



Inferential Focus

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Oh No, Mr. Bill! A Dire Scenario for the Economy

Mr. Bill, the clay figurine from 1970s Saturday Night Live animation shorts who was prone to endless disaster and misfortune, is back in ads for MasterCard, and the reemergence of the character whose stock phrase is “Oh No!” could not be a more fitting metaphor for the current economic outlook.

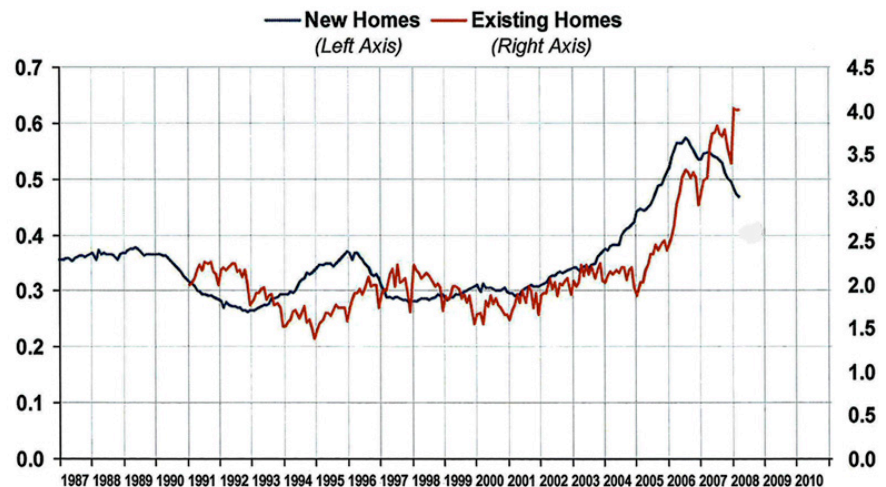
During Personal Briefings on, “The Housing Earthquake and Economic Tsunami,” many clients over the past 18 months have wondered about the chance of a U.S. recession. In 2005, we inferred that a recession was likely and we included the prospect of recession on the Tsunami Chart. In late 2007, we advised that a near-term recession was highly likely. Still, official figures for the fourth quarter of 2007 and the first quarter of this year show anemic growth and not the “two consecutive negative quarters” often used as the popular definition of recession. Yet we have seen several signs that the economy is primed for another turn downward – a recessionary turn. Therefore, we join Mr. Bill in a collective shout of “Oh No!”

Since 2005, the inventory of existing homes for sale has doubled, and according to the Census Bureau, which has tracked this figure for 28 years, the inventory is at an all time high.

Homeowners have not lowered prices enough to clear inventory. In comparison, homebuilders have lowered new home prices directly via the price tag and indirectly through various incentives and freebies such as covering the first few mortgage payments, covering the closing costs, or providing free swimming pools or upgrades to kitchens. Moreover, homebuilders have cut production of new homes. These changes have helped to clear

New and Existing Home Inventories

Millions of Homes

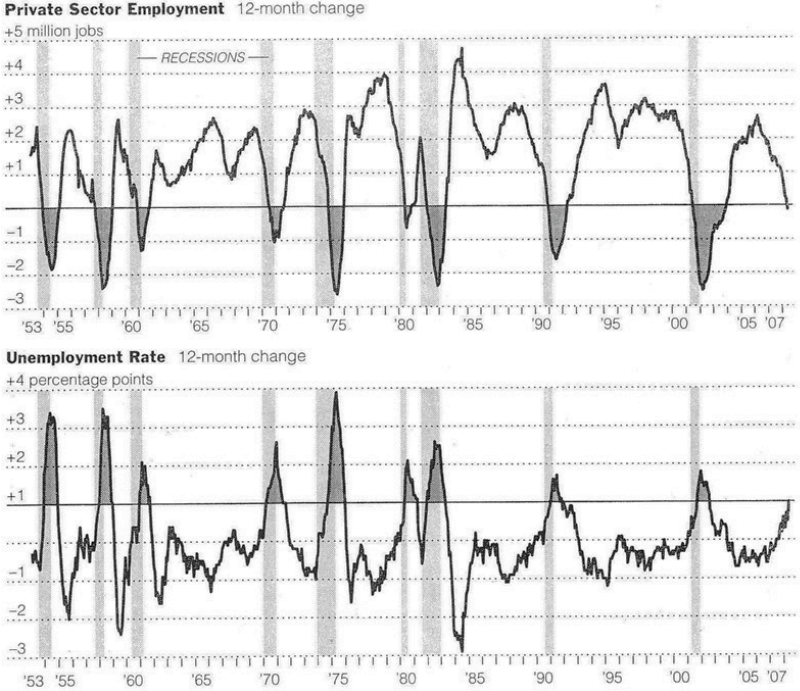


inventory in the new home market. Both markets are depicted on the chart (above) using data from the Census Bureau and the National Association of Realtors.

As long as homeowners with existing homes on the market can make their mortgage payments, they feel no pressure to lower prices to clear the record inventory of existing homes. We see two factors that could ramp up forced sales and clear out existing home inventory: further rate resets and layoffs.

Since the manias of the late 1990s, we have asserted that management is now hyper-obsessed with managing earnings, which means that they will let workers go and employ other cost cutting measures at any sign of weakness. To illustrate one extreme of this behavior, in June Siemens announced 17,000 layoffs from its worldwide workforce, **despite record profits last year**. If record profits cannot protect jobs, what will contracting economies do to the labor market? In fact, we have now experienced six consecutive months of job losses. In the last recession, job losses averaged 180,000 per month. So far this year, they have averaged only 58,000 per month. Corporations have only taken the easy first steps of the cost-cutting process, reducing worker hours and letting part-time workers go. The potential for an escalation in layoffs remains. Labor statistics have already hit two thresholds that commonly indicate recession.

The Bureau of Labor Statistics' (BLS) survey of business establishments has indicated a year-over-year drop in private sector employment 10 times since World War II, including starting in May this year. The first 9 times such a drop happened, a recession had already been underway. On average the recession began 5 or 6 months before the employment data turned negative. However, since a recession normally must occur for two quarters before it is "declared," such drops in this employment figure often foretell the declaration of a recession. Similarly, the BLS household employment survey has shown a 1 percent or greater year-over-year increase in unemployment the same 10 times since World War II, with the most recent period starting in May of this year. The previous 9 times, a recession had begun 3 to 10 months prior to the year-over-year 1 percent unemployment increase.



As the unemployment rate increases, so is the pace of mortgage rate resets. July, August and September of this year are the three months with the highest volume of rate resets for subprime mortgages since the subprime crisis began. We anticipate job losses and record subprime resets this summer triggering more foreclosures and forced sales. Forced sales would spell trouble for home prices. Again, as we noted above, thus far in the housing downturn, homeowners have not been forced to lower prices to clear the record inventory. While financial firms continue to

mark their mortgage backed derivatives to market prices, any fall in home prices will surely lead to more write-offs at financial firms.

As if the animators of some new economic version of Mr. Bill were trying to craft a dire scenario, municipal government spending, which as of 2007 accounted for 14 percent of the economy, should start falling after July 1 as many states begin their new fiscal years with budgets destined to run deeply in the red. Ironically, state and local governments have actually hired 100,000 new workers over the past six months, greatly easing unemployment figures. They might soon start reversing that practice. The combined problems of corporate managers laying off employees, a high volume of mortgage resets, and spending cuts from municipal governments threaten to truly undermine existing-home markets, complex financial instruments, available credit, liquidity and consumer spending and lead to another turn downward in the economy. Oh, no, Mr. Bill!