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# Economic Update

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We believe that the U.S. and global recessions are over and that sustained economic recoveries have begun, both in the U.S. and worldwide. The “global emergency rescue” of the financial system and the economy was a major success, at least from a short-term cyclical perspective and potentially from a long-term perspective as well. This “global emergency rescue” occurred as the result of parallel policy initiatives in many countries. A pattern of central bank liquidity actions, monetary stimulus and government fiscal stimulus occurred in many different countries. Comments and forecasts from the central banks and the key international agencies, such as the IMF, World Bank, OECD and BIS, helped reduce the potential “recognition lag” and “reaction lag” in government, corporate and policy circles as the severe financial crisis and economic decline occurred. While stimulative policy initiatives occurred in more of a parallel fashion than in a unified pattern, we believe that the high-level meetings of policymakers and political leaders, such as the G-8 and G-20 meetings, focused attention on the necessity for a quick emergency response and accelerated its execution.

While many long-term issues remain, the success of the “global emergency rescue” policies brought the financial system out of crisis and the economies out of recession. Despite widespread concerns that policymakers were “pushing on a string,” the financial and economic pattern of 2009 proved once again that policy is powerful. Our expectation was that proactive macroeconomic stimulus would end the financial crisis and recession. We believe it

has done so and that the risks of renewed financial meltdown and global recession are now behind us.

Substantial challenges remain. A key to understanding current economic realities is that while the changes in key variables (real GDP, production, operating rates, income) are shifting from negative to positive, the levels of many economic variables will remain deeply depressed relative to normal. The good news is about the direction of change, but the bad news is about levels.

Global imbalances persist. The U.S. current account deficit has dropped substantially, as oil prices dropped from their peaks, debt-financed consumption dropped and consumer goods imports weakened. This improvement reflected cyclical developments and further improvement should be hard to achieve. Gross exports and gross imports should both grow as the economic recovery unfolds, but little further improvement in U.S. net exports is likely. Imports are larger in size than exports and are likely to grow more rapidly in the coming expansion.

During the boom, spending in the private sectors of the developed countries was supported by private sector debt growth. That is now being replaced by rapid growth in government debt, with governments borrowing funds to finance both public spending and transfers to the private sector. This still represents a pattern of debt-financed spending in the developed world, with just a change in

borrower. The U.S. faces huge budget deficits today (a minor problem) and huge budget deficits forecast for years to come (a major problem). While the current budget deficits are cyclically appropriate, the persistent structural budget deficits are inappropriate. The political will to address long-term structural budget deficits does not yet appear to exist, although public concern has begun to rise. The result is great uncertainty about the long-term impact of a “pay-me-later” structural budget policy. Some fear a future spike in inflation, some fear a future spike in real interest rates (interest rates minus inflation) and some fear a foreign exchange crisis. Our view is that the high budget deficits of today do not preclude an economic recovery, but that the unresolved structural deficits create substantial risks for future years. We regard the emerging public concern about the prospect of persistent deficits as the first stage of a multiyear process of bringing the structural budget deficit under control.

Unemployment rates are likely to remain high in many countries. This may increase protectionist sentiment and raise the risk of a “jobs trade war.” We believe that the key to limiting the risk of a “jobs trade war” is for the global economic expansion to be sustained at a good pace, maintaining hope for a future fall in the unemployment rate. The consensus that policymakers should be slow to execute a quick exit path from stimulus creates favorable odds of an adequate pace of economic expansion.

Climate change negotiation can either raise or lower the risks of a “jobs trade war,” depending upon whether the outcome is conflict or cooperation. The relative competitiveness among countries is influenced by the level and expected trend of relative labor and non-labor costs, relative taxes, exchange rates and relative carbon costs. Carbon tariffs have already been proposed by some senators to offset potential carbon cost advantages of foreign suppliers. Carbon tariffs should gain growing attention as the impact of climate change issues on relative competitiveness becomes more controversial.

What kind of economic recovery is likely in the world and U.S. economy? The IMF has just revised up its 2010 global growth forecast to about 3%. We believe that the likely outlook is that the global economy has begun a simultaneous worldwide expansion and that the global growth rate in 2010 should be closer to 4%.

What about the U.S. economy? In the Postwar period, mild recessions have been followed by mild recoveries and

severe recessions have been followed by strong recoveries. If one were to go by historic precedents, the extremely severe U.S. recession in the last four quarters might be followed by a real GDP growth rate of about 8% in the following four quarters. We doubt that, and expect a growth rate of about 3% to 3.5%, with a “negative growth gap” of about 450 to 500 basis points due to all the factors generally cited by economic pessimists, including weak income growth, deleveraging and the lagged effect of lower real estate prices.

The U.S. economic recovery is easier to understand as an exhaustion of sources of weakness than as the sum of sources of strength. A bottoming in auto sales from extremely depressed levels was emerging even before the “cash for clunkers” program was adopted. “Cash for clunkers” merely borrowed demand from future months. However, auto sales had been so severely depressed for so long that there had finally been a buildup of pent-up demand. As auto credit is now more freely available and near-term uncertainties about the automobile industry have dropped, we believe that a cyclical uptrend from extremely depressed levels of auto sales has now begun.

With respect to house prices, we believe that the U.S. has entered a bottoming phase. We expect an L-shaped pattern for house prices but we are now near the inflection point from “down” to “flat.”

Another sector where the downtrend is showing signs of exhaustion is residential construction. Declining residential construction has been reducing the real GDP growth rate by about 1% quarter after quarter for the last several years, but there is a good chance that the second quarter of 2009 should mark the last quarter of declining residential construction. As in the case of the auto sector, residential construction dropped to an extremely low level, dramatically below peak levels. There is now growing evidence that a tentative uptrend is beginning. Again, the level is still severely depressed but we believe that an uptrend has begun.

Another area where weakness is showing signs of exhaustion is in the change in non-auto inventories. As severe liquidation of non-auto inventories gives way first to a slower pace of liquidation and eventually to modest positive accumulation, the contribution to real GDP growth will swing from negative to positive. The downtrend in capital equipment spending is also starting to show early signs of exhaustion. Some other sectors are

likely to remain weak. This notably includes the private structures component of capital spending, given the serious problems in commercial real estate. The state and local sector is usually a laggard behind cyclical developments in the rest of the economy. The recent recession was so severe that state and local spending is likely to stay sluggish for an extended period of time.

The economic superbears argue that consumer spending will remain severely weak because the savings rate will rise substantially further, to about 10% to 12%. We disagree. Consumer spending growth is likely to be positive but relatively slow for a different reason: the recovery in income growth is likely to be slow. Incomes will recover somewhat when the aggregate hours worked in the economy start to rise, but with wage inflation falling, interest rates low, dividends cut sharply and increases in government transfers likely to slow, there are a number of drags on the rebound in personal income. Cost-of-living increases for Social Security can now be expected to stall following the large rise earlier this year, given the way the cost-of-living formula works. Consumers may desire a 10% to 12% savings rate, but income growth should be so sluggish that they will fail to achieve it, leaving the savings rate close to its recent level near 5%. Consumption should grow, but at a modest pace.

Commercial real estate is under stress. There are serious difficulties in refinancing commercial real estate. However, commercial real estate needs a broad macroeconomic fix even more than it needs refinancing. In contrast with residential real estate, there was not much physical overbuilding of commercial real estate footage during the boom. Commercial real estate has suffered more from a negative demand shock due to the recession than from the legacy of overbuilding during the boom. The prices of commercial real estate properties were elevated by easy credit during the boom on the assumption that demand for space would remain strong. Many commercial properties were financed or refinanced against that peak valuation. One result of the financial crisis and Great Recession was to lower demand for commercial space and drive up vacancies, thus weakening the clearing price of commercial rents. As bankruptcies of tenants continue and leases roll over, cash flows are likely to drop.

Many owners of commercial real estate are finding it difficult to refinance, especially if their prior equity has been wiped out by the decline in valuations. There is

hardly a scarcity of investable funds seeking good returns in an environment of a zero Fed funds rate. Instead, the problem is that the future cash flows of many commercial real estate properties will be declining and potential investors have lacked confidence in their ability to predict how severe the future decline in cash flows will be. Confidence about sustained economic growth is the key to improved confidence in the ability to forecast how large the declines in future commercial real estate cash flow will be. We believe that refinancing stresses are basically symptoms of these underlying economic realities. It is notable that some of the "smart sellers" of commercial real estate at the peak of the boom are starting to form investment pools to purchase commercial real estate, a trend that should intensify if economic expansion is sustained. The core problem in commercial real estate is fundamental supply and demand and refinancing stresses are symptoms of those fundamentals. What commercial real estate most needs is the "macro fix" of a sustained economic expansion. Even though we believe that this will occur, the financial losses in commercial real estate are expected to be severe. Unlike residential real estate, however, commercial real estate is not the core of consumer net worth, limiting the spillover impact on consumption.

With excess productive capacity and a high unemployment rate, we expect the Federal Reserve to retain a zero Federal funds rate until the second half of 2010. While excess capacity in the goods and labor market is likely to sustain a downward shift in core inflation, reported 12-month headline inflation will shift upwards by 400 to 500 basis points. This is mainly the artifact of crude oil prices 12 months earlier. Headline inflation ran at an annual deflation rate of about negative 2% in the 12-months following \$147 crude oil and should rise at about a 2.5% rate in the 12 months following crude oil near \$30. A similar pattern should occur in other countries. This should not be interpreted as evidence of a major sustained acceleration in inflation.

Monetary ease may create a somewhat higher rate of sustained inflation by about 2012. Financial stresses, which have disrupted credit creation, have created impediments to the translation first of large increases in the monetary base into money supply growth and then of money supply growth into fast growth in nominal GDP. In addition, we are not yet at the phase of the cycle where a high proportion of nominal GDP growth is attributable to inflation rather than growth. Our most likely case is that

the long-term trend of consumer price inflation should be about 2.5% over the next decade.

Easy U.S. monetary policy is one explanation of the weakness in the dollar recently. Another is the interest expressed by major dollar holders in “reserve diversification.” The RMB is undervalued against the U.S. dollar and many other currencies. The dollar is blocked from falling against what it should (RMB), so it has fallen against what it can (other major currencies). In what is still a deflation-risk environment, we do not expect the Fed

to resist dollar weakness by tightening. As a result, any dollar weakness is unlikely to significantly reduce financial liquidity in the U.S. economy. In the current context, we believe that there are stronger odds of movement towards a negotiated reshuffling of influence within international monetary institutions than of disorder in the foreign exchange market. The simultaneous worldwide economic expansion means that risks are dropping in most countries. Financial stress is falling rather than rising, so we believe that dramatic moves appear unlikely.



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