

Themes on the Economy®

Prospects for A Growth Recession A Mid-Year Economic Review

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A Memorial Day Premonition?

“Where is the traffic? It’s rush hour, on a holiday weekend, and nobody is on the road.”

We were on our way to our lake house in Southwest Michigan, a popular drive-to destination for Chicagoans trying to escape the city, and instead of the usual traffic jams, the roads were clear. It was almost eerie as we kept waiting for brake lights to flash and traffic to slow. Had rising prices at the pump finally hit a tipping point for drivers?

AAA predicted the first year-over-year drop in driving plans for Memorial Day weekend since 9/11 and hotels reported shorter stays—those who did travel cut their vacation a day short to offset the higher costs of fuel and air fare. Even Las Vegas, which was seen as immune to economic uncertainty, reported declines in gaming revenues from a year ago in recent months.

The only exception is the ultra-luxury hotel market (rooms priced at \$500 a night and

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up), which continues to benefit from an influx of foreign travelers riding the weakness in the dollar, and from a surge in the number of stunningly wealthy households at home. Miami and New York are the strongest tourism markets, which is not surprising, given the large number of both foreign and wealthy travelers who seek out those cities as a destination.

Half Empty/Half Full

It is sometimes hard to discern whether the glass is half empty or half full when it comes to the current state of the economy:

- Optimists cite incoming data (which shows that the U.S. continued to skirt a statistical recession in the first quarter) as a sign that credit markets are improving. The data also shows the remarkable resilience that the U.S. consumer has shown in the face of once insurmountable odds. (If you had given me over \$130 per barrel oil, rising food prices, falling home prices, and a credit market crisis, and asked me to make a forecast on consumer spending six months ago, I would have forecast a fairly severe contraction rather than a slight expansion. The fact that consumers were able to spend at all in the first quarter is nothing short of miraculous.)

- Pessimists, on the other hand, fear that much of the weakness associated with higher food and energy prices, and the drag on wealth associated with falling home prices, is still ahead of us. This is to say nothing of cost-cutting by businesses, which has accelerated in recent months. Business travel budgets are getting hit particularly hard with many large firms cutting back on travel—some even cancelling off-site meetings—all of which keeps hotels from filling up their rooms during their off peak season.

This edition of *Themes on the Economy* takes a detailed look at the forecast for growth in the second half of 2008 and first half of 2009. The economy is expected to continue skirting a statistical recession, but that doesn’t mean times won’t be tough for a large cross section of the population as well as for businesses. Any gains that we do see in response to tax rebates and monetary stimulus over the summer are not expected to do much to boost consumer or business confidence ahead of the November election.

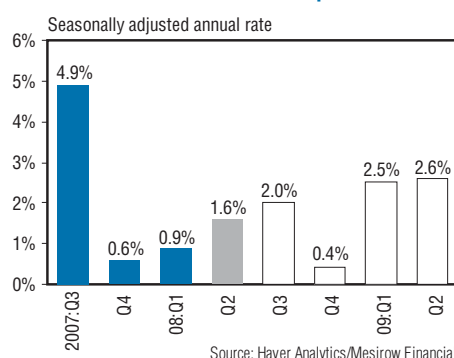
The 2008-09 Economic Outlook

A Double Dip?

Chart 1 shows the forecast for real GDP growth in the second half of 2008 and the

CHART 1

Real GDP Growth Remains Subpar



For all charts/graphs:

■ = Actual ■ = Estimate (e) □ = Forecast

CHART 2

Inflation Stays Too High

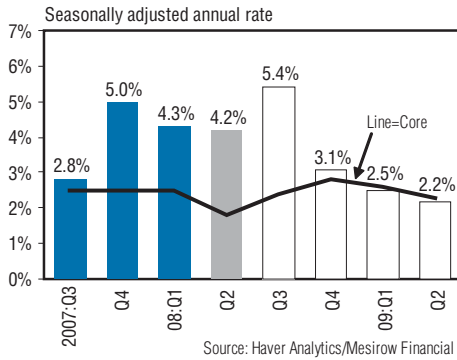


CHART 3

The Fed Eventually Must Tighten Policy

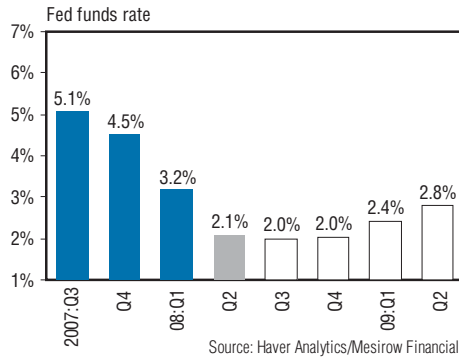
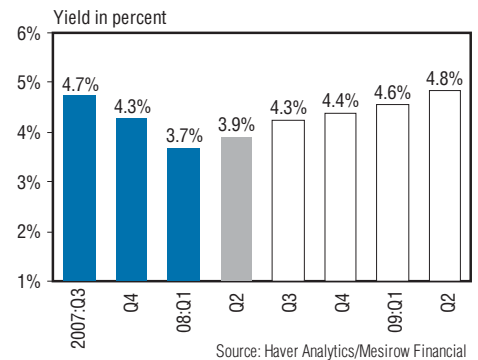


CHART 4

10-Year Treasury Yields Rise



first half of 2009. After picking up a bit in the wake of easier monetary and fiscal policy, the economy is expected to slow again at the turn of the year:

- The tax rebates and increased cash flow (created by lower mortgage resets) is expected to provide a lift for consumer spending in the second and third quarters. Indeed, even more of the tax rebates (55% instead of 40%) are expected to be spent between the second and third quarters. The problem is that much of that spending is now expected to be concentrated on staples instead of discretionary purchases. This is a disappointment in two ways as: 1) it will not provide as large of a boost to production and employment as a rise in discretionary spending alone would; and, 2) it will do little to improve consumer balance sheets by allowing consumers to pay down an already overwhelming level of debt. Separately, and perhaps more importantly for those running for re-election in November, a focus on staples over discretionary spending will not provide much of a boost to consumer attitudes prior to November. (It's just not as "fun" to spend your tax rebates on food than on a large-screen television.)
- The housing market has shown some signs of bottoming in recent months, with many already calling a bottom in starts. (Housing starts typically bottom at about a one-million unit rates, which is just about where they are today.) The hype seems a bit premature, however, given the persistently high level of inventories still on the market and surge in builder cancellations. (The cancellation rate on new homes has doubled from about 20% to 40% over the last year.) This is nothing to say of tighter lending standards, which are

taking a toll on new mortgage applications. Even the most qualified of borrowers—those with a verifiable income and 20% down—are having to pay more for a mortgage than they did a year ago. On net, starts and sales are expected to dip again before bottoming some time near the turn of the year. Prices will take significantly longer to turn around, particularly in the condo and rental markets, as construction in those markets is still relatively strong. Indeed, conditions are so bad that some condo-conversions (apartments converted into condos) are being put back onto the rental market instead of being listed for sale as a condo.

- Business investment is expected to rebound slightly in response to a pick up in investment in the oil, agriculture, and export sectors. The accelerated depreciation rates imbedded in the tax stimulus plan should also provide a boost to equipment spending in the fourth quarter, particularly on computers. However, uncertainty over credit markets and oil prices have cast a shadow on long-term projects, and are expected to mute the extent to which business investment picks up relative to history. Commercial investment is particularly vulnerable as the credit market crisis has cut off much of the funding for new projects.
- Inventories are expected to rebuild after being drawn down to unusually low levels, which should provide an extra lift for manufacturing activity. Indeed, well-managed inventories are one of the few bright spots in the economy today. Otherwise the weakness that we are experiencing would be much worse.
- Government spending is expected to remain relatively stable, with increases in

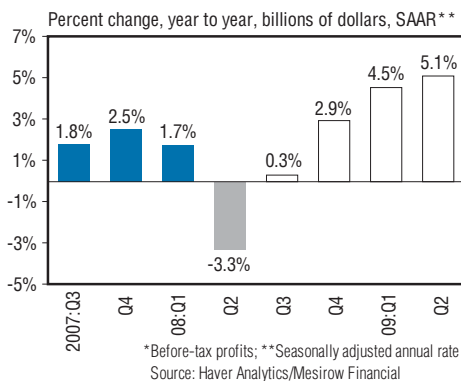
federal spending offsetting a slowdown in spending at the state and local level. Federal outlays have already picked up some in response to higher unemployment and increased subsidies for school lunches and food stamps. State and local government spending, which is subject to more strict balanced budget laws, however has slowed. Real estate revenues are falling short of expectations, especially in those areas with a large number of foreclosures. Spending on infrastructure, which includes education, is expected to be particularly hard hit as the societal costs of those cuts don't show up right away. (It is probably easier to fund a prison these days than raise the pay for good teachers. This is despite the fact that better teachers might limit the need for prisons.)

- Finally, there is trade, which is expected to be the bright spot in an otherwise dull outlook for the U.S. economy. Much of the rise in exports associated with the weak dollar is still ahead of us, as it typically takes as much as two years for the full effects of a shift in the dollar to work its way through the economy. (It takes time for hedges on the exchange rate to expire, contracts to be renegotiated, and producers to secure shipping routes to get their goods overseas.) Growth in Europe, where the dollar's advantage is the greatest, however, is showing some signs of weakening, which could limit the rise in exports.

On net, the economy is not expected to grow fast enough to absorb the influx of new workers to the labor force, and the unemployment rate is expected to continue to rise. This is closer to what economists term a "growth recession" than a true expansion—even though growth remains positive.

CHART 5

Corporate Profits* Rebound from 2007 Lows



Moreover, economic conditions are expected to continue to *feel* significantly worse than they look on paper to the overwhelming majority of Americans. Rising oil prices, in particular, are exacerbating the sense of being left behind, a feeling already present due to the housing bust and widening income gap.

Risks. Revisions to growth a year from now could reveal a recession that most felt, but that went unrecorded in 2008. Separately, persistently rising oil prices could prove an even greater threat to consumer spending and investment than already forecast.

Inflation Remains Too High

Chart 2 shows the forecast for core and overall consumer price inflation (CPI) in the second half of 2008 and the first half of 2009. Both the overall and core measures of price inflation are expected to abate, but remain well above the Fed's "comfort zone:"

- The recent weakness in growth has decreased bottlenecks and freed up capacity in key sectors, which should alleviate the upward pressure on goods prices. Lumber is actually selling below its production cost at the moment.
- Home prices are falling, which will eventually (by year end) show up as a drop in the "owner's equivalent rent" component of the CPI, which makes up about a third of the index.
- Wage gains are lagging, which is short-circuiting the usual pass through of wage-based inflation to a broader spectrum of prices.
- But, much of the recent rise in commodity prices has yet to show up in prices further down the pipeline. Gasoline prices, in particular, have yet to show the full effects of the recent spike in the price of oil. Moreover, the number of

companies willing to pass along increased commodity prices in the form of higher goods prices has picked up in recent weeks. (The announcement by Dow Chemical to raise its prices as much as 20% is especially worrisome for inflation, as they touch such a wide spectrum of consumer products.)

Risks. Tax rebates and recent monetary stimulus could artificially support the demand for food and energy over the summer, which could leave those prices significantly higher than currently forecast in the fourth quarter. This is nothing to say of the weak dollar, which along with pressure on the Chinese to revalue their currency, could provide some upward pressure on prices in the months to come.

Fed Attempts an About Turn

Chart 3 shows the forecast for monetary policy in the second half of 2008 and the first half of 2009. The Fed hesitantly abandons its concerns on growth and financial market stability for inflation:

- Credit markets are beginning to show signs of healing, albeit slowly, which should allow the Fed some breathing room on financial market stability. (The market for corporate bonds has shown the greatest signs of improvement.)
- The slowdown in growth is not expected to fully derail the upward pressure on inflation.
- And, persistently rising commodity prices are beginning to ratchet up inflation expectations, an issue the Fed takes seriously when weighing policy decisions.

Risks. The risk is that a slowdown in growth in late 2008 delays a tightening in monetary policy which will ultimately result in stronger growth and inflation in the latter part of 2009. This would require more aggressive Fed tightening than currently forecast in the second half of 2009 and 2010. (There really couldn't be a much worse scenario for Ben Bernanke, whose term as Fed Chairman comes up for renewal in 2010.)

Treasury Yields Rise

Chart 4 shows the forecast for the yield on the 10-year Treasury bond during the second half of 2008 and first half of 2009. Treasury yields are expected to continue to rise, and the spread between corporate yields is expected to narrow as credit markets stabilize:

- The flight to safety, which boosted values and reduced yields in the Treasury market in late 2007 and early 2008, is starting to show signs of reversing.
- The federal budget deficit is rising as a share of GDP, which should eventually increase the risk premium associated with Treasury bonds.
- Inflation is expected to rise on the list of concerns for both the Fed and investors, which should increase the spread required between short and long-term rates.

Risks. The question is not whether Treasury yields will rise, but when. A fourth-quarter slowdown in growth could delay, but will not stop, rates from eventually rising.

Equity Markets Trend Higher

Chart 5 shows the forecast for corporate profits in the second half of 2008 and first half of 2009. Cost-cutting and higher productivity growths are expected to boost corporate profits in late 2008 and early 2009.

This, coupled with some healing in credit markets and a prolonged period of easy monetary policy, suggests that equity markets should rally. Indeed, I would not be surprised to see the Dow Jones Industrial Average cross 14,000 before year end. Volatility, however, will remain extremely high, which means that this market will not be for the weak in the knees.

Risks. The risk is that equity prices rise more than forecast, particularly in the first half of 2009. Aggressive tightening by the Fed later in the cycle, however, will bring those prices tumbling back down again in 2010.

The Dollar Appreciates

The dollar is expected to appreciate slightly against the yen and the Euro as growth abroad slows relative to the U.S., and the interest rate differential between the U.S. and Europe narrows. The risk, however, is that the dollar remains structurally weak for some time to come, given the upcoming elections and uncertainty over the course of policy going forward.

Mesirow Financial Economic Forecast (Numbers as of June 6, 2008)

	2007(A)	2008	2009	2007:4(A)	2008:1(A)	2008:2	2008:3	2008:4	2009:1	2009:2
National Outlook										
Chain-Weighted GDP	2.2	1.7	2.1	0.6	0.9	1.6	2.0	0.4	2.5	2.6
Personal Consumption	2.9	1.5	1.1	2.3	1.0	1.8	1.9	-2.4	1.7	2.2
Business Fixed Investment	4.7	4.6	1.9	6.0	-0.2	5.2	4.3	3.6	-0.8	1.2
Residential Investment	-17.0	-21.7	-4.5	-25.2	-25.5	-20.4	-19.7	-14.9	-4.1	6.2
Inventory Investment (billions)	4.6	-12.0	17.5	-18.3	-14.4	-26.4	-16.3	8.9	15.7	16.6
Net Exports (billions)	-555.6	-452.1	-381.9	-503.2	-480.2	-459.5	-448.3	-420.2	-395.8	-384.5
Exports	7.9	7.5	6.3	3.9	1.5	7.8	8.4	7.8	5.8	4.9
Imports	1.6	-0.7	1.3	-2.6	-3.6	-0.6	3.3	-0.5	-0.5	2.6
Government Expenditures	2.0	2.2	1.7	2.0	2.0	1.7	1.5	1.8	1.9	1.8
Federal	1.7	3.2	1.9	0.5	4.4	2.6	1.0	2.1	2.1	2.2
State and Local	2.2	1.6	1.6	2.8	0.6	1.2	1.8	1.6	1.9	1.6
Final Sales	2.5	1.9	1.8	2.4	0.7	2.0	1.7	-0.5	2.2	2.6
Inflation										
GDP Deflator	2.7	2.2	2.3	2.4	2.6	1.5	2.9	2.4	2.8	2.1
CPI	2.9	4.3	2.9	5.0	4.3	4.2	5.4	3.1	2.5	2.2
Special Indicators										
Corporate Profits*	2.5	2.9	6.5	2.5	1.7	-3.3	0.3	2.9	4.5	5.1
Disposable Personal Income	3.1	1.9	1.0	0.9	1.8	12.7	-10.3	-1.4	3.8	2.7
Housing Starts (millions)	1.34	0.92	0.92	1.15	1.04	0.97	0.84	0.83	0.84	0.88
Civilian Unemployment Rate	4.6	5.4	5.8	4.8	4.9	5.3	5.5	5.6	5.7	5.8
Employment	0.8	-0.6	-0.1	-0.4	-1.4	-0.7	-0.4	-0.4	0	0.1
Vehicle Sales										
Automobile Sales (millions)	7.6	7.9	9.0	7.8	7.3	7.8	8.2	8.5	8.8	8.9
Domestic	5.0	5.2	5.8	5.2	4.9	5.1	5.3	5.4	5.6	5.7
Imports	2.5	2.8	3.2	2.5	2.4	2.7	2.9	3.1	3.2	3.2
Lt. Trucks (millions)	8.6	6.9	6.3	8.4	7.9	6.6	6.6	6.4	6.4	6.3
Domestic	7.1	5.6	5.0	6.9	6.5	5.3	5.3	5.2	5.1	5.0
Imports	1.5	1.3	1.3	1.5	1.4	1.3	1.3	1.2	1.3	1.3
Combined Auto/Lt. Truck	16.1	14.8	15.2	16.2	15.2	14.4	14.8	14.9	15.2	15.2
Heavy Truck Sales	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.4	0.4	0.4
Total Vehicles (millions)	16.5	15.2	15.7	16.5	15.5	14.7	15.1	15.3	15.6	15.6
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	3 ¹ / ₈	4 ¹ / ₂	3 ¹ / ₈	2 ¹ / ₈	2	2	2 ³ / ₈	2 ³ / ₄
10-Year Treasury Note	4 ⁵ / ₈	4	4 ⁷ / ₈	4 ¹ / ₄	3 ⁵ / ₈	3 ⁷ / ₈	4 ¹ / ₄	4 ³ / ₈	4 ¹ / ₂	4 ⁷ / ₈
Prime Rate	8	5 ¹ / ₄	6 ¹ / ₈	7 ¹ / ₂	6 ¹ / ₈	5 ¹ / ₈	5	5	5 ³ / ₈	5 ³ / ₄
Corporate Bond AAA	5 ⁵ / ₈	5 ³ / ₄	6 ³ / ₈	5 ¹ / ₂	5 ¹ / ₂	5 ⁵ / ₈	5 ⁷ / ₈	6	6 ¹ / ₈	6 ¹ / ₄
Exchange Rates										
Yen/Dollar	118	106	111	113	104	106	107	108	109	110
Dollar/Euro	1.37	1.54	1.48	1.45	1.56	1.55	1.53	1.52	1.50	1.49

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2007, GDP was \$11,567 billion in chain-weighted dollars.

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