

# Economic Review

February 2009

February began with anticipation of recovery plans from a new administration, but turned into doubt as economic weakness continued. GDP fell 6.2% in the fourth quarter of 2008, and is expected to contract in the first quarter of 2009. Japan reported an abysmal -12.7% GDP contraction in Q4, its worst performance since the 1970s. China's economy, bolstered by a large infrastructure plan, continued to expand, even as exports to the U.S. fell. European central banks cut interest rates further, and the Bank of England dropped rates to an all time low of 1%, dating back to the late seventeenth century. Oil prices rebounded to near \$40/barrel, as producers continued to cut production and demand rebounded slightly. A lack of clarity surrounding the economy and government intervention sent the Dow Jones Industrial Average down to levels last seen in May 1997 (December 1995 when adjusted for inflation) and 50% below its recent peak in October 2007.

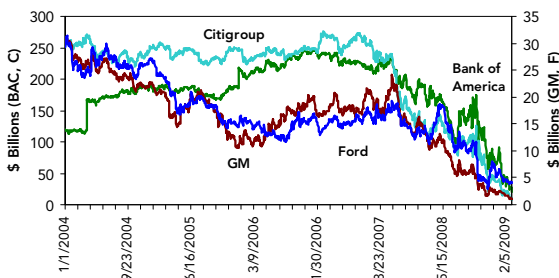
Dow Jones Index Falls to December 1995 Levels\*



\* Adjusted for Inflation

Sources: Bloomberg; Bureau of Labor Statistics

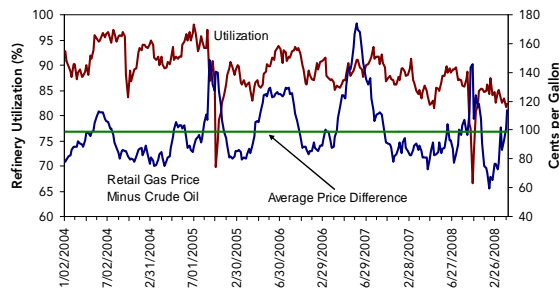
Banks' and Automakers' Stocks Close to Zero



Market Capitalization of Individual Companies

Source: Bloomberg

Oil Refiners Raise Gasoline Prices as Output Falls



Source: Energy Information Administration

The increasing likelihood of bank nationalizations sent stock investors fleeing. Bank of America and Citibank shares fell with renewed momentum after prominent Congressmen signaled a high likelihood of a federal takeover of the companies. In the event that this happens, equity holders would be wiped out. The unknown extent of the federal government's ambitions to further control and regulate other banks, with the potential of a total loss to shareholders, has caused investors to shun financial stocks.

President Obama introduced legislation to limit executive pay at companies receiving financial assistance from the government, including banks that received TARP funding. The move was prompted by employee bonus payments at several banks, which lost billions during the year and received billions from the federal government. Several banks announced their intentions to repay the capital ahead of schedule, in order to extricate themselves from additional regulations and oversight.

Timothy Geithner's speech to Congress regarding the Treasury's renewed plan for financial stability fell flat and sent negative shockwaves through stock markets worldwide. The plan, expected to provide specific relief for a struggling banking industry, contained turbid references and platitudes about reform and portrayed the Secretary as disconnected and unprepared to lead the difficult reformation of the banking system. An overstretched and understaffed Treasury department contributed to the cursory plan, and led to further concerns about the Treasury's ability to adequately execute its increased responsibilities.

General Motors and Chrysler provided further details about efforts to restructure and cut costs. GM planned to shutter its Saturn division, scale down Pontiac, sell Hummer, close several plants and significantly trim its workforce. Chrysler announced the elimination of several models and additional job cuts. The companies asked for an additional \$22 billion in funding from the federal government, on top of the \$18 billion received in January. GM also asked for funding from several other governments, including Canada and Germany. President Obama appointed a panel to oversee the restructuring efforts, which included Timothy Geithner in a lead position.

## Market Returns

As of February 28, 2009

	February	3 Months	YTD
S&P 500	-10.7%	-17.3%	-18.2%
Russell 1000 Value	-13.4%	-22.3%	-23.3%
Russell 1000 Growth	-7.5%	-10.4%	-12.0%
Russell 2000	-12.2%	-17.4%	-21.9%
MSCI EAFE	-10.3%	-14.2%	-19.1%
Barclays Agg	-0.4%	2.4%	-1.3%
3-Month T-Bills	0.0%	0.0%	0.0%

A sharply divided Congress approved a nearly \$800 billion bill aimed at relieving the current economic downturn. Initially conceived as an infrastructure spending and tax relief bill, the bill appeared strikingly different in its final form. Aside from the annual alternative minimum tax patch, tax relief for individuals was minimal and non-existent for businesses. The bulk of the bill provided funds for unemployment benefit extensions, healthcare, public aid, and block grants to states. Many states already face deficits for 2009, therefore the grants will, in large part, be used to pay debts and be unavailable for stimulative spending. President Obama announced plans to raise the top marginal income tax rate to the pre-2001 level of 39.6% in 2010.

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President Obama revealed a plan to provide up to \$275 billion to assist homeowners who are having difficulties paying their mortgages. The plan included direct payments of mortgages above certain payment/income ratios, interest rate buydowns, and other subsidies. The plan allocates an average of over \$30,000 to the nine million homeowners expected to receive the benefits. Mortgage servicers were offered little legal protection in the bill's provisions, which would modify contractual mortgage agreements by lowering principal, interest rates, and/or payment schedules, thus making voluntary participation fraught with legal dangers. Opposition to the plan drew loud criticism from taxpayers and homeowners who are current on their mortgage payments and unwilling to foot the bill amidst financial pressures already being faced with rising unemployment and impending state tax increases.

Government spending (federal, state, and local) in 2009 is likely to be at its highest percentage of GDP since 1945. It will represent the most rapid acceleration of government's share of GDP since 1952. History has shown that GDP expanded following the initial percentage increases, though after the enthusiasm for government spending growth waned, the economy contracted within a few years.

The 1930s, when viewed through the prism of government actions, have many similarities to current events. A troubled banking system, falling stock markets, a high penchant for government intervention, increased regulations, increased social spending, increased infrastructure spending, and a high level of deficit spending are striking in their similarities. Between 1930 and 1933, protectionist tariffs were enacted, the money supply tightly contracted, and a large number of banks failed. Government (federal, state, and local) spending grew only 1.5% annually, as budget rules limited spending growth amidst shrinking tax receipts. GDP fell each year, as the government took a hands-off approach and output fell by nearly 40%. During 1935 and 1936, government spending increased 15% each year, and GDP grew from 1934 to 1937. During 1937, the spending growth decelerated, as President Roosevelt feared stoking inflation. The resulting slowdown in spending growth caused the economy to contract nearly 4% in 1938. Only when war was imminent and government spending again accelerated did the economy return to full employment and strong growth, but it did not break the dependency upon government spending for economic growth.

Between 1930 and 1940, government (federal, state, and local) indebtedness rose 88%, and government's share of GDP rose from 13% to 20%. By 1945, government spending accounted for 52% of GDP, as war costs dominated the economy. As the spending waned, dropping to 36% of GDP in 1946 and 24% in 1947, the economy went into a sharp recession, contracting 11% in 1946 and 0.9% in 1947. As incentives for private industry were reignited and government built an interstate highway network, the economy had only three years of contraction between 1948 and 1974. The period between 1975 and 1982 was marked by two recessions, triggered by oil supply shocks, price controls, and the removal of the gold standard by Nixon. The resulting mismanagement by the Federal Reserve caused money supply to grow too quickly, allowing high inflation to cripple the economy. By 2008, government's share of GDP was 36%, and may likely rise to 43% in 2010-2011, given spending predictions and GDP trends. Our indebtedness will be about 95% of annual GDP, or over \$14 trillion.

The caution for the economy is that the more the government spends, the more private industry is crowded out of growth opportunities and access to capital. Economic growth becomes choppy, as new administrations usher in spending plans that either speed or slow spending growth. The economy has had its least volatile growth periods when the size of the government grows proportionally with the rest of the economy and incentives for businesses to grow and individuals to invest are kept active.

## GDP & Government Spending

