January 2010 Rotary Speech
By Shrub Kempner

THE ECONOMY

It's time to stop wondering if the United States is in recovery – we are - and start discussing just how large our expansion will be in 2010.

We estimate the U.S. GDP will grow at a 4% real rate (inflation adjusted) in 2010. We expect mild inflation for 2010, between 1 ½-2% in the core CPI. We also expect that job growth will be positive – an end to all these months of negative job creation. This should start to happen very soon, perhaps as early as the December numbers, but we don't think it's likely to be fast enough to reduce the unemployment rate much below 9%, from the present 9.9% during the year.

This projection of 4% real GDP growth is a lot more than the 2.6% projection, which is the median of economists polled at the end of the year. So, why? Why do we feel this way?

Last year I spoke to you and said that because of massive public policies worldwide, we were clearly in recession, but had been prevented from slipping into depression. Even though it would be painful, we in the U.S. would be pulling out in a relatively short time. Exactly - positive 2.2% in the third quarter and much stronger in the fourth.

The highly criticized "bail-out" and "government intervention" that began in the last days of the Bush Administration and continued in the present Obama Administration, have succeeded and those who criticized them for not working have been flat mistaken. Our policies, fortunately, coordinated with an unprecedented number of similar international policies, have:
Lowered interest rates to near zero, helping all of us.
Directly supported various industries such as the automobile industry, housing, and banking.
Encouraged the consumer via short term and long-term programs (short-term such as cash for clunkers and long-term lower interest rates.)

Further:
Only 1/3 of the infrastructure stimulus money has been spent – another 2/3 is to be spent in 2010 – about $400 Billion (or 2% of GDP)

Add to this, the private sector – very, very low inventories, which are in process of being rebuilt and which will add 2-3% total to the GDP in and of themselves, just getting inventories back to normal. This plus greater top-line sales and increased efficiencies, looks as if it will lead to a 25-30% profit increase for the S&P 500 this year and for the first time in a year, major increases in business capital investment.

Substantial exports – growth has been something like 20% even in the midst of a worldwide recession from the beginning of 2009 to now. The world is having synchronized growth and we will benefit from it.

The key American consumer, supposedly unwilling to make purchases, has indeed delayed gratification for most of the year. However, in the last 3 months, Americans have begun to spend on necessities and even some luxuries for the first time since the Fall of 2008. A bit like companies restoring their inventories. This is the least certain of the projections, but if I'm correct in assuming that jobs will start to be positively created, I feel the American consumer will probably increase spending at a rate of about 3% this year as compared to a negative last year.

That sounds okay, but typically after a very serious recession such as this one (years like 73-74 and 82-83 are comparable) the recovery has been much stronger than I project at 4% - more like 7-8% in the first year. There are significant headwinds that hold us back from that. They can be summarized as problems of de-leveraging.
A major foreclosure overhang which will hold back both housing and commercial real estate activity.
A high consumer debt as a percentage of GDP which has barely budged in the last year – a headwind for some time.
There is very large unemployment, which will only gradually decrease this year.
Finally, the need to remove the punch bowl, because these government programs of basically zero interest rates will have to be modified during the year as recovery steps in. Too rapid an increase in rates or reduction in banking reserves could be very negative to the recovery. Read Paul Krugman in today's *Chronicle* for good solid pessimism on this score.

Weighing all this, we call for no double dip, and a solid but relatively slow expansion for the U.S. and the world economy in 2010.

STOCK MARKET

As far as the stock markets are concerned, there are two major contrary factors:
On the positive side, profits will be increasing very substantially, possibly as much as 30% this year from last year.
On the negative side, the fear of and possibly actual increase in interest rates, which also may be compounded if we're too low in our inflation forecast of only 1½ - 2%.

I would be startled if gains for 2010 were anything like the overall 20% gains in the market of last year.

GALVESTON

Everything is colored by the rebound and recovery from Ike. As usual in the first year after a storm, there was a surge of economic activity. Money flowed in from insurance settlements, and there was massive construction and contractor activity as people worked to bring their houses and businesses back to the extent that was possible.

Since Labor Day, we've been in what I would not call a surge, but a slog, waiting to see what happens next. Certain very positive things are clear:
There will be up to $1 Billion+ in construction beginning early this year at the Medical Branch and lasting for at least the next 3-5 years.
The City will be spending a comparable amount on various utility programs, ranging from streets to sewage and water treatment plants.
New houses will be built, many of which built to own, by both the City and the Housing Authority during the next year or so.

All these should brighten the job and cash flow picture here for the next few years. However, I have qualified optimism about what will happen in the City, but one more time I'll say that what we need most for our long-term future is to create conditions so that more people who work here will be willing to live here and bring up their families here. That's the long-term key to Galveston's future, and everything we work on going forward should keep that ultimate goal in mind.