

The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client:

Washington, April 3, 2009

Within a year: Tough new financial regs as Congress and the White House work together to reform securities laws. Until the meltdown, policymakers assumed markets would self-correct. Now they know better, and the G-20 summit pact gives them another reason to get going quickly.

FINANCIAL MARKETS Washington can't prevent future bubbles. But it's determined to be more vigilant.

A lot more transparency is a given. It'll help regulators keep watch and use sunlight... a powerful disinfectant...to clean up bad practices and remove bad players from the financial markets.

But no old-fashioned rate setting regs or barring commercial banks from selling stocks.

Here's what we see coming in months ahead. On derivatives...requiring even more trading on exchanges of currency and interest rate hedges, as well as standardization of more exotic contracts, such as default swaps and securitized debt obligations. And when standardization isn't possible... much more collateral and more contract disclosure.

For pension funds...limits on the kinds of high risk investments they make. On hedge funds and private equity players...required SEC registration of larger entities and disclosure of strategies, making it easier for the feds to detect big movements and potential trouble spots developing on Wall Street. For insurers...offering federal charters, despite resistance from states. For all financial players...higher capital and liquidity standards. Firms will have to hold more securitized assets so they have skin in the game.

For Uncle Sam's watchdogs...some new powers and merging of old rivals, such as the Office of the Comptroller of the Currency and Office of Thrift Supervision. To manage system risks...and prevent AIG-like debacles...Fed and FDIC regulation over financial moves, regardless of a firm's core business. Plus more collaboration between the SEC and the Commodity Futures Trading Comm., though no merger.

On credit rating agencies...much more open decisionmaking processes. But they'll still get their payment from the firms whose debt they are rating. And on executive compensation...no caps, but clearer reporting to the SEC of pay at financial companies. Plus closer scrutiny of directors' compensation.

Together, the changes will bring more market stability...but at a steep price: Costlier lending, with some high risk borrowers cut out, even after recovery. Added operating costs for financial firms to meet paperwork requirements. A bigger bill for taxpayers...paying more regulators to track more activities. And less profit potential, consonant with fewer risks and less leverage.

ECONOMIC FORECASTS

↓	GDP growth -2% in '09, contraction
↓	Interest rates Prime at 3.25% in '09, 10-year T-notes yielding 3%
↑	Inflation Rising for a couple of months
↑	Unemployment NEW Increasing to 9.5% in '09
↑	Crude oil About \$57/barrel by late spring
↓	Housing sales Declining until second half of '09
↓	Retail sales growth A drop of over 1% in '09
↓	Trade deficit \$450 billion, 3.2% of GDP in '09
Complete economic outlook at kiplingerbiz.com/outlooks	

THE ECONOMY

The economy may no longer be in free fall, and a bottom could be in sight. Manufacturing, retail sales and housing are showing slight improvement. The stimulus will bring more gains this summer, but the job market is still suffering. In March, the average workweek fell to 33.2 hours, the lowest since the government began tracking the number in '64. The likely cause was a sharp increase in furloughs. It will take until 2011 or so before job creation really begins to perk up.

And that spells a quickly deteriorating market for office real estate.

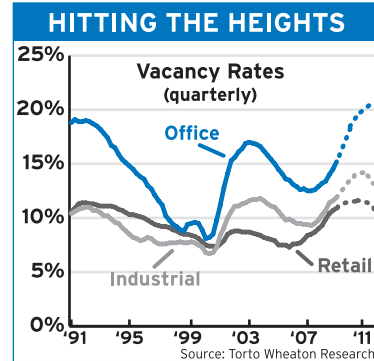
Vacancy rates are headed up sharply...

in Sacramento and Calif.'s Inland Empire, Tampa, Miami, Jacksonville, Fla., Phoenix and Las Vegas. In places like Salt Lake City, Austin, Texas, and San Jose, Calif., overbuilding is also hurting. In Denver and Houston, declines in energy prices add to the pain. And, of course, the auto industry's woes are plaguing Midwest cities.

Little help from federal efforts to thaw credit by lending to banks and others, using commercial debt as collateral. The problem: The Federal Reserve wants to take only top rated debt to protect taxpayers' interests. But it's lower rated debt that's the clog in the pipeline.

Meanwhile, it's very tricky to put a value on many office properties.

In the middle of recession, it's hard to figure out where rents, vacancies and demand will be next year. Fear of being stung means that few want to buy...or lend.

**ENERGY**

When new comprehensive energy legislation earns approval by Congress...

Utilities will have to slow growth in electricity use, offering programs that put the brakes on before they can get an OK for new plants or transmission lines.

To do so, they'll offer sweet deals to both businesses and homeowners:

Juicy rebates on the purchase of new, super-energy-efficient household appliances, industrial boilers, heating and AC systems and so on, replacing old energy gulpers.

Lawmakers aim to be fast out of the blocks. They'll craft legislation in the House this spring, hoping to get a final version to the White House by year-end. Other key elements likely to be included: A requirement that 25% of electricity come from renewable sources by 2025. Mandated efficiency standards for appliances, motor vehicles and commercial and residential buildings. And provisions to aid in the development of a smart power grid, curtailing growth in electricity usage.

To cross the finish line this year, Congress will jettison carbon cap proposals. Democrats won't risk a prolonged fight over curbs on greenhouse gas emissions.

When they reappear, the caps will be tied to protections against imports from countries that don't cut emissions. U.S. industries forced to shoulder high costs to meet their obligations can initially count on rebates from Uncle Sam. Eventually, they will be phased out as other countries adopt similar environmental restrictions.

Policymakers will insist on the right to impose tariffs if rivals veer off course.

TRADE

The dollar will stay strong through 2009, after near term turbulence.

Most major central banks are chasing the Fed in cutting interest rates. With little difference in rates, and weak consumption staving off inflation, investors will continue to view the greenback as the safest haven available.

Look for it to hit multiyear highs against the euro, U.K. pound and yen over the next two quarters, as their home economies continue to perform worse than that of the U.S. Emerging market currencies will take a particular beating as exports there tank. China's yuan, still heavily managed, will be the exception. On a trade weighted basis, the dollar is now up 15% from its nadir a year ago.

**AUTO
INDUSTRY**

It's not your father's Fiat that will roll into Chrysler dealerships this fall or early next year...the result of an arranged marriage between Chrysler and the Italian automaker. The fuel efficient MiTo, Bravo and Cinquecento are far from the breakdown prone cars that turned off U.S. buyers in the '60s and '70s.

The two car companies aren't as odd a couple as some might think. Fiat covets the Chrysler 300's rear-wheel-drive platform for a new Alfa Romeo and figures it could mop up the European market selling crossover SUVs that use the guts of the new Jeep Grand Cherokee. And Chrysler has no choice in the matter...it's wed the Italian as the White House wants or give up the ghost.
Look for the two to march down the aisle by the end of April.

**AIRLINE
INDUSTRY**

Last year's drastic capacity cuts are paying off for U.S. air carriers. As a whole, they'll break even this year, possibly even make a slim profit... \$100 million or so vs. a \$4-billion red-ink bath in 2008. Much lower prices for fuel are a big help, too. In contrast, European airlines are expected to lose \$1 billion. Hardest hit of all: Asian carriers, struggling with more capacity and lower demand.

Add-on fees are also proving a boon to U.S. airlines. Making customers pay extra for checking baggage, meals, more legroom and so on will add \$2 billion to their bottom lines. US Airways alone expects to generate \$500 million from fees.

Cutbacks in flights may come back to bite the legacy carriers, though. Look for low cost airlines to fill the vacated space, moving into markets where big carriers reduced capacity. Already, AirTran is moving into Milwaukee, where Northwest trimmed its sails. The low cost carrier is adding service from there to Washington, D.C., as well as from Atlantic City, N.J., to Atlanta. In months ahead, Southwest will add Boston's Logan Airport and NYC's LaGuardia to its offerings.

When the economy picks up, competition will begin in earnest.

Increased ticket taxes are likely to partially offset lower fares.

Airport officials say they need more funds from Passenger Facility Charges to meet rising airport construction and maintenance costs. Their proposal: \$7.50 per leg, with a \$15 maximum for a one-way flight. Current fees, last raised in 2000, are \$4.50 per leg, up to a maximum of \$9 for one-way fares and \$18 per round-trip.

Lawmakers are inclined to go along but won't OK a companion request to index fees in the future, allowing them to automatically rise with inflation.

Meanwhile, the White House wants a security tax hike. Airlines say no way, arguing that added security costs should be on Uncle Sam's ticket, not passengers'.

SPACE

A new space race is on. This time, it's China that's vying to take the lead. Next year, it aims to launch a small manned space station...Tiangong 1... a test craft in advance of a much larger station to be built and launched by 2020. By the end of this year, China intends to put an unmanned probe on the moon, landing a human there in a decade. That's slightly earlier than NASA's timetable for the U.S. to return astronauts to the moon to build a permanent base.

China is also hard at work on a heavy-duty rocket with the capability of lifting massive cargo into space. Only the U.S. and Russia have such rockets now.

Beijing's push into space is raising eyebrows in the West, sparking concern about technology that has uses for the military as well as for science and research.

And it's sure to spur more funding for NASA, which has been stunted of late. The White House may also blur the line between military and civilian space programs, allowing use of Pentagon rockets to launch unmanned scientific exploration missions. It won't go unnoticed that the U.S. will be doing exactly what it fears China is.



HEALTH COSTS

Cheaper biotech drugs are coming...some in just two years or so.
Congress will give FDA authority to approve generic versions of biologics,
 high priced drugs made from living tissue. A bill will likely pass later this year.

The generic versions may cost a third less than brand-name equivalents, saving consumers and employers an estimated \$25 billion over a 10-year period.

The key sticking point is how long patents for the original drugs will run.
 The industry wants 14 years of market exclusivity, arguing that the development of a complex biologic takes 10 to 12 years and can cost as much as \$1.2 billion. A Senate bill would provide 12 years of exclusivity, while a House bill offers only five.

HUMAN RESOURCES

Employers can relax, now that card check is on hold. It may even be dead
 from the blow dealt it by GOP Sen. Arlen Specter of Pa. The former supporter now says that he opposes legislation making it easier for labor unions to organize and requiring binding arbitration if a first contract isn't reached in 90 days. That leaves the Democrats at least one vote shy of the 60 needed to cut off debate.

Compromise may still be an option, but for now, neither side will budge.
 The unions seem content to wait for another election in hope of picking up backers, but that's an iffy proposition. Obama and many Democrats are undoubtedly relieved that they won't have to push hard for an effort that has already alienated business.

Help is near for an understaffed Equal Employment Opportunity Comm.
 The EEOC has a record backlog...a result of eight years of budget and staff cuts... but the recently passed omnibus spending bill provides funds for investigators and mediators. Still, it will take a while to hire and train staff, and in the meantime, new cases are surging. Long delays in resolving complaints will remain the norm.

The lengthy complaint process is bad news for employers needing answers. One option is to consider EEOC mediation, a streamlined process for settlements.

Some employers are seeing a nasty side effect of recession: Violence.
 Current and laid off workers are increasingly turning their anger against their bosses. In France, workers at 3M, Caterpillar and Sony plants have taken execs hostage. In Britain, vandals hit the home of the Royal Bank of Scotland's former CEO. The U.S. isn't immune, and midlevel brass are at as much risk as top officers.

Firms will need to revisit security plans. Hiring corporate security guards or off duty police officers for the workplace may not be enough to head off problems. Coordinating security with HR can identify individuals liable to cause trouble. Making on-site counseling available for those downsized can reduce tension. But attacks are just as likely outside the office, so keep local police in the loop.

CONGRESS

As lawmakers rail against executive pay and perks, keep this in mind:
They rarely turn a critical eye inward. They're quick to tout reforms... curbs on gifts and favors from lobbyists, etc...but rarely mention untouched benefits: A salary of \$174,000 (more for leaders), with an annual adjustment for inflation. Generous health care plans and pensions. Government paid foreign travel. Free outpatient care at military hospitals and a fully staffed medical office in town. Plus swimming pools, gyms, free parking and even subsidized haircuts.

Yours very truly,

Knight/Kiplinger
 THE KIPLINGER WASHINGTON EDITORS

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P.S. Did you miss our audio conference on the new COBRA subsidy law? Purchase a recording by visiting www.krm.com/kiplinger or calling 800-775-7654.