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Your guide to understanding  
today's economy and  
financial markets

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# W

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The sharp upward revision to second quarter 2008 U.S. economic growth... combined with economic performance in prior quarters... combined with consensus expectations of performance in future quarters... strongly suggests that a **W**-shaped period of economic performance is upon us (what a mouthful!)...

...such a notion can be gathered from the chart below, starting in 2007's third quarter.

Prior periods of economic gyration have included **U**-shaped economic decline and recovery, as well as periods of **V**-shaped economic decline and recovery. Perhaps the most ominous is the **L**-shaped economic event, a period of sharp economic decline, followed by a very delayed and laborious recovery.

## The Latest Revision

The U.S. Commerce Department's first official revision of U.S. economic performance during the April-June quarter notes an estimated 3.3% real (after inflation) annual growth pace of GDP. GDP, or Gross Domestic Product, is the most encompassing of all measures of U.S. economic output of goods and services.

The first official estimate in late July was at a less robust 1.9% real annual pace. Both the *before* and *after* growth

rates were the strongest since the July-September quarter of 2007.

It would be nice to note that the sharp upward revision reflects stronger economic performance across the board...

...it does not

...what the revision primarily suggests is even stronger U.S. export growth to the world than the initial estimate indicated.

## Economic Drivers

Picture the American economy as an eight cylinder engine. Various cylinders might represent the housing sector, the automotive sector, the agricultural sector, the manufacturing sector, the export sector, retail sales, and a couple more.

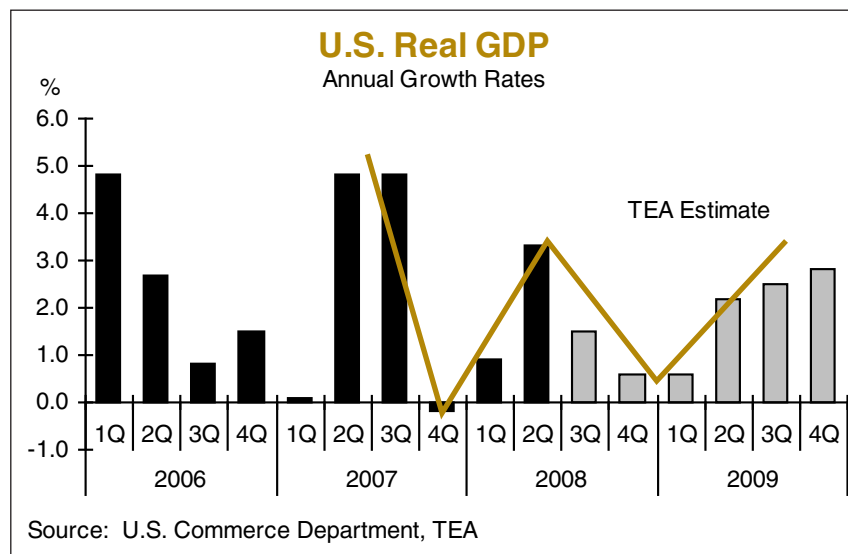
It is clear that the housing cylinder is "sucking gas." The automotive sector is doing the same.

However, the export cylinder is running with the pedal to the floor. The farm sector is also doing extremely well.

U.S. exports to the world have been at record levels throughout the past year, tied to strong global demand for U.S. goods and services. Weakness in the U.S. dollar of the past few years has simply made these American-made goods and services more affordable around the globe. The

agricultural sector cylinder is also doing well, with record farm income likely in 2008.

Stronger-than-initially-projected U.S. exports were the primary reason for the sharp upward revision to second quarter GDP. A less-than-expected



drawdown of business inventories and a few other things only economists would care about led to the revised 3.3% growth estimate.

## Slower Speed

One can now throw a wrench into the works...

U.S. export growth to the world is likely to slow, a combination of 1) weaker global economic performance expected over the next 12 months, and 2) a solid rebound of the U.S. dollar during the past two months, versus most major global currencies.

In addition, prices of most agricultural products have declined during the past few months, suggesting lesser amounts of farm income during the next year. Declining farm income expectations, combined with still high farm operating costs, suggest less aggressive investment into new farm equipment over the next year, another factor contributing to less robust economic performance in coming quarters.

One can also add in the fact that the roughly \$90 billion in one-time stimulus checks to consumers, which had a minimal impact on second quarter consumer spending, have now been either spent, saved, or used to pay down consumer debt.

Such a combination suggests that economic growth is likely to slow over the balance of the year from the second quarter's relatively robust growth pace. Most estimates of economists forecast the current July-September quarter could see GDP growth around a 1.0%-1.5% real annual rate. Fourth quarter estimates are even weaker, with real annualized growth between zero and 0.6%. Similar forecasts are to be found for the first quarter of 2009, before the economy shows more signs of growth.

## Housing "Pickup"

As noted, the export sector, the farm sector, and the consumer sector presumably will add less to U.S. economic performance in coming quarters. However, some improvement in the housing sector and the housing finance sector is likely over the next 12 months.

The national media's constant negativity toward the housing sector will

change at some point. One of these days, *Business Week* or *Newsweek* or *Fortune* will highlight a cover story under a banner like "What a Great Time to Buy a House!"...

...wouldn't that be a nice change?

## Down the Road

At some point, domestic and global credit markets will move closer to some level of normalcy...not aggressively back to *subprime*, *Alt-A*, and *ninja* loans... but actually providing reasonably-priced mortgage credit to reasonable borrowers.

At some point, declines in home prices of the past 12-18 months across dozens of American communities will bring out the bargain hunters in droves. More and more housing sector evidence suggests that most of the housing pain is now behind us.

At some point, gigantic losses and write downs of loans, investments, and exotic products with fancy names by major banks, investment firms, hedge funds, and numerous other domestic and global investors will move towards conclusion. This collection of lenders, loan packagers, and investors around the world has already taken losses of slightly more than \$500 billion. Such losses are likely to reach and possibly exceed \$1 trillion (\$1,000,000,000,000) before all is said and done.

At some point, the stronger of the remaining players listed above will see great opportunities to lend and invest around the world. New startups will also see great opportunities to "do business" with quality borrowers and quality investors.

At some point, perhaps during 2009, we will have gone full circle. Hopefully, we will have learned something collectively about seeing the investment risk associated with higher promised investment returns, about shying away from complex exotic-sounding financial instruments, and about the inevitable pain associated with excessive greed...

...hopefully



## "TEA"ser

I was married by a judge. I should have asked for a jury.

—Groucho Marx



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