Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

The Longbrake Letter*

Bill Longbrake

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I. Increasing Acceptance of an Extended Period of Subpar Growth and High Unemployment

1. <u>Hope vs. Pessimism</u>

Sentiment continues to oscillate between hope and pessimism. But when a dismal employment report spurs a stock market rally, as it did on September 3, 2010, just because it was a little better than expected, it is an indication that hope and optimism are ebbing.

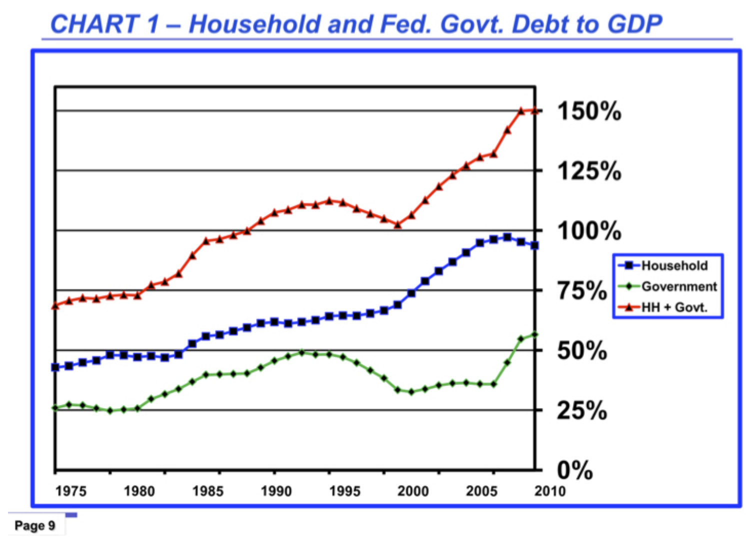
Slowly but surely more and more are coming to accept the view that economic recovery is likely to be muted, growth will be anemic and unemployment will remain high for an extended period of time. But acceptance is grudging and not yet fully embraced. Chairman Ben Bernanke and other Federal Reserve officials, while acknowledging the weakness of the recovery, continue to expect improved resource utilization (reduced unemployment and increased capacity utilization) during 2011. Jean Claude Trichet, head of the European Central Bank, voiced similar optimism at the recent Kansas City Federal Reserve Bank's annual Jackson Hole gathering when he spoke about how the dust is settling on the financial crisis.

The economic recovery we are experiencing is not the kind of outcome that most of us have been taught to expect, particularly given aggressive use of fiscal and monetary policies during the Great Recession. Such pump priming is supposed to stimulate demand and reignite a virtuous growth circle of income, spending and employment growth. **But, that has not happened.**

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

2. It's Different This Time — The Curse of the Credit Bubble

As a few have long since pointed out, the causes of the Great Recession were very different from those of other recessions in recent times. The Great Recession resulted when an enormous credit bubble marked by excessive use of debt burst.



Easy access to credit brought consumption forward in time and induced asset price inflation, most notably in residential homes, which further buttressed increased use of debt to finance consumption. Financial innovations, such as adjustable-rate mortgages, home equity lines of credit, credit default swaps and collateralized debt obligations, fueled the credit bubble, extending its duration and greatly increasing its size.

As can be seen in **Chart 1**, the combined debt to GDP ratio for households and the federal government rose from 102% in 2000 to 150% in the first quarter of 2010. This ratio is not falling, because the increase in federal debt, courtesy of massive deficit spending, is offsetting the reduction in households' leverage ratio. The federal debt to GDP ratio rose from 56.5% at the end of the first quarter of 2010 to 59.1% in July. So, household debt will need to fall by 2.6% from 93.7% at the end of the first quarter to 91.1% just to keep the combined ratio unchanged. (These data come from the Fed-

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eral Reserve's Flow of Funds which will be updated for the second quarter of 2010 in late September.) The pre-bubble level of household leverage was 69% at the end of 2000. It peaked at 98.2% in the first quarter of 2009 and has been declining since then. But, household deleveraging to date has only reversed about 15% of the bubble surge. Thus, it appears that household balance sheet repair is still at a very early stage and we have a long ways yet to go.

Traditional recessions typically occur after monetary policy has been tightened to dampen the inflationary consequences of rising demand for goods, services and labor relative to their supply. During the recession inventories are slashed and employment is reduced, which reverses the demand-supply imbalance and takes the steam out of inflationary pressures. The policy responses of cutting taxes, increasing spending and cutting interest rates all work to put a floor under aggregate demand. In a few months time the excesses that led to the recession are worked off and policy support of incomes and spending, which initially provides a safety net, eventually helps re-establish sustainable growth.

I suppose we shouldn't have been surprised that most expected the same pattern of recovery to emerge in the aftermath of the Great Recession, particularly since a greater amount of stimulus was applied than ever before. But, the same few who pointed out that the causes of the Great Recession differed considerably from those preceding traditional recessions, also pointed out that the historical record demonstrated that the historical record showed that recovery also followed a very different and much less benign trajectory.

3. The History of Credit Bubbles and Financial Crises Indicates That Recovery May Take Ten Years

Vincent R. Reinhart and Carmen M. Reinhart, in a paper presented at the Kansas City Federal Reserve Bank's annual Jackson Hole meeting, found that: *"real per capita gross domestic product growth tends to be much lower* ***during the decade following crises [emphasis supplied].***" In 10 of 15 cases unemployment did not fall back to its pre-crisis level even after the passage of 10 years. In 90 percent of the cases, housing prices were 15 to 20 percent lower than pre-crisis levels after 10 years. Prior to the onset of crisis the ratio of credit to GDP expands very rapidly. Afterwards it " *declines*

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by an amount comparable to the pre-crisis surge. However, this deleveraging is often delayed and protracted." During the 10 years or more while excess credit leverage is being unwound employment and output growth will be considerably less than they were during the credit expansion part of the cycle.

The important lesson from the Reinhart and Reinhart study of similar historical credit bubbles and financial crises is that the healing process is slow and while policy intervention can avoid or limit the potential for a self-feeding downward debt-deflation spiral, it cannot accelerate the healing process to any meaningful extent.

4. There Are No Quick Fixes

This is not an easy conclusion to accept. We are conditioned to expect policy intervention to ease pain and accelerate a return to "normal" conditions. To understand why an extended period of subpar growth and high unemployment is likely, consider the case of an individual household that has borrowed to the hilt and lived high on the hog. When the jig is up and there is no further access to credit to finance profligate consumption, the household must enter into credit counseling. Debts are rescheduled and household spending is severely curtailed with what little that is left over going to pay down debt. The process of working off excess debt takes a very long time. If an adverse life event intervenes, such as illness or unemployment, the task becomes even more difficult. Of course, the household can declare bankruptcy and start over again. But, that is far from a positive solution for two reasons. First, the household still must live within the means of earned income as access to credit typically is denied post-bankruptcy. Second, the losses still must be absorbed by someone and that someone's ability to spend will be limited because of the losses.

Economies are no different from households; after all economies are simply groups of households and associated institutions. Of course, the government can borrow and give the money to households or it can even assume the debt burden of households. But this merely transfers the problem of over indebtedness to another venue; it does not resolve the problem. The American public is already alert to this problem as evidenced by their collective alarm at the rapid rise in the size of the federal debt to GDP ratio.

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5. The Cure for What Ails the Economy Is To Reduce Dependence on Excessive Debt Leverage — This Will Take a Long Time

Some, such as Paul Krugman, assert that policymakers were much too timid and that a much greater amount of government stimulus would have averted the current malaise we now find ourselves in. The rationale is that the government provided insufficient income support to offset the amount of income lost through unemployment, underemployment and destruction of wealth. If the government had replaced most all of the loss, so the argument goes, that would have been sufficient to reignite the private economy. The flaw in the argument, however, is that the problem of excessive debt leverage would not have been addressed. Indeed, as I have pointed out before it is exactly this policy of borrowing our way out of trouble in previous recessions that led to a persistent secular rise in the level of total debt to GDP to the point, which we now appear to have finally reached, where we have hit the wall and can't go any further.

Thus, ***the job for policymakers now is to stop pretending that the economy will return to normal by applying the traditional palliatives.*** The traditional remedies simply won't have much impact until substantial deleveraging occurs. The task of policymakers should be to manage the process of deleveraging in an orderly fashion and accept the reality that this will involve an extended period of subpar growth and high unemployment. However, the risks of setbacks in such a setting are very high. Thus, policies need to be crafted to avoid unleashing a dysfunctional deleveraging process.

Policies also need to be shaped to develop new productive economic activity rather than sustaining potentially less productive spending patterns. This means shifting the emphasis of stimulus to infrastructure development, research and development activity, and job retraining and placing less reliance on income shock absorbers such as unemployment insurance. And, it definitely involves abandoning counterproductive programs such as "cash for clunkers" and housing tax credits. As we now know, such programs cause volatility — they shift the timing of demand but do not appear to change to any material extent the amount of demand. They are counterproductive to the extent that they delay the healing process. In the case of housing the problem is simple and straightforward.

During the credit bubble we built far more houses and rental units than

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population growth justified. The problem of excess supply in time will be resolved through population growth and new household formation. Short of bulldozing excess homes, no other policy will have much impact in reducing excess supply. Attempts to absorb excess supply through demand stimulus programs will be expensive and inefficient. However, having said that, there is one benefit that intervention may have brought us and that is housing price stabilization. CoreLogic estimates that the amount of the mortgage exceeds the value of the home for 23.7 percent of mortgages outstanding. This number would be higher if home prices had fallen further. We know from experience that high loan to value ratios are a good predictor of default. Thus, further home price declines would lead to an increase in mortgage defaults.

6. Risks of Significant Policy Errors Are High

Like a patient in intensive care, the U.S. economy needs attention. The economy is not yet ready to heal itself without external intervention. Yet, the political environment, as I discuss in detail in **Section II**, no longer is sympathetic to much in the way of further significant government intervention in the economy. The American people believe that intervention to date has accomplished little and worry about the longer run consequences of large budget deficits. This is the kind of situation, which the mid-term elections could easily re-enforce politically, that has in the past led to policy errors — in this case the error would be lack of intervention when it is still needed to help the patient recover — with the consequence that the economy's condition worsens.

II. U.S. Federal Budget Deficit and European Sovereign Debt Updates

1. U.S. Federal Budget Deficit Update (See *June 2010 Longbrake Letter* for an in depth discussion)

When the effects of government stimulus and inventory restocking are removed, private sector GDP has had great difficulty recording a positive quarter (see **Table 1** in **Section III** — "Near Term U.S. Macro Economic

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Outlook"). The 0.8% gain in the second quarter of 2010 was only the second quarter since the start of the Great Recession that recorded positive growth; the other was the fourth quarter of 2009, which was 1.0%. The private sector will need to do a lot better than that going forward as government stimulus goes into reverse and becomes a significant drag on growth during 2011.

The mood of the American public has become more negative in recent months regarding the value of further spending programs and tax strategies. With unemployment stuck stubbornly near the recession peak, Americans have difficulty believing that the past stimulus did much good. Arguments that policymakers and economists make that the economy and unemployment would have been much worse in the absence of massive federal government stimulus simply don't connect with the average American.

In addition, Americans are truly worried about the potential longer run consequences of large budget deficits. According to a recent Pew poll 51% of Americans believe deficit reduction should be a higher priority while 40% believe spending and/or cutting taxes to stimulate the economy should be a higher priority. Another poll found that only 6% believe that the massive federal budget stimulus has created jobs.

So, we are faced with the belief that a growing federal budget deficit will have dire consequences, which eventually would be true if nothing is done, and the belief that stimulus has had little to no beneficial impact. Mix this with election-year politics and we have a recipe for brewing a significant policy mistake.

Here is the rub. While reducing government spending is a necessary antidote to avoiding a future fiscal crisis, the timing of implementing such a policy matters a great deal. Premature withdrawal of government support when the private economy is fragile and households are still desperately working to repair strained balance sheets raises the real risk of renewed recession — the much feared double-dip. A contracting economy will not help solve the budget deficit problem. To the contrary it will worsen it by reducing government tax revenues. And, in the extreme, there is a risk that a debt-deflation reinforcing circle will be unleashed. Greece may already be headed in that direction, but we won't know for sure for several months because it takes time for policy actions to take hold and it takes additional time for responses to those policy actions to manifest themselves.

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Ideally, retrenchment of fiscal stimulus, or fiscal consolidation as economists like to refer to it, should be delayed until the economy is on stronger footing and has greater resilience to absorb stimulus withdrawal. We are not there yet. As American Enterprise Institute scholar John H. Makin has put it, "*We Do Not Have Liftoff*". Thus, the evolving political climate that on balance opposes further stimulus and may also result in stalemate over the extension of the expiring Bush tax cuts has set the stage for an experiment in fiscal austerity that could have disastrous consequences.

Unfortunately the political agenda is dominated by dogma, electioneering, and simple public perceptions, which are on the mark about what needs to be done in the long run but do not understand the importance that timing policy in a nuanced way has for achieving an optimal outcome that minimizes collectively both short run and long run consequences. (See **Section III** of the ***July 2010 Longbrake Letter*** for explanation of the policy optimization process.)

At the risk of oversimplification, Democrats tend to focus on tax fairness. On the spending side of the equation this involves providing income and benefits support to lower-income and middle-class Americans. On the taxation side, it involves higher tax rates for the wealthy and lower tax rates or tax credits (earned income tax credit and Making Work Pay tax credit) for lower-income and middle class Americans. President Obama affirmed this policy dictum on September 8, 2010 when he asserted that he opposes any compromise that would extend the Bush tax cuts for the wealthy beyond their scheduled expiration at the end of this year.

For Republicans the dogma is small government is good and that is best accomplished through tax cuts. The belief is that revenue that is left in the hands of the private sector will be deployed more productively than if it is spent by government with the result that economic growth is stronger and tax revenues grow accordingly. Also, starving the government of revenues forces curtailment of spending, which achieves the smaller government objective.

Thus, the battle lines for the upcoming mid-term Congressional elections have been clearly drawn. Democrats insist that more federal government spending is essential but that this must not include tax reductions for the wealthy. Republicans are adamant that all the tax cuts must be extended, preferably permanently, and deficit reduction, not further stimulus, must be

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the priority of fiscal policy. Apparently in an election year it matters little that the Republicans fail to explain exactly how the deficit will be cut.

There is an extremely slim chance that Congress will consider tax and revenue legislation prior to the election; stalemate is the far more likely outcome.

Unfortunately for the Democrats, the economy is weakening and the public holds them accountable. Paul Krugman, in a recent *New York Times* column on September 5, 2010 entitled "*1938 in 2010*", notes how eerily similar today's political and economic mix is to that of 1938. Thanks to Roosevelt's and Congress' decision during 1937 to reduce the budget deficit significantly, the depression-era economy lurched into a second severe recession during 1938. Krugman observed that a March 1938 Gallup poll found that 63% opposed increasing spending further and a similar percentage favored business tax cuts. The public had lost faith in the efficacy of government intervention. The result was a severe recession within an ongoing depression and a massive election defeat for Democrats in the 1938 mid-term elections, when they lost 70 House seats and seven Senate seats. November 2010 is shaping up for an equivalent debacle for Democrats. Already polls show Republicans leading Democrats in the generic ballot by ten percentage points (51% to 41%), a gap that is considerably higher than the one that preceded the Republicans' surprise recapture of the House in 1994.

All of this reflects anger and intense frustration. It is not as though the Republicans have better answers. They don't. But, Republicans will benefit electorally by simply continuing to say "no" to any proposal. Since it seems likely that the Republicans will recapture the House of Representatives and may come very close to doing so in the Senate as well, they have nothing to gain at this time by compromising. The greater risk of a blowout Republican victory in November is that they will misinterpret it as endorsement of their policies and beliefs, which amount essentially to letting the economy find its own way. To my way of thinking the recovery is far too fragile yet to withstand the withdrawal of government support. So a tough love strategy may beget the kind of outcome that occurred in 1938. That is not currently my expectation, nor my forecast, but it is this kind of policy error that blows seemingly sensible forecasts out of the water.

Recently, Tom Gallagher, a long-time political and economic analyst for ISI Group (International Strategy and Investment), retired. He provided

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clients with some extraordinarily thoughtful observations in his farewell missive. I quote a few lines:

> *"Politics in the first instance is about economics. So, I start with respecting what history says about post-crisis periods, namely that post-crisis business cycles are muted. The record of the last year suggests it's time to adjust one's priors and to raise the odds on this kind of outlook. The depth of the recession (the biggest since the Depression) and the magnitude of the policy response both argued for robust recovery. So the tepid response of the economy over the first few quarters of recovery gives added weight to the analyses that look at how economies perform after financial crises. Real GDP is likely to oscillate around a below-trend path for the next several years.*
>
> *This means it will be a tough time for incumbents. Republicans will do very well this November, giving them a chance to demonstrate their governing choices. With low prospects for co-operation over the next two years, voters starting out with low opinions of both parties, and a weak trend line for growth, 2012 will show both parties discredited and continued voter discontent. Obama is likely to be re-elected in 2012, but his odds are below the historical record of incumbents running for re-election due to the impact of deleveraging on the economic outlook."*

To recap, the Bush tax cuts expire at the end of 2010. Extension or modification requires affirmative Congressional action and this probably means that there will need to be a super majority of 60 votes in the Senate for anything to pass at all. The Democrats have been willing to extend most of the Bush tax cuts except those on wealthier taxpayers and there is some talk about raising the tax rate on dividends and capital gains. Whether the Republicans will accept that approach eventually remains to be seen, but a sweeping electoral victory weighs against such an outcome. After the election some kind of compromise seems the most likely outcome because what no one wants is for all of the tax cuts to expire but that is the default option if no compromise can be reached.

In the meantime the various tax and spending measures President Obama has proposed in recent days, including 100% up-front depreciation of capital investments, expansion of the research and experimentation tax credit, and

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transportation infrastructure spending, will go absolutely no where. There is a possibility that one or more of these proposals might end up in an eventual compromise package, but that is far from certain. What is certain is that probability of further fiscal consolidation is higher than the probability of significant new stimulus. This in turns means that the economy is on its own. In its current fragile state with the process of deleveraging still underway we will see in time whether the economy can muddle through or whether a 1938-like severe setback is in the offing.

2. European Sovereign Debt (See ***July 2010 Longbrake Letter*** for an in depth discussion)

Europe's move towards austerity will eventually slow its growth and perhaps even result in a double-dip recession there. During the summer, markets seemed oblivious to this risk as data reports were on the strong side. Such strength is to be expected as a natural result of a manufacturing and export surge as global trade recovered from the Great Recession. The decline in the value of the euro, courtesy of the Greek sovereign debt crisis had a temporary favorable impact on trade and economic growth. But, let there be no doubt — austerity is not a growth inducing policy. The consequences of reduced government spending, unless the meat cleaver approach is applied as it has been in Greece, take months to be implemented and work their way through the economy. As we move into the fall months, the complacency of summer is beginning to fray.

Three factors are at work that will bring the crisis back to prominence in due course.

First, most all European countries are pursuing fiscal consolidation policies in varying orders of magnitude. Inevitably this will reduce growth rates. The impact will be greatest for the countries with excessive debt to GDP ratios like Greece and those countries which are not cost competitive like Spain. To a limited extent the decline in the value of the euro will provide a benefit by exporting the deflationary consequences of fiscal consolidation to other countries. But in the aggregate this is a zero sum game. Not all countries can follow fiscal austerity programs simultaneously and expect other countries to bear part of the burden. This is analogous to the paradox of thrift — the more individuals attempt to save the less they are able to save collectively because substitution of saving for spending reduces economic

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activity and income.

Second, growth is slowing globally as the impacts of government intervention fade and the embedded disinflationary/deflationary impacts of excess aggregate global supply evolve. Thus, even a European export-oriented strategy based on depreciation in the value of the euro will likely run into strong headwinds of reduced global demand in coming months.

Third, while not much commented upon, governments in several major European countries are under the gun and could be out of office within a year. At the top of the list is Germany, but France is not far behind. Governments in Spain, Italy and the United Kingdom are also in jeopardy. Regardless of how matters sort themselves out in coming months, weak governments and economic instability are not a combination that bodes well for thoughtful and decisive policymaking. Indeed, the risk of significant policy errors is high.

While the outcome for Europe remains uncertain and it would be wrong to assert that it inevitably will be a bad outcome, nonetheless there will be further testing of the resiliency of the European monetary union. And I do feel confident in stating that the risks are considerable and are collectively tilted to the downside.

Recent developments indicate that the summer pause is over and the spotlight is likely to shine unfavorably on Europe once again in coming weeks:

- **Greece** — Greece is meeting or exceeding the fiscal consolidation time schedule it agreed to in May. The longer run consequences are not yet fully evident, but the ability of Greece to work through its financial problems without eventually defaulting on its sovereign debt remains doubtful. Market optimism is diminishing as reflected by the Greek 10-year bond yield, which reached 11.8% on September 8, after falling to about 8.0% in the immediate aftermath of the financial crisis in April and May.
- **Ireland** — During the height of the financial crisis in 2008 the Irish government guaranteed the debt of Irish banks. Losses at Anglo Irish Bank in particular continue to escalate forcing the Irish government to provide 22 billion euros in aid to date. Estimates of eventual aid

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to cover losses at Anglo Irish Bank range as high as 35 billion euros, an amount equal to 22% of Ireland's GDP. Total losses from all Irish banks that the government is committed to cover could eventually be as much as 80 to 90 billion euros. S&P recently downgraded Ireland's bond rating from AA to AA-, stating that absorption of banking losses could push Ireland's debt-to-GDP ratio to 113% by 2012, a level similar to that of Greece currently. 10-year Irish government debt yields have risen to a new high above 5.5%.

- **Germany** — Germany has been enjoying vigorous economic growth over the past few months which has led many to believe that the core of the European economy is sound and is well positioned to weather the financial difficulties of some of the European Union's smaller countries. However, this strength is probably a timing illusion brought about by the export orientation of the German economy, the strong rebound in global trade, the decline in the euro making German exports more competitive on world markets, and substantial government fiscal stimulus in the immediate aftermath of the global financial crisis in 2008. There is increasing evidence that the support these factors have provided to the German economy are waning. Industrial production growth is slowing and appears poised to contract. Exports have already peaked and fell in the most recent month. Fiscal consolidation is in the process of being implemented and it will be awhile before the growth dampening consequences are felt.
- **Euro** — After increasing in value against the dollar and other currencies following the spring Greek financial crisis, the euro's value is once again declining. This reflects increasing worry about the stability of European banks and the prospects for slower European economic growth in coming months.

We have not yet returned to crisis mode for Europe, but another episode in the next few months seems more likely than not.

So, the emperor has no clothes in my opinion. Time will tell all of us whether my instincts and analysis are firmly grounded or whether I have misunderstood and misdiagnosed the facts, which in turn has led me to a misguided and unduly negative outlook about European prospects.

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III. Near-Term U.S. Macro Economic Outlook

As the benefits of tax cuts and government spending programs diminish and continuing credit deleveraging holds back growth in consumer spending, overall real GDP growth has slipped below 2.5%, a level that needs to be exceeded to bring down the unemployment rate. This means that unemployment is likely to remain stubbornly high and could edge up a bit in coming months. Worry about the possibility of a double-dip recession has emerged. Growth near or somewhat below 2.5% for the next few quarters is the most likely outcome; however, policy errors, such as permitting all of the Bush tax cuts to expire or the Fed Reserve failing or waiting too long to engage in another round of quantitative easing, could push the economy in the direction of renewed recession. The enormous amount of excess capacity in the economy will continue to put downward pressure on inflation, but an outright and sustained decrease in prices is not likely. However, deflation would become a real possibility if recession were to re-emerge. Details follow for GDP growth, employment, consumer spending, housing, business activity and inflation/monetary policy.

1. GDP

The "second estimate" of second quarter GDP growth was 1.6% versus the "advance estimate" of 2.4%. The principal factors resulting in the decrease were a surge in imported goods and slower inventory restocking. The "final" second quarter estimate will be released at the end of September and should be near or slightly below 1.6%.

Importantly, after netting out the transitory effects of government stimulus spending and changes in inventories, adjusted GDP is positive and rises over time. In other words, both forecasters expect the private sector recovery to proceed; however, the extent of the improvement will be obscured by the top line published GDP number for several more quarters because it will include the negative drag from shrinking government stimulus. And, very importantly, neither forecaster expects top line GDP growth to exceed 2.5% until late 2011. This means that unemployment will remain at recent levels or even move up a bit.

The Fed's forecast is more optimistic and assumes that growth will be

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Table 1: GDP – Effects of Fiscal Stimulus & Inventories

- **Fiscal Stimulus (Federal + State & Local) turns negative in 2010 Q3 and Averages -1.7% of GDP in 2011**

	Bank of America					Goldman Sachs				
Quarter	Fore-cast	Stimu-lus	Net	Inven-tory	Net	Actual/ Fcst	Stimu-lus	Net	Inven-tory	Net
2009Q1	-4.9%	-0.6%	-4.3%	-1.1%	-3.3%	-4.9%	-0.6%	-4.3%	-1.1%	-3.3%
Q2	-0.7%	1.1%	-1.8%	-1.0%	-0.9%	-0.7%	1.1%	-1.8%	-1.0%	-0.9%
Q3	1.6%	1.4%	-0.2%	1.1%	-1.3%	1.6%	1.4%	-0.2%	1.1%	-1.3%
Q4	5.0%	1.2%	3.8%	2.8%	1.0%	5.0%	1.2%	3.8%	2.8%	1.0%
2010 Q1	3.7%	1.6%	2.1%	2.6%	-0.5%	3.7%	1.6%	2.1%	2.6%	-0.5%
Q2	1.6%	0.2%	1.4%	0.6%	0.8%	1.6%	0.2%	1.4%	0.6%	0.8%
Q3	1.8%	-0.9%	2.7%	0.4%	2.3%	1.5%	-0.9%	2.4%	0.4%	2.0%
Q4	1.5%	-1.1%	2.6%	0.3%	2.3%	1.5%	-1.1%	2.6%	-0.0%	2.6%
2011Q1	1.5%	-1.5%	3.0%	0.0%	3.0%	1.5%	-1.5%	3.0%	0.2%	2.8%
Q2	2.0%	-1.8%	3.8%	0.0%	3.8%	2.0%	-1.8%	3.8%	0.1%	3.7%
Q3	2.2%	-1.7%	3.9%	0.2%	3.7%	2.5%	-1.7%	4.2%	0.6%	3.6%
Q4	2.5%	-1.7%	4.2%	0.2%	4.0%	3.0%	-1.7%	4.7%	0.3%	4.4%

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Table 1 shows Bank of American's (B of A) and Goldman Sach's (GS) GDP forecasts quarterly for 2010 and 2011 and nets out the impacts of government fiscal stimulus and inventory accumulation. B of A recently reduced its estimates of GDP growth over the next several quarters with the result that both the GS and B of A GDP forecasts are now similar. Both forecasts are less optimistic than the Blue Chip consensus. However, I expect the consensus estimates in due course to be reduced and come into closer alignment with those of GS and B of A.

greater than 2.5%. Specifically, the Fed said in the August 10th FOMC statement: " the Committee anticipates a gradual return to higher levels of resource utilization in the context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated." The terminology "higher levels of resource utilization" is Fed-speak for falling unemployment.

To the extent that the Economic Research Cycle Institute (ECRI) index of leading indicators has real predictive power, it is signaling a nontrivial probability that the economy could slide back into recession later this year. Many economists discount the predictive power of this measure because it is fitted to past data after the fact. If the structure of the economy has changed and if the correlation between measures in the ECRI index and GDP growth has changed, then the ECRI index could very well be giving

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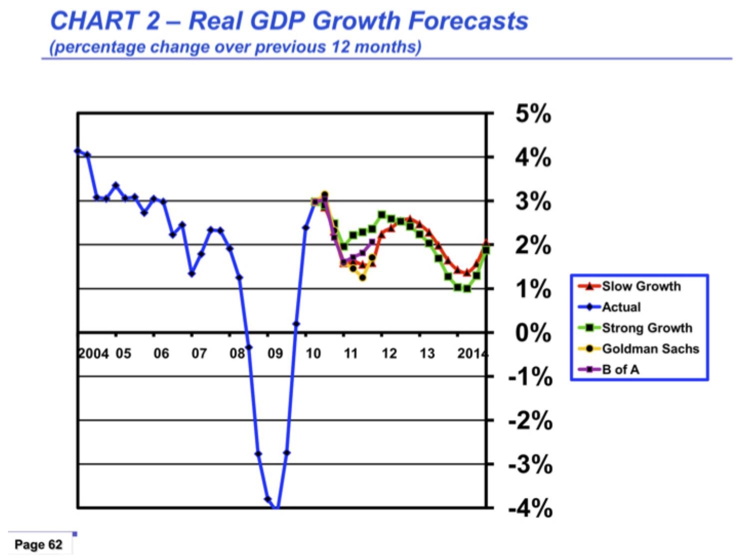

Chart 2 shows my GDP growth forecast for slower and stronger employment growth, as well as the GS and B of A forecasts. The revised GS and B of A forecasts track my slow employment growth scenario. I have included a forecast for 2012-14. Forecasting that far into the future is not particularly reliable but the projections do reflect the theme I have been sounding which is that growth is likely to remain weak for an extended period of time.

a false signal. Nonetheless, it would be imprudent to ignore this warning signal as it has correctly foreshadowed all of the last six recessions.

In the ***May 2010 Longbrake Letter*** I discussed how population growth and productivity combine to determine the noninflationary rate of growth in real GDP and how the gap between potential and actual GDP can be measured. A positive output gap imparts deflationary pressures while a negative output gap fuels inflation.

I assume that the potential growth rate in real GDP currently is about 2.8% annually. This figure is somewhat, but not much higher, than estimates of most others. It is derived by combining the contributions of labor force growth and labor productivity. It appears that productivity might be in the process of declining to a somewhat lower level on a sustained basis so that the potential growth rate of GDP is closer to 2.5% to 2.6%. If that is the case, it would actually become harder and would take longer to eliminate

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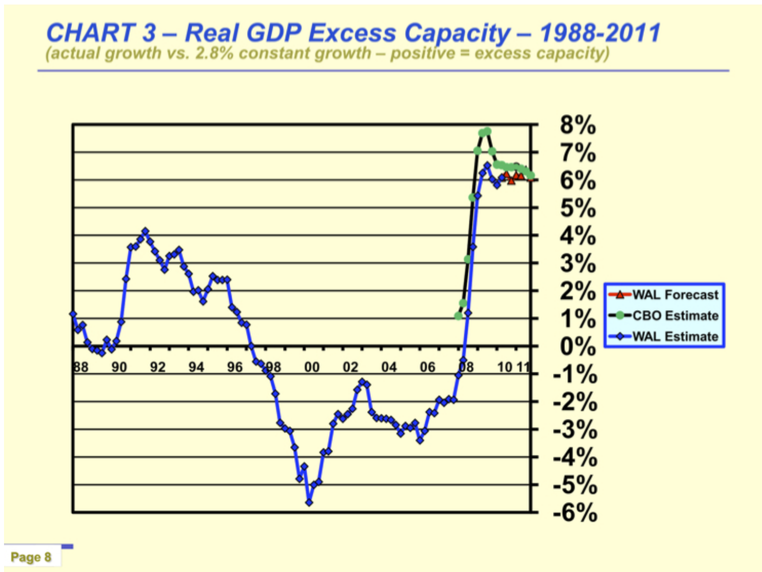
Chart 3 shows how the GDP output gap has fluctuated since 1988 and includes a two-year forward forecast. Measurement is difficult so you should not attribute precision to the data in the chart. However, the oscillations in the output gap over time tell an important story.



excess capacity.

The story that **Chart 3** tells is that there is substantial excess capacity in the economy and it is much greater than what occurred after the recession of the early 1990's. I calculate the level of excess capacity in the second quarter of 2010 as 6.1% which compares to the Congressional Budget Office's (CBO) estimate of 6.5% based on the second quarter second estimate GDP report and CBO's published full-employment GDP estimate.

The real story, however, is that it will take a long time to reduce excess capacity. By the end of 2011 excess capacity falls only from 6.5% to 6.2% using Bank of America's GDP forecast and CBO's estimate of full employment potential GDP. If Goldman Sach's GDP forecast is substituted for Bank of Americas', excess capacity inches down from 6.5% to 6.1% by the end of 2011.

The reason that excess capacity is important is that it signals that supply exceeds demand and generally when that is the case downward pressure

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exists on prices in the form of disinflation, that is, a declining rate of inflation. When the actual level of inflation is low, as it is currently, substantial and sustained excess capacity could lead to an outright decline in the general level of prices — deflation.

2. Employment

The August employment report, released on September 3, 2010, was weak with payroll employment declining 54,000. But the market reacted favorably because it expected a worse report. In recent months the top line employment number has been skewed by temporary Census Bureau workers. Because of that economists have focused on the change in private employment rather than total employment, which includes government workers, to gage to what extent the labor market is recovering. From January through April private employment increased an average of 119,000 per month with each month's total being greater than the previous month. This seemed to validate expectations of an incipient turnaround in employment. However, private payroll has averaged only 72,000 per month over the last four months including 67,000 in August.

Over the first eight months of 2010 total payroll employment has grown an average of 90,000 per month while private payroll employment has grown 95,000 per month. About 105,000 to 115,000 people enter the labor force each month. Thus, the unemployment rate would be edging up were it not for the exit of discouraged workers from the labor force. As it is, the unemployment rate has barely budged from 9.69% in January to 9.64% in August.

Adjusting the unemployment rate to include discouraged workers paints a different picture. This adjustment can be calculated by determining what the labor force participation rate would be in a normal situation. Because of the demographic changes that are occurring in the age distribution of workers as time passes, the labor force participation rate is currently declining very gradually. I calculate that the participation rate has declined from 65.72% at the beginning of the Great Recession in December 2007 to 65.29% in August 2010. However, the actual participation rate in August 2010 was 64.73%. The difference amounts to 1.4 million workers who really should be counted as unemployed. Certainly, when labor markets improve these discouraged workers will attempt to reenter the labor force. Adjusting for

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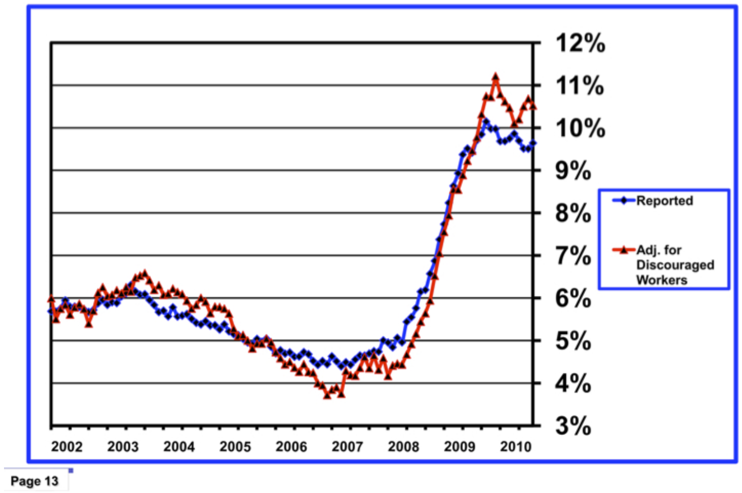
discouraged workers, the unemployment rate would have been 10.5%, not the actual reported rate of 9.6% in August.

CHART 4 – Reported Unemployment Rate & Adjusted for Discouraged Workers



As can be seen in **Chart 4**, the adjusted unemployment rate that includes discouraged workers peaked at 11.2% in December 2009. It then improved to 10.1% in April 2010, which was coincident with the surge in optimism that labor markets were turning around. However, since April the adjusted unemployment rate has deteriorated to 10.5%, while the official unemployment rate has improved from 9.9% to 9.6%. You can also see a pattern in **Chart 4** where the adjusted unemployment rate is higher than the reported rates during and just following a recession. The relationship reverses when reported unemployment is low, which implies that during times when jobs are easier to get, some individuals who would not normally seek employment enter the labor force.

The August employment report affirms that the severe deterioration in the labor market has ended. That is the good news. The bad news is that rapid recovery is unlikely and unemployment will remain at an extremely high level for a long time to come. And, because discouraged workers will gradually reenter the labor force as the economy recovers, it is likely that the unemployment rate will fall very gradually as shown in **Chart 5**.

The Conference Board's Employment Trends Index declined in August.

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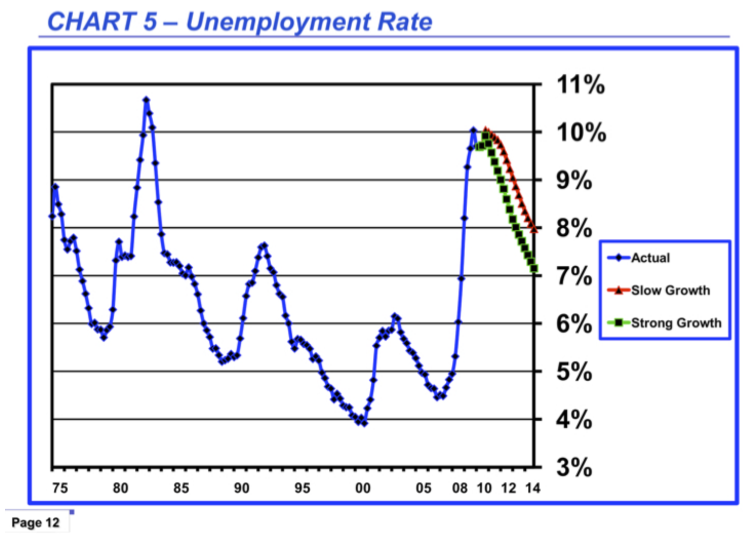

While the index indicates moderate job growth will continue, the decline in the index implies that the rate of growth is likely to slow further. The Manpower survey of hiring intentions for the fourth quarter edged down and is conveying a similar message. Details of the Manpower report were discouraging. Intentions to hire declined from 18% to 15% and intentions to cut staffing rose from 8% to 11%.

3. Consumers

Consumer spending accounts for approximately 70% of GDP, so it bears close scrutiny. Consumer spending depends on earned income, investment income, government transfer payments, pensions and an ability to monetize wealth. At an economy wide level, aggregate consumer spending also depends upon the number of employed workers, average hours worked and the average hourly wage rate.

In normal times growth in real consumer spending growth is fairly stable, averaging about 3.04% annually over the last 25 years. This is derived from a 0.9% annual rate of increase in the labor force and a 2.0% gain in real incomes due to productivity growth. The difference is due to a steady decline, until

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recently, in the saving rate.

Real disposable income growth has averaged 2.84% annually over the last 25 years. Spending growth has exceeded income growth because consumers through much of the last 25 years were able to tap wealth through access to credit. A steady decline in the consumer saving rate during most of the last 25 years was a direct result of a spending growth rate that exceeded the disposable income growth rate.

Since the onset of the Great Recession in December 2007, this has all changed. Real disposable income, in spite of a significant increase in government transfer payments, has grown only 1.0% annually. Real consumer spending has actually declined at a -0.4% annual rate over the same period as consumers have retrenched and paid down debt and increased savings. The saving rate over that period has increased from 2.4% to 5.9%.

Over the first seven months of 2010 real disposable income growth has accelerated to a 2.02% annual rate while real spending growth has been 1.77%. Both real income and spending growth continue to fall short of historical levels. The higher saving rate and continued reductions in consumer debt all point to an on-going process of household balance sheet repair. In the long-run this household de-leveraging process will be healthy, but the cost in the short-run will be spending growth that is consistently less than income growth and the collateral consequence will be slower improvement in GDP and employment growth.

Chart 6 shows that consumer spending growth is not likely to converge to the long-term norm of real income growth of about 2.9% until late 2011. Over the next year spending growth could decelerate for a while as fiscal stimulus diminishes disposable income growth and improvement in wage and salary income is insufficient to offset this decline. The rise to a 3.5% growth rate in 2012 is predicated on the assumption of strong employment and income growth as the economy improves. By 2014 the spending growth rate slows to a long-term norm consistent with a stable saving rate in the range of 6% to 7%.

Over the longer run aggregate consumer spending will depend on the level of unemployment and that will depend in turn on the overall health of the economy. Since employment growth is likely to occur slowly and wage growth will remain under pressure the odds strongly imply that spending

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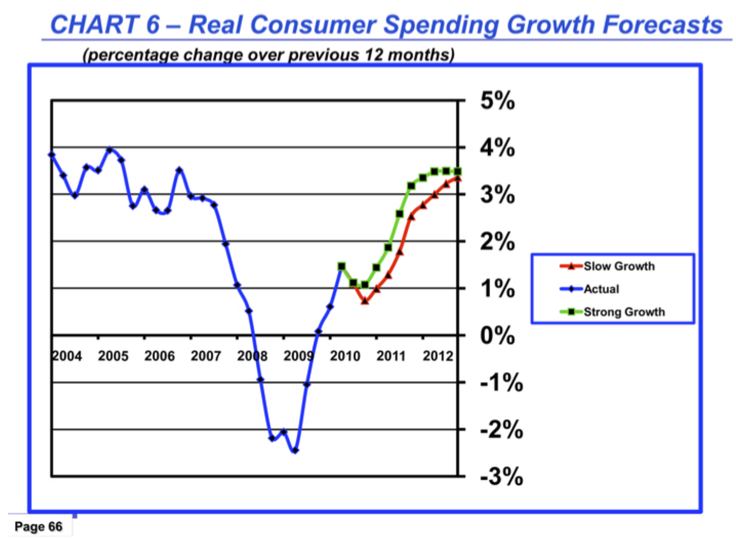

growth will be relatively weak as consumers continue to reduce reliance on debt, which is another way of saying that they will focus on increasing savings (see **Chart 7**).

Some believe the saving rate will move to a higher level of 7% to 9% that prevailed during the 1980's. Were that to occur, it would delay the recovery in consumer spending growth and extend the length of time required for the economy to return to full employment.

4. Housing Investment

In a typical business cycle, housing construction is a driver of economic recovery. That is not the case this time. Overbuilding during the bubble years lead to far greater than normal inventories of vacant homes and apartment units. **Chart 8** shows that inventories are nearly 2 million units above normal levels and have moved down only slightly over the last three quarters.

New residential homes sold in July amounted to an annual rate of 276,000, the lowest amount ever reported by the Census Bureau since it began keeping records in 1963. New residential building starts were 546,000 in July

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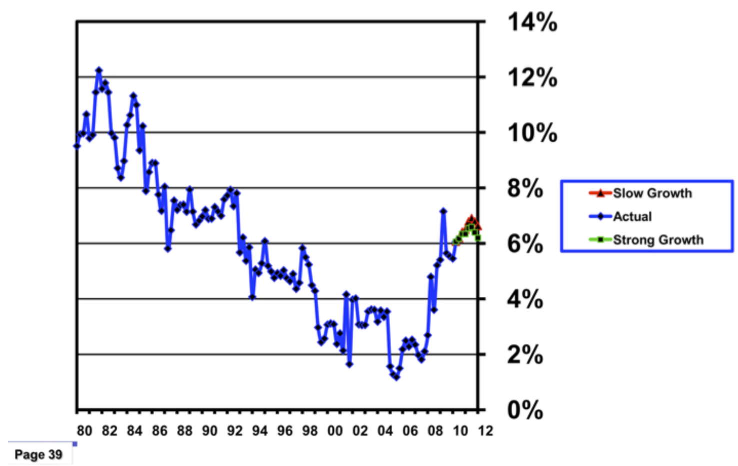
CHART 7 – Consumer Saving Rate (quarterly average)



— 432,000 single family homes and 114,000 multi-family rental units. See **Chart 9**.

The difference between single family starts and sales is huge and in the wrong direction. It is evident that the tax credit program boosted sales temporarily but it also appears to have boosted construction. If the policy objective was to reduce inventory, this surely was not achieved as excess inventory of single family homes has been stuck in the 600,000 to 800,000 range for the last five quarters. With the end of the tax credit program, and there is absolutely no prospect for any kind of renewal, it is widely expected that housing construction and sales will remain weak for an extended period of time. Both a forecast I generate and one that Bank of America produces indicate that housing starts have probably hit bottom but will not rise appreciably until 2012. The data in **Charts 8 and 9** certainly support that conclusion.

With softness in the housing market continuing and the artificial prop of the tax credit program gone, a resumption of declines in home prices, which had stabilized or even increased a little, seems probable. This is not yet apparent as housing price data is reported with a two to three month lag. However, anecdotal information from buyers of foreclosed properties suggests that price declines have resumed in some markets. Should hous-

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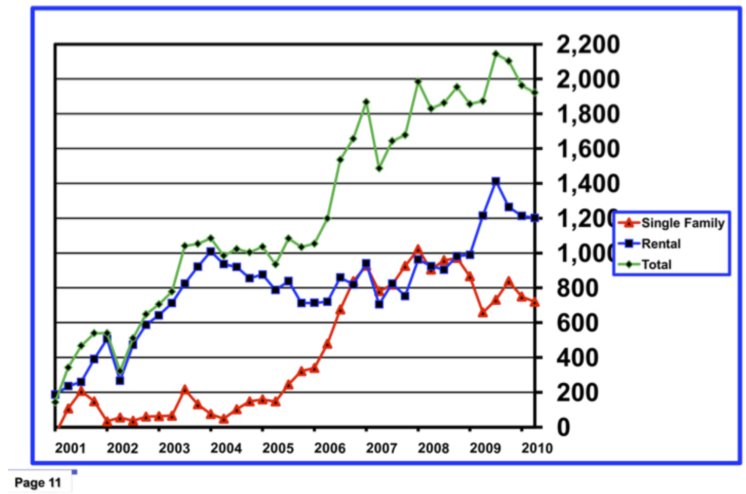
CHART 8 – Number of Units Above 1994-2000 Average



ing prices begin to decline again this likely would reinforce already weak consumer confidence and cautious spending plans.

5. Business Activity

The Institute of Supply Management (ISM) manufacturing index has been one of the few rays of sunshine from the private sector. Strength in manufacturing over the last year has had two drivers. I have already mentioned the first which is inventory restocking, which was the inevitable result of cutbacks in production that greatly exceeded declines in demand during the free-fall days in late 2008 and early 2009. It was inevitable that as demand recovered depleted inventories would have to be restored. But that process is nearly over.

The ISM index rose slightly in August to 56.3 from 55.5 in July, suggesting that manufacturing is gaining steam. However, the internal details painted a different picture — one where strong manufacturing activity is on its last legs and poised to pull back over the next few months. While production and employment rose, the indicators that measure pending production pressure, new orders and delivery backlogs, continued to pull back

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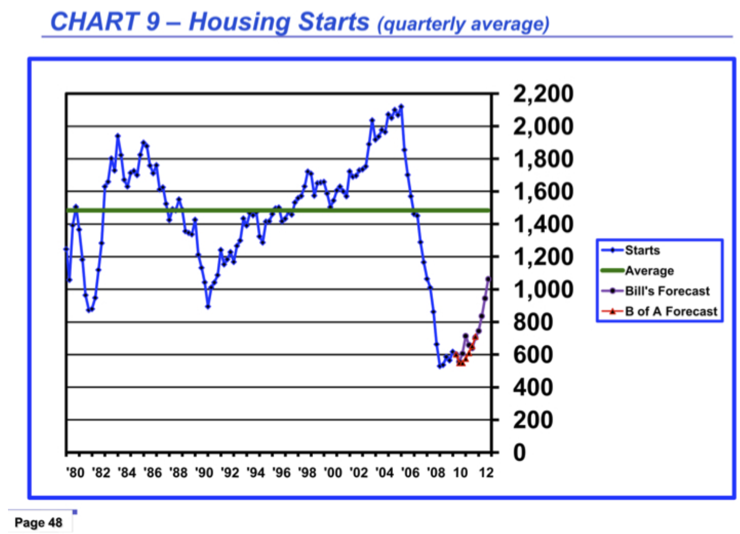

and are nearing the neutral 50 level. This implies that the ISM index will move down toward 50 over the next few months.

The second driver of manufacturing strength has been exports. China's aggressive infrastructure investment has been an important contributor as has a significant revival in international trade, which is analogous to the domestic inventory cycle. But, China's rate of growth is slowing a bit and the recent increase in the value of the dollar is beginning to take a bite out of exports.

The August ISM index for the service sector, which accounts for a far greater proportion of the economy than the manufacturing sector, dropped sharply to 51.5 from 54.3 in July. This index does not receive nearly as much attention as the manufacturing index.

Another business activity measure compiled by Goldman Sachs was unchanged in August, but again the internal details pointed in the direction of slowing activity in coming months. The employment and orders components both declined in August. Based on a study of inventories, Goldman Sachs concluded that production may be getting ahead of demand. All-in-all, these data points and analysis indicate that growth in business activity is likely to decelerate in coming months and may even decline.

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6. Inflation and Monetary Policy

Inflation is not a threat now and will not be for some time to come. Finally, chatter has shifted from fear of inflation to the threat of deflation. The potential consequences of deflation were examined in detail in the ***August 2010 Longbrake Letter***. As matters now stand, I expect inflation to continue edging down and approach the zero level in late 2011. However, I do not expect sustained deflation to establish itself. That view, however, could change if the political and policy environment lead to counterproductive monetary and fiscal policies. That is not my current expectation but the risks are not trivial and thus bear close watching.

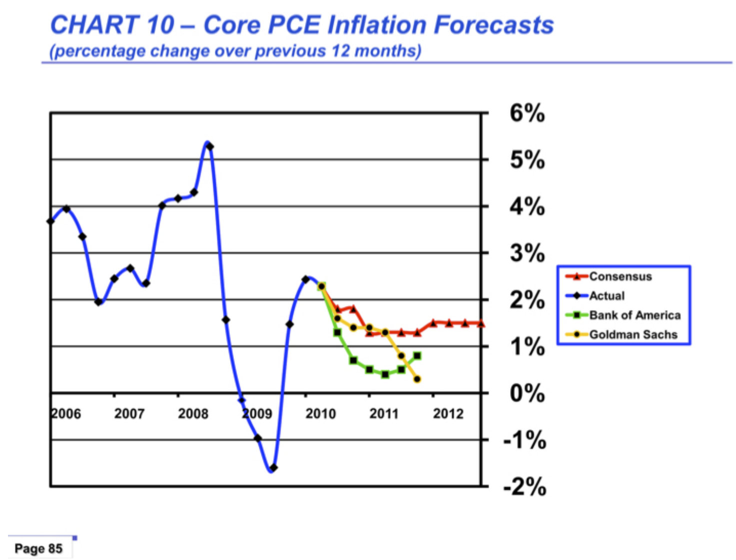

Chart 10 shows various forecasts for price inflation in core personal consumption expenditures (PCE). The core PCE measure excludes volatile food and energy prices. Both the Goldman Sachs and Bank of America forecasts project declining inflation over the next 18 months to close to zero but not below. The consensus forecast, which I believe will be scaled down over time, anticipates relatively flat inflation around 1.5%.

The question of consequence is one of what the Federal Reserve will do if the threat of deflation becomes serious and whether it will act in a timely manner.

Until the August 10th meeting of the FOMC (Federal Open Market Com-

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mittee), committee members tended to avoid use of the term "deflation" in public. The minutes included the following sentence: "***While no member saw an appreciable risk of deflation, some judged that the risk of further near-term disinflation had increased somewhat.***" This might be a politically motivated statement in the sense of fear that too much candor might prompt self-fulfilling expectations. Nonetheless, inserting it at all and stating it in strong terms suggests a committee that is overly optimistic, out of touch with the risks of what is developing, ignorant of market expectations as exemplified by the recent decline in the 5-year 5-year forward breakeven inflation rate to 1.87% from 2.77% in late April, or some combination of all of this. This, in turn, raises a concern that if the economy weakens materially, the FOMC will remain overly cautious and wait too long to intervene.

The tools the Fed has at its disposal to counteract deflationary pressures are limited and untested. The principal tool, often referred to as quantitative easing, would be aggressive purchase of Treasury securities and perhaps mortgage backed securities. Such purchases would flatten the yield curve by depressing long-term rates. It is not clear how effective such a measure would be in stimulating the economy if it is not accompanied by an increase in lending activity. The initial round of quantitative easing was not encouraging in this regard as nearly all of the securities purchased by the Fed were financed by increases in funds banks deposited with the Fed. Yields were brought down, but lending activity did not increase.

There are two other tools the Fed could deploy. First, the Fed could reduce the rate on bank deposits from the current level of 0.25%. The theory is that this would prompt banks to seek yield by making loans. When lending risks are high, as they are in today's deleveraging economy, it seems to me that losing a 0.25% yield provides little incentive to pursue lending opportunities more aggressively.

The other set of tools is aimed at changing investor expectations by convincing them that the Fed will keep rates low for a long time. Right now the Fed's policy simply states that rates will remain low for an extended period, but that leaves open to question just how long that period really will be. Greater certainty could be provided either by establishing a date or setting an explicit inflation target, many have suggested 3%. By making expectations more certain, longer term rates would decline, which would reinforce the quantitative effect of direct balance sheet purchases.

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All of these options have been discussed openly by Fed officials and all are in play. Again, the question is how long the Fed will wait to deploy any or all of these strategies and how bold will they be when action is taken. The historical record is not encouraging. The FOMC tends to follow, not lead, markets. Also, we know from long experience that monetary policy is a blunt instrument that takes a long time to impact economic activity. We have less experience with the effectiveness of monetary policy in periods following a financial crisis triggered by excessive leveraging, less experience when short-term rates are already at zero and less experience when deleveraging activity is still underway.

Because of all of this uncertainty and the real risks that monetary policy will have little substantive impact, the more reliable instrument of policy right now is fiscal policy. But, that is a story I examined above and it is not one I have a great deal of optimism about either.

Bill Longbrake is an Executive in Residence at the Robert H. Smith School of Business at the University of Maryland.

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