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Your guide to understanding today's economy and financial markets

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THREDGOLD
ECONOMIC
ASSOCIATES

The TEA Company
A Professional Speaking and
Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403

www.thredgold.com

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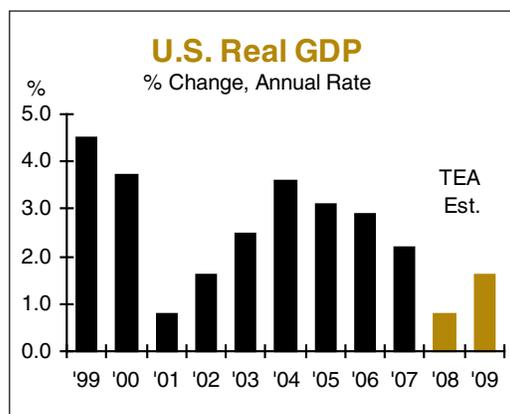
Summertime Outlook

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

The American Economy ...in the Twilight Zone

The U.S. economy seems stuck in that spooky area between minimal growth and mild recession. First quarter real (inflation adjusted) economic growth was revised higher to a 0.9% annual rate, with another revision to come. Many second quarter growth estimates are near zero, with most forecasters expecting somewhat better performance in the year's second half and into 2009.

Why? The combination of aggressive Federal Reserve ease, impressive U.S. export growth to a solid global economy, and the \$168 billion fiscal stimulus program will help. It is entirely possible that the economy could have one or no quarter of reported economic decline, only to have the National Bureau of Economic Research (NBER, the economy's official scorekeeper) announce later this year that a recession began around the end of last year.



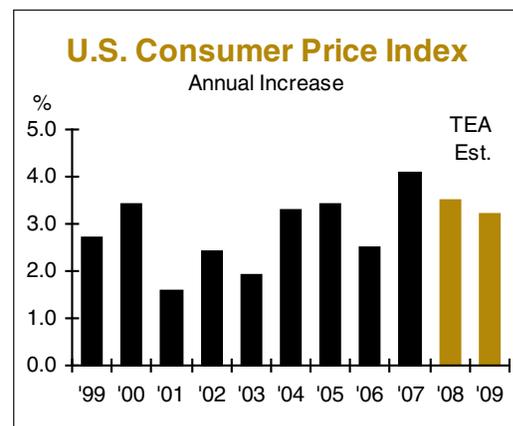
The Federal Budget ...a billion dollars daily

A menu of weak U.S. economic growth (or modest recession), enormous war spending, and Congressional economic stimulus could see the fiscal year 2008 deficit, which ends on September 30, exceed \$400 billion, or more than \$1 billion daily. Long-term challenges regarding entitlement funding will keep the pressure on.

Unemployment ...likely to move higher

The nation's unemployment rate is expected to move toward 5.2%-5.5% in coming months. By comparison, the

jobless rate averaged 4.6% in both 2006 and 2007. Longer-term labor shortages, especially for skilled workers, will remain center stage for years to come.



Inflation

...oil is the key

Sky-high oil prices, high commodity prices, and alarming food costs have pushed inflation pressures higher. Last year's 4.1% rise in the Consumer Price Index was the largest increase in 17 years. Most forecasters expect the CPI to rise 3.0%-3.8% in 2008.

Note that a measurable decline in oil prices later this year, should it occur, would unwind much of the inflation pressures that have developed. We still see inflation pressures under control in coming years.

The Federal Reserve ...staying on the sidelines

The Federal Reserve sliced its critical federal funds rate seven times between 9/18/07 and 4/30/08, with a cumulative decline from 5.25% to 2.00%. Such aggressive monetary ease ranks with any comparable period in the Fed's 95-year history.

The Fed is widely expected to stay on the sidelines in coming months. If U.S. economic performance deteriorates further, or domestic and global credit markets freeze up again, the Fed will cut its key rate for an eighth time. Conversely, solid evidence of U.S. economic stabilization and resumed growth will lead financial markets to expect modest tightening around year-end. In any event, the Fed

will continue to provide enormous amounts of financial market liquidity as needed behind the scenes.

Home Prices

...further pain on tap

Too many homeowners, builders, and “flippers” got carried away with expectations of higher and higher home prices during the past few years. This phenomenon was followed by one of the most painful real estate corrections ever, which continues today. Those markets which recorded the largest gains are also those under the greatest downward price pressure. Further home price declines are likely in select markets, while others are expected to stabilize.

The Global Economy

...slower, but still impressive

Most forecasts of global economic growth have been revised lower during 2008, tied to high energy prices and credit market volatility. Even so, real growth within a 3.0%-4.0% range would extend one of the most impressive periods of global economic growth on record. High global food prices are the latest major threat to hundreds of millions of global citizens.

The current Chinese fixation is all about a successful Olympic Games experience in August. Global protests regarding human rights were not in the game plan. In addition, Chinese leaders are fearful that severe air pollution could diminish their “image” during the Games. Numerous polluting industries in Beijing have been, or soon will be, mothballed until the Games are over. The Chinese response to its most severe earthquake in 30 years, and the displacement of more than five million people, will also be watched closely in coming months.

Solid economic growth in India remains on track, although inflation is a rising issue. Truckloads of money will have to be spent in coming years to bring a largely antiquated transportation infrastructure into the 21st Century. Japanese economic growth has actually improved in recent months as exports to other Asian nations have been impressive.

European economic growth has slowed during the past 12 months, a victim of high energy prices and a strong euro currency

that has dampened exports. European communities and businesses that cater to American visitors during the summer are keeping their fingers crossed, as travel “across the pond” is now more costly. The European Central Bank could face enormous pressure in coming months to reduce its key short-term interest rate in an effort toward economic stimulus.

For now, Russian Prime Minister Putin and President Medvedev enjoy widespread support as enormous oil revenues have boosted the standard of living of millions of citizens. Whether they can “play well together” in coming months and years is the real issue. Putin will continue to run the show.

Already enormous Persian Gulf oil wealth continues to accumulate. The Middle East? As always, tensions remain extreme.

The Brazilian economy, which represents half of South American economic output, continues to strengthen its hand in agriculture. Recent huge oil finds will raise its stature further. Other nations struggle with high taxes and enormous business red tape.

Canadian economic growth has stalled as a strong currency has hurt manufacturing and trimmed exports. Parts of western Canada are booming, tied to enormous investments into developing tar sands. The flip side? Environmental degradation is a major worry. Mexican growth is reasonable, but needs to strengthen to provide workers more opportunities at home. Modest Cuban reforms continue, with citizens now entitled to own cell phones. Computers are now legally available, although few can afford them.

The Bottom Line?

U.S. economic performance will be modest (at best) in coming months before likely improving (a bit) later this year and in '09. We also expect: a much larger budget deficit...rising near-term unemployment...uncomfortable inflation pressures...stable short-term interest rates...soft housing markets...and an anxious but reasonably solid global economy.



“TEA”ser

Q: What do you get when you cross the Godfather with an economist?

A: An offer you can't understand.

—from our book,
On the One Hand...The Economist's Joke Book



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Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance by Shawn Thredgold