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ECONOMIC UPDATE

2009

Stimulus, Stimulus Everywhere ...and a Slow Recovery.

by Gregory MacKay, Senior Vice President, Chief Economist

The most turbulent economic and market forces since the Great Depression have made unprecedented changes in the financial landscape this year. Was it just last October that the Dow Industrials were above 14,000, the S&P was above 1500 and the brokerage and banking interests were still separate industries? What a year. February saw a “massive” \$150 billion stimulus package pass with rebates of \$300-\$1200 going to most taxpayers. Now that looks small. Rumbblings began in March, with the creation of new first time ever lending-facilities to brokerage firms, and venerable Bear Stearns became the first house to fall, being rescued by giant J.P. Morgan Chase. As the sub-prime mortgage situation led into a growing credit squeeze, giants Fannie Mae and Freddie Mac went into conservatorship, Lehman Brothers failed, and Merrill Lynch merged with Bank of America. Banks weren't immune. Indy Mac failed, Wachovia will be bailed out by Wells Fargo, Washington Mutual became the biggest bank failure in history, and twenty three other banks have failed in 2008. (But for

comparison, the period of 1986-1995 saw 1,043 thrift institutions closed or resolved after poor lending practices and conditions in the 1980's.) “The bailout” stretched from 3 to 451 pages, totals over \$700 billion, changed direction (but not purpose) a couple of times, and is now being used to help the auto industry. Foreign sovereign banks ran for the cover and safety of the dollar, pushing its value to decade long highs and Treasury yields to 50 year lows. The Fed has dropped its lending rate to zero and promised to save all borrowers, using all tools possible. Insurance company AIG taught us all the meaning and cost of credit default swaps. Finally, President-Elect Obama and Congress have promised a two year, one trillion dollar pump to jump start the economy. Ponzi schemes are back in the news after many years of absence, with both financial and human tragedy. Quite a year.

In July, I was still hoping to miss a recession. The call this month was that it started in December 2007. A similar big miss on the fed funds rate, as the Fed really turned on the

jets trying to slow down the decline. G.D.P. growth third quarter 2007 to third quarter 2008 at +.7% was a hit as we targeted +.6% to +1.2%. Unemployment levels adjusted upward a little more quickly than we hoped, now at 6.7%, when we hoped for 6.0% or less. Inflation, rocketed about by some of the most volatile energy prices in history, is somewhat below our hopes, running from 1.1% to 2% depending on the survey.

So what's in store for 2009? First, let's get the primary message out. This is not and will not be the next Great Depression. Period. Let's talk about the primary doom and gloom out there, and try to put it in perspective. Yes, we entered a recession in December 2007, so this recession is now one year old, or slightly longer than the average of 10 months. And yes, it's not over yet. We could see this recession extend slightly longer than the 1981-1982 period of sixteen months. But the trough will probably be reached in the late second, early third quarter of 2009, and then the next expansion will begin. And normal expansions are 90+ months.

Now, let's talk about the various factors affecting our economy, and why succeeding generations won't be comparing this period to the 1930's. The consumer is being portrayed as bloodied and battered. The heart of the consumer problem remains housing. With housing prices still falling and paper gains on housing continuing to evaporate, it's a pretty bleak picture. But remember the self correcting feature here. Construction of new homes has slowed to levels of 6-8 years ago, and both supply and prices of new homes are at bargain levels. Same for existing homes, where supply hasn't grown from last year's levels, and price declines are slowing. Nationally, we've still got some weakness to work out. However, the Northeast is faring better, with mean and median prices within 1% of a year ago. We didn't overbuild. We're okay. The national numbers show that home equity withdrawal is slowing dramatically, and with it, consumer spending growth is approaching zero. The end of a ready supply of extra cash from home equity is actually helping the long term picture, as

the savings rate of consumers is increasing rapidly. The jobs picture seems bad to many, but the current and projected unemployment levels do not begin to match the double digit levels of the early 1980's. So we're pleased to see consumers reigning in their excess spending habits, but don't see a lot of economic strength from them until later in 2009.

With the consumer slowing, how is business going to cope? We'll see some more retail failures in 2009, but retail is an area that always takes the hit in a recession. Non-residential construction is already slowing and commercial vacancy rates are up. But, again, current and expected levels of these indicators don't begin to approach levels seen in past recessions. Business confidence indicators are also indicating rising stress levels. An interesting item here is corporate profits. Non-financial corporate profits were \$52.1 billion in the third quarter of 2008 versus \$-4.2 billion in the second quarter. Overall, U.S. corporate cash flow was up \$43.1 billion in the third quarter of 2008 versus a decline of \$60.5 billion in the second quarter. We're not calling for a miracle here, but we do suggest that there's still some room for most of corporate America to absorb some business shock. Only the financial corporations with

their massive write downs are showing big damage, and the government is shoveling cash their way. (More on that later.) So corporate investment and spending will also have a quiet first half of 2009.

The export/import picture will be more than a little political. Some of our lesser developed nation trading partners are already implementing tariffs and other programs to defend their internal economies. Tariffs wars never enrich anyone, and are a primary source of worldwide political distrust and destabilization. Not what we need in 2009. The international effort thus far to forestall a world wide crisis has been generally cordial. If energy costs stay reasonable, and currency exchange rates remain stable, we should muddle through 2009 as import costs should drop farther than export declines.

So where does that leave us? As President Ronald Reagan once said, "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'" But as with every recession, some federal intervention is needed. The possible damage to the economy due to structural stress put on

the financial system is different this time. The velocity and size of the housing and housing securities problems were totally underestimated by all well into 2008. To their credit, the Fed and U.S. Treasury have responded in size, and in several new and innovative ways to stem the capital evaporation that has taken place. By some estimates, most of the capital lost by the banking/investment/insurance sector has already been replaced. The Federal Reserve Bank has grown its balance sheet from \$900 billion in September 2008 to \$2.2 trillion today, and estimates of its forward size range up to \$5 trillion. That's a lot of air in the balloon, and we'll talk about inflation in a couple of minutes. With interbank interest rates approaching zero, quantitative easing – the addition of funding to the economic system by open market purchases of assets by the government – will take the main stage in 2009. So the monetary tools are in place. President-elect Obama, his economic team, and Congress have promised quick passage of a \$1 trillion package also aimed at stimulation. As we've said before "The fix is in." Both monetary and fiscal tools are ready, and here's what to expect: Mortgage rates

will continue to fall as banks cannot just sit on the new deposits and capital coming in. Good, safe, old-fashioned lending will return. Already refinances are reported to be happening at massive levels. The Fed's intent to buy toxic assets will take some of the pressure off the looming student loan, auto loan, credit card, small business loan crisis, and also allow banks to keep on lending. The success of the 2008 rebate checks – a quick, hefty pop in consumer spending – suggests the possibility of a repeat by Congress, along with the various infrastructure projects discussed. Some form of tax relief is also in the discussion stage, but a stimulus check is a quicker hit. With all of this monetary and fiscal stimulus happening, we'll turn this economy around before Labor Day.

The costs are staggering, and we'll be paying for some time to come, but there won't be a Great Depression, Round Two. Sure, all this cash is going to bring inflation back into play, but not for a year or two. There's just no wage pressure out there right now, and if oil stays reasonable (\$70 or below), the price inflation will continue to abate in 2009. And we don't see a weak dollar driving export demand through the roof. We're calling for an old fashioned "u" shaped recovery.

| For the record, for 2009: | |
|---------------------------|---------------|
| GDP | -1.5 to -2.0% |
| CPI | .8 to 1.1% |
| Unemployment | 7.5 to 7.8% |
| Federal Funds (12/09) | 1.00% |

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