**Midsummer Course Correction**

-- Investors and businesses in US following already bearish households

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In August, a compromise was reached on raising the debt ceiling. Still, S&P (but not the other two rating agencies) downgraded the AAA rating of US treasury bonds to AA+.

Stock market is volatile: down 500+ on Aug 4, down 600+ on Aug 8, up 400 points on Aug. 9, down 500 points on Aug 10th. And note, program trading late on these days intensified the magnitude of the changes.

Money coming out of the stock market went into the bond market, sending the yield on the 10-year Treasury bond down by roughly 80 basis points to 2.15 percent. This created the anomaly of yields falling sharply AFTER the downgrade of credit rating. Perhaps, 1) worried investors sought safety; 2) more investors feared a double dip recession; 3) money flowed to bonds temporarily and once the stock market quiets down, that money will come out of the bond market and go back to the stock market. Actually, all three are plausible.

There are two fundamental problems. First, investors and some business executives have become more concerned about slow or no economic growth, leading to volatile financial markets. Consumers have not necessarily become more worried because they were ALREADY very worried. So previously more optimistic investors and business executives have suddenly woken up to what consumers have been thinking about. The result is sharp declines in stock values.

The second and more fundamental problem is that worried consumers are paying down debt, building savings, and very cautious about spending unless job and income growth improve (which they are quite sure is not very likely to happen very soon). Business sees slow sales and therefore, despite large cash reserves, is holding back on investing and hiring. In turn, consumers think, “See,
we told you so.” Nothing changes. And there is very little help coming from fiscal or monetary policy.

Business does not make money on the sales that consumers do not make. Stock values ultimately reflect future profits. So the stock market woke up in early August that the period of relatively strong profit growth is over for now. And portfolio adjustment (over adjustment?) has been swift. Japanese investors have already seen this show (and don’t like it).

The Conference Board has revised its economic forecast downward: +1.6% in 2011, +1.8% in 2012. The main reason is explained above. In fact, it has not had to revise its forecast as much as some other forecasts, especially those from financial institutions. Its consumer and business sentiment surveys, as well as its Leading Economic Index, and Employment Trends Index have been describing a slow economic environment even as other forecasts were projecting as much as 3 percent growth for the second half of 2011. By early August, especially with the revisions to GDP history, that 3 percent scenario was no longer plausible.

The 2012 outlook is very weak, for the reasons described. Other forecasts are now more in line with this story. The question becomes, what could push US growth to a more robust path. It is clear there are downside risks, even to this very weak economic scenario (political gridlock, drought, hurricanes, strikes, etc.). Are there any upside risks? Yes, there are some.

1) Political agreement on fiscal policy. The probability is not very good, but it is possible

2) If bond yields remain very low for some time, mortgage rates could fall lower. That might spark some home buying and construction and a better housing market might slowly lead to a relatively more positive overall economic environment.

This is not a long list but at least there are a few potential upside risks to an otherwise very weak scenario. There is one more possibility. The Federal Reserve could entertain a QE 3. This is possible, even though QE 2 proved largely ineffective. Why? The value of quantitative easing is to flood the economic system with liquidity, and that indeed happened. But even with very
low interest rates, consumers, some businesses, and all state and local governments are busy reducing debt, not willing to add to debt. Austerity blunts the effect of quantitative easing (this is also why QE 2 had very little impact on inflation, despite fears to the contrary).

Slow growth, austerity, and debt problems are plaguing other parts of the global financial system, and sending stock values lower. Since investors are chasing the best returns on investment, what happens abroad impacts domestic markets and vice versa. In other words, the US financial markets might not have turned so bearish if there were bull markets abroad. The bear markets abroad have the impact of making the domestic market more bearish (just as the domestic market makes markets abroad more bearish). So many bears. Too few bulls. Is this the new normal? Well, at least for August.

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