



Weekly Economic Commentary



March 23, 2009

Back End of Economy Crashing; Policy Response Ramps Up

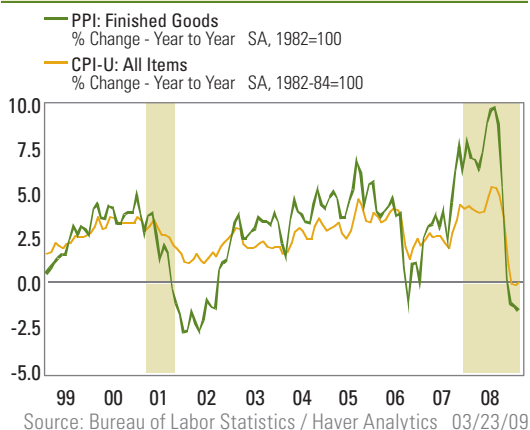
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ECONOMIC CALENDAR

| | |
|---|---|
| Monday, March 23 Existing Home Sales <i>February</i> | Friday, March 27 PCE <i>February</i> |
| Wednesday, March 25 Durable Goods <i>February</i> | Personal Income <i>February</i> |
| New Home Sales <i>February</i> | U of Mich Consumer Sentiment <i>March</i> |
| Thursday, March 26 GDP Price Index <i>Q4</i> | |
| GDP <i>Q4</i> | |
| Initial Claims <i>wk 03/21</i> | |

1 CPI and PPI Walking a Fine Line Between Inflation and Deflation



We have been writing for several weeks now that the “front end” of the U.S. economy consumer spending, which accounts for two-thirds of real gross domestic product, had stabilized thus far in the first quarter (Q1) of 2009 relative to Q4, but that the “back end” of the U.S. economy, business spending on plant, equipment, and inventories was still decelerating to the downside.

Nothing in last week’s economic data releases changed that view:

- The surprisingly strong housing starts data for February
- The better than expected—but still weak—Philadelphia Fed Manufacturing Index for March
- The weaker than expected reading on industrial production and capacity utilization in February
- The weaker than expected reading on the Empire State Manufacturing Index for March
- The better than expected weekly jobless claims data for the week ending March 14

In addition, the February readings on consumer and producer prices walked the line between inflation and deflation, and were generally welcomed by the markets.

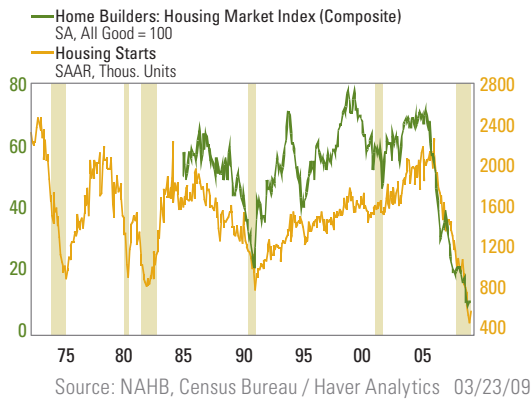
In all, the week’s data provided a solid backdrop for financial markets, which spent the latter half of the week (and the weekend of March 21 and 22) reacting to:

- The Federal Reserve’s surprise announcement on monetary policy
- The political backlash against AIG which may put in jeopardy any further Congressional assistance for financial markets, and
- The details of the Obama Administration’s long awaited Public Private Investment Fund (PPIF), designed to help lift toxic assets off bank balance sheets

On balance, the U.S. economy remains mired in a deep recession, but it is still tracking to our base case, as laid out in the 2009 Outlook. We expect real gross domestic product to decline sharply in Q1 2009, but not as sharply as in Q4 2008. Consumer spending will be a bright spot this quarter, while business spending on new office space and equipment is likely to be dramatically weaker than in Q4 2008. In addition, both inventory investment and exports areas also likely to be a big drag on growth in the quarter. Q1 2009 GDP is due out at the end of April.



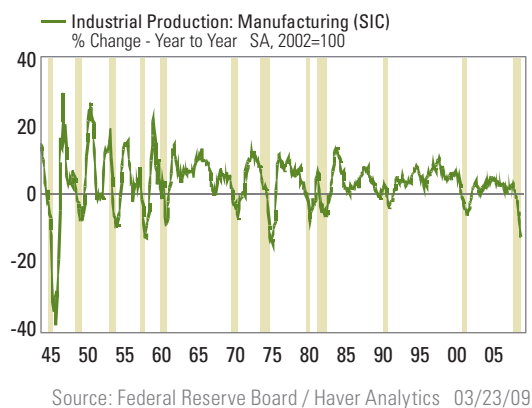
2 Is the Housing Market Stabilizing? Maybe...



On the policy front last week, the big news was the Fed's surprise announcement at the conclusion of its March 18 FOMC meeting. The Fed, sensing that it may be the "only game in town" announced several bold policy actions on Wednesday, March 18, 2009 aimed at supporting the U.S. economy by lowering interest costs for both consumer and business borrowers. In both scope and magnitude, the actions—which will be implemented immediately—shocked market participants, who on balance were not expecting anything unusual from the Fed right now.

Overall, we think the Fed's aggressive actions are welcome news for an economy (and financial markets) that are starved for bold aggressive action. Any recovery in the economy has to start with a sound banking system, and that banking system has to be encouraged to lend. Once that has been accomplished (hopefully via the TALF and the Administration's Public Private Investment fund), the actions announced by the Fed yesterday will certainly prompt borrowers to want to borrow, which in time, will lead to more investment and hiring, and eventually to a full recovery in the economy. We are still probably many months or quarters away from full recovery in the economy, but the Fed's actions probably move the date of recovery up by a quarter or so. Of course, markets look ahead and will react to this plan much more rapidly than the economy, and even after the first 24 hours or so, we have already seen some large movements in several asset classes.

3 As Evidenced by the Huge Plunge in Industrial Production, "Back End" of Economy is a Mess



We are growing more and more concerned that the current political environment could impede any recovery in the U.S. economy this year. The "political will" for providing the banking system any further capital has been nearly completely eroded in the wake of the latest flap over the AIG bonuses, and the U.S. House of Representatives bill that would tax those bonuses at 90%. In such a heated environment, it would be incredibly difficult for the Obama Administration to go to Congress and ask for more bailout money beyond what is already part of the \$700 billion authorized last Fall. We suspect that that line of thinking was behind the Fed's decision last week to ramp up its "quantitative easing" campaign, and also played a big part in how the details of the Public Private Investment fund were agreed to among the FDIC, the Treasury and Wall Street. Treasury Secretary Geithner is slated to release the full operational details on the PPIF on the afternoon of Monday March 23, 2009, as this publication goes to print.

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