The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

1729 H St. NW, Washington, DC 20006-3938 • kiplingerbiz.com • **Vol. 85, No. 41**

Dear Client: Washington, Oct. 10, 2008

What we are seeing is classic market panic. And the government can't quell that. Interest rate cuts won't bring investors back. They fear lenders still won't lend, erasing profits as businesses cut back or go under. Buying up debt won't stem alarm about a spreading global slide. Falling 401(k) balances only worsen the dread.

2008 PANIC

Uncle Sam's steps *will* help the economy… pumping liquidity into credit markets, keeping businesses' doors open and allowing them to meet payrolls, and setting a floor under housing. But not soon enough for scared investors.

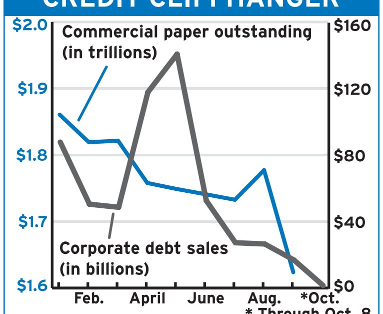
Here's how we expect the situation to unfold. In a few weeks, Treasury's plan will start up. Uncle Sam will begin buying up banks' toxic debt, getting it off their books…sequestered for resale later. By Thanksgiving, it'll be clear how it's going. If the reverse auctions planned aren't clearing away enough of the rubble to get banks lending again, Treasury can and will step in even more directly… taking the route the U.K. plans, buying banks' shares to provide the liquidity needed to keep wheels turning.

ENERGY FORECASTS

Energy Source	Current	Dec. 2008	March 2009
Crude oil (per barrel)	$81	$77	$82
Natural gas (per MMBtu at wellhead)	$6.70	$7.10	$7.30
Regular gasoline (per gallon)	$3.30	$3.00	$3.20
Diesel fuel (per gallon)	$3.90	$3.65	$3.80
Heating oil (per gallon)	$3.05	$3.25	$3.30
Electricity (per kWh)	11.7¢	11.2¢	11.6¢

By year-end, credit markets should be functioning better. Commercial paper will be moving again. Long-term lending…corporate bonds, etc…will start picking up. It will take more months to return to normal, however. Wide interest rate spreads will linger well into 2009. Typically 50 basis points, the gap between T-bill rates and those for three-month Eurodollar loans, for example, is now about 10 times that much and getting wider. That won't reverse, and corporate bond issuances and bank lending won't return to more normal levels until confidence in the credit markets is restored.

CREDIT CLIFFHANGER



Sources: Federal Reserve, Thomson Reuters

Finally, the economy won't grow for about a year. While measures taken here by the Federal Reserve and Treasury Dept. and by central bankers abroad will avoid another Great Depression, all the king's horses and all the king's men can't reverse the business cycle. Recessions run their courses. GDP will shrink through at least the first half of 2009. In the second half… weak recovery, at best. For the year, growth isn't likely to be much better than flat. Figure unemployment will climb to 7.5% or so next year and slightly higher in 2010.

As for the stock market, the slide will end when everyone prone to panicking has done so. And when the trend does turn around, you don't want to miss it.

The Kiplinger Letter (ISSN 1528-7130) is published weekly for $117/one year, $199/two years, $263/three years by The Kiplinger Washington Editors, 1729 H St., NW, Washington, DC 20006-3938.
POSTMASTER: Send address changes to The Kiplinger Letter, P.O. Box 3295, Harlan, IA 51593.

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REAL ESTATE

Meanwhile, the commercial property market is icing up as well. Little real estate is changing hands. Over the past year, total dollar volume of office space and hotel deals slid 75%, retail, a bit less, and industrial space, 60%.

And it's only going to get worse. With wary investors and tightfisted lenders stifling investing, more buyers will renege on deals. That'll force more bankruptcies by commercial building owners when they can't refinance maturing loans. What's more, recent Wall St. events haven't played out in the real estate markets yet... the Lehman Brothers bankruptcy, for example, threatens office and retail projects in Washington, D.C., and NYC. They'll be on hold, pending bankruptcy proceedings.

Rising unemployment spells more empty offices, cutting rental income and reducing property values. Because vacancy rates lag unemployment, the problem will linger even after employers start to add jobs again...and that's a year off.

Retailers will shutter more stores as consumers continue to pare spending.

And that means less need for warehousing, though the warehouse market should recover faster than other commercial real estate. The shorter construction time allows developers to cut back more quickly in response to changing market conditions.

At least there's less toxic debt looming over commercial real estate than there is in housing. Until 2006, lenders didn't dish out much easy credit for commercial buildings...years after lax lending began inflating the housing market.

And, of course, the degree of pain varies considerably from place to place.

Among the worst hit: Las Vegas, San Diego, Orange County, Calif., Phoenix and Orlando, Fla., places where building and property values soared in recent years.

Doing relatively better: Washington, D.C., where the government is the biggest industry. Houston, buoyed by oil. Plus Denver, Seattle and Dallas.

Not all retail REITs are taking a beating. Real estate investment trusts for shopping centers anchored by grocery stores and discounters are seeing returns go up...4.5% through Sept. 30 of this year. That compares with an 11% decline for those centered on malls, where many stores are geared to discretionary spending. The value orientation of properties, as well as geographic diversity, is what's helping.

FINANCIAL SERVICES

As banks tighten credit, alternative lending systems are poised to grow. Peer-to-peer lending through Prosper, Zopa, Loanio and other Web sites should easily top $5 billion a year by 2010, up from $282 million in 2006. About a quarter of such transactions, in which a P2P service matches borrowers with lenders and then services the loan for them, are for business purposes.

Looser standards explain part of the appeal. Private lenders are able to base decisions on broader criteria than banks typically do...relying more heavily on assessments of character and expertise and less on credit scores, for example.

But both borrowers and lenders find other benefits as well: Less paperwork, more transparency, faster processing and approval and more personal involvement. Plus competitive rates. Because P2P companies make their money on simple fees and not on the interest spread, both borrowers and lenders can negotiate better deals.

Microlending is going mainstream, too. Borrowers have typically been people with no or poor credit histories...ex-offenders, welfare recipients and immigrants.

Small business owners with good credit are turning to microfinanciers... an estimated 550 of them. Lenders, such as Accion USA and Seedco Financial, provide business loans as small as $1000 and as large as a quarter of a million. Interest rates can be steep, but aren't always. For Seedco, they run from 6% to 8%.

Also on the rise: Factoring...selling receivables for cash on the spot. Some services are reporting a 300% increase in business in recent months.

HEALTH CARE POLICY

Few issues separate McCain and Obama as much as health care does. But neither is likely to get anything close to what he wants anytime soon because of budget constraints and the growing likelihood of a long recession.

Incremental steps are the most any health care reformer can hope for in the next few years. Obama acknowledged as much in the second debate, but it would be even truer for McCain because of the Democratic Congress. McCain's plan would cost $1.3 trillion over 10 years. Obama's...$1.6 trillion.

Obama's proposal includes a mandate for large and midsize companies. They would have to provide coverage or pay a fee to help subsidize health care for the uninsured. Small firms would be eligible for credits if they cover workers.

McCain's would provide a $5000 per family credit to buy health coverage in the private market. But employer-provided benefits, which average $12,680 for a family, would be taxed as regular income. To increase consumer choices, McCain would allow consumers to cross state lines to look for the best deal.

Business groups aren't happy with either plan. They dislike McCain's because it would tax benefits and because they fear that healthy workers would opt out, raising the cost of care for those who still have coverage. They also dislike Obama's employer mandates, which would increase their costs. Businesses say both would accelerate a drop in employer-based health coverage.

Employers will press instead for limited health care improvements, focusing on cutting costs and improving the quality and effectiveness of care.

ELECTION 2008

Party control of the 50 governors' mansions will stay pretty much the same after this year's election. Democrats now hold the top spot in 28 states. Only 11 gubernatorial races will be decided Nov. 4, and incumbents are big favorites in seven. Open seats in Del. and N.C. also should remain in Democratic hands.

The only tight races: Wash. and Mo. In Wash., Gov. Christine Gregoire (D) is a slight favorite in her rematch against Republican Dino Rossi, who lost in 2004 by only 129 votes. In Mo., GOP Gov. Matt Blunt is retiring, and Democrat Jay Nixon, the state attorney general, is running about even with GOP Rep. Kenny Hulshof.

Control of governorships has a long-term political impact. Governors, along with state legislatures, will redraw congressional districts in a few years.

Voters will decide more than 150 ballot initiatives nationwide in November. They range from immigration to energy to abortion, and the verdicts on some of them will affect voters across the nation by blazing trails for other states to follow.

Energy. In Mo. and Md., voters will OK a requirement that 15% of electricity be produced from clean energy sources by 2021. Calif. environmentalists are pushing for a tougher 50% mandate by 2025, but odds are it'll be met with a thumbs-down. Also in the Golden State...a close vote on a $5-billion bond issue to provide incentives for buying or leasing energy efficient vehicles and to fund renewable energy research.

Environment. Minn. voters will say no to raising the state's sales tax to generate money for a number of popular environmental restoration projects.

Immigration. Approval is likely for a tougher immigration law in Ariz., letting the state permanently revoke the license of firms that knowingly hire illegals.

Unions. In Colo...a cliffhanger on the right to work, barring labor agreements from requiring workers to join a union and pay dues as a condition for employment.

Congress will be back in session Nov. 17...on standby to take more action if needed or to shore up the economy or the financial markets. At a minimum, lawmakers will review the massive intervention plan approved earlier this month.

For our latest take on the 2008 presidential election and more, go to Kiplingerbiz.com.

BUSINESS COSTS

Are commodities headed for a bust following the boom ignited last year? In a word, no. Despite the global economic slowdown, underlying demand for most commodities will remain strong enough to keep prices from plummeting.

Still, most...like oil...are well off previous highs, with no signs of returning.

For metals...just a modest further downtrend is in the cards. Ore producers opened a slew of new mines and processing facilities when prices were red hot. Now they can’t afford to shut them down and need to keep production going.

Come spring, prices should carve out a bottom. But don’t expect them to head much higher until the economy perks up and inventories are depleted. Nickel prices...down 20¢ a lb. to $6.90 or so by March, from around $7.10 a lb. By the end of 2009, the metal will have recovered to $7.75. Much the same for aluminum...sliding by 15¢ a lb. through this fall and winter but ending 2009 at a point slightly higher than now. Big stockpiles of copper and tin will take longer to whittle down. So...flat copper prices. Tin...dipping 50¢ a lb. by Dec. 2009.

Feed grain and soybean prices may actually climb a bit in 2008/2009. Late-maturing corn and soybeans dodged early frosts, so harvests won’t be stinted. But demand is rising even faster. The net result: Stocks will be drawn still lower over the coming marketing year, keeping steady upward pressure on prices.

AIRLINES & TRAVEL

The oil price slide may be enough to put some airlines back in the black. Paying $30 a barrel less translates into $10 billion a year for the industry. The key to earning profits this coming spring and summer, despite the ailing economy: More capacity cuts...maybe an additional 9% drop in the number of seats in 2009.

Also paying off: Add-on fees for everything from baggage to beverages to blankets. United Airlines expects to raise $700 million a year from them. American Airlines plus other carriers are likely to expand à la carte pricing... base fares with options to buy “extras” such as reserved seating or checked luggage.

Soon, fliers will be bombarded with in-flight ads, too. Spirit Airlines is selling onboard advertising space. Everything from overhead bins and bulkheads to tray tables and trash bags can be plastered with logos and “buy me” messages. Desperate to increase their revenues, other airlines are bound to follow suit.

Visitors from nine more countries will soon be able to forgo U.S. visas: Estonia, Greece, Hungary, Slovakia, the Czech Republic, Malta, Latvia, Lithuania and South Korea. 27 nations are already in the reciprocal visa waiver program.

Travelers from no-visa countries will need prescreening starting in Jan. They’ll be required to fill out an online form at least 72 hours before boarding a ship or plane and to answer a series of questions about contagious diseases, drug abuse, criminal convictions, terrorism, spying and genocide. An approval lasts for two years.

Ever wonder why border officials ask if you’re a terrorist or consort with one? Officials know no one will say yes. But a false statement provides leverage to authorities, and it’s an easier offense to prove than actual terrorist activities... a bit like getting Al Capone on tax evasion rather than nailing him for racketeering.

Yours very truly,

Knight Kiplinger

Oct. 10, 2008 THE KIPLINGER WASHINGTON EDITORS

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