A string of shocks through the spring and summer undermined business, consumer, and investor confidence. Odds of a renewed recession over the next 12 months, already one in three, will increase if stock prices continue to fall. The economy's path depends on how swiftly and effectively policymakers act to shore up confidence. If confidence improves, the economy's improving fundamentals can begin to build a foundation for better growth. We have lowered the forecast for U.S. real GDP growth to 2% annualized in the second half of 2011, and just over 3% in 2012.

The U.S. economy has suffered an extraordinary reversal of fortune. As 2011 began, the recovery appeared healthy and ready to become a self-sustaining expansion. Job growth was strong, unemployment was falling, and income and consumer spending were accelerating. Incredibly, the economy today is struggling to avoid another recession.

A string of unfortunate shocks are to blame. Surging gasoline and food prices and fallout from the Japanese quake hurt badly in the spring; more recently the debt-ceiling drama, a revived European debt crisis, and the Standard & Poor's downgrade have been especially disconcerting. Confidence, already fragile after the nightmare of the Great Recession and Washington's heated policy debates, was severely undermined. Stocks are nearing bear-market territory.

Policymakers are working to shore up confidence, but whether they will succeed is a difficult call. The odds of a renewed recession over the next 12 months are one in three, and rising with each 100-point drop in the Dow. While it remains likely that the recovery will continue, the near-term economic outlook is significantly weaker than it was just a month ago. Prospects for GDP growth and job creation have diminished substantially since our last forecast.
Crisis of confidence

Confidence normally reflects economic conditions; it doesn’t shape them. Consumer sentiment falls when unemployment, gasoline prices or inflation rise, but this has little impact on consumer spending. Yet at times, particularly during economic turning points, cause and effect can shift. Sentiment can be so harmed that businesses, consumers and investors freeze up, turning a gloomy outlook into a self-fulfilling prophecy. This is one of those times.

The collective psyche was already very fragile coming out of the Great Recession. The loss of 8.75 million jobs and double-digit unemployment have been extraordinarily difficult to bear. Businesses have also struggled with a flood of major policy initiatives from Washington, led by healthcare and financial regulatory reform. Other major policy debates, over issues such as immigration, energy and unionization, produced no legislation but still left business people nervous.

Unnerved investors

The drama over raising the nation’s debt ceiling, and especially S&P’s downgrade of U.S. debt, eviscerated what confidence remained. While losing the AAA rating has little actual significance—Treasury yields have fallen since the downgrade—it apparently unnerved investors, judging by the plunge in stock prices. Consumer and small-business confidence gauges are as low as they have been outside the Great Recession. The Moody’s Analytics business survey has held up better, but it too has weakened significantly in recent weeks, with hiring intentions turning notably softer.
A loss of faith in the economy can quickly become self-fulfilling. A key conduit is the stock market. Since equity prices peaked in late April, well over $3 trillion in wealth has evaporated. Since every $1 decline in stock wealth is estimated to reduce consumer spending by 3 cents, the loss to date means spending will take a $100 billion hit over the coming year. This in turn will reduce real GDP growth by about two-thirds of a percentage point.

**Signals to business**

Stock prices also serve as signals to business, letting firms know when it’s time to expand as well as providing the means to do so. Rising stock prices embolden managers to take risks and seek growth opportunities, and a rising market allows firms to issue more equity to fund investment, hire, or acquire other businesses. Conversely, falling stock prices weigh heavily on those animal spirits so vital to a well-functioning economy.

A crisis of confidence can also impair the financial system. Banks and other financial institutions borrow heavily from each other to fund their activities. Much of this is overnight or short-term borrowing; thus even a brief disruption in money flows can trigger a financial crisis. While such a scenario seems unlikely at the moment, serious stress lines are developing, particularly in Europe. The Euribor—the rate European banks pay to borrow for brief periods—has almost doubled over the past two weeks. European banks also appear to be turning to the European Central Bank maintain liquidity. The same stresses aren’t evident
in the U.S.; the Libor-Treasury spread has risen only modestly, but tensions are rising.

**How will policymakers respond?**

Whether the current crisis of confidence results in a double-dip recession critically depends on how effectively policymakers respond. Global central banks are responding aggressively. The ECB has begun purchasing Italian and Spanish sovereign bonds, helping to push down those governments’ borrowing costs. Before the ECB acted, 10-year yields on debt from both nations had spiked above 6%, a key threshold. Beyond that level, a country’s interest payments rise so quickly that debt loads become overwhelming. Italian and Spanish bond yields are currently closer to 5%.

![Europe's Spreading Debt Crisis](image)

European policymakers will almost certainly need to do more to quell the panic afflicting their financial system. Most significantly, policymakers must significantly expand the size of the European Financial Stability Facility, the fund used so far to bail out Greece, Ireland and Portugal. The EFSF has been granted more flexibility to deal with the crisis; it will soon be able to charge lower interest rates on loans to distressed nations and provide funds to resolve nations’ problem banks. But this isn’t enough to convince scared investors that the ESFS will have the resources to help if Italy, Spain or even France get into trouble.

**The Fed's commitment**
The Federal Reserve has also responded aggressively. The Fed took the unprecedented step of promising to keep interest rates very low until mid-2013. While this commitment has helped bring down long-term interest rates and should encourage more risk-taking by borrowers who know they can count on rates staying near 0% for two years, the Fed’s principal target was confidence. It was a bolder step than investors had expected, and it significantly lowers the bar for another round of quantitative easing. It now seems more likely than not that QE3 will begin in the next couple of months.

Meanwhile, the Obama administration is also asking Congress to give the economy additional fiscal support. Extending the current payroll tax holiday and emergency unemployment insurance benefits through 2012 would provide the most near-term help. Indeed, not doing so will shave close to a percentage point from next year’s real GDP growth and cost the economy about 1 million jobs. Congress seems disinclined to go along, given its current focus on fiscal austerity. Yet this could change quickly, particularly if the economy appears headed into recession. Even bolder fiscal action would be appropriate, including providing more financial aid to state and local governments to partially forestall layoffs and tax increases. This would be much harder politically, however.

**Better fundamentals**

If policymakers can quickly stanch the bleeding in confidence, the economy’s improving fundamentals can begin to build a foundation for better growth late this year and early next. These better fundamentals are most evident in the economy’s strengthening balance sheet.

Business balance sheets are about as healthy as they have ever been, showing many firms have repaid debt and locked in rock-bottom interest rates. The interest coverage ratio for nonfinancial corporations—the ratio of interest payments to cash flow—has never been lower, and the quick ratio—the ratio of liquid assets (mostly cash) to short-term liabilities—is as high as it has been since just after World War II. This improvement isn’t isolated, but widespread across industries.
Households have made significant strides deleveraging. Since they peaked three years ago, total household liabilities have fallen by $1.2 trillion, or about 10%. Debt service burdens—the proportion of after-tax income households pay to remain current—are falling fast and likely will be near record lows early next year. This is reflected in rapidly improving credit quality. The delinquency rate on household liabilities excluding first mortgages has come full circle and is now where it was prior to the recession. Even 30-day first-mortgage delinquencies are back to prerecession levels, and 60-day delinquencies aren’t far off.

The financial system is also much better capitalized and profitable. According to the FDIC, the core capital ratio, which never rose above 8% from the late 1980s through the Great Recession, topped 9% in the first quarter of this year. Returns on assets aren’t back to levels seen in the boom years, when they were juiced up by speculative lending and high leverage, but they are respectable. What banks are missing now is loan growth, and given their stronger capital positions, they are well situated to ease underwriting standards and open the credit spigot.
Even the government’s balance sheet will soon improve. The deal struck between the president and Congress to end the debt standoff did not solve the nation’s fiscal problems, but it was a substantive step in the right direction. The deal cuts $2.4 trillion in government spending over the next decade, more than half the $4 trillion in deficit reduction everyone agrees is our goal. The mechanisms to achieve these cuts appear durable, and judging by the loud protests from the Democrats who opposed such cuts, they think so too. Policymakers still need to raise tax revenues to achieve success, but that is likely as the expiration of the Bush tax cuts nears late next year. Under current law, tax rates will rise for everyone in 2013, but if policymakers simply agree to allow those tax cuts to expire only for those making more than $250,000 annually, they will have done what they need to do.

**Revised outlook**

This optimism notwithstanding, it is clear that the drop in confidence and the stock market’s slide have weakened the economy’s outlook. We are significantly lowering our expectations for near-term economic growth. Real GDP is now expected to expand at an annualized rate near 2% during the second half of 2011, and just over 3% next year. A month ago we projected GDP growth at 3.5% during the second half of this year and through 2012. A reduced rate of consumer spending growth accounts for most of the downward revision.
The economy needs to grow 2.5% to 3% per year to add jobs fast enough to keep the unemployment rate stable; this will not happen soon. Employers will have added about 1.25 million jobs on net between the fourth quarters of 2010 and 2011, and 2 million more by the fourth quarter of 2012. By then U.S. employment will total some 1 million less than expected in last month’s forecast. Unemployment will thus end 2012 near 8.5%, rather than falling below 8% as previously anticipated.

Even this outlook feels shaky given the turmoil in financial markets. The old adage that the stock market has predicted nine of the last five recessions is apt, but the recent free fall is disconcerting. Markets and the economy seem one shock away from dangerously unraveling. Policymakers must work quickly and decisively; we also need a bit of luck. We certainly are due for some.
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