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FINANCIAL AND ECONOMIC COMMENTARY

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As we enter the second half of the year, there are two major forces pulling at the economy. The first is the substantial healing that has taken place in the credit markets, but the second is the very slow recovery of consumer spending.

First, the bright side. The healing of the credit markets is no small matter. It was the terrible disruptions in credit that took place last September that are the principal cause of the worldwide recession. At that time, bank borrowing (LIBOR) rates soared over 300 basis points above the Federal Funds rates and making credit prohibitively expensive. As of this writing, the spread between the three-month LIBOR and the fed funds rate has dropped to 31 basis points, the lowest since January 2008 and well below the level that preceded the Lehman crisis. Similarly, healing has taken place on the long end. The spread between BBB bonds and the Treasury rate has dropped from 4.38 percentage points to 2.66 percentage points.[1] Although current spreads are still higher than the record low levels reached in 2006 before the crisis, the drop in spreads from their unusually elevated levels means that confidence has returned to the credit markets.

Despite the recovery of the credit markets, the economic impact of the credit crisis—namely, rising unemployment, a dramatic fall in asset values, and a significant retrenchment by the consumer—is taking far longer to heal. The robust consumption growth of the 2002–2007 expansion was fueled in large part by the rise in real estate values and the ease with which homeowners could cash in on rising home equity. Today, many homeowners are underwater and have a mortgage balance that is larger than the value of their home.

This situation prompts some analysts to predict that this will lead to a much-slower-than-normal recovery. But there are several factors that argue against this. Fear of unemployment, not falling home prices, is the principal factor influencing consumer spending, and the fear of becoming unemployed far exceeds the reality. The June unemployment rate touched 9.5%, and it is quite possible that that rate will eventually exceed the 10.8% rate reached in November 1982. But even if it does, unemployment will rise, at most, 2 percentage points, far less than the reported 30% to 40% of workers who fear they will be laid off. And as the economy mends, the fear of being unemployed will subside, and consumption will rise.

Furthermore, consumption is not the whole economy. There are several other sectors that are likely to boost growth. Housing starts have fallen about 75% from their 2006 highs, but the current level of 500,000 starts per year is less than one-half of what is needed to accommodate increased population and household formation. Additionally, we have increased spending by the government on infrastructure that is part of the stimulus package. Finally, our trade deficit has shrunk by more than 50% from its level before the crisis, as our exports have remained surprisingly strong. This all supports gross domestic product growth of 2% in the third quarter.

[1] Source: Bloomberg

One of the most intriguing and positive aspects of the current downturn is the increase in productivity growth. We will be getting more data as the quarter progresses, but preliminary evidence suggests that productivity growth may have accelerated during this economic downturn. Companies have cut payroll aggressively, and although this has contributed to the rise in unemployment, it is very positive for corporate profits.

Aggressive cost-cutting is not true elsewhere. Since the recession began, unemployment rates in the European Union have risen only slightly more than 2 percentage points, while rates have increased about 5 percentage points in the U.S. This means that the U.S. will be very competitive when demand returns and the recession ends. I believe this augurs well for stock prices and gives support to my estimate that stocks will end up 8% to 10% by year's end.

Register for the quarterly economic call with Professor Siegel.

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GLOSSARY

The London Interbank Offered Rate (or LIBOR) is a daily reference rate based on the interest rates at which banks borrow funds from other banks in the London wholesale money market (or interbank market).

Basis Point: A basis point is 1/100 of 1 percent.

BBB Bonds: Bond credit-rating agencies assess the creditworthiness of a corporation's debt issues and assign a rating, which is analogous to credit scores for individuals. BBB is a low to medium grade and has higher risk than AAA, which is considered the best rating.

Treasury Rate: It is a U.S. government bond interest rate and is considered to be the safest end of the risk spectrum in terms of different interest rates.

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