

The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

1729 H St. NW, Washington, DC 20006-3938 • kiplingerbiz.com • Vol. 85, No. 37

Dear Client:

Washington, Sept. 12, 2008

Struggling Wall St. banks make headlines.
But what's happening on Main St. is key
to the financial well-being of most U.S. businesses.
And there's plenty of trouble brewing there.

BANKING OUTLOOK

Hundreds of banks will fail by 2010 or so.
So far this year, 11 have gone belly-up.
By year-end...a few dozen more, with the pace
picking up in 2009. All told, figure that about 3%
of the nation's 8500 insured lenders won't survive.
That's the most in two decades...but less
than the 8% of banks that failed from 1987 to 1992.

Hardest hit areas: Calif., Fla., Ariz. and Ga...
marked by overbuilding or plummeting property values.
And states such as Mich. and Ohio,
where laid-off auto and other manufacturing workers
haven't been able to maintain mortgage payments.
But woes won't be limited to those regions.
Smaller banks that rode the housing wave upward,
growing quickly and without diversifying their lending,
are most likely to bite the dust no matter their location.

Spooked regulators will sniff out troubles nationwide. Acutely aware
of criticism by lawmakers that lending practices were allowed to become too lax...
Examiners are now determined to prevent further implosions on their turf.
Their overcautiousness is likely to make matters worse in the short run.
Lending standards will come under the microscope, and federal regulators will insist
that banks boost reserves and call business loans if collateral value has deteriorated.
They'll crack down hard on situations that at other times might have been shrugged off
as temporary blips. This time, they'll be unwilling to wait out some potential problems
and, in forcing the issue, may deal a lethal blow to banks that might have survived.

Also, bank failures typically rise even after the economy starts to improve.
Faults start to appear, but it takes a while for regulators to clean house. The FDIC,
the Federal Deposit Insurance Corp., now has 117 banks on its so-called problem list.
That's up from 76 last year but still lags reality. The fact is, examiners show up
at banks only once a year unless they have a specific reason to be more vigilant.

Most depositors needn't worry... federal insurance covers up to \$100,000
per depositor at each institution. Larger accounts should be spread among banks.
Borrowers at smaller regional and community banks face rougher weather.
Even banks sitting pretty will be stingier. They'll hike collateral requirements,
for example, set revenue benchmarks to be met and keep a tighter rein on borrowers.
So start improving your creditworthiness now. Buff up your credit score.
Get your books in order. And cultivate your local banker *before* you want to borrow.

ECONOMIC FORECASTS

↔	GDP growth A sluggish 1.5% in '08 and '09
↔	Interest rates Prime rate at 5% into early '09, 10-year T-notes yielding 4.25%
↓	Inflation Moderating in coming months
↑	Job growth Fewer monthly losses in '09
↓	Crude oil Averaging \$100/barrel in '09
↑	Housing sales A small pickup during '09
↓	Retail sales growth Around 1% next year
↓	Trade deficit Just over 3% of GDP in '09
Complete economic outlook at kiplingerbiz.com/outlooks	

Few signs of a thaw on Wall St.'s credit horizon.

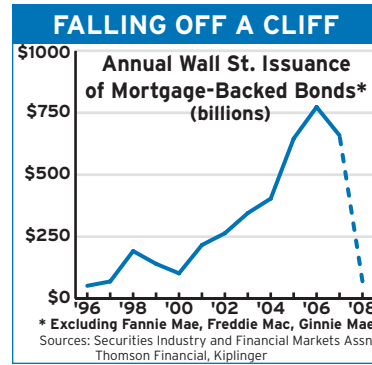
The landscape for both big commercial banks and investment houses remains icy...just \$39 billion in mortgage-backed securities issued from Jan. to July this year vs. \$517 billion over the same period in 2007.

Banks are reluctant to sell their iffy debt, fearing they'll take a much bigger slam than needed.

And few investors want to buy it, in any case.

Merrill Lynch recently sold \$30 billion in debt for 22¢ on the dollar and had to finance 75% of the transaction.

So write-downs will continue well into 2009, with up to \$1.5 trillion in red ink yet to hit the books.



And there's another blow coming Wall St.'s way: Sinking commodity prices, as the air slowly leaks out of the bubble...a course our Letter anticipated last April.

Shutdowns of badly burned commodity hedge funds are sure to rebound on Wall St. firms with a big stake in them. Lehman Brothers, for example, held a fifth of Ospraie Management's huge commodity fund, whose value dove 40% this year.

Of course, softer prices for commodities will benefit firms that use them.

Although prices for many industrial metals...copper, lead, nickel, zinc and tin... won't dip much from today's levels, they'll average 5%-10% lower next year than this. Similarly, crude oil prices have bottomed out at the \$100 mark. They'll climb again in 2009 but won't regain the 2008 peaks and will average 15% lower for the year.

That's good news on the inflation front, too. The moderating effect of lower energy prices, showing up in a more temperate Consumer Price Index for Aug., bolsters the Federal Reserve's decision not to hike short-term interest rates.

The Fed's concern is shifting from inflation to economic softness.

But don't expect an interest rate cut from Fed Chm. Ben Bernanke and his colleagues. They know a decrease won't restore the credit markets or end the slide in housing.

Odds are the next interest rate move...up or down...won't come before spring.

Note that "vulture funds" are starting to peck at the housing market.

In areas with good long-term growth potential...suburbs around Washington, D.C., parts of N.J., Calif., Ariz. and Fla., for example...bargain hunting investors are buying up finished lots from distressed home builders, paying as little as 35¢ on the dollar. They're betting on some big gains and are willing to wait a few years to cash in. It's one case where circling vultures are a sign of life rather than of death, signaling that a market bottom approaches and that improvement isn't too far off.

Little cheer for retailers in the coming holiday season. Santa's sleigh will bring only a 2% increase in sales as consumers struggle under the weight of rising joblessness, continued high gasoline prices and shrinking home values.

The key to boosting sales: Value-oriented marketing...coaxing consumers into buying more by bundling purchases, for example. The purchase of a sweater might be sweetened by retailers offering 50% off on a pair of matching slacks. Or a home theater might be packaged with a library of dirt-cheap DVDs to play on it.

Discounters will come out on top, but specialty stores will likely struggle.

Online retailers will gain, with growth in the low double digits...10%-12%. That won't match dazzling growth of some prior holiday seasons. Last year...16%.

Accessories and add-on gadgets will do well as penny-pinching consumers look to spruce up their wardrobes, homes and electronics rather than start fresh.

Holiday jobs will be tougher to come by, with employers hiring conservatively.

And service is likely to suffer...with longer lines and slower delivery the norm.



IN
CONGRESS

Lawmakers will head out of town by early October to hit the hustings. Democrats figure they can weather criticism about a do-nothing Congress, even as they roll up their tents without achieving much in the last few weeks.
Only two of 12 spending bills are likely to be OK'd...for the Defense Dept. and for veterans affairs and military construction. All other government spending will fall under short-term legislation extending current funding levels till spring.
There'll be plenty of talk about energy, but no agreement. Democrats feel vulnerable on offshore drilling, but the limits they want and their insistence on eliminating tax breaks for oil companies will turn off Republican members.

ENERGY

The first new nuclear power plants in decades: Hot-tub-size minireactors being developed by Toshiba, Hyperion Power Generation and NuScale Power. The miniplants can create enough electricity to power a town of about 25,000 homes. But municipal uses aren't likely. In four to five years, they'll show up in remote spots for heavy industry functions like oil extraction from tar sands or water desalination.
In 2014 or 2015, look for the first new full-size plant to come on line, followed by a score or more of additional facilities erected within a handful of years.
In fact, demand will be large enough to support assembly-line production. The Shaw Group and Westinghouse Electric are building an enormous facility in La. to mass-produce control systems, piping, steel reinforcing and other components for a standardized plant, the AP1000. Only the reactor core must be built on-site.

TECH

Cheaper, better digital video cameras are spurring innovative business uses. The technology allows automatic detection and alerts of unusual movements plus high-speed computer searches of video for particular images...ending the need for constant eyeballing. In addition to a slew of security uses...monitoring everything from sticky fingers at cash registers to wayward kids climbing cell phone towers... videos can measure customer wait times, find the best spots in stores for promotions and even read temperature and other gauges from afar, saving on shoe leather.

Are budget cuts requiring your firm to cut back on trade fair participation? Consider a virtual fair instead. In sort of an interactive webcast, vendors and conferees meet and greet and inspect wares on display without leaving the office. For vendors, costs are a third less than for participation in real-world trade fairs. Attendees also save big...no lodging, travel or meal costs. Among the companies offering virtual fairs: ON24 of San Francisco and Unisfair of Menlo Park, Calif.

The U.S. Postal Service is going digital, with Intelligent Mail. Next May, unique scannable bar codes will start to show up on business and first-class mail. The codes should speed up processing of letters and packages and will allow mailers as well as post offices to track the movement and delivery of each piece of mail. For users, they'll also bring to snail-mail billing and direct marketing the same kinds of efficiencies in data mining and management now afforded online communications. At first, mailers can choose whether or not to use "smart mail," but by May 2011, all bulk mail must be coded and about half of first-class mail will be voluntarily ID'd.

As your business software licenses expire, consider "cloud computing"... software and information storage that's in a "cloud" online instead of in-house. Financial data, inventories, payroll and customer relationship management can be handled with word processing, spreadsheet, database and other programs from companies that include Google, InfoStreet, Bill.com, Salesforce.com and more.

It's cheaper, cutting IT staff needs. And security concerns are fading with new software. Still...it'll be only about 12% of the market four years from now.



**AIR
TRAVEL**

Looks as if Congress will finally pass a bill of rights for airline passengers. Lawmakers facing reelection don't want to keep voters waiting any longer, so they'll add the protections to a piece of must-pass legislation this month.

The bill will force carriers to prepare plans to ease the pain of long delays. And they'll face stiff fines if they are not ready to provide food, water, bathrooms, cabin ventilation and fresh air anytime a plane is kept sitting for hours on a runway.

Cutbacks by the major airlines are taking a big toll on the nation's airports. Fewer flights undercut the landing fees that airports rely on for their revenue.

The result: Hiring freezes, layoffs and salary caps at many airports.

Plus higher airport advertising rates as airports try to make up the gap. Higher fees, too, for using land around airports. And costlier parking for travelers.

To lure airlines back or attract new ones, airports are offering incentives, though they can't afford to do so on a long-term basis. Airports in Baton Rouge, La., Columbus and Dayton, Ohio, Mobile, Ala., and several in Fla. and Calif., for example, are either waiving or reducing fees, or paying for airline advertising in local media.

The capacity cutbacks are huge...eliminating 20 million U.S. carrier seats this year. That's 33% of worldwide cuts, but not 33% of U.S. capacity, as reported in our Aug. 29 Letter. It amounts to a 9% drop in total U.S. seats. Sorry for the goof.

LABOR

The machinists strike at Boeing may be a long one. The union's relationship with the firm has long been testy...this is the seventh strike since 1948... and Boeing's direct offer to workers backfired big-time. It infuriated union leaders and workers alike. When the vote came, an overwhelming 87% opted to strike.

Job security is the key issue. But pay and benefits are problems, too.

Boeing has a lot at stake...it's already a year behind in filling orders and risks losing out to competitors. The strike is costing Boeing \$100 million a day.

Hollywood will avoid a second strike this year. Screen actors won't walk out as writers did earlier. Too many members don't like how the union is handling talks.

But much of the damage has already been done. Studios have been operating at a snail's pace since the actors' previous contract ran out at the end of June. Producers will compensate by spacing out new releases over the course of 2009.

**THE
WORLD**

The U.S. isn't the only country facing a choice of leadership this year. Three key American allies are in the same boat: Israel, Japan and Canada. Two of the three will get a new head of government, while one looks to stand pat.

Israeli Foreign Minister Tzipi Livni will probably replace Ehud Olmert as prime minister when the ruling Kadima Party picks a new leader. A moderate, she's apt to push hard for a peace agreement with the Palestinians next year.

In Japan, five are vying to lead the ruling Liberal Democratic Party. A slight edge goes to Taro Aso, who favors a lot more spending on public works to revive the economy. Whoever wins will call new elections in October or November.

Canadian Prime Minister Stephen Harper is a good bet for a second term. He's hoping his Conservative Party also wins big in Oct., giving him a tax cut mandate.

Yours very truly,



THE KIPLINGER WASHINGTON EDITORS

Sept. 12, 2008

P.S. Looking for ways to take the pain out of performance reviews? We can help. Join us for a 90-minute interactive audio conference on Oct. 7. You can register online at www.krm.com/kiplinger or by phone at 800-775-7654.