The Overview, September, 2010

- Economy Recovering
- Recovery Threatened
  - Inflation / Deflation
- Government Policies
- Risks, Conclusions, etc.
Not around here pal.
The Business Cycle and Recessions

Source: NBER
The Business Cycle and Recessions

Expansion, 57

Recession
10/18

Source: NBER
The Business Cycle and Recessions

Expansion, 57

Recession 10/18

Cycle, 67

“recession over” is a direction - better

Source: NBER

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The Business Cycle and Recessions

Business conditions are a level:
- good
- average
- bad

"recession over" is a direction - better

Expansion, 57
Recession 10/18
Cycle, 67

Source: NBER
The Business Cycle and Recessions

Expansion, 57
Recession 10/20

Continued Recovery / Inflation?
Double-dip Recession / Deflation?

Source: NBER
The Overview, September 2010

- The recession is over but the recovery is weak
- Continued growth / inflation, or
- Double-dip / deflation?
The Overview, September 2010

- The recession is over but the recovery is weak
- Continued growth / inflation, or
- Double-dip / deflation?

- The four forces which started and ended the recession hold answers:
  - Oil
  - Housing
  - Fed policies
  - Fear

(GDP: $14T, 3.3% ave. growth)
Oil Price Shocks and the Economy

- Real Crude Prices (average of Brent, Dubai, WTI spot prices), Y/Y% growth
- Real GDP, Y/Y% growth

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

Oil price shocks damage the economy… but it takes awhile
Oil Price Shocks and the Economy

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

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The Housing Market
Case - Shiller Home Price Index, % Change

16%? How about 6%

+5.4% anlzd rate since 5/09 low
## The Housing Market

### A real mixed bag w/distortions from tax credit expiration

<table>
<thead>
<tr>
<th></th>
<th>Good</th>
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<td>record low in July</td>
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<td>up only 1% y/y, double-dipped</td>
</tr>
<tr>
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<td>Down only 2% since low of 4/10</td>
<td>down 5% y/y, double-dipped</td>
</tr>
<tr>
<td><strong>Starts</strong></td>
<td>up 14% since low of 4/9</td>
<td>down 7% y/y, 20% from 4/10 double-dipped</td>
</tr>
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<td>up 8% since low of 4/9</td>
<td>down 4% y/y, 18% from 3/10 double-dipped</td>
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## The Housing Market

A real mixed bag w/distortions from tax credit expiration

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Remember, we knew the data would look weak after April, so we won’t know for months yet what’s really happening.
The Treasury Yield Curve vs. GDP

Steepness of Yield Curve: 10yr-3 mo Treasuries (bps)

Real GDP Growth, Y/Y % Change

Source: Census Bureau, Federal Reserve
The Treasury Yield Curve vs. GDP

Steepness of Yield Curve: 10yr-3 mo Treasuries (bps)

Real GDP Growth, Y/Y % Change

Source: Census Bureau, Federal Reserve
Yield Curve Steepness: 10 yr yield - 3 mo. yield (bps)
Uncomfortable trend, but still quite high

Source: Federal Reserve
Yield Curve Steepness: 10 yr yield - 3 mo. yield (bps)
Uncomfortable trend, but still quite high

Source: Federal Reserve

- Sovereign debt worries
- Weak economic data
- Expectations
- Fed on hold
- Feeling better

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How we got here - fear

RISK MEASURES IN THE CREDIT MARKETS

source: Financial Times, Merrill Lynch, Federal Reserve

TED spread: banks' lending - borrowing rates

1 mo. LIBOR: rate banks charge each other

Sept. 15th; AIG, Merrill, Lehman
Fear receding; credit getting easier...
...but nobody wants it ...

Net % of Banks...

- Stronger Demand C&I Loans, Large
- Stronger Demand Consumer Loans

source: Federal Reserve

still gloomy
...but we need business to take it

Lending, Credit Expansion, Helps Drive GDP

- Real GDP, 4qs/4qs growth (left scale)
- Net % banks tightening C&I loans to small firms (right scale, inverted)

source: BEA, Fed. Reserve

4 forces, indictrs
So the 4 forces:
• Got us into recession
• Got us out of recession
• And may be faltering

So what do the measures of the economy say?
Real Gross Domestic Product (GDP)
annualized quarterly growth rate

Consensus forecasts generally 2%-3% in 2010 and 2011

4 consecutive quarters up!... (but still anemic)
Consumer

Real Personal Consumption Expenditures, y/y% Growth Rate

source: BEA

pent-up demand
Real Personal Consumption Expenditures, y/y% Growth Rate

Source: BEA

Pent-up demand

Pent-up demand
Consumer

Real Personal Consumption Expenditures, y/y% Growth Rate

source: BEA

but it's weak

ten-up demand

ten-up demand

© Copyright Euler Hermes 2010
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.)

Manufacturers’ New Orders: Durable Goods

Manufacturers’ New Orders: Nondefense Capital Goods ex Aircraft

DGO up 20% since 3/08 low.
y/y=9% vs 3% ave

NDCGXA up 21% since 4/08 low.
y/y=11% vs 3% ave

source: Census Bureau
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.)

Manufacturers' New Orders: Durable Goods

Manufacturers' New Orders: Nondefense Capital Goods ex Aircraft

DGO up 20% since 3/08 low. y/y=9% vs 3% ave

NDCGXA up 21% since 4/08 low. y/y=11% vs 3% ave

But growth peaked 3 months ago

source: Census Bureau
Business conditions good: low interest rates, inflation, labor

Corporate Profits
(pre tax w/IVA and CCadj)

source: BEA
Business conditions good: low interest rates, inflation, labor

Corporate Profits
(pre tax w/IVA and CCadj)

- Q/Q annualized (left axis)
- Y/Y (right axis)

Great! but slowing

source: BEA
One last measure, Bankruptcies

U.S. Business Bankruptcy Filings, quarterly

- 2010 forecast = -10%, but still near highs of 1990s
- Down 3 consecutive quarters, first since 2002
- 40-50% annual growth rates from 2008 - 2009

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Employment

Jobless Claims, 000's

-31% since peak

-26% since peak

Initial Claims, left scale
Continuing Claims, right scale

source: Labor Dept.
Employment
Jobless Claims, 000's

-31% since peak
-26% since peak
...but stalled

source: Labor Dept.

Initial Claims, left scale
Continuing Claims, right scale

© Copyright Euler Hermes 2010
Employment
Private Sector Jobs Created and the Unemployment Rate

Non-Farm Payroll Jobs Created (000’s) (left scale)

Unemployment Rate (right scale)

source: Labor Department

positive past 9/10 months!
Employment
Private Sector Jobs Created and the Unemployment Rate

Non-Farm Payroll Jobs Created (000’s) (left scale)

Unemployment Rate (right scale)

source: Labor Department

positive past 9/10 months

a long way to go

3% 4% 5% 6% 7% 8% 9% 10% 11%

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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 9.6%-temp. gets worse as unemployed job seekers re-enter job force
• 9/10 mos. had positive job growth
Recap

• 4 forces caused recession, now helping recovery
• Consumer, manufacturing, and most indicators positive but slowing
• Employment lagging but getting better
• So what’s the holdup?
Structuralists:
Too much taxes, regulation, uncertainty make business reluctant to expand (showed evidence)

Keynsians:
Demand too weak, stimulate, spend, then tax (questionable results)

Either way…
Arguments for double-dip / deflation or continued slow growth / inflation

**Double dip / deflation**
- Monetary policy ineffective
- Fiscal policy damaging
- Shaky housing market
- High unemployment
- Taxes and regulation
- Weak consumer

**Slow growth / inflation**
- Monetary policy set to “nuclear”
- Banks wanting to lend
- Low inflation, interest rates, labor rates (now)
- High corporate profits
- Big increase in M&A
- Rest of the world growing
- Change in WDC, fiscal policy coming
- Yield Curve very positive (leads 3-5 quarters)

On to inflation...
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.
The U.S. government will want inflation.

1-2 years down the road
Inflation

Several types of inflation:

• Consumer price inflation - bread
• Money price inflation - interest rates
• Commodity price inflation - oil
• Asset price inflation - stocks, houses
• Government policies can contribute to inflation
Monetary policy (Takes 3-5 Q’s to work!)

- Run by the Fed, Bernanke
- Interest rates, money, QE

Fiscal Policy

- Run by the administration and Congress
- Taxes and spending
Monetary Base: Printing Money, Quantitative Easing

Source: Federal Reserve Bank of St Louis, BLS
Monetary Base: Printing Money, Quantitative Easing

Source of Inflation: Too Much Money

Monetary Base

CPI

4qs % Δ

source: Federal Reserve Bank of St Louis, BLS
The Fed will reverse all that, because, here’s what happens if you print a bit too much money:
# German Hyperinflation

**Wholesale Price Index**

<table>
<thead>
<tr>
<th>Date</th>
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<tbody>
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# German Hyperinflation

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<td>100.6</td>
</tr>
<tr>
<td>Jan 1923</td>
<td>2,785</td>
</tr>
<tr>
<td>July 1923</td>
<td>194,000</td>
</tr>
<tr>
<td>Nov 1923</td>
<td>726,000,000,000</td>
</tr>
</tbody>
</table>
Zimbabwean Hyperinflation

231 000 000% (official, July 08)
89.7 × 10²¹% (HHIZ, 14 Nov 08)
6.5 × 10¹⁰⁸% (Forbes Asia, 22 Dec 08)
The Fed is unlikely to let that happen.

So change in balance sheet and public statements will start 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... June – October... important
The Fed is usually too late: ave. 10 mos from peak unemployment to tightening.

Source: Federal Reserve, BLS
Federal Funds Rate vs Inflation

- CPI (left axis)
- Fed Funds (right axis)

A technical rebound in CPI, or the start of the chase?

Source: Federal Reserve, BLS
The Fed is almost always too late: ave. 31 mos from tightening until peak CPI

A technical rebound in CPI, or the start of the chase?

Source: Federal Reserve, BLS
Fiscal Policy
The Federal Reserve Bank at least has a plan to reduce spending and mop up liquidity (or do the opposite). Little debate over policy so far.
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

Gov’t gets tax revenue $100

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

Office of Management and Budget
www.budget.gov
Federal Budget Deficit as a % of GDP

1960 - '07

<table>
<thead>
<tr>
<th></th>
<th>Ave.</th>
<th>Max</th>
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<tbody>
<tr>
<td>U.S.</td>
<td>-2.1%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>UK</td>
<td>-2.2%</td>
<td>-7.9%</td>
</tr>
<tr>
<td>France</td>
<td>-1.7%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>Italy</td>
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<td>-12.4%</td>
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<td>-10.2%</td>
</tr>
<tr>
<td>Canada</td>
<td>-1.8%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>EU targ.</td>
<td>3.0%</td>
<td>0%</td>
</tr>
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Sources: The Federal Reserve. Congressional Budget Office
Federal Budget Deficit as a % of GDP

A New Era of Responsibility!

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
Federal Debt as a % of GDP (CBO)

1991-2007

U.S. 63%
Italy 110%
Germ. 58%
UK 42%
Federal Debt as a % of GDP (CBO)

- U.S.: 63%
- Italy: 110%
- Germ.: 58%
- UK: 42%

A New Era of Responsibility!

1991-2007

Fiscal Stimulus

- $787B stimulus spending: goes into 2011, only 64% has been “spent”
- $150B “Jobs Bill”
- $25B to state govt to prevent layoffs
- Another $65B recently
- Now another $50B in infrastructure spending (not stimulus)

- Congressmen have no apparent understanding of economics, the costs of indebtedness, or that they are committing our children to work for foreign nations to pay the debts, long after they have died.
Fiscal Policy

On Wednesday, September 8th, just a few days ago, the U.S. Treasury borrowed $21 B “on your behalf,” for 10 years.
Fiscal Policy

On Wednesday, September 8th, just a few days ago, the U.S. Treasury borrowed $21 B “on your behalf,” for 10 years.

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And it will borrow a similar amount in early October for 10 years.
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About 10% of this amount will be borrowed from the Chinese (and another 10% from the Japanese)

In 10 years my kids, and yours, will be paying taxes to repay those loans to the Chinese.
## Recent Treasury Issuance, $B

<table>
<thead>
<tr>
<th>Month</th>
<th>10 yr</th>
<th>30 yr</th>
<th>All (net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan-09</td>
<td>16</td>
<td>0</td>
<td>29</td>
</tr>
<tr>
<td>Feb-09</td>
<td>21</td>
<td>14</td>
<td>81</td>
</tr>
<tr>
<td>Mar-09</td>
<td>18</td>
<td>11</td>
<td>204</td>
</tr>
<tr>
<td>Apr-09</td>
<td>18</td>
<td>0</td>
<td>134</td>
</tr>
<tr>
<td>May-09</td>
<td>22</td>
<td>14</td>
<td>19</td>
</tr>
<tr>
<td>Jun-09</td>
<td>19</td>
<td>11</td>
<td>218</td>
</tr>
<tr>
<td>Jul-09</td>
<td>19</td>
<td>11</td>
<td>155</td>
</tr>
<tr>
<td>Aug-09</td>
<td>23</td>
<td>15</td>
<td>104</td>
</tr>
<tr>
<td>Sep-09</td>
<td>20</td>
<td>12</td>
<td>147</td>
</tr>
<tr>
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<td>20</td>
<td>12</td>
<td>71</td>
</tr>
<tr>
<td>Nov-09</td>
<td>25</td>
<td>16</td>
<td>235</td>
</tr>
<tr>
<td>Dec-09</td>
<td>21</td>
<td>13</td>
<td>154</td>
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<td>16</td>
<td>15</td>
</tr>
<tr>
<td>Jun-10</td>
<td>21</td>
<td>13</td>
<td>250</td>
</tr>
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<td>68</td>
</tr>
<tr>
<td>Aug-10</td>
<td>24</td>
<td>16</td>
<td>79</td>
</tr>
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</table>
• 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

as the deficit gets larger...

...interest rates climb

yield on 10 yr. Treasuries (rhs)

Deficit as a % of GDP (lhs)

Sources: The Federal Reserve, Congressional Budget Office

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

...interest rates climb

yield on 10 yr. Treasuries (rhs)

as the deficit gets larger...

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
"FX$ vs. Oil, 12mo %change

-oil weaker...

-oil rises

Sources: Nominal Broad Trade-Weighted Exchange Value of the US$, Fed. Average Spot Price: Crude Oil: Average of Brent, Dubai & WTI (US$/Barrel); World Bank"
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

Outstanding credit market debt/GDP

10 yr. Yield

source: Federal Reserve

interest rate swaps

secrtzation of mortgs

stock index options

interest rate options

private label MBS

inflation whipped, interest rates fell

sec. auto, cred cards

© Copyright Euler Hermes 2010
The Big Picture; the Evolution of Easy Money

Outstanding credit market debt/GDP

10 yr. Yield

interest rate swaps

interest rate options

private label MBS

inflation whipped, interest rates fell

..."easy money"

source: Federal Reserve

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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:

• Canada, Australia, Malaysia, Norway and India have already started tightening

• China – put restrictions on lending to prevent bubble
Recap

• 4 Forces
• Recovery
• Inflation
• Debt, deficits
• Risks
• Conclusions
Risks

• Housing market collapses / foreclosures
• Monetary policy becomes ineffective
• New taxes and regulations
• Austerity
• Endless “Stimulus” packages
• Oil prices spike
• Protectionism
• PIIGS damage the euro-zone and us
• Global growth stagnates
• Double dip
Conclusions

• Recession over thanks to oil, interest rates, and lack of fear. Expect GDP growth of around 2% over next few years

• Recent weakness suggests recovery slowing but not stopped. Very easy to lose big picture.

• Monetary policy is aggressive, but risks inflation long term.

• Fiscal policy of huge deficits is disastrous, will cause inflation in consumption, money, and bubbles, while tax increases will surely damage growth.

• Bubbles are caused by “easy money” which will come around again some day as the credit cycle eases…
Conclusions
Arguments for double-dip / deflation or continued slow growth / inflation

Double dip / deflation
• Monetary policy ineffective
• Fiscal policy damaging
• Shaky housing market
• High unemployment
• Taxes and regulation
• Weak consumer

Slow growth / inflation
• Monetary policy set to “nuclear”
• Banks wanting to lend
• Low inflation, interest rates, labor rates (now)
• High corporate profits
• Big increase in M&A
• Rest of the world growing
• Change in WDC, fiscal policy coming
• Yield Curve very positive (leads 3-5 quarters)
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