

Armageddon Has Not Cometh

MARKET PESSIMISM KNOWS NO BOUNDS, AND NOW IT'S LITERALLY running off the charts. The word "recession" is showing up in the business press at a rate not seen even in the trough of the tech boom-bust cycle earlier this decade. The cognoscenti are liberally using macabre phrases such as "deflationary death spiral" and "Armageddon cometh" in their prognoses for the future of the United States economy.

Surveys find that fund managers are underinvested and hoarding cash at levels last held in the immediate aftermath of the 9/11 terrorist attacks. Hedge funds, too, are in complete retreat, with record low exposure to the market. Meanwhile, retail investors in the United States haven't been this bearish on stocks since 1990. According to the popular betting Web site Intrade.com, the probability of a recession in the United States this year is nearly 70 percent.

All this pessimism comes despite data that still do not indicate that the United States has entered a recession. Trends in employment, retail sales and industrial production show domestic demand has indeed slowed to a crawl, but is far from falling off the cliff. In addition, export growth remains robust and is on track to add almost a percentage point to U.S. GDP in 2008. While it's true that some of the data tend to lag behind current economic activity, so do the opinions of economists and the commentariat. In the past, they have not been able to distinguish a cyclical slowdown from a recession until the economy is midway into the event.

So either history is going to be turned on its head this time, with the consensus announcing a recession well before it has arrived, or all the current fuss is going to seem like a bit of a hoax. At the moment, the latter outcome looks more likely.

While it's hard to deny that the United States is in the throes of a full-blown credit crisis, a look back at similar episodes in the developed world and a closer examination of the wider economy suggest that the United States is well poised to skirt a recession. The typical conditions that cause a recession, from inflation to widespread investment excesses in capital spending, do not currently exist. Furthermore, past credit crises have not always led to economic slumps. In fact, though many today forget it, even the Japanese



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economy expanded 1.5 percent a year during the 1990s till the Asian financial crisis.

The more mature stages of a long expansion involves an outbreak of higher inflation, prompting an increase in interest rates. As inflation is mostly the product of diminishing productivity gains and declining profitability following years of investment, the corporate sector is then forced to aggressively cut spending and jobs to meet profitability targets.

Of course, the Fed did increase interest rates from 1 percent in 2004 to 5.25 percent in 2006, but that was more about normalizing interest rates after an extended low-rate regime. Monetary policy never got too tight in the United States, and inflation has not been a serious problem in the present cycle. As a result, the Fed is now in a good position to aggressively cut interest rates. In the past credit crunches, including the savings-and-loan crisis in the late 1980s, inflation concerns prevented the Fed from being more proactive.



More important, apart from the troubles in the financial sector, U.S. corporations are in fairly good health. Profit margins are close to record highs, and investment levels are in line with historical norms. U.S. firms did not succumb to overspending during this business cycle, as scars from the 2001-02 recession were still raw. Inventories are also at fairly lean levels as businesses have been paring back on their stock since the middle of last year given all the well-advertised warnings about the coming slowdown.

During recessions, payrolls decline by a massive 215,000 heads a month; at present, however, modest increases are still underway. If companies do not feel the pressure to layoff workers and income growth keeps rising moderately, the consumer will retain enough of a cushion to weather the turmoil. It is important to remember that unlike corporations, consumers don't change their behavior overnight. Consumers make gradual changes to their lifestyles, and while it's almost certain that there will be a downshift in spending habits in response to the housing-market shock and tougher financial conditions, any abrupt change seems unlikely.

Chances are that what we'll see instead is many quarters—if not years—of subpar growth in the U.S. economy, not a dramatic downturn, as both the consumer and the financial sector gradually rebuild their balance sheets with ample help from policymakers. The negative effects of credit crises tend to linger for years, since the bias of a democratic system is to amortize the pain over time rather than swallow it in one shot.

This may not be the most desirable outcome to the purists who would rather see all problems liquidated immediately. But for investors facing storm clouds in the markets today, any outcome short of a full-fledged recession will feel like early spring after a winter of discontent.

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