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What's in a Name? Recession?

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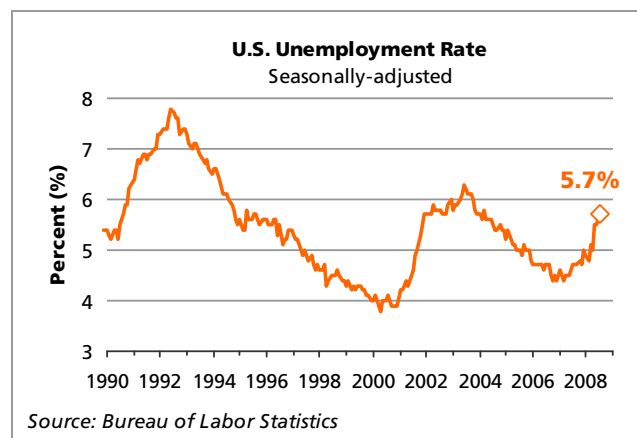
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Some good news: commodities prices have stood down, exporters are doing well, and productivity gains have been stronger than expected in this sluggish economy. Government tax rebates gave a boost to consumers just as fuel prices soared. Additionally, government support for Fannie Mae and Freddie Mac may have arrested what could have been a nasty outcome for the mortgage market. These factors have kept our economy growing. That said, the economy and the mortgage market both will struggle to improve much over the near term.

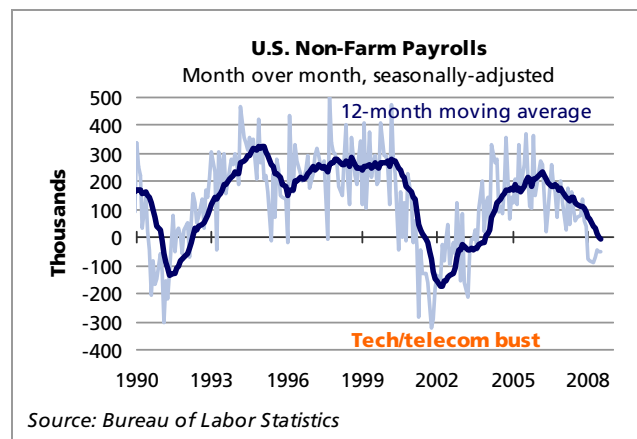
Tackling mortgages first, it is interesting that the needs of the Government Sponsored Enterprises (GSE) are now somewhat aligned with the interests of the U.S. Treasury. They both want to avoid a very unpopular injection of taxpayer funds. For the GSEs, it would mean massive dilution (or a wipe out) of shareholders. Yet, going forward, there will be less support for the housing market because of tighter lending standards, higher fees, and a shrinking of the GSE's balance sheets. Add in that housing prices continue to fall, that some ten month's worth of housing supply is on the market, and that 8,500 homes a day slip into foreclosure, then the path to better times looks like it may take a while.

One reason for this is the freezing up of the monetary policy transmission mechanism, which means the Fed has eased the interest rates it controls, but market rates – mortgages, consumer loans, corporate credit costs – have increased or at least not fallen. These market rates would be a lot higher if the Fed had not eased, but the unwinding of leverage throughout the financial system has reduced the supply of funds available and increased its price. As aggressive as the Fed's actions have been, the financial system is struggling and the credit markets remain in disrepair. There have been banks failing each of the last several weeks. It is hard to imagine a robust economic outlook without money and banking recovering first.

The unemployment rate reached 5.7% in July. It is not likely the Fed can tighten while this increases.



Non-farm payrolls have declined each month this year, though they have not dropped as much as during the tech and telecom bust earlier in this decade.



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At the same time, we face a host of other headwinds. Job creation, as measured by non-farm payrolls, has been negative every month this year. The unemployment rate has increased to 5.7%. These indicators of the employment situation do not bode well for either consumer spending or the already bleak future for housing prices. This data also indicates that the job market has joined the auto and housing industries in recession. Data from our major trading partners shows a slowdown in growth too, which the drop in commodities prices likely reflects. No doubt this has eased the Fed's inflation fears somewhat.

As for the economy as a whole, what's in a name? GDP remains positive; perhaps technically this is not a recession. It sure feels like one. In the bond markets, Treasuries remain overvalued, reflecting the flight to quality that they represent. They are likely to remain pricey until the credit and financial system heals a bit further. ■

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