Economic Commentary

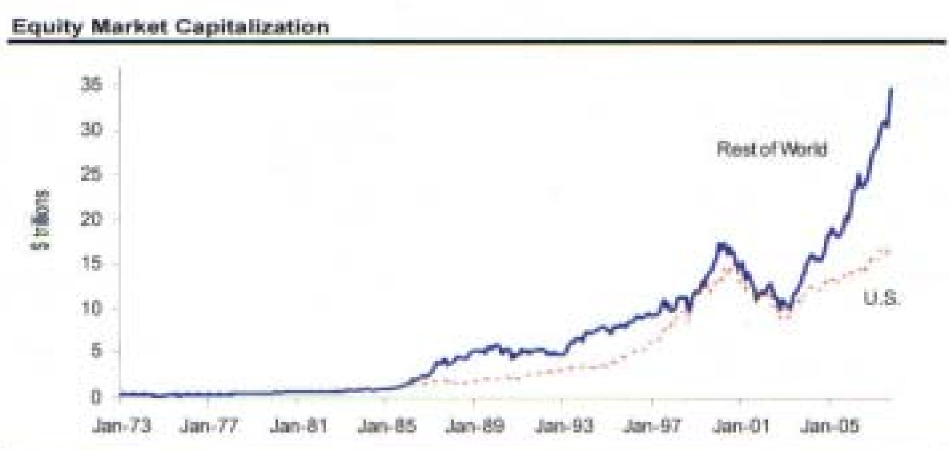
January 5, 2008

Some Predictions for 2008 and Beyond, A Note to a Friend

My predictions for 2008 are not pretty:

- US will experience very slow growth, most likely a recession -Fed will cut interest rates, but not like last time, it is constrained by higher inflation and a very weak dollar. Unfortunately, this time lower interest rates will not have the same effect they did last time, rates will be low but people will not be borrowing, a classical liquidity trap!
- US dollar will surprise us -yet again- on the downside! The 1.10 rate will be re-tested sooner than anybody believes and if breached, I envision the loonie at 1.20 - 1.25 and the euro at 1.67!
- Equity market will experience a mild correction for now, because it will be propped by interest rate cuts and increased liquidity by the Fed - However, once it becomes clear that low interest rates are not the panacea everybody is expecting to lift US economy out of the slump, profits will start falling, confidence will decline and may even spark panic, at that point a mass rush for the exits is possible and markets will turn very nasty (later in 2008 or 2009)
- A lot depends on US economic policy, however, until this time next year Bush is a lame duck President with bankrupt ideological views to make a positive contribution - this in fact is a huge risk for markets and the world economy -remember, no US president has seen so much turnover in Treasury Secretaries, or Chiefs of the CEA.
- Following the corporate malfeasance scandals of 2001-03, we have just witnessed the biggest financial scandal in US and probably world history - the structured investment vehicles (SIVs) also known as mortgage-backed securities, asset backed securities or collateralized investment obligations that were conceived and packaged in the US with contaminated sub-prime mortgages and then sold around the world with fat fees with the seal of Moody's and S&P and the blessing of the US administration- , this will turn off the whole world from the US economy and Americans from the markets. Very destructive for confidence and trust, the stuff that keeps markets healthy and functioning. Secondly, like last time, it is not auditors that will unearth new scandals, but the forces of recession will, new scandals and business failures will come to light that will further damage confidence. Thirdly, the US is a superpower overextended. The cost of the war on terror that the US under Bush was foolish enough to shoulder alone, will serve as an albatross that will drag the US down. Bush should have listened to the advice of Colin Powel and then CIA Chief George Tennet and uphold the “Powel doctrine”.

- The world equity market capitalization has doubled since 2002 to $50 trillion, that's 110% of global GDP. See Chart below. Do you think it can keep rising so fast without any significant corrections? China may be emerging as an economic superpower, and so it will over the next few years, however, the Chinese are not sophisticated investors and do not have sufficient experience playing the ponzi game. Financially, China is still a paper tiger, not to mention their outright lack of transparency. Beware! An implosion in Chinese financial euphoria, either endogenously or exogenously generated, can do enormous damage as well and complicate the situation even more.
- Lastly, I have a feeling that we are in the early stages of a tidal shift in values. US consumers are about to turn more spiritual and environmentally more conscious. They have seen their materialist dreams reach their peak the last few years and they are now realizing that the half-million dollar homes and new SUVs parked on their driveways have not made them any happier, on the contrary, they are now breaking their hearts. A shift towards higher personal saving and lower consumer spending, the traditional values of thrift and hard work are about to set in. Also, Henry Ford used to say that the top executive in a company should not be paid more than 40 times the lowest paid employee. Now, the median compensation -including stock options- of the top US executives has risen to 400 times the lowest salary. If nothing else is a sign, this is one! If all that these high paid executives have accomplished -apart from lining their pockets- is to bankrupt an economy, it will turn public attitude against big business and against free markets in general.
- The US economy has been running on steroids the last six years. Ninety percent of US growth has been driven by borrowing and consumption demand. Public and private investment and exports have been less than desired. Now that the debt-income ratio have risen to the max (130% of personal disposable income (PDI) and property values are falling, appetite for new debt has run out, and so has the US economy, at least for now.



Source: Haver, Bear, Stearns & Co. Inc.

- A major shift in US economic policy is needed. Those who took the risks to drive up asset values and precipitate the crisis should bear the costs. The sources of economic growth should shift away from debt finance to wealth creation, the old fashioned way through export led growth and investment. Saving and investment instead of borrowing and consumption. Economic policy should be more geared to competition, innovation and industrial growth –were America has traditionally been strong- and away from Wall Street, financial engineering, leveraging, speculation and greed. And the focus of public policy must shift back to the middle class and away from the interests of the highly privileged special interest groups like big oil, big pharmaceuticals, big insurance, big agribusiness and the military-industrial complex. Public policy must also be extra careful not to fall for the temptation of protectionism but stay the course in promoting free trade and global competition, while intensifying pressure on emerging economic powers to do the same.
- Most of all, US economic policy must recognize that continued American economic and political leadership in the world demands that it makes sacrifices for the good of the global economy. Financial excesses and speculation in conjunction with low interest rates, external borrowing and money creation only serve to undermine the strength of the US dollar and weaken the international monetary system that relies so much on a strong and stable US currency as an international means of payment, store of value and unit of account. Loss of confidence in the US economy and financial markets runs the risk of destabilizing the world economic order, precipitating currency instability and global inflation in the long run. A loss of economic influence and hegemony around the world is the end of this road. The world needs a strong America, and a stable monetary system!

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