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Monday, November 10th, 2008

[For the U.S. Economy in the New Year, the Pain Will Precede the Promise](#)

[Editor's Note: This is the second installment of a new series that looks at the global investing outlook for 2009.]

**By Shah Gilani**

**Contributing Editor**

**Money Morning/The Money Map Report**

If there's a proverb that captures the outlook for the U.S. economy in the New Year, it's the one that says: "It's always darkest before the dawn."

Regardless of any formal announcement of whether or not the United States drops into an actual recession, the ongoing credit crisis guarantees a contraction of the American economy by virtually every measure we know. That period of darkness will be marked by a dramatic slowdown in economic activity, as well as by rising unemployment, additional declines in U.S. stock prices, and constant volatility. It could last as long as 12-18 months.

But when the dawn does come, it will be one to remember. If

U.S. President-elect Barack Obama gets it right - and I have every reason to believe that he will - then investors will be presented with the greatest investment opportunity of our generation. At that point, shares of American companies will be at such low levels that wholesale buying by individuals, mutual funds, pension funds, institutional money managers, and foreign-controlled sovereign wealth funds, will generate gains that will not only make us whole, they will make us rich once again.



## A Market Mandala

Creating an analysis of the U.S. economy's outlook for the New Year is akin to creating a [mandala](#), a geometric work of art whose pattern, symbolically or metaphysically, represents a microcosm of the universe from the human perspective. In some Buddhist temples, mandalas are made of tiny colored beads, painstakingly created by several monks as a form of meditation. In celebration of the ever-changing nature of the universe, the mandala is then joyously shaken by its creators, until it is once again nothing more than chaos embodied in a box of colored beads.

Regardless of the big picture, analysis of a mandala - or the economy - always starts at the center and emanates outward. With the U.S. economy, that centerpiece is credit. The credit crisis has shaken the complex mandala that is our economy and transformed the United States economy into chaos. It's complex because this economic-forecast mandala derived its form from thousands of individual pieces - in the case of the economy, from scores of data points, many of which are currently dark and foreboding.

The credit crisis we are experiencing results from the contraction - or worse, the cessation - of lending. Under normal circumstances, institutions and markets freely facilitate capital movement between lenders and borrowers. But that's not happening, now.

Because of a lack of transparency into the balance sheets of borrowers holding such complex and illiquid securities as collateralized debt obligations, credit-default swaps, and non-performing loans, and because of increasing recessionary fears affecting businesses and households, lenders don't want to increase their loan exposure. Banks are holding onto the cash and liquid securities they control, using them as a cushion against their own potential losses. The U.S. Treasury Department's direct-to-bank capital injections do not alter these banking realities. In fact, as a *Money Morning* investigative story recently demonstrated, instead of using these taxpayer-provided infusions to increase their lending, these [banks are using the money to finance takeover deals](#).

## The Recipe for a Recession

Whether or not the United States is technically in a recession ultimately will be divined by the [National Bureau of Economic Research](#) (NBER). The business-cycle dating committee of this privately run, nonprofit economic research group [is right now studying five factors in an attempt to determine if the United States has entered a recession](#) and, if so, when that downturn started, *MarketWatch.com* reported. Those five factors are:

- Gross Domestic Product (GDP).
- Industrial production.
- Employment
- Income.
- Retail sales.

Regardless of any formal announcement by the NBER of whether we're in a recession, the credit crisis guarantees a general contraction of economic activity, by every measure.

[“Any doubt that we’re officially in a recession can be put aside.”](#) Anthony Karydakakis, former chief U.S. economist for JPMorgan Asset Management ([JPM](#)) - and now a professor at New York University’s Stern School of Business - recently wrote in *Fortune* magazine. “The rapid deterioration of labor markets points to a sharp decline in hours worked and output in the fourth quarter. This is likely to lead to a decline in personal consumption to the tune of 5.0% or so for that period. Since [consumer spending] makes up about 70% of the economy, the stage has already been set for real GDP to shrink at a more than 4.0% rate in the fourth quarter.”

Confirmation of that belief is evident by looking at each of the NBER’s five key indicators.

- **Gross Domestic Product (GDP):** The U.S. Commerce Department estimated that the U.S. economy, as measured by GDP, rose 0.9% in the first quarter. In the second quarter, GDP advanced an estimated 2.8%. For the third quarter, GDP declined an estimated 0.3%. My own econometric models suggest that GDP actually contracted at a 1.5% pace in the third quarter and will decline another 2.75% in the fourth quarter. For the year, that would mean the U.S. economy actually fell 0.55%. The U.S. economy last posted a full year’s negative GDP in 1991, when it declined 0.2%. **Verdict: Recession.**
- **Industrial Production:** This measure of output by the nation’s factories and mines dropped 2.8% in September, and a very steep 6.0% in the third quarter. **Verdict: Recession.**
- **Employment:** The U.S. Bureau of Labor Statistics announced Friday that October’s unemployment rate was 6.5%, a jump of 0.4%, which was double what most economists expected, and also its highest level in 14 years. The economy has now lost a total of 1.2 million jobs since the beginning of the year, with [nearly half of those losses occurring in the last three months](#) alone, pointing to an acceleration in the pace of erosion in labor markets. Karydakakis, the Stern School professor, wrote in *Fortune* : “By way of comparison, during the 2001 recession and in the sluggish growth that followed in 2002-03, the unemployment rate reached a peak of only 6.3%, in June 2003. We’ve already exceeded that mark and, given that we are still in the early phase of the current recession, the unemployment rate should be expected to push toward the 7.5% range - and possibly higher - during the next three months to six months.” **Verdict: Recession.**
- **Income:** Personal income increased \$24.5 billion, or 0.2%, and disposable personal income (DPI) increased \$25.7 billion, or 0.2%, in September. [Personal consumption expenditures](#) (PCE) decreased \$33.6 billion, or 0.3%. Excluding the rebate payments made to U.S. taxpayers under the [Economic Stimulus Act of 2008](#), DPI increased \$30.3 billion, or 0.3%, in September, and increased \$44.0 billion, or 0.4%, in August. **Verdict: Too close to call.**
- **Retail Sales:** October retail sales are coming in well below already-diminished expectations, and some reports have been downright depressing - including [The Neiman Marcus Group Inc.](#) -26.8%; The Gap Inc. ([GPS](#)) -16%; The Nordstrom Group ([JWN](#)) -15.7%; J.C. Penny Co. Inc. ([JCP](#)) -13%; Kohl’s Corp. ([KSS](#)) -9%; Ltd. Brands Inc. ([LTD](#)) -9%; Target Corp. Inc. ([TGT](#)) -4.8%; and Wal-Mart Stores Inc. ([WMT](#)) +2.4%. In a report last week, Moody’s Investors Service ([MCO](#)) projected that the retail sector’s woes will continue into 2009 as consumers cut back on buying apparel, footwear and accessories “in order to save money for essentials.” The credit rating firm said in a separate report that holiday spending “will prove even weaker than expected,” amid October’s financial-market swoon. **Verdict: Recession.**

If U.S. exports are taken out of the GDP calculations going back to January, it's apparent that there has been very little domestic growth in the economy. And when revisions are finalized in the next few months, we'll be looking back at the recession that we're all but certain is upon us right now. Until the credit markets are freed up and borrowers are extended credit at reasonable rates, it's unlikely that credit, the centerpiece of the economy, will be anything other than a major cog in the wheel.

There are some signs of a thaw, but not anytime soon. The [U.S. Federal Reserve's lowering](#) of the [Fed Funds target rate](#) to 1.0%, and coordinated rate reductions by the Bank of England and the European Central Bank, as well as other major world-wide central banks, may start to ease the stranglehold gripping the worldwide credit markets. The London interbank offered rate (Libor), a critical interest rate against which trillions of dollars of mortgages, bank loans and derivatives are priced, [dropped to 2.39% last week](#) from a high of 4.82% on Oct. 10.

The prospect of President-elect Obama's choosing a different means of attacking the credit crisis will be closely watched and, by itself, may create an air of confidence that perceptions will change. But changed perceptions will not be enough.

The truth about our economic outlook is that it is predicated on demonstrably better transparency. If U.S. banks follow the lead of their European counterparts, which [have recently been freed from fair-value, mark-to-market accounting](#), and which may retroactively mark assets to "internal models" back to July, then balance-sheet clarity will continue to be cloaked in darkness. Lack of confidence in the banking system will persist, especially among the banks themselves. The first order of attack needs to be the creation of a fundamental leadership position that leads to an open, transparent and accountable measure of balance sheet assets and liabilities. As long as failing banks are being propped up, this cycle of credit contraction will persist.

The outlook for the economy is inextricably tied to the price of oil. The run-up of benchmark crude this summer to the record \$145 a barrel level, and its subsequent fall to half that level, has wreaked havoc throughout the economy. Similarly, the run-up in commodity prices, and their subsequent fall, also has caused a lot of damage. Together, the dramatic rise and fall in the price of oil and other commodities is a harbinger of greater volatility in the future.

## Follow the Money

Follow the money. Capital rapidly inflated the tech-stock bubble. When that bubble burst, capital flowed into and flooded the hard-asset world of real estate. When that bubble burst fast, speculative money dove into oil and commodities. When the U.S. and world economies looked weak, those bubbles burst. The looming threat of inflation this past summer instantly gave way after the drop of oil, gold, metals and agricultural commodities. And now, *deflation* is seen as the looming threat on the horizon.

Which threat should we worry about?

The answer is - both. The prospect for near-term deflation seems all too real. As raw material prices fall and finished good prices fall due to a lack of purchasing power resulting from lack of credit and world-wide recessionary fears, the U.S. consumer has fundamentally changed his or her collective psychology. Is U.S. consumerism, which is responsible for 70% of GDP, in full retreat? If it is, as all

measures project, then it's likely that government stimulus efforts will overshoot their intended mark. Just look at what the United States has done already as it battles this financial crisis. It has:

- Handed out more than \$150 billion in stimulus rebate checks.
- Floated a \$700 billion financial bailout rescue plan - almost \$160 billion of which has already been placed.
- Bailed out American International Group Inc. ([AIG](#)), to the tune of \$125 billion.
- Covered JP Morgan Chase & Co.'s bet on taking over [The Bear Stearns Cos.](#) - to the tune of \$29 billion.
- Looked to [lend struggling automakers](#) \$25 billion.
- Agreed to guarantee depositors at all banks.
- Stepped in to buy commercial paper that no one else will buy.
- Guaranteed money-market-fund investors.
- And backstopped the Federal Deposit Insurance Corp. (FDIC), Fannie Mae ([FNM](#)) and Freddie Mac ([FRE](#)).

And now we're getting wind of another stimulus package and more help for everyone.

If, in six months to a year, the credit markets are facilitating borrowers again, the massive buildup of U.S. debt will result in a falling dollar and higher interest rates.

That spells inflation.

A massive re-inflation of the economy portends another flood of speculative money into oil and commodities. The cycles are increasingly condensed, more volatile and will be increasingly more disruptive.

Welcome to the brave new world of global finance and speculation.

The Federal Reserve's balance sheet has ballooned from \$900 billion to more than \$1.8 trillion. That's 13% of GDP. The Treasury Department has telegraphed [its intention to float \\$550 billion of debt in the fourth quarter and estimates it will have to float another \\$368 billion in the first quarter of 2009](#). Our national debt will then be close to 49% of GDP.

If there is an easing of credit in the economy, and borrowers come to market with the pent-up demand that has not been met for the past year, the competition for funds will raise interest rates. Higher interest rates will counter any stimulus effect from government programs.

Who will buy U.S. Treasury debt if the world is less apprehensive about credit quality? Lenders will once again seek higher returns, potentially forcing the Treasury Department to increase its rates. The potential of this event may sink the dollar if investors perceive that the U.S. economy is stagnant and the world is awash in dollars. The [yield curve](#) - the spread between the Treasury's two-year and the 10-year paper - has been steepening. A steepening yield curve, where short-term borrowing costs are low and long-term rates considerably higher, is good for banks that borrow short and lend long.

But if the perception of risk diminishes, and the perception of future inflation increases, the [yield curve will invert](#) and the threat of rising rates will cause a sell-off in the short end of the curve and a

rush into longer-dated maturities. Any increase in short-term interest rates would be painful for struggling banks. An [inverted yield curve](#) would be devastating, and inevitably would lead to more bank failures.

## Home on the Range ...

At the core of the U.S. economy sits a desperately ailing piece of the mandala - the U.S. housing market. The once bright prospect of home ownership, which historically formed a beautiful economic picture, right now doesn't exist. For most Americans, the family home constituted the bulk of their wealth. Or at least it did. And this family financial portrait will get worse before it gets better, since the real estate collapse is far from over. Goldman Sachs Group Inc. ([GS](#)), for instance, projects another 15% drop in housing prices.

I think that's conservative. Mortgage rates are actually rising as Fannie and Freddie have to pay higher interest on their short-term notes and bonds. Thirty-year fixed-rate mortgage paper averaged 6.47% last week, up from its 52-week low of 5.36%. The 15-year fixed paper was trading at 6.18%, up from its 52-week low of 4.91% (based on [Bankrate.com](#) ([RATE](#)) rate surveys). This trend is definitely not our friend. As housing prices continue to fall, and inventories stagnate and grow in many areas, homeowners are increasingly underwater and are increasingly entertaining foreclosure as a viable economic alternative to indentured servitude.

The [Hope for Homeowners Plan](#), which looks to lower interest rates and reduce principal on mortgages, and which makes homeowners pay a share of the appreciation on their home to their lender when they sell it, was initiated in October and was expected to garner some 400,000 takers. As of last week, according to *The Wall Street Journal*, there had been only 42 takers. That's not a misprint - 42 - I even checked with *The Journal*.

In the real estate realm, the proverbial "other shoe" hasn't dropped yet, but certainly is dangling - and that's commercial real estate. As homeowners writhe in agony and stop spending, retailers will go out of business, businesses of all stripes will suffer and commercial real estate will implode. The leverage left over from just the private equity foray into commercial real estate in the acquisitive 2006-2007 period is staggering. Refinancing will be impossible. Banks are stuck with hundreds of billions of dollars of leveraged loans that they took on as bridge and mezzanine financing from the private-equity shops alone, at the time believing they would be able to securitize those loans and sell them off to investors.

There's no chance of that, now.

One deal in particular illustrates this entire mess. Private equity behemoth The Blackstone Group LP ([BX](#)) took [Hilton Hotels Corp.](#) private for \$26 billion. Blackstone put up \$6 billion of its own money as equity and borrowed the other \$20 billion from Bear Stearns, Bank of America Corp. ([BAC](#)), Deutsche Bank AG ([DB](#)), Goldman Sachs, Morgan Stanley ([MS](#)), Merrill Lynch & Co. Inc. ([MER](#)) and Lehman Brothers Holdings Inc. (OTC: [LEHMQ](#)).

Based on a current analysis of the deal at the multiple of seven times projected cash flow that the market currently puts on Starwood Hotels & Resorts Worldwide Inc. ([HOT](#)) - Hilton's nearest rival - if Blackstone values its property comparably, it will have to mark its Hilton holdings down 50%,

because it paid 13 times projected cash flow. That wipes out all of Blackstone's equity in the deal. What's more, the \$4 billion portion of the loan that Bear Stearns took on, courtesy of JP Morgan Chase casting off Bear's orphaned liabilities, now sits on the Fed's balance sheet - and isn't likely to go anywhere anytime soon.

Until the real estate cycle completes its implosion and begins to stabilize, there's nothing that will fundamentally alter the outlook for the economy. This is Ground Zero. President-elect Obama must resist creating only a political solution to the overwhelming economic problem of declining house prices and declining real estate prices in general. Any attempt to put a band aid on this economic plague will only delay the day of reckoning. I regret deeply the conclusion that the lake must be drained before we can realistically climb out of it. But there just aren't enough ferrymen to get us all to shore.

### **Always a Silver Lining - My Forecast**

The outlook for the economy is not rosy - and that's an understatement. But there is a silver lining. Even in the near term, the stock market will present innumerable wealth-creation opportunities.

- First, there are plenty of shorting opportunities out there now, and more will present themselves in the future.
- Second, in due course - in perhaps 12-18 months - we will be presented with the investment opportunity of our generation. If President-elect Obama gets it right, and I believe he's got the potential to bring us all together and get the country through this (and if you're reading this Mr. President-elect, I'd like to put in my vote for [New York Fed President] [Timothy Geithner](#) as next U.S. treasury secretary), American companies will be able to be purchased so cheaply that fortunes will be made. The recovery will not only make us whole, it will make our people and our nation rich again.

I have absolutely no doubt that the United States will lead the world back into balance. The sea change that has arrived is the result of the conservative experiment having lost its true moorings, pushing the economy into disaster. Not that a wholesale swinging of the pendulum to the other side would be good. In fact, it would be disastrous. We have the potential to end up with a new, fair, transparent and judiciously regulated environment where capital formation can again spread its wings and the U.S. economy can fly.

There are new hands reaching into the colorful box of beads that comprise the American landscape and economy. From any human perspective, the United States is more than a microcosm of the universe; it is the center of the world as we know it. It will take time to construct the new mandala. We all need to meditate on the process to ensure that the design we embrace will ultimately be inclusive, forward-looking and - like all great art - an inspiration to all who view it.

**[Editor's Note:** Contributing Editor R. Shah Gilani has toiled in the trading pits in Chicago, run trading desks in New York, operated as a broker/dealer and managed everything from hedge funds to currency accounts. In his recent investigation of the U.S. credit crisis, Gilani was able to provide insider insights that no other financial writer or commentator could hope to match. He drew upon the experiences and network of contacts that he developed through the years to provide *Money Morning*

readers with the "real story" of the credit crisis - and to propose [an alternate plan of action](#). It's a perspective on the near-financial meltdown that more than a quarter-million readers have read in *Money Morning* alone - to say nothing of the hundreds of other Internet outlets worldwide that have picked up and published Gilani's unique insights.

How can you protect yourself? Well, with the U.S. financial markets in such disarray, *Money Morning* is looking for profit opportunities beyond U.S. borders. In our [newest report](#), we've discovered a firm that's been posting quarter-after-quarter of earnings surprises - even as the rest of Wall Street tanked. Not only does this company have a lock on China - the fastest-growing market on the planet - this corporate gem is also riding the profit wave of the most-powerful global trend we're following right now. If you act immediately - as an added bonus - you'll also receive a *free* copy of CNBC analyst Peter D. Schiff's

*New York Times* best-seller, "[Crash Proof: How to Profit from the Coming Economic Collapse](#)."&quot

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### **Jim Rogers: China's Expansion Depends on Water**

Oil isn't China's most precious resource. China must spend \$162 billion in the next five years to clean up its polluted rivers-as nearly 40% of them are undrinkable. "China has a huge water problem," Legendary investor Jim Rogers says. "...If they don't solve it, or if they don't solve it in time, then China has failed." [Find out which six global water treatment powerhouses are set to make "liquid profits."](#)

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1. *Pingback by [Free Economy Blogs» Blog Archive » Global Stocks, US Futures Rise on China Stimulus; Yen Falls](#) on [10 November 2008](#):*

[...] For the US Economy in the New Year, the Pain Will Precede the Promise Money Morning - USA The US economy last posted a full year's negative GDP in 1991, when it declined 0.2%. Verdict: Recession. Industrial Production: This measure of output by ... See all stories on this topic [...]

2. *Comment by [david whetsell](#) on [10 November 2008](#):*

I see the only way we can get out of this mess is doing the following. As the article stated," Since [consumer spending] makes up about 70% of the economy ". This means there are not many jobs to create wealth. All the last 20 years have been based on consumer spending financed by borrowing . It only created service and consumer spending jobs. If the world banks generated 50 trillion dollars by printing US funny money to reinflate the ballon that just burst,who would you lend the money to? The people that can not pay there home loans,credit cards, second moragages, studant loans,car loans and ETC... as these are the people who caused it to begin with. Them and the greedy bankers who want the taxpayers to bail them out. I bet they are laughing at as all the way to the bank. The only way this country can bring the economy back is to cut taxes on businesses,stop over regulating businesses and put high taraffs on imports to force the companies back to the USA. All I see from Obama and company is higher taxes regulations to force the power compaies out of business and the total collupse of the dollar. I am glad I sold all my stocks,bonds and 401k s several years ago and bought gold and silver. I am investing in renewable energy.

3. *Comment by [D Wetzstein](#) on [10 November 2008](#):*

The conservatives did indeed loose their mooring and let the liberal socialists take unfettered control by letting them make bad loans and insisting mortgage companies make bad loans to put poor people in homes they could not afford. The President elect (together with Democrats in Congress) will attempt to Nationalize big business. I do not see how that will create an environment to make us rich? If the Fed owns the car industry and oil industry etc... how can we also own them?

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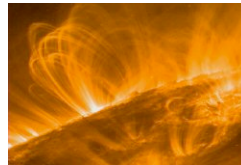
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