U.S. Economic and Interest Rate Outlook

The Shoals of Depression Have Been Avoided, but the Economy Still Faces Strong Headwinds

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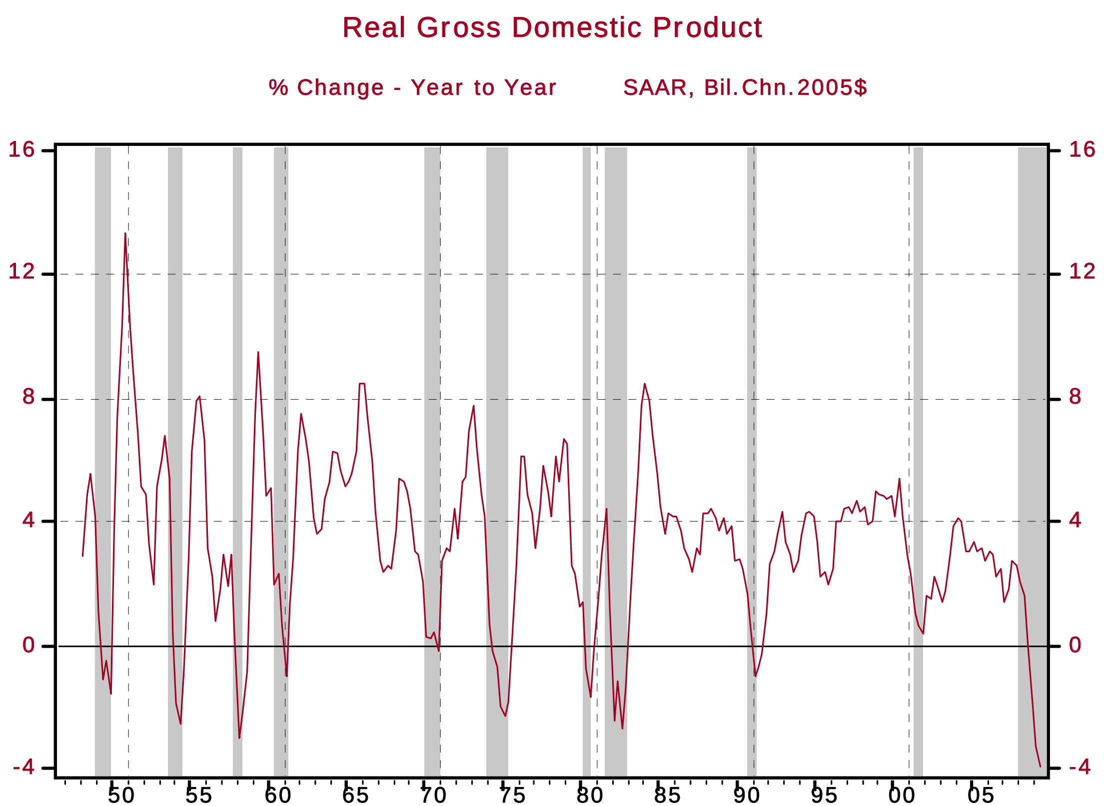
We have just weathered the longest (19 months?) and deepest recession in the post-WWII era.



Source: Bureau of Economic Analysis /Haver Analytics

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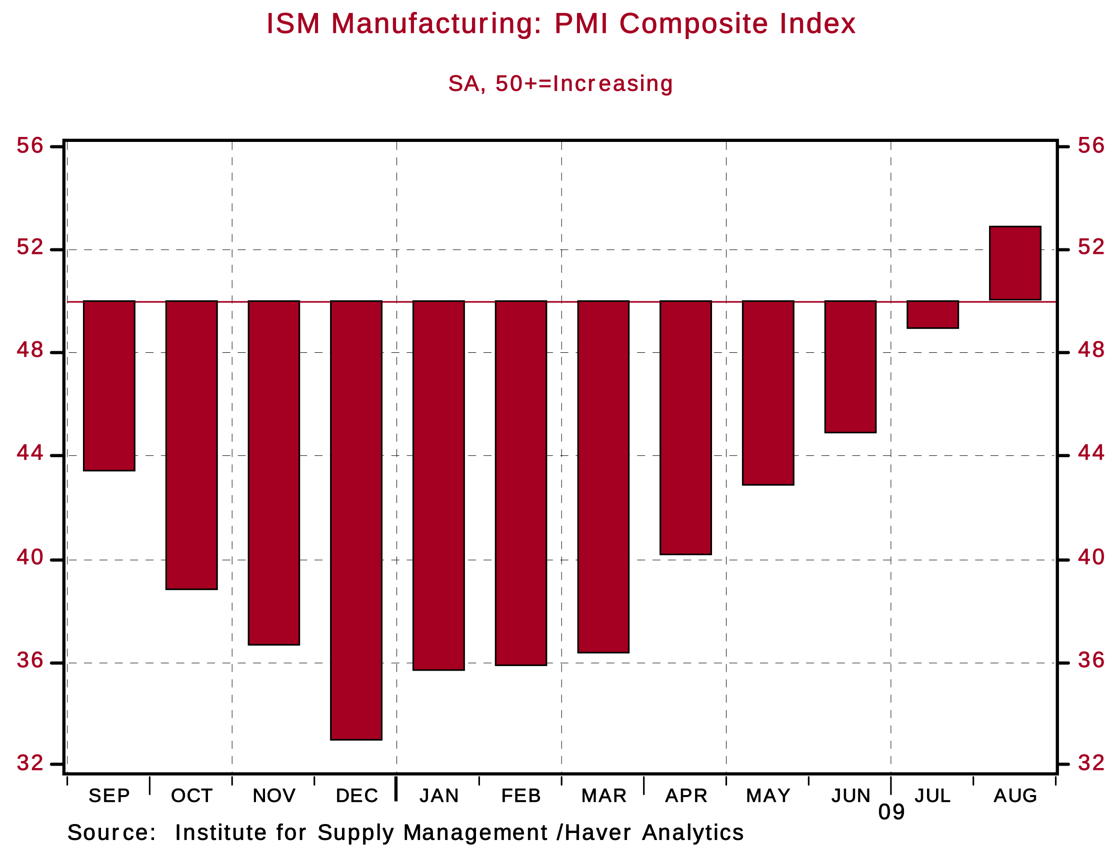
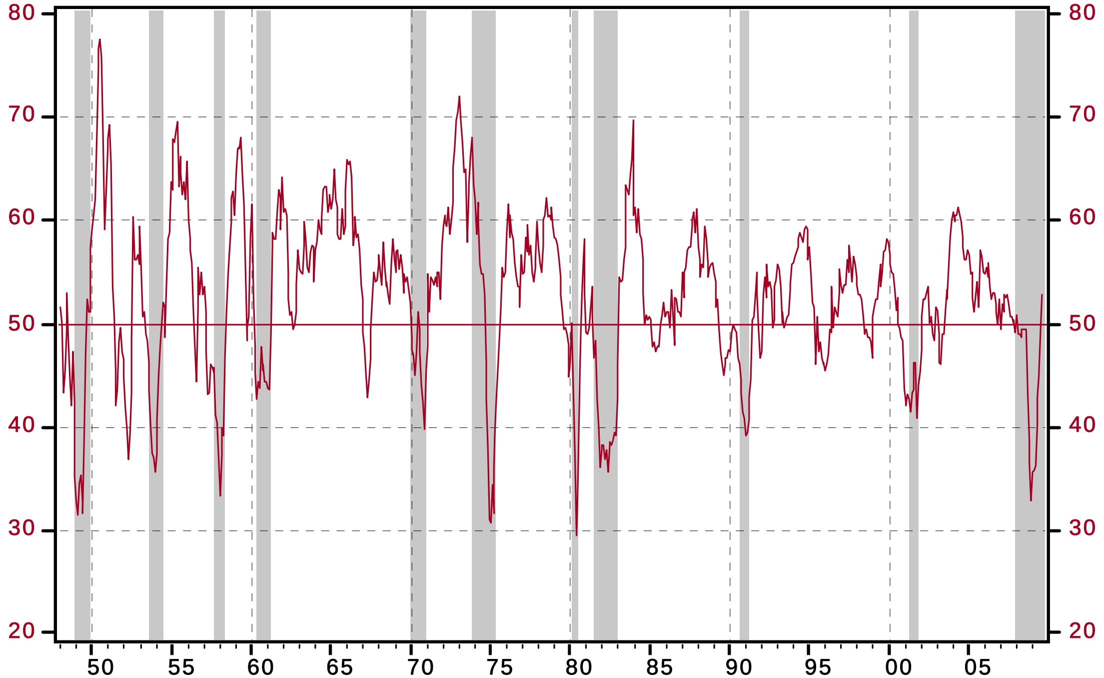
In August, the ISM-Mfg. Composite Index popped above 50 for the first time since January 2008.



The behavior of the ISM-Mfg. Index suggests that the recession ended in July 2009.

ISM Manufacturing: PMI Composite Index

SA, 50+=Increasing



Source: Institute for Supply Management /Haver Analytics

It is not that any one sector is soaring …

…rather a number of sectors have either stopped descending or are descending at a much slower rate.

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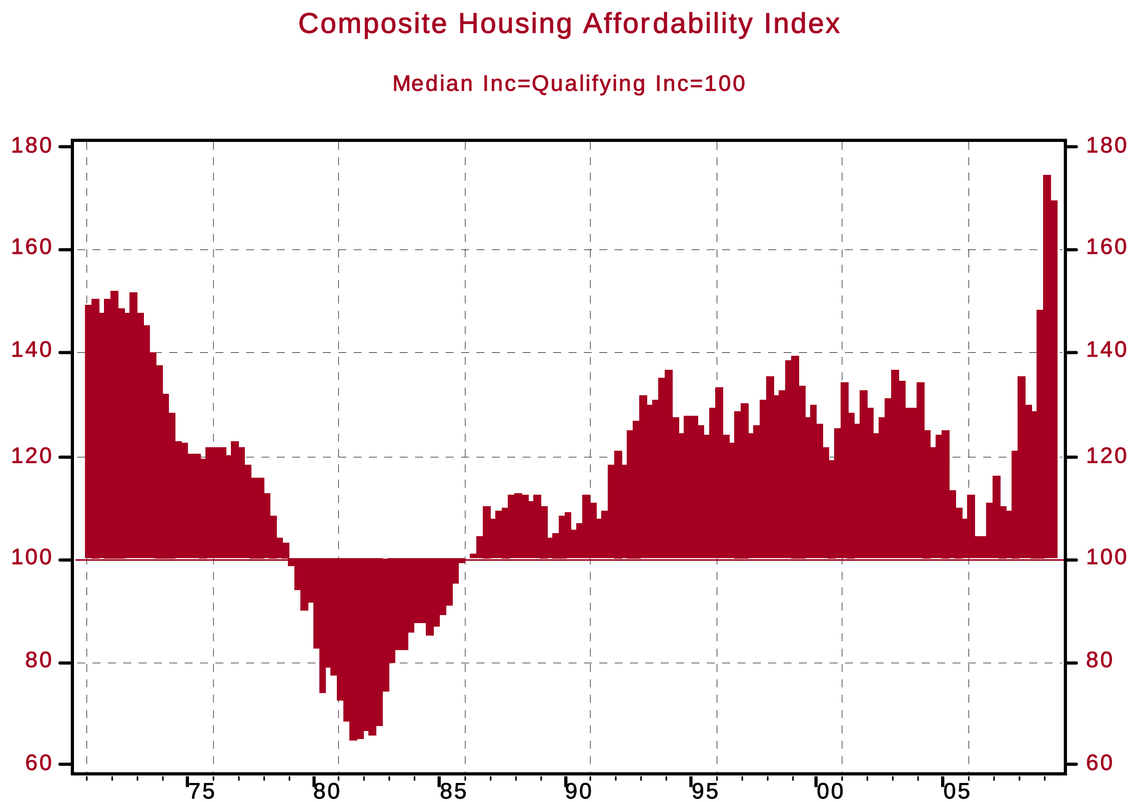
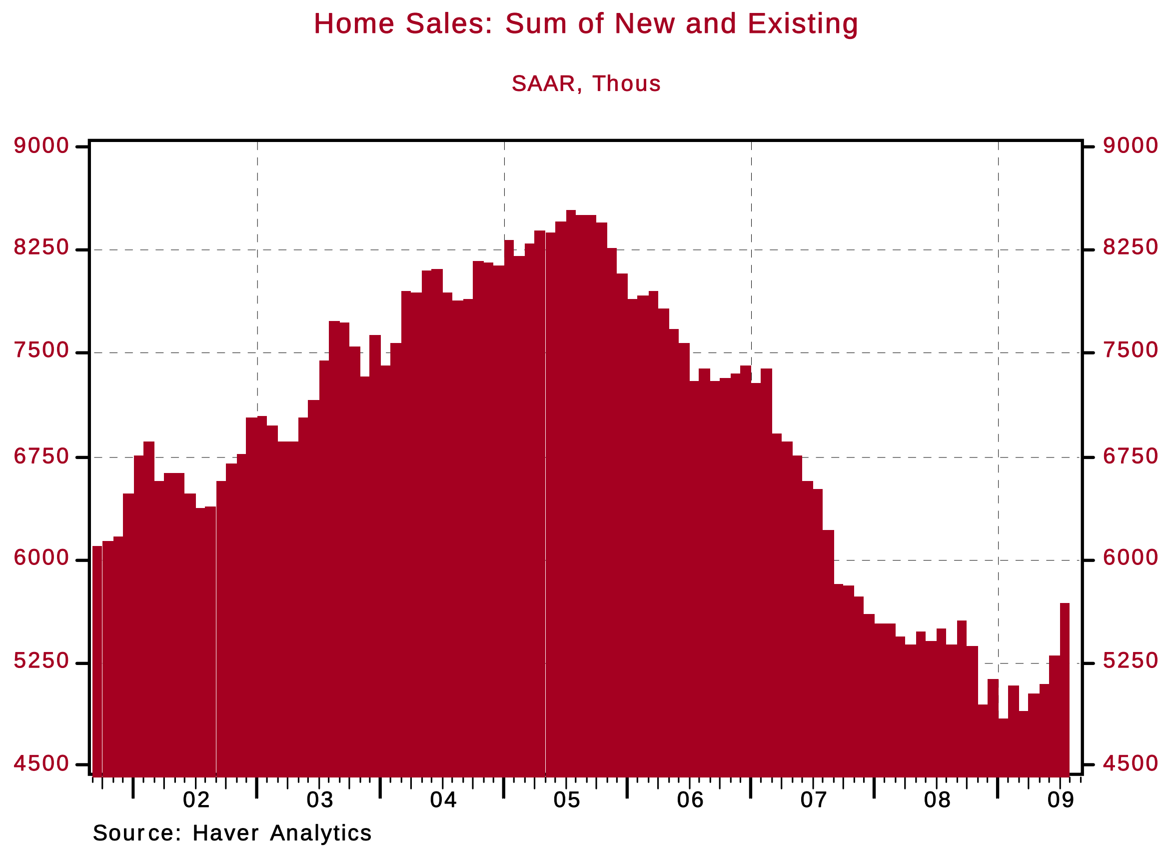
Thanks to the sharp decline in home prices and the low level of mortgage rates, house purchases are now much more affordable.

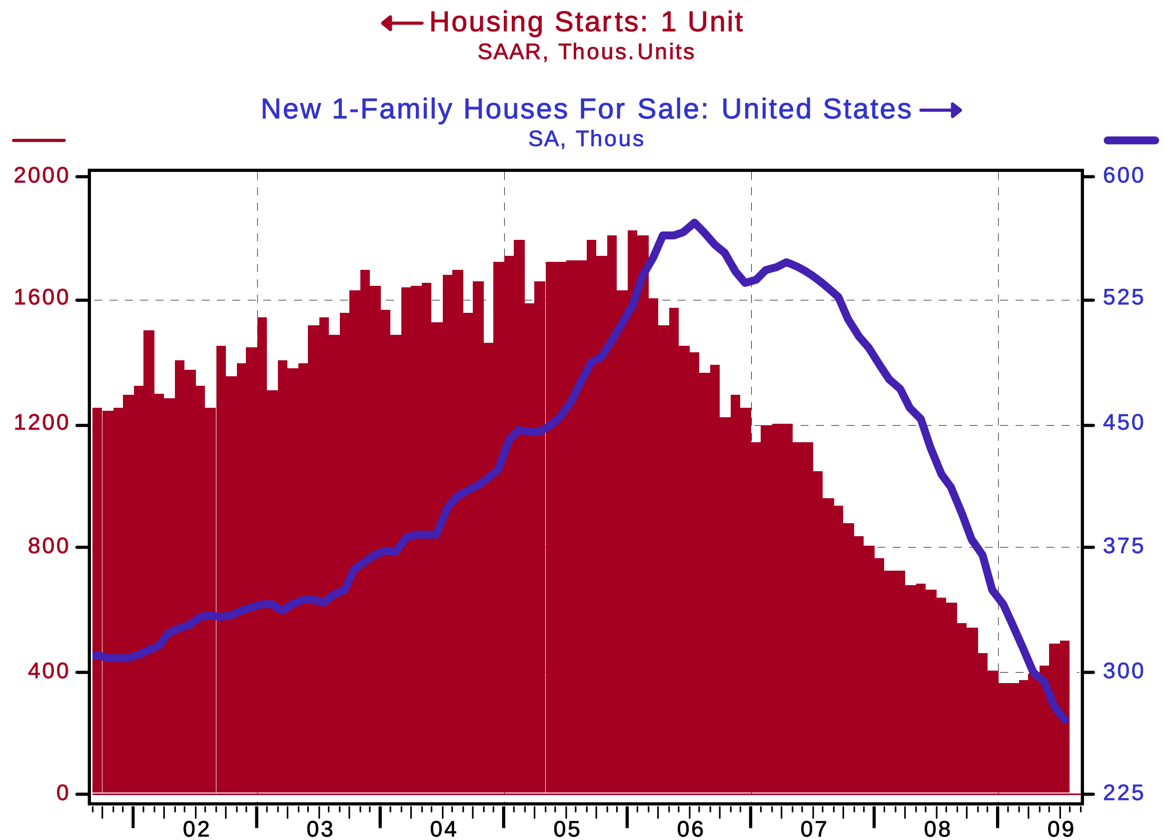


Source: National Association of Realtors /Haver Analytics

High housing affordability plus the $8K first-time-homebuyer tax credit has resulted in four consecutive monthly increases in home sales.

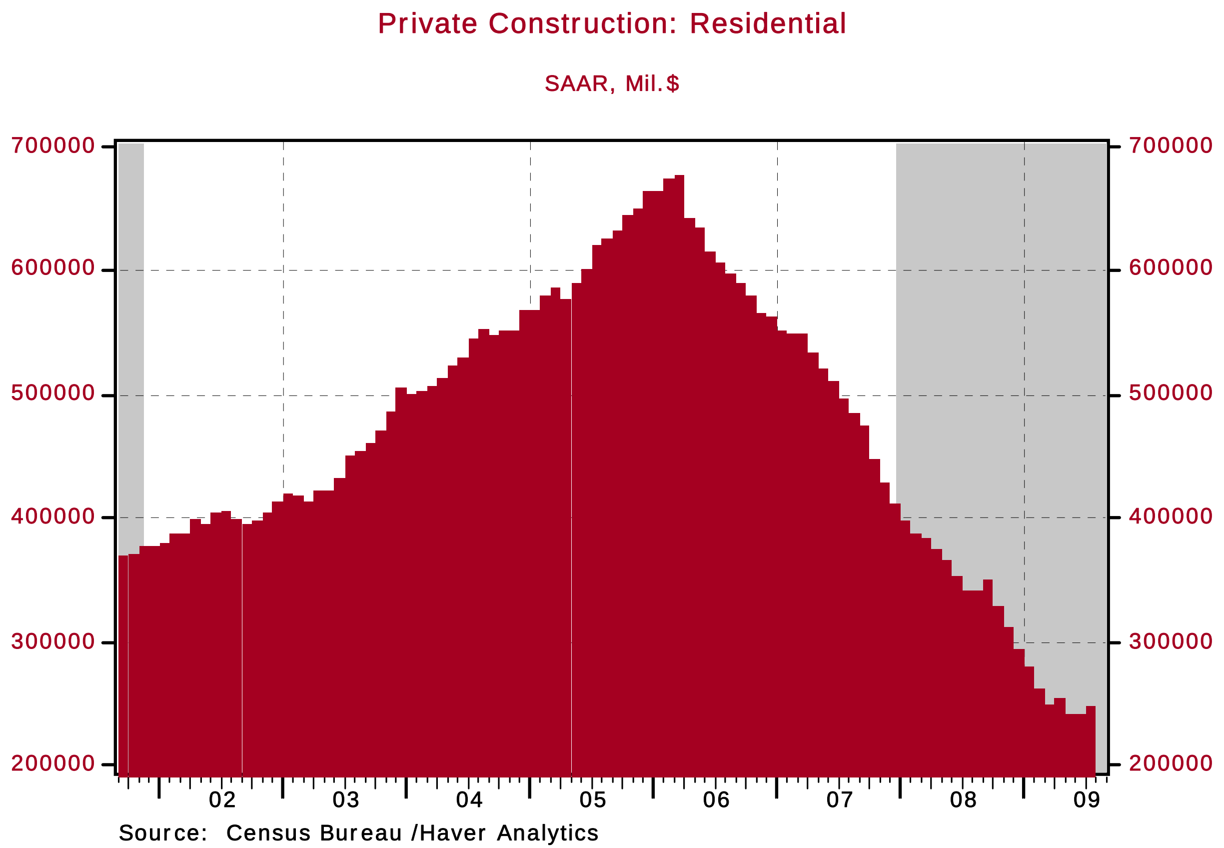


The sharp decline in the inventory of new homes has led to five consecutive increases in starts of new single-family homes.

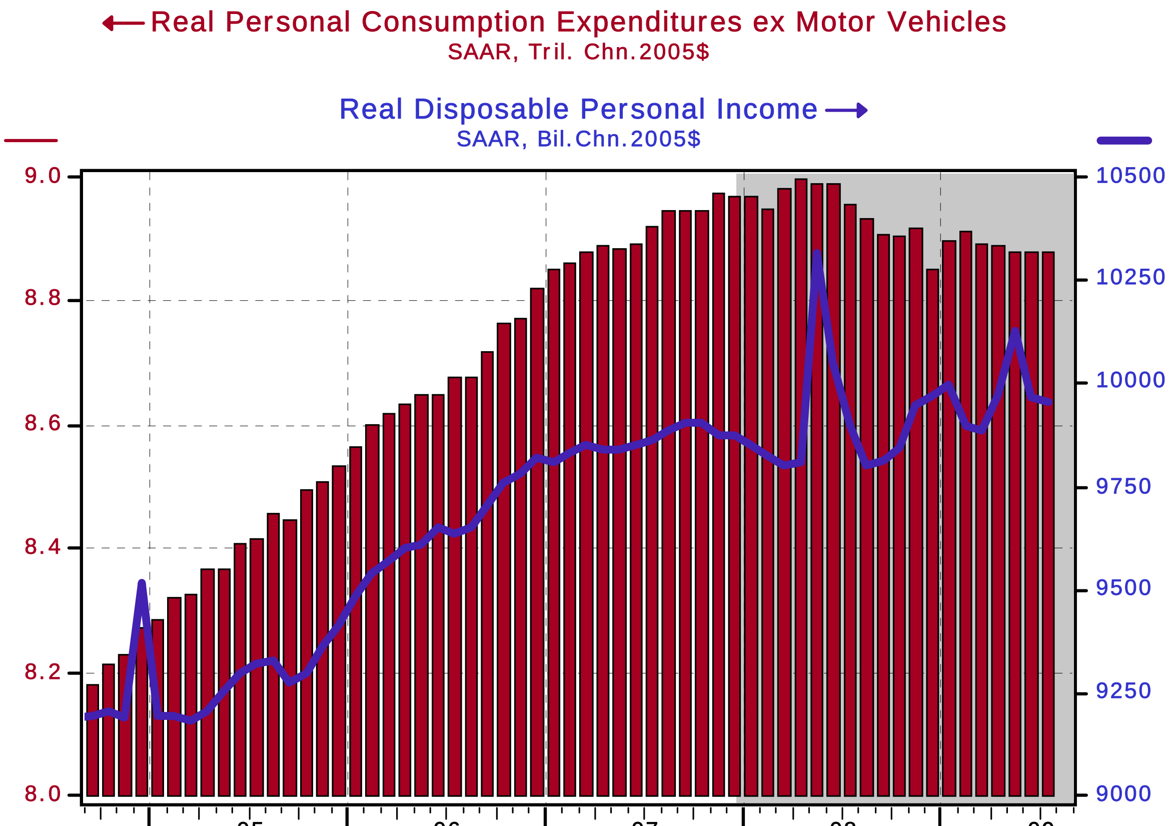


Source: Census Bureau /Haver Analytics

Thus, after its steep slide starting in 2006, expenditures related to residential construction appear to have bottomed.

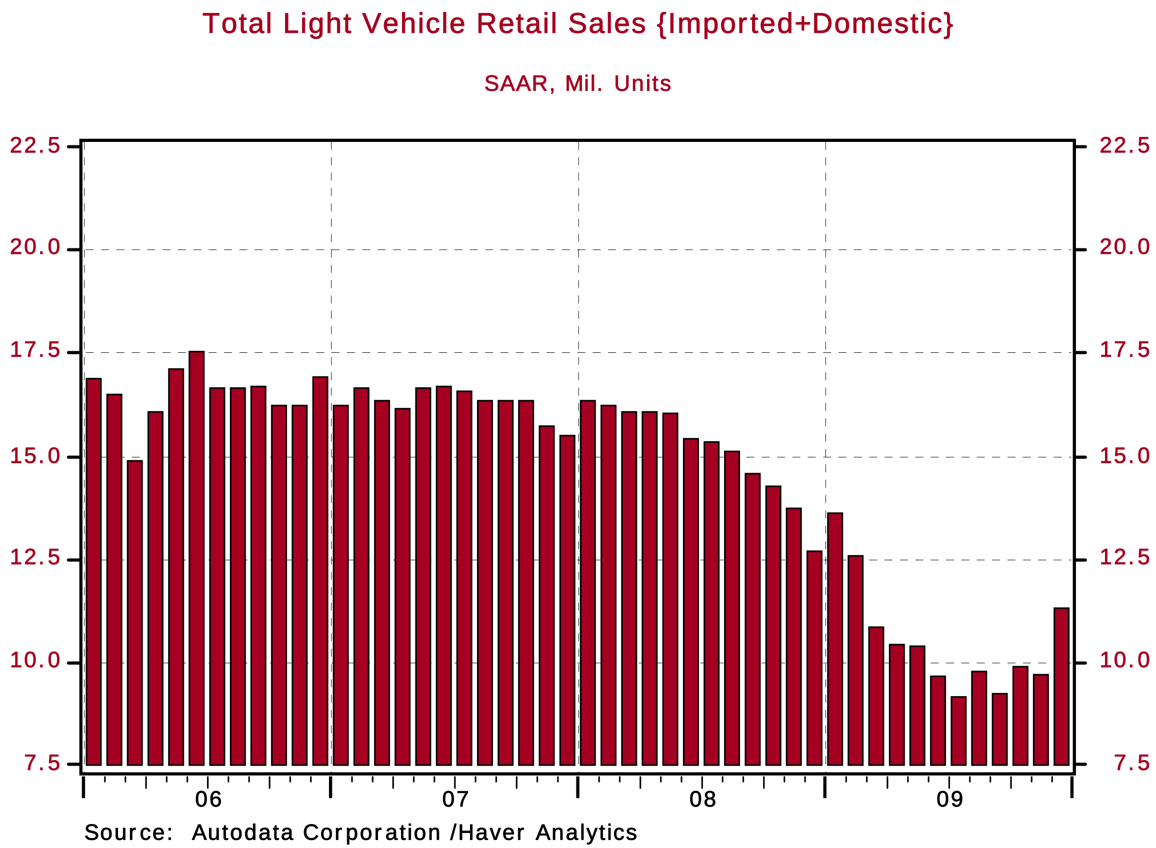


The tax cuts of the fiscal stimulus program plus unemployment insurance have helped stabilize disposable personal income, which, in turn, has helped stabilize consumer spending.

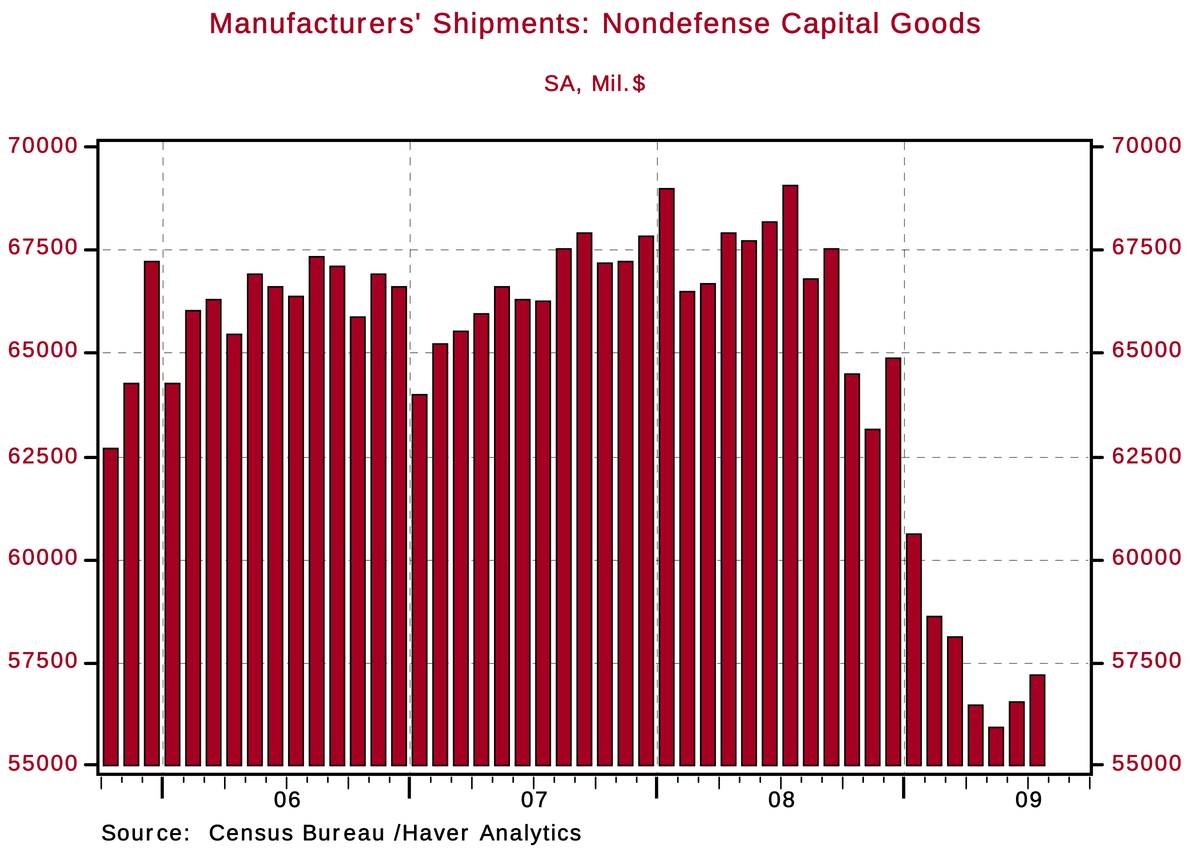


Source: Haver Analytics

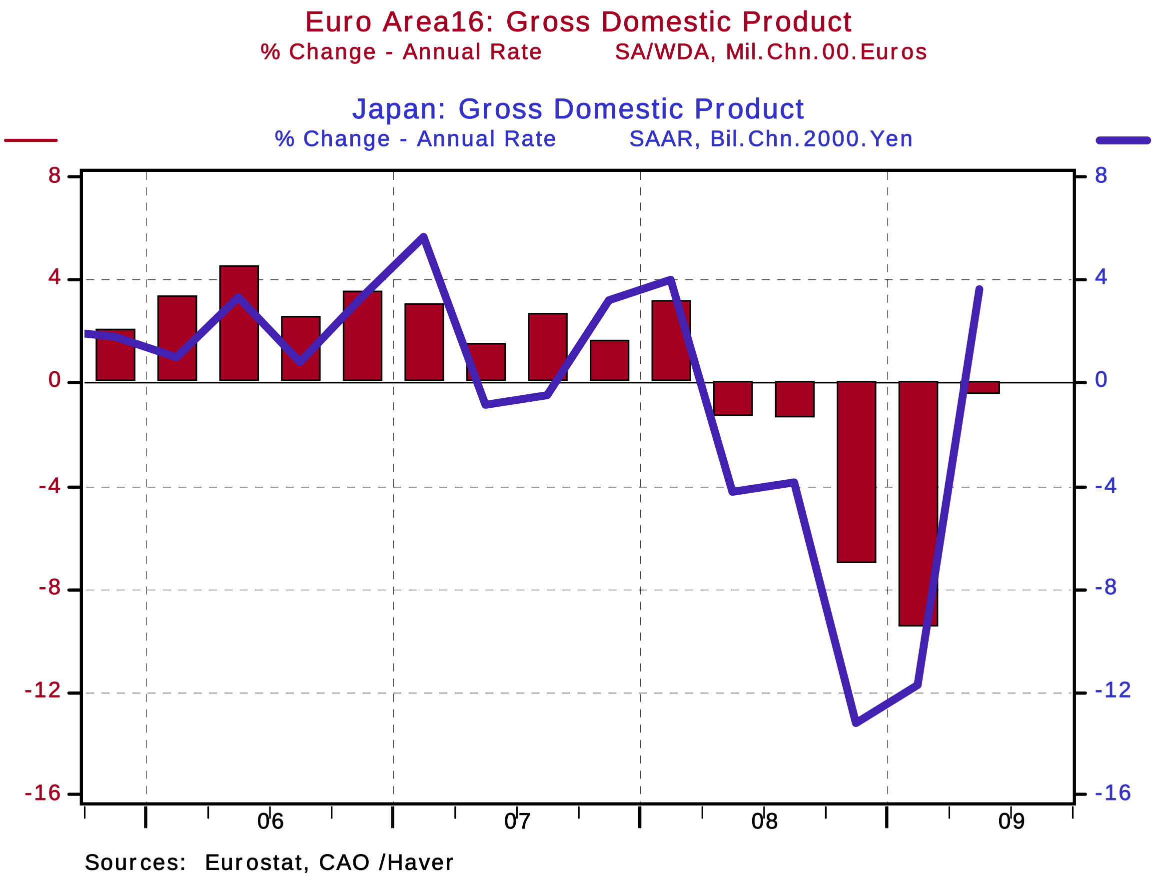
Car and truck sales appeared to have bottomed even before "cash-for-clunkers." There is natural replacement demand given that some of us are still driving 1995 Subarus!



Some of those drill presses, computers, and 737s need replacing, too.



Economic activity is improving in the developed economies ...



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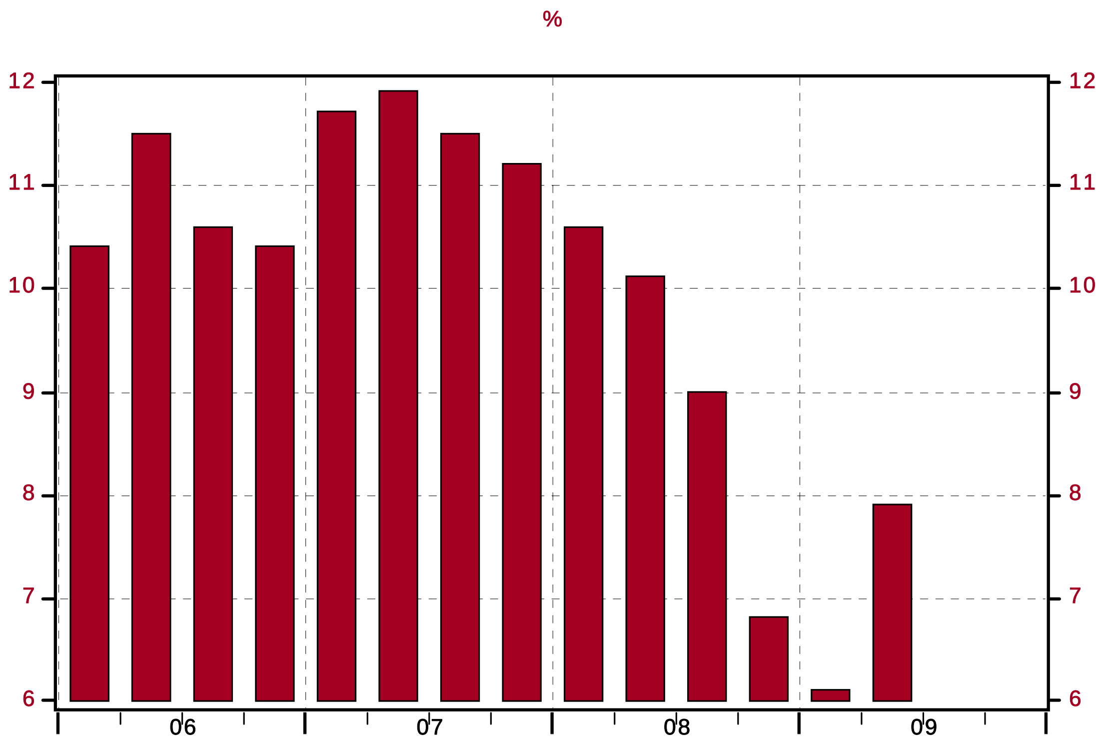
... as well as in China ...

China: Real GDP: Year-to-Year Percent Change



Source: China National Bureau of Statistics /Haver Analytics

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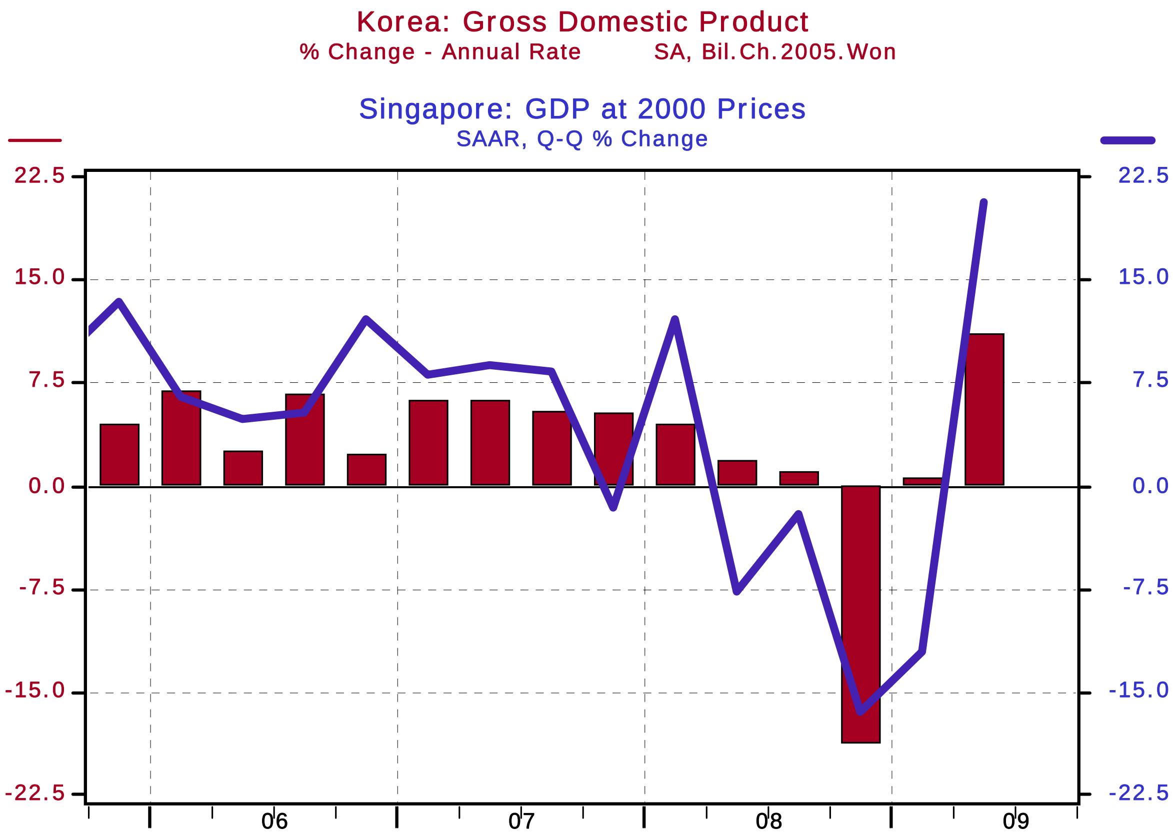
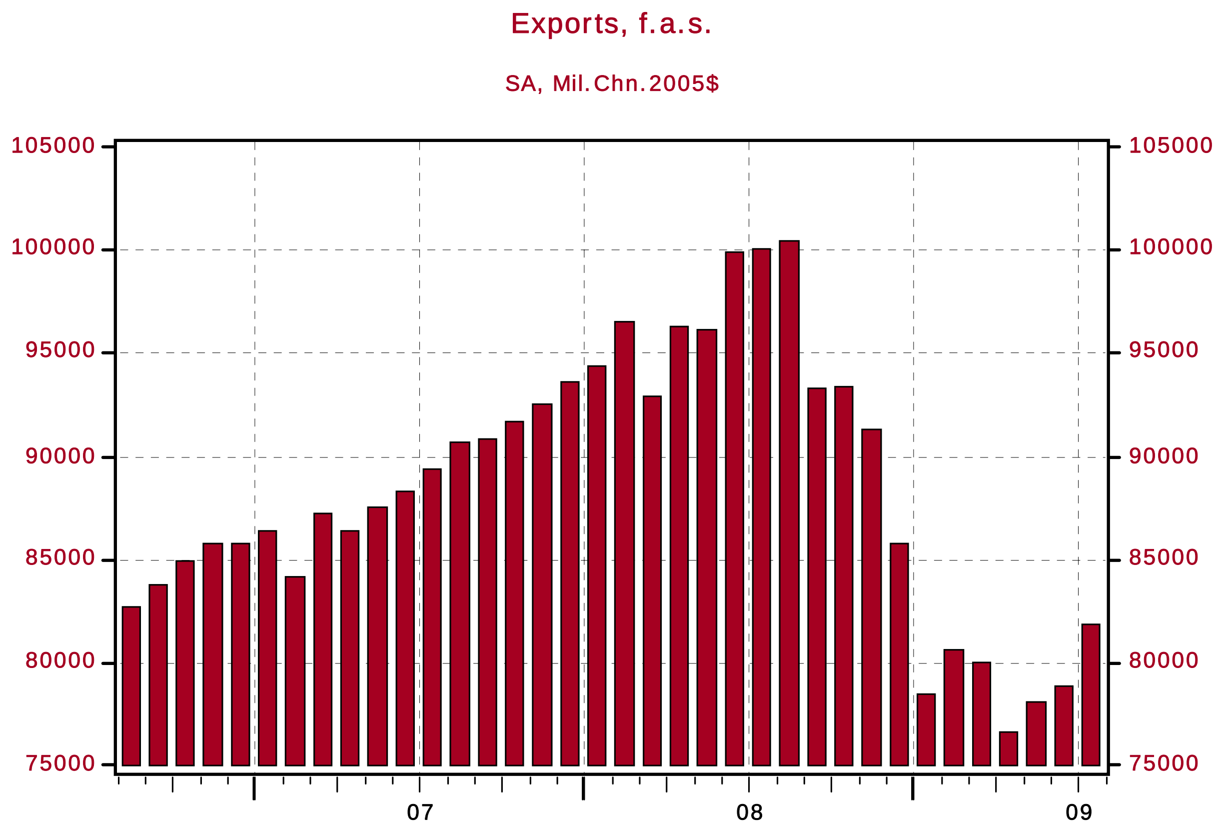
... other developing economies.



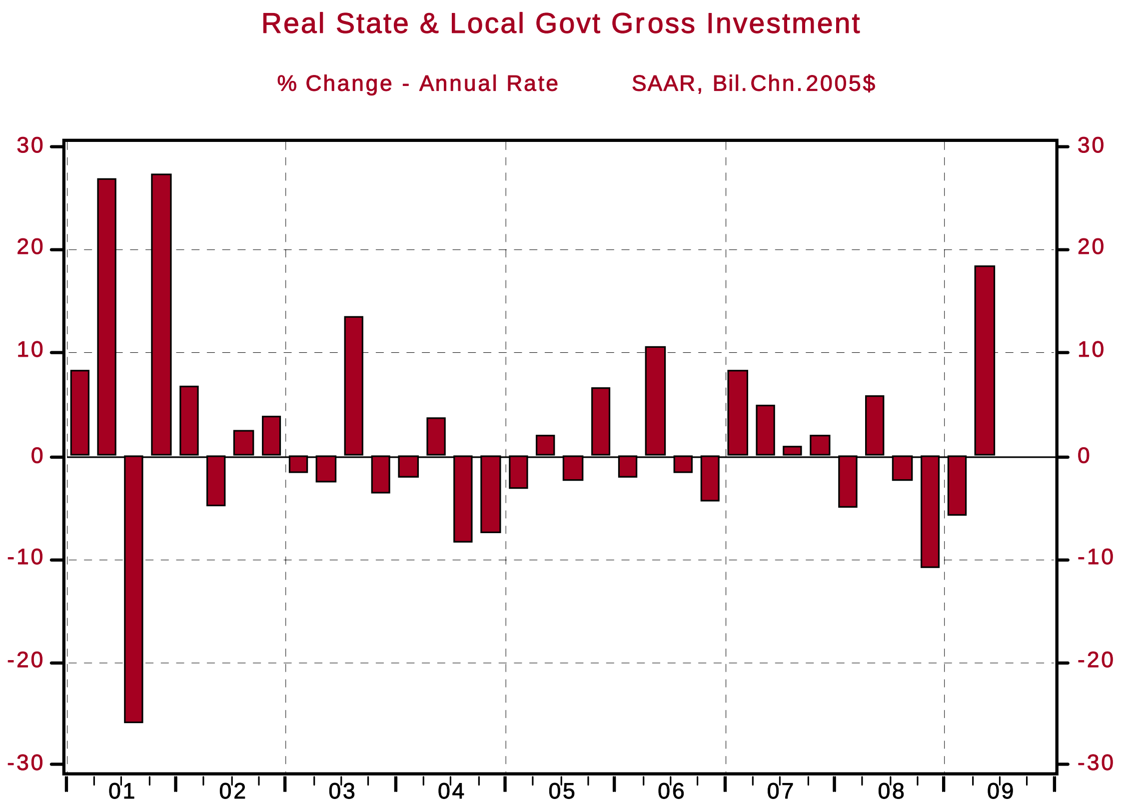
Sources: Bank of Korea, Department of Statistics/Haver Analytics

The economic recovery underway in the rest of the world is boosting U.S. exports.



Source: Bureau of the Census /Haver Analytics

State & local government infrastructure spending in Q2 grew at its fastest rate since 2001 due to the "Build America Bonds" program authorized by the fiscal stimulus program.



Source: Bureau of Economic Analysis /Haver Analytics

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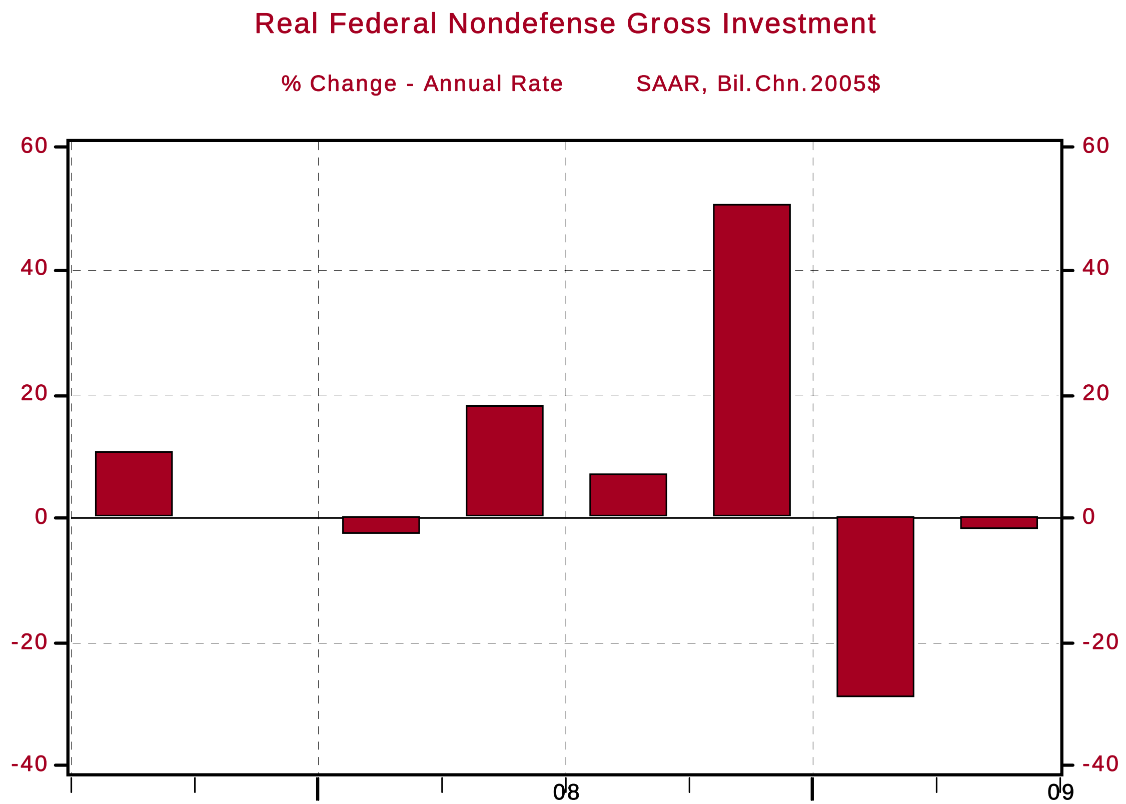
Speaking of the stimulus program, for the most part, the federal *spending* portion of it has yet to kick in.



Source: Bureau of Economic Analysis /Haver Analytics

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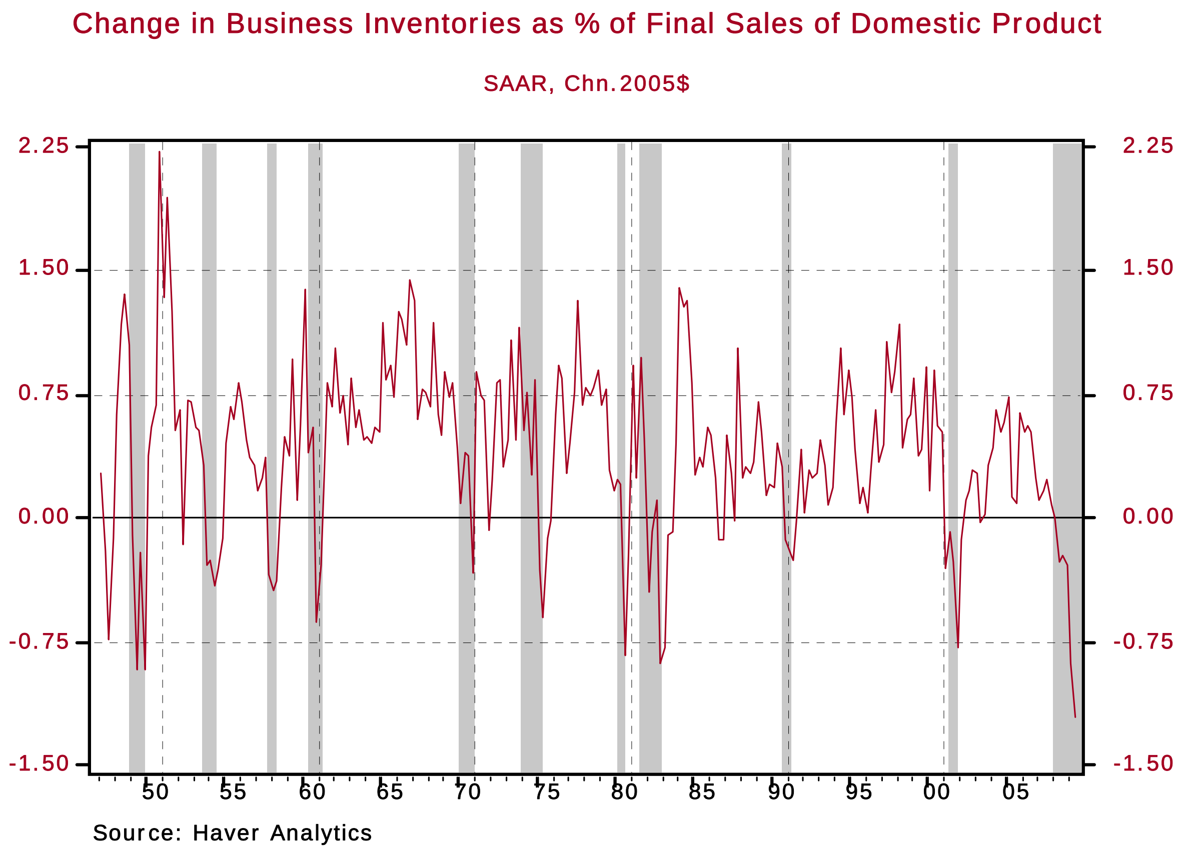
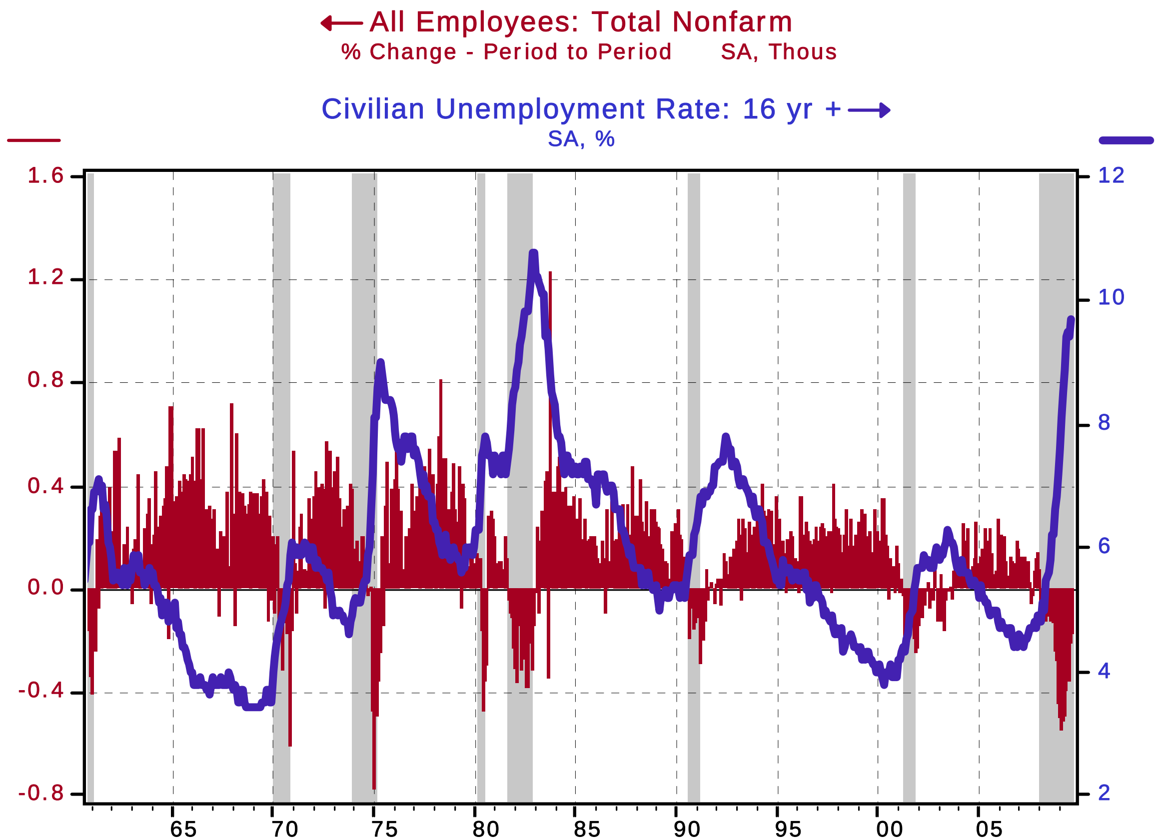
After the largest inventory liquidation in the post-WWII era, some businesses will have to begin restocking because their shelves are bare.



Although job growth and a drop in the unemployment rate have yet to occur, both of these improving labor-market indicators tend to lag in economic recoveries.



Source: Bureau of Labor Statistics /Haver Analytics

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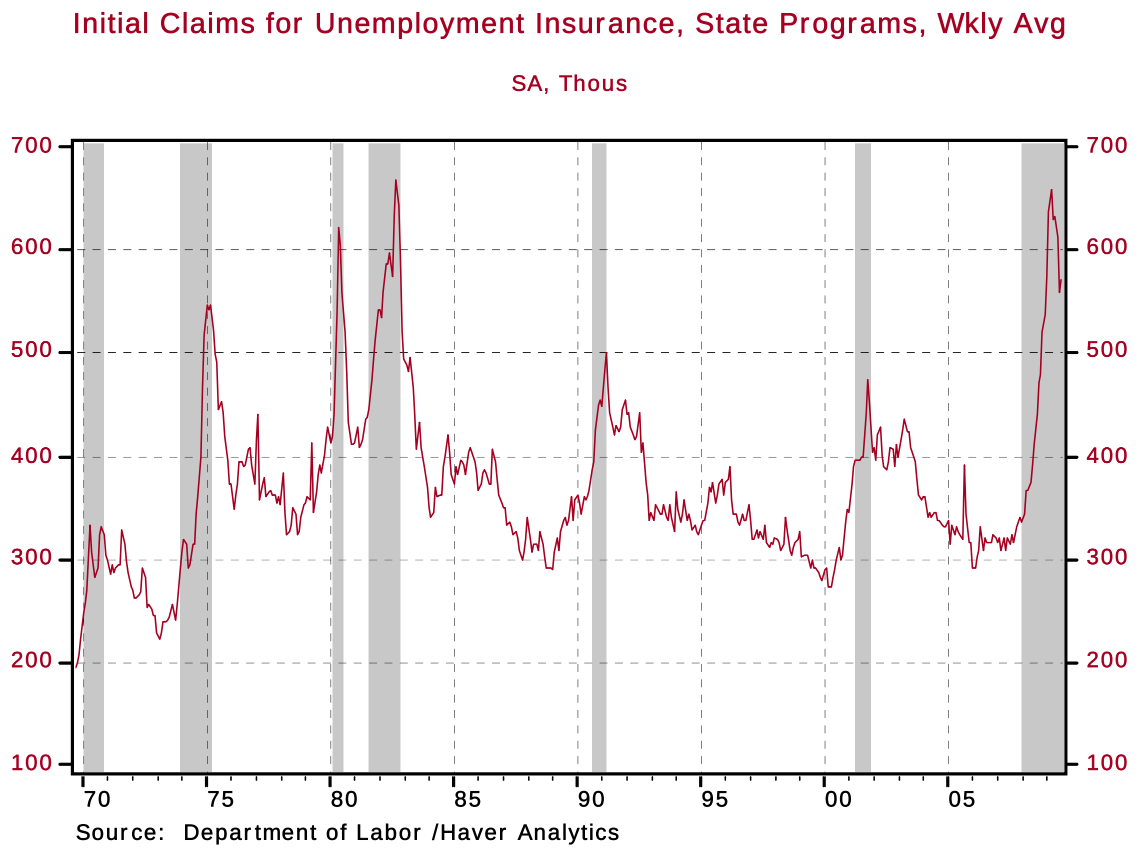
But the level of first-time unemployment insurance claims is falling, which typically happens just before or at the onset of recoveries.



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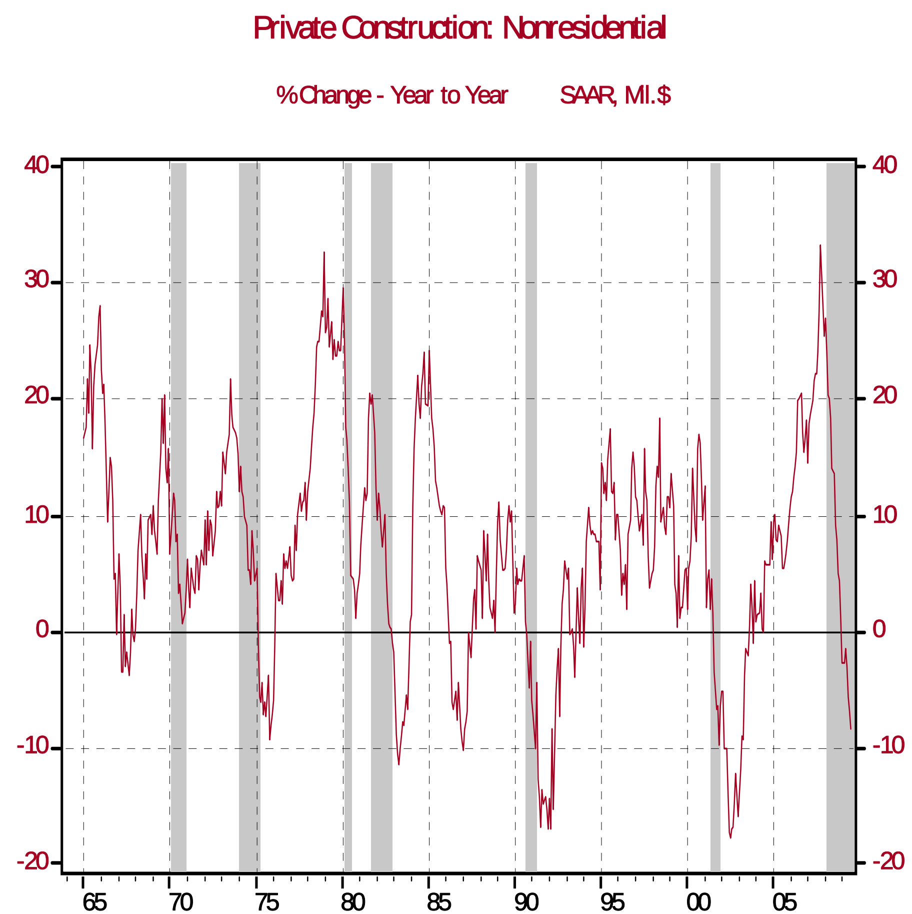
If there is one sector that is not improving, it is commercial real estate.

- A lagging sector.
- High and rising unemployment will keep office vacancy rates rising.
- Mall vacancy rates will remain high as retailing is years away from returning to its recent boom era.
- Hotel vacancy rates will remain high as discretionary travel will be slow to strengthen.



Source: Census Bureau/Haver Analytics

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Financial market conditions are improving

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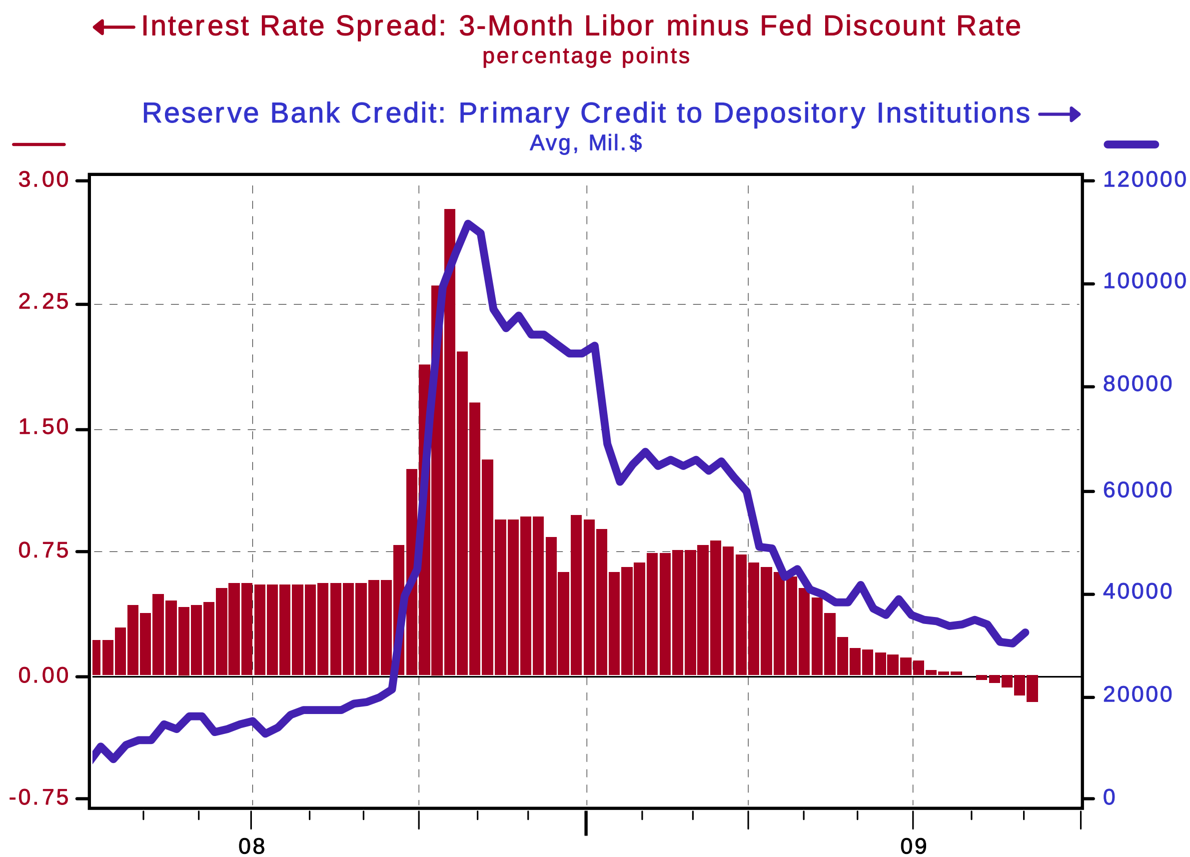
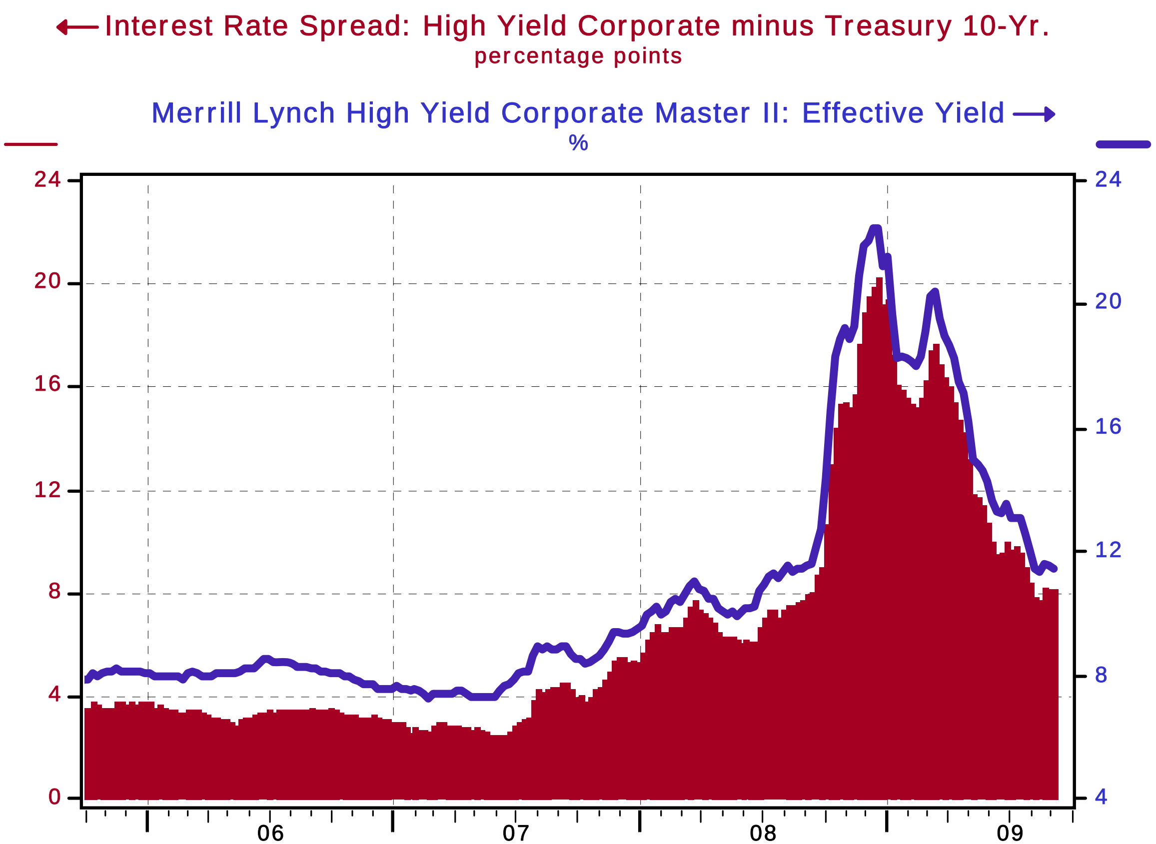
After Lehman collapsed, the interbank loan market froze up. This market now is thawing as evidenced by the decline in Libor interest rates and the decline in discount-window borrowing from the Fed.



Source: Haver Analytics

After Lehman failed, the bond market was pricing in a rerun of the early 1930s. Risk appetites have been whetted now that the worst case has not occurred.



Source: Haver Analytics

The S&P 500 was up nearly 50% from its early March low by Labor Day.

Standard & Poor's 500 Stock Price Index

EOP, 1941-43=10

Source: Wall Street Journal /Haver Analytics

The economy still faces strong headwinds

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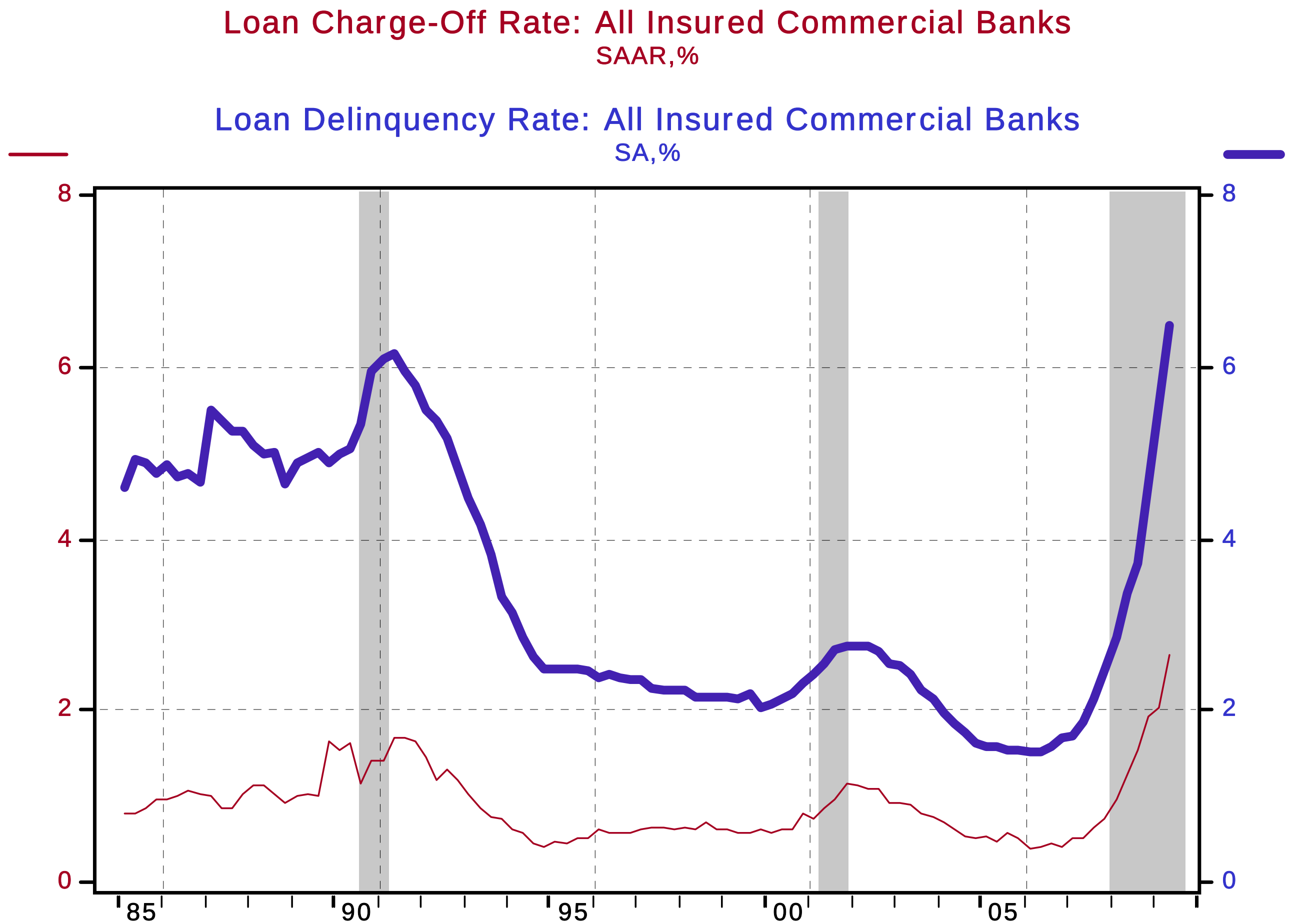
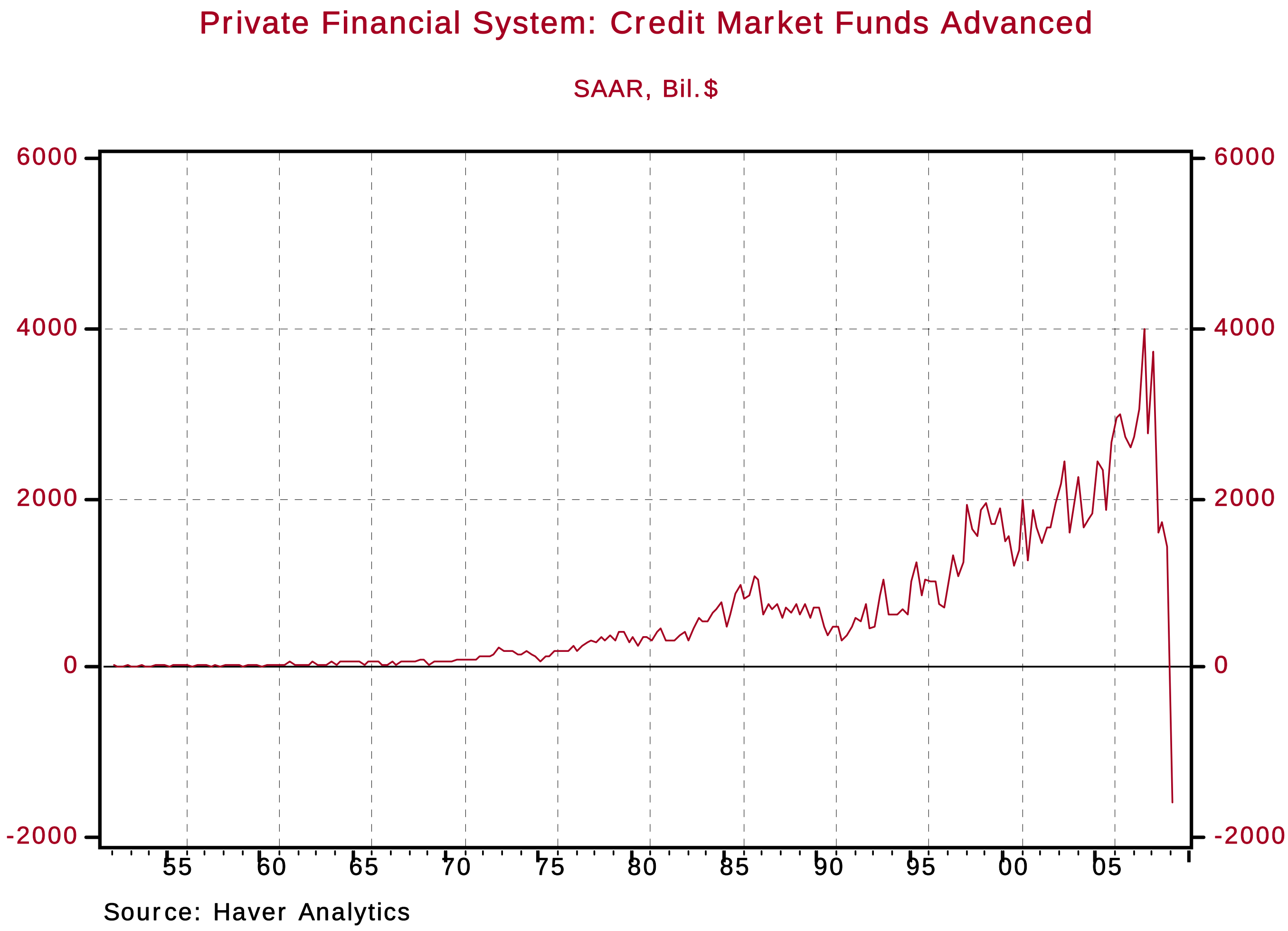
Commercial banks are experiencing extremely high loan charge-off and delinquency rates.



Source: Federal Reserve Board /Haver Analytics

As a result, there has been an unprecedented decline in net lending by the private financial system.



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Financial institutions have acquired much-needed capital through the TARP program and new equity issuance in the market. But with a wave of commercial mortgage defaults expected, some institutions could become undercapitalized again.

Until financial institutions are confident of their longer-run capital adequacy, they will be unable and/or reluctant to create new credit, which will restrain the pace of the economic recovery.

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It will take households some time to recover from their “overindulgence” in the past expansion.

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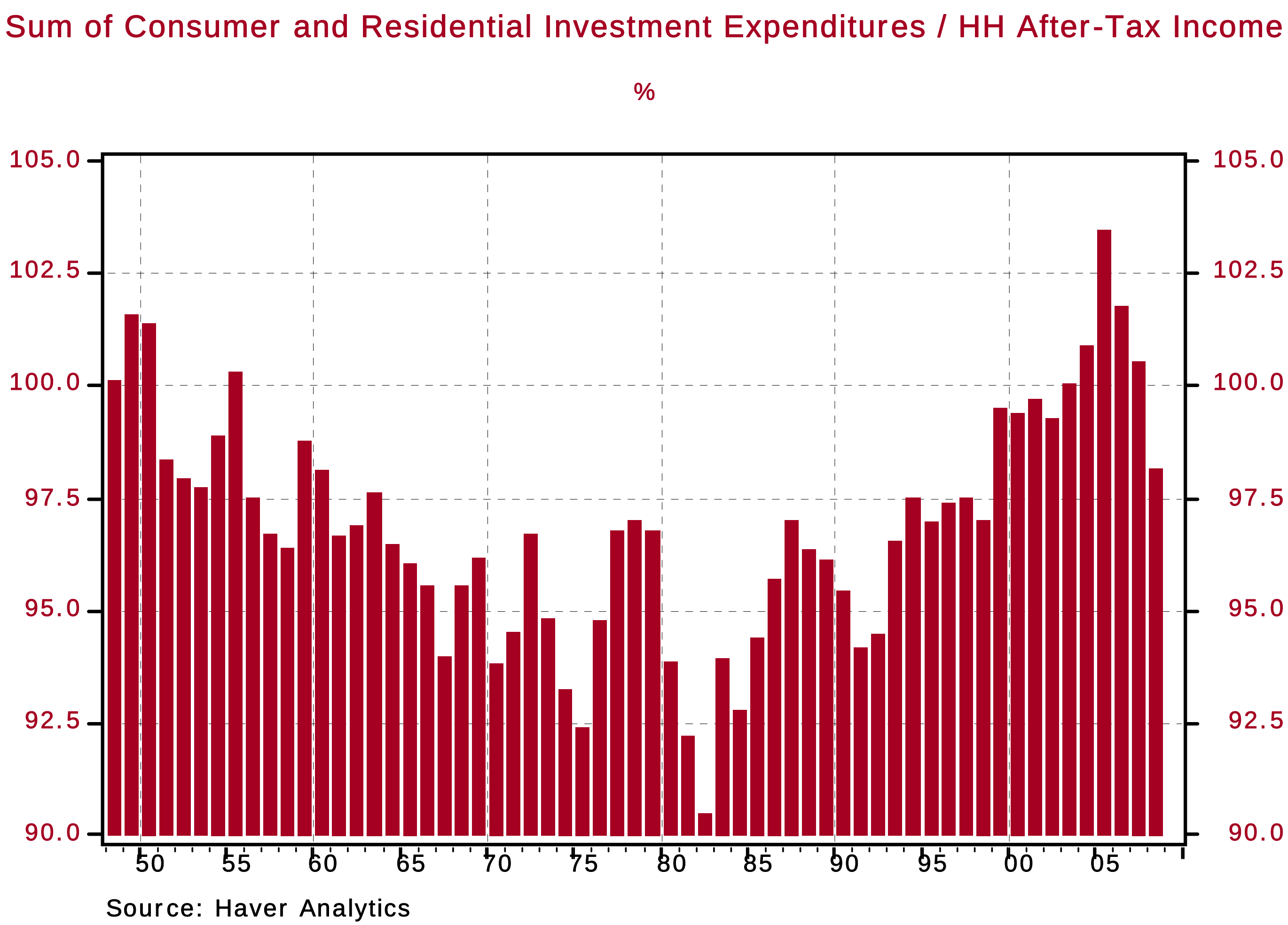
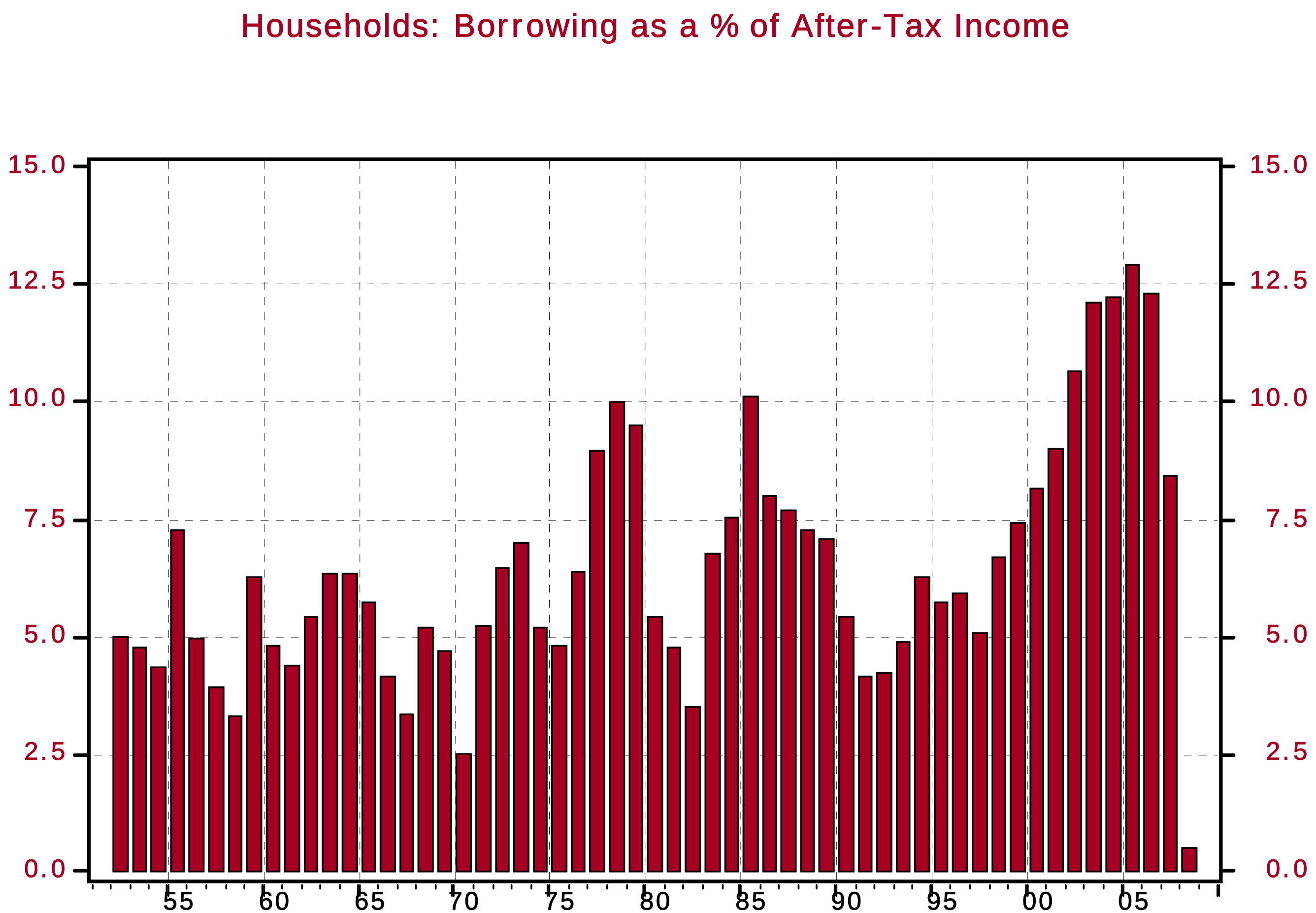
Total household expenditures reached record highs relative to after-tax income in the past ten years.



In order to fund their increased spending, households stepped up their borrowing, largely against the equity in their houses, to record levels relative to their after-tax incomes.



Source: Haver Analytics

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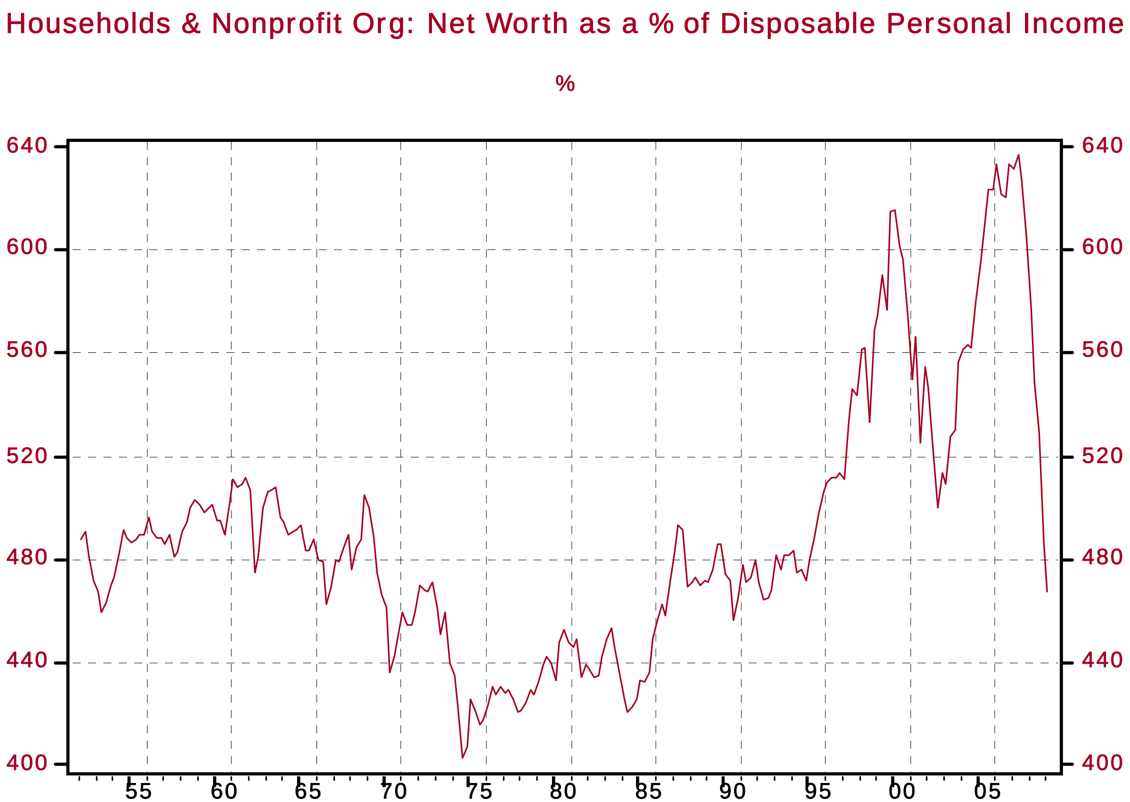
The record increase in household debt in combination with massive declines in the market value of their assets has resulted is a sharp loss in net worth, or household wealth.



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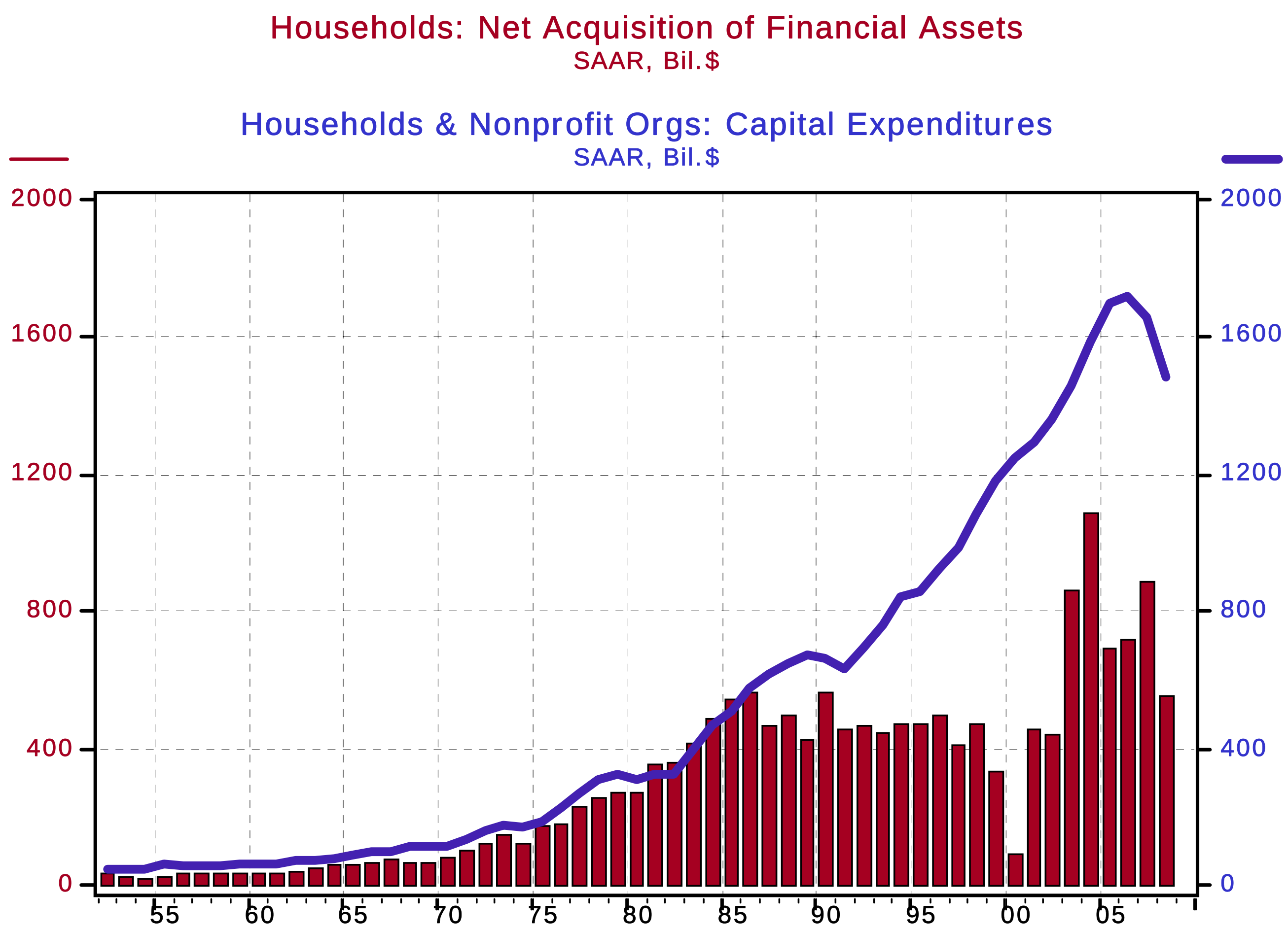
Households are likely to rebuild their wealth through the purchases of stocks and bonds rather than the purchases of McMansions, SUVs and plasma TVs. All else the same, this would impart downward pressure on interest rates.



Source: Federal Reserve Board /Haver Analytics

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Is the federal deficit a headwind?

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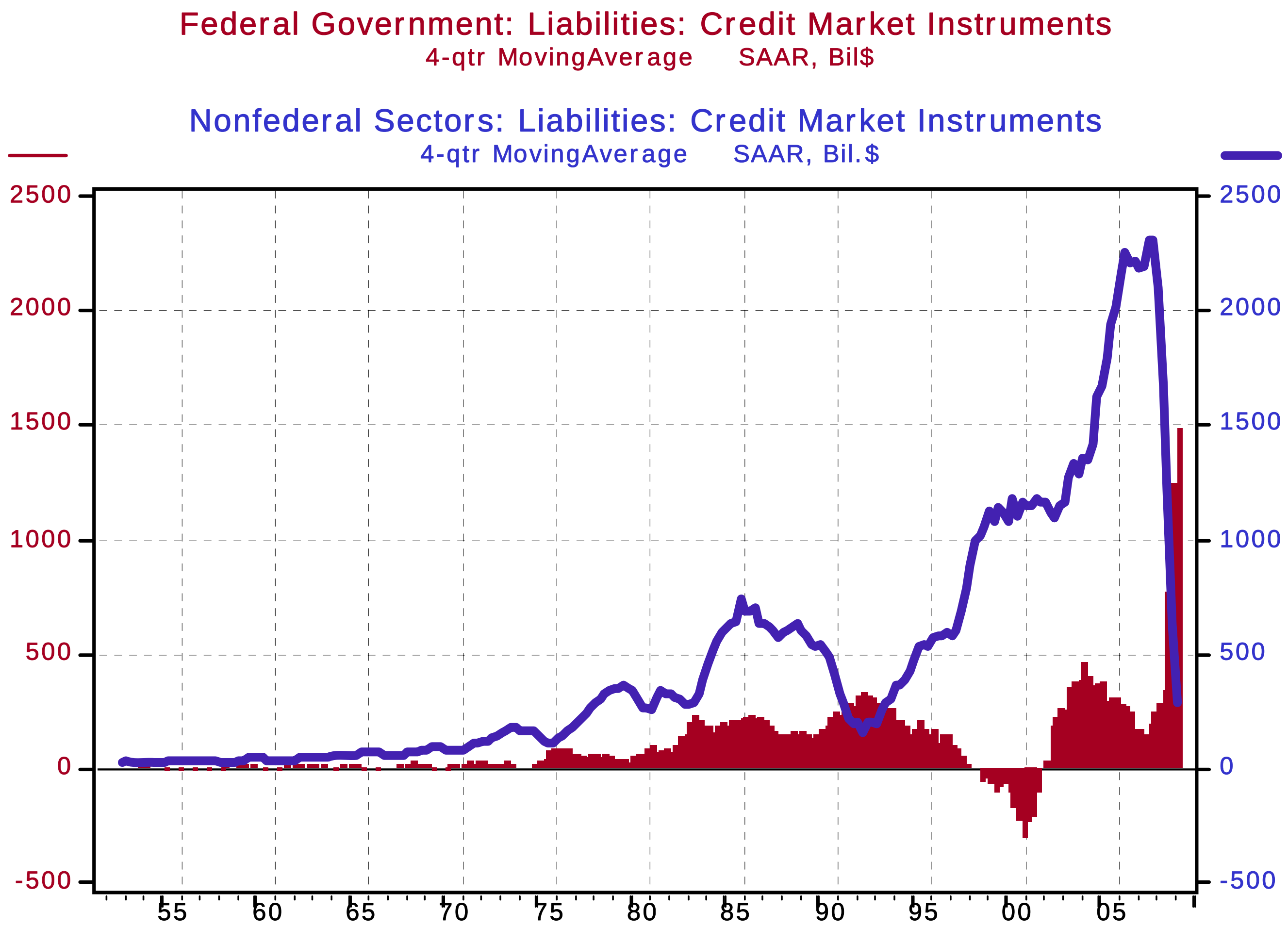
Not right now. Although Treasury borrowing has soared in recent quarters, the pace of nonfederal borrowing has slowed sharply.



Sources: Federal Reserve Board, Haver Analytics

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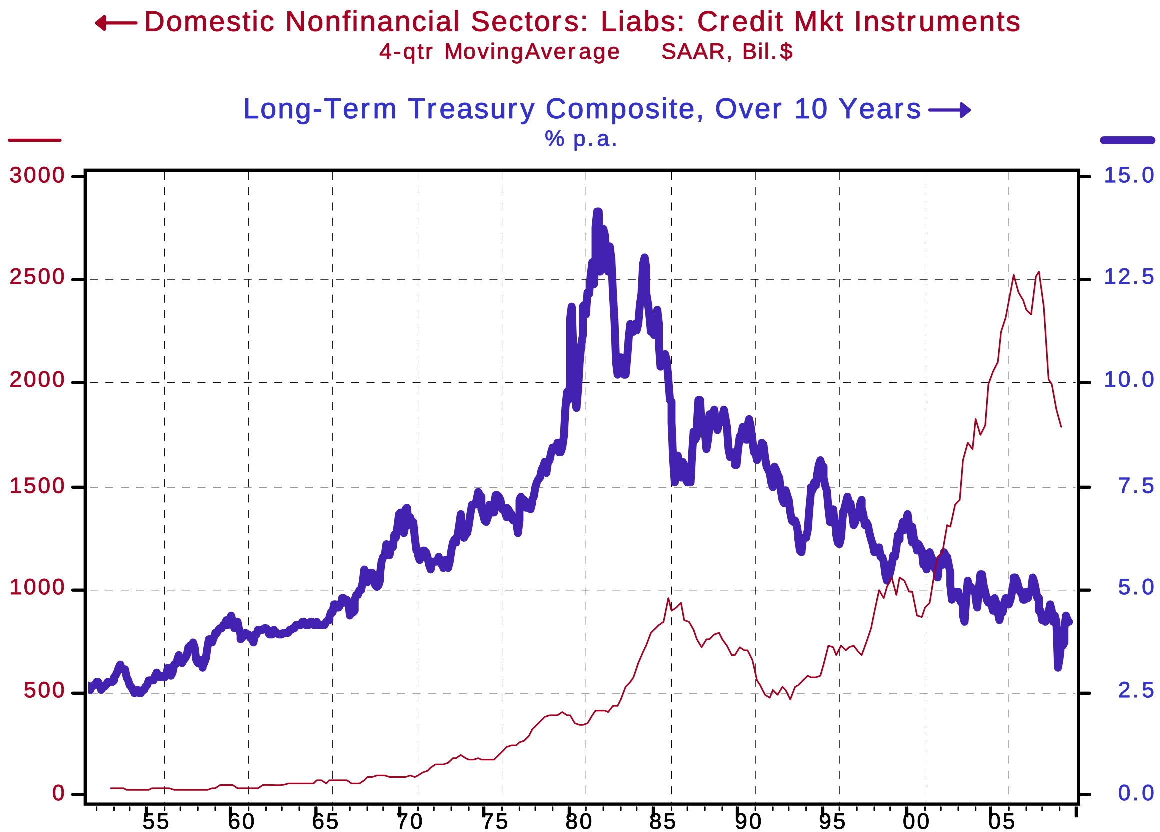
Thus, the pace of *total* nonfinancial sector borrowing has slowed, which has helped keep Treasury yields at relatively low levels.



Sources: Federal Reserve Board, U.S. Treasury /Haver Analytics

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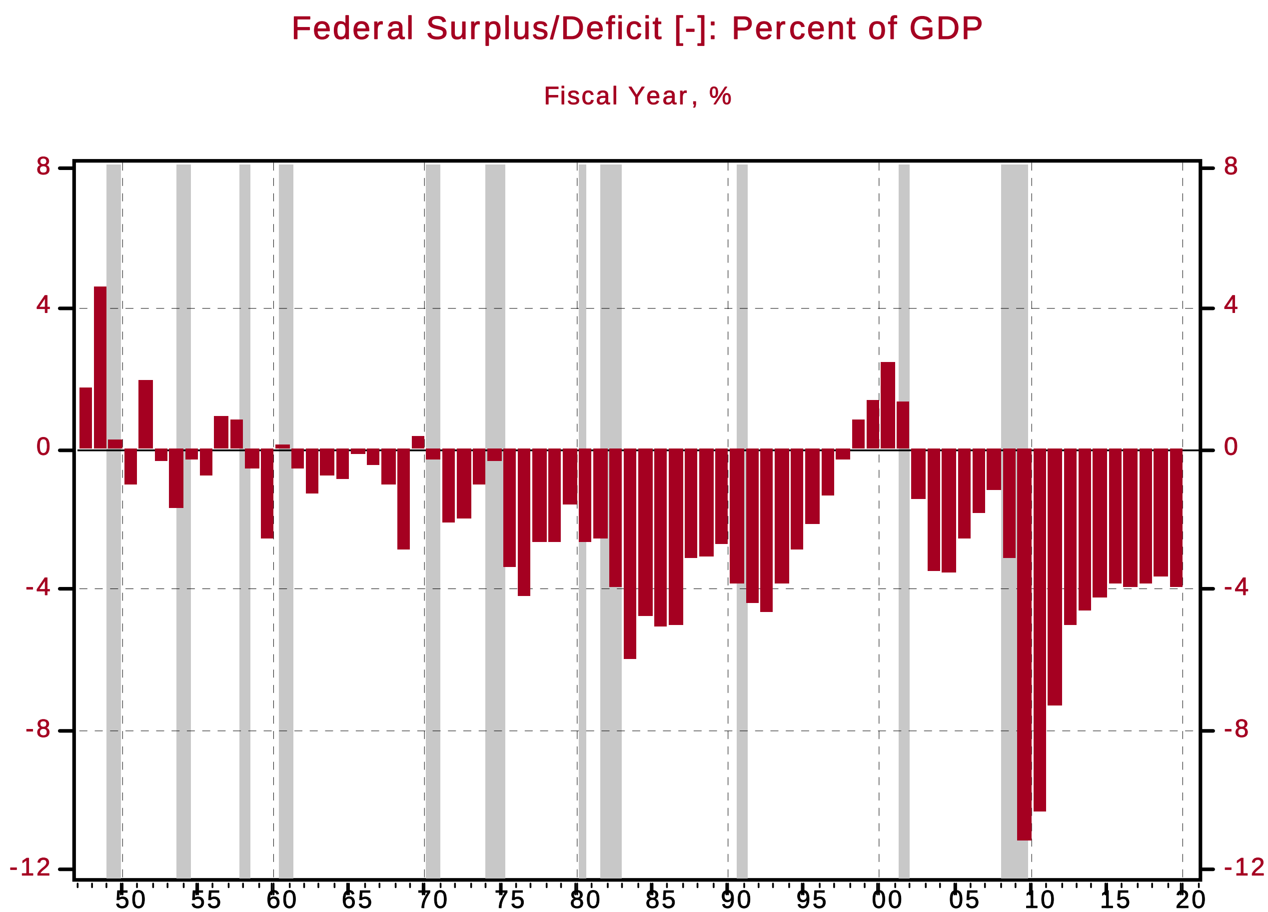
But with federal budget deficits projected to run at rates near 4% of GDP well into the economic recovery, federal spending could "crowd out" business investment, which would lower future *potential* economic growth.



Source: Office of Management and Budget /Haver Analytics

Will the headwinds prevail, pushing the economy back into recession?

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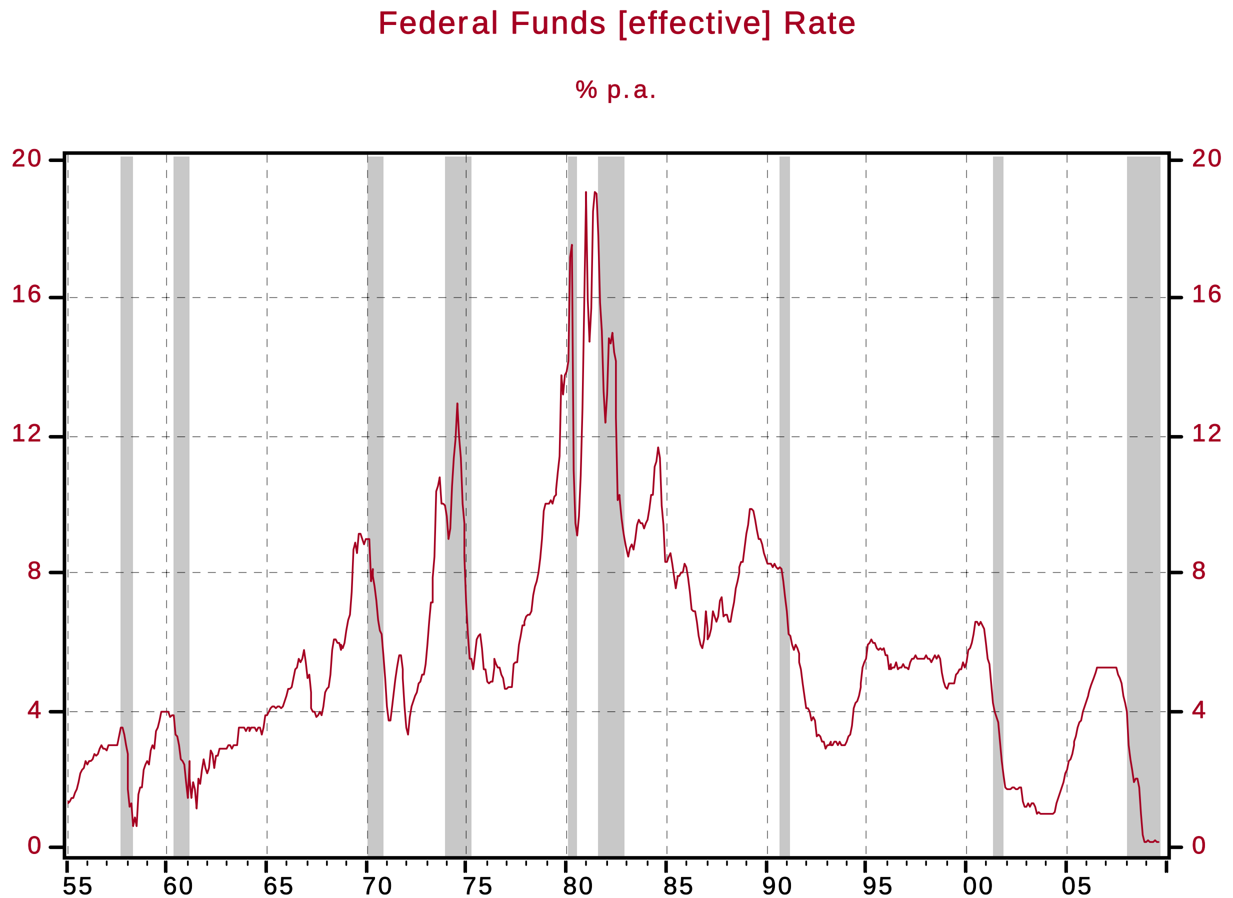
Not likely. Over 50 years of history suggests that the economy does not enter a recession unless the Fed pushes it into one.



Source: Federal Reserve Board /Haver Analytics

What about inflation? Won’t all the credit the Fed has created in recent years guarantee rapid inflation?

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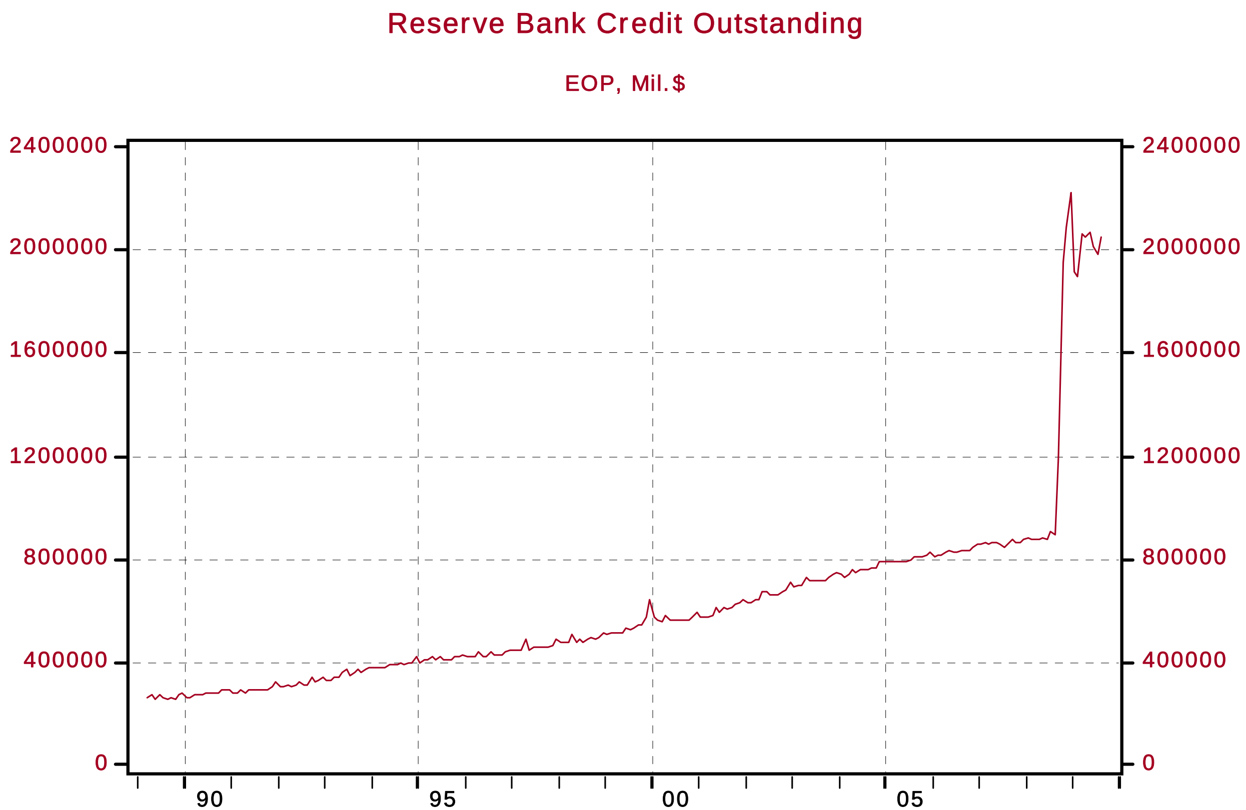
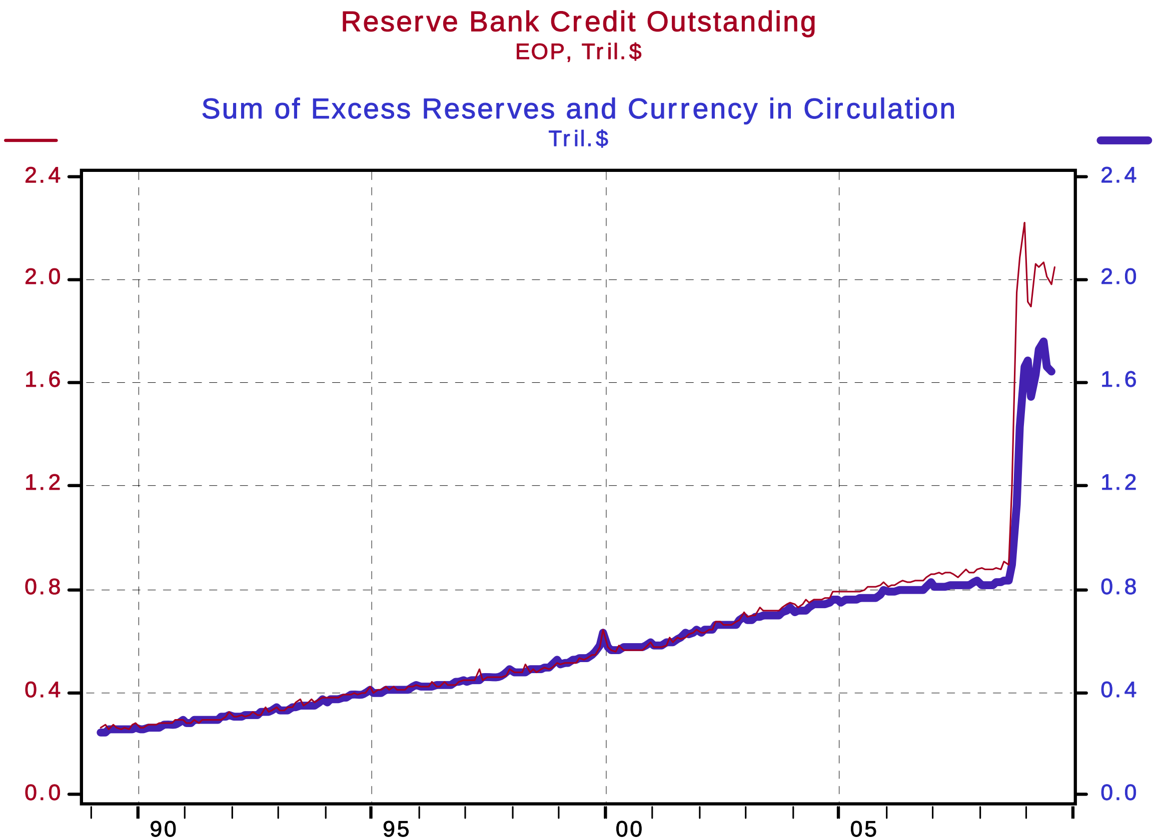
Fed credit has soared from $877 billion at the end of 2007 to over $2 *trillion* at the end of August 2009.



Source: Federal Reserve Board /Haver Analytics

But the bulk of this Fed credit creation has ended up as currency sitting in safe deposit boxes and excess, or idle, cash sitting on the books of banks.



Source: Haver Analytics

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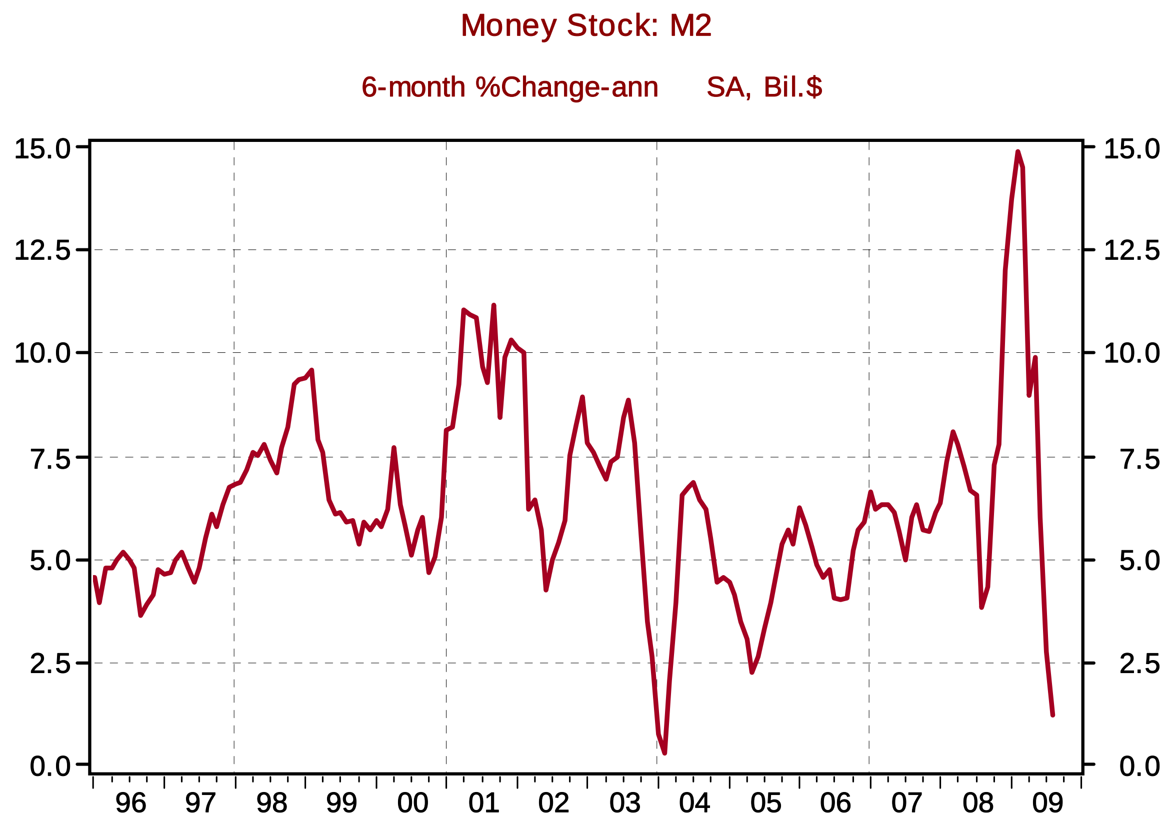
Although growth in the broad measure of money supply skyrocketed right after the Lehman failure, it has fallen back to Earth in recent months.



Source: Federal Reserve Board /Haver Analytics

To summarize:

- The recovery has commenced.
- Balance sheet repair by financial institutions and households will restrain the pace of the recovery through 2010.
- Because the recovery will be muted initially, the unemployment rate is likely to continue rising through the first half of 2010, perhaps peaking out at a level over 10-1/2%.
- The sharp increase in Fed credit is not *currently* inflationary, but has the *potential* to be if the Fed does not neutralize this credit at the appropriate time.
- The earliest the Fed is likely to begin "neutralizing" the credit it has created is midyear 2010 and then, only tentatively.

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Selected Business Indicators

Table 1 US GDP, Inflation, and Unemployment Rate

	2008		2009				2010				Q4 to Q4 Change			Annual Change		
	08:3a	08:4a	09:1a	09:2a	09:3f	09:4f	10:1f	10:2f	10:3f	10:4f	2008a	2009f	2010f	2008a	2009f	2010f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	-2.7	-5.4	-6.4	-1.0	2.5	1.9	1.6	2.3	2.5	3.2	-1.9	-0.8	2.4	0.4	-2.7	1.9
CONSUMPTION EXPENDITURES	-3.5	-3.1	0.6	-1.0	2.0	1.5	1.7	2.0	2.0	2.3	-1.8	0.8	2.0	-0.2	-0.7	1.7
BUSINESS INVESTMENT	-6.1	-19.5	-39.2	-10.9	-13.2	-5.4	-3.2	-0.8	0.2	2.8	-6.0	-18.3	-0.3	1.6	-19.3	-4.2
RESIDENTIAL INVESTMENT	-15.9	-23.2	-38.2	-22.8	0.0	1.0	1.5	2.5	4.0	5.0	-21.0	-16.7	3.2	-22.9	-22.2	0.2
CHANGE IN INVENTORIES ('00 dlrs, bill)	-29.7	-37.4	-113.9	-159.2	-150.9	-120.9	-115.9	-105.9	-100.9	-85.9				-25.9*	-136.2*	-102.2*
GOVERNMENT	4.8	1.2	-2.6	6.4	2.4	1.8	1.6	1.3	2.1	1.8	3.1	1.9	1.7	3.1	1.9	2.0
NET EXPORTS ('00 dlrs, bill.)	-479.2	-470.9	-386.5	-331.8	-295.4	-293.0	-285.4	-274.3	-262.9	-253.5				-494.3*	-326.7*	-269.1*
FINAL SALES	-2.9	-4.7	-4.1	-0.1	1.7	0.9	1.4	2.0	2.3	2.7	-1.4	-0.3	2.1	0.8	-1.8	1.6
NOMINAL GROSS DOMESTIC PRODUCT	1.4	-5.4	-4.6	-1.0	5.2	3.9	3.7	3.7	4.6	4.8	0.1	0.8	4.8	2.6	-1.1	4.1
GDP DEFLATOR - IMPLICIT (% change)	4.1	0.0	1.9	1.1	2.6	2.0	2.1	2.3	2.3	2.9	2.0	1.6	2.4	2.1	1.6	2.1
CPI (% Change, 1982-84 = 100)	6.2	-8.3	-2.4	1.3	2.8	2.2	2.3	2.5	2.5	3.1	1.5	1.0	2.6	3.8	-0.5	2.4
CIVILIAN UNEMPLOYMENT RATE (avg.)	6.1	6.9	8.1	9.3	9.7	10.1	10.4	10.7	10.7	10.5				5.8*	9.3*	10.6*

a=actual
f=forecast
*=annual average

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Outlook for Interest Rates

TABLE 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	**08:3a**	**08:4a**	**09:1a**	**09:2a**	**09:3f**	**09:4f**	**10:1f**	**10:2f**	**10:3f**	**10:4f**	**2008a**	**2009f**	**2010f**
Federal Funds	1.94	0.51	0.18	0.18	0.16	0.20	0.25	0.25	0.70	1.20	1.93	0.18	0.60
2-yr. Treasury Note	2.36	1.21	0.91	1.01	1.05	1.00	1.05	1.20	1.50	1.85	2.00	0.99	1.40
10-yr. Treasury Note	3.86	3.25	2.74	3.31	3.55	3.60	3.70	3.85	4.00	4.15	3.67	3.30	3.93

a = actual

f = forecast

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