

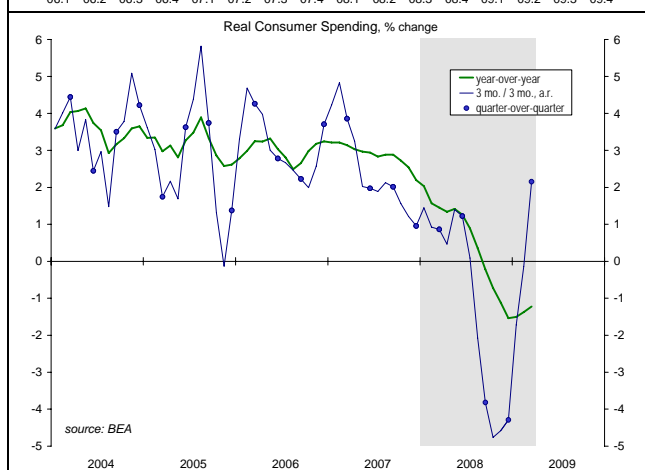
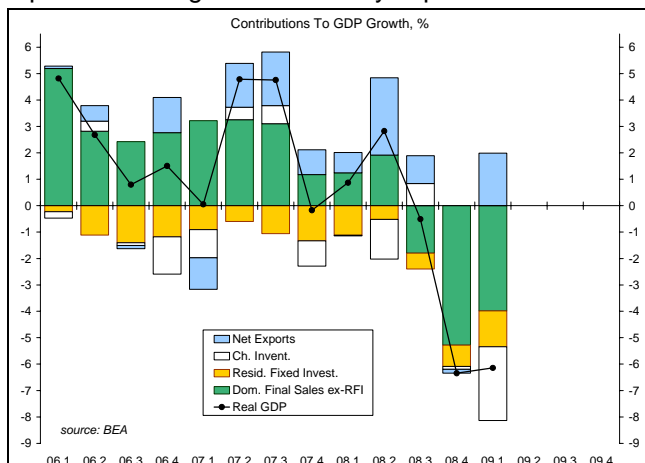
Economic Research – Scott J. Brown, Ph.D.

Monday, May 11, 2009

Still Contracting, But At A Slower Rate

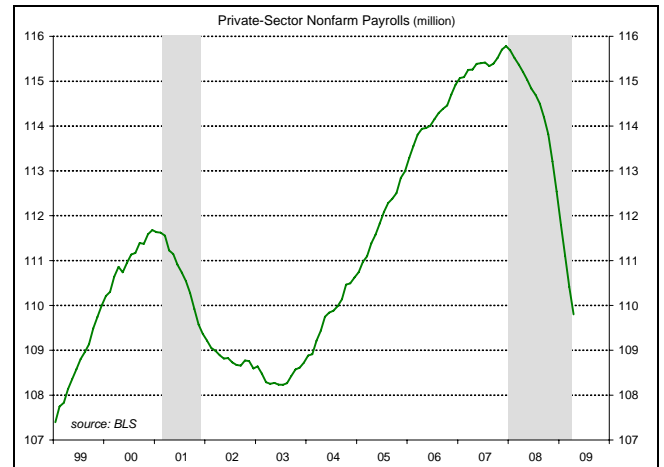
- Recent data suggest that the worst part of the economic decline is behind us.
- However, the economy is still contracting, albeit at a slower rate of decline. Downside risks continue, but fiscal and monetary policy efforts should help the economy to bottom in the second half of the year and to improve (gradually) into 2010.
- Inflation is unlikely to be a problem over the next couple of years. Federal Reserve accommodation can be unwound in time, but at some point it may prove to be a delicate balance between heading off future inflation and encouraging the fledging recovery.

Real GDP fell at a 6.1% annual rate in the government's advance estimate for the first quarter. Consumer spending rose at a 2.2% annual rate – a contrast to the -4.0% pace seen in the second half of 2008. Business fixed investment sank sharply. Residential homebuilding fell further. Imports and exports both tumbled, but the trade gap shrank, adding to the overall GDP figure. Inventories plunged, which helps set the stage for a recovery in production.



Consumer spending was supported by a few special factors in 1Q09. Private-sector wage income fell at a 6.5% annual rate. However, annual cost-of-living adjustments in Social Security and government wages (based on y/y inflation through September of last year) were relatively high (personal income fell at a 2.0% pace). Personal tax receipts were down sharply (-15.5% from a year ago), leaving disposable income up at a 5.1% pace in the quarter. Lower gasoline prices helped push the PCE Price Index to a -1.0% annual rate, leaving inflation-adjusted disposable income at a +6.2% pace. The government cost-of-living increases occur in January and will not be a factor until next year (when they will be much smaller). Gasoline prices have been trending up since the end of last year. Tax payments may have room to fall further (economists call these automatic stabilizers – tax payments fall as the economy weakens, helping to lessen the overall downturn). As part of the \$780 billion fiscal stimulus package, tax withholding went down in April.

The personal savings rate rose to 4.2% for the quarter, up from 0.2% in 1Q08 – and monthly figures suggest that the rate may be stabilizing in the 4.0% to 4.5% range (one of the biggest fears was that the savings rate might jump to 8% to 10%, making the current downturn a lot more severe and longer lasting).



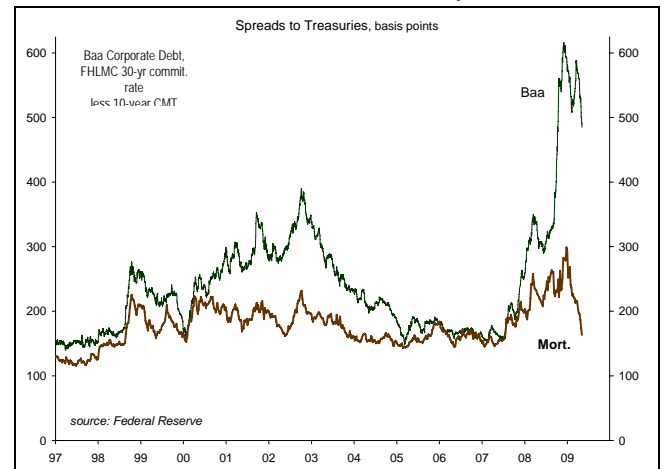
Nonfarm payrolls fell by "only" 539,000 in the initial estimate for April. That's still very high, but not as bad as the 707,000 average decline in the first three months of the year. Hiring for the 2010 census added 63,000 to the April total. The Census Bureau is currently hiring about 140,000 workers to verify and update addresses. Temporary employment for the census will peak at over 700,000 in April of next year (as the non-response follow-up program begins), supporting the job market and the overall economy (although most of these jobs will be shed in the third quarter of next year).

The unemployment rate rose to 8.9% in April, up from 4.7% just before the recession began. The unemployment rate is a lagging economic indicator. We can expect to see it rise even after the economy begins to recover. Nonfarm payrolls are a coincident economic indicator, although payrolls did not begin to rise until almost two years after the 2001 recession had ended. Weekly claims for unemployment insurance benefits are a leading economic indicator. Jobless claims were still very high in April, but were lower than they were in March. We must see a significant moderation in the trend in weekly claims if we are to have much confidence that the economy is nearing a bottom.

The Federal Reserve sharply expanded its credit easing efforts in March, committing to buy up to \$1.25 trillion in mortgage-backed securities by the end of the year. The Fed doubled the amount of agency debt (Fannie Mae, Freddie Mac, Federal Home Loan Bank) it will buy this year to \$200 billion and began buying long-term Treasuries (up to \$300 billion over the next six months). The Fed's Term Asset-Backed Lending Facility (TALF), which is to purchase securities backed by auto loans, student loans, and small business loans, has been slow to get off the ground, but the list of potential collateral is being expanded to include securities backed by commercial real estate loans.

The more aggressive stance of monetary policy has generated some fears that the Fed is sowing the seeds of future inflation. However, there is simply too much slack in the U.S. and global economies to generate much inflation heat. Chairman Bernanke has testified that Fed policymakers have not taken lightly any of their decisions over the last several months. The Fed has spent "an enormous amount of time" crafting exit strategies for its liquidity and credit easing programs. Recessions that are caused by financial crises tend to be more severe and longer lasting. A common mistake is for policymakers to remove the punchbowl too early, leading to a relapse before the economy fully recovers.

Monetary and fiscal policy should help support growth later this year and in 2010 (most of the fiscal stimulus package arrives next year). However, efforts to fix the financial system will be necessary to ensure a lasting recovery. Results of stress tests of the 19 major bank holding companies have now been released. These results have been criticized for being too easy, or too strict, or too manipulated, but at least we know where things stand. There has been limited progress on the Public/Private Investment Fund, which will purchase "legacy debt" from the banks. Congress is likely to enact more stringent regulations on the banks, but it will take many months to work out all the details. Bank lending has continued to tighten, but apparently at a slower pace in the three months ending in April. The Fed's efforts have pushed mortgage rates down (although Chairman Bernanke has indicated that the Fed is not targeting mortgage rates or the 10-year Treasury yield). Credit spreads have narrowed and should continue to improve as confidence in the economic recovery builds.



In the forecast, note that inventories do not have to rise to add to GDP growth – they simply must fall at a slower rate (which seems almost certain). Corrections in payrolls and business investment should help shore up corporate profits, setting the stage for a recovery.

	2008	3Q08	4Q08	1Q09	2009	3Q09	4Q09	1Q10	2Q10	3Q10	2008	2009	2010
GDP (↓ contributions)	2.8	-0.5	-6.3	-6.1	-0.8	-0.2	1.0	2.3	2.9	3.0	1.1	-2.8	1.8
consumer durables	-0.2	-1.2	-1.7	0.6	-0.3	0.1	0.1	0.2	0.2	0.3	-0.3	-0.4	0.2
nondurables & services	1.1	-1.6	-1.3	0.9	-0.1	0.6	0.8	1.5	1.6	1.7	0.5	-0.1	1.2
bus. fixed investment	0.3	-0.2	-2.6	-4.7	-1.9	-1.2	-0.6	-0.3	0.1	0.2	0.2	-2.2	-0.4
residential investment	-0.5	-0.6	-0.8	-1.4	-0.3	-0.1	-0.1	0.1	0.2	0.3	-0.9	-0.7	0.1
government	0.8	1.1	0.3	-0.8	0.4	0.5	0.6	0.7	0.7	0.5	0.6	0.2	0.6
Domestic Final Sales	1.5	-2.3	-5.8	-5.1	-2.3	-0.3	0.9	2.2	2.8	2.9	0.0	-3.1	1.6
exports	1.5	0.4	-3.4	-4.1	-2.0	-1.4	-0.6	-0.1	0.1	0.2	0.8	-2.1	-0.4
imports	1.4	0.7	3.3	6.1	2.1	0.8	0.1	-0.3	-0.4	-0.5	0.6	2.8	0.0
Final Sales	4.8	-1.3	-6.2	-3.4	-2.2	-0.9	0.4	1.8	2.5	2.7	1.4	-2.4	1.9
ch. in bus. inventories	-1.5	0.8	-0.1	-2.8	1.4	0.6	0.5	0.5	0.4	0.4	-0.3	-0.3	0.5
Unemployment, %	5.4	6.0	6.9	8.1	9.2	9.7	10.1	10.3	10.3	10.3	5.8	9.3	10.3
NF Payrolls, monthly, th.	-153	-208	-553	-707	-510	-210	-80	70	120	20	-257	-377	80
Cons. Price Index (3 mo)	6.5	3.1	-12.4	2.2	1.8	1.9	2.0	2.1	2.2	2.2	0.2	2.0	2.2
excl. food & energy	2.5	2.3	0.2	2.2	1.7	1.8	1.9	2.0	2.0	2.0	1.7	1.9	2.0
PCE Price Index (q/q)	4.3	5.0	-4.9	-1.0	1.4	1.6	1.8	1.9	2.0	2.1	3.3	0.3	1.9
excl. food & energy	2.2	2.4	0.9	1.5	1.8	1.6	1.7	1.8	1.9	1.9	2.2	1.6	1.8
Fed Funds Rate, %	2.09	1.96	0.53	0.19	0.17	0.18	0.19	0.23	0.40	0.65	1.94	0.18	0.56
3-month T-Bill, (bond-eq.)	1.7	1.5	0.3	0.2	0.2	0.2	0.2	0.3	0.5	0.7	1.4	0.2	0.6
2-year Treasury Note	2.4	2.4	1.2	0.9	0.9	1.2	1.4	1.8	2.5	2.9	2.0	1.1	2.6
10-year Treasury Note	3.9	3.9	3.2	2.7	3.1	3.2	3.3	3.7	4.2	4.4	3.7	3.1	4.2