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A Slowdown or a Recession in the U.S. in 2008?

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> "… Middle East oil producers will remain central to world security. The [Persian] Gulf will be a primary focus of U.S. international energy policy." Vice President Dick Cheney's Energy Task Force Report of May 2001

> "The worst evils which mankind has ever had to endure were inflicted by bad governments." Ludwig von Mises (1881-1973), Austrian economist

> "The essence of so-called war prosperity; it enriches some by what it takes from others. It is not rising wealth but a shifting of wealth and income."Ludwig von Mises (1881-1973), Austrian economist

The U.S. economy, as well as the world economy, is proving to be most resilient. This has persuaded most observers to expect moderate economic growth of 2 to 3 percent and a moderate inflation around 2 percent for years to come, while unemployment remains at a thirty year low.

Indeed, the consensus among strategists is now to bet on international competition and productivity gains to keep costs and prices tame, and on a lower dollar to improve the trade balance; they place their hope on a relatively stimulative monetary policy to keep consumption and investment spending up and expect the worst of the housing decline now to be over. They also think that crude oil prices peaked near $80 a barrel in July 2006, and that excess oil supply will keep energy prices low—under $69.50—after the current Fibonacci rebound and the completion of a big head and shoulder top. With stock prices making new highs, some point out that presidential and stock market cycles are favorable to higher stock prices, since investing during the 27 months before a U.S. presidential election has proved in the past to be more profitable than investing during the 21 months after the elections. —With such a rosy scenario, call it scenario A, it is not surprising that many investors are enthusiastic about financial markets, some expecting double-digit earnings growth this year and next.

While one may hope that economic conditions remain favorable or even improve, the conditions for another less rosy scenario, call it scenario B, are also present and could unfold in the coming months, if certain potential shocks were to materialize. What probability can we assign to such an unraveling scenario B? It is hard to say, but personally I would give it one chance out of three to occur. Why?

As we explained in our blog of last October 16, **(Headwinds for the US Economy),**

macroeconomic conditions make it a matter of months, not years, before the U.S. economy and the U.S. dollar begin to experience some downward pressures. We are now approaching that point of reckoning. —Let us remember that the U.S**.** **gross domestic product (GDP)** is the largest in the world at more than $13 trillion, that Americans have a **net home equity** equal to about $ 14 trillion (but declining) while American households have a **net ownership of corporate equities** of about $ 10.5 trillion (still increasing). However, home ownership is more widespread than stock ownership: Slightly more than two thirds of Americans own their homes, while somewhat less than half of American households own equities. What is more, stock ownership is fairly concentrated, with the top 10 percent of investors owning about 80 percent of all stocks. —This may help to put into proper perspective the possible impact on household finances of the current housing crisis, as compared to the relative ebullience in stock-related wealth.

Thus, what could be the reasons for slower economic growth in the coming months? First, the artificial short term stimulus that the Bush-Cheney administration gave the economy before the 2004 and 2006 elections, through a combination of large tax cuts and large increases in military outlays, is about to run its course, and the piper will have to be paid. Second, record budgetary and current account deficits have severely neutralized the Fed's monetary policy stance because interest rates cannot be reduced substantially for fear of a collapse of the U.S. dollar (and a resurgence of imported inflation), while less stimulus is expected from the federal budgetary deficits as they are being slowly reigned in. Third, all this is taking place at the same time that the construction industry is in disarray and housing prices have tapered off or are declining, while the Kuznets real estate cycle decline that began in 2005 is expected to last until 2010-11.

Fourth, this raises the question of how long the American consumer will keep up the high pace of spending in such a context. During the years of the housing boom, consumer spending was driven by the accumulation of wealth and record consumer indebtedness, most of it in the form of mortgages, as the price of houses increased. Now that the reverse is occurring and **foreclosures** are on the way up, a retrenchment in consumer spending cannot be ruled out. Logically, especially with **consumer confidence crumbling,** this should be expected.

A fifth factor is now entering the picture to make matters potentially worse: The protectionist push from the Democrat controlled Congress risks putting in jeopardy the flow of capital of about $2 billion a day that the U.S. economy is borrowing from abroad, mainly from China and Japan. Looming trade frictions between the U.S. and China could force the Fed to raise interest rates, and not lower them as most observers expect—in any case, the Fed would surely not lower them as much as it would be warranted to alleviate the housing crisis.

All that is needed now to complete the picture, as a sixth factor, would be the collapse of one and possibly several major financial institutions under the pressures of bad loans and record foreclosures. Particularly at risk is the some $2.5 trillion mountain of debt concentrated in subprimes and Alt-A loans. Already, one major sub-prime lender (New Century Financial) has filed for **Chapter 11 bankruptcy protection**. Others are likely to follow, because 2007 is the year when a large number of sub prime real estate loans have to be renegotiated at higher interest rates. The rate of foreclosure is bound to spike in the coming months, possibly culminating in the next two years into a financial hurricane.

A seventh geopolitical factor could also throw fuel on the fire. Indeed, if the clumsy Bush-Cheney regime goes ahead with its neocon plan to bomb and attack Iran, the coming U.S. economic slowdown could be transformed into something much worse. Indeed, during the coming years, the world economy will have to adjust to a **peak in oil production** and to higher energy prices, after the current lull. If geopolitical mistakes turn the richest oil producing region into a hot war zone for many years to come, the worldwide economic consequences will be disastrous.

What does it all mean in practice? It means that while extrapolating the past is often a good way to see into the future, it does happen that major turns can occur anytime, when conditions are ripe and nobody expects them. For example, the April 1960-February 1961 recession followed the end of President Dwight Eisenhower's second term. Nothing in the presidential politics cycle therefore precludes a 2008-09 recession. [Recession: a period of sustained production decline: usually considered to last two quarters in a row].

The above scenario B can likely be avoided if no major shocks, such as a premature oil production peak, large financial bankruptcies or a U.S.-Iranian war, do not materialize. If they do, however, all bets are off. It would seem only prudent to prepare and take measures for the possibility of such a less palatable scenario occurring.

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