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A Murky Forecast

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There is a credit crisis, this is clear. We also have a lack of transparency as to where and how large additional write downs might be. Who forecast that Bristol Myers' earnings would be hit by losses in corporate cash that was inadvisably invested in structured products? Who is next? Over \$100 billion in net worth of financial institutions has vanished, requiring them to raise additional capital, and also impairing their ability to provide the continued flows of credit required to maintain economic growth. The market for structured securities, including loans for autos, credit cards, jumbo mortgages, and LBOs, is all but closed. These have to be financed elsewhere. Lending policies are tightening as bank balance sheets and capital are stretched and risk aversion prevails. Flows of credit to Main Street are beginning to be affected.

At the same time, housing prices are fading rapidly and housing starts have collapsed. To the extent that wealth, especially in home values, grew faster than the economy as a whole, it makes sense that there be some reversal of that relationship. However, it requires a big shift in mindset to grasp that the several decades it took for that relationship to get out of whack might require an equally long period to reverse. Add in the need for baby boomers to liquidate their houses for retirement spending and the magnitude of the problem starts to reveal itself. Demand from young adults or immigration are not fully offsetting these sellers. In all, there is limited ability to bolster consumer spending when borrowing against a declining asset value. Instead, we witness delinquencies and defaults increasing.

And then there is the problem of higher food and commodities prices, particularly energy. As workers are not gaining extra wages to pay for these, they represent less an inflation problem than a cut in personal income, requiring a reallocation of spending in the consumer's market basket. Inflation won't get much press when housing prices are falling and economic growth is anemic. The resilience of the consumer, though, has been brought in to question.

Conventional thinking would indicate that these issues would cause deep economic convulsions and require significant time to heal. Yet, at the same time, the policy responses have been significant. A few important developments include: aggressive monetary easing; legislative and executive branch focus on a fiscal stimulus package; the Fed's Term Auction Facility (TAF) liquidity facility; large cash injections from sovereign wealth funds; and coordinated efforts to address the creditworthiness of the monoline insurance companies. "Don't fight the Fed" has historically been good advice. With the Fed's own repair job in process, and the host of other responses, portfolio managers typically would be advised to begin to increase portfolio risk exposures. Yet fear remains greater than greed as the forecast is somewhat murkier for a few reasons.

One unknown is the resiliency of the consumer. Delinquencies and defaults (in mortgages of all sorts, and auto loans and credit cards) have risen to historical highs at the same time as 2007 economic data revealed continued gains in personal income and economic growth. Third quarter GDP was 4.9%, not exactly recessionary, but fourth quarter GDP has been initially estimated at only 0.6%. In other words, there were consumer cracks before the current signs of much slower growth. How will the consumer hold up in 2008 when growth is already clearly slower?

This complicates the second problem. The impact on the flow of bank credit is still unknown. We have not seen the last of write downs, as delinquencies and defaults on household debt are going to increase, further impairing valuations of complex securities. With constraints on bank capital there will be continued limits on access to funding going forward for a myriad of consumer and business purposes.

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