How We Got to a Perfect Storm

As a research analyst at Keller Williams, I attended an economic presentation made by Tim McGee, the director of Macro Strategy and Research for U.S. Trust, Bank of America Private Wealth Management. I have written up my key takeaways below.

Tim said that while there are patterns to every business cycle, there are **three longer-term trends** that have come together to create a "perfect storm" to make this recession worse than what we have experienced in the past:

1. **A lack of evolution of the regulatory system for the financial industry**
    - The regulatory system of the financial industry was designed to prevent bank runs and bank panics.
    - In 1913, the Federal Reserve was created as a "lender of last resort" after the bank panic of 1907.
    - In 1932-1933, there was a systemic breakdown of the banking system (failure of the Federal Reserve) and as a result – the FDIC was created. Since that point, there hasn't been a systemic run on the banks because there has been confidence in the system.
    - Therefore, we have had a regulation system designed for the "old world" banking architecture, but the financial system has developed so fast over the past 70 years that there were areas of finance (such as mutual funds, credit default swaps) that were not protected. Because we failed to update our financial regulations, we fell too far behind, and the system basically imploded.

2. **Households were using more debt**
    - Households were progressively more leveraged over the last 50 years – expansions and growth have been fueled by a use of credit that was bigger than what was justified.
    - Now, with the current state of the economy, several changes to the pattern of recent debt use will likely happen:
        - The savings rate will begin to go up.
        - The next global expansion will not depend on the US trade deficit going up or on US consumers using more debt.
        - China is in the process of shifting its growth policies away from export-led growth (supported by the past years of spending and debt use of Americans) to internal consumption – and therefore, their trade surplus will begin to go down.

3. **Declining inflation and declining interest rates**
    - Typically, the Central Bank's policies have been to keep inflation down.
    - The Federal Reserve is now scrambling to keep deflation out of control.

Other interesting points made at Tim McGee's economic presentation:

- McGee believes that we're in the worst part of the recession now – and we can have confidence that we are on the road to recovery because:
    - Aggressive monetary policy is starting to work.
    - Fiscal policy will kick in.
    - Businesses have begun to go overboard with gloominess (over liquidation) over the past few months – and this tends to be an eventual basis for recovery.
- This will be a year of global rebalancing:
    - We should export more relative to our imports; our trade deficit will decrease.
    - We will see major fiscal stimulus from the federal government with the new administration to fill the void left by the private sector (for instance, infrastructure, mortgage help, middle class tax cuts, money for state and local governments to deal with issues like Medicaid because they now have less money from taxes to deal with it)
    - Important to remember that "overdoing " the fiscal stimulus policies is safer for the economy than "under doing it"
- We are way ahead of Europe in taking care of the current financial mess. Europe has a problem getting fiscal policy together because they need political collaboration to do so, which is difficult when each country has different interests. Therefore, the US is likely to be the first to get over the crisis.
- House sales have fallen to a level that seem to be stabilizing
    - In the second half of 2009, the housing market is expected to improve. These improvements can be attributed to: mortgage relief for those people who need it, tax cuts for the middle class and lower mortgage rates
- Investment implications
    - The stock market tends to reach the bottom a few months before recovery. The stock market should get out of the bear market in the spring/summer 2009