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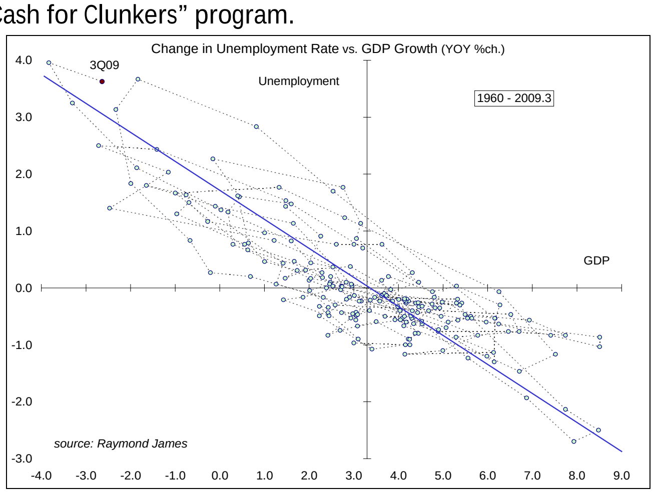
Still A Gradual Economic Recovery

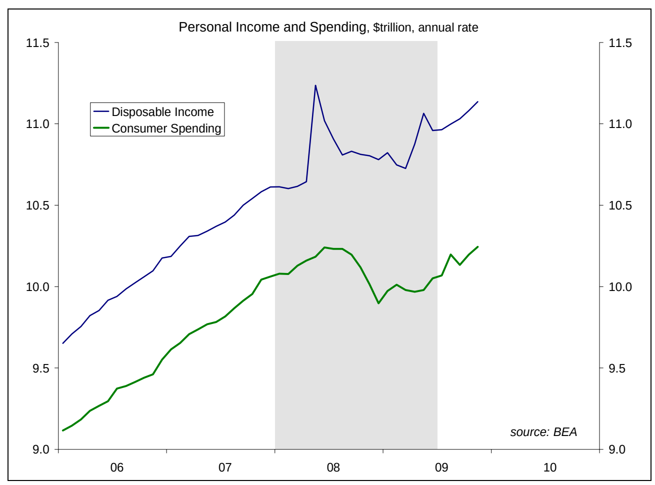
- *The pace of job losses has slowed and the economic expansion continued to advance into early 2010. New hiring should begin to pick up. However, the economy will continue to face a number of headwinds in the near term.*
- *More fiscal stimulus in the form of a job creation bill is likely. However, stimulus will begin to ramp down later this year and into 2011. Uncertainty regarding whether the Bush tax cuts will be extended could be a problem for the stock market.*
- *The Fed is expected to keep the federal funds rate low well into the second half of the year and possibly into 2011. However, the policymakers will have a number of tools available during this tightening cycle.*

The advance estimate of real GDP growth for 4Q09 will be released on January 29. It's likely to be relatively high. Some estimates on the Street are in excess of 5%. However, it's largely an inventory story. Inventories don't have to rise to add to fourth quarter growth – they simply have to fall at a slower pace. Nominal inventories were reported higher in both October and November (remember, it's the inflation-adjusted figures that matter for real GDP growth), and the headline GDP estimate will depend critically on what the Bureau of Economic Analysis assumes for inventories in December. Ex-inventories, GDP growth is likely to have been relatively lackluster – positive, but not especially strong (on the order of 1% to 2%) – held back partly by a retreat in vehicle sales following the third quarter's "Cash for Clunkers" program.



Real GDP growth is projected to be about 3.0% to 3.5% in 2010 (4Q10-over-4Q09). That would be decent growth in a normal year, but it would be disappointing given the depth of the recession. We need to see much stronger growth – 4%, 5%, or 6% – for a number of years to push the unemployment rate down significantly. The pace of job losses slowed over the course of last year, and especially in the fourth quarter. However, we've seen little evidence of new hiring. The job market will get some support from the 2010 census in 1H10.

There's good news in the economic outlook. The financial system has stabilized, job losses have decreased, and we appear to be on the cusp of positive feedback loops. If consumers spend a little more, businesses invest a little more, and banks lend a little more, that tends to lead to more of the same. That's how recoveries progress. However, the economy still faces a number of headwinds which are likely to restrain the pace of growth: continued problems in the housing sector, problems in commercial real estate, huge strains on state and local government budgets, and tight bank credit. Homebuyer incentives are set to expire in the spring. Federal Reserve purchases of mortgage-backed securities will end in March. The 2010 census will serve as a mini-stimulus package in the first half of the year, but the economic impact turns negative in the second half of the year as temporary workers are let go. The $787 billion fiscal stimulus package will start to ramp down later this year, effectively acting like a drag on GDP growth into 2011. The Bush tax cuts are scheduled to sunset at the end of the year. On balance, positive forces ought to offset the negative forces in the growth outlook, but those negative forces will prevent the economy from experiencing the typical V-shaped recovery one normally sees following a sharp recession.



Consumer spending represents about 70% of the overall economy. The biggest driver of spending is income. Wage income weakened in 2009, but thanks to the economy's automatic stabilizers (tax payments fall in a recession, while transfer payments, such as unemployment insurance benefits, increase) disposable income held up well. There are serious issues with the estimated savings rate. Savings are not observed directly, but are calculated as a residual (income less taxes and outlays) and are subject to large revisions (usually higher). The savings rate appears to be stabilizing around 4.5% to 5.0%. Equivalently, spending has adjusted as a percentage of disposable income. Both will still tend to trend similarly over time, but the pace of spending will be a little lower than it would be otherwise. The key will be to replace temporary support with labor income. We need to generate job growth.

The $787 billion stimulus package approved last February has provided critical support to the economy. While critics argue that the unemployment rate is higher despite the stimulus, it would have been even higher without it. From the beginning, the stimulus plan was not billed as a cure-all, but was to be viewed as transitional support while the private sector economy recovered. The President's Council of Economic Advisors estimates that the stimulus added 2.6 percentage points to 2Q09 GDP, 2.8 to 3Q09, and 2.7 to 4Q09. Those estimates are generally in line with those of private forecasters.

The Obama Administration is expected to push for a new stimulus plan, geared toward boosting new hiring and increasing the flow of credit through small banks to small businesses. Another stimulus plan may be difficult to achieve politically. There is a growing populist movement that wants to reduce the deficit. However, it's an election year and most legislators will probably not want to vote against a "jobs" bill. The literature of such stimulus is mixed, with some incentives merely rewarding firms that would have hired workers anyway. However, there should be a significant positive impact on job growth overall.

The Bush tax cuts are scheduled to sunset at the end of this year. Raising taxes in a fragile economic recovery is not a good idea. Officially, the Obama Administration's stance is the same as during the 2008 presidential campaign – that is, it will seek higher marginal tax rates at the upper end of the income scale and a higher capital gains tax rate for wealthier households. Unofficially, the administration is reported to be considering whether to extend the Bush tax cuts to support the economic recovery. This extension could serve as a bargaining chip to get something from the Republicans. However, the players should push for an agreement sooner rather than later. The uncertainty about 2011 tax rates could be a negative factor for the markets and the economy in the second half of the year.

Talking to small business owners all the way up to CEOs of major corporations, one becomes aware of "policy risk." This is the uncertainty regarding the costs of healthcare reform, cap and trade, and other administration proposals. Whether these costs will be seriously detrimental to business is debatable. However, the perception of higher business costs may be enough to limit firms' willingness to hire new workers and expand. Business attitudes were also relatively poor during the first couple of years of the Clinton Administration. However, the second half of the 1990s was very good for most businesses. The key will be in ensuring that new regulations and reforms are not too onerous for business. A lot of fears about this being "the worst business climate ever" seem a little overdone.

The budget deficit is shaping up to be a significant political issue this year. The public view is that the budget deficit should be reduced. Most economists believe that as well. However, reducing the budget deficit in an economic recovery is a bad idea. The main goal should be to ensure the economic recovery. Reducing the deficit can come later. The surge in the deficit has been largely due to cyclical and temporary factors. However, even after the economy recovers and the temporary spending increases have faded, the federal government is still expected to run relatively large budget deficits – and the main reason for that is the rising cost of Medicare. One goal of healthcare reform was to reduce the cost of medical cost inflation. If one believes that, then a failure of healthcare reform would actually make the budget deficit worse over the long term.

Real GDP growth is likely to be a bit above 3% in 2010 (4Q10-over-4Q09), supported partly by a moderate inventory rebuild. Growth is likely to be relatively lackluster otherwise. Oil prices will remain an important wildcard, but the largest uncertainty is tax policy. If the Bush tax cuts are extended, the growth outlook into 2010 would be somewhat brighter.

	4Q08	1Q09	2Q09	3Q09	**4Q09**	**1Q10**	**2Q10**	**3Q10**	**4Q10**	2008	**2009**	**2010**	**2011**
GDP (↓ *contributions*)	-5.4	-6.4	-0.7	2.2	4.6	3.2	3.1	3.0	3.0	0.4	-2.5	3.0	2.8
consumer durables	-1.6	0.3	-0.4	1.4	-0.1	0.3	0.3	0.3	0.3	-0.4	-0.3	0.3	0.3
nondurables & services	-0.5	0.2	-0.2	0.6	1.3	1.3	1.5	1.6	1.7	0.2	-0.1	1.2	1.6
bus. fixed investment	-2.5	-5.3	-1.0	-0.6	-0.3	0.2	0.3	0.4	0.5	0.2	-2.2	0.0	0.5
residential investment	-0.8	-1.3	-0.7	0.4	0.2	0.3	0.2	0.3	0.4	-1.0	-0.7	0.2	0.4
government	0.2	-0.5	1.3	0.6	0.5	0.4	0.3	0.1	-0.1	0.6	0.4	0.4	0.0
Domestic Final Sales	-4.9	-6.4	-0.9	2.3	1.6	2.4	2.7	2.8	2.8	-0.3	-2.8	2.2	2.7
exports	-2.7	-4.0	-0.5	1.8	1.6	1.0	0.8	0.7	0.5	0.6	-1.2	1.0	0.6
imports	3.1	6.6	2.1	-2.6	-2.0	-1.2	-1.0	-0.8	-0.7	0.5	2.2	-1.2	-0.7
Final Sales	-4.7	-4.1	0.7	1.5	1.2	2.2	2.5	2.7	2.7	0.8	-1.7	2.9	2.8
ch. in bus. inventories	-0.6	-2.4	-1.4	0.7	3.4	1.0	0.6	0.4	0.3	-0.4	-0.7	1.0	0.2
Unemployment, %	6.9	8.2	9.3	9.7	10.0	10.2	10.1	10.0	10.0	5.8	9.3	10.1	9.7
NF Payrolls, monthly, th.	-553	-691	-428	-199	-69	60	150	40	90	-257	-347	85	143
Cons. Price Index (3 mo)	-12.4	2.2	3.3	2.5	3.3	2.7	1.9	2.0	2.1	0.2	2.7	2.2	2.2
excl. food & energy	0.2	2.2	2.4	1.3	1.3	1.4	1.5	1.6	1.7	1.7	1.8	1.6	1.8
PCE Price Index (q/q)	-5.0	-1.5	1.4	2.6	2.6	2.7	1.8	1.9	2.0	3.3	0.2	2.3	2.0
excl. food & energy	0.8	1.1	2.0	1.2	1.3	1.3	1.6	1.6	1.7	2.4	1.5	1.4	1.7
Fed Funds Rate, %	0.53	0.19	0.18	0.15	0.12	0.22	0.24	0.25	0.25	1.94	0.16	0.24	0.97
3-month T-Bill, (bond-eq.)	0.3	0.2	0.2	0.2	0.1	0.2	0.2	0.3	0.3	1.4	0.1	0.2	1.1
2-year Treasury Note	1.2	0.9	1.0	1.0	0.9	1.0	1.4	1.8	2.3	2.0	1.0	1.6	2.6
10-year Treasury Note	3.2	2.7	3.3	3.5	3.5	3.7	3.7	3.8	3.9	3.7	3.3	3.8	4.1

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