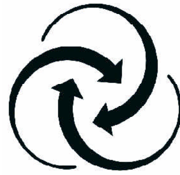

THE JEROME LEVY FORECASTING CENTER

Foresight of the Recent Recession and Financial Crisis by the Jerome Levy Forecasting Center

Housing

"Home prices, corrected for general inflation, are on average 40-50% above their normal range. The demand for dwellings cannot support these levels, which were attained only through an unprecedented speculative mania started by plunging interest rates and then accelerated by extraordinary financing practices."

—December 2006 Levy Forecast

Economy

"The economy cannot generate enough profits to stay out of recession without vast, inflating asset bubbles and heavy, reckless lending, and it appears to be losing both."

—August 20, 2007 client bulletin

"So far, most investors do not appear concerned that subprime loan problems will spread to higher quality segments of the mortgage market or to markets for other types of debt... The consequences [of subprime ills] will spread to other parts of the mortgage market and to virtually all financial markets unless some new development—and we cannot think of a likely candidate—provides offsetting support and financial relief."

—February 9, 2007 client bulletin

"The economy will need a big, positive surprise to prevent financial conditions from worsening, profits from sliding, and the expansion from breaking down as we move through the year. Yes, we could be wrong on the timing, but our confidence is growing."

—February 9, 2007 client bulletin

"The economy's financial condition is becoming increasingly fragile and will continue to do so until the expansion and financial stability break down. Yet the dominant view among investors and analysts seems to be that the economy's financial arrangements are robust and durable."

—March 5, 2007 client memo

Financial Stability/Collapse

"Just as the last recession was caused by the bursting stock market bubble, the next recession will be caused by the deflating housing bubble. This time, however, the financial sector will be much more exposed. Aggressive lending by banks, mortgage finance companies, and other nonbank financial institutions fueled the housing bubble . . . Moreover, household sector financial health is even more alarming than corporate financial health was in 2000. The household debt service burden is at a record high and climbing, and loan performance problems have been kept suppressed only by easy lending against home equity, which is now falling.

Just as accounting shenanigans exaggerated corporate earnings in the 1990s, the proliferation of derivatives and their murky accounting has likely padded financial institutions' balance sheets and created an illusion of soundness. Fannie Mae's recent troubles with derivatives accounting is only a tip of the iceberg. More widespread accounting problems will undoubtedly surface as the deflating housing bubble leads to surging household defaults and serious financial sector problems."

—November 2005 Levy Forecast

"[Global liquidity glut] has a nice reassuring sound if you are in the business of investing... Since a glut stubbornly persists (unlike a spurt or a flood), a 'liquidity glut' sounds like something that will be around for a while, perhaps easing investors' assessments of near-term risks. However, from the profits perspective, the situation is not so benign... When the liquidity glut departs, it may

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do so in violent episodes, ultimately giving way to credit scarcity and spreading asset deflation."

—December 19, 2006 client memo

"For several years easy money masked the mismatch between tiny risk premiums and extraordinarily risky financial arrangements... The risk pendulum is swinging back from its summer of 2006 extreme of complacency with the force of a wrecking ball. The only question is when it will hit something big. We encourage erring on the side of overestimating the danger to financial stability... Do not count on the developing downturn remaining within the parameters of past periods of recession and financial trauma."

—August 20, 2007 client bulletin

Consumers

"The personal saving rate, as defined in the NIPA, reflects the powerful phenomenon of unsustainable consumer spending. Its decline since 2002 was made possible by increasing home equity extraction, and its recent floundering suggests that the home equity well is starting to run dry. As this enormous source of additional consumer spending power fades, the resulting drop in spending will be a serious blow to profits."

—December 2006 Levy Forecast

"Households are stretched as never before. The time is nearing when households will have to face up to the consequences of the alarming growth in debt... Household loan performance problems are poised to surge."

—December 2005 Levy Forecast

Inflation

"There is a hot new bull market in inflation fear... Inflation fears and rising yields will only result in more economic distress, financial upheaval, disinflation, asset deflation, and reasons for the Fed to cut rates."

—May 29, 2008 client bulletin

Interest Rates

"Most likely the Fed will continue to hold its federal funds target at 5.25% until cascading financial and economic problems associated with the deflation of the bubble compel it to cut aggressively. Although we cannot entirely rule out conditions that would prompt the Fed to raise rates one more time, such an event is not likely. Once economic weakness and financial instability prompt the Fed to start cutting rates, it will continue cutting through 2007 and into next year. Treasury yields will fall sharply over the next 12 months and beyond."

—February 2007 Levy Forecast