Where do we go from here?

By Marc Emmer

In the house of cards that is the U.S. economy, the Federal government has moved "all in". In the largest gambit since the U.S. depression, the feds are attempting to overcome stagnant credit markets and a fundamental imbalance in supply and demand with an ominous $787 Billion stimulus package.

Meanwhile, the staggering layoffs by U.S. companies are an attempt to reign in overcapacity. The stimulus package is risky, given that only a fraction of the stimulus is appropriated to providing additional liquidity, a blip on the screen in a $50 trillion U.S. credit market[i]. One might wonder if this strategy will work.

Recent history provides some context. As Nobel Prize winning economist Paul Kruger points out, there have been two recent examples of central banks providing capital infusions to banks in return for equity. In the 90's Sweden and Japan stepped in to sure up credit markets, only to privatize them after their banking systems returned to stability. To mirror the Japanese effort proportionally, the U.S. would need to infuse $400 billion of liquidity.

Typically, Joe the plumber has most of his wealth tied up in his house. Thus, the depressed real estate market has been far more harmful than falling equities. The emergence of "toxic assets" has been so extreme that the entire economy of Iceland is threatened by its central bank's failure, triggered by falling home prices in places such as Stockton and Detroit.

As written in this space, we find it useful in our practice to consider three scenarios in the face of such uncertainty. Every business should develop three budgets based on a similar set of forecasts considering their current business model, positioning and trends. Here are several scenarios that could play out in 2009 and beyond:

Favorable - The spending portion of the stimulus is ingested directly into the economy. Banks, many of which are hording liquidity, start lending again. The housing market which has already started to stabilize (in places like Santa Clarita) bottoms out in 2009. Unemployment rates drop 1-2%, consumer confidence is restored and U.S. companies begin to repair their damaged infrastructure.

Unfavorable - We face the horrific prospect that the stimulus package won't work. The government is considering forming a "bad bank" (an attractive prospect if I have ever heard one) to acquire a portion of the estimated $5 trillion of troubled assets on balance sheets of U.S. banks. Even worse is the prospect of massive European banks failures (given their lower reserve requirements).

High unemployment rates are deflationary, thus it is highly unlikely that prices will rise anytime soon. Deflation is a self-fulfilling prophecy because if companies cannot raise prices, they cannot hire staff or invest in internal systems, marketing, etc. which keeps demand low. The wild card is energy prices. While OPEC seems satisfied with $40 a barrel for oil, if we suffer a natural disaster or terrorist attack, oil prices could spike again, even if Americans can't afford the increase. The price of oil is artificially low, and will certainly rise again, eventually (renewable energy is years away). If real estate prices move lower, or banks fail to fund loans to small businesses, the Fed has few options left as the Federal Funds rate is virtually at

zero and the 10 Year Treasury is at 3%. If the stimulus does not yield the desired result, our economy could sink into a long term, protracted recession or worse.

Likely - The most likely scenario is that the stimulus provides some temporary relief (especially for those companies who tap directly into Federal spending on programs such as expansion of the electricity grids, home weatherization and development of vehicle batteries). The stimulus could take as long as a year to really make a significant impact, and during that time, unemployment should remain high and the stock market will be volatile. Low interest rates will eventually bring buyers back to the real estate market if lenders are willing to lend. Some liquidity should return to the market so that small businesses can extend their credit lines. The business climate should stabilize, although margins will remain razor thin. For certain, a massive amount of leverage will be removed from the financial system.

Eventually the U.S. government is likely to suffer losses in its portfolio of toxic assets, growing the deficit and devaluing the dollar, reversing recent gains in the trade deficit. It seems that business owners will bear a higher tax burden for years to come.

It is our view that there is no magic bullet for what to do in a downturn. The fundamentals are the same; optimize cash flow and inventory, focus on core competencies , shed poor performing businesses and focus on value (although pricing may need to be more competitive). Perhaps the biggest lesson many have learned is that expenses (especially labor) need to be structured so that they are variable with demand. The strong will continue to make good investments in people, technology and R&D.

As companies brace for the year ahead, difficult decisions will need to be made, but we will come out of this eventually; we always do.

Marc Emmer is President of Optimize Inc. (www.optimizeinc.net), a Valencia, CA based management consultant firm. Marc is an accomplished author and speaker and is sought after by CEO's as an expert on strategy, profit improvement, and performance management. Marc can be reached at 661.310.2212 or at marc@optimizeinc.net.

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[i] Adapted from The Return of Depression Economics by Paul Krugman Norton & Company 2009

What outcomes are likely from the government stimulus packages of 2009?