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The Economy at a Tipping Point
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The economy and print markets are deteriorating. The financial gridlock is spreading and creating economic sclerosis. The economy is at a tipping point and in serious risk of falling into a recession in the 4th quarter with a spillover into 2009. Where the economy and print markets go from here is very much dependent on the success (or failure) of the financial rescue legislation passed on 10/3 and other actions from the Treasury, Federal Reserve and FDIC. Politicians have been pointing the finger of blame for this crisis at each other. The real reasons for the financial meltdown are complex and nebulous but involve a mix of five developments over the past two decades or so:
1. The clever and complex securitization of mortgages and other exotic financial instruments created over the past 25 years may have outsmarted the market and regulators.
2. The 1994 Community Reinvestment Act requiring banks to increase mortgage lending to low income households.
3. The politcalization of Freddie Mac and Fannie Mae that loosened lending standards.
4. Monetary policy that was too generous for too long, especially in 2003-2004.
5. The "mark to market" accounting requirement to value balance sheet assets at current market values rather than at book values.

Each of these developments resulted in both benefits and costs but over the last few months they have coalesced into a witch's brew poisoning our financial system. A little slowing of the economy after seven years of growth was all that was needed to heat this brew to a boiling point.

The rescue plan is a necessary but not sufficient condition to tip the economy in a positive direction. The $700 billion commitment pledged in the Emergency Economic Stabilization Act is a major boost to the economy as it amounts to 5 percent of GDP and over 60 percent of the estimated $11 trillion in total checking, savings, other bank and money market accounts and bonds currently held by households. However, remember that this is not a direct boost to GDP since the commitments are to secure existing financial assets. Still, the impact of the legislation will keep the economy from sliding further than it would have with no rescue.

Assuming the legislation works and helps to avert systematic failure in financial markets the most likely outlook for the remainder of this year is still poor at best and the full year numbers remain generally consistent with our forecast from a year ago and our mid-year outlook of a couple of months ago.

The economy managed to grow by almost 2 percent over the first six months. Third quarter economic growth was probably less than 2 percent and the fourth quarter will be even less with the disruptions to the financial system already in place—possibly falling to near zero or even negative territory. Even so, the 2008 economy could expand by around 1-1.5 percent for the entire year. The outlook for 2009 is for more of the same--around 2 percent growth which is below trend.

On an even more pessimistic note much damage has already been done to the "real economy" and conditions may still deteriorate further before they get better. An alternative scenario is for the economy to still fall into negative territory in the 4th quarter to start a recession that will spill over into 2009.

However, it appears for now that it will slow even further but not go negative in the 4th quarter and start a slow and sluggish improvement next year.

The "bad but could be worse" scenario means that printing shipments will end the year close to even or slightly negative. The more pessimistic economic view scenario would push print markets down even father—perhaps 2 percent or more. We will provide additional analysis and details on both the economic and print market outlooks as this drama plays out.

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