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Forecast 2009: Deflation and Recession

A Special Report From John Mauldin

Where are we headed in 2009? John Mauldin examines some of the larger forces which will have a major impact on the economies of the world over the coming year. Deflation, deleveraging, the fallout from the stimulus plans, housing, consumer spending, unemployment, and a lot more...

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Where are we headed in 2009? We will explore that in detail over the next few issues of Thoughts from the Frontline, but today we will start with some of the larger forces which will have a major impact on the economies of the world, and I will end with my usual attempt to forecast the various markets. We will look at deflation, deleveraging, the fallout from the stimulus plans (note plural), housing, consumer spending, unemployment, and a lot more. There is a lot to cover. But first two quick announcements.

Along with my partners Altegris Investments I will be co-hosting our 6th annual Strategic Investment Conference in La Jolla, California, April 2-4. I have invited some of the top economic minds in the country to come and address us, giving us their views on what seem to be a continuing crisis. It will be a mix of economic theory and practical investment advice. Already committed to speak are Martin Barnes, Woody Brock, Dennis Gartman, Louis Gave, George Friedman (of Stratfor), and Paul McCulley. I anticipate adding another stellar name or two. This is as strong a lineup as we have ever had, and on par with any conference I know of anywhere.

Due to securities regulations, attendance is limited to qualified high-net-worth investors and/or institutional investors. Early registrants will get a discount. Last year we had to close registration, and I anticipate we will run out of room again, so I would not procrastinate. Simply click on the link below, give us your name and email, and you will be sent a form next week to register.

https://hedge-fund-conference.com/2009/interest.aspx?m=t

I should note that most attendees say this conference is the best investment conference they have ever been to. One of the benefits is being with several hundred very nice people in a relaxed setting. We do it up right.

Second, I and some of my fellow newsletter writers (Bill Bonner and Dennis Gartman, among others, are slated to be there) are going to be hosting a special tribute dinner to honor Richard Russell for his outstanding contribution of over 50 years to not only the craft of investment writing but also to the lives and investment portfolios of his readers. He is one of my personal heroes as well as a good friend. At 84, his writing today is better than ever, and now he writes every day, not just once a month! Richard is an institution in the investment writing world, and after talking with his wife Faye he has said he will let us plan the dinner.

Richard has some of the most loyal readers anywhere. I have personally talked to people who have been reading *Dow Theory Letters* almost since the beginning (1956), and their enthusiasm for all things Richard has not waned. We have a long list of people who want to attend.

Based on the response so far, we believe we can get a large roomful of Richard's friends, writing colleagues, and fans who have benefitted from his wisdom over the years, to honor him for a life well-lived and a true servant's spirit, as well as being a guide not just in the markets but in life. The dinner will be Saturday evening, April 4, 2009 in San Diego. In order to know how many people we should plan for, please send an email to russelltribute@2000wave.com indicating how many tickets you would like. If you have already responded, you will get an email with a link next week for you to register. If you have not and want to come, I suggest you do so quickly, as again we anticipate a packed room. The tickets will be $195, with any money left over going to Richard's favorite charity.

*(**Note:** If you register for my conference, you must register separately for the Russell Tribute Dinner, which will be held at a different venue, after the close of my conference on Saturday. Thanks!)*

And for new readers and those who get this letter forwarded to them, you can get a free subscription of your own just by going to www.InvestorsInsight.com. And now to our regular letter…

Muddle Through on Hold

First, a quick look back at how I did in my 2008 forecast issue. In general, it was not a bad year in terms of getting the direction right on many of the markets, including gold, oil, the dollar (especially against the pound sterling), and stocks. Some predictions were on target, like a second-half rebound in the dollar.

But I missed the economy. I noted then that I believed we were already in recession (which we have now found out that we were), and I wrote that a recovery would begin by the end of the year, but that it would be a very weak one for a long time – my basic Muddle Through scenario. Obviously, the recession is a lot worse than I thought it would be at the time. Looking to the end of this letter, I now think we will be in recession through at least 2009 before we begin a recovery, which will again be a rather anemic Muddle Through period of maybe two years, for a variety of reasons, some of which I cover today and others over the next few weeks.

And I should note that it was not long into the year before I began to get decidedly more gloomy, as many of you noted. And I expect that this year will bring a few surprises that will cause me to change my opinions yet again. When the facts change, I will try and change with them.

Forecast 2009: Deflation, Deleveraging, and the Stimulus Effect

For a very long time, I have been adamant that deflation is in our future. In the next few pages I outline how inflation might come back, but I doubt it will be this year. For now, deflation is the economic factor that the Fed and central banks will be battling. And believe me, it will be a very large and controversial battle.

We had a brief period last summer where inflation (as measured by the Consumer Price Index or CPI) was over 5%, and the trend was clearly up. The increase was almost entirely due to food and energy costs. Core inflation (less food and energy) was around 2%. Many commentators noted that real people actually bought gas and food and we should look at overall CPI and not just core. Now, with the drop in food and energy costs, their impact has vanished.

For the three months ending last November, the compound annual rate for the CPI was a negative(!) -10.2%, reflecting the almost 70% drop in energy. Annualized core CPI for the last three months ending November was a very low 0.4%. November CPI was a flat 0.0%. It has been falling steadily for the last five months.

December is likely to be negative. There is a trend here, and if you are a central banker it is not one you like. And that trend is being manifested in every part of the developed and much of the developing world. It is a global problem.

Given how high inflation was last summer, how could I credibly maintain that deflation was in our future? For reasons that I wrote about extensively then. Briefly, we were in a recession. Recessions are almost by definition deflationary. We had two massive bubbles bursting: the very visible housing bubble which was massively destroying wealth, and the less visible but even more powerful bursting of the credit bubble, which was accompanied by profound deleveraging and the destruction of what Paul McCulley termed the Shadow Banking System.

It would be a strange, strange world indeed if inflation could get any real traction in such an environment, and it didn't.

But now we have a structural problem in that deflation has the potential to get some very real traction going forward. Why? Because not just in the US, but all over the world, we built too much of almost everything. Too many houses, too many manufacturing plants, too many retail stores – and just too much stuff.

In the US, capacity utilization is falling rapidly. Typically, if we produce "stuff" (cars, food, lumber, etc.) in the range of 80% of potential capacity, that is considered to be a good economy. Capacity utilization has been dropping for some time and is down below 75% for all industries, but in many industries is close to 70%. And the clear trend when looking at ISM manufacturing statistics is that it has a lot further to fall.

That means industries have no pricing power, as they can make a lot more "stuff" than they can sell. And when demand due to the recession drops as well, prices fall as producers try to stay in business.

> *"It is estimated that over 70,000 retail stores will go out of business in the next six months."*

As a very visible example, global output capacity for automobiles is 92 million cars, but sales will probably be around 60 million. Output in the US will be around 12 million, but right now sales are only about ten million. The average American household has 2.2 cars. Evidently, consumers are reducing the number of cars they own, buying used cars, and making their current vehicles last an average of 6 months longer – all in just the last year.

Many auto plants, both in the US and abroad, are simply going to have to be closed. "Super-efficient Toyota expects its first operating loss in 70 years in the fiscal year ending March 31. Weak sales in China will probably force many of her 80 automakers to merge. Russian sales dropped 15% in November and 25% in Brazil from a year earlier." (Gary Shilling)

Just as there are too many auto dealers and too much auto manufacturing capacity, there are too many stores for a country whose consumers are in retreat. Consumer spending could easily drop 7% as the saving rate heads back up to 5% (or even more). It is estimated that over 70,000 retail stores will go out of business in the next six months. That would be in line with the 140,000 that closed doors last year. The economy and its businesses have to adjust to a new level of spending that will be the first serious consumer recession in 26 years.

Looking at Federal Reserve data, both total household debt and mortgage debt outstanding dropped in the third quarter, for the largest drop in 40 years. As I wrote almost two years ago, the disappearance of Mortgage Equity Withdrawals is having a negative impact of about 3% on US GDP. Evidence shows that this is also happening in Great Britain and other parts of Europe where there was a housing bubble.

Lies, Damned Lies, and Government Unemployment Numbers

There are some who see a ray of hope in the recent jobless claims reports, which have dropped back to "only" 467,000 in initial unemployment claims, down from 491,000 for the last week, after being over 500,000 for several weeks. Those numbers are seasonally adjusted. That hope disappears if you look at the actual numbers. For the current reporting week ending January 3, 2009, the advance number of initial claims came in at 726,420. Last week's advance number was 717,000. We have been above 600,000 new initial claims every week since the third week of November. Continuing claims jumped massively, by 744,000 to 5,316,124.

> *"It is possible that almost 1 million jobs were lost in December. I doubt the market would have liked that number."*

No conspiracy here. This is what happens when you try to smooth a volatile trend by using seasonal adjustments. If you use past performance as the tool by which you smooth the trend, when the trend changes, the seasonally adjusted numbers will be either too large or too small. Thus, the data understated the growth of jobs in 2003 because recent past performance had been bad, and it is now understating the number of unemployment claims and actual unemployment.

In December, the number of unemployed persons increased by a seasonally adjusted 632,000 to 11.1 million and the unemployment rate rose to 7.2%. Since the start of the recession in December 2007, the number of unemployed persons has grown by 3.6 million, and the unemployment rate has risen by 2.3% and is now at 7.2%.

I happened to be watching CNBC at the time of the release of the data, and several commentators remarked how much better the number was than they thought it would be. I wish they were right, but again, the actual numbers showed a loss of 954,000 jobs, over 50% more than the headline number reported in the press release. And that assumes that new businesses created 72,000 jobs from the birth/death model that I so frequently write about. It is possible that almost 1 million jobs were lost in December. I doubt the market would have liked that number.

I should note that the Bureau of Labor Statistics does not hide that number. You can find it if you dig for it. But most analysts seem to prefer just to take the press release and go with it. And most of the time that is fine. But in times like this, when trends are changing, you miss the bigger picture and get misleading data.

Unemployment could rise to 9-10% or more this year and on into 2010. That means we could easily see another 3 million lost jobs over the next year. That is going to put a lot of negative pressure on consumer spending. It also means that wages are not likely to rise, and we have already hard evidence of wages falling in many industries as companies try to find ways to remain solvent.

And that 9% will be the headline number. If you add people who have part-time jobs but would like a full-time job, and what are called marginally attached workers, the current rate is already 13.5%.

Average hours worked dropped to the lowest level since they began collecting data in 1964, as did hourly income. Given the increasing difficulty for consumers to borrow money and with income dropping, plus increased savings on the part of consumers, it is difficult to see how pricing power is going to come back any time soon.

This problem is multiplied throughout the developed world. The developing world, which sells products and goods to the US and European consumers, is starting to feel the pinch. Chinese and other Asian exports are dropping (more on that in future letters, but the data is ugly).

Overcapacity, rising unemployment, imploding leverage, lack of borrowing and/or lending, a serious retreat by consumers, and increased savings are all the conditions needed to bring about deflation. Left unchecked, we could soon see something like what Japan has experienced, and even potentially worse, as they started with a savings rate of 13%.

But deflation is not going to be left unchecked. It will be fought by central banks everywhere with low rates and the printing press, as well as government spending. And so, let's turn our attention to that process.

Central Bankers of the World, Unite!

There are many people who believe that the Fed and the Treasury increasing the money supply will bring about uncomfortably high inflation. And it is indeed their intention to "reflate" the economy. They are well aware of the problems that would develop if the US (and Europe!) caught "Japanese disease" or a prolonged bout of deflation. Bernanke has made it clear that "it" (as he called deflation in his 2002 speech) would not be allowe to happen on his watch.

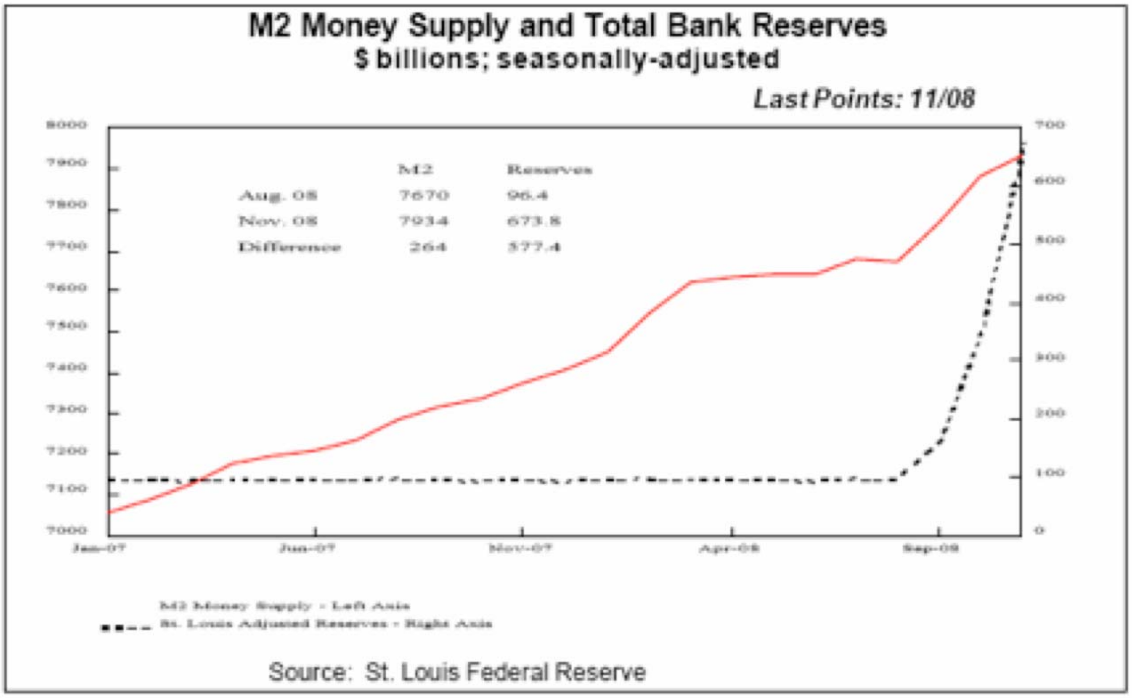
And we have already seen a rather large growth in the monetary base. But as I wrote a few weeks ago, the velocity factor of money is slowing rapidly, creating the ability – or dare I say it? – the actual need to expand the money supply (you can read that at the InvestorsInsight website) . But is it having an effect?

Good friend Gary Shilling raises some doubts (**emphasis mine**):

> *"Central banks around the world continue to cut their target rates, although in today's frozen credit market, that won't ever get the horse up on his feet, let alone to the water and drinking. The distrust of banks for even loans to other banks is shown by the still wide spread between LIBOR and the Treasury bills they covet.*
>
> ***"The M2 money supply is 60 times bank reserves, so normally when the Fed gives the bank another dollar in reserves, M2 rises by $60. But between August and November of last year, the $577 billion rise in reserves resulted in a mere $264 billion growth in M2, less than one half!"***

See the chart below (the red, smooth line is M2, the dotted line is the adjusted reserves).

CHART 49



The Fed is aggressively expanding its balance sheet. They have made clear that they intend to purchase mortgage securities, consumer loans, and credit card securities. Corporate loans are on the table, as well as other forms of debt. (Finland is getting ready to purchase corporate debt. The list of countries that do so will rise very quickly.) This will be direct infusion of money into the system. As Bernanke said in 2002, he knows where the keys are to the room that has the printing press. And they are going to use it.

Obama and his advisors have signaled they intend to run a deficit of at least a trillion dollars. Right now, as I add it up, it is more like $1.3 trillion (the stimulus number keeps moving), and given that tax receipts are going to drop and unemployment benefits will rise (care to bet that unemployment benefits won't be extended to 52 weeks instead of the current 26?), it could be closer to $1.7-2 trillion. That would be almost 15% of GDP!

Let's get this straight. The only difference between the Treasury and the Fed under an Obama administration and the Bush administration is that Obama will be even more willing to spend (although Bush certainly showed little restraint). Incoming Treasury Secretary Tim Geithner has worked at Treasury and is now president of the New York Fed. There will be little difference between his policies (and those of Larry Summers, Obama's economic advisor) and those of Bernanke and Paulson. And like Paulson, he is going to have to make up the playbook as he goes.

The Fed and the new administration are "all in," as they say in Texas hold 'em poker, in the fight to defeat deflation and get the economy growing. And eventually England and

Europe will get it and join the fight (both the European Central Bank [especially!] and the Bank of England are behind the curve).

But there is a problem.

Lowering rates isn't enough to get consumers to spend when they have seen their wealth erode from losses in the value of their houses and investment portfolios and retirement accounts. The stimulus last summer was largely saved or used to pay down debt. What was an annualized stimulus of 3% of GDP in the second quarter, which is quite large, only kept GDP growth positive for one quarter.

> *"This recession is going to be the longest in anyone's memory."*

Obama talks about creating 3 million jobs. If he can do it, that would only partially offset the job losses that will happen in his first year in office. But it will take a long time for much of the stimulus he is talking about to make its way into the economy. You can't turn on infrastructure projects in one quarter. It takes a lot of time to plan. New green power plants? Wonderful. I'm all for it. But they take years to authorize and build. Tax cuts? Again, much of it will be saved or used for debt.

The reality is that the US and much of the world are going to see their economies shrink for at least another year. And when that new, lower level is reached, the economy will slowly start to grow again. Remember those 71,000 retail stores closing? That means that those left standing will get more business and will be able to expand and grow and hire people. That is how recessions work. Excess capacity is worked through. Businesses cut back until they can get positive cash flow.

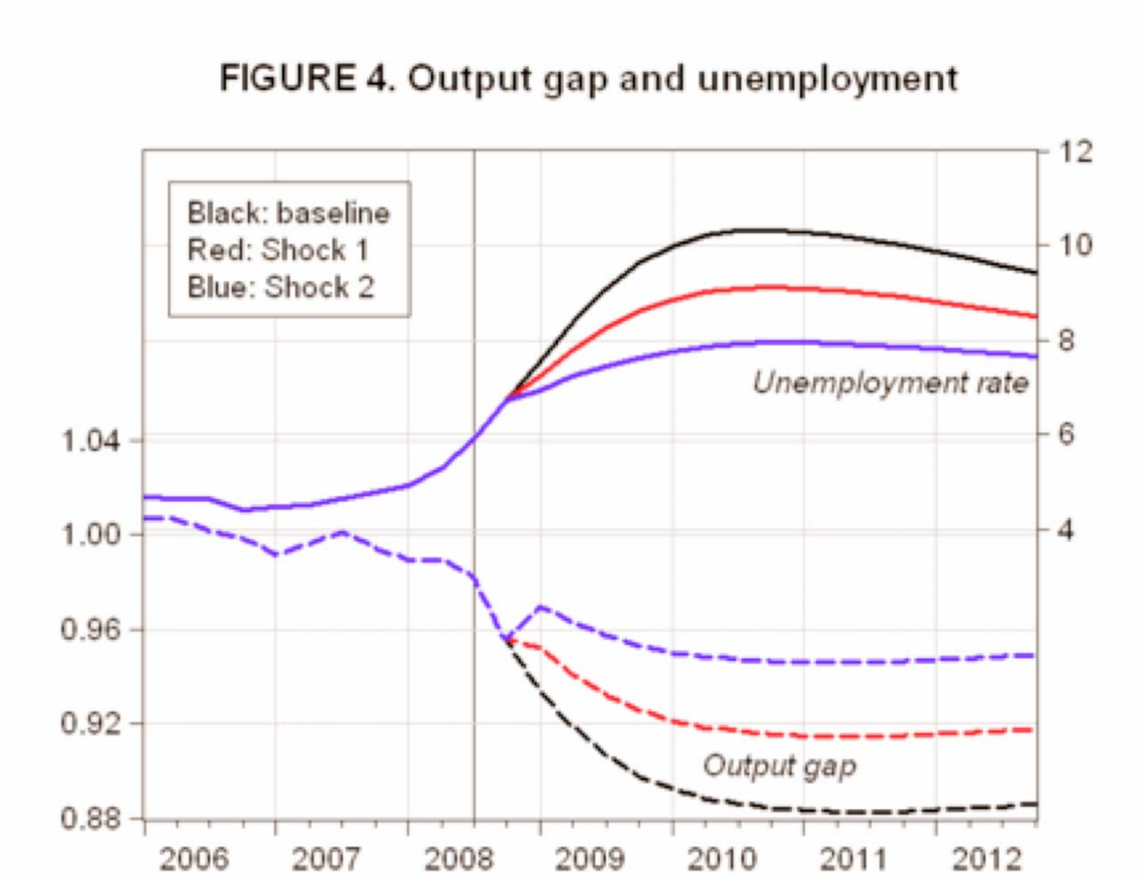
In 1978, in the midst of high inflation, bear markets, and malaise about all our jobs going overseas, the correct answer to the question "Where will all the needed new jobs come from?" was "I don't know, but they will." That is the correct answer today. That is what free markets and capitalism do. They find a way to make new paths and new businesses where none existed before. And it will happen again. Just with a little lag this time.

In the meantime, there is a lot of pain. An Obama administration is going to do what it can to help relieve that pain, even at the cost of trillion-dollar deficits for several years.

This you can take to the bank: If the Fed buys $500 billion in assets of various kinds and if the US government spends an extra trillion dollars and deflation is still a concern, they are going to double down and do it again. And yet again if they think it is necessary. They are not going to stop until the nominal economy is growing and inflation is above at least 1%.

How much will that number finally be? No one really knows. This has never been attempted. Maybe the initial stimulus package and Fed debt purchases will be enough. My bet is that it won't be, but that is just a guess. We are in uncharted waters. But the captains of the boats are all Keynesians. They are going to fight a recession and deflation with old-fashioned stimulus. And that means we had better adjust our portfolios and businesses for that reality.

Just to give you a picture of what economists think about the effect of the stimulus, let's turn to the Levy Economics Institute of Bard College, which is one of my favorite sources for original economic insight (http://www.levy.org/). They are a rather conservative lot. The graph below shows what two different levels of government stimulus will mean to the economy. They graph unemployment at no stimulus (top black line) and at two levels of "shock" or stimulus. Shock 1 is about $380 billion and shock 2 is about $760 billion. The dotted lines are what is known as "output gap," or the measure of the difference between the actual output (actual GDP) of an economy and what it could produce at its most efficient (potential GDP).



"The implication of these projections is that, even with the application of almost unbelievably large fiscal stimuli, output will not increase enough to prevent unemployment from continuing to rise through the next two years.

"It seems to us unlikely that U.S. budget deficits on the order of 8–10 percent through the next two years could be tolerated for purely political reasons, given the strong and widespread belief that the budget should normally be balanced. But looking at the matter more rationally, we are bound to accept that nothing like the configuration of balances and other variables displayed in Figures 3 and 4 could possibly be sustained over any long period of time. The budget deficits imply that the public debt relative to GDP would rise permanently to about 80 percent, while GDP would remain below trend, with unemployment above 6 percent.

"Fiscal policy alone cannot, therefore, resolve the current crisis. A large enough stimulus will help counter the drop in private expenditure, reducing unemployment, but it will bring back a large and growing external imbalance, which will keep world growth on an unsustainable path.

"… At the moment, the recovery plans under consideration by the United States and many other countries seem to be concentrated on the possibility of using expansionary fiscal and monetary policies.

"But, however well coordinated, this approach will not be sufficient.

"What must come to pass, perhaps obviously, is a worldwide recovery of output, **combined with sustainable balances in international trade**."

Let me wrap up with a quick note about housing. The economy is going to have a rough time getting back to trend growth with the housing market in the tank. New home sales fell 2.9% in November, while the median price declined 11.5%. Unsold inventories stood at a rate of 11.5-month supply. Housing starts fell nearly 19% in November, while the number of building permits was down 15.6%. Sales of existing homes in November fell more than 8%. The S&P/Case-Shiller 20-city housing index showed an 18% drop in prices in October from a year earlier, while the 10-city index declined 19.1%. Prices in the 20-city index have fallen more than 23% since their July 2006 peak, while the 10-city index is down 25% since its top in June 2006.

It will be 2011 before we work through the excess supply of homes, especially as we are seeing more and more come onto the market because of foreclosures. Prices are likely to drop another 10%. There will be more wealth destruction and more pressure on consumers. 10% of all mortgages are either delinquent or in foreclosure.

Predictions 2009

Let's close with some predictions. Ten out of ten analysts in the recent *Barron's* forecast saw stock prices rising 10-20% this year. For reasons I outlined last week, I think we could see a tradable rally in the next few months, but at the very least test the lows this summer, if not set new lows. Earnings are going to be far worse than any analyst's projections I have seen. And earnings drive stock prices.

Further, this recession is going to be the longest in anyone's memory. It is going to seem like it is never going to end (it will, I promise), and more and more investors are just going to give up on stocks. The buy and hold for the long run mantra is wearing thin. In inflation-adjusted terms, the stock market is about where it was in 1973! If you reinvested dividends, that gets you to 1991 (again, inflation-adjusted). It takes a lot of buying to make a bull market. It only takes an absence of buying to make a bear market.

Could we get a rally after the summer or fall lows? Sure. And it could be a good one. A lot depends on how fast the stimulus kicks in and whether it really has an effect. Will the Fed really buy large-cap corporate debt? I hope we can see something like a 1974 bottom in stocks develop.

I think the correlation between the US stock market, other developed markets, and emerging markets is close to one. I prefer to stand aside until the US economy has a clear direction and we can see whether the stimulus actually works. And then we can look at the world economy. I won't embarrass them by naming names, but those who argued for "decoupling" between the US and the rest of the world are not looking good. Someday, but not this decade.

I would be a buyer of quality bonds, both corporate and municipal. The key is to have a bond analyst who knows what they are doing and not just looking at ratings. There are some real values in the bond market today.

I would not be a buyer of US government debt. Treasuries, if not in a mini-bubble, have little upside potential and just don't yield enough. Why would I hold a ten-year treasury for 2.39%? I like TIPS at these prices. TIPS are pricing in deflation for ten years and, as I outlined above, I don't think the Fed will allow deflation to take hold.

With all the massive printing of money, you would think I expect the dollar to crash. I don't. The question is, what will it fall against? The euro? Really? The pound is better valued, but England and Europe are going to have to cut rates and apply massive stimulus as well. Every developed country will have problems. I can see holding Canadian, Australian, and other commodity-country currencies, but the leverage needed to make it a reasonable investment potential is too risky for individuals.

I can't see the Japanese letting the yen get too much stronger. China seems to want to halt the rise of the yuan, and the rest of Asia will devalue their currencies to maintain whatever they think of as a competitive advantage. Longer term, I like Asian currencies.

After a year of bouncing around, gold may be poised to rise against all major currencies. We could easily see new highs in the next year.

I think oil is going lower (and maybe much lower – can you say $1-a-gallon gas?) in the near term. As I have written about before, oil is now in the steepest contango on record. That means oil is cheap today and more expensive in a few months. That is not normal. Oil is bidding for storage. You can make 20-25% on your money in a few months if you can buy oil and find somewhere to store it. At least 25 supertankers have been leased to store oil, and sources say another ten are being bid for. It remains to be seen if OPEC can really cut enough to make a difference in the near term.

As for the other metals, I think it is quite likely copper and its industrial allies will fall in price at least for the near term, until production can be cut and demand in Asia begin to rise again. I would not be a buyer of long-only commodity funds for the near term. Someday the bull market in commodities will return, but not until Asian demand picks up.

The risks to my forecasts are quite clear. The stimulus could happen quicker and be more effective than I think, and the economy and the markets could surprise to the upside. On the other hand, and more scarily, the Fed could be pushing on a string in a liquidity trap and the economy and markets could get hit harder, along with most assets.

Briefly, if you would like to look at a range of money managers I think have the potential to navigate the current market successfully, let me suggest you contact some of my partners around the world. If you are an accredited investor (net worth $1.5 million) and would like to look at a group of hedge funds and especially commodity funds in the US, go to www.accreditedinvestor.ws and fill out the form, and my partners at Altegris Investments will get in touch with you. If you are in Europe, use the same link and I will get you in touch with Absolute Return Partners in London. In South Africa, my partner is Plexus Asset Management. We will soon be announcing new partners in Canada and in Latin America.

If your net worth is less than $1.5 million, my US partners at CMG have a platform of managers and traders that take direct-managed accounts with minimums of $100,000. These are liquid and fully transparent accounts with managers with long-term track records. You really should check it out. The link is http://www.cmgfunds.net/public/mauldin_questionnaire.asp.

And if you are an advisor or broker and would like to see the managers on the Altegris or CMG platforms and how you can access them for your clients, sign up and note on the form you are in the business. It might actually be fun to make a client call with a recommendation for a fund or manager that was up in 2008.

La Jolla, Bermuda, and Europe

Tiffani and I head out to La Jolla Monday to meet with Jon Sundt and his partners at Altegris Investments. There have been a lot of positive developments of late, including new managers, and of course we will be talking about the upcoming conference. And I will get to have a quick happy hour with Richard Russell and his son. The Tribute dinner is going to be so much fun.

On Wednesday, I am hosting a dinner at my new home for a small group of family office heads, hedge fund managers, and local businessmen. We are calling it an "Idea Dinner" and will throw out thoughts on how to invest in the coming year. I will report anything interesting.

I will be in Bermuda January 28-31 for a speech and some time away from the office to write on the book Tiffani and I are doing on millionaires. It is a fun project. And I have to have it finished by the end of February so I can get to London and Europe and New York in March.

I am always optimistic at the beginning of the year. Even though I see a serious recession, I am working, like every businessman in the world, on making my business grow in spite of problems in the economy. Free markets with motivated entrepreneurs will be what really create a growing economy.

It is time to hit the send button. There is a fire in the family room, and it is time to relax. Enjoy your week. I know I will.

Your more optimistic than this report implies analyst,

John Mauldin

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