Don't look now: Here comes the recession

Even with a boost from holiday spending, the U.S. economy looks shaky, thanks to slumping housing prices, Wall Street woes and debt-laden consumers. How bad could it get?

By Colin Barr, senior writer

NEW YORK (Fortune) -- The cash registers were ringing on Black Friday, but make no mistake: American consumers are jittery, and seem all but certain to push the U.S. economy into recession.

After years of living happily beyond their means, Americans are finally facing financial reality. A persistent rise in energy prices will mean bigger heating bills this winter and heftier tabs at the gas pump. Job growth is slowing and wage gains have been anemic. House prices are sliding, diminishing the value of the asset that's the biggest factor in Americans' personal wealth. Even the stock market, which has been resilient for so long in the face of eroding consumer sentiment, has begun pulling back amid signs of deep distress in the financial sector.

The latest evidence of the long-awaited consumer retrenchment: Chic discounter Target (Charts, Fortune 500) last week reported a weaker-than-expected third quarter, as sales of higher-margin apparel and home goods slowed. Starbucks (Charts, Fortune 500) reported for the first time that customer traffic in its stores declined in its latest quarter compared to a year earlier. Wal-Mart (Charts, Fortune 500) shares hit a six-year low in September after the retail giant posted another wan sales increase.

With consumer spending accounting for about three-quarters of U.S. economic activity, some economists say it is inevitable that the economy will stop growing at some point in the coming year, for the first time since the mild recession of 2001. "Right now, the question is how bad it's going to get," said David Rosenberg, chief North American economist at Merrill Lynch. "The question is one of magnitude."

Not everyone agrees. Many economists believe the Federal Reserve will steer the economy into a period of slow growth but avoid a recession, which is typically defined as two or more consecutive quarters of economic contraction. Indeed, the Fed already has twice cut its overnight interest-rate target, and options markets show investors expect the Fed to cut by another quarter-point at its Dec. 11 meeting, taking the Fed funds bank-lending rate down to 4.25%.

Government officials have steered well clear of recession talk, with recent Fed documents citing instead the risk of "an unexpectedly severe weakening in economic

activity." But Rosenberg and others are skeptical of the Fed's influence on an economy staggering under a mountain of personal, corporate and government debt. The economic recovery underway in 2002 was driven by low interest rates and abundant credit availability -- helped along by then-Fed chief Alan Greenspan's decision to cut interest rates as low as 1% in 2003.

Rosenberg said the low rates and easy underwriting meant loans were available to just about anyone with a pulse, so recent economic gains were more credit-induced "by a factor of four" than any other U.S. expansion on record. Now many of those loans are going bad, which is why investors are fleeing any debt riskier than U.S. Treasury securities.

Making matters worse, the banking system is coming under severe strain. Wall Street has recognized more than $40 billion in losses this year on souring subprime mortgages and a related problem, the toxic debt known as collateralized debt obligations. The losses could constrain the economy by forcing banks and brokerages to sock money away rather than lending it out to businesses and individuals.

Freddie Mac (Charts, Fortune 500), the big government-sponsored mortgage investor, provided some insight into that dynamic last week, when it said a $2 billion third-quarter loss had wiped away two-thirds of its regulatory capital surplus -- raising the prospect that the company will have to become a seller of mortgages at a time when the limping housing market desperately needs Freddie to be a buyer.

"The infection that started in housing is spreading," said Northern Trust chief economist Paul Kasriel. He says banks are extremely vulnerable to the defaults and foreclosures now sweeping American neighborhoods, with mortgage exposure amounting to 63% of U.S. banks' earning assets.

As a result of that exposure - and the hefty losses that financial institutions are going to have to take as more loans go bad -- Kasriel believes Fed chief Ben Bernanke is in a very different position than Greenspan was seven years ago, when the economy last showed signs of heading into recession.

"I'm wondering if Bernanke will have the same latitude" to cut rates, Kasriel said, referring both to the uncertain health of the banking system and the persistent weakness of the U.S. dollar, which is trading at lows unseen since the end of the gold standard in 1971. When Greenspan slashed U.S. interest rates in the early part of the decade, "the financial system was intact," Kasriel said. "Banks were able to extend cheap credit."

But with banks choking on bad loans, Kasriel doesn't expect to see the return of the easy lending standards that fueled the housing boom. Instead, he expects to see "greater risk aversion" that will slow credit growth and reduce the value of assets like property. He says the median U.S. house price would need to fall 17% to return to its 2001 level, which he notes was hardly at the bottom of the house-price cycle. A decline of that

magnitude will further erode home-equity borrowing by Americans and, presumably, deliver one more blow to consumers' wallets.

The American consumer seems to grasp the risks. A growing number of Americans expect the economy to tip into recession in the next year -- 40% last week, up from 31% in October, going by a Reuters/Zogby poll released last week. Rosenberg said government statistics show that 500,000 self-employed workers have lost their jobs since July -- a greater loss than was seen in all of 2001. Reported unemployment figures remain low, but Kasriel says those numbers "smell worse than a week-old fish."

The combination of an emerging consumer recession and a heavily stressed financial system has some experts suggesting that a financial meltdown looms.

"In short, the financial markets are at a critical point," fund manager John Hussman of the Hussman Funds wrote last week in a Web site post devoted to discussing a possible financial crisis. "It's possible that investors will somehow adopt a fresh willingness to speculate, but my impression is that in the weeks ahead, investors will be forced to recognize that the recession risk has tipped."

Others are more direct. Nouriel Roubini, an economics professor at New York University who has been predicting the collapse of the housing bubble for years, wrote recently that not only is a recession inevitable, he also sees "the risk of a severe and worsening liquidity and credit crunch leading to a generalized meltdown of the financial system of a severity and magnitude like we have never observed before."

Such a meltdown, he writes, would include bank runs such as the one seen earlier this year at Britain's Northern Rock and the bankruptcy of some broker-dealer firms.

That view isn't widely shared, of course. Few expect Americans to find themselves out on the street corner soon selling apples. Jim Griffin, an economist who writes for *ING Investment Weekly* in Hartford, Conn., shuns recession forecasts as unreliable and believes worries about the nation and the financial system are mostly overstated.

Griffin sees this fall's turmoil as "part of the next historical phase" in the global economy, as the U.S. shifts from driving world growth to riding behind developing nations. He expects U.S. export growth to help cushion the blows dealt by the housing bust and related bad debt.

Merrill Lynch's Rosenberg is less sanguine than Griffin, but he too discounts the voices of doom. "We've had consumer recessions before," Rosenberg said. "The world doesn't end." Let's hope not. ■