Godsey & Gibb Associates
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Life After Debt: Back to Basics (Series Overview, Part I of IV)

An Analysis of Economic Transition for the Government, Consumers and Businesses

The current recession and financial crisis, driven by what has been described as "the great credit unwind" and a "global margin call" by many in financial circles, has profound, transformative qualities for the future of the U.S. economy. Not unlike the proverbial analogy of trying to put the toothpaste back in the tube, Godsey & Gibb Associates believes that the eventual economic recovery will not be a return to the past. While the dislocations and price adjustments in the current environment have been painful for many, the former "realities" (house prices, stock prices, consumption growth rates, low government deficits) will likely not return soon. Instead, multiple, transgenerational factors are at work, which could lead to profound differences in the economy and financial markets for some time to come. In this series overview (and in three parts to follow), we plan to analyze the issues, and the impacts, of the transition that is taking place for the government, consumers and businesses in the U.S. economy.

We start with a review of the components of overall U.S. economic growth, which we plan to analyze. The expenditures approach to valuing gross domestic product (GDP) is below:

GDP = Government Consumption and Investment (G) + Personal Consumption (C) + Gross Private Domestic Investment + Net Exports

In addition to consumption by the government and consumers, the last two components above represent business activity, such as construction and manufacture of capital goods, inventories and total exports less imports.

We believe it is important to examine the root causes of the current downturn in order to properly evaluate how the economy will eventually emerge. Over the course of the last cycle, low policy interest rates created easy money. Home ownership levels reached record levels due to the growth of so called "affordability mortgage products" such as interest only and adjustable rate loans, a general lack of due diligence on the part of mortgage lenders with regard to income, employment or credit history, and a lack of responsibility by many borrowers. The excessive credit creation also lead to new highs in consumer spending levels, which we view as unsustainable.

In addition, financial risk management went by the wayside on Wall Street and the subsequent turmoil from deleveraging increased risk aversion by institutions, making it harder for companies to access capital markets. Housing based losses at financial institutions eventually led to caution, and a freezing up of available credit. Investors' appetite for debt unwound, leading to a collapse in prices for houses, commodities and financial assets.

The Federal government has responded as both lender, and spender, of last resort, with an unprecedented expansion of monetary and fiscal policies. Lower interest rates and an expanding budget deficit will have important future economic and financial market implications.

For the economy at large, we believe it is going to be "back to basics", with a focus on needs, not wants, as the major participants come to grips with the realities of a less leveraged system.