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INTERVIEW

No Doom, Just Gloom

David Levy, Chairman, Jerome Levy Forecasting Center

By LAWRENCE C. STRAUSS

AN INTERVIEW WITH DAVID LEVY: With many tough years ahead, this economist suggests getting hyperdefensive in assets like Treasuries.

\+ **ECONOMIC FORECASTING IS A TRICKY, IF NOT DISMAL, SCIENCE**. David Levy, who comes from a family whose roots in the industry go back to the early 1900s, acknowledges it is impossible to hit the nail on the head every time. However, the chairman of the Jerome Levy Forecasting Center in Mount Kisco, N.Y., did spot trouble brewing some time ago, although he thought the economy would implode a lot faster than it did. He thinks the economic-stimulus package is a step in the right direction -- however flawed -- but he doesn't expect a quick recovery. In the meantime, he likes Treasuries. Last week, *Barron's* caught up with Levy, 54 years old, to hear his latest forecasts.

Barron's: *Forecasting is a very difficult task. If there is a call you would like to have back, what would it be?*

Levy: You don't do this for three decades without accumulating a number of forecasts that didn't exactly hit the nail on the head. The most recent and important one was our prediction that the financial unwinding and economic decline would unfold fairly rapidly after the bursting of the housing bubble, which began in late 2005.

We expected the economy to fall into recession and financial crisis before the end of 2006. We failed to recognize the enormous inertia in structured-mortgage finance, and the risk-obscuring Wall Street money machine that caused mortgage-lending standards to paradoxically ease until 2007.

In the past, banks always started tightening [lending] standards shortly after the housing market turned down. The result [this time] was an enormous, and still rising, volume of home-equity extraction until late 2006, with a lagged impact on the economy that didn't begin to wane until late 2007.

Your consumer-confidence index is at an all-time low. What is that based on?

Confidence is a symptom that aggravates the problems. There are very good reasons that people don't have confidence, but the fundamental problem underlying the economy is that balance sheets in the private sector became much too large to be supported relative to incomes.

Just how bad is this economy?

We have to go through not a year, or two, but many years of getting balance sheets back into line with incomes.

Stretching the rubber band required not only that we have a lot of asset inflation so we could borrow against the assets, but also that we increasingly liberalize our attitudes about investing and lending.

Now that things are blowing up, it has moved us back to much more conservative and cautious attitudes toward lending and asset valuation. This means the contraction in asset values and debt will ultimately be pushed even further than they would normally have to go. So it is going to take years and years.

Are you referring to U.S. consumer debt?

I am talking about the household sector; the nonfinancial business sector, which had a record debt-to-GDP [gross-domestic-product] ratio; and the financial sector, which, of course, is at ridiculous levels.

How long will it take for a recovery?

This process is going to take more than one recession. This is what causes depressions -- when you have this kind of severe, long-term imbalance. It will take something more on the order of a decade.

It doesn't mean a period of continual decline, however. We will have business cycles, and we will have some growth during those cycles. But, as measured by the amount of time, it is similar to the Great Depression.

I don't think it will be as long as the two lost decades in Japan, but it will be a difficult period. However, it will be, to use a term we coined some years ago, a contained depression, meaning the government efforts to prop up the financial system prevent things from completely breaking down. And the fiscal stimulus will help us along.

So the good news is that we aren't headed for the Great Depression, but the bad news is that we are in for a tough economy for many years to come.

Here is a very basic fact about this period. Balance-sheet contraction makes it impossible for the private sector to generate the profits it needs to function, whereas balance-sheet expansion generates booming profits. Therefore, it isn't a matter of getting rid of the bad assets from the bank, and then the economy is ready to go. This process involves not just cleaning up the banking sector, but also shrinking assets and liabilities.

How long before we start seeing GDP turning positive again?

The earliest recovery would be in 2010. But I am not sure we are going to get a recovery then, based on the economic-stimulus plan that has been passed so far, although it is moving in the right direction. But the enormity of what it is trying to overcome may be too great. It is very likely we will see additional moves by the government later this year, so there will be something added, mainly because of higher unemployment.

One of the problems for any government trying to deal with this situation is the expectation that, like past recessions, it is a problem that should get cleaned up and we should go back to some level of prosperity.

But it is much more difficult this time. If we had no government action -- and if we had let Citigroup (ticker: C), AIG (AIG) and Bear Stearns and a whole bunch of other firms all go under -- the whole system would have collapsed by now. We are having enough trouble as it is, but we have managed to avoid another Great Depression. No one gets any credit for that, because things are so miserable compared to expectations. And the government is going to have a very difficult time keeping the public behind it as things unfold.

Because people get impatient?

Yes, and the single biggest political problem is going to be unemployment.

Which you see going a lot higher, possibly to 12% before this is over, compared with 8.1% in February.

That is correct. We have been losing more than a half-million jobs a month. If you look over the course of any past recession, the rate of job loss doesn't moderate over the course of that recession. It intensifies.

What does higher unemployment mean for the economy? More foreclosures?

Definitely. And it aggravates all the financials -- and, again, this is one of the things that is critical: this vicious cycle encompassing the deteriorating financial conditions and the deteriorating economy.

And that is the main reason why people have consistently underestimated this crisis, going back several years. At first, there was a lot of talk about it being contained in subprime mortgages, and that maybe housing was bottoming. But it hasn't bottomed.

What will finally get us out of this tailspin?

The basic instinct of government is: If the economy is hurting, we had better do something, whether it is cutting taxes or spending more money.

There are pros and cons to all of these options, but all of them have some effect in boosting the economy.

The government will do more eventually; inventories do get worked off; housing won't be able to fall indefinitely; residential construction won't be able to fall much further; and you have other things that start to kick in. The biggest challenge will be [determining] how bad the rest of the world [is] going to be.

What do you see for emerging markets?

They face what could be a tragic outlook, because they have no means, in many cases, to contain their own depressions, because of foreign debt and their exposure to foreign-exchange markets.

Which countries are you talking about?

Well, certainly the BRICs [Brazil, Russia, India and China], but also the smaller countries. Eastern Europe is the most obvious basket case right now.

What is it structurally about emerging-market economies that is causing them to fall apart?

Two things. One is that they were heavily dependent on exports to the U.S. and other big-balance-sheet economies, primarily Europe, but also countries like Australia and Canada. The other factor was that one of the symptoms of having bigger and bigger balance sheets, along with all these pressures on investors and lenders, is that it made it harder for them to make sound loans and investments. And it got harder to get the returns they wanted in the so-called liquidity glut, which led to incredibly cheap capital everywhere, with almost no risk premium.

So in countries like Brazil, a consumer-credit market developed that never existed before. In Eastern Europe, people could finance housing like mad. But when credit got cut off, it was a big shock to these economies.

There is no free lunch... Does it worry you that the additional debt the U.S. government is issuing will cause rates to rise, making an economic recovery even harder to attain?

I am actually bullish on Treasury bonds. While there is a huge increase in Treasury debt, there are going to be dramatic reductions in the amount of private debt available. That is already happening. We have maybe a $1 trillion to $1.5 trillion increase in our annual federal borrowing. But a couple of years ago, we had a $4 trillion rate of private-debt growth, which is collapsing.

Treasuries have had a big run. Late last week, the 10-year Treasury was yielding 2.83%.

In a zero-inflation to mildly deflationary environment, amid fear about equities and a lot of other assets, the idea of getting a solid real return of practically 3% on the 10-year bond, without risk, is pretty attractive. Another thing to consider for investors is what other sovereign debt are they going to hold?

Europe has got even worse problems than we do, with more debt -- if you average all of the countries -- and the U.K. has bigger financial problems.

What's your outlook for corporate profits?

Obviously, we had a horrendous fourth quarter of 2008. We might see a little bit of a bounce from that into the first quarter, but we expect the trend for profits to be flat to down, and [to remain] at very poor levels.

Is there any chance of a recovery in corporate profits by 2010?

It depends on how bad the world is, and what else our government does. One of the questions is: Can consumers cut back their spending faster than their incomes are falling? In the past few months, they have been able to do that, causing some pretty wrenching declines in spending.

And to some extent, if personal savings go up, it is essentially at the expense of business profits. So while we need higher savings in the long run, the shift is very painful.

You said recently that you expect core consumer prices to slip on a year-over-year basis. Is that good or bad for the economy?

In this case, it is a negative.

No one is worried about the cost of living going up. To the extent that there is deflation, it means margins are going to be squeezed. It means, to some extent, that businesses are able to cut their pay rates, but that also means somebody else's income is being squeezed.

What about the housing market? Is there a bottom in sight?

No, it is still declining, and this issue of dealing with foreclosures is a real one. If we don't deal with that, we are going to see more foreclosures as more people lose their jobs. There is so much downward momentum in home prices, and such an overhang in the market, that we are likely to see prices overshoot on the downside.

Longer term -- say, a decade from now -- you are bullish on the prospects for U.S. manufacturing. Why is that?

We are going through a very rough period, but we are going to move into a period where labor costs are much less important than manufacturing location. Logistics and proximity to markets will be much more important. That is because automation will become more advanced, taking many of the labor costs out of manufacturing.

But won't that automation lead to fewer manufacturing jobs?

Not exactly. There will be more capital spending, which equals profits. It is similar to agriculture, which 100 years ago employed a much larger percentage of the population. Manufacturing has been shrinking for a long time, but you will have more workers working here, and more of the plants will be here, even if they have fewer workers per unit produced.

What are you telling your clients when it comes to investing?

People use the term defensive, often at various points of the cycle, but this is a period to be hyperdefensive. Treasuries are attractive, and we have a class of new government-guaranteed debt instruments that need to be looked at so we know what is really guaranteed and how much is guaranteed, but there are some higher yields in some of those instruments.

What is an example?

The government has put guarantees on some of the bank debt, for example. I'm not recommending a particular instrument. But the most important thing is to put your cash where it is safe -- short-term Treasuries, even if you don't want to buy long-term Treasuries.

Anybody who weathers the next year or two without losing any money is going to feel like a hero. This period is going to create some great investment opportunities. But right now, we have asset deflation spreading across the board, along with financial instability and too much uncertainty.

Thanks very much, David.