

Special Analysis from the PMA... Muddling Through the Recession

By Dr. Ken Mayland, President, ClearView Economics, LLC

Tone of the Economy...

At the end of first quarter, the economy continued to struggle through its economic nightmare. The nation's GDP contracted at a 6.3% annualized rate during the last 3 months of 2008, and a similar decline WILL be suffered for the first quarter of 2009.

At this time, we are experiencing the *maximum degree of recession stress*, and there is no way of sugar-coating half-million monthly drops of jobs and percentage point pullbacks of industrial production. But I want to assure you that this will not go on ad infinitum, and warn you NOT to extrapolate these results far into the future.

There are three mistakes laypersons, pundits, and even some economists typically make when it comes to situations like the present one. First, there is some tendency to see the economy as a bottomless pit, where business just keeps spiraling down lower and lower. A more productive way to view the economy is as making a transition from one equilibrium to a lower one. The drop-off of jobs, production, and sales is the *dynamics* of how you get from one equilibrium to the other. But once you get there, then the economy flattens out.

The second mistake is forecasting by means of *simple extrapolations*. This is the most common manner in which expectations are formed. In other words, the future will resemble the recent past. If the economy was always on cruise control, this might work OK. But when business is shocked by major events or changes-of-state of some critical economic variables, then trend projections go awry.

Policy Impetuses...

The third mistake that I believe many analysts are making is under-estimating the impact of the \$800B stimulus package that the President championed and the Congress passed. Now I will confess that I do *not* like ending the work requirement for welfare and

creating a health insurance entitlement for the unemployed. And I would have placed far greater dependence on infrastructure investments that could create future wealth.

Nevertheless, what I think is *irrelevant*. This \$800B stimulus package is now *law*. It will now start unfolding *immediately*. It is hard to get one's mind around what \$800B means, but it is HUGE. While the Congressional Budget Office may not be the most accurate and unbiased of forecasters, they nonetheless project, based on the mid-points of the estimated impacts, that this stimulus package will add 2.6 percentage points to GDP growth in 2009, and 1.5 million jobs. In 2010, GDP is projected to be 2.2 percentage points higher than a baseline projection with no stimulus, and jobs 2.4 million higher. Maybe these estimates are somewhat too generous, but the main point is that the impacts are *substantial*.

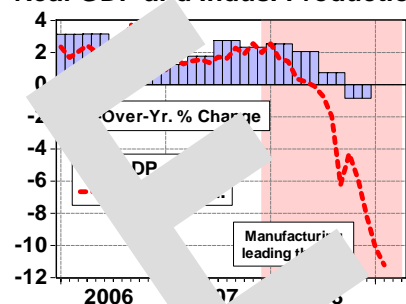
The Prospects...

Housing starts and auto sales are AT trough levels that establish that "lower equilibrium." Like a storm that blows itself out, those elements of drag on the economy will fade away, diminishing the economy's rate of decline. The extreme easing of monetary policy is a change-of-state that will help move the economy in a positive direction. The drastic fall of the price of oil is a change-in-state that has helped to re-liquefy consumer coffers. And the \$800B stimulus package is a change-in-state that will quickly restore the

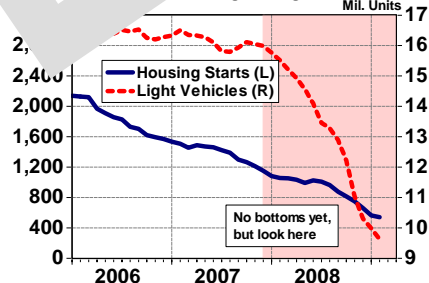
inadequate aggregate demands that separated us from our potential.

So my advice is to be on the lookout for signs of recovery. Now we are NOT going to see these signs of recovery in April, when we are looking at March data. The same goes for May. But maybe in June we will see real hints that the economy is coming around.

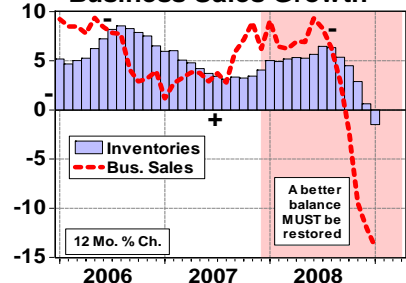
**Growth Trends:
Real GDP and Indus. Production**



**Leading Indicators:
Housing Starts and Light Vehicles**



**Business Inventories Vs.
Business Sales Growth**



Dr. Ken's "Blue Chip" Forecast

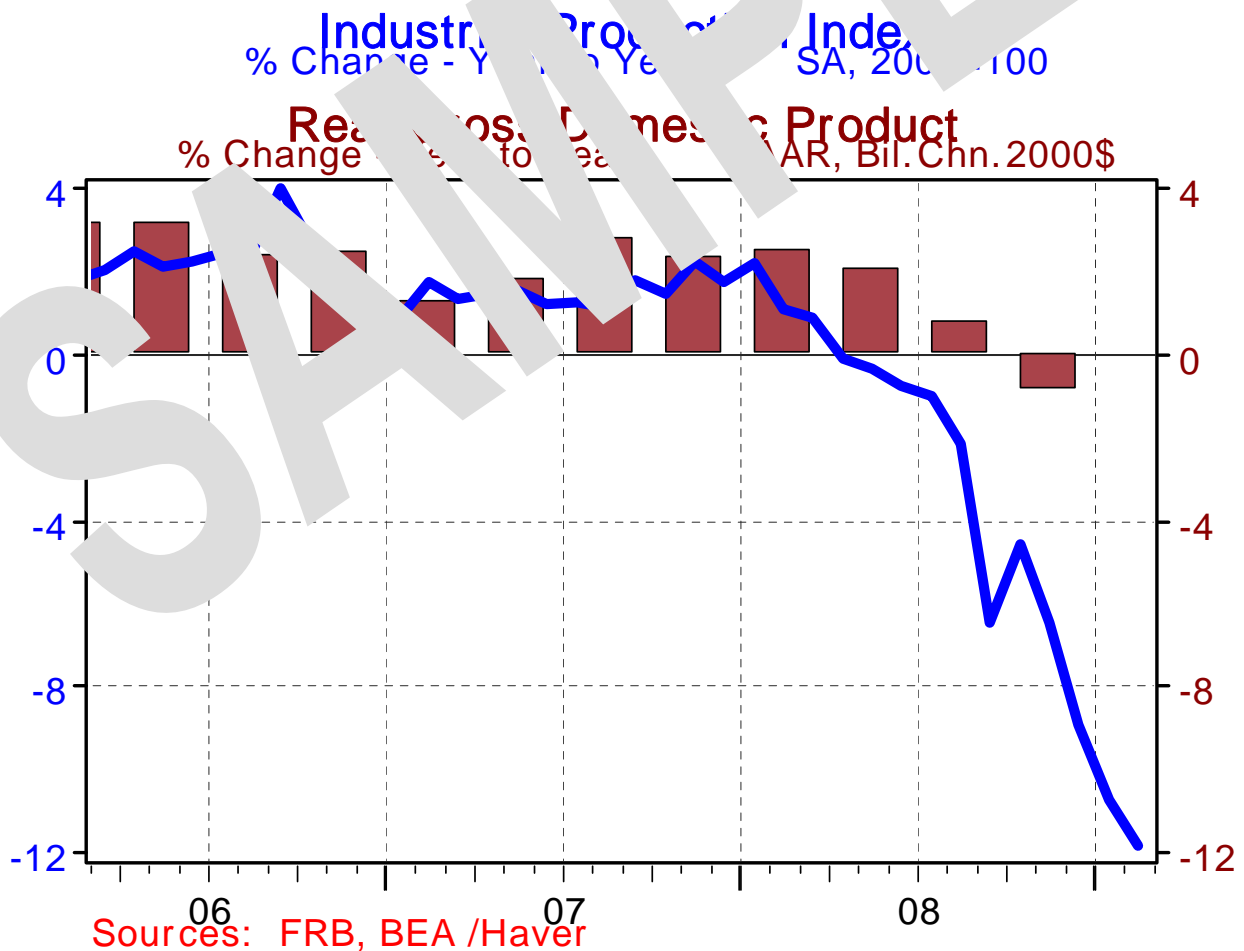
Indicator:	08:Q4a	09:Q1f	09:Q2f	09:Q3f	2008a	2009f
GDP (%Ch, AR)	-6.3	-5.0	-1.9	1.6	1.1	-2.3
Industrial Production (%Ch, AR)	-12.3	-15.0	-6.0	3.0	-2.2	-9.6
CPI (%Ch, AR)	-8.3	-2.0	2.5	5.0	3.8	0.1
Prime Rate (%)	4.06	3.25	3.25	3.28	5.09	3.37
Auto & Lt. Truck Sales (Mil. Units, AR)	10.3	9.8	9.8	10.5	13.1	10.3

a=actual, f=forecast, AR = Annual Rate. Ken Mayland is a member of the **Blue Chip** economic forecasting panel. Questions? Shoot me an email: drken@cvecon.com

Economic Momentum

CHART 1: Economy-wide and Industrial Sector Momentum. This “macro” chart provides a great sense of where the economy is *in the business cycle*. Computing and displaying the 4-quarter changes of GDP (“the economy”, **red bars**, right scale) and the 12-month changes of industrial production (mostly the manufacturing sector, **blue line**, left scale) produces a good measure of the “momentum” of business. The one-year period is long enough to smooth out short run volatility due to some special factor, but short enough to capture changing trends. The chart displays about three years of data to keep the focus on relatively recent trends. **What to look for:** You want to visually see if the economy is fundamentally *accelerating or decelerating*, and whether the economy is *at or approaching a peak or trough level*.

CURRENT SITUATION (Latest observations, 2008:Q4 and February): The best way to think about a “recession” is an economy *transitioning from a higher equilibrium to a lower one*. All the negativity in production, sales, employment, and orders is the *dynamics* of how you get from one equilibrium to the other. But once you get there, the rate of decline flattens out. During the Q4 to Q1 period the economy was seeing its period of *maximum recession stress* (i.e., the greatest rate of decline). By Q2, the housing and auto sectors will pretty much hit bottoms, and the huge \$800B stimulus package begins taking effect. The economy contracted 6.3% (annualized) in Q4, and probably a similar rate in Q1. A considerably reduced rate of decline will probably be seen in Q2, and maybe a small increase in Q3—but let’s see how the indicators evolve.



Quarterly report includes 23 charts with individual analysis and comments by Dr. Ken Mayland following the format for chart one on previous page.

CHART 2: Employment Growth Momentum Total, and Manufacturing.

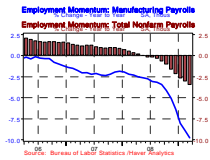


CHART 3: Recent Labor Market Trends Month-to-Month Changes.

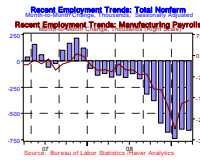


CHART 4: Capacity Utilization (Manufacturing) Versus Capital Spending on Equipment and Software.

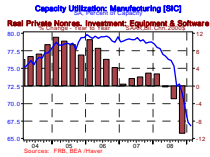


CHART 5: Total Business Sales Growth Versus Total Business Inventory Growth.

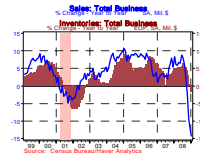


CHART 6: ELABORATION of Chart 5.



CHART 7: Major Industrial Markets, Autos and Light Trucks (NAICS 3361-3).

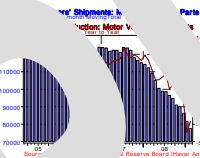


CHART 8: Major Industrial Markets, Heavy Trucks (NAICS 336120).

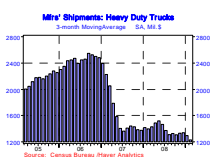


CHART 9: Major Industrial Markets, Aerospace/Aircraft (NAICS 3364-9).

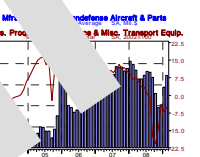


CHART 10: Major Industrial Markets, Electrical Equipment, Appliances, and Components (NAICS 335).

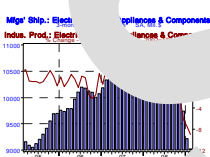


CHART 11: Major Industrial Markets, Machinery (IP = NAICS 333; Shipments = 3332).



CHART 11b: Major Industrial Markets, Construction and Farm Machinery (NAICS 333120 and 333111).

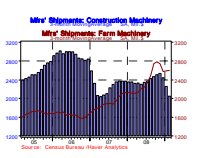


CHART 12: Major Industrial Markets, Plastics and Rubber Products (IP = NAICS 326; Shipments = 326).

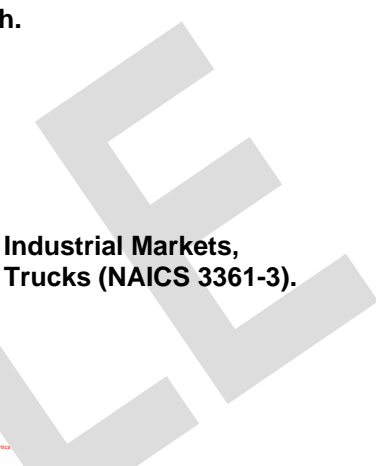


CHART 13: Housing Starts.

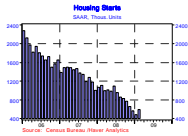


CHART 15: Inflation Dynamics, PART 1.



CHART 17a: Individual Raw Material Prices, Copper and Aluminum.



CHART 18: Crude Oil and Natural Gas Prices.

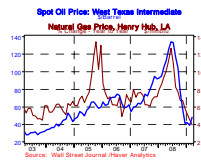


CHART 20: Foreign Exchange Rates.

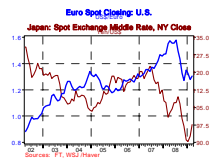


CHART 22: Weekly Initial Claims for Unemployment Compensation.

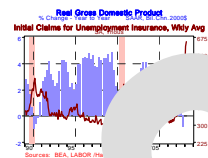


CHART 14: Popular Inflation Measures.

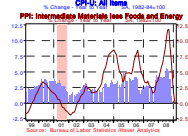


CHART 16: Inflation Dynamics, PART 2.

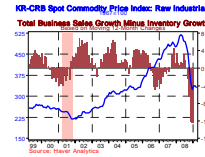


CHART 17b: Individual Raw Material Prices, Nickel and Steel.



CHART 19: The Trade-Weighted Dollar and Import Prices (Excluding Oil).

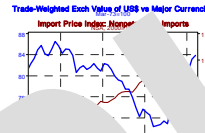
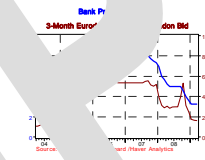


CHART 21: Interest Rate Trends.



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