Tea Leaf

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Your guide to understanding today's economy and financial markets

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Summer View

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

The U.S. Economy

...growth resuming?

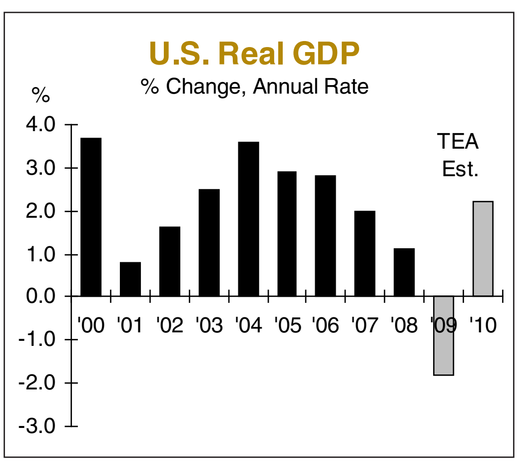
The extended American recession, now into its 18th month, will be the longest and deepest of any since the Great Depression. A return to positive (if modest) U.S. economic growth during the July to September quarter is the consensus view of forecasting economists. Modest growth should be followed by more robust performance during 2009's final quarter and more solid growth throughout 2010.

A return to U.S. economic growth clearly does not suggest that problems with housing, commercial real estate, sick investment portfolios, and wobbly financial markets are behind us. But it IS a step in the right direction!

Budget Deficits

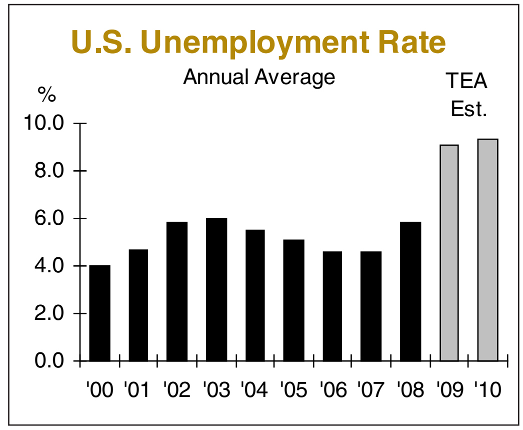
...tooooo much

The Obama Administration's aggressive spending initiatives will see a deficit approaching $2,000,000,000,000 in fiscal year 2009, which began October 1, 2008. For each dollar the government takes in, it will spend two. Such a deficit will be four times the largest ever recorded, which, by the way, was last year. To the Administration's defense, it did inherit major economic and financial challenges from the Bush Administration.



The greater issue will be how to rein in estimated deficits averaging nearly $1 trillion annually during the following eight years. The President is likely to face more opposition to aggressive spending by more conservative members of his own party.

Commercial banks will be aggressive in returning TARP funds to the U.S. Treasury in order to get the government out of their boardrooms. The phrase "We're from the federal government and we're here to help you" hit home one more time.



Unemployment

...approaching 10%

The U.S. economy suffered a net decline of 3.1 million jobs during 2008, the worst year since 1945. Even greater losses will occur in 2009. However, monthly reported losses should ease as the year progresses.

The nation's jobless rate has reached 9.4%, with additional increases in store. The jobless rate could approach, or slightly exceed, 10.0% by early 2010.

Inflation

...which camp?

Consumer prices (the CPI) actually declined 0.7% during the most recent 12-month period, following the 0.1% rise during 2008, the smallest increase in 54 years. Most forecasters see the CPI rising near 1.5% in 2009.

Where we go from there is the subject of intense debate. One influential camp of economists sees major inflation pressures after 2010 resulting from aggressive monetary policy and massive budget deficits.

The other vocal camp sees a Japanese-style deflation unfolding in coming years, tied to weak residential and commercial real estate values, major slack in labor markets, and global recession. Pick your poison.

jeff thredgold, CSP
ECONOMIC FUTURIST

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

The Federal Reserve

…near zero

The Fed's critical federal funds rate, at an all-time low of 0.00%-0.25% since mid-December 2008, could easily stay at that level most of the year. The Fed has engaged in one unprecedented program after another, collectively known as "quantitative easing," to address the near-paralysis that has all too frequently plagued financial markets for the past 12-24 months. The Fed's "exit policy" from such actions is drawing greater scrutiny.

Long-Term Interest Rates

…which direction?

Thirty-year fixed-rate mortgages for conventional loans averaged 4.82% (Freddie Mac) during most of April and May, before rising nearly 1.00% in recent weeks. Mortgage finance for higher-priced homes remains spotty in many communities.

Whether the Fed will boost its purchases of U.S. Treasury notes and mortgage-backed securities or do something else creative in an attempt to push rates back down is the $64 question. Lower rates would help existing home prices to stabilize and clear high levels of new and foreclosed homes from the market.

The Global Economy

…2010 rebound?

Economic and financial challenges abound for both developed and emerging nations across the global community. However, significant increases in stock markets around the globe suggest the worst is behind us.

For the first time since World War II, the U.S., Japan, and Europe are in recession simultaneously. Renewed U.S. economic growth, combined with reasonably solid growth in China and India, suggest the global recession could conclude by mid-2010.

Japan is in serious recession, with the economy contracting at a roughly 15.0% annual rate during 2009's first quarter. A plunge in exports to the world was the culprit. However, more recent signs suggest some level of economic stability may be at hand.

China—which recently surpassed Germany to claim the #3 economic ranking in the world behind the U.S. and Japan—is dealing with major challenges tied to economic growth slowing from 120 miles per hour to near 75 mph. China is making solid efforts to boost domestic demand within its economy, in part fueled by its own stimulus program.

India's economic growth pace slowed from near 9.0% annually to a 5.8% annual pace during 2009's first quarter. Stronger growth is likely over the next 12 months.

Europe and the U.K. are currently buried in serious economic downturns, with the likelihood that both could be laggards in 2010 as the global economy picks up speed. Ailing financial systems and problem loans to Eastern Europe will likely constrain a rebound when it does occur.

Russian politicos are keeping their fingers crossed, hoping oil prices continue to rise. The dive in oil and commodity prices of the past year soon led to painful budget cuts, sharply higher unemployment, capital outflows, and a record decline in industrial production.

High levels of government inefficiency and rampant corruption are part and parcel of doing business in many South American nations. Such a reality is more painful when commodity prices are lower than before.

Mexico is getting hit from all sides, leading its economy to plunge at a 21% annual rate in the first quarter. This nation's critical tourism sector has been hammered by 1) fewer global visitors tied to recession; 2) the serious escalation in drug trafficking violence which has kept visitors away; and 3) the H1N1 (swine) flu which only added to tourism weakness and other economic disruptions.

Canada remains in recession as its top customer…the U.S.…buys less. Eastern provinces deal with a weak auto sector, while the west deals with lesser commodity values.

The Bottom Line?

A serious and lengthy U.S. recession should give way to stabilization and modest growth in coming months. We also expect…unprecedented budget deficits tied to massive "stimulus" spending…more employment pain…modest inflationary pressures this year…extremely low short-term and volatile long-term interest rates…and a sick but soon-to-improve global economy.

"TEA"ser

When I look up into the night sky and gaze at the stars, I often wonder, "Is there intelligent life out there in the cosmos…or are they just like us?"

jeff thredgold, CSP
ECONOMIC FUTURIST

THREDGOLD
ECONOMIC
ASSOCIATES

To receive the *Tea Leaf* free via email, sign up at
www.thredgold.com

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