
Todd's Perspective

Winter 2009

Economic Forecast 2009

Speech by Bosworth Todd before the Louisville Rotary Club
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Our economy is in the midst of an economic decline of unknown length or depth. It is likely to be longer than average because of the strain on consumer balance sheets following the consumption excesses of the past decade. My guess is this will last through most of 2009. The Economist predicts a 1% decline in real GDP. While we obviously do not know what the stock market will do this year, I believe most of the misery is already discounted. From the highs of October 2007 to the lows of November 2008 the market, as measured by the S&P 500, declined 51%. In the words of Hank Paulson, Treasury Secretary: “We are dealing with a historical situation that happens once or twice in a hundred years.”

Total Debt a Record Eight Times GDP

Never before have we been so leveraged with debt. Rob Arnott, Chairman of Research Affiliates, points out that in the last 10 years, total debt in our economy, including households, corporations, and government has soared from nearly five times gross national product to over eight times. Now we find the Fed is creating more money in less time than ever before to cope with the crisis. Niall Ferguson, History professor at Harvard, recently wrote in the Financial Times that excessive debt is the reason we are confronting no ordinary recession, curable by

a simple downward adjustment of interest rates. It is a reason we still have to confront what looks like the biggest recession since the 1930's.

As he points out we now see just how big a portion of our growth since 2001 was financed by mortgage equity withdrawals. Without that as a means of financing consumption our economy would barely have grown at a 1% rate.

Deleveraging is Underway

Fortunately, at the moment global fear has created demand for dollars and for U.S. Treasury securities. Thus interest rates are extremely low. When economists talk about “deleveraging,” they usually refer to the slow process whereby corporations and households increase savings to payoff debt. This can also be a drag on the economy. The alternative is a more radical reduction of debt. Historically such reductions have been done in one of four ways: default, bankruptcy, inflation, or conversion. Some homeowners are choosing to default on their mortgage. Many companies, such as retailers, are being driven towards bankruptcy. Inflation is unlikely in the short-term because the Fed's expansion of the monetary base is not creating expansion of broad money supply; the banks would

rather shrink than expand their balance sheets. That leaves conversion in which, for example, existing mortgage debt is converted into a long-term, low interest loans, such as 30 year, 2% amortization. This radical step would represent a haircut for the creditor yet it is often preferable to the alternative.

Our Forecast for 2008

Mercifully I find that I failed to forecast the Dow for 2008. Had I done so I am sure it would have been way too optimistic. I did forecast a real GDP growth up 1.5%, close to the actual 1.2% gain. My inflation forecast of 2.8% was off slightly. It turned out to be up 3.8%. I was way off on interest rates. I forecasted the Fed funds rate at 3%, it ended the year at an unbelievable 0.25%. Likewise, 30 year Treasuries are near all time low. I had forecast 4.7% interest rate. It closed the year at 2.7%. While I correctly said some very scary things about the banking crisis, I also said “we are betting we will avoid a recession because Bernanke will do all he can to minimize the pain.” I said “Bernanke has the knowledge and the power to act in a dramatic way if needed.” We now know that the worst post-war recession began in January a year ago.

This Is No Ordinary Recession

Most recessions are inventory corrections lasting less than a year. This is a balance sheet event. Both assets and liabilities in households are declining for the first time. It entails asset liquidation, debt repayment and rising personal savings rate. The investor's objective is now safety and income.

For 2009 I forecast a 1% decline in real GDP. I predict zero inflation and no change in the current extremely low level of interest rates on U.S. Treasuries.

Our unemployment rate rose to 7% in December. It will likely peak soon at 9%. Our 4th quarter real GDP is estimated to have been a painful minus 5%. Housing starts and car sales are in a depression. Economic data is equally depressing in most foreign countries. Thus we are witnessing massive global monetary and fiscal stimulus. In the U.S. these measures include TARP, tax cuts, bank rescues, guaranteed loans, a partial Detroit bailout, zero short rates, accelerating money supply, and “quantitative easing” – better known as printing money. We learned our lesson from the 1930s, where we raised interest rates, taxes, and protective tariffs. Thus we had over 20% unemployment and deflation of 25%. Now we are in the midst of what will likely to be the most severe recession since the 1930's, but not a depression.

Thankfully our policy makers stepped up efforts to stem the economic slide. So far, from the stock market view point, it is working. The Dow is now at 8,700. It first fell below that level about three months ago, on October 9th. It has since traded in a wide range between 9,600 in early November and 7,500 on November 20th.

There have been five major bear markets over the last 83 years, 1926-2008. Only the four year decline in the great depression 1929-1932 was more severe than the current Bear market.

I believe it is risky to sell after a collapse of this magnitude. It is worth noting the strength in the stock market in the recovery year in these earlier examples. While I caution that the past is not necessarily prologue, it is risky to liquidate stocks after a collapse this large. Those who sell now assume they will be skillful enough to get back into stocks at an even lower level. The future is never predictable. Those now waiting for a better

time to buy stocks are likely to maintain that posture well into the next Bull market. My guess is the S&P 500 has a modest 15% recovery in 2009. The current dividend yield on the S&P is 3.1, substantially better than the 2.1% yield on 10 year Treasuries. The total return on the S&P since the 1974 lows has been 11% a year, despite the drag of a zero return over the past decade.

Madoff With Ya Money

“If something sounds too good to be true, it probably is”. This was the response of one of my business associates to a friend who many months ago asked if he should invest in Bernie Madoff's hedge fund. Unfortunately his friend ignored this warning, lured by the promise of a steady 10% return.

Madoff was actually turned in to the authorities two weeks ago by his two sons upon learning their father was running the biggest Ponzi scheme of all times, \$50 billion. His downfall came when some investors actually asked for their money back. Sophisticated investors are guilty of naivety, and litigators will thrive.

The Lehman Fiasco

Ben Bernanke and Hank Paulson did the right thing in bailing out Bear Stearns in March. However, with hindsight, they should not have let Lehman Brothers go bankrupt in September. The stock market and several other market measures of risk aversion spiked dramatically after that moment. As the Bank Credit Analyst pointed out in their year end review, “The sudden loss of trust in the financial system pushed the economy past the tipping point.”

Make Quantitative Experts Accountable

It is ironic that much of our economic woe today reflects the failure of subprime mortgages in 2007 whose risks were downplayed by the same quantitative methods that caused the collapse of Long Term Capital Management in 1998. Nassim Taleb, author of “The Black Swan: The Impact of the Highly Improbable” complained that risk methods that failed dramatically in the real world continue to be taught to students in business schools. Lehman Brothers and Morgan Stanley used the model, called Value at Risk, citing that it is used on CFA exams. Nassim says these quantitative methods were used to create complex derivatives. They did not work and could provide undue comfort by hiding risks. He urged removal of Value-at-Risk books from the shelves of academia.

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