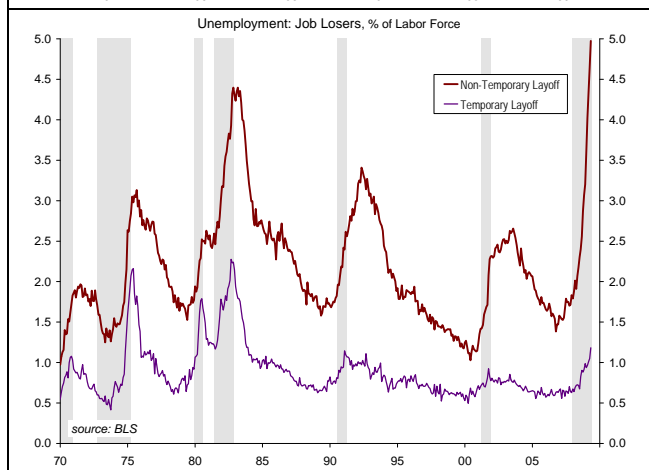
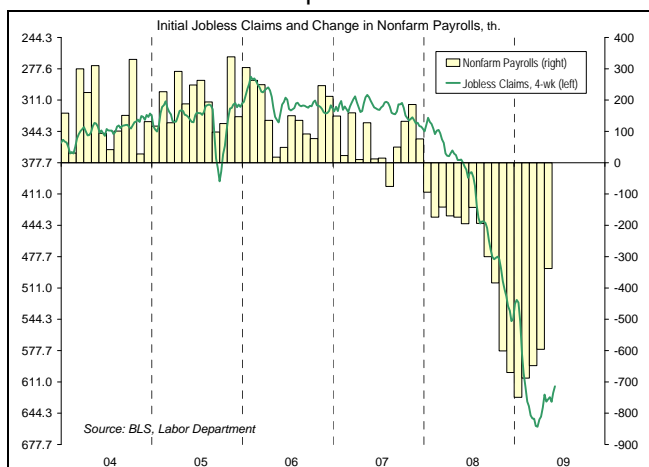


## Economic Research – Scott J. Brown, Ph.D.

### Nearing An End, But Recovery To Be Gradual

- Recent data suggest that the recession may be nearing an end. However, the recovery is expected to be gradual, with downside risks remaining near term.
- Monetary policy should remain accommodative through early 2010 and fiscal stimulus will have a greater impact later this year and more so in 2010.
- Stabilization in import prices and a pickup in commodity prices suggest that deflation will not be a problem. With a large amount of slack in the economy, inflation is likely to remain low for several quarters.

Recent economic data have been mixed, but are consistent with the view that an end to the recession may be near. Residential construction figures and auto sales appear to be stabilizing (granted, at very low levels). Labor market conditions remain very weak, but are not as bad as a few months ago. The job market is a lagging indicator coming out of a recession. We can expect the unemployment rate to rise well after the recovery is on its way. As with the last two recessions, significant structural change will lead to relatively weak job conditions for several quarters.

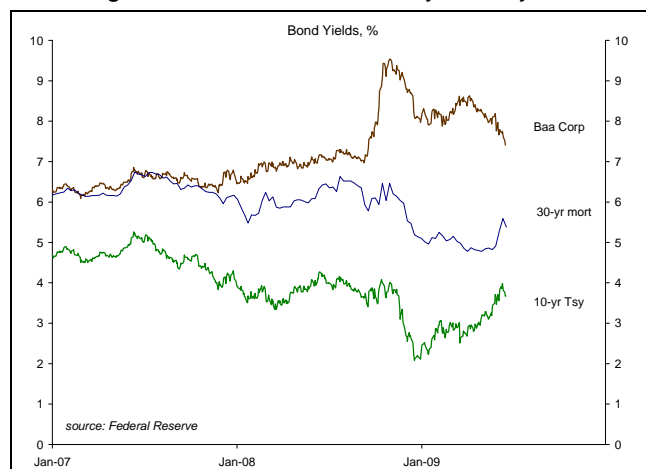


## Friday, June 19, 2009

A number of special factors (lower tax payments, lower gasoline prices) helped support consumer spending growth in the first quarter. However, the weak job market and tight credit have restrained spending in the second quarter. Higher gasoline prices are a constraint on household budgets. The drop in gasoline prices at the end of last year boosted consumer purchasing power into the first quarter. However, gasoline prices have increased steadily since the end of last year. A further increase, to more than \$3 per gallon, would jeopardize the recovery.

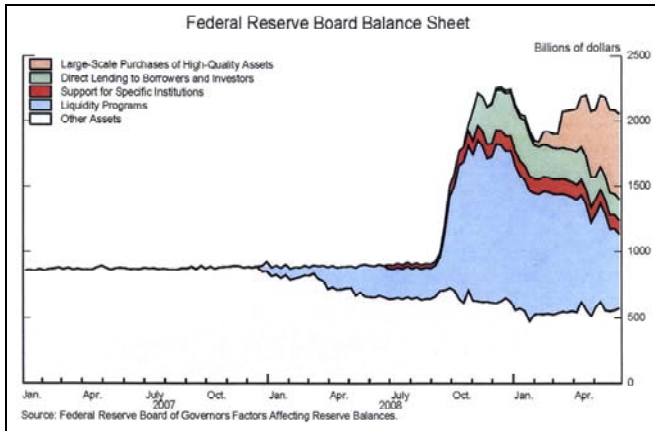


Higher long-term interest rates may also dampen the prospects for recovery. An increase in long-term rates is a natural outcome as the economy starts to recover, as fear subsides and optimism begins to improve. However, long-term rates should not rise so fast that the recovery is thwarted. It's often difficult for the market to find the right balance. Some volatility is likely.



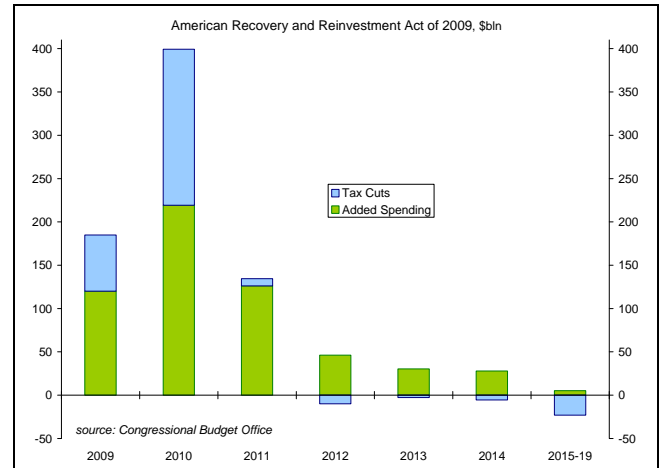
Higher Treasury yields do not necessarily mean that other long-term rates have to rise. Corporate bond spreads to Treasuries should continue to compress as investors grow more confidence about the recovery.

Many investors are fearful that the Fed's aggressive monetary policy and increased government borrowing will lead to inflation. However, the economy will experience a large amount of slack in labor and product markets for some time. While money supply growth has been rapid, the velocity (or turnover) of money has plunged. The Fed's policy actions have not led to a surge in bank lending. So it's hard to see where inflation would come from. Commodity price pressures are a wildcard and a resumption of strong global growth could lead to an increase in the price of oil and other inputs.



Federal Reserve officials are confident that policy accommodation can be removed in a timely fashion when appropriate. The Fed's liquidity and lending programs will be scaled back over time. The Fed has already seen a decrease in demand for a number of its liquidity facilities (in addition, Treasury has seen some repayments of TARP funds). At this point, the Fed's purchases of Treasuries (up to \$300 billion) will end in September. With deflation looking like less of a threat, the Fed may stop there. The Fed's purchases of mortgage-backed securities (up to \$1.25 trillion) is set to end in December. The Fed now pays interest on bank reserves and should be more easily able to rein in bank lending once it begins to tighten monetary policy

To date, only about \$50 billion of the \$790 billion fiscal stimulus package has gone out the door. Thus, there should be little evidence (so far) of its impact on the economy. About \$135 billion in stimulus will arrive in the remainder of the current fiscal year (ending September) and nearly \$400 billion will show up in FY10. The stimulus will help support the economic recovery. The drop-off in FY11 (-\$265 billion) will have a contractionary impact on growth, but hopefully, the private-sector economy will improve enough to offset that (otherwise, further stimulus may be needed).



Recessions that are caused by financial crises tend to be more severe and longer lasting, with recoveries that are gradual and fragile. There are already some calls for a scaling back of monetary and fiscal stimulus, but it's much too soon to remove accommodation.

In the near term, the outlook for GDP growth will be heavily influenced by what happens with inventories. Relative to 1Q09, inventories don't have to rise to add to overall growth – they only have to fall at a slower pace (which seems very likely, but it's impossible to predict the timing precisely). Longer-term, there's a potential for above-trend growth as the recovery advances (and the unemployment rate begins to move back towards 5%).

	2008	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	2008	2009	2010
GDP (↓ contributions)	2.8	-0.5	-6.3	-5.7	<b>-0.7</b>	<b>-0.2</b>	<b>1.0</b>	<b>2.3</b>	<b>2.9</b>	<b>3.0</b>	1.1	<b>-2.7</b>	<b>1.8</b>
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	0.5	-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	-4.5	-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	-0.7	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	-5.3	<b>-2.3</b>	<b>-0.3</b>	<b>0.9</b>	<b>2.2</b>	<b>2.8</b>	<b>2.9</b>	0.0	<b>-3.2</b>	<b>1.6</b>
exports	1.5	0.4	-3.4	-3.9	-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	<b>-2.2</b>	<b>-0.9</b>	<b>0.4</b>	<b>1.8</b>	<b>2.5</b>	<b>2.7</b>	1.4	<b>-2.4</b>	<b>1.9</b>
ch. in bus. inventories	-1.5	0.8	-0.1	-2.3	1.5	0.6	0.5	0.5	0.4	0.4	-0.3	-0.2	0.5
Unemployment, %	5.4	6.0	6.9	8.1	<b>9.3</b>	<b>9.8</b>	<b>10.1</b>	<b>10.3</b>	<b>10.2</b>	<b>10.2</b>	5.8	<b>9.3</b>	<b>10.2</b>
NF Payrolls, monthly, th.	-153	-208	-553	-691	<b>-405</b>	<b>-210</b>	<b>-85</b>	<b>90</b>	<b>140</b>	<b>30</b>	-257	<b>-348</b>	<b>93</b>
Cons. Price Index (3 mo)	6.5	3.1	-12.4	2.2	<b>2.8</b>	<b>2.2</b>	<b>2.0</b>	<b>2.1</b>	<b>2.2</b>	<b>2.2</b>	0.2	<b>2.3</b>	<b>2.2</b>
excl. food & energy	2.5	2.3	0.2	2.2	<b>2.2</b>	<b>1.8</b>	<b>1.9</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	1.7	<b>2.0</b>	<b>2.0</b>
PCE Price Index (q/q)	4.3	5.0	-4.9	-1.0	<b>1.9</b>	<b>2.8</b>	<b>1.8</b>	<b>1.9</b>	<b>2.0</b>	<b>2.1</b>	3.3	<b>0.5</b>	<b>2.0</b>
excl. food & energy	2.2	2.4	0.9	1.5	<b>2.3</b>	<b>1.6</b>	<b>1.7</b>	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>	2.2	<b>1.7</b>	<b>1.8</b>
Fed Funds Rate, %	2.09	1.96	0.53	0.19	<b>0.17</b>	<b>0.20</b>	<b>0.25</b>	<b>0.29</b>	<b>0.70</b>	<b>1.17</b>	1.94	<b>0.20</b>	<b>0.97</b>
3-month T-Bill, (bond-eq.)	1.7	1.5	0.3	0.2	<b>0.2</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.9</b>	<b>1.4</b>	1.4	<b>0.2</b>	<b>1.2</b>
2-year Treasury Note	2.4	2.4	1.2	0.9	<b>1.0</b>	<b>1.2</b>	<b>1.6</b>	<b>2.0</b>	<b>2.5</b>	<b>2.9</b>	2.0	<b>1.2</b>	<b>2.6</b>
10-year Treasury Note	3.9	3.9	3.2	2.7	<b>3.4</b>	<b>3.7</b>	<b>3.9</b>	<b>4.1</b>	<b>4.3</b>	<b>4.4</b>	3.7	<b>3.4</b>	<b>4.3</b>