

Forecast 2008: Recession and Recovery

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Housing: Going Down, Down, Down

Who's Got My Credit Default Swap Back?

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The Fed: Too Little, Too Late

Europe, Santa Barbara, China, and The Motley Fool

By John Mauldin

It's that time of year, when I throw caution to the wind and present my annual forecast issue. Jumping to the conclusion, I think a recession has begun, so the relevant question is to ask when the recovery will begin. We will look at the housing market, the continued implosion of the credit markets, and the deteriorating employment picture. Will the Fed worry more about employment and recession or about the very real inflation pressures? Oil? Gold? Which way the dollar? I am going to make some unusual calls, as well as highlight what I think will be the next looming problem in the growing credit crisis. We'll try to cover it all in just a few pages.

But first, one quick commercial note. I am looking to establish a relationship with a few venture capitalists, and/or broker-dealers who specialize in private equity placements. If such a relationship might interest you, please feel free to contact me. And now, let's jump into the letter.

As is usual for the forecast issue, we begin by looking at how I did last year. All in all, not bad. I correctly predicted the housing and subprime crisis, noted that there was a potential for the credit crisis to spread (which it did), and suggested that we would end the year in recession. As I will make the case later in the letter, I think we did just that in December. I got the direction of the dollar right, as well as energy, but I was wrong (as usual) about the stock markets. I thought a recession would lead to a lower stock market for 2007. It now looks like that lower stock market will show up in 2008.

And Dow-Jones columnist Jakob Spencer graciously included me in his list of analysts who got their predictions right. "Author and newsletter writer John Mauldin was particularly prescient in pointing out in plain language to his million plus readers the potential for the early rumblings in the subprime-mortgage market to upset the much larger market for securitized assets of all stripes. Before most retail investors knew what the initials 'CDO' stood for, he spelled out the dangers and urged caution."

At the beginning of each year I choose a theme for the forecast issue. This year, it is "Recession and Recovery." I think we've entered a recession. As I've been writing for over a year, I think this will be a mild recession, but the recovery period will be prolonged and slow. My best guess now is that the recovery will begin in the third quarter of this year. The National Bureau of Economic Research is the final arbiter of when recessions begin and end. However, it will be at least a year and more likely 18

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months before they give us a decision. By that time, we will be well on the road to recovery. So, let me make my case that we are in recession.

18,000 Jobs? Not Really.

The Bureau of Labor Statistics put out its monthly employment report today. The consensus forecast was for 70,000 new jobs. BLS came out with only 18,000 jobs, promptly putting the market into a funk, with the Dow falling 256 points. Since the economy needs to create about 150,000 jobs a month just to account for growth of population, today's employment numbers are quite anemic. But it's worse than the headline number would indicate.

I have touched on this in earlier letters, but let's quickly revisit something called the birth-death ratio.

The Bureau of Labor Statistics actually does two different surveys. One is called the payroll or establishment survey, which is comprised of calling approximately 160,000 businesses (out of 9,000,000) and seeing how many workers they have that month. They survey enough businesses to cover about 1/3 of non-farm employees. And that should be enough to get a good idea of where things are going, right?

Close, but not exactly. They do not contact very many small businesses, and of course cannot call new businesses. And since small and new businesses are the engine of job growth in the US, it is important to include an estimate for them. And they do this by estimating the number of new jobs in various categories that are created or lost by means of something called the birth-death (BD) ratio.

The BD ratio estimate is based upon past history. While estimating the most recent month's employment picture is quite difficult, you can do a fairly accurate job when you go back a few years, using other government data, tax information, etc. And so you can create a trend for how many jobs you miss due to the birth and death of jobs in the small business area. Now, remember, that number is an **average** of many years of history. As an average it is fairly accurate over long periods of time.

But there is one flaw in this methodology: it will tend to underestimate new jobs when the economy is recovering from recession and overestimate them when the economy is slowing down. Thus, in 2003-4, the Democrats were beating up Bush about the jobless recovery. As it turns out, those employment numbers were massively revised upward a few years later. There was in fact a powerful recovery going on, just not in the statistics. However, nobody but a few economic geeks paid attention, as it was last year's news.

This month the BD ratio created 66,000 new jobs for the establishment survey, or 48,000 more jobs than the headline number. Let's look at a table directly from the BLS web site.

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2007 Net Birth/Death Adjustment (in thousands)

Supersector	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Natural Resources & Mining	-2	1	1	2	1	1	2	1	1	0	0	0
Construction	-52	11	27	49	40	26	8	15	12	14	-3	-9
Manufacturing	-23	3	6	3	7	7	-10	4	3	-5	4	2
Trade, Transportation, & Utilities	-29	10	19	30	29	19	-13	22	16	28	24	23
Information	-9	5	0	7	5	-1	-3	3	-3	4	4	3
Financial Activities	-17	11	8	26	7	6	6	11	6	25	8	17
Professional & Business Services	-48	28	21	44	19	20	-5	20	6	36	12	5
Education & Health Services	10	12	1	47	13	-9	5	14	11	39	11	9
Leisure & Hospitality	1	34	39	95	75	81	44	26	-36	-37	-10	14
Other Services	-6	3	6	14	7	6	-8	4	1	-1	1	2
Total	-175	118	128	317	203	156	26	120	17	103	51	66

Does anyone seriously think that 17,000 jobs were created in the financial services world this last month? Where did that 17,000 number come from? Well, last year it was also 17,000. In fact, if you look at 2006, the numbers track very closely with 2007, which track closely with 2005, and so on. My prediction is that in a few years when the data is revised we will find that December saw a loss of jobs.

And good friend Barry Ritholtz writes: “Consider: The B/D generated 1,239,000 jobs from February thru November 2007. That's rather surprising, since the total NFP jobs created since [January 2007 was 1,208,000](#). In other words, the Net Birth/Death jobs created over 10 months was actually greater than the total NFP jobs created in all of 2007. That's rather odd, don't you think?”

Now, I mentioned that the Bureau of Labor Statistics does two surveys. The other one is the household survey, where they simply call 60,000 homes (at random) and ask how many people are in the home and who has jobs (part-time or full-time), does anyone want a job who doesn't have one, and so on. This survey covers people who are employed both by large and small employers, illegal immigrants, etc.

(By the way, this is going to become increasingly suspect as more of us simply use cell phones and do not have a home phone. It will skew the survey.)

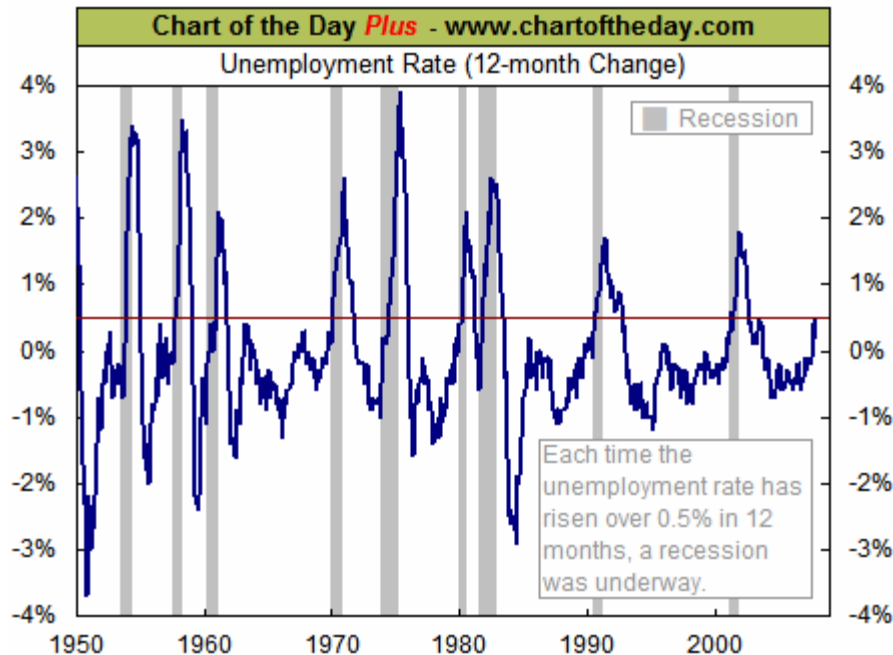
These surveys tend to parallel each other, except at turning points in the economy. Then there can be some large discrepancies. As an example, take this month's household survey.

There was a loss of 436,000 jobs in the household survey. Unemployment rose to 5%, up from 4.4% last February, and 4.7% last month. Writes Philippa Dunne from *The Liscio Report*: “Rises of that magnitude are rare; it's 1.6 standard deviations from the mean, and at the 92nd percentile of monthly changes since 1950. They're even rarer outside recessions; of the 55 rises of 0.3 point or more, just 18 have been in expansions, and most of those were either close to recessions or in jobless recoveries. In fact, the last time we saw a 0.3 point rise was in January 2001, two months before the official cycle peak. More than half the rise in unemployment came from permanent job losers.”

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Now we know why Christmas consumer spending was so weak. And some segments of the economy were particularly hard hit. Unemployment rose to 17.1% for all youth, and 34.7% for black youth (up by 5%!!!). 6.9% of single women with children are unemployed, and are losing jobs faster than the work force at large. Part-time jobs are way up. The BLS also tracks part-time jobs of people who are doing them out of economic necessity, and that is up even more.

All in all, this was an ugly labor report. Look at the graph below from Chart of the Day. (www.chartoftheday.com)

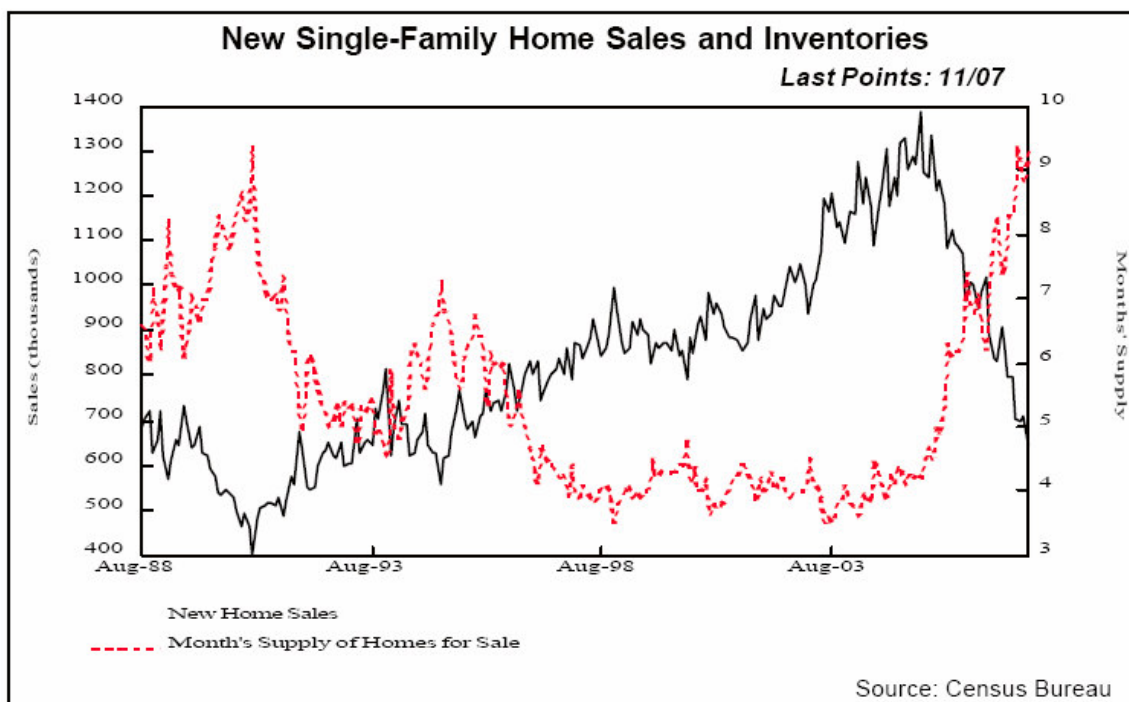


A rise of 0.5% unemployment (from the bottom) has always been associated with a recession. We are already up 0.6%. It is hard to imagine how it will not be so this time. So, how did we get here? As I have written for a long time, it is the result of the bursting of the twin bubbles of the housing market and the credit markets. This process is going to take a long time, and create major headwinds for the economic recovery. Let's look briefly at each one, although I will go into more detail in later letters.

Housing: Going Down, Down, Down

Let's look at two charts from Gary Shilling's latest letter. They pretty much say it all:

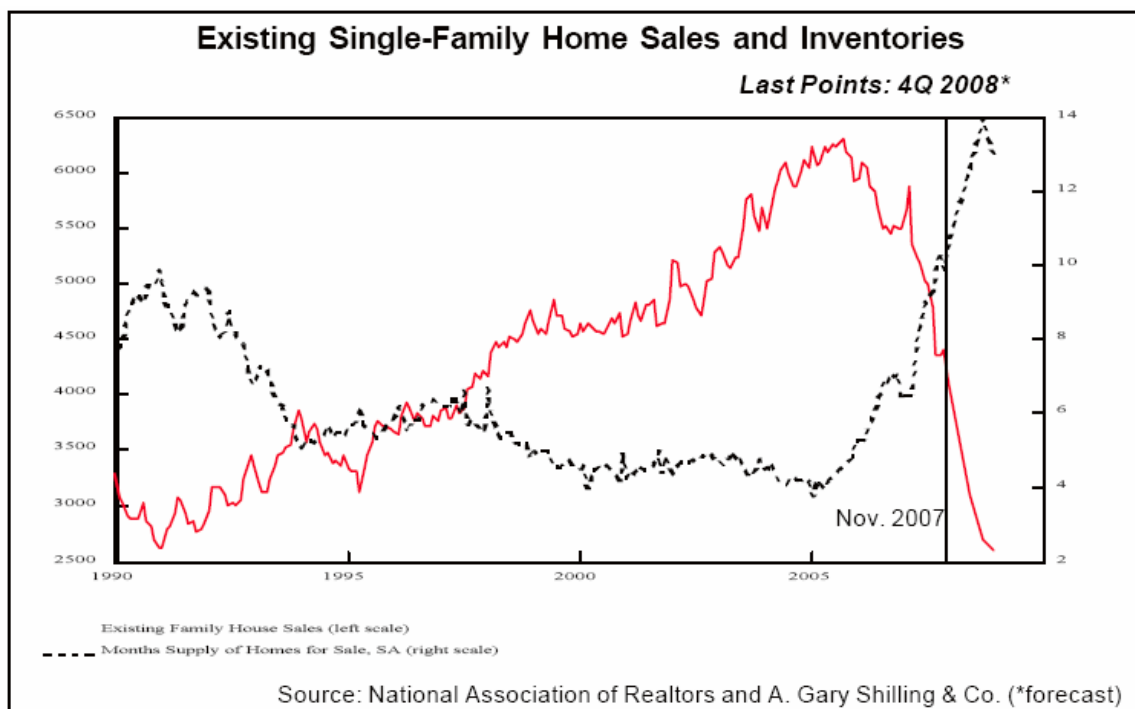
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Notice that the inventory of new homes is continuing to rise. Also, that new home sales have not fallen to the level of 1991. There is still significant potential downside for new home sales. Separate work by Shilling suggests that some 2,000,000 excess homes have been built over the past decade. These have been bought by speculators and people who we are now discovering they cannot afford to make the payments on the homes. Low rates, rising prices, and reckless lending standards spurred an irrational rush into housing speculation, and sent the wrong signals to builders, who responded by overbuilding.

New home construction is still way too high given the inventory levels, and will fall further. It is way too early to call a bottom of the housing market, or a recovery of home builders. Now let's look at the next chart:

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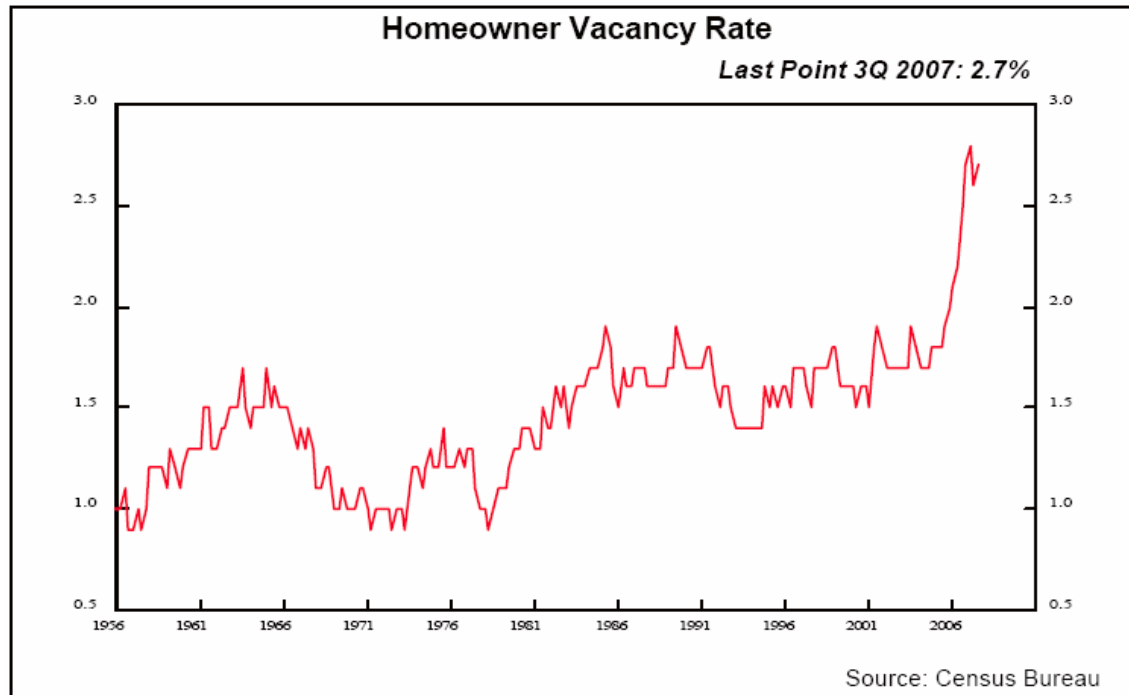


Shilling projects housing prices to drop by about 25%. Some will counter that Gary is way too bearish, but Bank of America estimates are not far from that. Professor Robert Shiller of Yale, who created the S&P Case/Shiller index which tracks housing prices, recently suggested in a *Times Online* article that homeowners have lost about \$1 trillion and could lose three times that much over the next few years. That is consistent with a 20-25% drop in home prices.

And remember, that is a national average. Some areas in California, Nevada, and Florida where speculation was particularly rampant could see drops of up to 50%. Writes Shilling: "And there's lots more to go. As noted earlier, it would take a 24% decline in prices to re-establish the normal relationship with building costs. A 27% fall is required to bring house prices back in line with rents. And a 50% drop is needed to return to norm when house prices are adjusted for overall inflation and their growing size." Ouch.

One last chart from Gary to illustrate the problem. Vacant properties are at an all-time high. Speculators who bought homes to flip are now in a cash crunch. They can either rent at a loss, or see their homes foreclosed. This is going to create a real oversupply of homes for at least several years.

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As I have made the case for over a year, the negative wealth affect from falling home prices is going to put a damper on consumer spending. The reduced ability to borrow money on homes is going to put a crimp in consumer spending. Higher unemployment from fewer construction, mortgage, and housing-related industry jobs will negatively affect spending.

This is going to be a problem until at least the middle of 2009, as it will take that long to work through inventories and foreclosures. That is one of the reasons why I think the recovery will be slower than it normally would be. But now let's turn to the second bubble, and a brewing problem that could mean a further round of massive bank write-offs.

Who's Got My Credit Default Swap Back?

My middle son is an online gamer, typically playing combat games with teams formed by players from around the world. To advance in the rankings, you have to work together. "I've got your back" is a frequently heard term in my house. If no one has your back in the gaming world, you can be pretty sure that the enemy will soon be there and you will be a statistic.

The "back" for the mortgage investment business seems to be particularly absent. As in the online gaming world, it could get ugly really quick. And a lot uglier than I thought just a few weeks ago.

In a brilliant article in the *Wall Street Journal*, Carrick Mollenkamp and Serena Ng detailed the rise and fall of a collateral debt obligation (CDO) called Norma, ushered

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into existence by Merrill Lynch. This is a \$1.5 billion CDO created in March of 2007 with over 90% of its paper rating “A” or better, and \$1.125 billion rated AAA. In November 2007, the entire CDO was downgraded to junk.

That is not particularly news, as there are a lot of subprime CDOs that are being downgraded. What caught my eye was how this CDO was created. Quoting (and emphasis mine):

“For Norma, [the manager] assembled \$1.5 billion in investments. **Most were not actual securities, but derivatives linked to triple-B-rated mortgage securities. Called credit default swaps, these derivatives worked like insurance policies on subprime residential mortgage-backed securities or on the CDOs that held them.** Norma, acting as the insurer, would receive a regular premium payment, which it would pass on to its investors. The buyer protection, which was initially Merrill Lynch, would receive payouts from Norma if the insured securities were hurt by losses. It is unclear whether Merrill retained the insurance, or resold it to other investors who were hedging their subprime exposure or betting on a meltdown.

“Many investment banks favored CDOs that contain these credit default swaps, because they didn't require the purchase of securities, a process that typically took months. With credit default swaps, a billion-dollar CDO could be assembled in weeks.

“UBS Investment Research estimates that CEOs sold credit protection on around three times the actual face value off triple-B-rated subprime bonds. ‘The use of derivatives “multiplied the risk,” says Greg Medcraft, chairman of the American Securitization Forum, an industry association. ‘The subprime mortgage crisis is far greater in terms of potential losses than anyone expected, because it's not just physical loans that are defaulting.’”

The article goes on to detail how the entire CDO world is one large daisy chain of credit default swaps. Who's got your back? And who's got the back of the guy who has your back? And you better hope it is not ACA.

Never heard of the company? You will. ACA has dropped 95%, from \$16.55 to \$0.86 today. Why? Because the company sold credit insurance on CDOs. “If now junk rated ACA can't come up with an additional \$1.7 billion in capital by January 18, it will be insolvent and the \$69 billion in credit default swaps on CDOs it underwrote will be worthless.” (Shilling) \$69 billion? That is huge. Think that won't hurt balance sheets all over the world?

Counterparty Risk is the Real Sleeper Issue

There is never just one cockroach. Write this down. Counterparty risk in the credit default swap market will be a huge story in 2008. Losses are going to mount far higher than estimates from just a few months ago. I believe that many financial

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institutions will be taking large losses every quarter for the next few quarters. At the end of each quarter, investors will hope that this is finally the end. "Surely this time they have gotten it all out in the open." It won't be, because banks can't write down loans until the counterparty risk problem is solved. Who's got your back?

Between more massive subprime-related losses, being forced to bring SIVs back onto their balance sheets, and deteriorating credit quality in other bank lines (like credit cards and auto loans, as well as commercial real estate), banks are going to be forced to raise capital and tighten lending standards. This is not something that is going to happen in one quarter. It may take the better part of the year for all of this to flush out of the system.

This tightening stance will also contribute to a slower than usual recovery. Even if the Fed cuts rates again and again, the banks still have to raise capital and become more prudent lenders. And that means the cost of borrowing is going up.

The Fed: Too Little, Too Late

There are those who hope that the Fed will ride to the rescue with more rate cuts. I believe they will, but it is a case of "too little, too late." I think we will see a Fed rate below 3% by the end of the summer, if not before. But they are likely to initially take it slow, until it is clear we are in a recession, and/or inflation pressures have abated.

While rate cuts will help in general, the problem is that rate cuts won't help the credit crisis, won't solve the problem of credit default swaps, and won't bring back the subprime market. These are problems we simply have to work our way through, and it is going to take time.

Investment banks and the financial services industry made a great deal of money on securitizing all manner of risk. In general, that is a very good thing, except when the risk is fraudulent subprime mortgages. That source of income is drying up. You can bet the banks are working overtime on creating new forms of securitization that will allow for transparency and increased investor protection. There is a market for risk properly packaged and understood. Profits at investment banks are going to be under pressure until these new structures are developed and accepted by the marketplace. They have the incentive to get this done quickly and done right.

So let's get to the predictions. I think that we are in a recession for most of the first half of this year, and that we begin a slow recovery in the second half. It will be a Middle Through Economy for at least another year after that. That would suggest that most companies will come under serious earnings pressure. If history is any indicator, that means we should see a bear market in the first half of this year. How deep will depend on how fast the Fed cuts, but I don't think we are looking at anything close to the bear market of 2000-2001. Still, I wouldn't want to stand in front of a bear market train.

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Consumer spending is going to slow, and it will be slower to rebound, for reasons outlined above. That will also make the recovery in the stock market a little slower. But I expect to become bullish on the market sometime this summer, if not before. I'm looking forward to it.

It also follows that bonds are a good buy at this point. It would not surprise me to see the 10-year bond fall to 3.5%.

I think the United Kingdom follows the United States into a mild recession, and European growth will come under pressure. Nearly every central bank in the developed world outside of Japan will be cutting rates by the beginning of summer. China will not have a hard landing this year.

I've been bearish on the dollar since early 2002. Sometime in the first half of this year I think we see the dollar bottom out against the euro and the British pound. When the Bank of England and the ECB start cutting their rates, the dollar will start rising. The US will recover faster than its European counterparts, and that will help drive the dollar higher. The dollar is massively undervalued against those currencies. I think the dollar ends up higher by the end of the year, maybe by 10% or more. As I have written before, I expect the dollar to be at \$1.20 against the euro once again, and sometime next decade it will be at parity.

But not against Asian currencies. I expect the dollar to continue to drop against the Chinese yuan, the Japanese yen, and other major Asian currencies.

This will be a challenge to gold, and we could be in a period of price consolidation for the yellow metal. But at current prices, gold stocks are attractive.

There will still be significant growth in emerging markets, which will therefore increase demand for oil and energy, offsetting potentially weaker demand in the developed world. Six months from now energy inflation will begin to subside, if only because the year-over-year comparisons become easier. I believe oil is going higher, but maybe not this year, barring a crisis of some type. I am still a believer in natural resource stocks and alternative energy for the long run.

Europe, Santa Barbara, China, and The Motley Fool

I will be traveling to Europe the third week of January. I will be in Geneva on Monday the 21st, Zürich on Tuesday, Barcelona on Wednesday, and in London on Thursday and Friday, coming back Saturday. We do have time in the schedule for additional meetings. My European partners at Absolute Return Partners in London are taking care of my schedule, and I'll be glad to put you in touch with them.

When I get back from Europe, Tiffani and I will be going to Santa Barbara to meet with Jon Sundt and the partners at Altegris Investments for our annual planning meetings. This year we're going to go to Jon's ranch house in the coastal mountains. It is

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a beautiful place, and I'm looking forward to our time together, and also to raiding his wine cellar.

I don't often do this, but I have been reading South African partner Dr. Prieur du Plessis's blog for a while, and for those of you who want timely market comments, you should consider subscribing. It is free, but I find it valuable. You can go to: <http://www.investmentpostcards.com>.

I mentioned a few weeks ago that I had been nominated for Investor of the Year by the Motley Fool. Well, the online votes are in. From their web site: "You saw this one coming, right? Buffett wins again, with 41% of the vote, in another 2-to-1 margin of victory. The surprise runner-up here: John Mauldin – advisor to the hedge-fund stars, president of **Millennium Wave Advisors**, and author of the *Thoughts From the Frontline* weekly newsletter. What makes Mauldin a worthy second to the Oracle of Omaha? Read his May 2006 interview with the Fool (parts [one](#), [two](#), and [three](#)) and find out." I am going to do another interview next week and will give you a link when it is up.

And no, I am not going to China. Not yet anyway. But a few weeks ago my Chinese-language version of this letter topped 2000 subscribers. I started this letter, seven years ago, with 2000 subscribers. We'll see if lightning can strike twice. You can subscribe to the Chinese version at www.frontlinethoughts.cn.

It is time to hit the send button. Friends and family are calling. I am going to try and get a few of them to help me take the tree down this year. It was an especially nice tree, and created some nice memories in the new place.

Thanks for being part of my Thoughts from the Frontline family, and for recommending it to your friends. I do appreciate it.

Your thinking he is going to be tired at the end of the week in Europe analyst,

John Mauldin