

The Economy and the Odds Of A Recession **by Gary D. Halbert**

The US economy has been dealt a serious blow, what with the housing downturn and, in particular, the subprime mortgage meltdown. While we don't know the exact magnitude of the housing downturn, we do know it is large and likely to get larger. Numerous forecasters believe this alone could send the US economy into a recession next year.

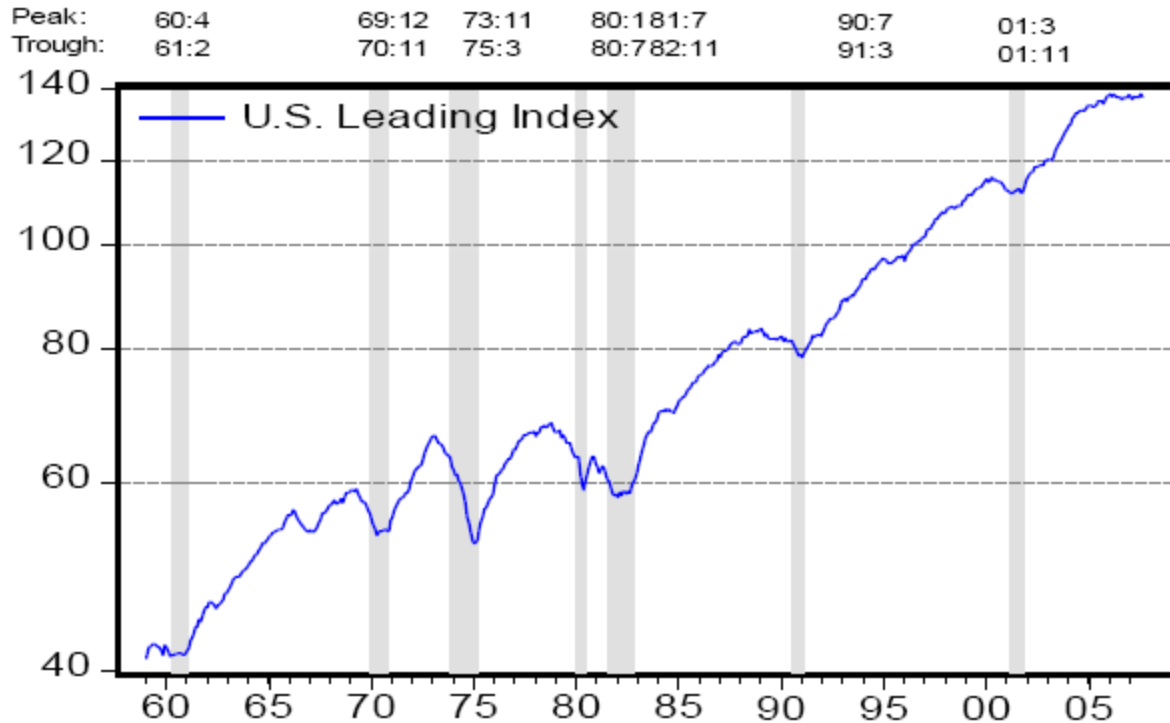
And of course, how could I not speculate on whether the Fed will cut rates again – everyone else is. Many analysts are against any further rate cuts, as they fear inflation is coming back, especially with gold soaring to near \$750. On the other hand, many analysts believe the Fed must cut rates because of the credit crunch and fear that we are headed for a recession.

Yet the editors at the Bank Credit Analyst continue to argue that a recession is not the most likely scenario just ahead. BCA believes that the housing slump and related problems ensure that the US will see at least two to three more quarters of below-trend growth (GDP under 3%), but they continue to believe that a full-blown recession in the US is not likely over the next year. I will explain their reasoning later on.

The Index of Leading Economic Indicators

Before jumping into the latest reports on the economy, I want to make some important observations about one of my favorite economic reports, the Index of Leading Economic Indicators, or "LEI." There are some in the economics world who do not believe the Index of Leading Economic Indicators is a very reliable forecaster of the US economy. I don't know why. I think the LEI is one of the best indicators of the major trend in the economy.

The Conference Board publishes the LEI monthly report, as shown below. The gray-shaded vertical areas in the chart denote periods of recession. If you look closely, you will see that the LEI turned decidedly lower in advance of each recession.



Source: The Conference Board

As you can clearly see from the chart, the LEI has been a very good indicator of recessions and well in advance. While there's no guarantee that it will always be so accurate, it is not currently signaling that we are headed for a recession in the near future. Interestingly, the LEI has been in a broad trading range, essentially sideways since 2005.

If you would like to read the entire Conference Board report on the latest LEI, click on the following link: http://www.conference-board.org/pdf_free/economics/bci/LEI0907.pdf

The Latest Economic Reports

While not all of the economic news has been bad over the last month or so, most of it has not been encouraging. In September, the government released its final estimate of second quarter economic growth at 3.8% (annual rate), down from its previous estimate of 4.0%. 3.8% growth is very impressive, but quite a lot of bad news has appeared since the end of June, and few forecasters expect anything near 3% growth for the third quarter.

On the manufacturing front, the ISM Index fell to 52.0 in September, the third monthly decline in a row. Factory orders fell 3.3% in August. Durable goods orders fell 4.9% in August. The good news is that industrial production and construction spending rose very modestly in August (also latest data available).

The unemployment rate rose to 4.7% in September. According to the Labor Department, the largest job losses were once again in manufacturing and construction.

The Consumer Confidence Index plunged for the second month in a row in September, falling 5.8 points last month to 99.8, the lowest reading in almost two years. Likewise, the latest University of Michigan Consumer Sentiment Index remains very low at 83.4.

Surprisingly, consumers continue to spend, although the trends point to a slowdown. Retail sales rose 0.6% in September, above expectations, following a rise of 0.3% in August, and the latest we have on personal spending was a 0.6% increase in August. While the latest spending figures are positive, the sharp drop in confidence suggests that consumer spending is likely to slow in the months ahead on a seasonally adjusted basis. It will be interesting to see how consumer spending holds up during the upcoming holidays.

Since consumer spending makes up approximately 70% of GDP, this is the key number to watch, since the level of spending will likely determine whether or not we have a recession next year. As long as consumer spending remains at least marginally positive, we should avoid a recession.

Much of that depends on the housing market which continues to slide. New and existing home sales fell again in August. Pending home sales fell another 6.5% in August, following a 10.7% decline in July. Pending home sales plunged 21.5% for the 12 months ended August, the largest one-year decline on record. The inventory of unsold homes rose another .4% in August, pushing the number of unsold homes to 4.58 million, a 10-month supply at the latest rate of sales according to the National Association of Realtors.

Will The Fed Cut Again

There is much heated debate as to whether Bernanke & Company will move to cut rates again. Economists and market forecasters now are split in two camps. On one side are those who maintain the Fed's last rate cut was too aggressive and who see no reason for further moves. On the other side are those who say the housing slump has us headed for a recession and believe the FOMC will have to cut again, given this and other signs of US economic weakness.

I happen to be in the camp of those who believe the Fed should cut rates again. The Fed's September 18 policy statement suggests, in my view, that more cuts are certainly a possibility:

“Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time...”

Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth."

Clearly, the Fed is aware of the housing related credit crunch and how serious it is. Likewise, they are well aware that the economy is slowing down. As discussed above, most of the economic reports that have come out since September 18 have been negative. BCA believes it is possible the FOMC could cut the Fed funds rate to 4% before yearend. One big reason the editors at BCA believe this is their outlook for US inflation, which they expect to surprise on the downside in the months ahead. It has been concerns about inflation that have made the Fed hesitant to cut rates.

BCA Believes a Recession is Not Likely

Long-time clients and readers know how much I respect **The Bank Credit Analyst** (www.bcaresearch.com). As I have written often over the last several months, BCA continues to believe that a recession in the US is not the most likely scenario in this cycle. Martin Barnes and his fellow editors at BCA are well aware of the seriousness of the housing slump and the credit crunch. As a result, they certainly don't rule out a mild recession, but they expect the US economy to surprise on the upside once again, as it has for the last 25 years.

The bottom line, as I see it, is we simply don't know if the housing slump will worsen to the point that it chokes off consumer spending and we go into a recession. I am not convinced that we have heard all the bad news that is to come from the housing slump, the subprime meltdown and the credit crunch. And let me emphasize that while BCA maintains that a recession is "*not the most likely scenario*," they do not rule it out.

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is \$197 for 12 issues and may be obtained by visiting his website at www.profutures.com.