

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

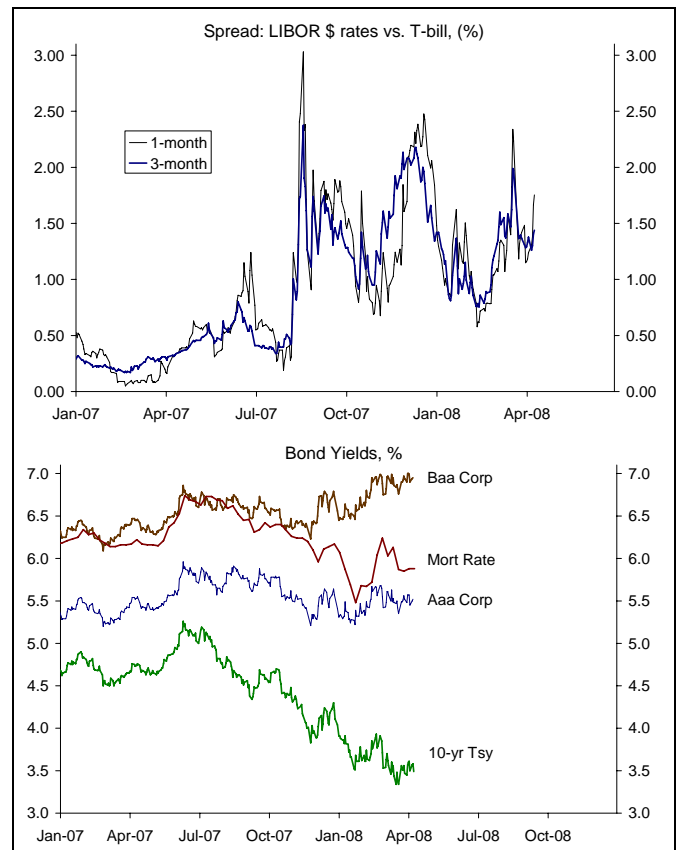
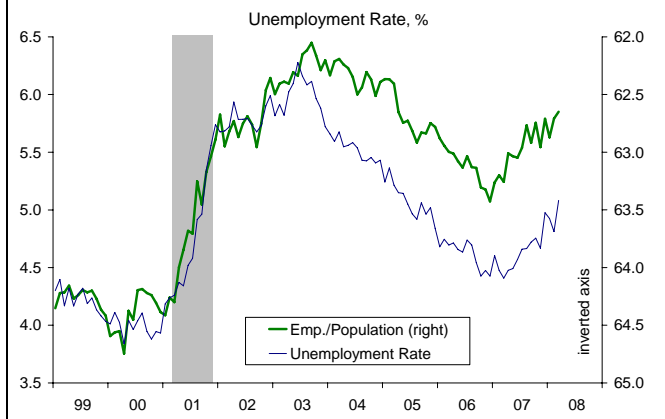
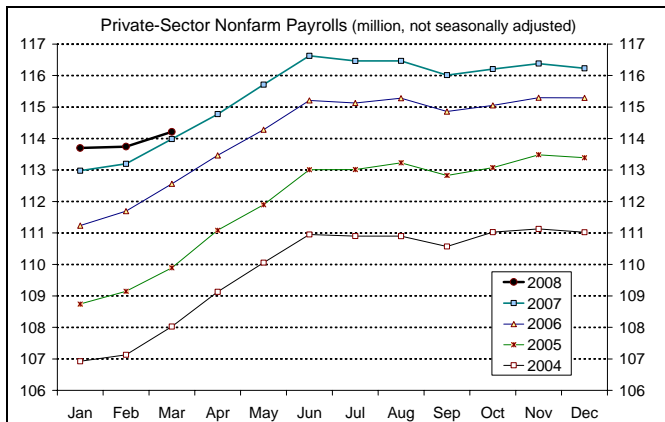
Thursday, April 10, 2008

Fear's Here, But So's Hope

- Recent data suggest an increased likelihood that the economy has entered a recession. The job market, in particular, has deteriorated significantly.
- A tightening in bank and nonbank credit, record oil prices, and further declines in home prices have generated further downside risks to the growth outlook.
- The Fed's efforts to promote liquidity and support growth should lead to improved conditions in the second half of the year. The stock market will improve before the economy does, but there will likely be much second guessing on the strength and timing of the recovery.

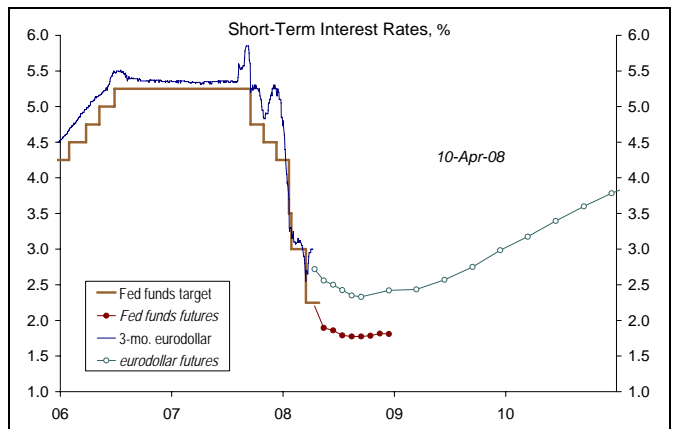
Real GDP rose at a 0.6% annual rate in the final estimate for 4Q07 (the same as the two previous estimates). Real consumer spending growth, which accounts for 70% of GDP, was flat in December, January, and February, and unit motor vehicle sales, which account for much of the volatility in quarterly consumer spending, fell further in March. Homebuilding activity has continued to contract, and nonresidential construction, which added about 0.5% to GDP growth in the last four quarters, may have started to fall. Net exports will likely add to GDP growth, but not enough to offset weakened domestic demand.

Nonfarm payrolls were reported to have fallen by 80,000 in March, following declines of 76,000 in both January and February. Prior to seasonal adjustment, the economy added 574,000 jobs in March, vs. 892,000 in March 2007 and 981,000 in March 2006. March through June is when firms generally add to payrolls. Outside of manufacturing, the current situation can be characterized as a period of reduced hiring rather than large-scale job losses. However, claims for unemployment insurance benefits have begun to trend higher, boosted partly by the fallout from a strike in the auto industry. The number of individuals receiving unemployment insurance benefits is rising, reflecting the difficulty in finding new work.

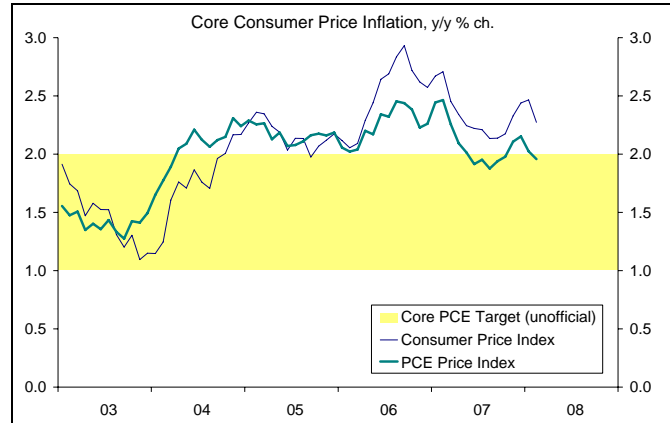


The credit markets have remained troubled, further dampening the economic outlook. The Fed has now introduced three major liquidity programs, which have appeared successful. However, a general de-leveraging and reappraisal of risk, as well as efforts to improve capital adequacy, will continue. Interbank lending is far from normal, as reflected in wide spreads relative to central bank rates. Credit spreads have widened, partly reflecting a massive flight-to-Treasuries as investors have generally sought to diminish spread trades (closing out positions in riskier securities and closing hedges).

Crude oil prices are now at record highs again and gasoline prices should continue rising through the spring. Wage income has been moderately strong over the last several months, but has been offset by higher inflation. In addition, households have less ability to borrow against their homes. Consumer spending growth is likely to remain weak in the near term. An expected moderation in food and energy prices should help reduce overall inflation and improve consumer purchasing power in the months ahead. However, a further rise in energy prices would further dampen the consumer spending outlook and limit the scope for further cuts in short-term interest rates.



The Fed has lowered the Fed funds target rate by 300 basis points since last summer (and the discount rate has been trimmed by 375 bps). However, with inflation a growing concern, the Fed is unlikely to cut rates aggressively from here. Fiscal policy will provide some support, in the form of tax rebates to be mailed in May, June, and July. There is plenty of room for further fiscal policy, although it may be difficult to get anything enacted until after the tax rebates have had some chance to work. A few items left out of the fiscal stimulus bill are sorely needed: an extension of unemployment insurance benefits and aid to the states. Many state budgets are required to be balanced, making state fiscal policy pro-cyclical. States are forced to either raise taxes or cut spending when things slow down, amplifying the economic downturn. The government may also consider the purchase of distressed properties.



While overall inflation has remained high, core inflation has fallen back to the upper end of the Fed's comfort range. The Fed does consider food and energy prices when setting monetary policy and there are some flaws in how inflation is measured. However, the Fed is interested in the underlying trend of inflation and the PCE Price Index ex-food & energy is the best measure we have. A softer dollar has led to increased inflation in imports and less competition for domestic producers. Some measures of inflation expectations have begun to rise. However, wage pressures are moderate and a weak economy should help keep inflation pressures in check.

The list of negatives is large. Lower home prices will prolong and deepen the housing correction and dampen consumer spending. Banks have continued to tighten credit on all types of consumer and business loans. Nonbank credit has dried up. The downside risks to growth are still considerable. However, accommodative monetary policy should ultimately prevail.

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	2007	2008	2009
GDP (↓ contributions)	0.6	3.8	4.9	0.6	0.2	-0.2	1.6	2.2	2.4	2.4	2.2	1.3	2.1
consumer durables	0.7	0.1	0.4	0.2	-0.5	0.1	0.2	0.2	0.2	0.2	0.4	0.0	0.2
nondurables & services	1.9	0.9	1.7	1.4	1.0	0.8	1.1	1.2	1.4	1.4	1.6	1.1	1.3
bus. fixed investment	0.2	1.1	1.0	0.6	0.1	-0.3	-0.3	0.0	0.1	0.2	0.5	0.2	0.1
residential investment	-0.9	-0.6	-1.1	-1.3	-1.0	-0.8	-0.4	-0.2	-0.1	0.0	-1.0	-0.9	-0.1
government	-0.1	0.8	0.7	0.4	0.1	0.1	0.2	0.3	0.2	0.2	0.4	0.3	0.2
Domestic Final Sales	1.7	2.2	2.5	1.3	-0.3	-0.2	0.8	1.5	1.7	2.0	1.9	0.8	1.6
exports	0.1	0.9	2.1	0.8	0.6	0.5	0.4	0.5	0.5	0.6	0.9	0.8	0.5
imports	-0.6	0.6	-0.7	0.2	-0.2	0.3	0.1	-0.2	-0.4	-0.5	-0.3	0.0	-0.3
Final Sales	1.3	3.6	4.0	2.4	0.1	0.6	1.4	1.8	1.9	2.1	2.5	1.6	1.9
ch. in bus. inventories	-0.7	0.2	0.9	-1.8	0.1	-0.8	0.2	0.4	0.5	0.3	-0.3	-0.3	0.3
Unemployment, %	4.5	4.5	4.7	4.8	4.9	5.3	5.7	5.9	5.9	6.0	4.6	5.5	6.0
NF Payrolls, monthly, th.	109	105	71	80	-77	-50	20	50	75	90	91	-14	96
Consumer Price Index	3.6	4.3	2.5	6.2	3.0	2.2	2.3	2.3	2.3	2.3	4.1	2.5	2.3
excl. food & energy	2.2	2.3	2.5	2.6	2.1	2.1	2.1	2.1	2.1	2.1	2.4	2.1	2.1
PCE Price Index (q/q)	3.5	4.3	1.8	3.9	3.5	2.2	2.2	2.1	2.1	2.1	2.6	2.9	2.2
excl. food & energy	2.4	1.4	2.0	2.5	2.2	1.9	2.0	1.9	1.9	1.9	2.1	2.1	1.9
Fed Funds Rate, %	5.25	5.25	5.09	4.49	3.18	2.11	2.00	2.00	2.20	2.65	5.02	2.54	3.19
3-month T-Bill, (bnd-eq.)	5.1	4.9	4.4	3.5	2.1	1.5	1.7	1.8	2.0	2.60	4.5	2.1	3.3
2-year Treasury Note	4.8	4.8	4.4	3.5	2.0	1.9	2.5	3.7	4.0	4.3	4.4	3.0	4.5
10-year Treasury Note	4.7	4.8	4.7	4.3	3.7	3.9	4.5	4.8	4.9	5.0	4.6	4.3	5.1