

# The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client:

Washington, Nov. 14, 2008

When Barack Obama takes office Jan. 20...  
He'll face the worst economy in decades...  
With no hope of a quick or easy recovery.

## THE ECONOMY

First quarter 2009 GDP will likely drop 2%, following a 4% dive in 2008's final quarter. That'll be the biggest contraction since Reagan's start, when the U.S. weathered eye-popping drops of 4.9% at the end of 1981 and 6.4% at the beginning of 1982. Back then, joblessness and inflation were far higher, but credit markets weren't iced up as they are now, and most consumers were carrying a lot less debt.

Expect 2 million jobs to disappear in 2009. And that doesn't include the additional job losses that will result if one of Detroit's auto firms folds. Unemployment will top 8% by Dec. 2009.

This recession is more serious than most. Typically, they get ugly fast and then end... through surges in home building and manufacturing. The Federal Reserve cuts rates and jobs are created. Soon consumers start spending, and recovery begins.

Not this time. There aren't any quick fixes. Obama's team is eyeing a massive stimulus, perhaps \$500 billion or more. It will include permanent middle-class tax cuts, an extension of jobless benefits, additional funds for food stamps and aid to states for Medicaid as more workers lose insurance benefits along with their full-time jobs.

Infrastructure spending will spark a big fight. Obama wants much more, including investments in alternative energy. Republicans say it will take too long to help the economy. But many Democrats say the recession will still be under way when the money kicks in, and the jobs will be needed to sustain a healthy recovery.

Another battle: The deficit, which is spiraling out of control. Next year, it will exceed \$1 trillion, or 7% of GDP. That will top the modern high of 6% in 1983 but is still well shy of the record 30% set in 1943 at the height of World War II. And the national debt has nearly doubled in eight years...to more than \$10 trillion. Fiscal hawks say Congress can't help everyone who needs it. But many economists are telling Obama to boost the economy first and worry about the deficit later.

One bright note: Obama can count on help from the Fed's unused firepower. The federal funds rate is headed down to 0.5% by early 2009, and the Fed's other tools will be used to keep pumping liquidity into the banking system to get lenders lending. Another important help to the economy will come from relatively low oil and gas prices. The difference between crude oil at \$147 a barrel in July and \$60 a barrel in November is like adding a percentage point to GDP for the year. If oil hovers near \$80 a barrel in 2009, it'll blunt the recession's severity considerably...a lucky break for everyone.

## ECONOMIC FORECASTS

↓	<b>GDP growth</b>	
		Zero growth in '09
↔	<b>Interest rates</b>	<b>NEW</b>
		Prime at 3.5% by early '09, 10-year T-notes yielding 4.25%
↓	<b>Inflation</b>	
		Declining in coming months
↑	<b>Unemployment</b>	
		Rising to 8% in '09
↓	<b>Crude oil</b>	
		Averaging \$80/barrel in '09
↑	<b>Housing sales</b>	
		A small pickup during '09
↓	<b>Retail sales growth</b>	
		Struggling to stay positive in '09
↓	<b>Trade deficit</b>	<b>NEW</b>
		\$458 billion, 3.3% of GDP in '09

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**GLOBAL  
OUTLOOK**

China's \$568-billion stimulus is a big deal...but not big enough.  
Only \$150 billion of it is new money, and it'll be spread over two years. Most of the rest was set aside earlier for infrastructure and earthquake repairs.  
The stimulus will help, but China needs to spend far more, much faster to keep GDP growth in 2009 from slipping below 8%, the minimum necessary to create jobs for those entering the workforce. A significant increase in jobless rates drives up the risk of unrest, threatening political stability and the ruling regime.  
U.S. firms will see limited benefits from the new spending China does offer. Beijing will steer much of it to Chinese-owned firms, though some business will go to U.S. heavy equipment makers and health care and engineering services firms.

Emerging markets may be next to bear the brunt of the financial crisis. Many banks and firms borrowed heavily in recent years, gobbling up lower rates from more developed nations. Now, with credit scarce, banks are calling in loans.  
The larger and more responsibly managed economies will have a cushion. The Fed will provide Brazil, South Korea, Mexico and Singapore with currency swaps worth about \$120 billion. The International Monetary Fund will offer easy loans.  
But it may not be sufficient. The IMF has a \$250-billion reserve fund, but the amount needed to stem the emerging markets crisis could total \$1 trillion.  
The top risk: Eastern Europe, which would drag down the euro zone, too. German, Austrian and Swiss banks are heavily exposed, and the east is a top market for euro zone exports. Plus the worse the euro zone gets, the more U.S. firms suffer.

**TRANSIT  
& TRAVEL**

From Wall St. to Main St. to *under* Main St., the credit crisis is spreading.  
More than 30 mass transit systems are at risk of defaulting on \$16 billion in loans. Metropolitan areas in Calif., Colo., Ill., Mass., N.J., N.Y., Ohio, Ore., Pa. and Washington, D.C., were all left in technical default by the recent meltdown at American International Group (AIG), which backed loans to finance plans to buy and lease railcars, buses and other equipment. Antsy banks want their money back.  
Many systems are in court or working with states to guarantee financing. But as a contingency, they're also making plans to slash service and boost fares.  
A resolution may come too late to prevent disruptions for commuters.

A double whammy for tourism: Fewer Americans traveling next year.  
Plus a cutback in overseas visitors. A 3% decline is likely next year as the economic slowdown hits worldwide. The strengthening of the dollar also hurts, making it less of a bargain to come to the U.S. and shop with foreign currencies. For the past two years, foreigners have helped keep the tourist industry afloat, with near double-digit annual increases in the number of tourists coming ashore.

**BUSINESS  
COSTS**

The cost of banking will skyrocket next year for consumers and small firms that rely on credit cards to help finance their operations. Fees will rise on everything from checking accounts to wealth management as banks struggle to make up for lost investment revenue and higher federal deposit insurance fees.  
Overdraft and credit card fees will climb 5% next year, double the increase in 2008. Late fees for credit payments will soar, and ATM fees may climb 20%.

But expect a break on commercial insurance rates. They'll keep declining, though at less than the double-digit fall of this year. Expect a 6% drop on average.  
There will be some exceptions. Look for modest increases in rates in directors' and officers' liability insurance...a result of more shareholder lawsuits. And inflation will hike rates in 2009 on autos and homes by 2% and 5%, respectively.

Also rising next year: Premiums to the Pension Benefit Guaranty Corp. They'll go up \$1, to \$34 per participant. They are now indexed to inflation.



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Who will have Obama's ear when he takes over the Oval Office?

It won't just be his official staff, congressional leaders and the Cabinet.

Obama likes to listen to a wide range of advice before making big decisions, and many of those he'll consult will stay out of sight, helping only when asked. They'll include Robert Rubin, Tom Daschle, Colin Powell and some less known:

Sen. Dick Durbin (D-IL) has been a friend and Senate mentor to Obama. He was also one of the first to urge him to run for president. As majority whip, Durbin is well placed to give advice on any legislation Obama wants to pass.

Valerie Jarrett, a close family friend from Chicago, may get a high post in the White House, perhaps as chief of urban affairs, her area of expertise. But she'll also be an adviser at large, with unparalleled access to Obama.

Austan Goolsbee and Paul Krugman, of the University of Chicago and Princeton, respectively, will get Obama's attention on economics. Goolsbee helped shape Obama's proposals for middle-class tax cuts and health care. Krugman, who's also a *New York Times* columnist, wants a big stimulus plan.

John Rogers, a Chicago mutual fund manager, is another close friend and an informal adviser on finance, urban renewal and federal-state relations.

Sen. Richard Lugar (R-IN) worked with Obama on foreign affairs issues. Lugar could be invaluable as a liaison and advocate with Senate Republicans.

Tony Lake, national security adviser to Bill Clinton, will also be on call.

John Doerr, a Silicon Valley technology investment whiz, will be on hand when Obama wants advice on green technology and other high-tech research.

Charles Ogletree and Laurence Tribe, both Harvard law professors, will help with constitutional issues, including intelligence gathering boundaries, habeas corpus, prisoners at Guantánamo Bay and limits on executive power.

Jan. 20 won't be all parades and inaugural balls for Obama and his aides.

The new president will move within hours to mark a change in direction, issuing executive orders to reverse several of President Bush's controversial policies. Congress may weigh in soon after with passage of bills blocked by Bush's vetoes.

Expect these 10 quick moves: Debt rescue package. New regulations or guidelines are likely to make bank mergers easier, to limit golden parachutes for executives of firms taking government help and to define exactly which industries are eligible for bailouts. Also possible...a temporary easing of pension funding rules.

Mortgages. Obama's team is working on additional steps he can take to help struggling homeowners, with further moves by Congress likely, if needed.

Financial regulations. He'll create an advisory board to supervise efforts by all agencies to review and overhaul the nation's financial regulatory structure.

Emissions. Obama will reverse the Environmental Protection Agency's move to stop Calif. from cutting carbon dioxide emissions from cars by 30% in seven years.

Oil and gas drilling. He'll block leases on 360,000 acres of land in Utah.

Stem cells. He'll undo the ban on funding for embryonic stem cell research.

Family planning. Look for a quick end to the so-called global gag rule, which bans funds for groups that provide counseling on or perform abortions.

National energy council. The administration will set up a supervisory panel to coordinate all policymaking related to energy independence and climate change.

Children's health. Congress will act quickly to expand health insurance for kids, a program run by the states. Bush vetoed a move to do so earlier this year.

Guantánamo Bay. Obama will announce plans to close the prison as soon as possible, though it will take many months to determine the fate of the prisoners.



**ENERGY**

A U.S. natural gas boom? Better believe it, and it'll begin in just a year.  
Look for rapid development of monumental-size natural gas deposits  
trapped in mile-deep shale formations that zigzag beneath N.Y., Pa., Ohio and W.Va.  
The Marcellus Play contains as much as 1000 trillion cubic feet of gas.  
If there is that much and it can all be mined, it will meet U.S. needs for 40 years,  
at current usage. New drilling techniques make it more feasible and profitable.  
Among the firms involved: MarkWest Energy Resources and Atlas Energy Partners.  
That should slow the rise in prices. They've soared 400% since 2000.  
But relief may be tempered. Demand for gas will grow sharply  
when Congress imposes emission limits on carbon dioxide, a greenhouse gas  
linked to global warming. That will mean a greater reliance on gas-powered plants.

**CLIMATE  
CHANGE**

A cap and trade bill for greenhouse gases is coming, by 2010 at the latest.  
Many Republicans will object to putting new burdens on the economy  
during a recession. Such a bill would require utilities to spend billions of dollars  
for new equipment, driving up electricity bills for consumers and businesses.  
But supporters will argue that new regulations will provide a needed boost  
by forcing companies to invest in infrastructure, creating thousands of new jobs.  
That jibes with Obama's promise to spend \$15 billion on alternative energy in 2009.  
And the alternative would be an expensive patchwork of state programs.  
Other states will follow California in regulating emissions once Obama lifts Bush's ban,  
unless Washington takes the lead. For many, a federal rule would be the lesser evil.

**BUSINESS  
TECH**

Microsoft's Windows 7 software will work more smoothly than Vista,  
the operating system introduced last year. Many firms won't buy software  
or upgrade computers until Windows 7 is issued in late 2009 or early 2010.  
Among improvements: Windows 7 boots up faster, uses less power  
so batteries run longer, automatically finds a nearby printer for your laptop,  
has less intrusive security alerts and allows simpler remote access to networks.

Is a workaholic on your gift list? Consider cell phones that work when wet.  
You'll have to wait about two years, however. Waterproof phones already exist,  
but they lack the bells and whistles that many users want. Demand from teenagers  
who want to text friends from tubs, beaches or while out in the rain is the driver.  
Four out of five teenagers carry phones, and their buying power tops \$100 billion.  
Waterproofing clear-coat technology developed by the Northeast Maritime Institute  
adds \$75 to the cost, but that will come down as production increases.

The new phones will also be a lot sturdier than today's products.

**MIDDLE  
EAST**

Don't expect Obama to achieve a breakthrough in Mideast peace talks soon.  
He'll earn goodwill from both sides for his willingness to get involved faster  
than Bush. But no peace agreement between Israel and the Palestinians will stick  
as long as Hamas and the Fatah-led Palestinian Authority are at each other's throats.  
And if Israel chooses Benjamin Netanyahu to replace Ehud Olmert as prime minister,  
the Likud Party leader is likely to take a hard line against any major concessions.

Yours very truly,



THE KIPLINGER WASHINGTON EDITORS

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P.S. Looking for tips on how to better manage your off-site employees?  
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