

Where's the Economy Going Now?

By Gary D. Halbert

The financial and investment markets are currently as jittery and nervous as I have ever seen them in my 32 plus years in this business. The housing downturn and the subprime and related credit market problems have led to a level of general distrust among both financial institutions and individual investors that we have not seen in my adult lifetime.

This growing nervousness and distrust is largely focused on the issue of “transparency.” Among the major financial institutions, no one seems to know exactly how much or what type of bad debts may be on the other guy’s books. The sudden collapse of Bear Stearns, one of the largest Wall Street investment banks/broker-dealers, just over a week ago has only heightened the level of distrust across America’s financial markets.

Around the world the question is which US financial institution will be the next shoe to drop? And is the Fed ready (or even able) to bail out any and all comers as it did in the Bear Stearns collapse?

At the same time, concerns continue to mount over the general health of the US economy. A broad consensus of economists and market forecasters holds that the US economy is either already in a recession or will be shortly. While we are still weeks away from the first advance report on the first quarter GDP, it is hard to argue that a recession is not upon us.

Over the last year, numerous respected economic forecasters have suggested that the US economy would either barely side-step a recession this year, or that the recession would be limited to only two to three quarters of mildly negative growth. Over the last couple of months, however, forecasts have increasingly been downgraded, and now most expectations suggest the recession will drag on well into 2009, and that the recovery will be slower than previously expected.

And last but not least, there are growing concerns about our economic future should either Hillary Clinton or Barack Obama win the White House in November, since both pledge to raise taxes should either of them become president.

All of these concerns and uncertainties raise even more questions about how to invest successfully in this very complex and challenging environment. The Dow Jones Industrial Average recently slipped below 12,000 once again, down over 15% from the all-time peak last October. Bond yields are easing back to their lowest levels in five years, so there does not seem to be a lot of opportunity there either.

Meanwhile, the price of oil spiked well above \$100 per barrel, and gold prices exploded briefly above \$1,000 per ounce. Investors in droves are trying to figure out how to jump on the commodity bandwagon, but it remains to be seen if it’s too late to join the party. On the other end of the spectrum, the US dollar continues to plunge to new lows and here too, one wonders how risky a bet it is to short the dollar now.

I certainly don't propose to have all or even most of the answers. I do not see the current atmosphere of mistrust and nervousness ending anytime soon. Likewise, I don't see market volatility subsiding in a meaningful way in the near future. We may have to get used to it, which may mean some changes in the way you approach your investments. But I'm getting ahead of myself.

The US Economy – What Kind of Recession?

Our most reliable indicator of the US economy is the Commerce Department's Gross Domestic Product report. Unfortunately, these reports are issued well in arrears. For example, the final GDP report for the fourth quarter of last year is expected soon; the consensus expectation is for growth of only 0.6%, unchanged from the preliminary report on February 28.

As I write this, the first report on the first quarter GDP, which everyone in the financial world is anxiously awaiting is expected soon. Most analysts expect the advance report for the first quarter will show negative growth in GDP, but that remains to be seen. In the meantime, let's review some of the latest economic reports we have recently seen.

The Index of Leading Economic Indicators (LEI) is arguably the best measure of economic trends short of the GDP reports. The latest LEI report for February showed a decline of 0.3%, in line with expectations. The monthly LEI has declined in each of the last six months, the worst showing since early 2001 when we entered the last recession, which proved to be both mild and short.

While the negative monthly LEI reports over the last six months have not been overly severe in the aggregate, we must keep in mind that in 2001 we did not have a housing/credit crisis as we have now. We did not have many of the nation's largest financial institutions on the ropes due to huge subprime and related credit problems. Thus, it is no stretch to conclude that a recession this time around will likely be more severe and long-lasting than in 2001.

With consumer spending accounting for approximately 70% of GDP, this is the next area to direct our attention, and the news is not good. The Conference Board reported this morning that the Consumer Confidence Index fell to 64.5 in March. This followed the plunge in February to 76.4, down from 87.3 in January. Consumers are clearly worried.

Most other economic reports of late have been disappointing at best. Retail sales fell 0.6% in February, following a surprise rise of 0.4% in January. Industrial production fell 0.5% in February after rising a modest 0.1% in January. In following, the factory operating rate in February fell to 80.9, down from 81.5 in January. The ISM Services Index rose from 44.6 in January to 49.3 in February, but any reading below 50 is an indication of a slowing economy.

The official US unemployment rate fell to 4.8% in February, down slightly from 4.9% in January. But this number is misleading, as is often the case, given that a net 85,000 jobs were lost nationally in January and February.

On the housing front, the numbers continue to deteriorate overall. Housing starts fell 0.6% in February and were down 7.2% from the average in the fourth of 2007. Building permits plunged 7.8% in February to the lowest level in 16 years. Existing home sales actually rose slightly in February, up 2.9%, largely because home prices have now fallen to levels many view as bargains. While existing home sales rose slightly, they were still 23.8% below year-ago levels. The median price nationwide for existing home sales fell in February to \$195,900, down 8.2% from year-ago levels.

As noted above, predictions of a quick rebound in the US economy in the last half of this year have all but disappeared, and most forecasters now believe the current or upcoming recession, while it may not be overly severe, will last well into 2009, and the recovery will be slow at best. Unless these economic trends reverse in short order, there is little doubt that we are headed for a recession if we are not there already.

Are We There Yet (Market Bottom)?

Anyone who has taken an extended road trip with their children has experienced the “*are we there yet?*” question. Today, many investors are asking this same thing in regard to the equity market’s recent drop, and whether or not it’s time to reinvest. It’s a very important question, especially for those at or near retirement, who may not have the luxury of time to make up losses should the markets continue to move lower.

Many market analysts believe we are now in a full-fledged bear market because we have seen the Russell 2000, the NASDAQ Composite and the NASDAQ 100 indexes decline by 20% or more from their previous highs. The Dow Jones Industrial Index and the S&P 500 Index have not declined by 20% at this point on a closing basis, and this is causing some market observers to believe that we are approaching a major bottom.

I am not so optimistic, however. In light of the unusual problems we face this year – with the economy slowing down and all the financial problems we have – I am not convinced that the equity market downturn is over. This market correction (or worse) could well last a bit longer.

Conclusions

The US economy is faltering, as the latest data show. Whether we are indeed in a recession is still not clear, but the odds increasingly favor it. With the housing crisis worsening by the week, a recession could linger longer than has been previously expected.

What does appear to be clear is that the US economy will be in a slowdown for at least the next year. It may not be clear over the next year if we are in a recession, but economic growth will almost certainly be disappointing.

The declines in the stock markets over the last six months may well have been an early indicator of what lies ahead for the economy. Some of my best sources believe that we are facing several more years of disappointing stock market returns. I am not yet ready to fully embrace that view.

But as an avid watcher of economic data, I think it is naïve to believe that a quick recovery in the economy and the markets is right around the corner. The Fed's recent actions should remind us that we are in uncertain times, and we should keep that in mind when it comes to our investments.

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.