

THE ECONOMIC SITUATION

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2008 Forecast Issue

- ❑ Reviewing the forecast.
- ❑ The R word, bananas and comquats.
- ❑ Gold and Oil, one more time.
- ❑ Mr. Kohler's horse trough and you.

It is time for the 2008 forecast.

In my December **Situation Report**, I offered some thoughts and a preliminary 2008 forecast for key economic variables. I also promised to provide some hard numbers in January. While still awaiting the Commerce Department's final 2007 GDP estimate, we must get on with the hunt. I provide here my estimate for 2008 end-of-year values for key economic variables. Perhaps, more than a word of explanation is in order.

FORECAST TIME

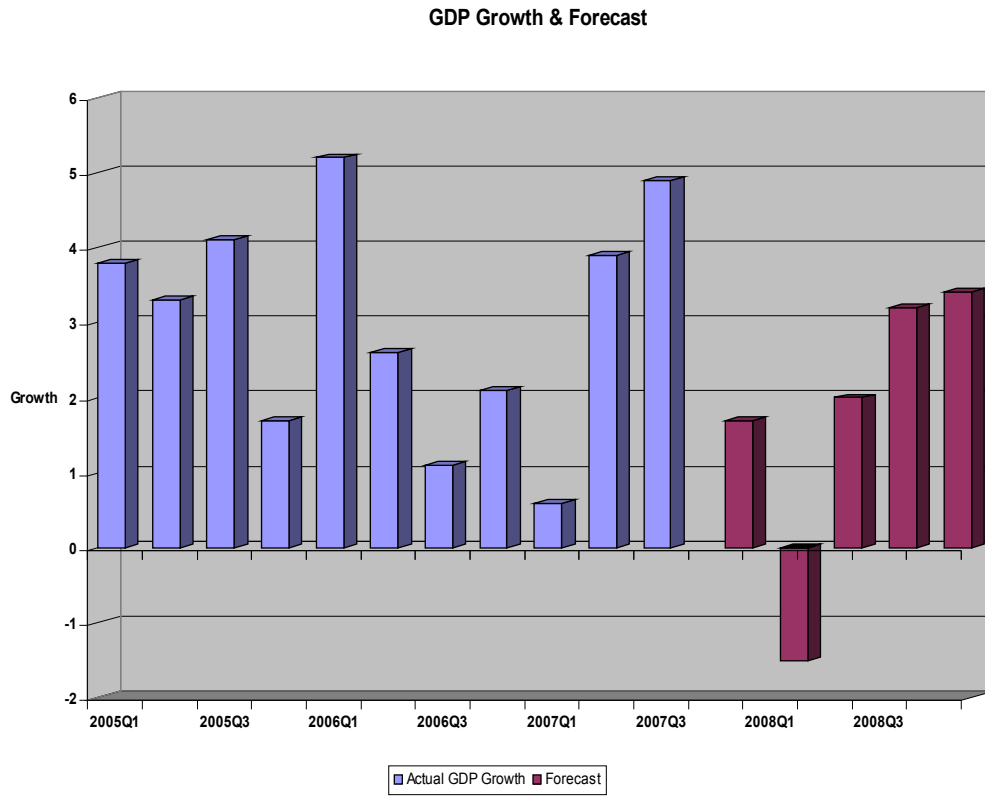
Actual 12/31/07 Forecast 12/31/08

• Real GDP Growth	2.6%*	2.2%
• CPI Inflation	4.2%	3.0%
• 30-yr. Mortgage	5.84%	6.10%
• Unemploy Rate	5.0%	5.0%
• Prime	7.25%	6.00%
• Dow	13,264	14,200
• Employ Growth	120M	110M
• Oil	\$93	\$80
• Gold	\$838	\$700

*Estimate.

GDP growth

To get the year started, I expect 1Q2008 GDP growth will be negative 1.5%. This is as close as we will come to recession..., I hope. Quarterly GDP growth should then turn positive and proceed at a positive pace throughout the year, with the year's last quarter showing a somewhat normal 3.2%. My expectations are driven by two major forces. The weak housing sector is expected to reduce GDP growth by more than one percent. Expanding exports are expected to provide some offset. With housing and weak consumer spending clawing their way from the cellar and with continued export growth, I expect the economy finally to achieve balanced growth by year end. The GDP profile I expect is shown here.



The R word is not in the story..., at least for now

In describing the outlook, I did not use the R word. There is no recession in my forecast, although that is surely not the case for a growing herd of economic forecasters. To be labeled recession by the National Bureau of Economic Research, which is the official score keeper, the economy must experience negative growth for two consecutive quarters, this along with some other less specific ingredients. I show one quarter of negative growth.

Funny thing about the R word. There was a time during the Carter Administration when fear of recession was more than the president could stand. Apparently, he believed a recession could be avoided if none of his officials used the word in testimony or discussion with the press. In a word, they were muzzled.

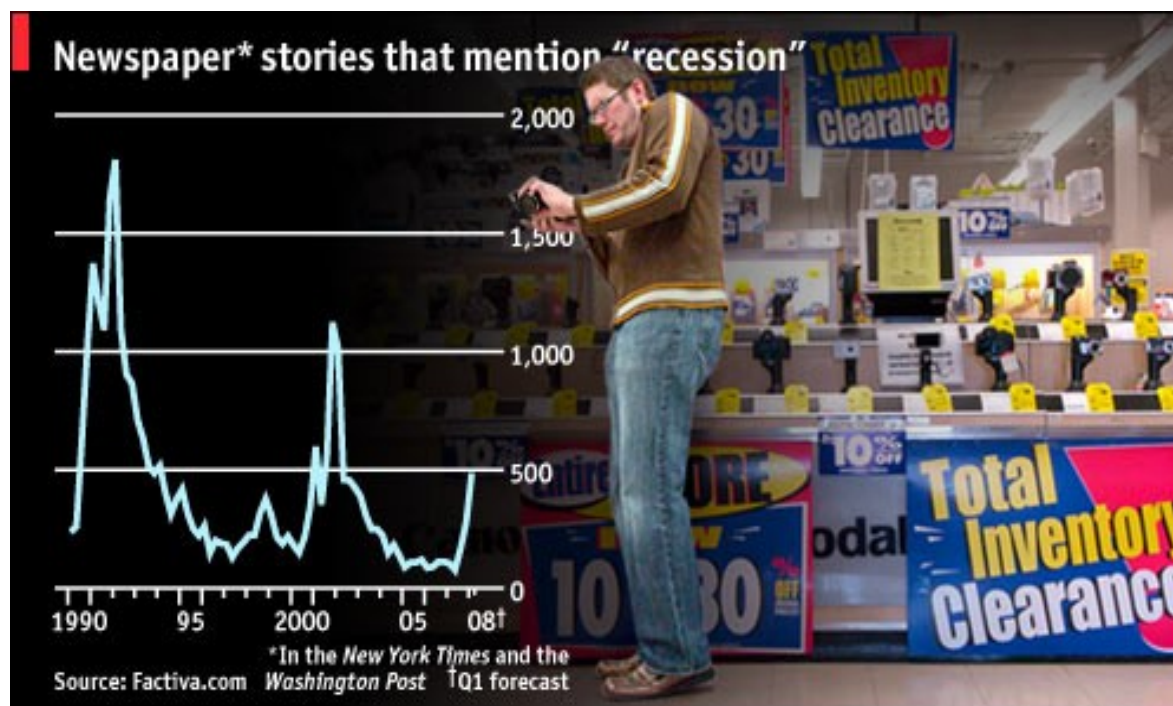
Bruce MacEwen, creator and host of Adam Smith, esq, (www.bmacewen.com) tells how Mr. Carter's regulatory czar and head of the Civil Aeronautics Board Alfred Kahn dealt with the muzzle. Not one to be cornered when it came to talking, Fred Kahn was called to the Hill to testify

about the economic outlook. When asked point blank about the prospects for a recession, Fred, somewhat floored, remembered his instructions and noted that he could not speak directly to the question, but that he did expect there might be a “banana.” Banana then became the Washington code word for recession. Bruce MacEwen tells us that when the banana industry complained, Fred Kahn changed the code word to “cumquat.” The cumquat lobby was less effective in avoiding the hit.

Yes, we have no bananas. Please pass the word.

Another way to predict recessions.

It turns out the frequency of occurrence of news stories with the word “recession” is the basis for The Economist magazine’s recession index. That’s right, the Economist doesn’t chase after employment and money supply numbers to build a forecast instrument. The newspaper just counts the word, and a darned accurate indicator results. I provide here the latest picture from The Economist. At last count, the spike was high enough to justify a recession call. But as shown in the image taken from the Economist web site, it is headed in that direction.



Inflation

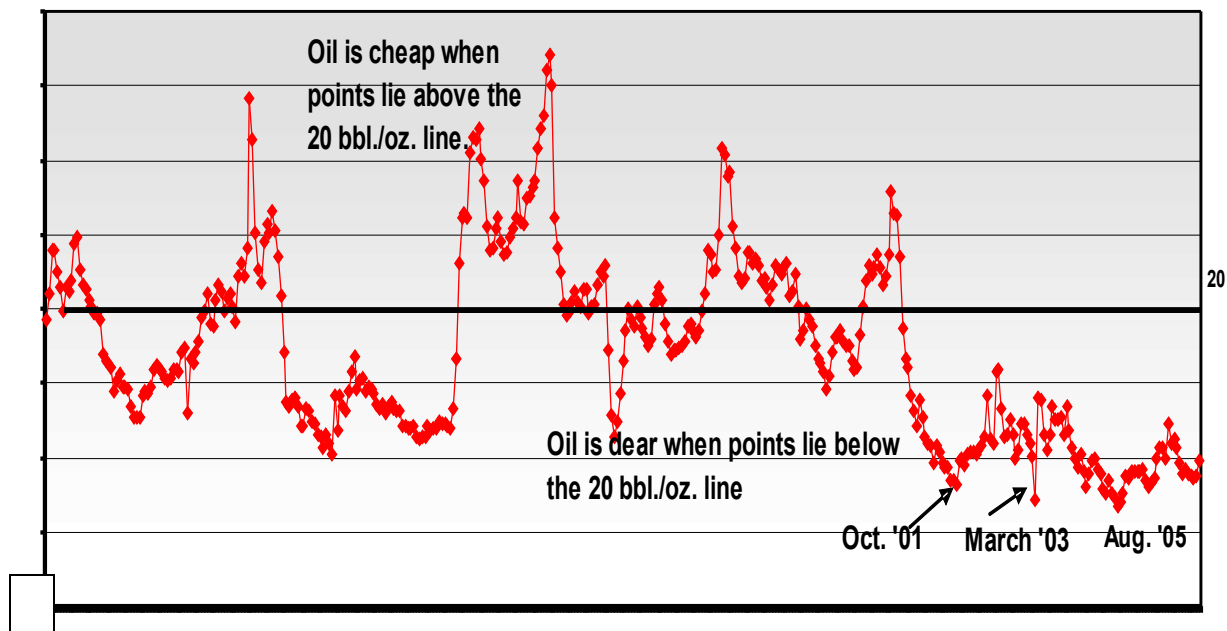
With CPI inflation hitting 4.2% for 2007, there is little doubt but that pressure on prices will continue. However, the yield on inflation adjusted Treasury bonds suggests that price pressures are weakening somewhat. I also expect that slower economic growth will reduce inflation pressures. For these reasons, I call for 3.0% CPI inflation in the year ahead. Of course, a good part of CPI inflation comes from the weaker dollar, which causes the price of oil and other imports to rise.

While on the subject of oil and inflation, this may be the right time to revisit the gold/oil relationship. The next chart shows our tried and true friend, the price of oil stated in terms of gold. Readers will recall that the chart shows the number of barrels of crude oil that can be purchased with an ounce of gold.

Please note that since 2001, the price of crude oil has remained relatively flat when stated in terms of gold. (I have marked the dates of the U.S. invasions of Afghanistan and Iraq, and also the date of Katrina. The price of oil in gold reached higher points in each case.)

So why are we seeing record prices for oil in the U.S.? Because the U.S. has allowed the dollar to diminish in value. When we print more money, the Arab traders logically ask for more pieces of green paper before shipping another barrel.

Gold and Oil: How many barrels for an ounce? ⁰¹¹⁵⁰⁸



Oil and gold prices

I expect the price of gold and oil to be lower at the end of the year. These forecasts are based on three things: 1) declining inflation, 2) stronger dollar, and 3) decline in demand that results from the slower economy.

Mortgage rates and unemployment

The interest rate on 30-year fixed rate mortgages has weakened considerably in the last few weeks due mainly to the collapse of the housing market in major U.S. regions. Both the supply of and demand for mortgage credit have fallen significantly. I do not expect to see a major reversal in housing until late 2008. For this reason and the lower rate of expected inflation, I expect mortgage interest rates to remain relatively stable.

The unemployment rate for December 2008 is expected to rest at 5.0%, which is the current rate. But along the way, I expect unemployment to rise, perhaps to 6.0% to 6.25%. In short, I expect to see the unemployment rate take the shape of an inverted bowl, with the peak occurring in 2008's late summer.

The Prime and Dow

With equity markets rocking and rolling, making a forecast for year-end values is challenging, to say the least. But making forecasts for the volatile Dow is always a challenge. With full expectations that we will see recovery from the current depressed averages and then a small relative gain, I set the Dow for December 31, 2008 at 14,200.

And the Prime? As suggested by my forecast, I expect the Fed to reduce overnight lending rates, and therefore the Prime, by a full percentage point. This gives a year-end Prime lending rate of 7.00%.

Mr. Kohler's tub

I can't end this special report without putting in a word for entrepreneurs who make life so much better for all us. This one is John Michael Kohler, an Austrian immigrant who settled in Sheboygan, Wisconsin, in 1873.

Had a bath lately? This was quite a luxury for most of recorded history. In fact, it is said that only one percent of U.S. homes had indoor baths with running water in 1921. The Saturday scrub, if it came that often, was in a steel tub in front of the fire, or in the back yard for men. All this had begun to change in 1883 when John Michael Kohler decided to add a coat of enamel to one of the cast iron horse troughs he made in his foundry. He then added claw feet to make the first enameled bathtub. With that, things began to get better on the home front. Well they at least got cleaner. Never satisfied and always creative, Mr. Kohler also invented the bubbler drinking fountain. A visit to Kohler, Wisconsin, a model city and home of the company, sounds like a promising idea. Among the sites recommended is a museum that houses a full array of Kohler's early plumbing products. The line up along one wall is called the Great Wall of China.