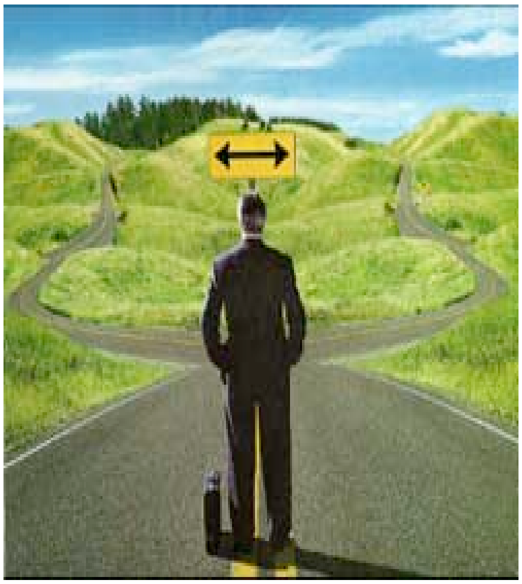
Planning For A Period Of Uncertainty

Why This Recession Is Unfortunately Going To Continue For Some Time Yet

by Patrick J. McKenna



If you've had a chance to take your family for a drive this summer, you may have heard that familiar question: "Are we there yet?" And who amongst us isn't thinking the same thing as we travel down the recession highway looking for road signs that point towards the promised recovery.

This prolonged economic slump is forcing many firms to explore an entirely new playbook for how they are going to deal with 2010. The proper role of any firm leader, in my view, is to have the courage to interrogate reality and the capacity to help your partners do the same – as unpleasant or difficult as that reality may be to face.

One year ago I authored a white paper intended to help managing partners interrogate the reality of the day entitled: *Managing Through A Prolonged Downturn*. In that paper I publicly submitted that *for the next five years, every time you think it's safe to get up and dust yourself off from this downturn, every time you feel like you've endured the worst of it, another piece of news is going to come along to freshly bludgeon you. This time the economic slowdown is going to be a lot different and, in many ways, a hell of a lot tougher*.

Today, political pundits and the media are both claiming, "the recession has ended." So who am I to suggest that they are wrong? But I am going to!

This 'recession' is already the second longest since the first leg down of the Great Depression. That downturn of the early '1930s went on for 43 months. This one is now exceeding 20 months - officially - which makes it longer than any other since the Great Depression. Will it continue? Should you and your firm be planning for a recovery?

In spite of what all of the media reports might claim, this economy is not yet in recovery mode. The best news that the media can present is that the rate of contraction is slowing. There are some other nagging doubts. The latest figures show foreclosures still increasing - up 7% in July 2009 from the year before. And house prices are still going down . . . while unemployment is still going up. And consumer prices are falling, indicating a Japan-like deflation. Business profits are falling. Consumers are continuing to cut back. But except for that - housing, jobs, sales, profits and deflation - everything is looking buoyant!

In this update I intend to revisit a few of the reasons why I predicted that this would be a five-year downturn and explore where things are at today. I will attempt to explain why I think this recession is going to continue and why we are now in a state of uncertainty with respect to when growth may continue. Let's look at just a few of the foremost contributors:

1. UNEMPLOYMENT

First, guess with me, how many jobs the US private sector has added over the last 10 years? Answer: Almost none. Private sector employment is back to levels of 1999. There are more jobs in restaurants and health care, but far fewer in manufacturing. Our total net gain: zilch!

Unfortunately, we are seeing the worst unemployment rate since 1982. Tens of millions of workers have no memory of that era. They have borrowed and spent on the assumption that nothing like this could happen to them. But it has.

The new psychology is one of caution and uncertainty. Even professionals who are older and in more senior positions know that their firms are facing severe pressures. Entire industries aimed at the consumer, especially those tied to housing and finance, are in a crisis worse than any seen since the end of World War II.

The bottom line is this – if Americans do not return to work, THERE IS NO RECOVERY. Memorize this. Post it on your refrigerator, your mirror, your desk, your firm's strategic plans - wherever! But let's get to some hard statistics.

Unemployment has been estimated by many good economists as being around 20%. Unfortunately for these people, their-government lifeboats are slowly running out of air. Those 3 million people who lost their jobs in the second half of last year? Once you factor in their dependants, that equals 10 million people who have no income and no savings. And how about the other 4 million others who lost their jobs in the first half of this year? They will be next. The numbers get so depressing, I hate to even count them up.

So maybe you're asking yourself, "Aren't the unemployment numbers getting better?"

As usual, however, the headline jobless numbers, and the recent surprising drop in the U. S. unemployment rate, presents a sugar-coated version of reality. Beneath the surface, the picture is extraordinarily sour. Since some 400,000 job seekers stopped actively looking for work in July 2009, they effectively disappeared off the government radar screen, not unlike the so-called zombie banks that keep imploding all over the U. S. And like magic, the unemployment rate fell.

According to Seeking Alpha, 13 million Americans will lose their benefits by the end of December. This is the cutting edge of a huge new trend - people not only unemployed, but out of unemployment benefits. Sadly, there are 30 million people in the United States now on food stamps. There are only 200 million working-age Americans (age 15-64). Is there any wonder why the Administration is saying they will have to raise taxes on the middle class to fund their programs?

Now remember, unemployed people don't spend money. They don't buy technologies, or durables, or even pay their mortgage. They don't support the companies that you hope will need your legal services. Meanwhile, bankruptcies are up 600% in this recent downturn. And that includes the time after Congress affected new rules to make bankruptcy harder.

Then there is the underemployment factor. This is getting some attention, but not enough. Businesses have cut workers' hours. They don't want to lose workers, since there are costs of firing, such as an increase in the firms' state unemployment insurance rate. There might even be a lawsuit for discrimination. Then there are re-hiring issues. It takes time to screen applicants. It takes time to re-train new workers. It is better to keep old workers, but cut their hours. This is being done on a massive scale. The numbers are grim. An estimate by Federal Reserve Bank of Cleveland is this: the number of total involuntary part-time workers has increased by five million,

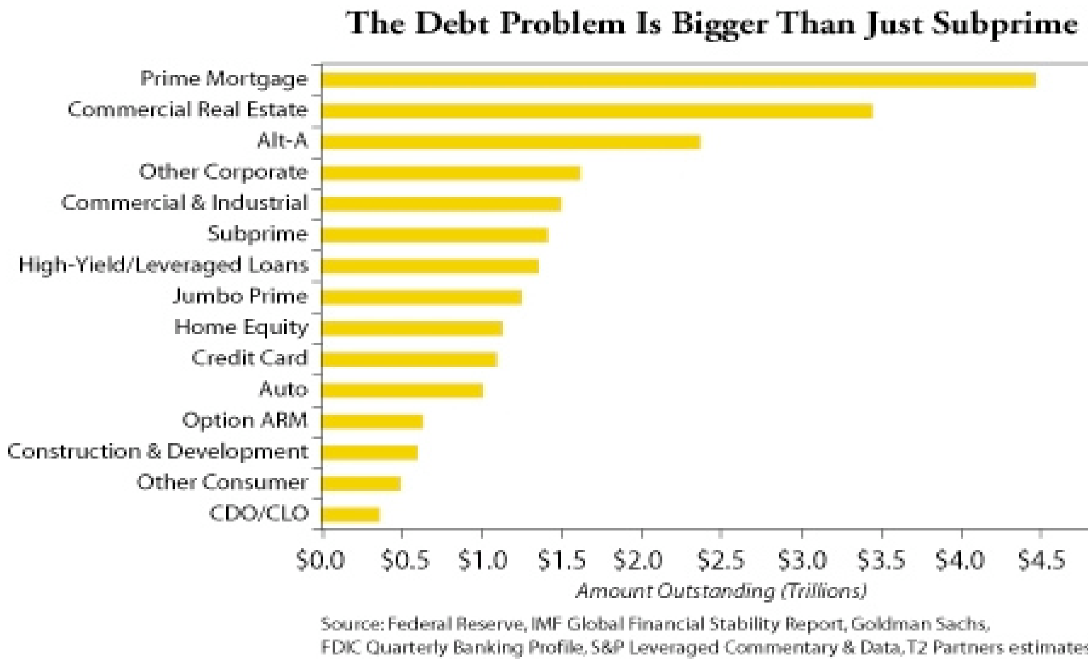
Then the Federal Reserve made a shocking prediction. It forecasted that the U.S. economy would add NO NET NEW JOBS over the next five years! Whoa! No net new jobs? That ought to scare you. The Census Bureau predicts that the U.S population will grow over five years. But the numbers of new jobs will remain static. That is, for every job gain there will be a loss.

This job-stagnation is a recipe for all sorts of bad things at the local, state and national levels. Government budgets won't balance. And, just look at what is happening in state and local governments. Downscaling government means fewer state-level jobs. Fewer people drawing salaries from the government means more people looking for work elsewhere. But they will not find it in the blown-up industries and zombie companies of 2009. They will have to wait...and wait...and wait...

2. HOUSING

It is hard to imagine any economic recovery when we have mountains of debt to work through. The mortgage bubble infected a number of areas beyond just subprime. The subprime crisis was the first to drop, like a marathon dancer that falls to the floor exhausted. But there are still other dancers on the floor ready to topple over too.

Take a look at this chart, which has gained some currency in the worried circles of financial people. It's worth a bit of study. It shows you the other dancers on the floor.



Subprime sits at the bottom. Alt-A is the next riskiest slice of mortgages above subprime. Alt-A are mortgages to people who are better credit risks than subprime, but still not prime. Documentation is still spotty as far as verifying income, and loan to values are high. Plus, about a quarter of these mortgages went to non-owner-occupied homes - which were subject to even greater speculation.

The scary thing is that this mortgage market is 50-100% bigger than subprime. Unlike subprime, Alt-A loans typically have five-year resets - meaning, the interest rates adjust to higher rates. The Alt-A reset surge doesn't really get started until 2010! It continues through 2012.

You'll also see something called "option ARMs" on that chart. These loans usually have ultra-low teaser rates and often were interest only. Again, the reset surge for these loans only starts in 2010.

You'll also see something called "jumbo prime." These are big loans - on average about $750,000. These were common in the most inflated bubble states, such as California and Florida, and were often made to poor credit risks. This is a market of $1-1.5 trillion - about as big as subprime.

Then there are home equity lines, which you'll see just below jumbo prime. These loans are second loans, behind all the garbage I mentioned above. That means that many home equity loans will be a total loss for the lenders, as housing prices have collapsed and can't support the junk loans in first position, much less junior liens like home equity lines.

I won't go into all of these loan categories, but I think you get the picture. Just consider this: it is now estimated that half of all Americans who have mortgages will be underwater in 2011.

The post-2001 recovery was driven by the FED's monetary policies. These policies stimulated growth by lowering mortgage rates and creating the housing bubble. That bubble is now long gone. As housing continues to decline as a result of Alt-A and option ARM mortgage re-sets, the economy will need to find another source of expansion.

3. BANKING

As we all know, the Federal Deposit Insurance Corporation (FDIC) guarantees depositors that they'll get their money back if a bank fails, at least up to a certain amount. To fund its operations, the FDIC collects small fees from the banks that are held in reserve for the purpose of taking over troubled banks and paying off depositors. Over 6,000 small banks went bankrupt from 1930-33. The FDIC was created in 1934 to prevent that kind of bank run. Its presence calmed depositors, who knew that a government-chartered institution insured their accounts. Since the Great Depression, a period marked by widespread runs on banks, the FDIC has done a good job of fulfilling its mandate. So how are they doing in this crisis?

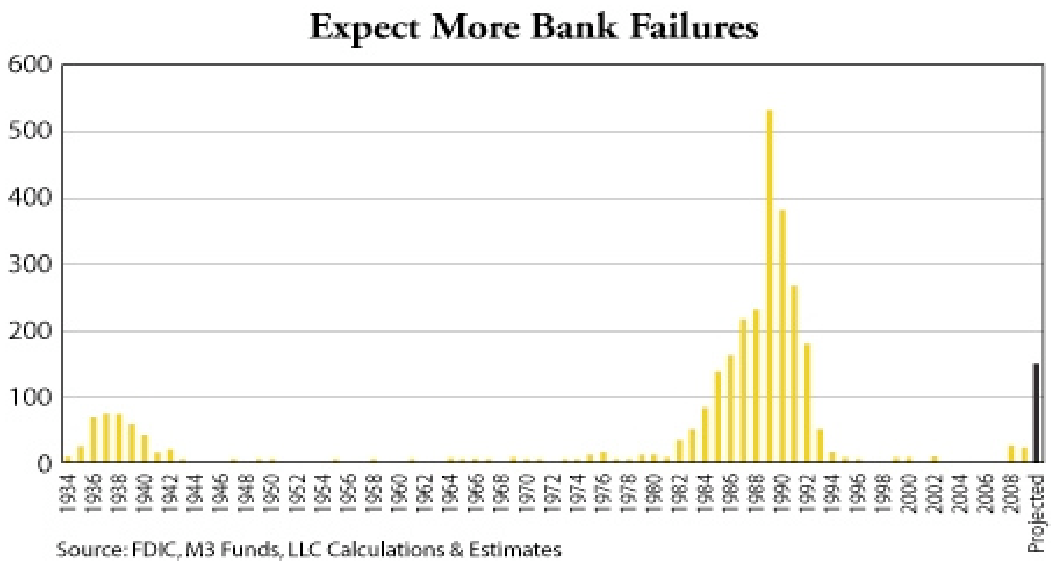
In a nutshell, they are in trouble.

According to a letter, posted on the FDIC's website, from an unidentified banker in Alabama:

> *If the public were to understand that the FDIC's deposit insurance fund was at or near the point of depletion, there would be a massive run on every bank in the country and the any remaining stability in the financial industry would be gone. This would likely result in the government having to take over more of these failed institutions and eventually having to guarantee all deposits thus resulting in a nationalized banking system, which I 100% opposed.*

As of mid-August, a disturbing 77 banks had gone belly up this year - the most since 1992 - costing the FDIC some $13 billion. Into the battle against bank insolvency the Fed brings a level of reserves that can best be described as paper-thin. From almost $60 billion last fall, the FDIC's reserves have been drawn down to only about $13 billion today, a 16-year low. It is hard to draw any other conclusion but that hundreds of billions in new funding will be required to keep the FDIC and many, many troubled banks operating.

Meanwhile, the FDIC has a list of over 300 troubled banks and thrifts (this is probably a low-ball estimate by the FDIC). The list doesn't include the biggest banks that are considered too big to fail, as they are being separately supported with bailouts.



The FDIC has an incentive to delay the announcement of another bank failure. If the bank can somehow dig its way out of its crisis, the FDIC conserves its reserves. The FDIC is delaying the announcement of its takeover of three regional banks whose liabilities could deplete the FDIC's reserves. Two of these banks have reported negative Tier-1 Ratios. This means that they have a negative ratio of assets vs. liabilities. They are legally bankrupt. The third bank needs a $500 million infusion of private capital, plus another $500 million from the Federal government. If this bank goes under, it will be the sixth largest bank failure, by assets, in U.S. history.

The FDIC has not closed any of the three banks. I am told that by law, it must take Protective Corrective Action. It hasn't. These three banks are regional banks, not small local banks whose losses the FDIC can afford to absorb without much publicity on a Friday afternoon.

The banks are allowed to carry these dead and dying assets on their books at par value. Under the law they should have seized these three banks (and many dozens more, including some really big ones) some time ago, but doing so will force them to tap the Treasury "emergency" credit line. They're well-aware that this could instill quite a bit of panic in the public (never mind Congress!); as such they, along with OTS and OCC are conspiring to (once again) hide the truth and pray for an economic recovery before they are forced to act as the law demanded months or even years ago!

Why did the banks' accountants not reveal these problems sooner? According to one knowledgeable source:

> *An enormous number of banks are holding loans at or close to "par" that really aren't. They're holding mortgages at massively-inflated values, even on defaulted properties, and this is why you are not seeing more foreclosure sales - that is, why inventory is being held back. If they sell it the accountants will force recognition of the loss, which will render them instantly insolvent, but so long as they "extend and pretend" they are marking these loans way, way above recovery value. The upshot*

of this is that these firms' balance sheet claims on asset values are massively inflated, regulators know it, and they're intentionally ignoring it.

If this is true, then the continuing crisis in housing will pressure the banks even more. The suggestion that the crisis is over ignores the looming losses from defaults on re-sets of Alt-A mortgages and Option ARM mortgages. Over he next two years, they will rival the losses inflicted on lenders by subprime mortgages.

When banks refuse to sell empty foreclosed houses, the houses deteriorate. The bankers delay and pray, hoping the housing market will turn back up. They don't want to list these properties as losses. They are allowed to delay such a listing until the properties are sold. Empty houses deteriorate fast: weather, squatters, and vandals. This is why private property insurance firms revoke property damage insurance after 30 days of vacancy. These capital losses are mounting, thereby lowering the value of the loans' collateral. These are hidden losses. The lenders' books do not record these losses. The longer banks delay sales of foreclosed houses, the greater the capital losses for these banks. The longer the FDIC refuses to close these banks and get these properties sold, the larger the losses the FDIC will suffer when it finally closes the banks. The longer these empty houses are not sold, the longer this sword of Damocles hangs over the residential real estate market. This all delays any possible recovery.

Meanwhile, banks are not lending. They are keeping money with the FED as excess reserves. The bankers know that the next wave of residential real estate loan re-sets will hit next year. Commercial real estate is also going to fall. Vacancy rates are up. No one expects a near-term reversal.

This then, answers the great fundamental question that seems to baffle so many market commentators. Why aren't the banks lending? People point to the trillions of dollars the government pumped into the economy, including on bank balance sheets. The answer is that the bankers know they will need the money to cover losses from their toxic loan portfolios. The banks are clearly not lending. Banks are cutting lines of credit to consumers - and to businesses, too. New loans in various business categories are down 60-80% from where they were a year ago. It is hard to imagine any economic recovery when the banking system has such gaping holes it needs to fill.

CONCLUSION

Bankers see what is coming: more defaults, more real estate declines, more foreclosures, and more write-downs. They remain in paralysis mode.

The economy is still on its back. Moody's senior economist testified before the Senate Finance Committee in late July that the financial system's $1.2 trillion in losses so far will be followed by $1.4 trillion. He said that almost 1,000 banks are at risk of failing. No one noticed.

My friend, Jack Butler, the global co-leader of Skadden’s corporate restructuring group told practice leaders during a session that we co-facilitated in mid-August, that his analysis clearly shows that 2010 will be an even more difficult year financially for law firms.

There's a report that New York commercial properties are running up towards a 23% vacancy rate. Shoppers are not shopping. Businesses are not going to hire new workers when things turn up. They are going to add hours to the workers who are still on the payroll.

And while American industry is struggling, according to an in-depth survey of more than 5,000 people conducted by Alix Partners, Americans say that even after the recession ends, their spending will return to just 86% of pre-recession levels – which would take one trillion dollars per year out of the U.S. economy for years to come.

A recovery without increased spending? There will be demands for another stimulus. A jobless recovery? It's not possible.

We now live in a pink slip nation. We now live in uncertain times. You might want to consider all of this in your firm 's strategic planning as this just may continue for some years to come.

This article was written on August 20, 2009 and the author gratefully acknowledges the work of Bonner and North, economists extraordinaire, in helping inform and shape my understanding of today's economic challenges.