

The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client:

Washington, March 27, 2009

For this massive economic rescue plan...

There's an onerous price to be paid:

A ballooning federal deficit...equal to 12.2% of the country's gross domestic product this year and a post-World War II high. Though Obama pledges to halve next year's \$1.3-trillion deficit by 2013, success is a long shot, requiring a lot to go right.

DEFICIT DAMAGE

For the next decade or so... annual deficits much below \$700 billion will be tough to come by, and some are bound to top \$1 trillion.

So...a tremendous debt to be serviced.

Uncle Sam already owes a sum that equals 41% of GDP. By 2019, the national IOU could amount to twice that percentage, as expenses for Medicare, Social Security and other programs pile up quickly with the huge bulge of baby boomers retiring.

Interest will claim much more of the budget.

Payments already account for 4.2% of federal outlays. By 2013, they'll be about 11% and headed higher.

The inevitable result: Either higher taxes...

Or less money to spend on everything else, from food safety to road building, education, health care, energy, the environment, even homeland security and defense.

For Washington policymakers...a long series of tough choices to be made.

And the ambitious White House plans for health care reform, education, energy and other initiatives may be out of reach. Obama will be forced to cut back or delay.

In any case, Uncle Sam will have to borrow much more to foot the tab.

And long-term Treasury rates will climb to attract the investors needed.

As U.S. households increase savings in a new, more austere economic climate, their 5% share of Treasuries will increase. In the 1990s, before the allure of stocks and real estate surged and bond yields fell, households held 20% of Treasuries. But even if that level were regained...and that's unlikely...it wouldn't be enough to fund the \$4.2-trillion increase in Treasury borrowing coming in the next few years.

To coax foreigners to keep lending...rates several percentage points higher.

No escape from inflation, either. All that cash the Federal Reserve is pumping into the ailing economy now will become excess as consumer spending recovers and the slack in the economy is absorbed...a shift likely to begin in early 2011.

Count on the Fed to raise short-term rates. But by the time the hikes start to constrain price increases, inflation will already be running at about 4%.

The bottom line: Obama made a painful trade-off, opting to dose the patient to head off disaster now, despite the certain misery from the side effects later.

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 Rising to 9% in '09
↑	Crude oil NEW 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

There's no doubt it'll be a lousy retail year. Overall 2009 sales...down 1%. Look for 150,000 individual stores to close and some big names to fold. With consumer confidence sinking and joblessness rising...slim odds of improvement. But not all sellers will suffer equally. Some...notably behemoth Wal-Mart, but also dollar stores and discounters...are weathering the storm better than others. Ditto, retailers such as Apple, Urban Outfitters and others offering distinctive items.

Note, too, that sliding monthly sales comparisons don't tell the whole story. Landlords, suppliers and others trying to gauge prospects of particular retailers need to consider other factors.

Some companies are betting on smaller sales... But bigger profits. Trendy Abercrombie & Fitch, for example, saw sales drop 30%, measuring Feb. 2009 over Feb. 2008. Still, slashing inventory and cutting costs are expected to increase the company's profit margins.

Cash on hand is a factor, too. It'll help firms such as JC Penney, Amazon.com and GameStop survive, withstanding the long battering while others succumb.

Meanwhile, retailers want bankruptcy reform to give them more time to decide which stores to close. Their argument: Setting a maximum...now 210 days...forces chains to shutter stores that might be able to survive and keep workers on the job. Landlords' response: Unlimited extensions would complicate re-leasing and mean more space going dark. The odds of a retailer win aren't great, despite mounting bankruptcies. Nine public companies have filed so far this year. By year-end, about 30 will do so.

One place retailers are winning: They've got the upper hand with suppliers. And they're using it to pare product selection, reducing lower-volume and/or lower-margin lines and putting more emphasis on private label products. The approach is likely to last after the recession ends. Consumers seem to be fond of it. One example: Drugstore chain Walgreens slashed 18% of one category and saw an 11% jump in sales as well as a more expected 13% increase in profits.

For some small suppliers and manufacturers, that may prove a boon. It'll let them compete for shelf space purely on merit and not through slotting fees, the pay-to-play arrangement that benefits high dollar producers and is often used now.

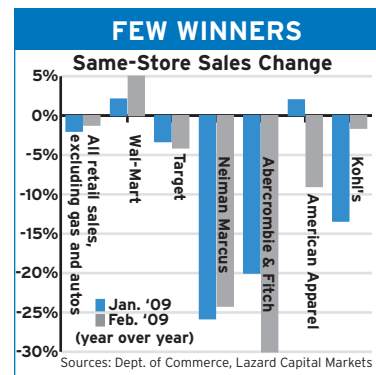
FINANCIAL SERVICES

Coming SEC rules will mirror money market funds' self-regulatory efforts. But what the industry recommends, federal regulators will require, including precautions most major firms already take: Ensure 5% of assets is available to investors within a day and 20% within seven days. Limit fund investments to those with Tier 1 ratings and maturities of 75 days or fewer. And disclose portfolios monthly. There's one industry recommendation the SEC isn't likely to swallow: Voluntary suspension of redemptions for five days if a fund risks breaking the buck... share values dipping below \$1 each. The feds will keep that authority for themselves. Industry is especially concerned about preventing flight from funds in Sept., when federal insurance...set up after a fund broke the buck in '08...will likely end.

Credit card banks aren't through cutting credit card lines. By 2010, about 20% less credit...a drop of \$1 trillion...will be available to consumers via plastic. Most won't initially notice the loss; it's mainly untapped credit that's being reeled in.

Higher credit lines won't come back postrecession, either. Greater caution will stick for at least a few years, potentially quashing a consumer spending rebound.

Small businesses are likely to feel the pinch. Credit card use by them is at or near a high. About half of smalls depend on plastic as a source of financing.



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**CENSUS
WOES**

Business groups are casting a wary eye on preparations for the Census. The Commerce Department is expecting even more problems than usual as it hires 1.4 million workers to count and categorize the population next year. The data determine everything from congressional districts to federal funding for a myriad of programs, including transportation, education and health care.

Firms rely on the figures to set marketing and advertising strategies.

Obstacles abound: Multiple language barriers and cultural differences, more homeless...displaced by natural disasters or through home foreclosures... and a growing number of sometimes hard to find cell-phone-only households. The count is supposed to include illegal immigrants, but many avoid counters. Privacy and identity theft concerns make other people reluctant to cooperate.

**BUSINESS
COSTS**

One likely consequence of the Federal Reserve's \$1-trillion credit rescue: Higher commodity prices...oil, natural gas, copper, nickel and other metals... as investors cozy up to commodities as a hedge against an inflationary updraft.

No giant push, though...just a gentle nudge from the massive cash infusion.

Oil prices in the \$50 to \$60 range through early fall... about \$10 higher than previously expected. Slack demand will hold gasoline price hikes to an extra 10¢. Figure prices to top out near \$2.25 a gallon during the peak summer driving season. Natural gas prices won't soften more than about 25¢ per million Btu through summer. Then they'll firm up, heading toward \$6.75 or so in the last months of the year.

Expect a 10%-15% jump in prices for most metals used in consumer goods and industrial products: Tin, nickel, aluminum and lead. For copper and zinc... somewhat greater increases by year-end: About 25% for copper, 33% for zinc.

ENERGY

The plan for a nuclear waste repository at Yucca Mountain, Nev., is dead. The state's lawmakers stalled it for decades, despite ongoing federal funding. Now the man in the Oval Office is willing to end it, letting the idea slide into oblivion.

That won't abort the coming nuclear power renaissance, though. From 2015 to 2030 or so, two dozen new plants will be fired up. Of course, construction costs will rise to accommodate on-site waste storage, but by only a fraction of the \$6-billion to \$8-billion price tag for a new nuclear power plant. And Yucca repository or no...

The fee electricity users pay to finance a nuclear graveyard won't disappear. The money isn't reserved for the Nev. site. Meanwhile, Treasury puts it to other uses.

Coal companies are fighting a losing battle on mountaintop removal mining. Environmental groups are determined to reinstate a partial ban that was lifted late in the Bush administration...through the courts, in Congress or by the Interior Dept. They've got a sympathetic ally in Obama, as his administration's recent decision to review permits granted under Bush shows. The likely result: Tougher restrictions.

Is it an oak, maple or birch? No, it's a "power tower"...a generating system designed to mimic a tree's form, using it to capture both solar and wind energy. Wafer thin "leaves" absorb sunlight, converting it to electricity to be stored or used. Ditto, the energy released when faux foliage rustles in the breeze. A single "tree" could power a house year-round. A grove of them...a fifth of a typical town's needs.

The first towers will show up around 2011. In a decade...a bumper crop.

**GREEN
JOBS**

An opportunity for small construction companies: Weatherizing homes... paid for by Uncle Sam. Some \$5 billion of economic stimulus will end up at companies that do insulation, siding, windows, heating & cooling, roofing and more. States will pass funds on to local nonprofits or governments to subcontract the work.



**THE
BUDGET**

Congress will pass a slightly smaller budget than Obama wants next year... About \$3.5 trillion in 2010...a \$1.2-trillion deficit. His request: \$3.6 trillion, which would put the deficit at about \$1.3 trillion. Congress wants the deficit cut to 3% of GDP by 2014, down from 8.7% in 2010 and 12.2% of GDP this fiscal year.

But mostly the budget just puts off making decisions Obama wants now.

No determination, for example, on what to do about various tax cuts in 2011, how much to spend on health care or how to create a carbon emissions program. No money set aside for more financial rescues, either. Those decisions will come, but not until later in the year, when more specific programs have been debated. And despite what Congress says, it could easily push the deficit higher again.

**STATE
FINANCES**

No more cushy pensions for state jobs. Look for major belt-tightening... older retirement ages, added years of service, higher worker contributions. Retirees won't be immune, either. Many states will freeze cost-of-living boosts.

Hardest hit: Alaska, Conn., Ill., Okla., R.I. and W.Va. They were hurting even before public funds lost an average of 26.6% in 2008, as did private funds.

But states won't abandon pensions. Some that tried to make a switch to defined contribution plans found it wound up costing money. Longtime employees were still entitled to payouts, and new workers were no longer contributing to funds.

LEISURE

Major League Baseball will prove anything but recession proof this year. The sport has a buffer, thanks to its multiyear broadcasting contract. But with firms slashing advertising and luxury suites, baseball won't escape a hit.

Most teams will offer discounts to keep their fans from drifting away.

Look for lower ticket prices by midyear and more bargains at concession stands.

For franchises already in trouble, relocation may be the only salvation.

At risk: Florida Marlins, Kansas City Royals, Pittsburgh Pirates, Cincinnati Reds.

Hollywood will do very well this year...a rare bright spot in the economy.

People may spend less on entertainment during a recession, but they still spend. A movie date, even with popcorn and a soda, is still a relatively cheap night out.

Domestic box office receipts are on course to break \$10.5 billion this year, up from \$9.85 billion in 2008. Ticket sales are 11% above this time last year.

But the movie industry still has problems to reckon with. Tight credit will reduce the number of films it can produce. Piracy will keep biting into profits. Incentives to keep production in California will fall flat. Studios will have to cut jobs.

**NORTH
KOREA**

A North Korean rocket launch would force Obama to take a harder line.

Scheduled for April, the launch would violate a UN ban, even if its intent is to put a satellite into orbit, as Pyongyang claims. Obama will seek fresh sanctions, but China will balk. Instead, he'll put North Korea back on the U.S. list of sponsors of terrorism and restore sanctions to block banks from dealing with Pyongyang.

At the least, it will set back a return to six-party nuclear talks for months.

Obama had considered direct talks with North Korean reps under Chinese auspices, but the rocket launch and U.S. response will take that off the table indefinitely.

Yours very truly



THE KIPLINGER WASHINGTON EDITORS

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