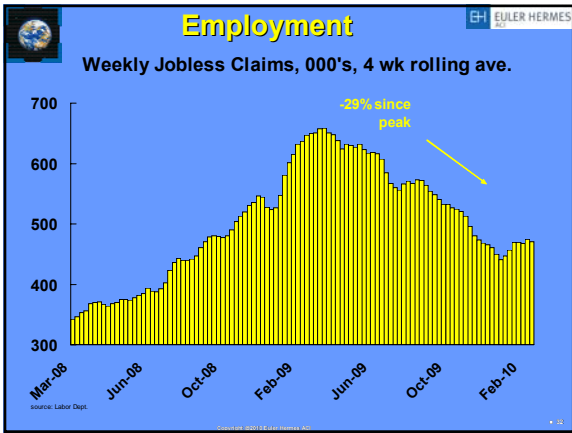


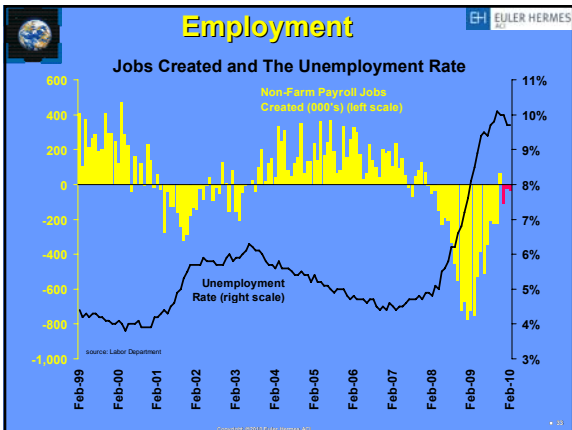


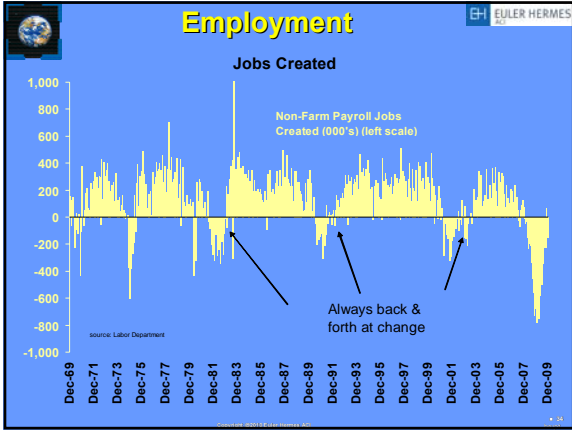










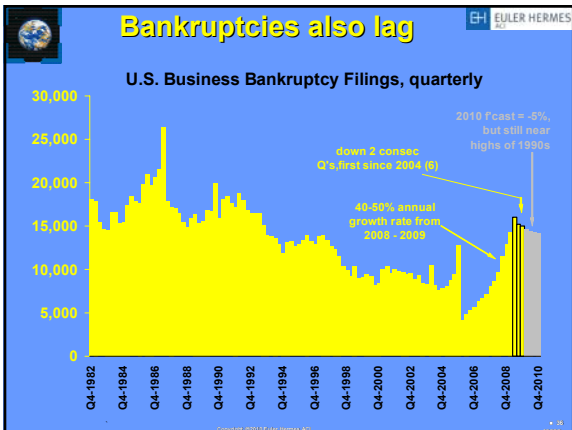




Employment

We are right on the cusp of 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%
- November had positive job growth
- February probably had positive job growth (but snow distorted data)
- Fed signalling



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  **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

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  **INFLATION**

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  **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.

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Which Inflation Measure do You Like?
Annualized Rates of Inflation

	1 yr	5 yr
CPI	3%	3%
CPI core	2%	2%
PPI	5%	3%
PPI core	1%	2%
PCE	-1%	3%
PCE core	1%	2%
GDP deflator	2%	3%
Hrly wages	3%	3%
Treas note, 2 yr	-2%	-2%
Treas note, 10 yr	0%	-1%
Commodities	-22%	4%
Oil	-44%	10%
Gasoline	-37%	6%
Gold	-1%	18%
Houses	-15%	-2%
Stocks	-22%	-2%



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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**

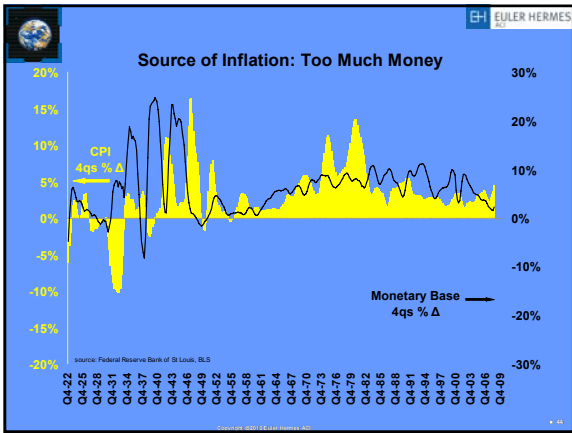
Fiscal Policy

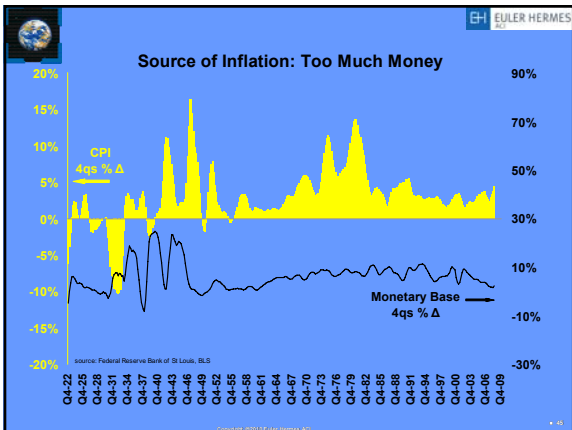
- **\$150B stimulus in 2008: tax rebates**
- **\$787B stimulus: lower taxes, increase spending – can work.**
- **But it's a terrible sham - 75% will be spent after the recession! Inflation, deficit, debt.**

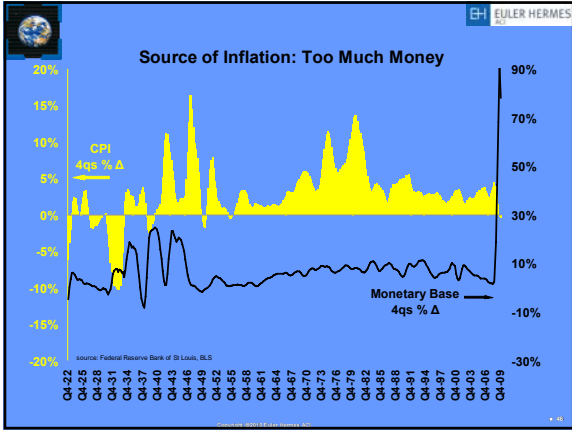
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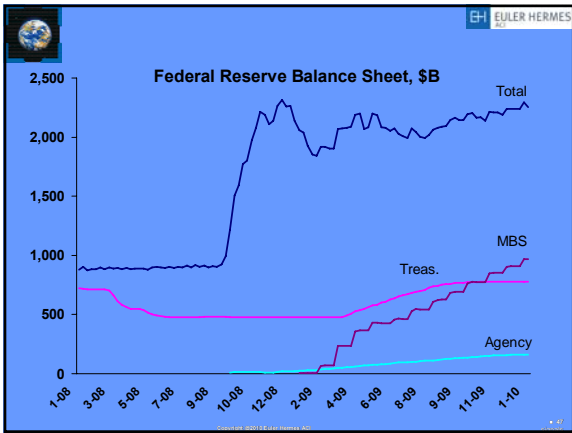
Monetary Policy

- Normally controlled via Fed Funds rate, yield curve
- This time also needed to print money










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...



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


- Print extra dollar bills
- All \$ bills become worth less
- So need more \$ bills
- Print extra dollar bills
- All \$ bills become worth less
- So need more \$ bills....
- ... example



German Hyperinflation

Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4



German Hyperinflation

Wholesale Price Index

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Jan 1920	12.6
Jan 1921	14.4
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German Hyperinflation

Wholesale Price Index

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Jan 1922	36.7
July 1922	100.6

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Wholesale Price Index

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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

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Zimbabwean Hyperinflation

ZWD vs USD Exchange Rate History

231 000 000% (official, July 08)
89.7 x 1021% (HHIZ, 14 Nov 08)
6.5 x 10108% (Forbes Asia, 22 Dec 08)

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The Fed is unlikely to let that happen.

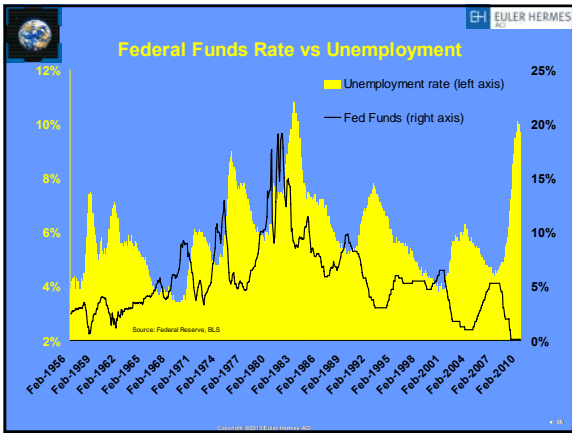
So change in balance sheet and public statements are starting to signal gently that it WILL have to come

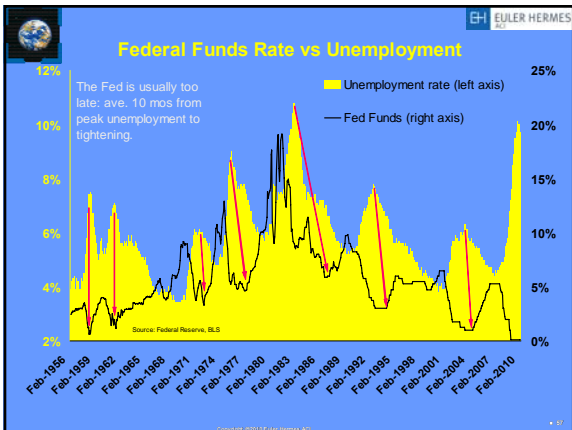
"But there's no sign of inflation and unemployment's high!"

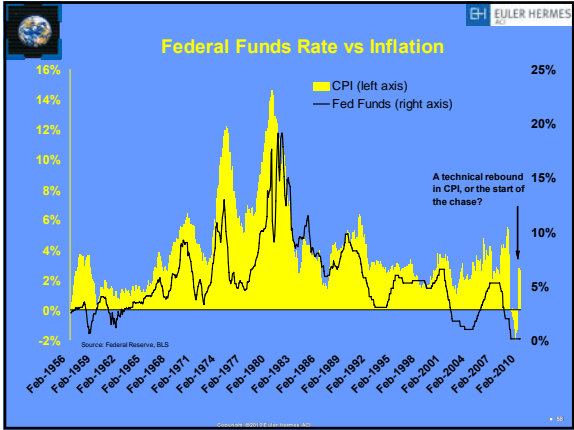
Of course there isn't! That's not the point!

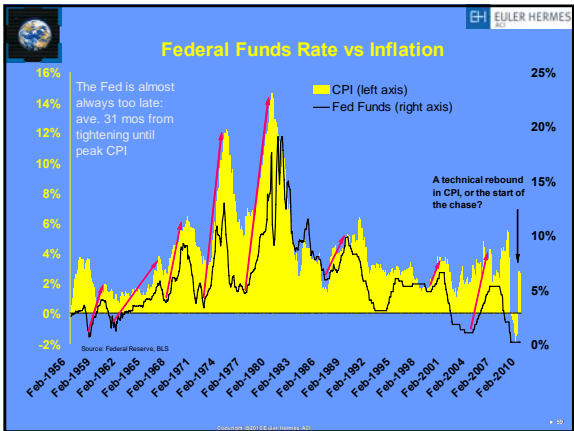
The point is that inflation gets out of hand easily, and it takes a really long time for changes in monetary policy to have full effect; 3-5 Qs.

First note that unemployment peaks around 1-2 Qs after recession ends.









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.

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Fiscal Policy

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

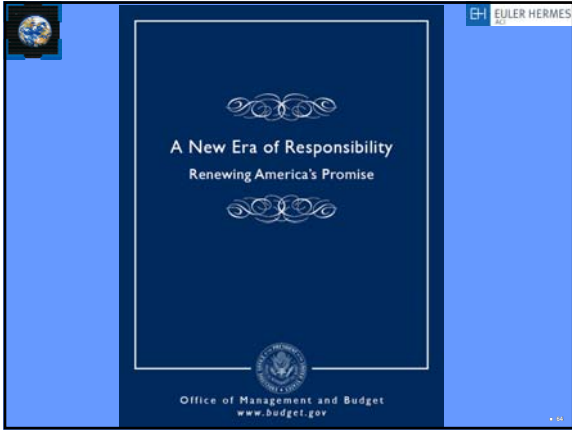
The Federal Government's plan is to spend more, to effectively increase liquidity, and to increase the debt burden.

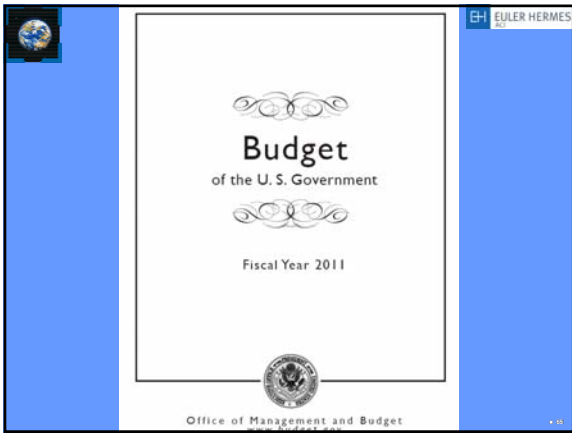



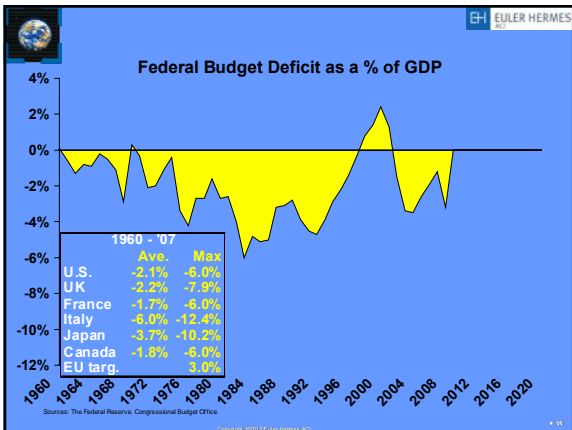
Spending, Deficits and Debt

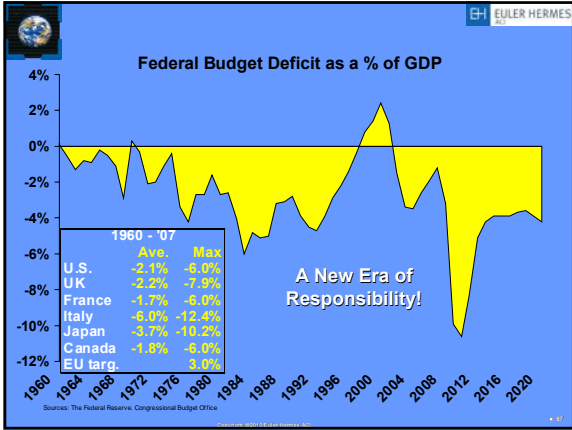
Gov't spends	\$120
<u>Gov't gets tax revenue</u>	<u>\$100</u>
Deficit	\$20

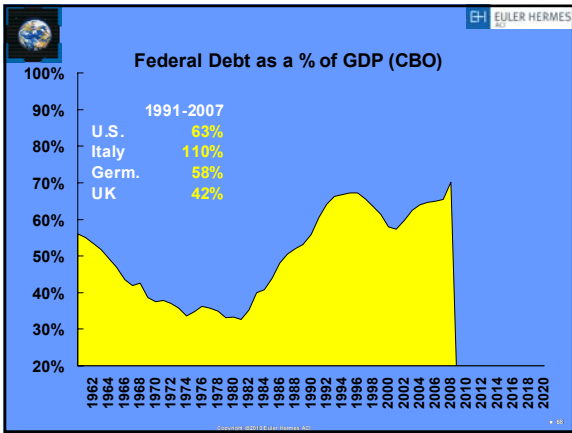
- Treas. gets loan, issues \$20 notes/bonds
- Not a Ponzi scheme, no intent to deceive, return is fixed, debt retired, revolving credit

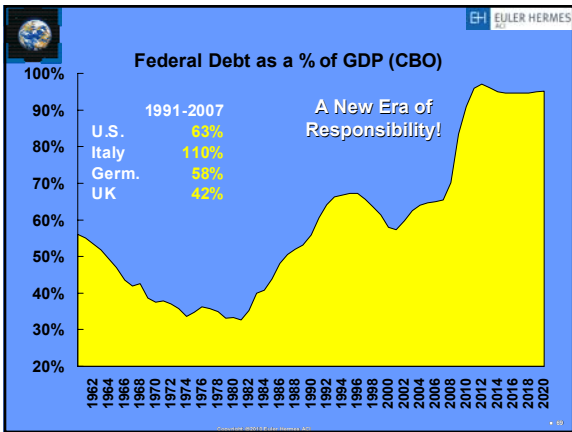


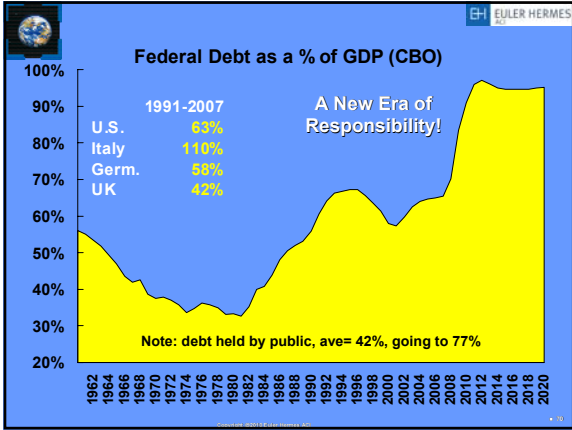






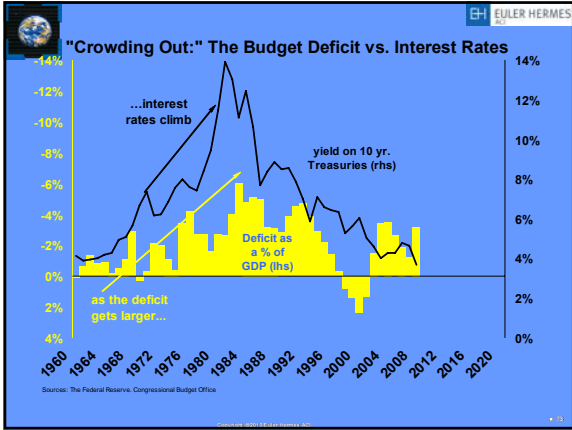


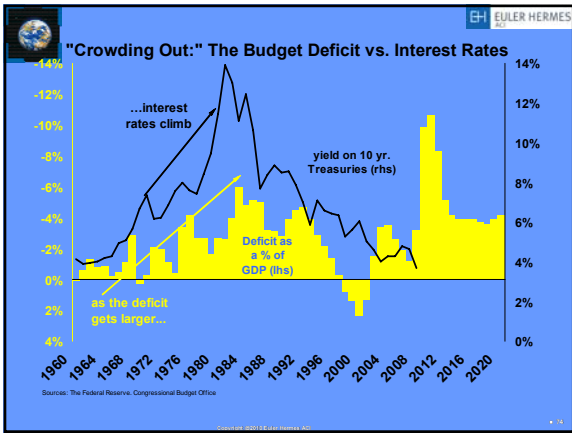




- ### The Fiscal Stimulus
- \$787B stimulus spending: several more years, only \$333 (42%) has been “obligated”, only 35% has been “spent”
 - \$15B “Jobs Bill” in the works... Baucus “We’re just getting started.”
 - \$25B to state govts to prevent layoffs
 - Health Care!

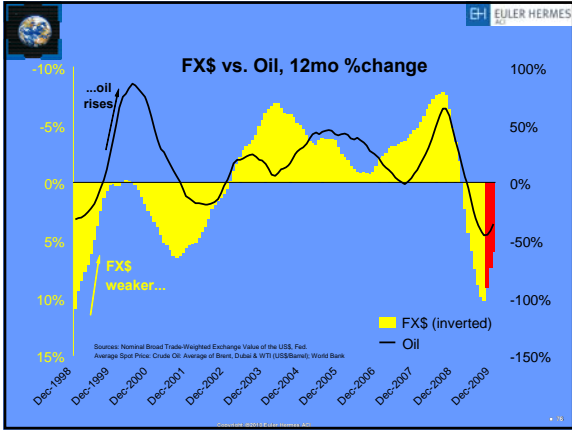
- Deficit will contribute to Inflation of Consumer Prices
- And will really contribute to Inflation of Money Prices; Interest Rates





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



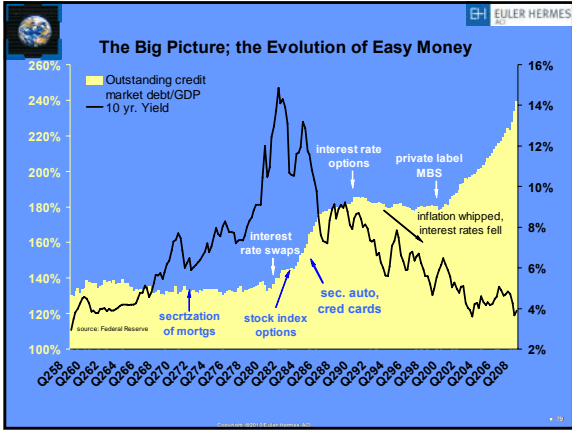
- ### The Trouble With Oil is...
- It may soar on deficits and \$FX, but it is probably more likely to soar based on fundamentals
 - Its supply is fixed but demand is ever-growing
 - It's denominated in US\$
 - Its use is pervasive
 - \$1B/day in US, or around 3% of GDP
 - 85 million bbls produced / 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 68% of our oil. The outside world could easily crush us. Drill, for our own safety.

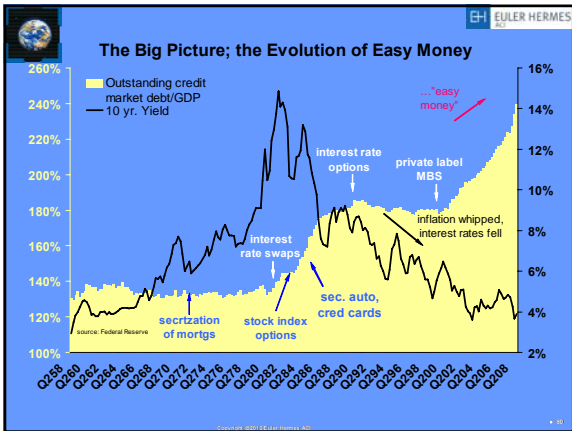
So we've seen consumer, interest rate, and commodity inflation.

Final Form of Inflation: Bubbles


How did that mess just happen?
How did that bubble form?


How about the one before that?
(and Dubai now, and Asia now)






- 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 not 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 not the last financial crisis you will ever see.
(Sorry).





A final word on inflation 

We've seen pressures on consumer, interest rate, and commodity inflation, but...

...other countries are already feeling it, preparing for it:

- China – put restrictions on lending in Jan and Feb
- India – raised twice for 75bps, f'cast 8.5% inflation
- Australia – raised four times, 1%

 **Conclusions** 



- Recession over thanks to oil, housing, interest rates, and lack of fear. Expect GDP growth of 3% - 4% over next year
- 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, late 2010 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
- The World is Going to Change

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 **Risks** 

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

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 **Thank You** 

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Source: IMF, Prof. Jeremy Siegel



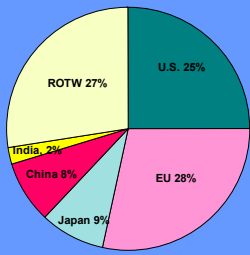
News From the Future

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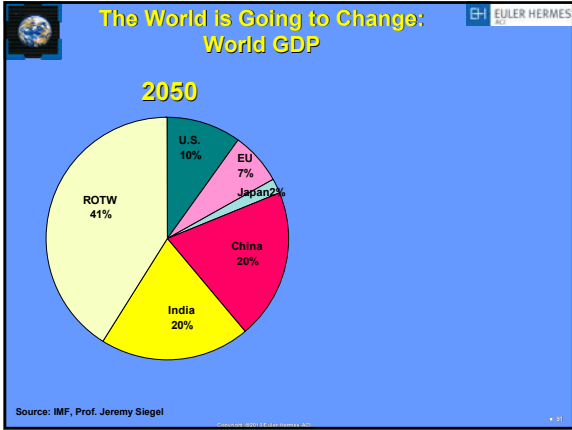
**The World is Going to Change:
World GDP**

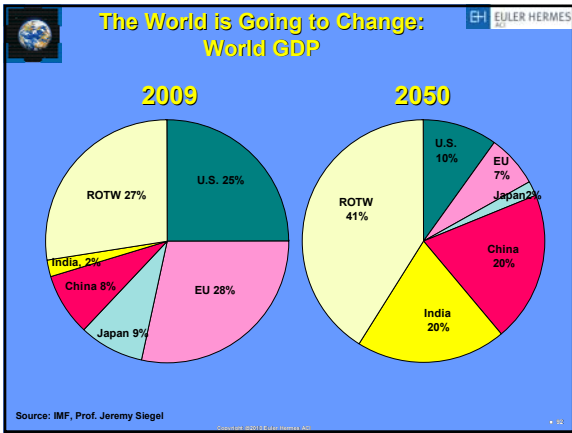
2009

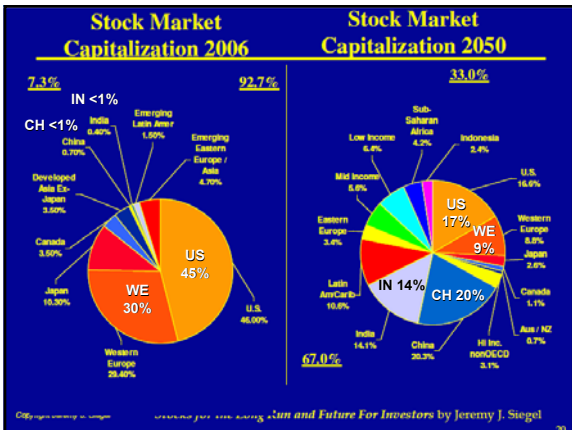



Region	Percentage
U.S.	25%
EU	28%
Japan	9%
China	8%
India	2%
ROTW	27%

Source: IMF, Prof. Jeremy Siegel







 **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 not doomsday. It does not mean the end of U.S. prosperity, freedom or global importance, but...

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**China says to the U.S.,
“Get your house in order.”**


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**China says to the U.S.,
“Get your house in order.”**

Moody’s: ... doubt

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- 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
- The World is Going to Change

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Risks

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- Double Dip – weak consumer + something else bad sends us back into recession
- Commercial real estate
- State budgets broken
- More waste
- Oil prices spike
- Increasingly divisive politics
- Global growth stagnates

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Thank You

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