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Monthly Economic Outlook

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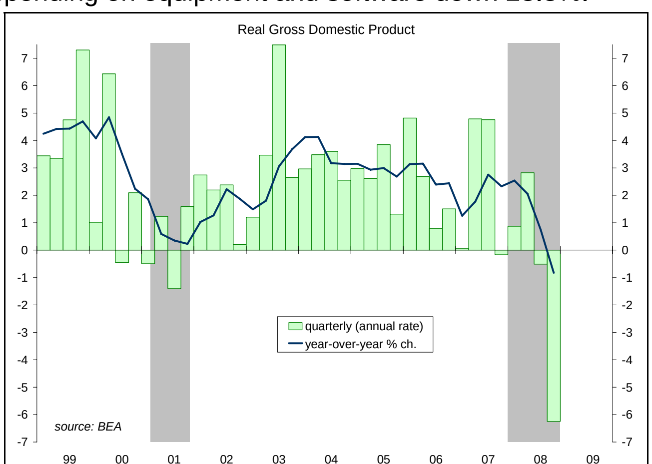
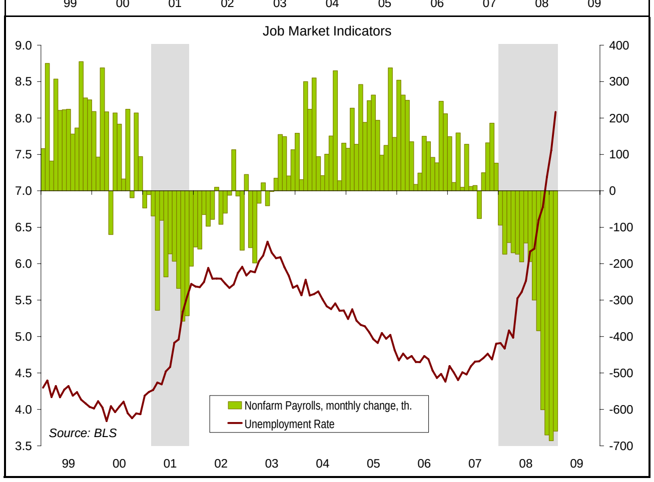
An Uneasy Outlook, But There's Hope

- *The U.S. economy continued to weaken broadly in early 2009. Job losses have been enormous.*
- *The Fed will continue to make nontraditional efforts to boost the flow of credit, and fiscal stimulus will help shore up growth later this year and in 2010, but financial stabilization will be key to a sustainable recovery.*
- *The economy is likely to bottom out later this year. However, the risks remain tilted to the downside.*

Real GDP fell at a 6.2% annual rate in the fourth quarter, according to the government's revised estimate. That puts the decline from the 2Q08 peak at 1.7%. In comparison, GDP fell 3.1% peak-to-trough in the 1973-75 recession and 2.7% in the 1981-82 recession. Each of those recessions lasted 16 months (we are 15 months into the current recession).

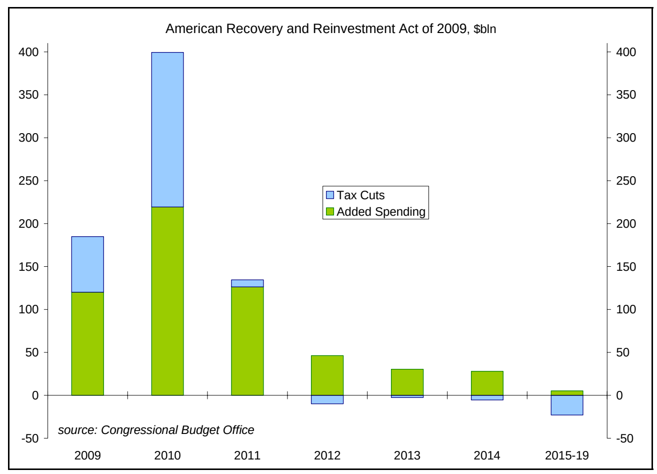
Consumer spending fell at a 4.3% annual rate in 4Q08, following -3.5% in 3Q08. The drop in gasoline prices (from last summer) appears to have helped lessen the downside in spending in 1Q09. Business fixed investment fell at a 21.1% annual rate, with spending on equipment and software down 28.8%.





The pace of job losses has shown no sign of moderation. Nonfarm payrolls fell by 651,000 in February – a 662,000 average monthly decline over the last three months. The economy has lost 4.4 million jobs since the recession began (December 2007), with more than half of that (2.6 million) in the last four months. The percentage decline in jobs is the worst (-3.2%) since the Great Depression. The unemployment rate jumped to 8.1% last month, a 25-year high.

While the U.S economy has contracted severely, weakness is generally as bad or worse in other major industrialized economies. In the past, other countries have often helped lift the U.S. out of recession (through higher exports). However, we're all on the same page now. The U.S. has applied major policy moves to end the downturn and other countries are employing similar efforts. However, as yet, there is little evidence that the pace of global economic decline has moderated. Yet, policy efforts do take time to have an impact.



The American Recovery and Reinvestment Act of 2009, signed into law on February 17, calls for $787 billion in tax cuts and added spending. The plan appears too small to kick-start the economy. Most of the stimulus arrives next year and beyond. A relatively large portion is tax cuts, which will provide less bang for the buck than added spending in the current environment. However, the fiscal stimulus plan should help support growth in 2010. The Obama Administration estimates that the plan will create or prevent the loss of 3.5 million jobs (that is, the level of jobs will be about 3.5 million higher than it would have been otherwise).

Federal Reserve officials have continued to state that short-term interest rates will remain *"exceptionally low for some time"* (such a declaration is one tool in combating deflation). The Fed will continue "credit easing" operations, funding the purchases of mortgage-backed securities and asset-backed securities.

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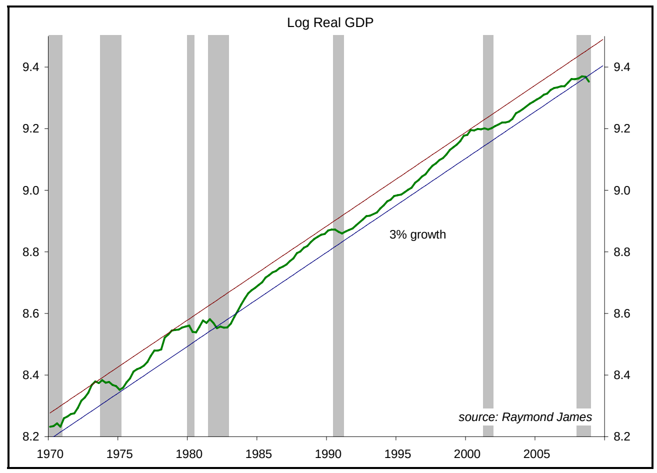
Monetary and fiscal policy efforts will not lead to a sustainable recovery until the financial system has been stabilized. Concerns about the banking system have dampened the economic outlook and helped send the major stock market indices to multi-year lows.

In February, Treasury Secretary Geithner unveiled the administration's Financial Stability Plan. Short on manpower and reportedly having shifted gears just days before it was to be announced, Geithner's plan, little more than a framework, was poorly received by the markets. The plan covers four major areas. First, banks will undergo stress tests to determine how much more capital they may need and the government will inject more capital on a case-by-case basis (it's possible that the government will need to borrow more money to make this happen). Second, there will be a $500 billion to $1 trillion Public-Private Investment Fund to purchase troubled assets from the banks. That sounds a lot like the old plan and we still don't have many details about how it will work (the idea is to use the private sector to price the assets with the government minimizing the downside risk and providing the leverage). Third, the government will work to improve housing affordability and prevent foreclosures (the government has already announced some details, with mixed public reception). Fourth, the Treasury will supply funds to the Fed's Term Asset-Backed Lending Facility, which the Fed will lever up to $1 trillion. Through the TALF, the Fed will lend money to investors to purchase AAA-rated asset-backed securities, effectively helping to restore the flow of credit to consumers and businesses. The TALF will get underway this month, with subscriptions recorded on March 17 and funds distributed on March 25.

For the markets, the question remains whether the government will nationalize the major banks. Officials state that there is no intention to do so. However, by receiving equity interest in exchange for capital injections, the government has already partially nationalized the major banking institutions.

For investors, the current environment has become extremely challenging. No one knows when the economy will bottom and how severe the downturn will be. The pace of decline since the autumn has stunned economists and policymakers. Sharp contractions are typically followed by sharp rebounds, as pent-up demand helps fuel the eventual recovery. However, in the current environment, it may take some time to work through financial sector difficulties. Over the last few decades, the U.S. economy has grown about 3% on average. If this trend were to hold, the recovery prospects would appear to be promising. The unemployment rate seems likely to exceed 10% by the end of the year. An eventual move back to 5% would imply a strong period of above-trend growth. The Fed expects 3.8% to 5.0% GDP growth in 2011. However, the aging of the population and maturation of female labor force participation may result in a lower long-term growth trend. Fed officials now place the long-term noninflationary growth rate at between 2.5% and 2.7%.



Projecting real GDP growth accurately is always challenging, but more so in the current environment. The near-term risks are still tilted toward the downside. Fiscal stimulus and census hiring should help the labor market to stabilize in the first half of 2010.

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	2008	2009	2010
GDP (↓ *contributions*)	0.9	2.8	-0.5	-6.2	**-4.0**	**-1.5**	**0.0**	**1.2**	**2.7**	**3.0**	1.1	**-2.3**	**1.9**
consumer durables	*-0.3*	*-0.2*	*-1.2*	*-1.7*	***0.0***	***0.0***	***0.1***	***0.2***	***0.2***	***0.2***	*-0.3*	***-0.5***	***0.2***
nondurables & services	*0.9*	*1.1*	*-1.6*	*-1.3*	***-0.2***	***0.6***	***0.7***	***1.0***	***1.6***	***1.7***	*0.5*	***-0.1***	***1.4***
bus. fixed investment	*0.3*	*0.3*	*-0.2*	*-2.5*	***-2.2***	***-1.4***	***-0.8***	***-0.4***	***-0.2***	***0.1***	*0.2*	***-1.4***	***-0.3***
residential investment	*-1.1*	*-0.5*	*-0.6*	*-0.8*	***-0.5***	***-0.3***	***-0.0***	***0.0***	***0.2***	***0.3***	*-0.9*	***-0.5***	***0.1***
government	*0.4*	*0.8*	*1.1*	*0.3*	***0.1***	***0.3***	***0.5***	***0.6***	***0.7***	***0.6***	*0.6*	***0.4***	***0.6***
Domestic Final Sales	0.1	1.5	-2.3	-5.7	**-2.4**	**-0.8**	**0.4**	**1.3**	**2.5**	**2.9**	0.0	**-2.0**	**2.0**
exports	*0.6*	*1.5*	*0.4*	*-3.4*	***-2.2***	***-1.6***	***-0.8***	***-0.2***	***0.1***	***0.2***	*0.8*	***-1.5***	***-0.1***
imports	*0.1*	*1.4*	*0.7*	*3.0*	***1.6***	***0.8***	***0.2***	***-0.1***	***-0.3***	***-0.4***	*0.6*	***1.3***	***-0.2***
Final Sales	0.9	4.8	-1.3	-6.4	**-3.0**	**-1.6**	**-0.2**	**1.0**	**2.4**	**2.7**	1.4	**-2.1**	**1.5**
ch. in bus. inventories	*0.0*	*-1.5*	*0.8*	*0.2*	***-1.0***	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	*-0.2*	***-0.1***	***0.3***
Unemployment, %	4.9	5.4	6.0	6.9	**8.0**	**8.9**	**9.5**	**10.0**	**10.2**	**10.2**	5.8	**9.1**	**10.2**
NF Payrolls, monthly, th.	-113	-153	-208	-553	**-650**	**-420**	**-180**	**-60**	**70**	**100**	-257	**-328**	**75**
Cons. Price Index (3 mo)	3.7	6.5	3.1	-12.4	**3.4**	**2.1**	**2.2**	**2.3**	**2.3**	**2.3**	0.2	**2.5**	**2.3**
excl. food & energy	2.1	2.5	2.3	0.2	**1.9**	**2.0**	**2.0**	**2.1**	**2.1**	**2.1**	1.7	**2.0**	**2.1**
PCE Price Index (q/q)	3.6	4.3	5.0	-5.0	**-1.2**	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**	3.3	**0.4**	**2.0**
excl. food & energy	2.3	2.2	2.4	0.8	**1.0**	**1.8**	**1.9**	**1.9**	**1.9**	**1.9**	2.2	**1.5**	**1.9**
Fed Funds Rate, %	3.18	2.09	1.96	0.53	**0.20**	**0.21**	**0.22**	**0.23**	**0.35**	**0.45**	1.94	**0.22**	**0.58**
3-month T-Bill, (bond-eq.)	2.1	1.7	1.5	0.3	**0.2**	**0.2**	**0.2**	**0.2**	**0.3**	**0.5**	1.4	**0.2**	**0.6**
2-year Treasury Note	2.0	2.4	2.4	1.2	**0.9**	**1.3**	**1.9**	**2.3**	**2.5**	**2.7**	2.0	**1.6**	**2.8**
10-year Treasury Note	3.7	3.9	3.9	3.2	**2.8**	**3.3**	**3.6**	**3.9**	**4.1**	**4.3**	3.7	**3.4**	**4.3**