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The economy chugs along, but remains vulnerable



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The U.S. economy has had a terrific run. S&P 500 companies have had 19 consecutive quarters of double-digit earnings increases year over year.

The economy is slowing, as indicated by the almost snail's pace growth of 0.6 percent in the first quarter, but many economists believe the economy is in a trough and see a good year ahead.

The Fed is hoping for yet another Goldilocks — “not too hot, not too cold.” We generally concur, but believe that a shock to the system could spell trouble. Alan Greenspan, the former Federal Reserve chairman, put the odds for a recession at one-in-three.

Where are the problem spots that could stall the U.S. economy?

• **Unraveling of the credit markets** — The subprime mortgage markets could be the tip of the iceberg. The yield curve has been inverted — short rates yield higher than long ones. Historically, in this interest-rate environment, lending activity slows dramatically as margins at lending institutions shrink (banks borrow short-term and lend long).

Private equity and hedge funds are competing with the lending of banks and, consequently, have forced them to be more aggressive in an environment where they usually are tightening lending practices.

If leveraged strategies unravel and/or lenders have problems, it will shrink the current abundance of liquidity. This could throw the economy into a recession.

• **Evaporation of the “wealth effect”** — The U.S. savings rate has been negative for quite some time. In other words, U.S. consumers have been outspending their earnings due to increased asset values in their homes, retirement plans and equity investments.

Arguments can be made about the flaws of the government savings rate statistic, but if housing continues to slump and/or if we have a stock market correction that's sharp or prolonged, the resilient U.S. consumer could be in trouble. Two-thirds of economic growth is consumer-driven, and with the consumer already overspending, a sharp decrease in wealth could push the United States into a recession.

• **Soaring energy prices** — Higher prices at the gas pump and increased home heating bills are a direct cost to consumers. Further, business will attempt to pass along the cost increases to manufacture or transport goods to their customers.

We're seeing inflation creep into the system as a consequence of higher energy and commodities prices. There's no bigger tax, especially on the middle class, as inflation.

While Federal Reserve Chairman Ben Bernanke is inflation-conscious, he could be placed in a difficult situation — a slowing economy and higher inflation (known as “stagflation”). Forcing rates higher would help curb inflationary forces, but could shut down economic growth at the same time.

• **Bad policies in Washington** — The rhetoric is flying about trade policies, and a floating Chinese yuan. While an argument could be made for more favorable treatment by China of our domestic goods and services, America's reliance on China's low-cost goods and labor has helped keep inflation at historical low levels.

Increased protectionism could drive prices higher, and the Fed would be placed in another difficult position. While U.S. labor may have suffered from the global economy, it's started to benefit from China's explosive growth and demand for raw materials, such as steel.

While rattling the saber may be a negotiating ploy, Washington must be careful here. A trade war could collapse our dollar, and put the economy at risk.

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• **Terrorism** — The American economy generally has shrugged off any bad news from the war. However, if terrorists are successful in the United States or Europe, the impact on the economy would be detrimental. Similar to what happened after 9/11, both consumer spending and business spending could drop dramatically, and the economy could stall.

There are certainly other circumstances that would hurt our economy. The inexperienced Fed chairman is key to handling a crisis and the resulting impact on our economy.

The economy looks to be satisfactory in 2007, but corporate earnings are slowing, inflation is rearing its ugly head, and any number of negative surprises could derail our long, steady ride.