

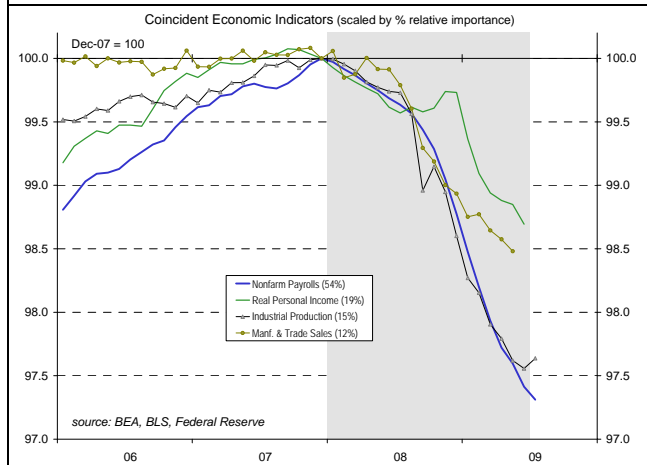
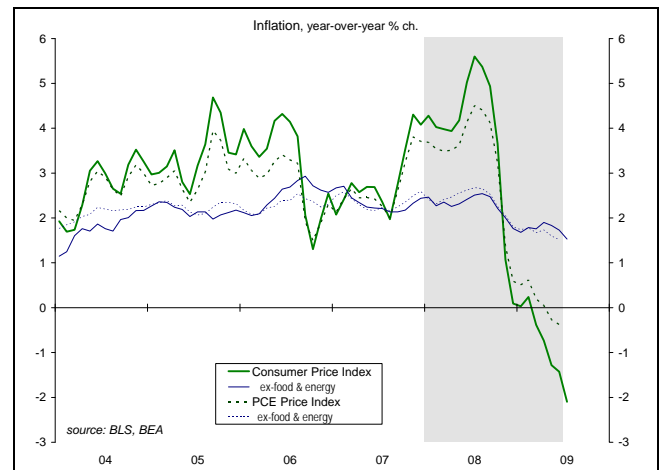
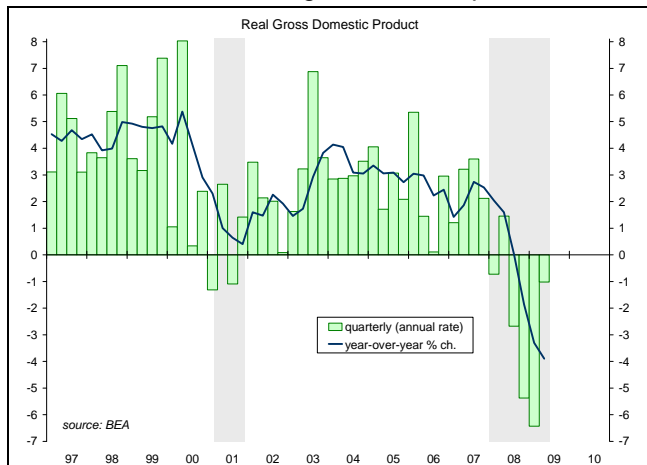
Wednesday, August 19, 2009

Economic Research – Scott J. Brown, Ph.D.
Near A Bottom, Recovery To Be Gradual

- Recent data have continued to suggest that the economy is flattening out.
- The recovery is expected to be gradual, with continued weakness in the labor market.
- With inflation expected to remain low, the Federal Reserve is expected to keep short-term interest rates very low well into 2010. Fed policymakers have begun the end game for the plan to purchase Treasury securities, but are keeping their options open.

Real GDP fell at a 1.0% annual rate in the advance estimate for 2Q09. That figure is likely to be revised a bit lower when the government reports the second estimate on August 27. Comprehensive benchmark revisions showed that the economic downturn was much sharper than reported earlier. Consumer spending fell at a 1.0% annual rate in 2Q09, following +0.6% in the first quarter. Business fixed investment fell at an 8.9% pace, vs. -39.2% in 1Q09. Inventories fell at a faster pace. Monthly data suggest that the inventory correction has more room to run. However, a slower pace of inventory reduction will add to GDP growth in the quarters ahead.

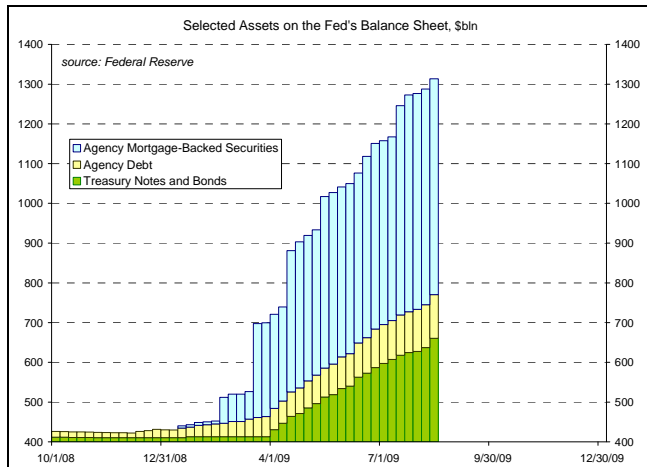
Nonfarm payrolls fell by 247,000 in the initial estimate for July. That's still very high, but much less than the 691,000 monthly average for 1Q09. Other coincident indicators appear to have slowed their rates of decline as well. Industrial production rose 0.5% in July. However, the increase in output, along with part of the slower pace in job losses, was related to a seasonal issue in autos. Auto plants shut down early each July for retooling ahead of model year changeovers. Amid substantial weakness in the auto sector, the seasonal layoffs were smaller than usual, resulting in seasonal adjustment gains in payrolls, hours, and production. Still, the pace of job destruction, while still relatively high, has slowed significant relative to a few months ago.



The Consumer Price Index fell 2.1% in the 12 months ending in July. Technically, that's deflation (a fall in the general price level). However, the decline is largely an unwinding of last year's surge in energy prices. It's not the type of deflation that we worry about (where demand and prices spiral lower). Ex-food and energy, the CPI rose 1.5% y/y – and if one excludes this spring's jump in tobacco prices, core inflation would have been 1.2%. That's at the low end of the Fed's comfort range. Part of the decline is due to the housing glut. Rental prices are either falling or rising less rapidly.

Many investors remain concerned that the Federal Reserve may be fueling future inflation. However, the high degree of slack in the labor and product markets suggests that inflation pressures are unlikely to build anytime soon. The Employment Cost Index (which includes benefits, as well as wages and salaries) rose 1.8% in the year ending in June. Nonfarm productivity rose 1.8%, as well. There is no inflation coming from the labor market, which is the widest channel for inflationary pressure. Import prices and commodity prices have generally stabilized in recent months, suggesting neither outright deflation, not significantly higher inflation.

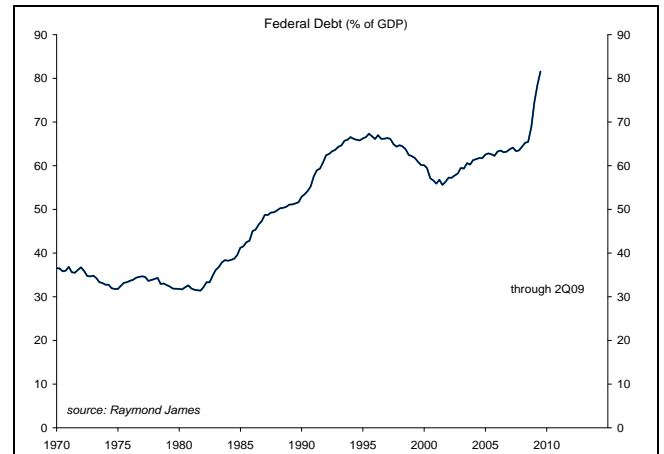
In its August 12 policy statement, the Federal Open Market Committee, left the target rate for Fed funds at 0% to 0.25% and repeated that *“economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period.”* The FOMC made explicit the endgame for its plan to purchase up to \$300 billion in long-term Treasuries. *“To promote a smooth transition in markets as these purchases of Treasury securities are completed,”* the FOMC wrote, *“the Committee has decided to gradually slow the pace of these transactions and anticipates that the full amount will be purchased by the end of October.”* The Fed bought about \$260 billion in Treasuries from late March (when the program began) to mid-August. The Fed’s program to buy up to \$1.25 trillion in agency mortgage-backed securities and up to \$200 billion in agency debt is set to run to the end of this year. The Fed said it would continue *“to evaluate the timing and overall amounts of asset purchases in light of the evolving economic outlook and financial conditions.”*



The Fed’s July survey of senior loan officers showed banks continuing to tighten terms and standards on all types of loans. Except for an increase in prime residential mortgages, loan demand has decreased.

In addition, the Fed’s survey noted that banks expected that *“lending standards across all loan categories would remain tighter than their average levels over the past decade until at least the second half of 2010; for below-investment-grade firms and nonprime households, the expected timing is later, with many banks reporting that standards for such borrowers will remain tighter than average for the foreseeable future.”* Tight credit, especially to small business, is expected to be a significant restraining factor in the recovery. Larger firms have been able to access credit in the bond market.

By August 7, only \$77 billion (or about 10%) of the \$787 billion fiscal stimulus package had “gone out the door,” much of which was tax cuts, which do not provide a lot of bang for the buck in the current environment. Half of the stimulus will arrive in FY10 (which starts in October). The fiscal stimulus should provide significant support to the economic recovery over time. The stimulus will add to the near-term budget deficit. However, the deficit will decline as the economy recovers and temporary spending fades.



A reduced rate of inventory reductions should add significantly to GDP growth over the next few quarters. Domestic demand (largely consumer spending and business fixed investment) should remain relatively soft.

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	2008	2009	2010
GDP (↓ contributions)	-2.7	-5.4	-6.4	-1.0	2.0	2.8	3.1	3.3	3.4	3.3	0.4	-2.7	2.7
consumer durables	-1.0	-1.6	0.3	-0.5	0.6	0.1	0.2	0.2	0.3	0.3	-0.4	-0.4	0.2
nondurables & services	-1.5	-0.5	0.2	-0.4	0.3	0.6	1.2	1.4	1.5	1.5	0.2	-0.2	1.0
bus. fixed investment	-0.7	-2.5	-5.3	-0.9	-1.0	-0.8	-0.4	0.0	0.2	0.4	0.2	-2.2	-0.4
residential investment	-0.6	-0.8	-1.3	-0.9	-0.2	-0.1	0.0	0.1	0.2	0.3	-1.0	-0.8	0.0
government	1.0	0.2	-0.5	1.1	0.8	1.4	0.8	0.8	0.6	0.5	0.6	0.5	0.9
Domestic Final Sales	-2.7	-4.9	-6.4	-1.5	0.5	1.2	1.9	2.6	2.8	3.0	-0.3	-3.2	1.7
exports	-0.5	-2.7	-4.0	-0.8	-0.1	0.1	0.2	0.3	0.4	0.5	0.6	-1.6	0.1
imports	0.4	3.1	6.6	2.1	0.6	-0.1	-0.3	-0.4	-0.5	-0.5	0.5	2.8	-0.1
Final Sales	-2.9	-4.7	-4.1	-0.2	1.0	1.2	1.8	2.5	2.8	3.0	0.8	-2.0	2.7
ch. in bus. inventories	0.3	-0.6	-2.4	-0.8	1.0	1.6	1.2	0.8	0.6	0.3	-0.4	-0.7	0.9
Unemployment, %	6.0	6.9	8.1	9.2	9.5	9.8	10.0	9.9	9.8	9.8	5.8	9.1	9.9
NF Payrolls, monthly, th.	-208	-553	-691	-436	-210	-95	70	120	20	90	-257	-358	75
Cons. Price Index (3 mo)	3.1	-12.4	2.2	3.3	2.1	2.0	2.0	2.1	2.1	2.2	0.2	2.4	2.1
excl. food & energy	2.3	0.2	2.2	2.4	1.8	1.8	1.9	1.9	2.0	2.0	1.7	2.0	1.9
PCE Price Index (q/q)	5.0	-4.9	-0.9	1.7	2.9	1.7	1.9	1.9	1.9	2.0	3.3	0.5	2.0
excl. food & energy	2.4	0.9	1.6	2.4	1.6	1.7	1.7	1.8	1.8	1.9	2.2	1.8	1.8
Fed Funds Rate, %	1.96	0.53	0.19	0.18	0.18	0.20	0.22	0.27	0.67	1.16	1.94	0.19	0.58
3-month T-Bill, (bond-eq.)	1.5	0.3	0.2	0.2	0.2	0.2	0.3	0.4	0.9	1.3	1.4	0.2	0.7
2-year Treasury Note	2.4	1.2	0.9	1.0	1.0	1.2	1.6	2.0	2.5	2.6	2.0	1.0	2.2
10-year Treasury Note	3.9	3.2	2.7	3.3	3.6	3.7	3.9	4.1	4.2	4.2	3.7	3.3	4.1