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# Outlook for the Economy: Considerations for Business

Christian T. Lundblad

Professor of Finance &

Edward M. O'Herron Distinguished Scholar

Kenan-Flagler Business School

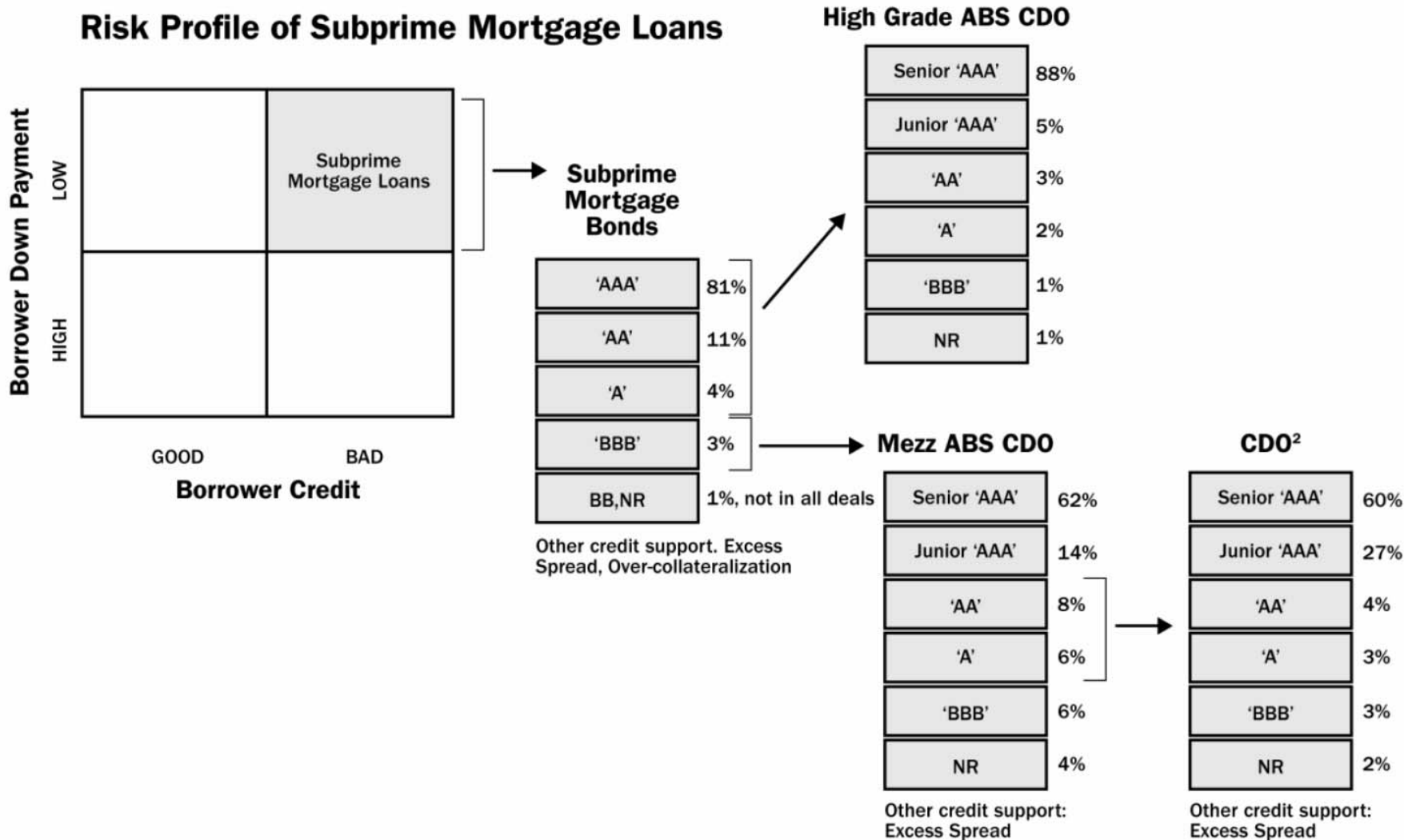
The University of North Carolina at Chapel Hill

# What did we just witness?

- Complexity of financial system has exploded in the last decade
  - Asset-backed securities & Structured finance (e.g., MBS, CDOs, etc.)
  - New intermediaries
  - Institutions expanded into nontraditional areas
  - New, poorly-understood derivative products (e.g., CDS)
- It is so complicated that many institutions do not understand what they own, let alone what others own

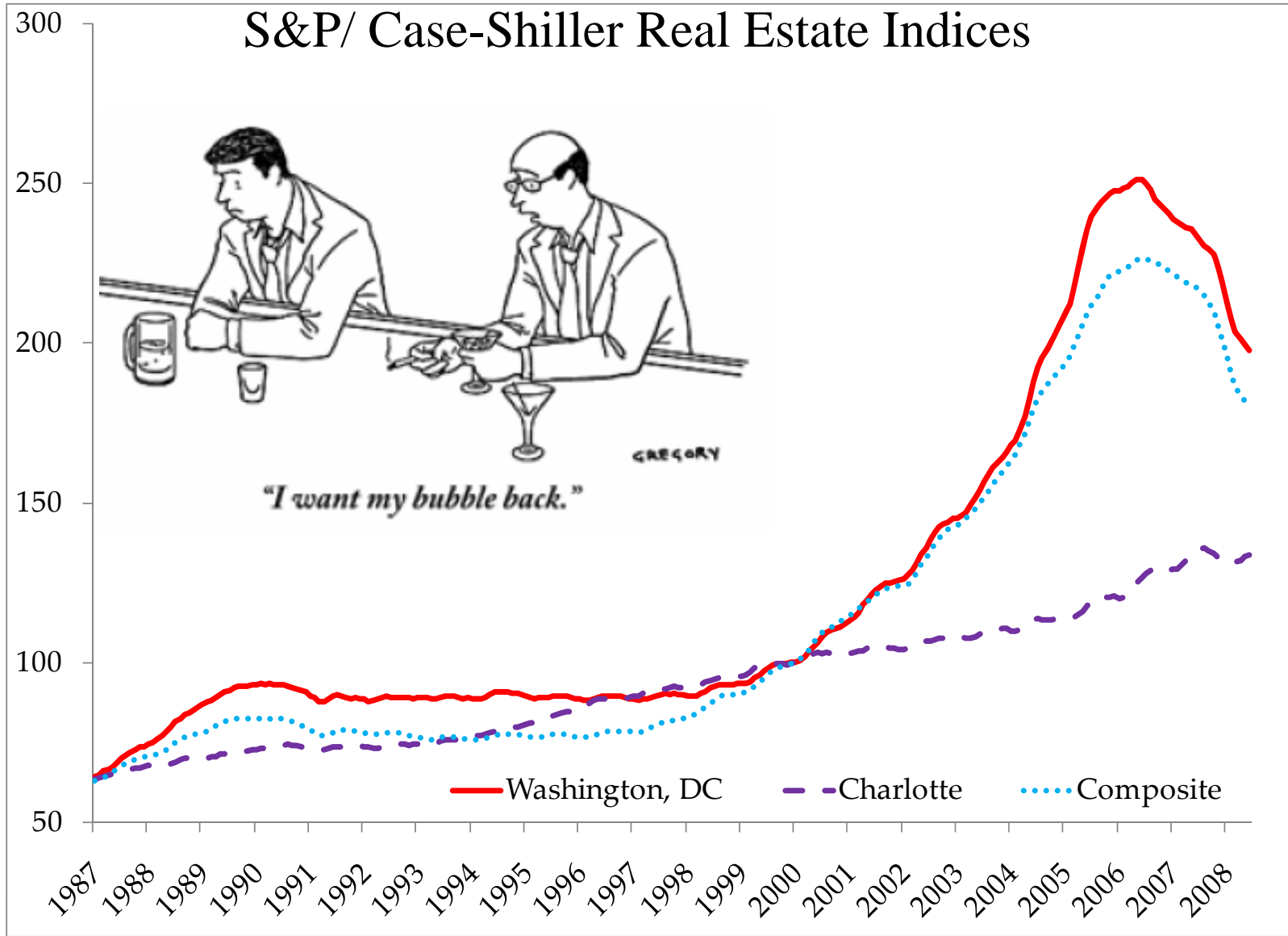


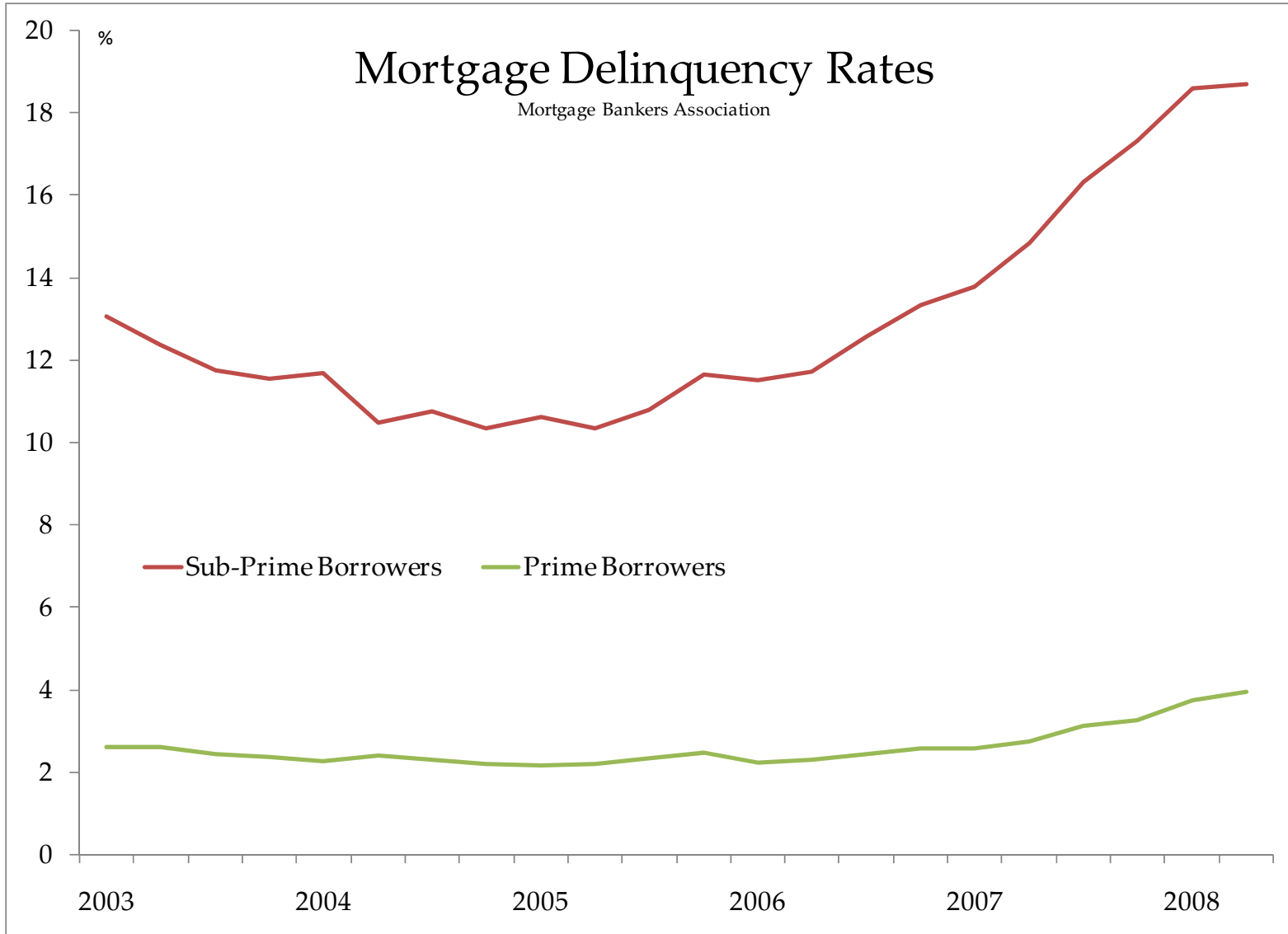
# Securitization and Complexity





# Real Estate (in Meltdown)





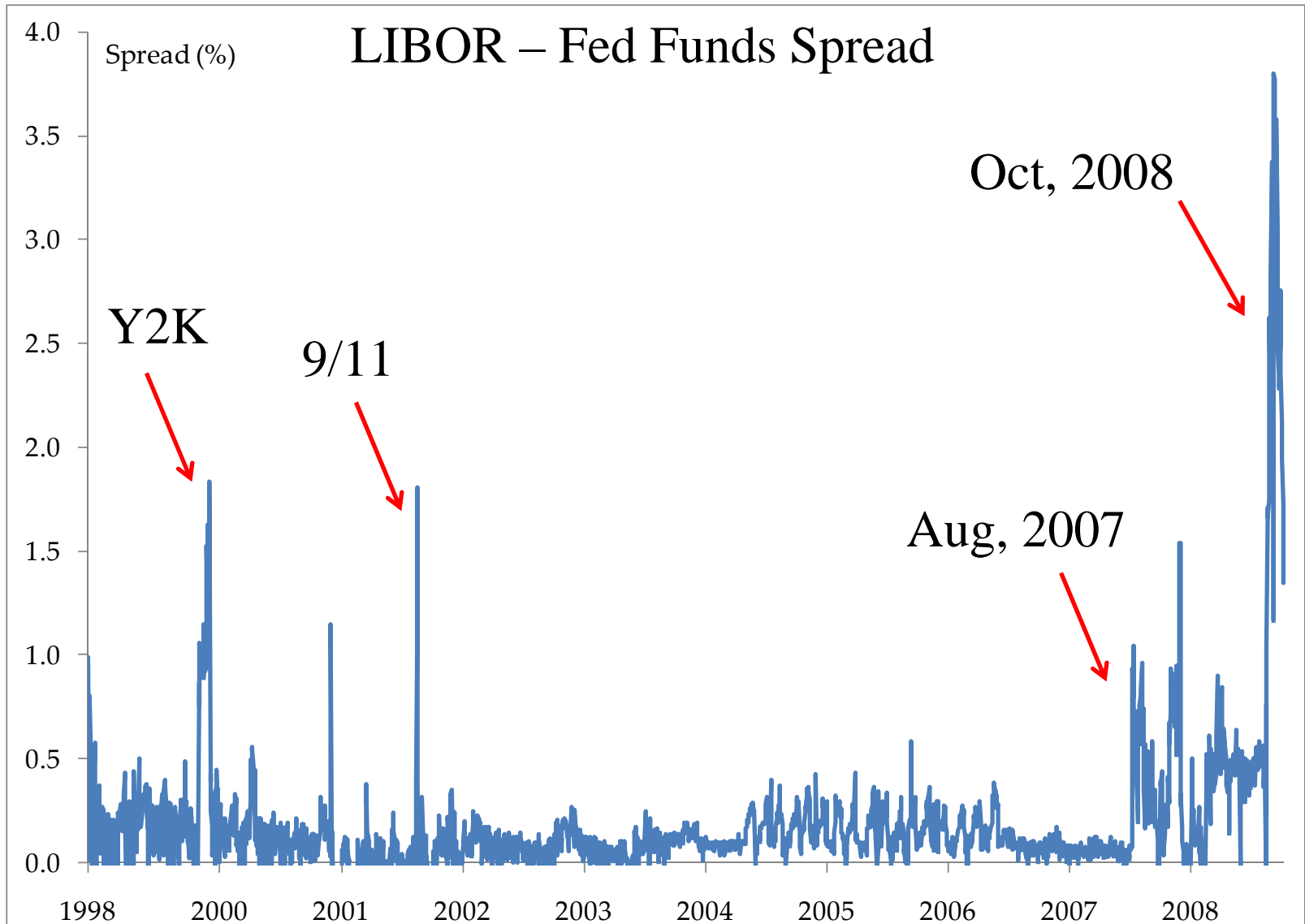
# What was done to try to to minimize damage?

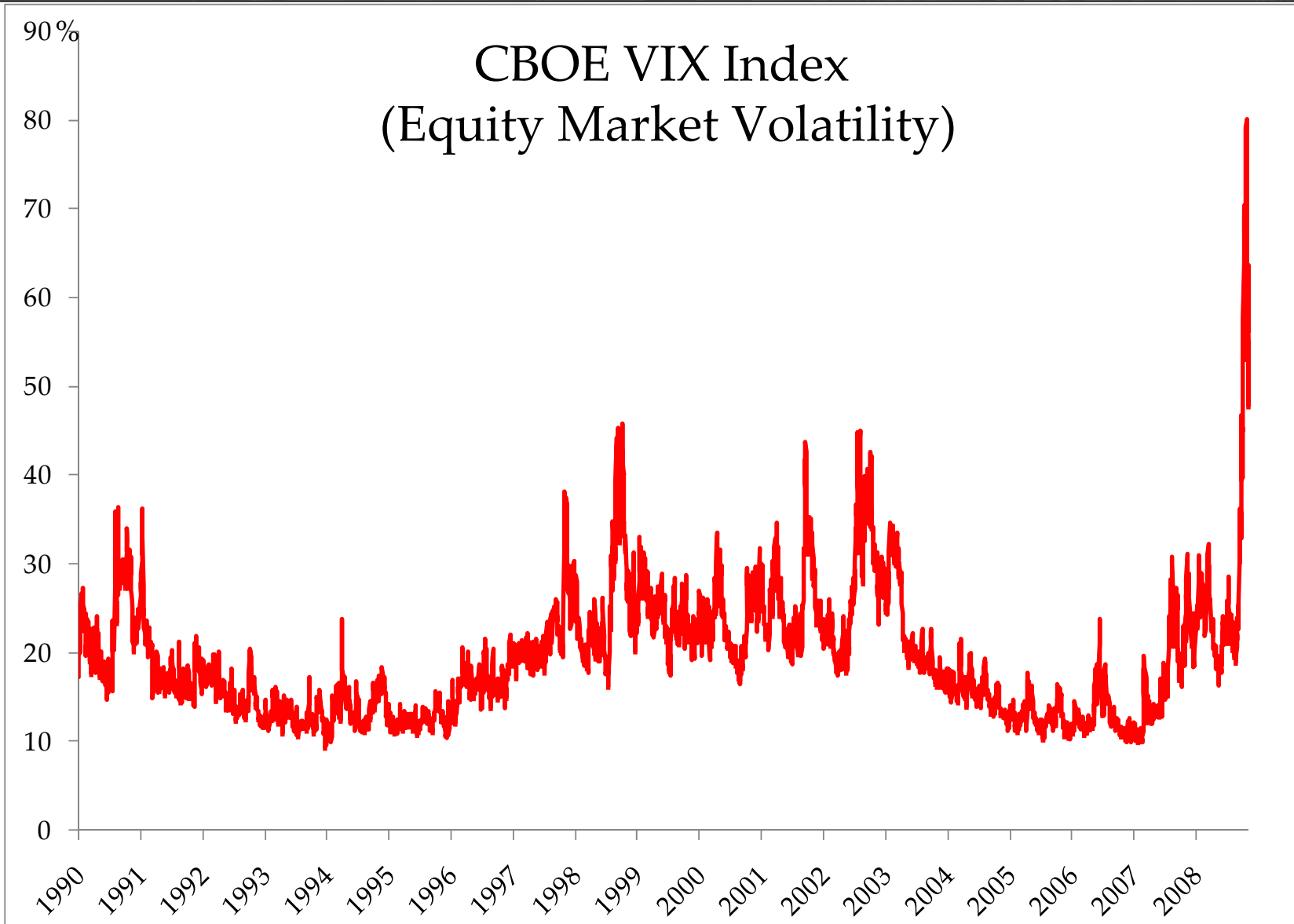
To recover, banks need to sell “troubled” assets and/or raise new capital...

## Role for Government(s):

- Extend guarantees to other markets (money market funds, interbank lending, other types of accounts)
- Raise deposit insurance limits
- Encourage lending (e.g., by injecting equity capital)

Big fear: the *financial accelerator*







## **Financial / Credit Crisis**

## **Housing Market Contraction**

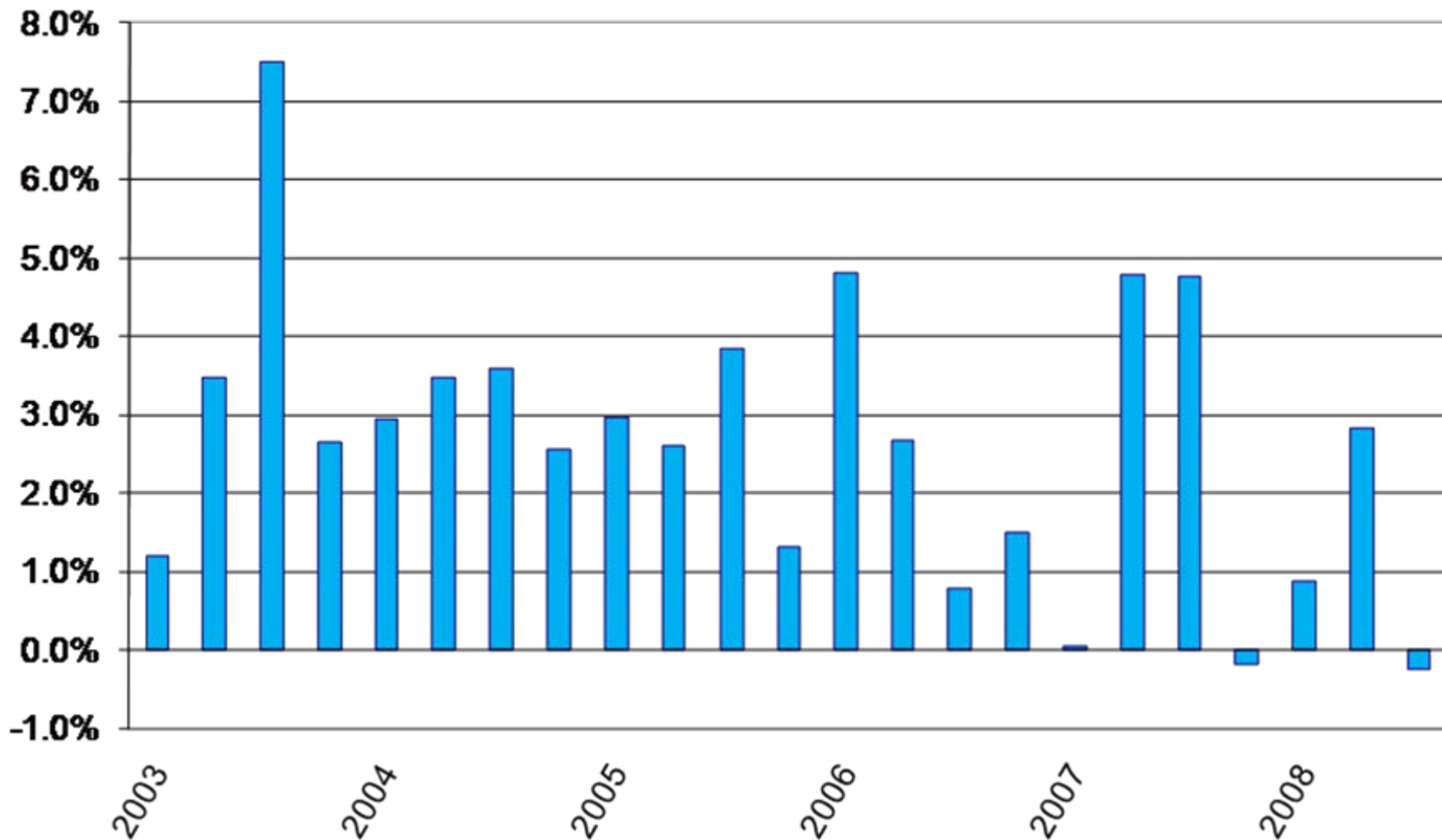
## **Economic Recession**

- **Upside**
  - Commodity prices are off their peaks
  - Central banks and governments are serious
- **Downside**
  - Negative ‘wealth effect’
  - Employment picture
  - Anxiety
- **Unknowns**
  - Scale of global economic contraction
  - The “unknown” unknowns



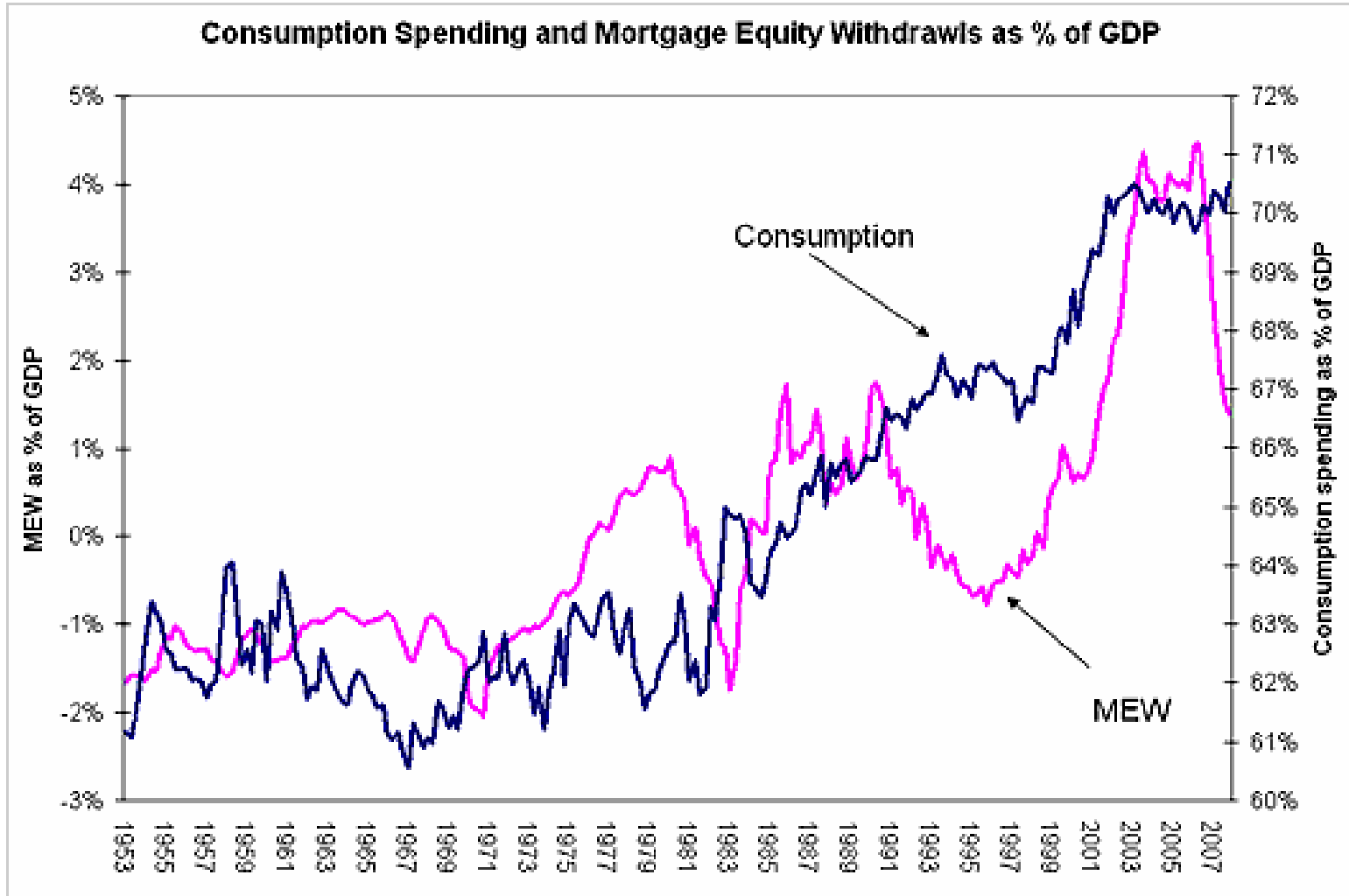
# Real U.S. GDP Growth

(2003-present, quarterly)





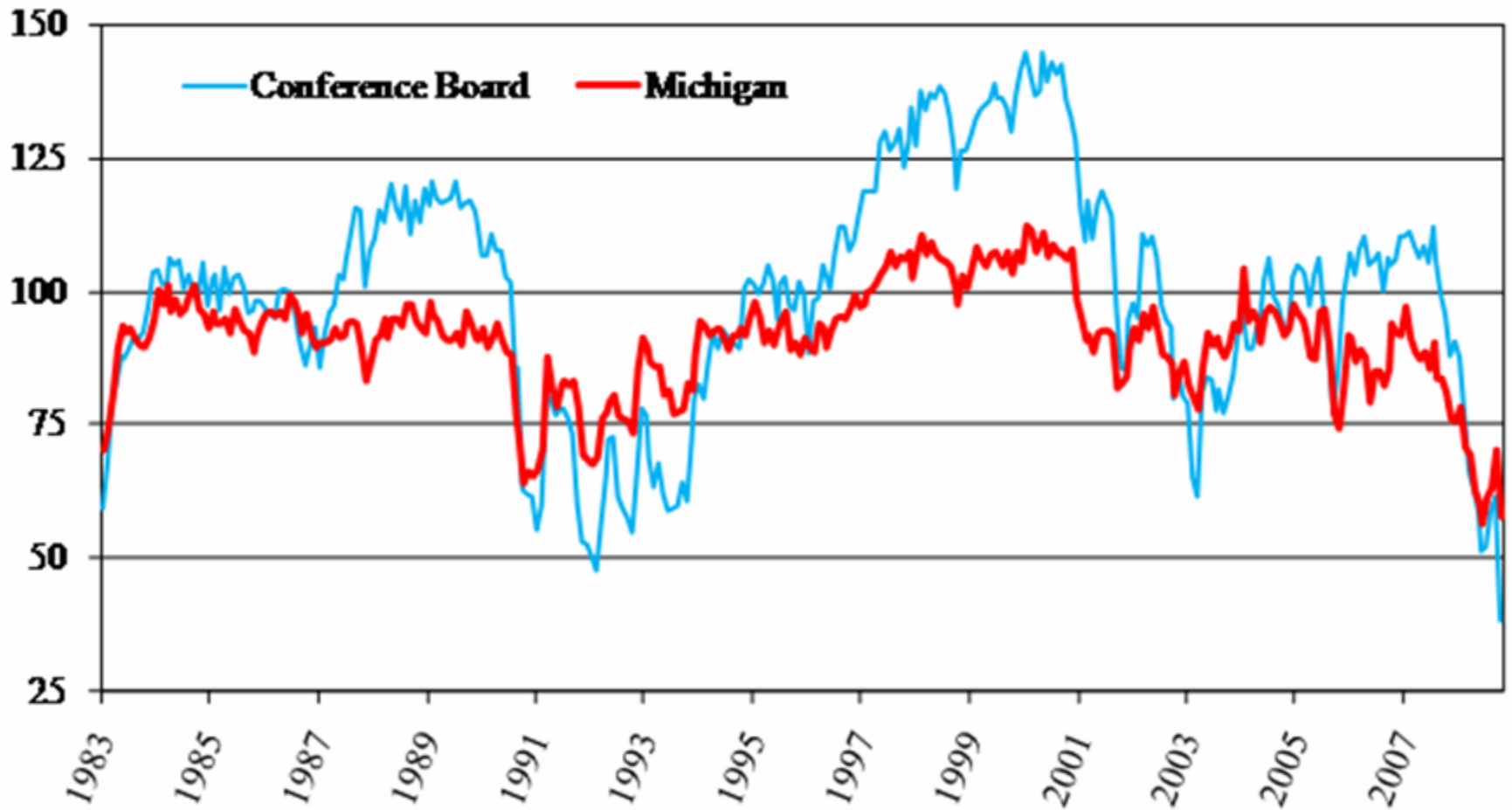
# Financial / Housing Crisis



Consumption and GDP data from the Bureau of Economic Analysis (BEA). Mortgage equity withdrawals are measured as the year-over-year change in mortgage debt (from the Federal Reserve Flow of Funds) minus 70 percent of residential investment spending (from the BEA). (Source: L. Josh Bivens, Economic Policy Institute)

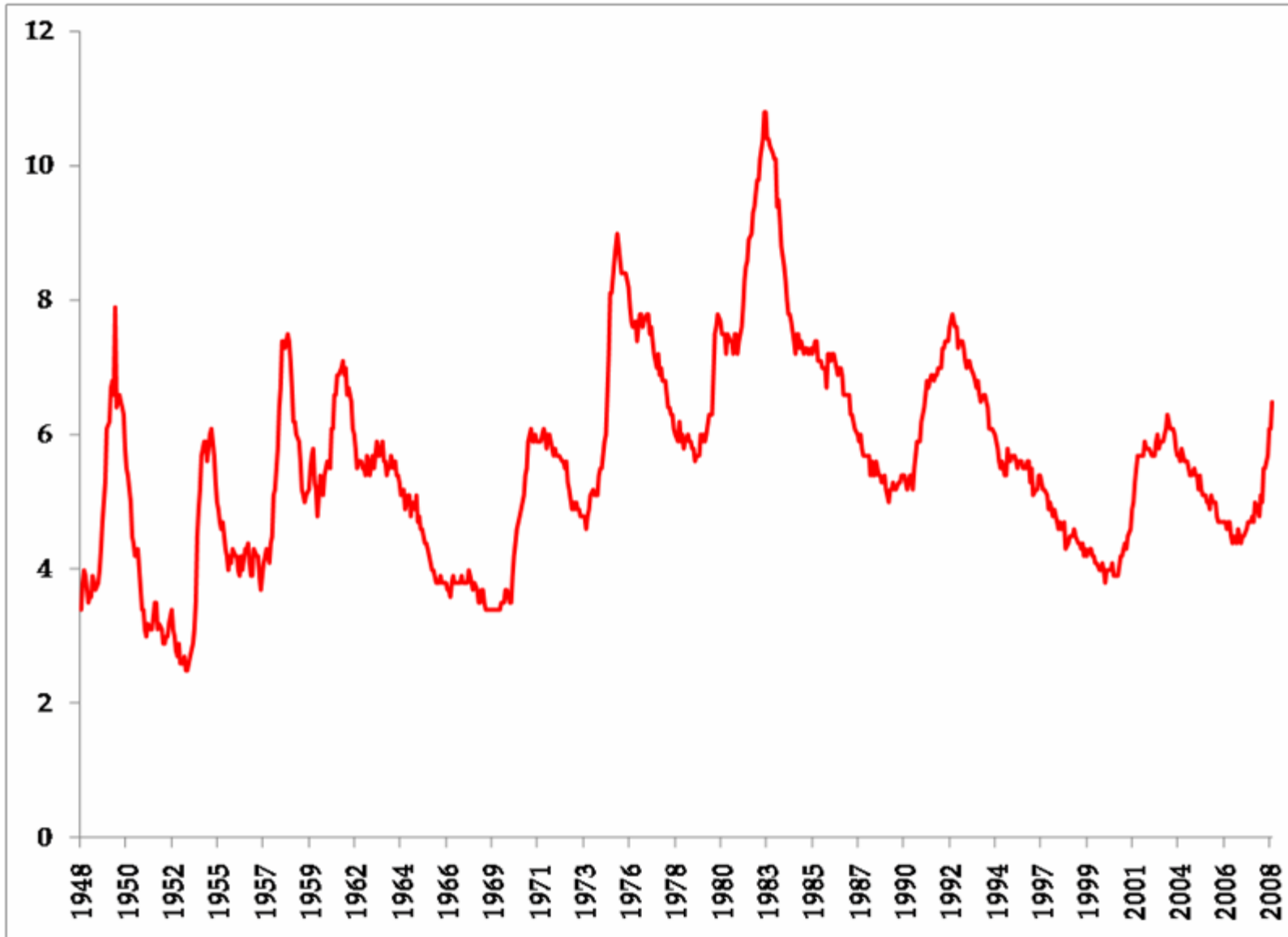


# Consumer Confidence





# U.S. Unemployment Rate (Percent)

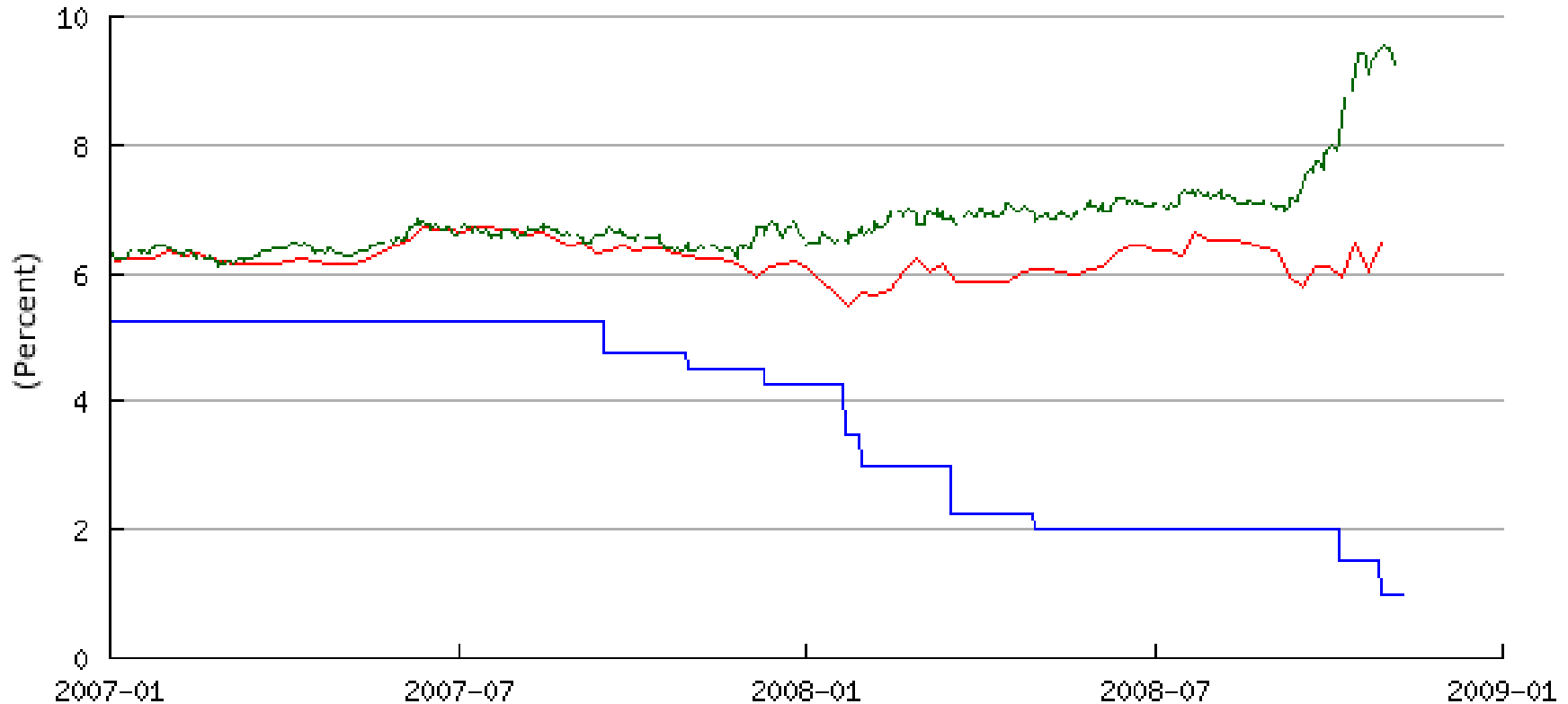




# Pushing on a String?



Federal Funds Target Rate (DFEDTAR)  
vs. 30-Year Conventional Mortgage Rate (WRMORTG)  
vs. Moody's Seasoned Baa Corporate Bond Yield (DBAA)



2008 Federal Reserve Bank of St. Louis: [research.stlouisfed.org](http://research.stlouisfed.org)

- DFEDTAR (Left)
- WRMORTG (Left)
- DBAA (Left)

## How deep will this recession be?

Q4/2008 will show a significant contraction

Likely to mirror recessions of 70s and early 80s

Unemployment could easily approach 8% in 2009

**Credit constrained businesses will struggle**

## How long will this recession go on?

Financial crisis is better understood

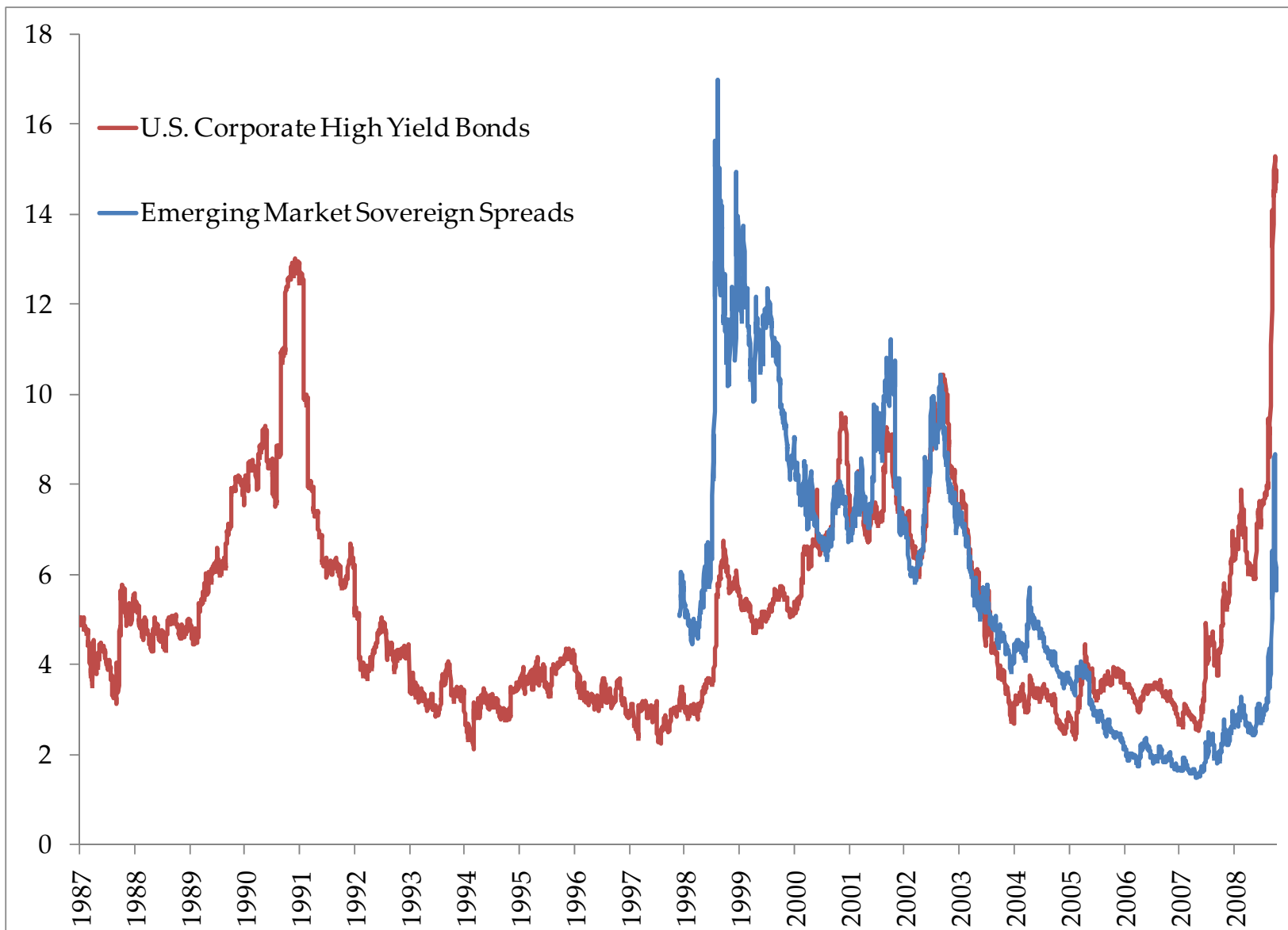
2009 is likely to be a tough year

## Forecast uncertainty?

## Further rate cuts & fiscal stimulus?



# Recession... Borrowing Costs (Spreads over Treasuries)





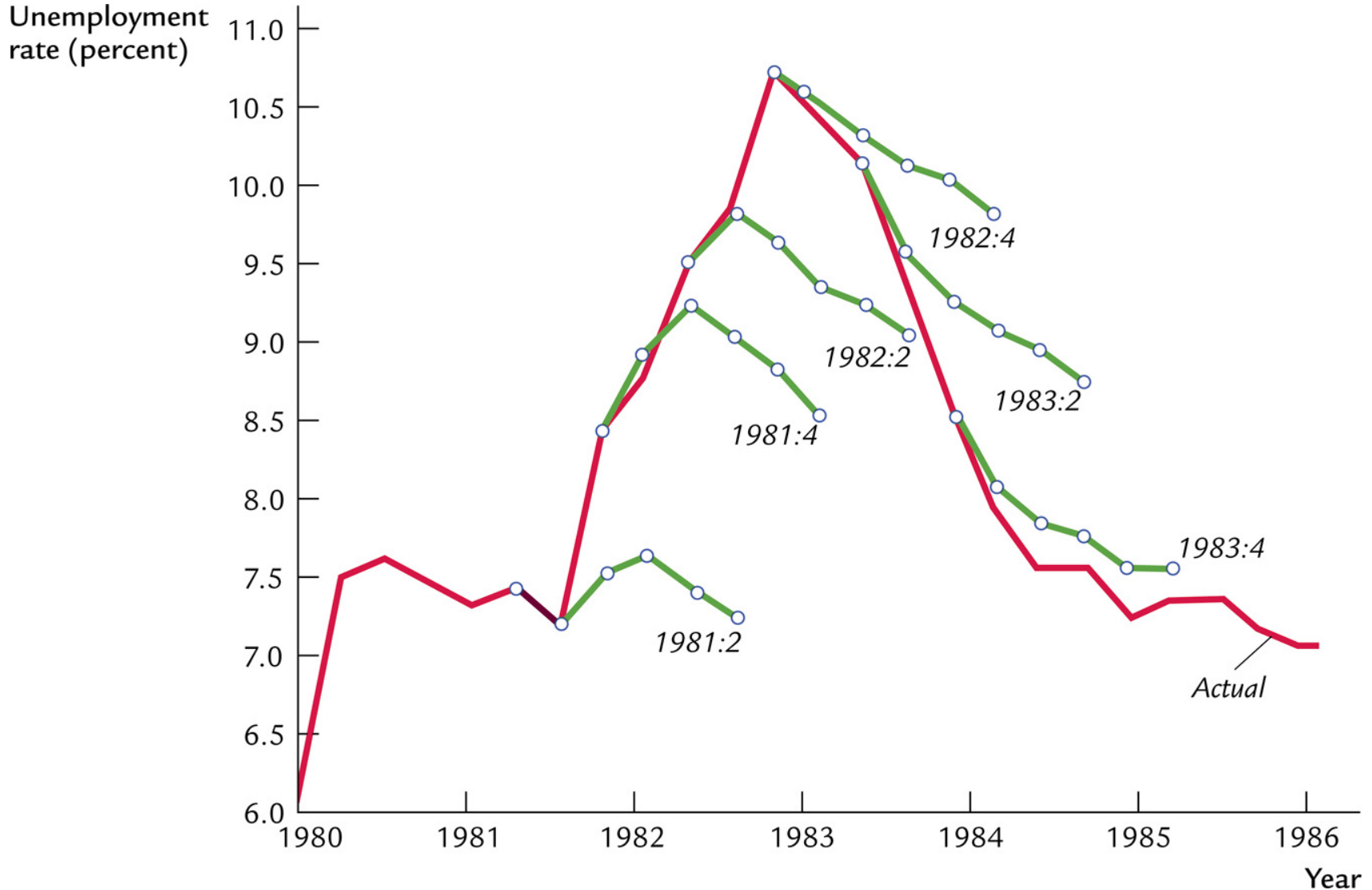
## Business Cycles: Duration and Amplitude since WWII

Dates of Contraction	Duration (Months)	Maximum Negative Quarterly Growth Rate	Dates of Expansion	Duration (Months)	Maximum Positive Quarterly Growth Rate
Nov48-Oct49	11	-5.50	Oct49-July53	45	17.60
July53-May54	10	-6.30	May54-Aug57	39	11.90
Aug57-Apr58	8	-10.30	Apr58-Apr60	24	10.90
Apr60-Feb61	10	-5.00	Feb61-Dec69	106	10.30
Dec69-Nov70	11	-4.20	Nov70-Nov73	36	11.60
Nov73-Mar75	16	-5.00	Mar75-Jan80	58	16.30
Jan80-July80	6	-7.90	July80-July81	12	8.00
July81-Nov82	16	-6.50	Nov82-July90	92	9.80
July90-Mar91	8	-3.20	Mar91-Mar01	120	7.10
Mar01-Nov01	8	-1.60	Nov01-?		
Now?	?	?			

Downturns, while painful, are relatively brief



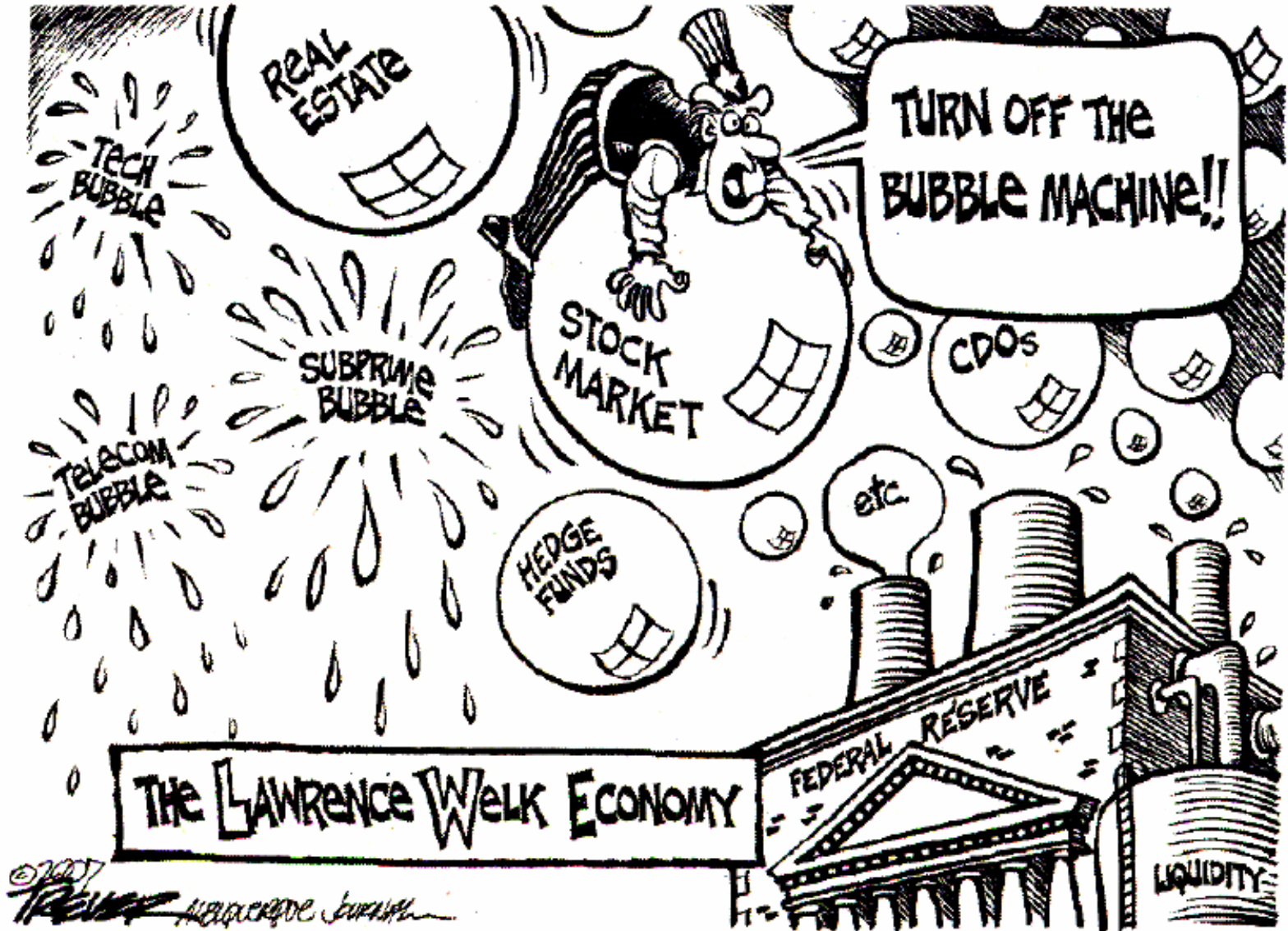
# Forecasting Caveats: The Recession of 1982



The predicted unemployment rate (in green) is the median forecast of about 20 forecasters



May you live in interesting times...

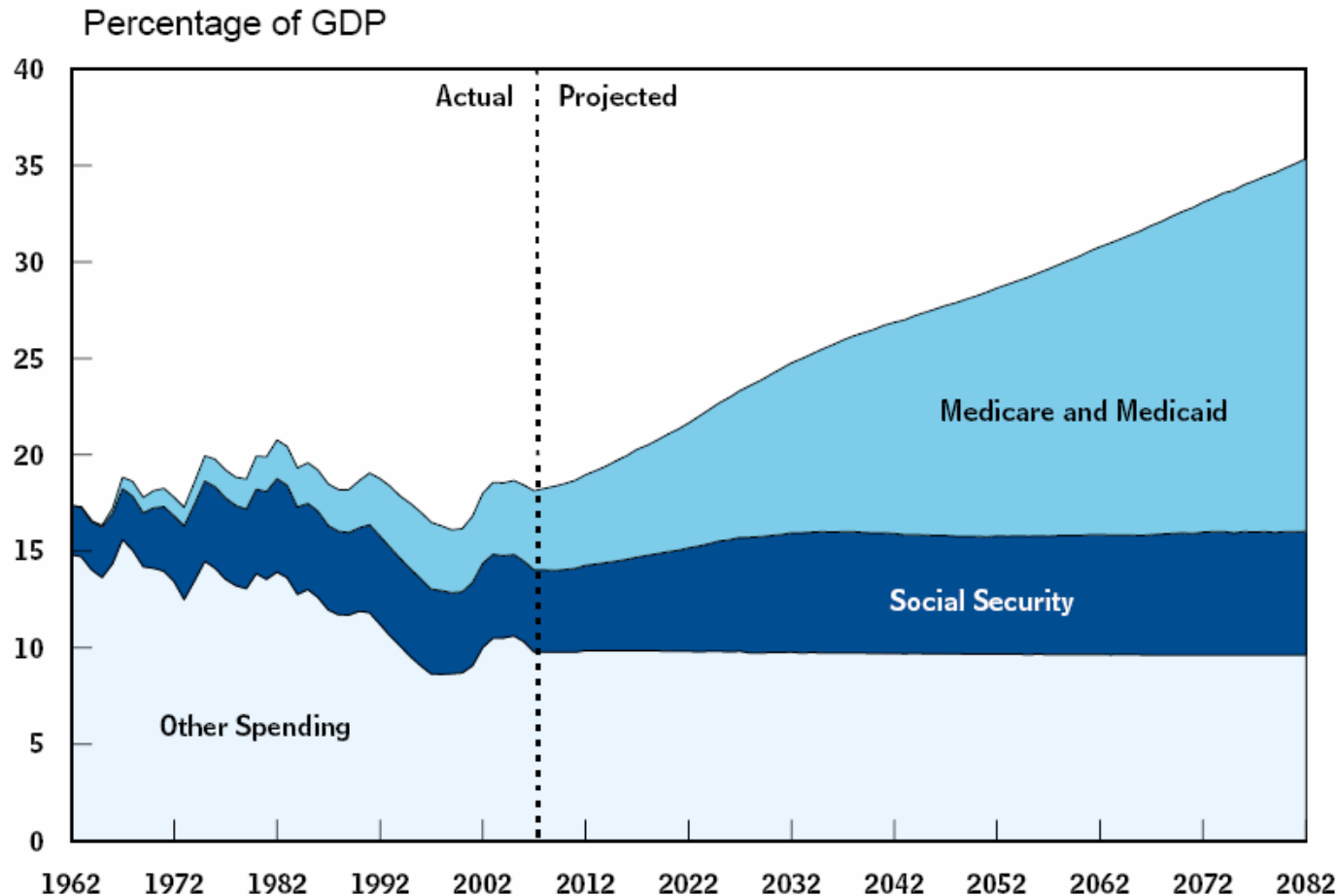




Unfortunately, we have much  
bigger fish to fry...



# The real danger may reside elsewhere



**Greenspan (*Age of Turbulence*, 2007): Collectively, the entitlement issue is “likely to be a defining question of the next quarter century.”**