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Overview

- How did we get into such a mess?
- Recent evidence is dreadful
- Look for a severe recession lasting into 2nd half of 2009
- What will change going forward?

What's With Financial Markets?

- Too much financial innovation and too little regulation
 - Asset bubbles are fueled by expansion of credit
 - Subprime mortgages and securitization
 - Now credit is shrinking, banks are deleveraging

What's With Financial Markets?

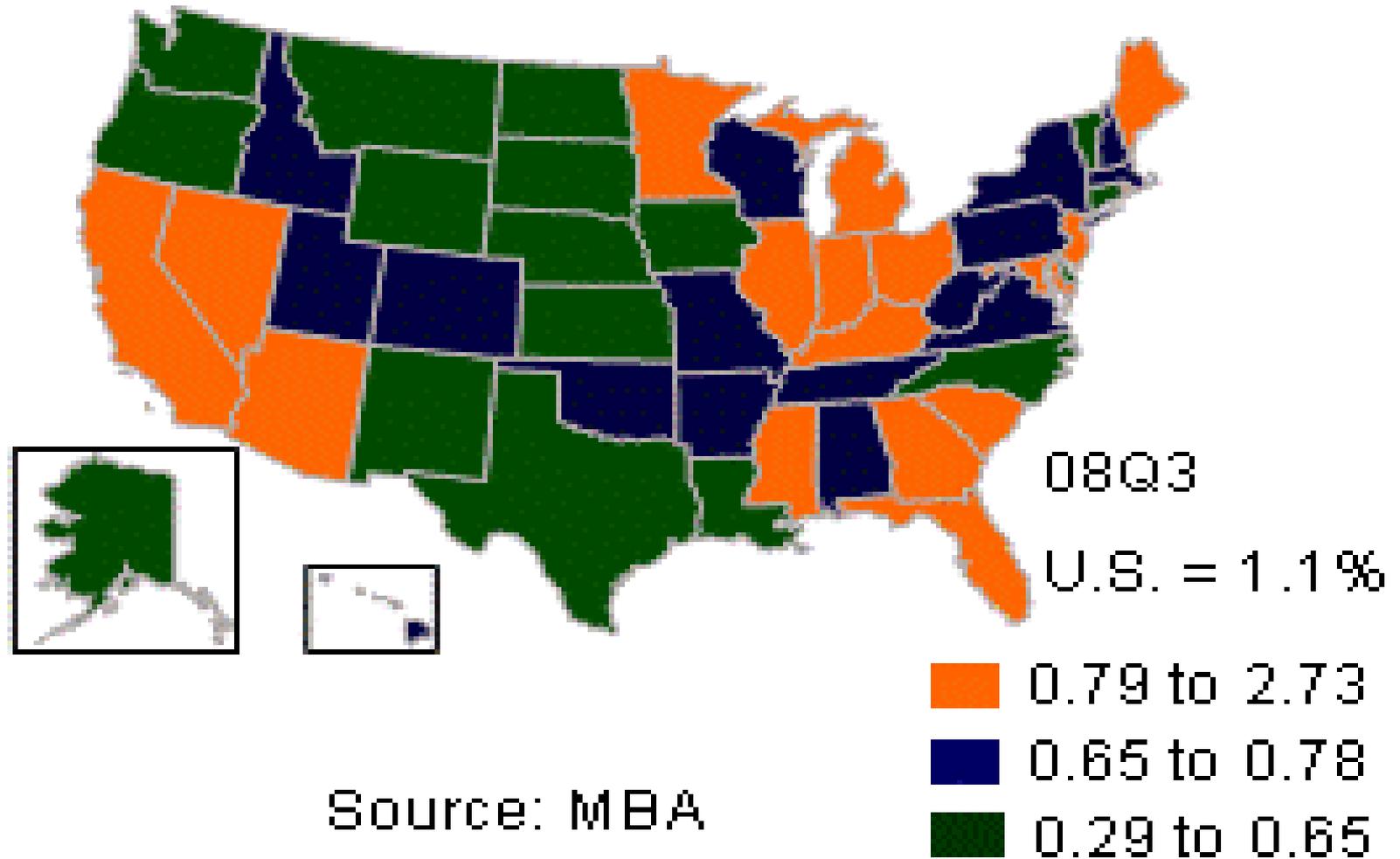
- Liquidity wasn't the problem, but it's the answer
 - Solvency of investment banks (primary dealers)
 - Lightly regulated, huge leverage (hedge funds)
 - Bernanke is following the handbook for financial crises
 - Flood the system with liquidity
 - Rescue the first, let the second fail

What's With Financial Markets?

- Panic has sent asset prices tumbling
 - Stock market down 40+%
 - Commodities – oil below \$50 from \$140
 - Housing prices falling (U.S.)
 - 9% (NAR), 7.9% (FHFA-OFHEO), 21.8% (S&P Case Shiller)
- The underlying problem is declining home prices

Coastal and Midwest Markets Hit Hard

% of all mortgages starting foreclosure process



What's With Financial Markets?

- Federal Reserve as lender of last resort
 - New lending facilities for
 - Primary dealers (includes investment banks), asset-backed commercial paper market, money market mutual funds, foreign central banks
- Fed gov't actions
 - nationalized mortgage markets
 - taken control of nation's largest lender
 - buying preferred stock in 100+ banks
 - Buying GSE securities and longer-term Treasuries

Effects on the Real Economy

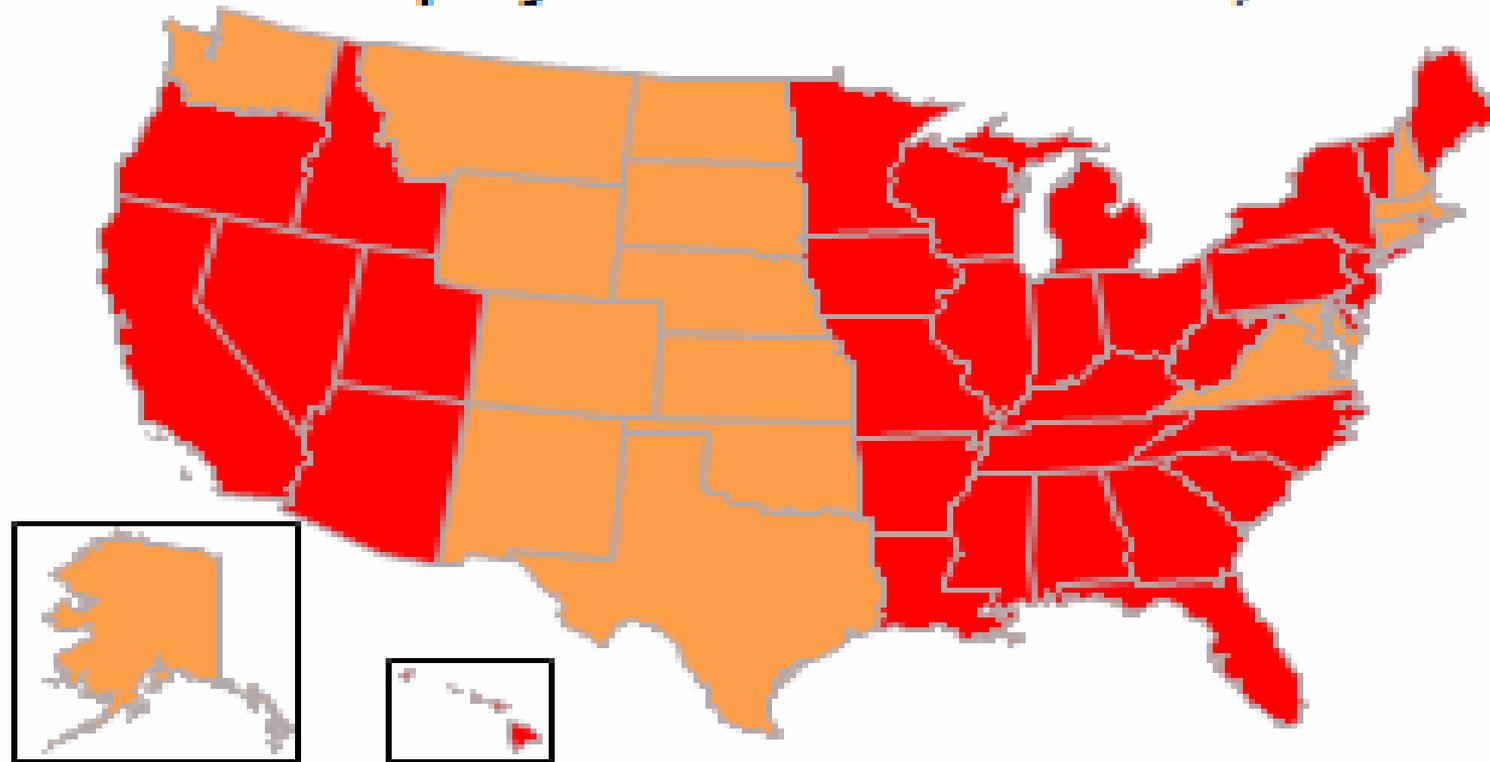
- Economy floats on sea of credit
- Since September-- in a free fall
- Consumers in full retreat
 - Confidence at lowest levels since early 1980s
 - HH net worth has fallen 13%
 - Consumption dropped 3.7% 3Q, largest 28 yrs
 - Auto sales lowest since 1983
- Unemployment rate is 6.7%, 14-yr high
- Homebuilding at lowest level since 1945

Effects on the Real Economy

- U.S. has been in recession since December 2007
 - Recession is already one year old
 - Losses were mild until August/September
- Expect a severe recession lasting at least through mid-2009
 - Similar to 1974-75 recession and early 1980s recessions

States in Recession

Based on Employment and IP Growth, Oct 2008



Expansion



At Risk



Recovery

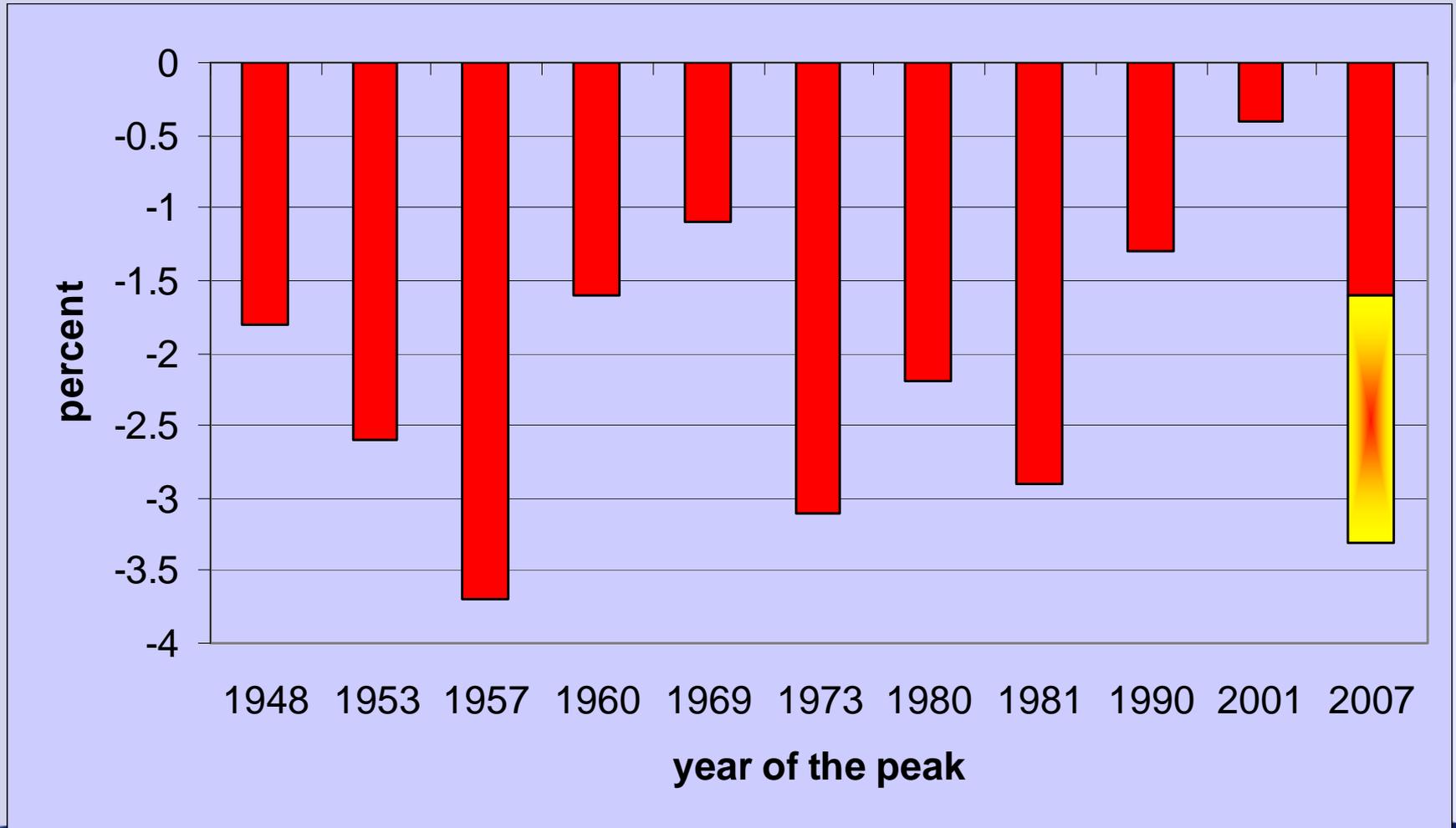


In Recession

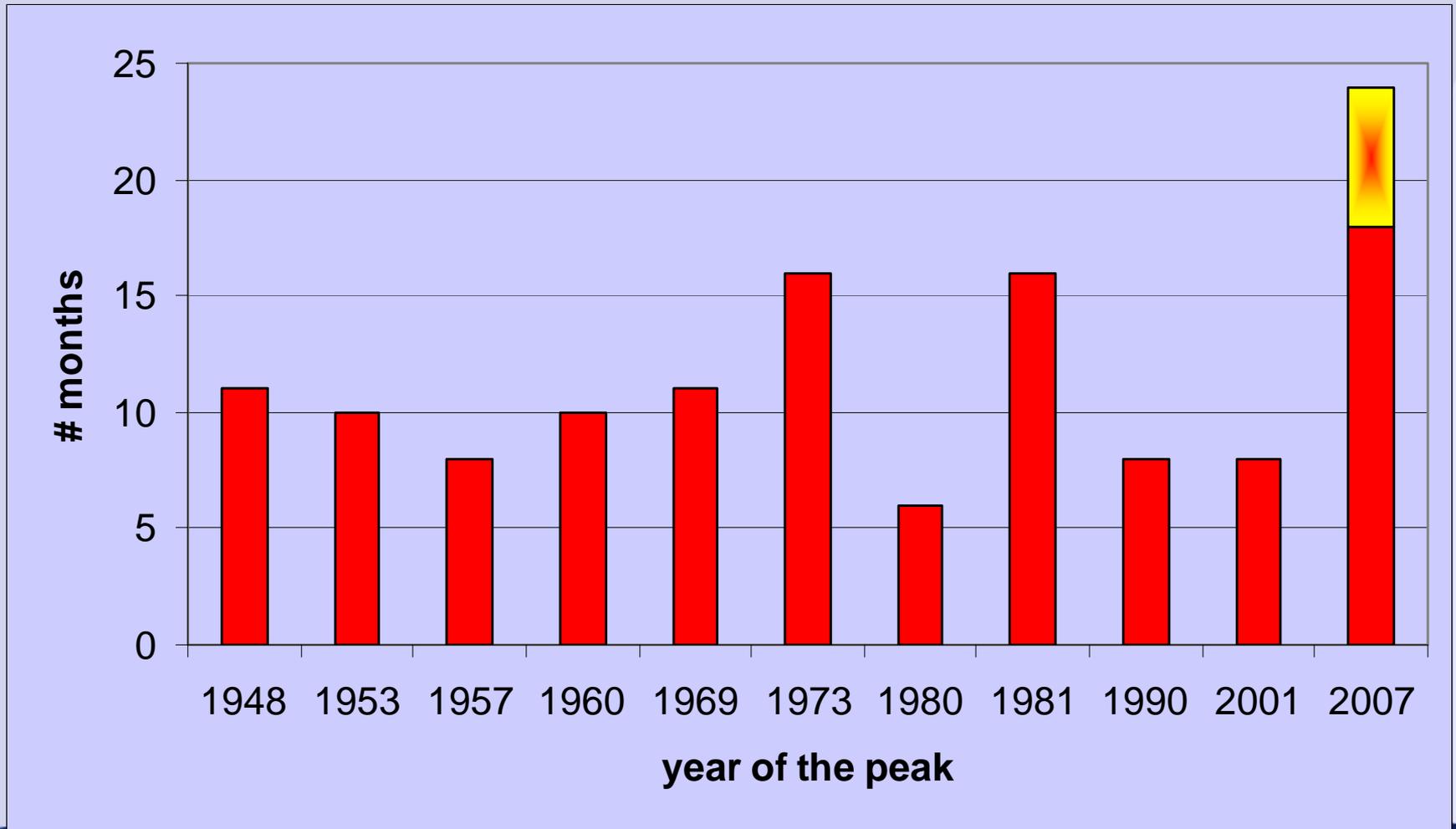
Why Not Depression?

- Four factors will limit severity
 - Falling oil prices add nearly \$300 bil
 - Swift and coordinated action by governments around the world
 - Huge amounts of liquidity infused into financial markets
 - Additional fiscal stimulus from Washington

GDP Declines in Post-WW II Recessions



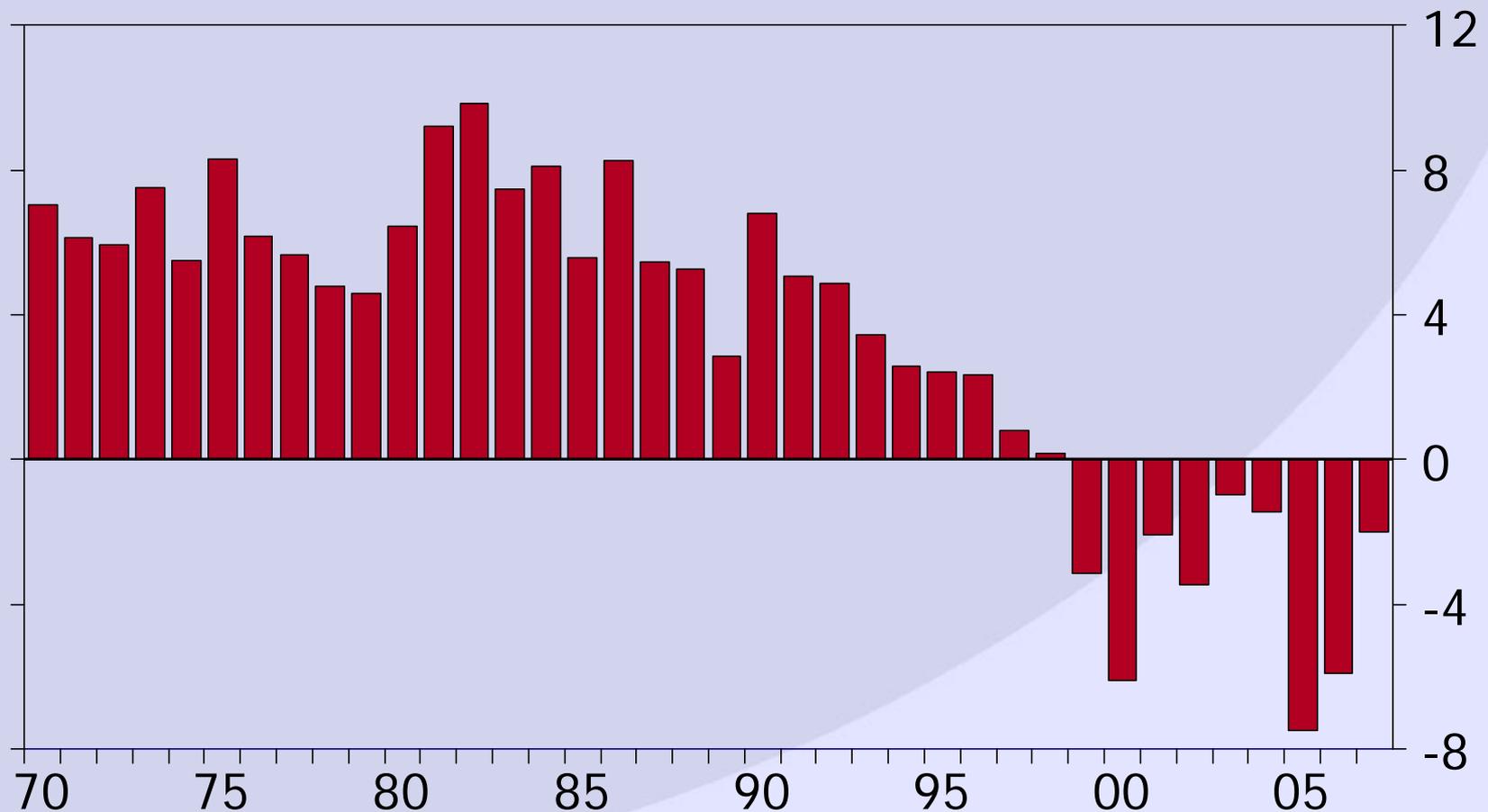
Duration of Post-WW II Recessions



Consumers Are In Full Retreat

- Money to support spending has disappeared
 - Tax cuts
 - Selling of huge amounts of corporate equities
 - Mortgage equity withdrawals
 - Heavy borrowing on credit cards
- Since 1999 households have been running a deficit

Households: Net Financial Investment as % of Personal Income



Are Current Events Transformational?

- More regulation for financial markets
- Moral hazard
- Household spending and savings
- Policies to promote home ownership

Are Current Events Transformational?

- Will foreign capital continue to buy US debt?
- How will federal government undo its position in markets?

Conclusions

- World economy is in recession that will extend well into 2009 or beyond
 - Foreclosures and bankruptcies will soar
 - Consumers spending will not lead us out of recession
 - Public sector will struggle to balance budgets
- Monetary and fiscal actions are working
- Solvency is key

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