Weekly Economic Commentary

March 09, 2009

Front End of the Economy May Be Stabilizing, but Back End is Still a Mess

Scattershot Approach to Policy not Helping

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ECONOMIC CALENDAR

Tuesday, Mar 10
Wholesale Inventories
January

Wednesday, Mar 11
Treasury Statement
February

Thursday, Mar 12
Retail Sales
February

Initial Claims
wk 03/07

Business Inventories
January

Friday, Mar 13
Trade Balance
January

Import Price Index
February

U of Mich Consumer Sentiment
March

In our 2009 Outlook, we stated in our base case scenario that:

"We expect that real GDP growth in both the first and second quarters of 2009 will be negative—close to the fourth quarter 2008 decline in the first quarter, and less negative in the second quarter. We expect real GDP growth to be roughly flat in the second quarter."

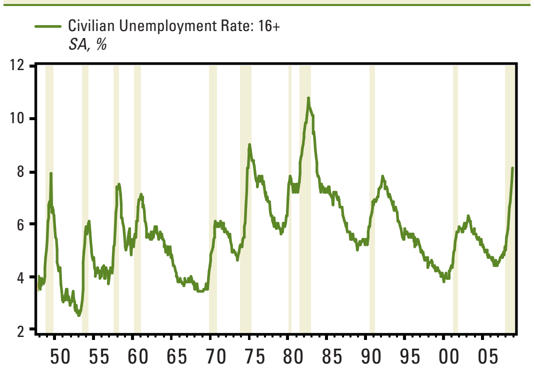
In recent weeks, we have been writing that based on the incoming data, the pace of decline in real GDP Q1 2009 would not be as severe as the 6.2% drop recorded in Q4 2008, and that is still largely the case, but only if we only refer to the "front end" of the economy—the Consumer sector. Accounting for two-thirds of GDP, consumer spending appears to have stabilized in early 2009 relative to the fourth quarter of 2008, as evidenced in recent reports on real personal spending in January, retail sales in January, and the chain store sales data for both January and February. The February retail sales report from the U.S. government is due out later this week.

However, the economic data released thus far for January and February 2009 on the "back end" of the economy — business spending on buildings, equipment and inventories— suggests that corporations are still struggling to realign output and inventories with the current U.S. and global economic reality. Evidence of this can be found in the ISM reports on manufacturing in January and February, employment, jobless claims, hours worked and industrial production in January and February.

Thus, inventory investment—which is part of gross domestic product—could potentially be a big negative in the Q1 2009 GDP report, which is due out in late April. As a result, the risk is rising that the pace of decline in overall real GDP in Q1 2009 could be more severe than the 6.2% decline posted in Q4 2008. Paradoxically, however, a weaker reading Q1 GDP could be good news for the economy later in the year, if the weakness is due to a big decline in inventories. A dramatic paring of inventories in Q1 may leave more room for rebuilding them in later quarters, with the concomitant production (and employment) gains that will add to growth.

In fact, a "kitchen sink" first quarter GDP report may mean that GDP growth, over the rest of the year, could even be a bit stronger than our base case, meaning that the economy could climb into positive territory in both the third and fourth quarters of 2009. Our base case is that the U.S. economy doesn't move into positive territory until Q4 2009. One other point we would like to make on this topic is that even if we do get a huge (-7.5% or more) decline in real GDP in Q1, it doesn't mean that we are headed to the bear case—if the drop is dominated by a large inventory liquidation.

1 At 8.15, the Unemployment Rate Hit a 26-Year High in February



Source: Bureau of Labor Statistics / Haver Analytics 03/09/09

2 The Sharp, Unwanted Rise in the Inventory to Sales Ratio in Late 2008 May Lead to a Sharp Inventory Liquidation in Early 2009

Source: Bureau of Economic Analysis, Haver Analytics 03/09/09

The bottom line is that for now, we are sticking to our base case for the U.S. economy as outlined in the 2009 Outlook. However, as we have noted in these pages for the past several weeks now, we are growing more concerned with each passing week that the lack of clarity—and in some cases, lack of traction—on key policy initiatives aimed at ameliorating the crisis is weighing on both the economy and financial markets. On that front, we did get more details last week or two of the four elements of the Obama Administration's Financial Stability Plan (FSP), the housing rescue plan (Homeowner Affordability and Stability Plan), and the expansion of the Term Asset Backed Securities Loan Facility (TALF), the joint Fed-Treasury program designed to reignite the securitization market. In time, these programs, along with the Federal Reserve's simulative monetary policy and the $787 billion fiscal stimulus plan passed by Congress in mid February, will act to boost the economy

However, we continue to note that policy voids remain to be filled, and the Obama Administration's response to the crisis remains scattershot, at best. The market lacks any real details on the remaining part of the Financial Stability Plan (FSP) and the Private- Public Investment Fund (PPIF) - aimed at lifting bad assets off of the balance sheets of the nation's banking system. Details on the PPIF are likely to be released this week. We remain hopeful that that the details of all the policies will be released soon, and that the programs themselves begin working to restore confidence in the financial system and the economy. Until then, we think the economy and markets will suffer, and remain volatile.