RKM INVESTMENT RESEARCH

Projecting the Shape of the Economic Recovery

2010 & Beyond

by

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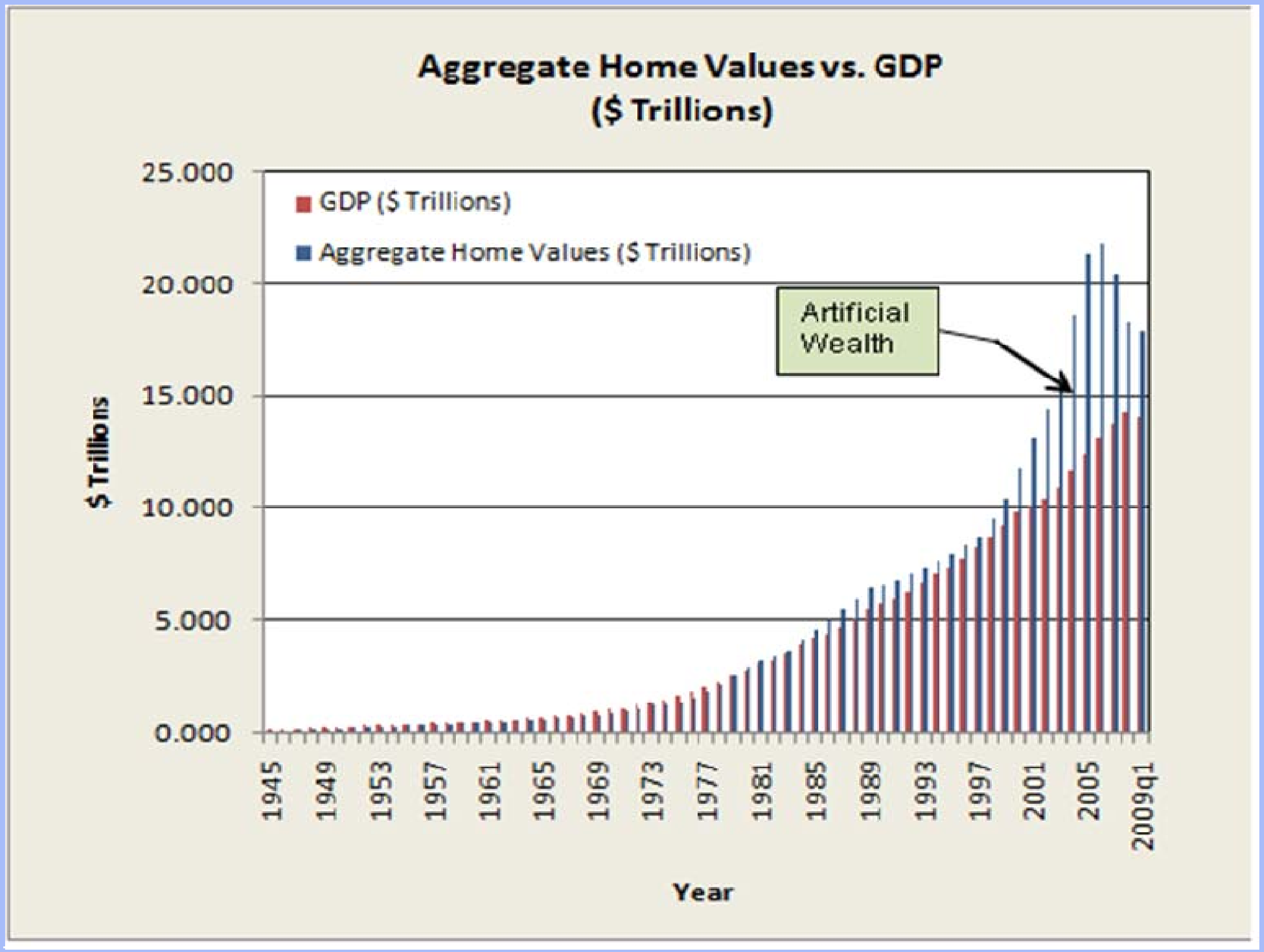
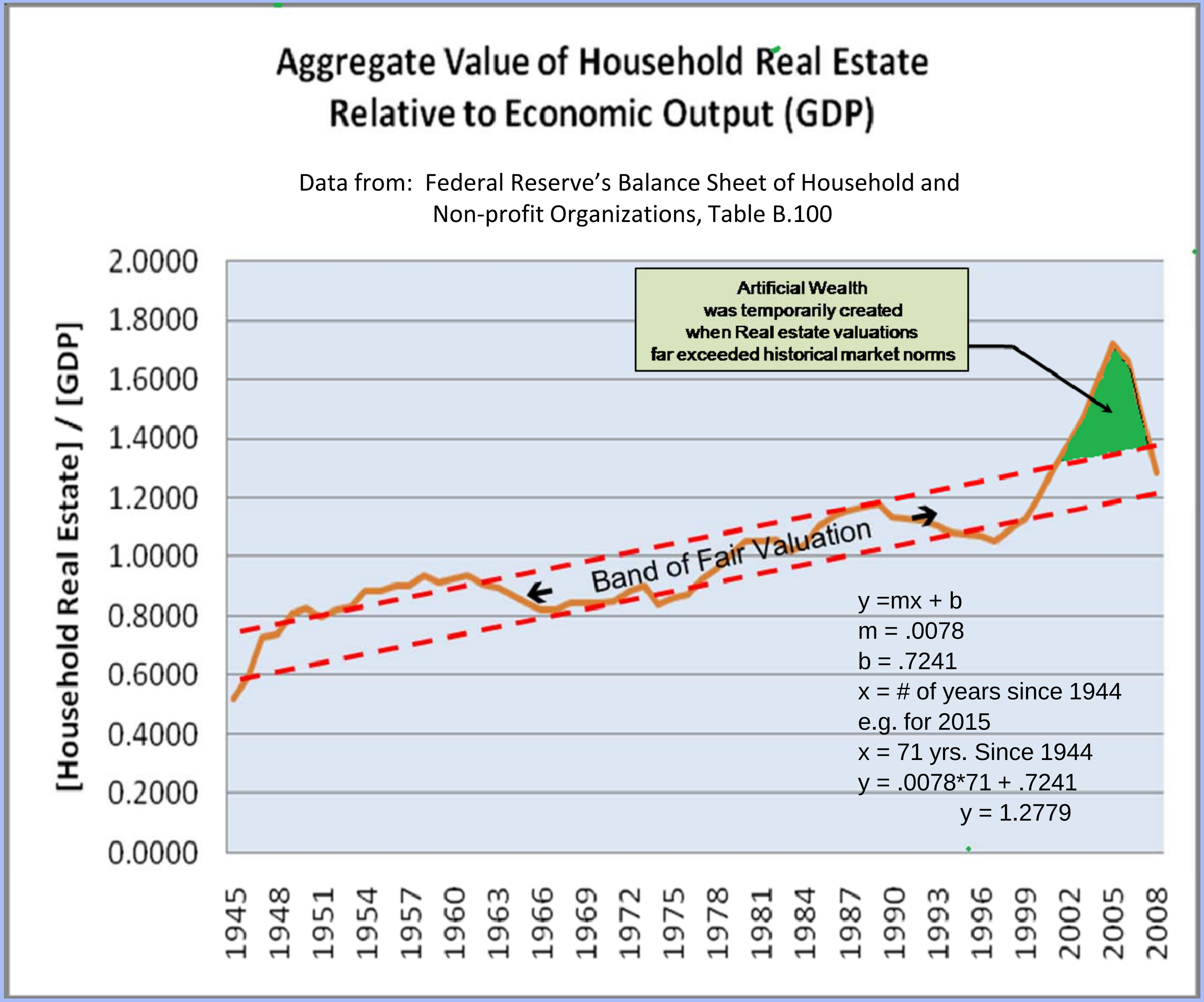
Objectives of Presentation

- Estimate the shape of the recovery curves for the U.S. economy:
  - GDP
  - Employment
- Work through the thought process supporting these projections

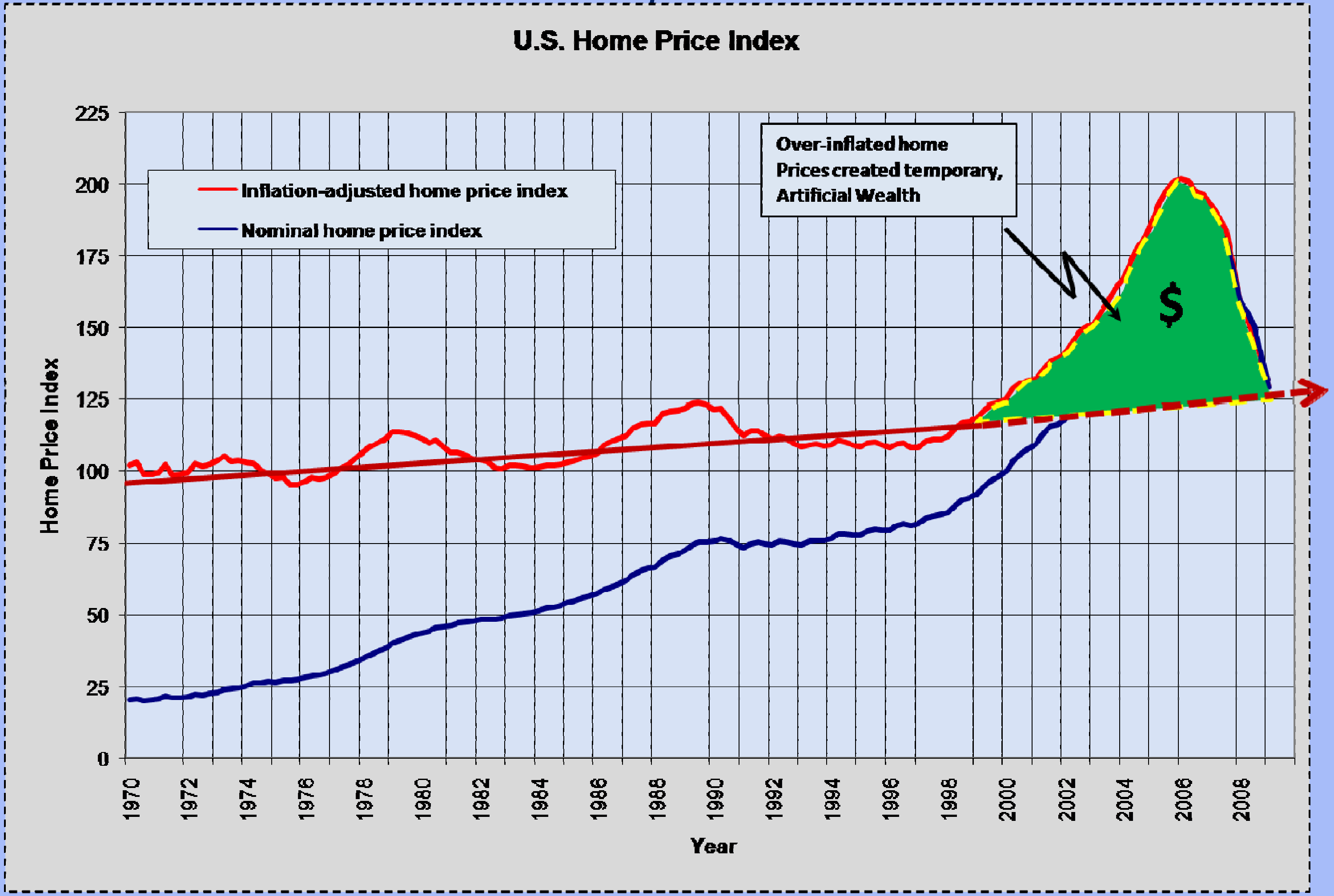
A Re-Cap of the Rise & Fall of Artificial Wealth



Introducing a new Metric: The Band of Fair Valuation



Over $4 Trillion of Nominal (non-inflation adjusted)Residential Real Estate Wealth Has Vanished; and $6 Trillion if inflation is considered between 2006 and Q3 2009



Projecting the Shape of the Economic Recovery Curves

- Entails accurately accounting for the re-building of the economy; filling the vacuum left after the implosion of the run-up in “Artificial Wealth”
- Other:
  - Deleveraging
  - Population Demographics
  - Capacity Utilizations

Foundational Elements Driving the Recovery

- **It is easy to loose sight of the big picture when we are regularly updated with over 100 macroeconomic variables:**

  ISM Manufacturing Index , Reuters/Univ. of Michigan Consumer Confidence Survey , % of Fannie Mae loans that are delinquent, Under-employment Rate, Exports of Goods and Services, Durable goods orders - vs. previous month , % Change in Factory Orders, # of months supply of unsold homes , Automotive Sales , Sales of Pre-existing Homes, Employment/Population Ratio - monthly change - % , Chicago Purchasing Managers Index , Consumers' Expectations for the economy for next 6 months , % of Businesses Planning to Increase Staffing , Construction Spending, % of Businesses Planning to Decrease Staffing , Orders for Computers & related products , HELOC Delinquencies, National Association of Realtors index of pending home sales, No. who lost jobs in the month, # of unsold homes - % Change, New Claims for Unemployment Benefits , # who continue to collect Unemployment Insurance , Savings (% of Disposable income) , Foreclosures, Orders for Big-Ticket Manufactured Goods , Present (Current) assessment/situation index , Change in # classified as not looking for work cumulative # of unemployed , …

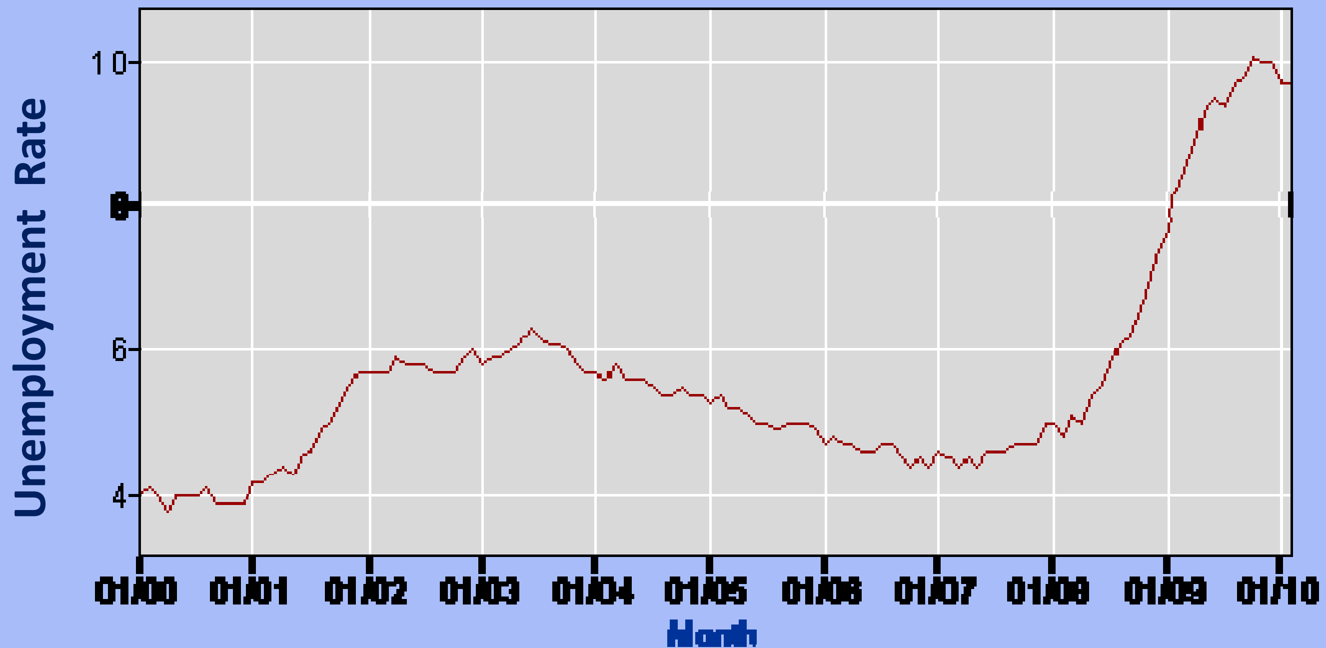
Foundational Elements Driving the Recovery

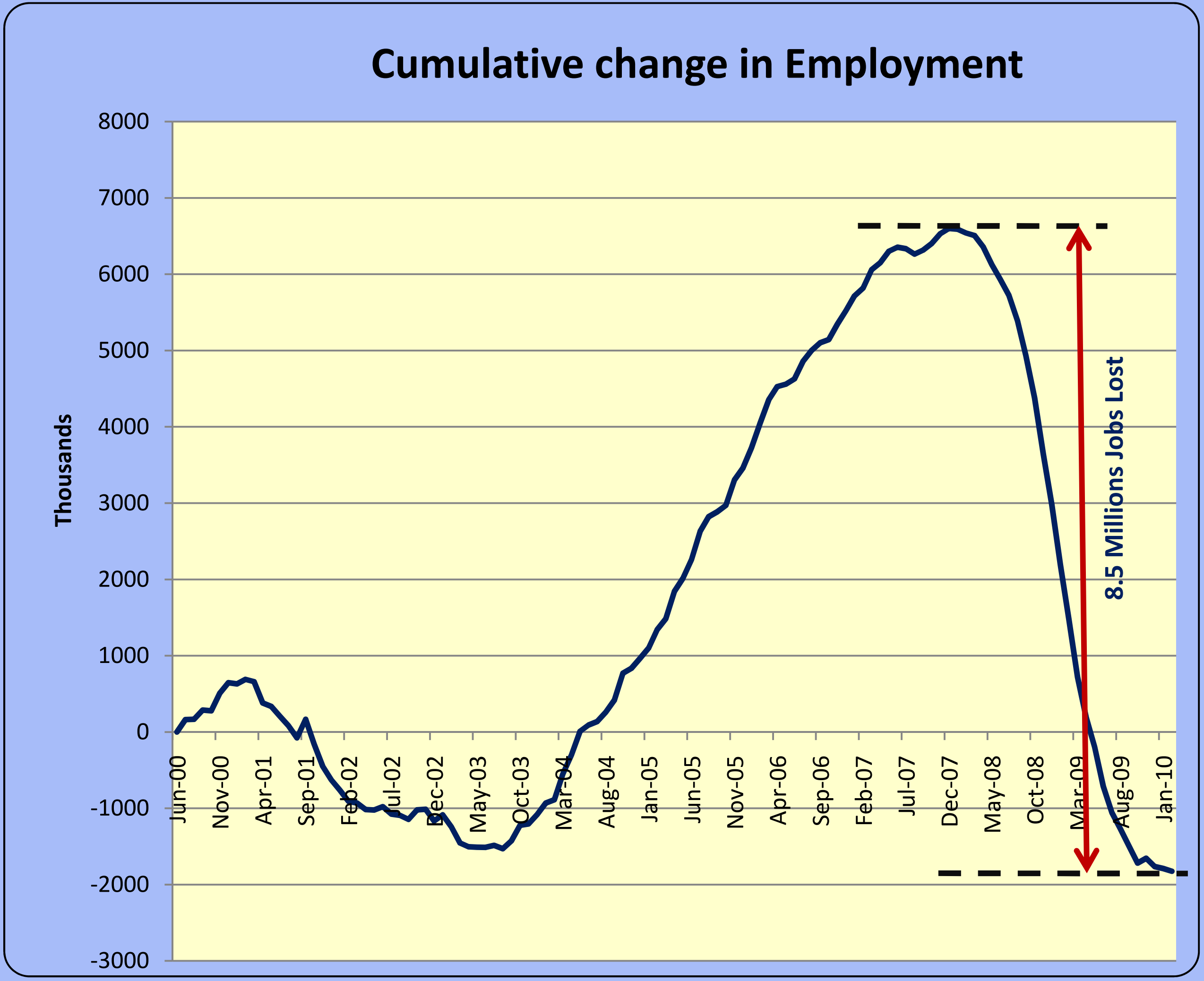
- **Let's focus on those parameters with the largest influence in driving the recovery**
- **The single largest component of our GDP, hence, the most important variable in driving the recovery will be:**
  - **Consumer Spending (C.S.)**
- **Primary factors drive consumer spending:**

$$C.S. = f\left(disposable\ income = f\left(\sum_{i=1}^{n} \left[\begin{array}{r} w_1 \bullet employment + w_2 \bullet interest\ rates + \\ w_3 \bullet portfolio\ wealth \circ \circ \circ + w_n \bullet x_n \end{array} \right] \right) \right)$$

To get better insights into the jobs recovery we need to understand what types of jobs were created and lost between 2000 and 2009

What can we deduce from the plot below?





- Aggregate residential Real Estate values peaked in ’06
- The fly-wheel momentum effect kept consumer spending going for another year
- However, by the end of ‘07 the jobs created as a by-product of the run-up in Artificial Wealth started to vanish
- As of today, 8.5M jobs have vanished since the start of the recession
- Many of these jobs are not coming back!
- These jobs must be replaced with different jobs associated with real wealth creation. This is a building process.
- It will happen & is happening; However, it will take years to lay the foundation for solid growth of the U.S. economy

Source: Labor Dept: http://data.bls.gov

Consumer Spending will Drive the Recovery, but …

- Confidence in the ability to save enough for a comfortable retirement is only 16%
- The percentage of workers with less than $10,000 in savings grew from 39% in 2009 to 43% in 2010
- Workers with less than $1,000 in savings jumped to 27% from 20% in 2009
- Consequently, many workers were caught flat-footed when the recession hit; they learned a hard lesson – that they didn't have sufficient funds to power them through the recession… They were also carrying too much debt to be able to rely on their credit cards or HELOCs
  - They must de-leverage and
  - They must save more money

1. Savings data from the Employee Benefit Research Institute's annual Retirement Confidence Survey
2. http://www.babyboomersretirement.info/index.html

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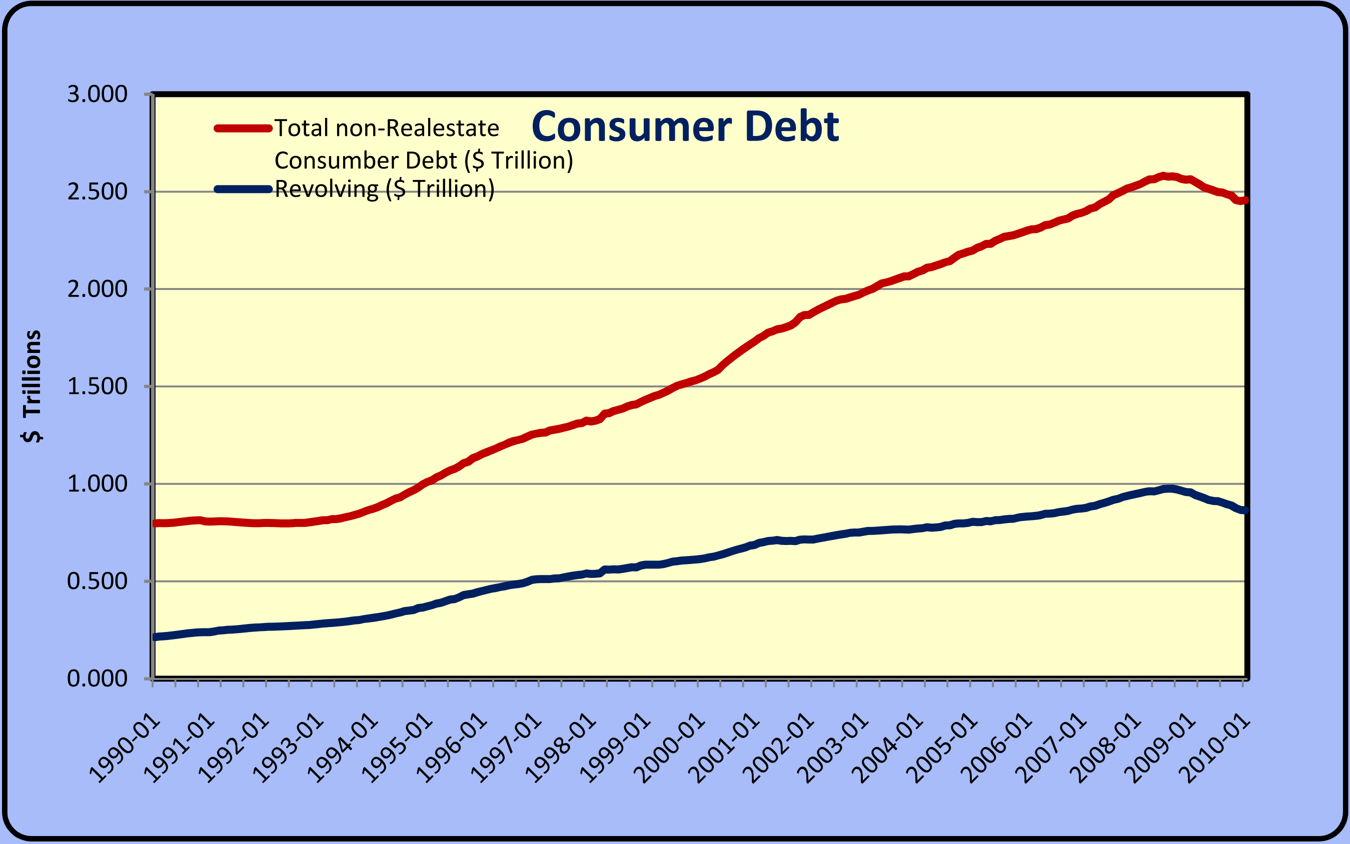


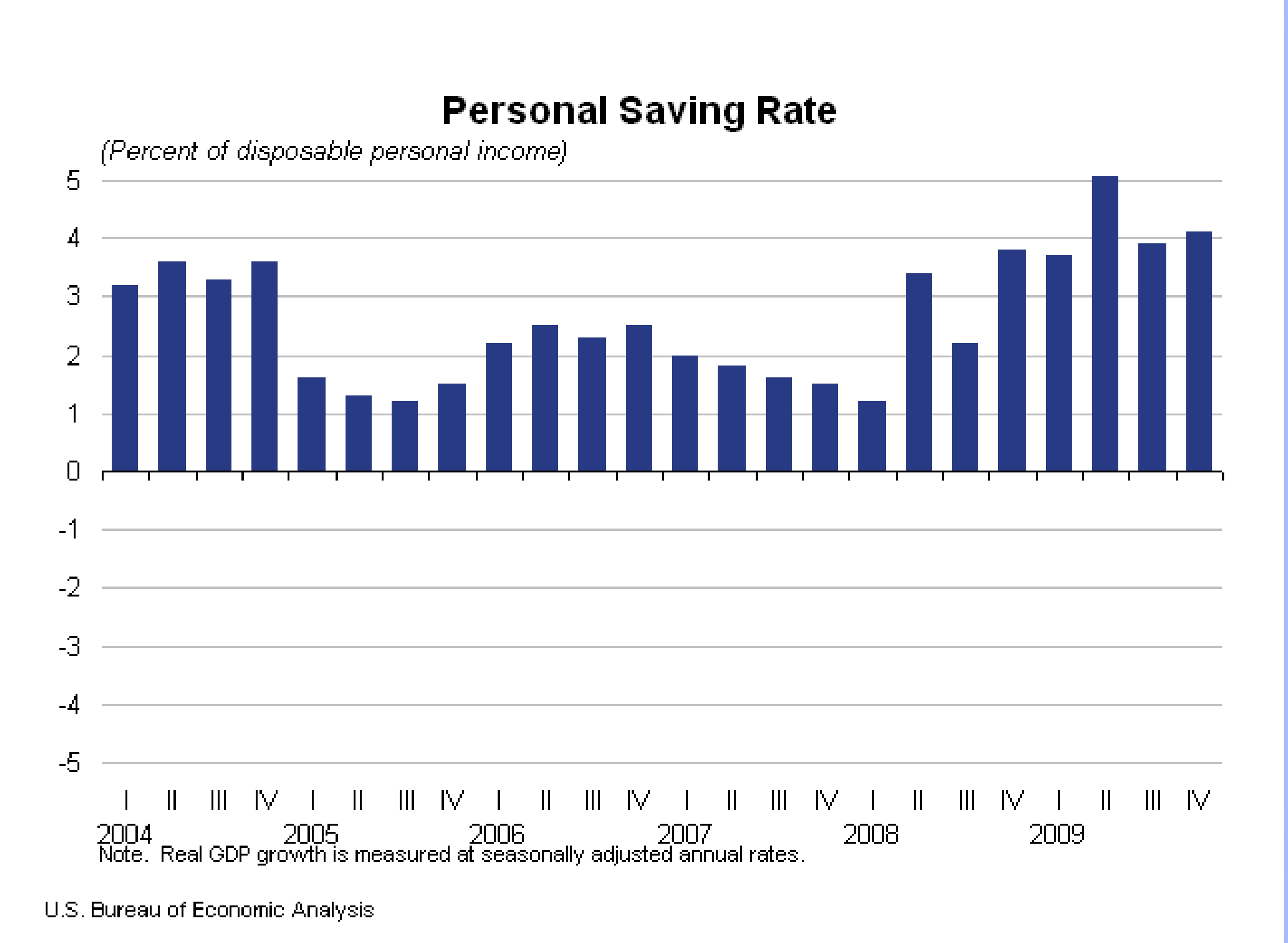
- Total Consumer Debt Peaked @ $2.58 Trillion in July-08
- Revolving (Credit Card) Debt peaked at the same time at $947 Billion
- Once Burned, Twice Shy: Consumers want to pay down their debt.
- This is now a higher priority than discretionary spending

The S & P 500 is up 70% since March 2009, but …

- The market has given investors back only about half of what they have lost
- The total value of U.S. stocks is still down by about $5.5 trillion from the market's 2007 peak
- Thus, Americans have lost $11.5 trillion of (artificial) wealth since the peak: {$5.5 Trillion lost Portfolio Wealth} + {$6 trillion lost real estate wealth}
- A wave of 76 million baby-boomers entering retirement,
  - 7,918 boomers turn 60 every day ➔ 330 per hour!
- I argue that we are destined to see an increase in savings, especially among the baby-boomers, given the vast amount of wealth was wiped out by the recession

Diminished Consumption

Consumers are Cutting Back on Their Spending & Increasing Their Savings …



What will happen when the Fed stops purchasing MBS from Fannie Mae and Freddie Mac?

- **There is about $14.6 trillion in total U.S. mortgage debt outstanding.**
- **There are about $8.9 trillion in total U.S. mortgage-related securities.**
- **The Fed purchased $1.25 trillion (14%) of these MBS.**
  - This drove "demand" ➔ propped up prices ➔ led to lower interest rates
- **Raising the Fed Funds rate will only make matters worse**

Re-cap of the Status of the U.S. Economy Today

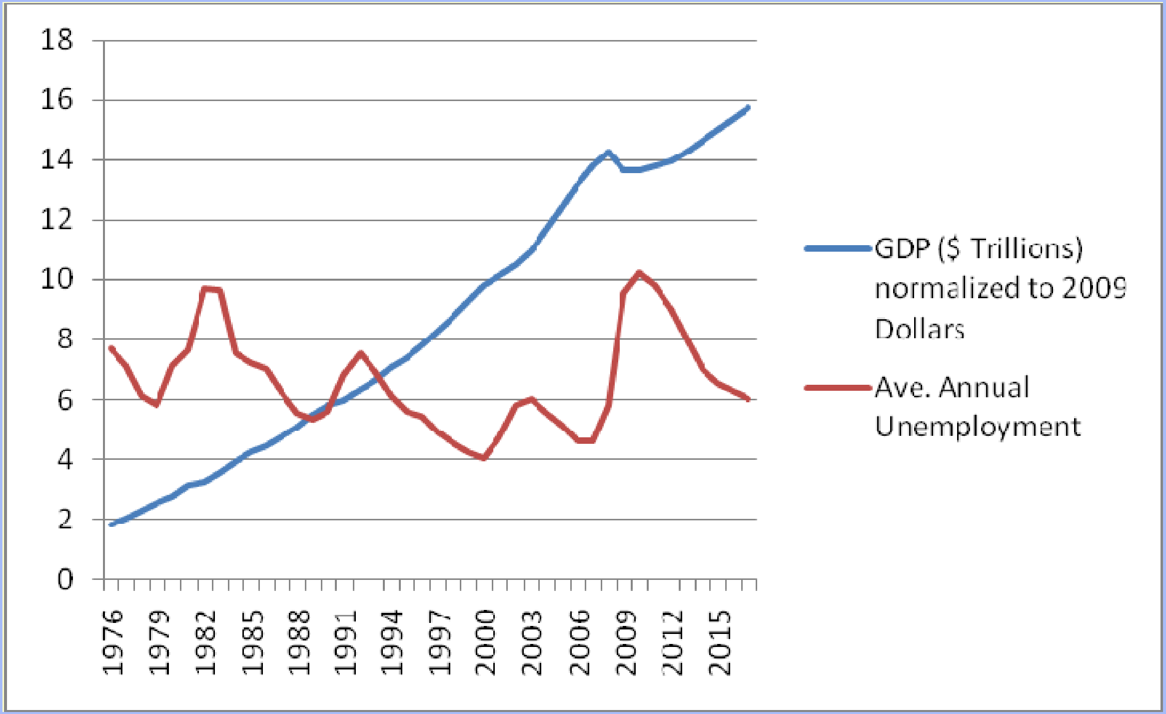
- There are at least 15 million Americans out of work
  - One in six Americans is either unemployed or underemployed.
- Over 6 million Americans have been unemployed for at least six months
  - 40% of the ranks of the jobless.
- More than 5 million homeowners are behind on their mortgages.
- In the 20 City Composite Case-Schiller Home Index, the median home price dropped by $60,000, or 32%, from $185K to $125K.
- Roughly 30% of manufacturing capacity is sitting idle.
- Nearly 19 million residential housing units, or about 15% of the stock, is vacant.
- Commercial real estate values are down 30% over the past year.
- The average American worker has seen his/her level of wealth plunge $100,000 over the last two years, even with the recovery in equity markets this past year.
- Bank credit is contracting at an unprecedented 15% annual rate so far this year as lenders sit on a record $1.3 trillion of cash.
- Unit labor costs are down an unprecedented 4.7% over the past year

Looking Forward

- Stimulus spending will rapidly go away this year
- Taxes are likely to go up in 2011 (possibly the largest tax increase ever)
- It will take years for new companies to be formed to absorb workers whose jobs are not coming back
- There is already over-capacity at existing companies, so, hiring will be slow and will grow only in accordance with serving the demand
- Americans are spending less and are saving more
- Americans are de-leveraging by buying less on credit (and less overall) and by paying off their debt
- All is not doom & gloom; we're seeing improvement in some sectors
- The economy has bottomed out and from this point in time on we'll be in a slow rebuilding and recovery phase

… So, now let's take a look at the projections

Conclusion: The Recovery Will Take Several Years



- It will take until 2016 for the unemployment rate to drop to 6.25%
- It will take until 2013 for our GDP to return to 2008 levels on an inflation-adjusted basis
- These projections remain identical to those I published last August in my paper with Michael D. Intriligator, Ph.D. *The Rise and Fall of Artificial Wealth*
- Bottom-line: The economy is starting to improve. However, it will be a long & painful recovery. There will be no "Great Rebound" nor any V-Shaped recovery

- Thank you