INFERENTIAL FOCUS BRIEFING

IF 2930
Fourth Quarter 2008

QUARTERLY SUPPLEMENT

"You're only given a little spark of madness. You mustn't lose it."

–Robin Williams, comedian

Index of Fourth Quarter Communications

❑ Ad Spenders Seek More Bank for Their Buck

Ad spending is dropping, as we warned in 2007 that it would, and the drop is especially troubling since it came amidst record presidential-campaign spending. Meanwhile, online ad spending, which remained resilient through most of 2008, has recently also started to drop, *albeit* far less than overall ad spending, suggesting companies are under real pressure to cut costs. Companies are trying to get more resourceful with the budgets they have left, shifting ad dollars to more-targeted media, such as a move from broadcast TV to cable TV, or a move from online display ads to online search ads. As the scrutiny rises for the return from ad dollars spent, various companies are offering improved capabilities to target ads to individual communities and households and to meter the effectiveness of those ads. Such companies are well positioned in a world in which business scrutinizes budgets. **(eF 317)**

❑ China, As The World Turns: Beijing's Interests and the World's Economy

As most of the world's economies slip into recession, hopeful political leaders of those troubled economies are looking to China for market stimulation. Unfortunately, China has limited capability and is headed toward its own slowdown. Yet China cannot afford to experience too steep an economic downturn because such a condition would likely trigger further social discontent, and so Beijing has been focusing on stimulating domestic growth. As global markets contract, negatively affecting China's exports, Beijing hopes Chinese consumers, among the most frugal savers in the world, can enliven the sagging domestic economy. Beijing will be spending public money on projects to stimulate the economy and will try to encourage its consumers to loosen the purse strings on their considerable savings. In addition, Beijing will be using its massive currency reserves to exploit economic weaknesses elsewhere in the world and advance its strategic position where possible. **(IF 2927)**

❑ Endgame in Afghanistan?

With the security situation in Afghanistan deteriorating severely in early 2008, several anomalies suggest that various parties are trying to negotiate a settlement that would bring a sort of détente to the warring factions of the region. These signs include a call by the British ambassador to seat an "acceptable dictator" in the nation, Afghani President Karzai's sudden willingness to negotiate directly with Taliban leader Mullah Omar and an attempt by Saudi leaders to broker a power-sharing agreement between the Taliban and the government in Kabul. We had already seen various tribal leaders of the Taliban working at cross-purposes, with some increasing their affiliation with Al-Qaeda's international terrorist network and others caring more about local ethnic nationalism. Will international military and political leaders succeed at widening this divide and negotiating a settlement with those factions not married to Al-Qaeda influence? Time will tell**. (eF316)**

❑ Erroneous Analogies & Misleading Metaphors: Finding a Solution Requires Finding the Right Context

Explanations for how and why bank panics and other economic downfalls take place in the U.S. have been part of the public conversation since the nineteenth century. Those explanations often resort to analogies and metaphors, as has been the case in assessments of the current financial crisis. Some of the popular analogies being used have weaknesses, particularly ones revolving around Black Monday, 1987, Japan in the 1990s, the U.S. in the 1970s and most often cited past event, the market crash of 1929 and the ensuing Great Depression. Each of these explanations lacks something that makes its use risky because the dynamics are different.

Besides analogies, some analysts have turned to metaphors, and this time, events occurring in the current financial situation have uncovered the fallacies behind two popular metaphors: the "invisible hand," the concept that something quasi-magical guides decisions that individuals make in such a way that their actions have a positive effect on the wider economy, and the math metaphor, which holds that modeling markets and behavior can somehow provide a clear picture of how humans will behave, even in the face of novel circumstances.

We provide one new analogy and a different metaphor for consideration. The analogy is to the Panic of 1893, which had many of the characteristics of today's crisis, while the metaphor is of an ecosystem, which by its nature would account for the complexity and interconnectedness of the many facets of today's financial world. Because analogies and metaphors provide a specific picture of what is taking place and point toward specific kinds of responses, getting the right analogy and a correct metaphor must precede any effective response. **(Special Briefing)**

❑ Extreme Volatility

At a macro level, we have identified three relatively new forces in the world – World War III, Power Centers, and the Effects of Sovereigns in the Marketplace. When acting in conjunction, these powerful global dynamics have produced a new reality – one of extremely large numbers – in concentrations of capital, exploding populations and skyrocketing economic growth. The effects of these large numbers are creating stresses in areas such as the financial sector, energy, food, water, technology and trade.

We decided to examine one area with very large numbers – the concentration of capital – and look at the effects of the current economic downturn through this prism. One outcome has been extreme volatility in world stock markets and commodity prices. For example, October 2008 was the most volatile month for the Standard & Poor's (S&P) index of 500 stocks in its 80-year history. Also, oil prices fell 33 percent in October – the worst month for that market since oil futures began trading, in 1983. The market- and asset-price volatility is occurring during a time of global illiquidity plus debt and currency imbalances. This has produced a perception of extreme risk.

As governments, investors and individuals attempt to mitigate the effects of a risky financial environment, we can expect cash and bonds to be desirable, leverage to be avoided, long-term planning and budgets to be scrutinized, increased regulation and stopgap measures to be passed and possible trade contractions.

❑ Great Opportunity (A)

As the economic tsunami wreaks havoc on the global economy, governments have gotten involved with various actions to "bail out" and "stimulate" their economies. We have seen aggressive interest-rate reductions, repeated injections of liquidity, government takeovers of banks and other private firms and government backing of bank deposits, to name but a few. We fear these varied actions merely address the symptoms of bigger underlying problems that remain unfixed. Acknowledging the multifaceted complexity of the situation involves getting what we have called a correct "diagnosis" of what is taking place. The core diseases of this economic malady as it currently stands include: 1) Elevated real estate values in the process of being revalued downward; 2) extended global leverage in securities constructed on top of devaluing assets (mostly real estate) and dependent on accounting practices that require short-term valuations; 3) spending cutbacks among corporations and local/state/provincial governments, including widespread and deep personnel layoffs just as efforts to increase revenues put more stresses on citizens and 4) a reverse wealth effect, prompted by declining assets (home, investments, etc.) and contracting resources (stagnant salaries, excessive debt loads), triggering a global contraction of consumer spending – still the engine of world growth.

Moreover, in the world of permeable borders (the World War III we have been discussing since 1998), global economies are so interconnected that nothing short of a globally coordinated fix can "cure the disease." Individual nations taking actions on their own will not fix the problem. We have noted that multiple sources suggest U.S. President-elect Obama has a penchant for pragmatism as opposed to ideology. Such pragmatism will be needed not only to recognize the correct diagnosis of the economy's problems but also to implement the necessary fixes, some of which perhaps fall well beyond any mainstream ideology. We feel that the coming change of administration presents a golden opportunity for such events to occur. As the new administration takes power, we must watch carefully for signs that it has diagnosed the true illness and is moving to treat it. Is their plan predicated on global coordination of the world's developed economies and largest emerging markets? Is a changing of the rules for accounting on the table? Do proposed stimulus and bail-out packages address the remaining core economic problem: falling home prices and business layoffs? The change in leadership provides the opportunity to address these major problems, and if they are addressed, our view forward will be substantially more optimistic. **(Special eFocus)**

❑ Infrastructure Back on Track

Global infrastructure spending contracted suddenly in the latter half of 2008, as emerging markets redirected government funds toward subsidies to battle consumer price inflation and U.S. municipal governments cut spending in light of massive deficits. But infrastructure already looks set for a comeback. The sudden global recession has caused a collapse in commodity prices, lessening inflation fears but increasing fears of slowing growth and unemployment. Countries like Thailand and China are ramping up infrastructure spending again as they seek to stimulate growth. Meanwhile, in the U.S. infrastructure is seen as increasingly essential and a worthy earmark of fiscal stimulus, with voters even approving tax hikes locally when those hikes would be spent on mass transit projects. With mass transit increasingly seen as a green and resourceful option for squeezed American consumers, support for using economic stimulus money to expand transit systems will likely stay high. **(eF 318)**

❑ In Tough Times, Public-Sector Workers Get Scrutinized

As people feel the pain of wiped-out retirement accounts, squeezed budgets, lost health care insurance coverage and layoffs, resentment may increase toward a particular sector of workers with job security and generous guaranteed retirement benefits: public employees. We have already seen increased scrutiny of pay-and-benefits packages of public employees in New York, New Jersey and Massachusetts. We suggest that scrutiny will increase because public attitudes are shifting to what we are calling The Next American – a mindset that includes an emphasis on community fairness and a preference for resourcefulness in spending. Political leaders may also scrutinize contract bidding, union contract negotiations and the sort of frivolous spending which the public now rails against at AIG. A combination of fiscal austerity and public anger could create a new dynamic in the public sector, which perhaps foretells heavy oversight of future fiscal stimulus packages. **(eF 314)**

❑ Labor and the Next American: Union Leverage in an Era of Economic Weakness

For nearly two decades, employees have tried to keep pace with new work realities, including employers dumping pension plans, shifting benefit costs, cutting staff and outsourcing jobs. But stagnating salaries and the end of easy credit have individuals rethinking their ability to shoulder these burdens and considering "getting with a group."

Union membership has reversed its downward spiral of the past 25 years, and unions have recently been demonstrating some leverage in contract negotiations. The Next American, with a new set of values and perspectives, favors the get-with-a-group mind-set and has a less than positive attitude toward the kind of corporate leadership that has been forcing individuals' standard of living down. Organized labor is benefiting from the spread of the Next American's point of view. **(IF 2926)**

❑ Miracle of Beijing (The): China Takes Decisive Action and – Apparently – Quickly Reverses Its Economic Fortunes

In the first half of this year, the Chinese economy seemed to be headed for a substantial slowdown. Seeking to avoid that possibility, the Chinese Politburo rebuffed the central bank's focus on fighting inflation and said the country's focus would instead be on economic growth. Beijing made several substantive and forceful changes, and more recent numbers have suggested that China could have already reversed its economic course.

Such turnarounds are more typically the stuff of fables, not reality. With the U.S. and other Western economies stalling, a Chinese economic turnaround, should it prove to be fact not fable, could increase that country's standing as a model for more and more developing countries. The question remains: Has there been a Beijing miracle? **(IF 2925)**

❑ Multipolar Versus Multilateral: Sovereignty and a New Financial Architecture

The interconnectivity of global financial affairs has caught many by surprise and has shocked those just starting to understand the extent of the current financial crisis. Despite this interconnectivity, most countries are acting as if such linkages do not exist (or do not matter) and are taking independent actions to stimulate or stabilize their own economies. World leaders are suggesting many different multilateral plans to address the current transnational crisis, but their willingness to yield sovereignty to coordinate and regulate a global response has been less than enthusiastic. As a result, a new and de facto financial architecture has started to surface, one in which those who have money and credit are in the new power positions. **(IF 2928)**

❑ Scanning Genes and Rewiring Cells: More Healthcare Breakthroughs

The cost of sequencing DNA has been falling logarithmically, by a factor of 10 every year. With the cost of sequencing the entire human genome expected to be $10,000 next year, applications of such technology are set to proliferate. Some firms are already offering DNA testing for groups of risk genes at $1,500, allowing people to adjust their lifestyle to confront their hereditary risks. The lowered price of such testing also leads to a series of unanswered ethical questions (such as who can have access to such information) that could become a surprise political controversy in the coming years. Low-cost sequencing could lead to improved understanding of genes, and in turn more therapies, including epigenetics – a field of science in which doctors can turn particular genes on and off. In 2008, researchers showed great progress in that field, "tricking" cells of one kind of human tissue into transforming into another kind, by switching on and off certain genes in the cell. **(eF 315)**

❑ "The Uncertainty is Prolonged": An Already Challenged India Deals with New Realities

India's challenges have grown more difficult, and the country's future more uncertain. Economic troubles including mass poverty and shifting foreign investment have been made worse by the global financial crisis that hit the country's financial system, even though Indian banks stayed clear of the trick financial instruments behind the global crisis. The central bank has taken decisive action but, so far, to no avail. In addition, domestic tensions and terrorist attacks from abroad have made the Indian situation even more tenuous, exposing the country's vulnerability in the area of security. With growing domestic discontent and national elections looming in 2009, India's economic fortunes could be uncertain for some time. **(IF 2929)**

❑ Umbrellas in the Storm

We have written extensively about the effects of the unwinding of the housing market and the ensuing losses in the financial sectors and how those losses would work their way into the wider economies, both domestic and global. The slowdown in lending and borrowing, layoffs, budget cutbacks and a pullback in spending have been some of the responses at the individual and corporate levels. For the most part, however, consumers and businesses have responded, in turn, by becoming more resourceful. For example, they are spending less overall, looking for sale prices, using technology to cut costs and turning to discount resources. (See, "Not Lately, or Any Time Soon," **IF 2829**, 12/13/07)

These kinds of forced changes are creating opportunities for those companies that offer products and services that meet the demands of resourceful consumers and businesses. For the most part, consumers are "seeing the upside of trading down," and retail enterprises that cater to this new mindset are prospering. Individuals are purchasing more private-label items, especially at drugstore chains and supermarkets, than traditionally branded products. Sales increases at discount retailers are outpacing those at department stores. Thrift stores report an increase in middle-class and upper-income shoppers in 2008. Surplus and salvage food stores, which sell close-outs, damaged or soon-to-expire products, have reported same-store sales increases in double-digits, rather than the flat to single-digit increases at the nation's biggest traditional grocers. Consumers are using the Internet to access sample-sale sites such as Gilt.com, which has reported adding 15,000 new members per month, as well as price comparison and discount coupon sites.

Individuals, in looking to control spending, are also shifting their views of what is acceptable behavior, and companies that offer the products or services for this reassessed consumer are benefiting. For example, the number of working adults choosing to "brown bag," or bring their lunch from home, has increased from 35 bagged lunches per capita in 2006 to 38 in 2007, as soup, sandwiches and pasta brought from home offer a cheap, fast lunch alternative for many workers. In addition, driving rather than flying, driving small-sized (energy efficient) versus mid-sized cars, growing vegetables in a home garden rather than buying them at a supermarket, filtering water instead of purchasing bottled water and even installing home safes to replace risky investment vehicles – these all represent choices being made by the resourceful consumer.

At the same time, companies are taking actions to weather the recession that will also positively affect their bottom lines. Operational efficiencies are one set of tactics that can boost earnings while offering long-term increases in productivity. For example, the consulting firm Accenture estimates that its telepresence-enabled meetings replaced 240 international trips and 120 domestic flights in one month alone, saving the company several million dollars. Software and services companies, such as those in the areas of outsourcing (both internationally and domestically), video conferencing and cloud computing, offer operational efficiencies that should persist long past the economic downturn.

"It's getting harder to distinguish between the garden variety raving lunatic and the angry cell phone caller."

Did You Know?

- Nearly 300,000 people have applied for the approximately 7,000 available jobs in the Obama administration. (*The Week*, 12/12/08)

- The 2008 corporate-bond default rate was 2.8 percent as of November. Default rates rose to 10.5 percent in 2001 following the Internet bubble crash and 12 percent in 1991 after property prices slumped. (*Financial Times*, 11/13/08)

- A survey by the National Institutes of Health (NIH) revealed that 62 percent of doctors who treat arthritis and other joint problems believe that using a placebo treatment is ethically acceptable. (*Atlanta Journal Constitution*, 10/24/08)

- Television viewing on all devices has hit an all-time high, with the average American watching 142 hours of television monthly, up 4 percent over last year. (*The Week*, 12/12/08)

- No year in this decade has seen as many IPOs as any year in the 1990s – not even as many as in 1991, a recession year. (*Investor's Business Daily*, 11/25/08)

- Recent spending by China's 1.3 billion consumers plus some 1 billion of Indian consumers amounts to $600 billion – or about one-sixth that of U.S. consumption spending. (*Christian Science Monitor*, 10/23/08)

- The economic cost of diabetes in 2007 was estimated at $218 billion, according to a study commissioned by Novo Nordisk; this includes both the medical and indirect costs arising from lost productivity, disability and early retirement. (*Associated Press*, 11/18/2008)

- The below-subprime sector, which consists of borrowers with credit scores lower than 550, is the fastest-growing credit tier for auto loans. Below-subprime loans made up 13.7 percent of all open auto loans in the third quarter of 2008, up from 9.6 percent in the fourth quarter of 2006. (*Automotive News*, 12/1/08)

- In two states, Indiana and Michigan, funds that pay unemployment benefits have dried up, and both states are borrowing from the federal government to make those payments. Thirty additional states, according to the National Association of State Workforce Agencies, are "at risk" of their unemployment benefit funds reaching insolvency over the next few months. (*New York Times*, 12/15/08)

- In 2006 and 2007, private-sector asset flow into African countries overtook official development assistance, at $40 billion and $38 billion, respectively, from all sources. (*African Banker*, Fourth Quarter 2008)

- Payday lenders outnumber McDonald's franchises in four out of five of the nation's most populous states. (*Newsweek*, 11/3/08)

- India is leasing an Akula-class nuclear submarine from Russia; this will make India the sixth nuclear-submarine-operating country. (*Jane's Defense Weekly*, 11/12/08)

- Several Indian airlines have defaulted on their fuel bills. (*Times of India*, 11/20/08)

- Since 2006, American households have spent some $400 billion more than they've earned. (*Christian Science Monitor*, 10/23/08)