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Even the most aggressive rescue plan isn't likely to avert recession at this point.

Amid the early waves of fear and risk avoidance afflicting the markets last fall, we recognized that the mounting pessimism would have economic consequences of its own, apart from any substantive threats to growth (see "Fear Itself" November 16, 2007). While we said the economy was likely to skirt recession, a slowing of economic activity would probably be difficult to avoid.

That call has held up well in the months since. While growth in the fourth of quarter of last year was recorded as slightly negative, the first two quarters this year have been positive, with the second quarter posting a downright vigorous growth rate exceeding 3%, thanks largely to an export boom. Of the three classic recession indicators -- decline in industrial production, drop in payroll employment, and rise in unemployment -- only the unemployment rate has thus far exceeded its recession threshold. The other two aren't even close (see "Perception, Election, Reality and Risk" September 5, 2008).

Update to strategic view

US MACRO: The economy up to now has proven surprisingly resilient in the face of financial market turmoil. The latest tumult, however, may prove to be more than it can endure. Without a very quick restoration of the market's capacity to bear risk and create capital, at least a brief and mild recession seems unavoidable.

[see Investment Strategy Dashboard]

No question, though, the risks to the economy have amped up significantly with the recent intensification of credit market turmoil. The fear factor that last fall was first raising the price of risk has been magnified by alarming proportions. Amid the chaos that seized upon the credit markets last week, junk bond spreads blew out to nearly 1000 bp, just 100 bp below their peak in the worst of the blowout in 2002. The rush to safety and spurning of anything associated with risk blew out the TED spread to more than 300 bp, a jump of more than 150 bp within the space of five sessions, and the LIBOR-OIS spread soared to 154 bp, versus the normal level of less than 10 bp, last seen prior to the outbreak of turbulence last summer. These indicators have all come off their worst levels since the panic peaked at the middle of last week, but they remain highly elevated.

Simply put, no economy can sustain growth if its credit markets are in paralysis -- or, for that matter, if consumers, workers, investors and entrepreneurs are sidelined by fear. The $700 billion bailout package that the Bush administration has proposed would probably relieve the worst of the risks and allow the markets to resume some degree of functional normality. It

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remains to be seen, however, whether the administration will succeed this week in getting its program enacted by Congress, and without a variety of additional conditions that could impair its effectiveness (see "It's Not the RTC -- It's a $700 Billion LBO" September 22, 2008. It also remains to be seen how quickly the markets will be stabilized once the program is in place. Taking $700 billion in distressed assets off the books of the financial system can not be done overnight, nor, as Congress is apparently worrying, will it necessarily be done competently. Whether the markets can be revived just by virtue of the fact that a recovery effort is underway is an open question. The economy requires a swift restoration of the market's risk-taking capacity. An extended dearth of capital and risk appetite will almost certainly nudge the economy over the definitional edge of recession.

The current situation is further complicated by the Fed's stance and its policy outlook. The most sensitive market price indicators have significantly upped their inflation premium in the gathering crisis. The price of gold, which fell below $750 prior to the intensification of credit turmoil, broke back through $900, and as of this writing is trading around $890. We have stubbornly regarded the correction in gold from levels approaching $1000 this summer as having been overdone, and at least partially due to trading exigencies tied to the precipitous drop in crude oil prices (see "Gold: Is Enough Enough?" August 13, 2008; and "Deflation? Surely You're Joking" August 21, 2008). The gold price from time to time can get disconnected from the fundamentals that determine the real purchasing power of the currency, but not for long. In the context of the continuing credit market disarray, it's clear that the Fed will not begin moving to normalize its exceedingly easy policy posture in the near term. In fact, Fed funds futures are now fully priced for an inter-meeting rate cut before the end of September. In June, the futures were pricing for a rate *hike* by September, with a funds rate of 3.25% by next April. Now, the first rate hike is not fully priced in the futures curve before next summer.

In the short run, the Fed maintaining such an accommodative posture at least will not be a factor posing a drag on growth. However, the short-run "feel good" positives from inflation are always reversed in the longer term. Inflation is corrosive to the economy's underpinnings, raising the risks to capital, upping the real tax rate on capital (the capital gains tax is unindexed), and discouraging productivity-boosting capital investment. And when push comes to shove, the Fed will at some point have no choice but to respond to the inflation it has created, and by the time it chooses to do so, it will likely require an aggressive and extended tightening campaign, entailing obvious economic risks.

The gold price rally has been accompanied by a corresponding fall in the dollar, with the trade-weighted value of the currency losing about a third of the gain it had made since mid-summer. A renewed episode of dollar weakness certainly will not be a plus in attracting the capital needed to support growth and help stabilize the markets. And if the dollar appears likely to be beset by an extended period of weakness, a flight from US assets by foreign holders could ensue.

BOTTOM LINE: The economy up to now has proven surprisingly resilient in the face of financial market turmoil. The latest tumult, however, may prove to be more than it can endure. Without a very quick restoration of the market's capacity to bear risk and create capital, at least a brief and mild recession seems unavoidable.