



# MUSINGS FROM THE PANTHEON

OCTOBER 10, 2008

THOUGHTS ON THE ECONOMY AND MARKETS. NOT HYPE, JUST INSIGHT.

## THE MOMENT OF TRUTH

Clients understand that my worst economic fears continue to unfold. We reached a tipping point, or “Minsky Moment”, because of too much debt. And now the government is trying to use all resources and bailouts in its power to prevent deleveraging on a mass scale. And I must confess that as dark as my fears were about the economy, I remained steadfastly optimistic that our government could prevent this vicious “negative feedback loop” from spreading. Now I find myself less certain, but still hopeful.

Today the credit markets stand frozen. If financial institutions are the heart of the economic system, then credit is the lifeblood. And today, our heart no longer beats and no blood travels to vital organs. Worst, the emergency room overflows with other patients in cardiac arrest: Europe, Asia, South America, Russia and on and on. And the doctors’ better quit trying CPR and start rolling out the defibrillators at once!

While I remain confident that Doctor Bernanke understands what to do, I question whether European doctors agree on prospective treatment. And unfortunately, if Europe’s economy dies, ours likely goes down with it. While not the most eloquent or uplifting speaker, President Bush said it best, “This sucker could go down.” And so, as we look into the abyss, we reach the moment of truth.

Will, and can, the world’s leading politicians and central bankers act to revive the financial system? Unfortunately, no one knows.

But even if I assume that our leaders act successfully, the global economy entered a deep recession this quarter. Consumers and investors alike rightly suffer from heightened anxiety. And this anxiety will result in retrenchment and caution. Two months ago, in “The Eye of the Storm”, I wrote the tranquility resulting from government rebate checks would prove short-lived as the financial crisis would feed into the real economy. And today we now feel the brunt forces reining against us. All eyes remain glued to financial markets, and that is where the fear is easily seen. But those who still check the economic data realize that pain now engulfs the real economy.

Layoffs continue to rise, with nonfarm payrolls shedding 159,000 jobs in September and 684,000 year-to-date. Average hourly earnings rose a mere 3.4%, far less than inflation which advanced 5.3%. Growth in retail sales continues to decline and remains negative after adjusting for inflation. The ISM index declined significantly last month to 43.5, signaling manufacturing likely entered recessionary conditions in September. And with automobile sales plummeting around 27% year-over-year, who would argue that manufacturing contracted last month. Add a strengthening

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dollar, and manufacturing may be nearing its own perfect storm. But, perhaps most important, and least reported, consumer credit contracted last month for the first time since June, 1992. With personal consumption accounting for over 70% of the economy, any slowdown in spending resounds deeply. And my fears continue to mount that American consumers finally hit their debt limits. This bodes ill for the economy, and repairing individual balance sheet means the ensuing recession and stagnation will likely last far longer than most investors realize. Unlike the dot.com recession, unfortunately many consumers will feel the pain coming over the next few quarters.

However today, with stock markets down nearly 40%, the financial system needs massive intervention. Simply buying toxic assets will no longer satisfy as a policy prescription. I expect at this weekend's G7 meeting a coordinated effort at guaranteeing or nationalizing the financial system in some shape or form. Lehman Brothers was allowed to fail to stem moral hazard. But the result witnessed complete freezing of financial markets. Institutions now need to worry about the credit risk of other institutions. And given the opaque nature of financials' balance sheets, it's much easier to just not lend any money. Instead, every institution just hoards its own cash. This lack of confidence represents the key systemic risk at present. The situation today appears remarkably similar to the bank runs of the Depression. Just as depositors feared bank failures and rushed to get their money out of the bank, today's financial institutions fear one another and refuse to lend. And just as government deposit insurance stemmed bank runs after the Depression, today financial insti-

tutions need similar insurance to entice confidence.

I believe this weekend that governments around the world will offer the bailout of bailouts. And they will succeed in unfreezing the credit markets. Confidence will return and stock markets will rejoice. But after the early euphoria, investors' attention will return to the economy's health. And unfortunately, the patient at best will be in rehabilitation and not off to the races.



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