

The Global Economic Outlook

March 2009

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The now nearly synchronous and severe retrenchment in global business activity, which extends at least as far back as December 2007 when the United States first formally entered recession, has, over recent months, achieved a breadth and depth without parallel in the modern postwar period. The financial contagion, accelerated by the stunning collapse of a succession of global financial firms last fall, has heightened anxiety and uncertainty about the future course of spending and investment worldwide—draining entire economies of the benefit of what John Keynes called, *animal spirits*, or the willingness of individuals and firms to assume entrepreneurial risk, make long-term commitments, in sum, have trust in basic economic systems, institutions, and counterparties. It has fallen now to governments and monetary authorities to repair the public trust by both pruning away and restoring large swaths of the system by which credit is expanded, managed, and traded. So far, fortunately, there has been both the willingness to act and to innovate, but it remains whether even the current cumulation of government stimulus and central bank intervention can sufficiently offset the steepening decline confronting most developed and emerging economies.

In the United States, the Commerce Department estimated that fourth quarter real gross domestic product, or the sum total of all goods and services produced adjusted for inflation, contracted at an annualized rate of 6.2%, or the worst quarterly performance since the last significant recession of the early 1980's. Personal consumer expenditures, which account for more than two thirds of total output in the U.S., fell by 4.3% in the quarter after having fallen by 3.8% in the preceding period. Consumer spending has been legitimately pressured by increasing unemployment and reductions in household wealth totaling some \$12 trillion in 2008. As a consequence of the escalating, large-scale destruction in aggregate demand, businesses have been compelled to draw down excess inventories—an adjustment process likely to extend well into 2009 before it must reverse. Nonetheless, business capital investment, or spending on new software, equipment, and productive capacity, declined at a sharp 21% annualized rate suggesting low confidence and visibility on the part of business leaders with respect to eventual recovery.

Residential fixed investment continued to exact its long-abated, substantial toll on GDP, falling by more than 22% in the quarter. New home sales have ebbed to new lows, expanding the inventory of unsold homes and assuring future declines in home prices. By some measures, home prices are down nearly 30% from their cyclical high levels of July 2006, but it is not inconceivable that prices will eventually trough near rent-to-valuation equilibria established long before the housing and credit manias. Even though mortgage rates have fallen and housing affordability has increased, turnover will remain inhibited as long as lending capacity is withheld by banks suffering capital erosion and increasing delinquencies. These types of adverse feedback loops are highly destabilizing obstacles to recovery and especially difficult to correct even in more forgiving environments.

In terms of global trade, what had earlier showed great promise for the U.S. economy has also faltered as many of the world's most vibrant economic regions have now also experienced precipitously weakening demand. Net exports, which have contributed positively to U.S. growth over much of 2008, finally receded in the last quarter. The temptation but also great danger during such times is withdrawal toward protectionism or economic isolationism. Such policy mistakes easily begin with a newly forged but desperate nationalism or nationalistic primacy that can rapidly devolve into tariff disputes, treaty impingements, and competitive currency devaluations. Ultimately, the correct policy prescriptions for slowing and eventually reversing the economic decline must include measures directly targeted at reducing housing inventories and stabilizing home prices, increasing the viability of and confidence in the banking system, capping unemployment, and encouraging further deleveraging of consumer balance sheets—a formidable array but nonetheless integral to sustainable recovery.

In Europe, while the severity of the contraction in output growth last quarter approximately matched that of the U.S. on an annualized basis, total unemployment across the sixteen euro sharing nations exceeded the U.S. rate by more than 0.5% in January. Increasing labor and product market slack combined with lower commodity prices and falling core inflation should encourage significant further policy action with respect to interest rate reductions and increased stimulus. Rapidly expanding deficits, however, present new risks—especially among the more burdened economies of Greece, Ireland, Spain and parts of Eastern Europe.

In Asia, GDP contracted sharply across many nations. Japan's output collapsed at a staggering 12.7% annualized rate. Thailand fell by 21%, and Singapore, Korea, and Taiwan all performed as dismally. Both India and China continue to report expansions but of a far more muted variety than has been their recent experience. China, however, with a well managed public debt structure and \$2 trillion in foreign reserves, has an exceptional current capacity to withstand the global crisis.