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Financial FAQs

Irrational Pessimism--II

In the face of encouraging economic fundamentals—such as soaring corporate profits, improved job creation and rising incomes—why so much pessimism in the markets? Interest rates have plunged and stock values are gyrating wildly, as if we were still in the recession that economists agree ended last June or July.

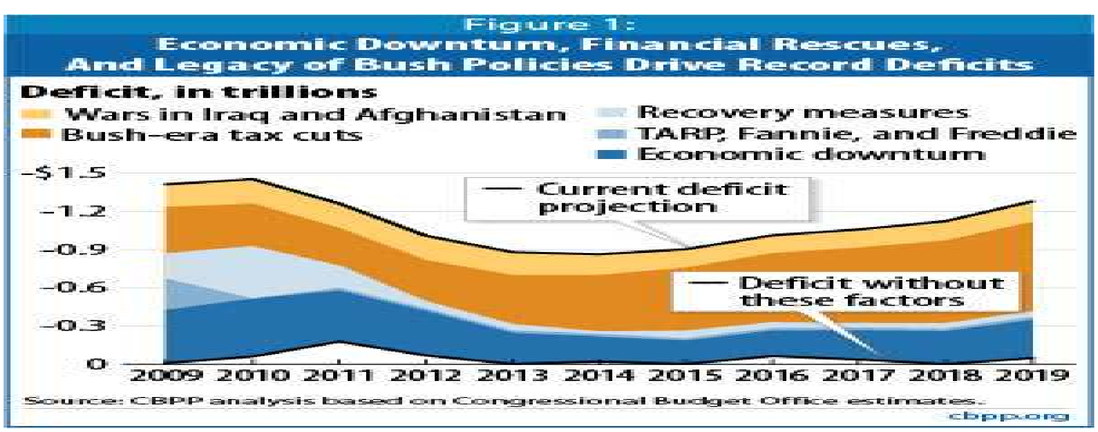
Sure, Europe is having some problems, but that counts for very little here—just 15 percent of our exports. And it is being compensated by increased exports to Asia and South America—which is why both our manufacturing and service sectors are surging.

Yet even Nobel economist Paul Krugman is pessimistic, as the G20 summit meeting announced that paying down debt was more important than continuing to stimulate growth.

"We are now, I fear, in the early stages of a third depression," he said. "It will probably look more like the Long Depression than the much more severe Great Depression. But the cost — to the world economy and, above all, to the millions of lives blighted by the absence of jobs — will nonetheless be immense.

"And this third depression will be primarily a failure of policy. Around the world — most recently at last weekend's deeply discouraging G-20 meeting — governments are obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending."

So why so much pessimism, which is affecting consumers as well? The answer is a lack of confidence—in both our markets and governmental institutions. This is mostly because of the housing and financial market meltdowns, but also the huge amount of debt amassed during the past decade, which will probably take decades to pay down. The federal deficit is just one such. Deficits could be paid down sooner, of course, if governments were to continue with their stimulus policies, since the main shortfall is the revenue shortfall due to the recession. And emphasizing deficit reduction reduces economic growth, hence revenues.



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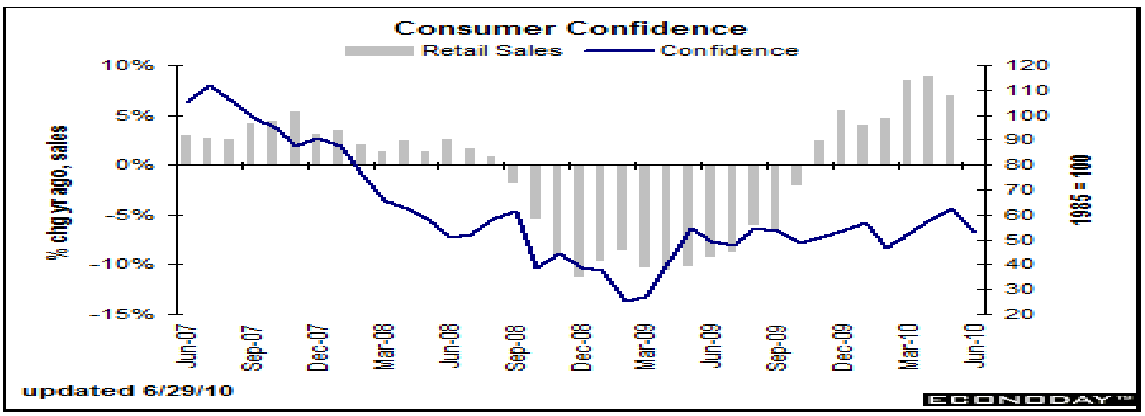
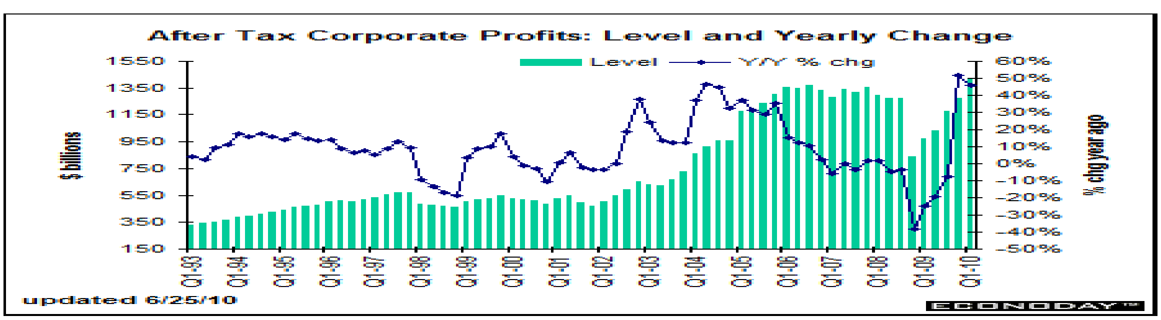
The deficit for fiscal year 2009 was $1.4 trillion and, at nearly 10 percent of Gross Domestic Product (GDP), was the largest deficit relative to the size of the economy since the end of World War II. If current policies are continued without changes, deficits will likely approach those figures in 2010 and remain near $1 trillion a year for the next decade. Most of the deficit was revenues lost from the Bush-era tax cuts, according to the Center for Budget and Policy Priorities (CBPP). Next, were monies borrowed to pay for the wars on terror, while some 25 percent of the deficit is revenue losses from the Great Recession.

This is probably why the Conference Board's consumer confidence report was a major disappointment, falling dramatically and showing regional weakness tied no doubt to the Gulf spill. The consumer confidence index fell to 52.9, in a nearly 10 point decline the size of which usually corresponds with an economic shock. The decline was led by severe weakness in the East South Central (37.7 June vs. 56.0 May) and the South Atlantic (49.1 vs. 62.8). But other regions are weak too including significant drops in the Mid-Atlantic and Pacific regions.



Yet corporate profits are soaring. Corporate profits in the first quarter advanced to a revised annualized $1.424 trillion from the initial estimate of $1.393 trillion. The Fed's latest Flow of Funds report that corporate profit margins rocketed to 36 percent in the first quarter. Since records began in 1947 they have never been this high. The highest under Ronald Reagan was 30 percent. Profits in the fourth quarter were up an annualized 58.0 percent, following a 37.0 percent jump the prior quarter.



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But will the good news sink in, and so outweigh the pessimism of the consumers feeling so underwater with their debt load? The reason for such soaring profits is companies are not hiring new workers, but getting more out of their existing work force. So, only if businesses begin to create jobs in substantial numbers will the general pessimism be lifted. When will that happen? That is the question.