

U.S. Economic Outlook

June 2008

Economic Outlook

- The U.S. economy continues to struggle, weighed down by the combined effects of three formidable shocks: the housing slump, the credit crunch, and the spike in energy prices, the latter of which is not only depressing activity but also putting upward pressure on inflation.
 - ▶ Credit markets have improved considerably, though, as fears of a collapse of the financial system and a sharp deterioration in economic activity have greatly receded. Still, credit conditions remain more restrictive than a year ago, and bank lending standards continue to tighten.
 - ▶ Also, the downshift in housing continues, with activity and prices still falling while foreclosures and delinquencies rise. And the run-up in energy prices has persisted, heightening concerns about "stagflation."
- Despite all the negative shocks, the economy has been able (barely) to keep its head above water – a testament to its underlying resiliency, an aggressive policy response, and the relative strength of global growth.
 - ▶ Real GDP has continued to advance, albeit modestly and well below the economy's trend potential.
 - ▶ The labor market has softened, with payroll growth turning mildly negative and the unemployment rate rising, though the recent jump in the latter likely overstates the trend, and the overall deterioration has so far been modest relative to past cyclical downturns.
 - ▶ Consumer sentiment has tumbled, no doubt reflecting higher energy prices, declining house prices and softer labor markets. And it's all begun to take a toll on consumer spending, which has slowed recently.
 - ▶ But business investment has been sustained, supported by the solid financial conditions of many firms, and net exports remain a powerful spur to growth, benefitting from the weaker dollar and strong demand abroad.
- Looking ahead, the lagged effects of spillovers from the housing correction, tighter credit conditions, and higher energy prices will likely continue to exert a drag on activity for some time.
- On the flip side, though, much of the Federal Reserve's aggressive policy stimulus is still in the pipeline, and the tax rebate checks should provide a temporary spur to spending. Also, housing affordability is recovering, and house prices may not need to fall that much further to bring them back into alignment with fundamentals.
- On balance, we expect economic activity to remain sluggish for awhile, but then gradually claw its way back toward trend-like growth in 2009 as housing bottoms, credit markets heal, and energy prices stabilize.
- On the inflation front, headline measures will likely remain elevated for a time, reflecting higher commodity prices. While this poses risks to underlying inflation, we expect those risks to be contained. Inflation

Economic & Financial Market Projections

	Real GDP	Core CPI	10-year Treasury yield	S&P 500
	(Q to Q % chg, ann rate)	(4-qr % chg)	(%, last mth of qtr)	(last mth of qtr)
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2006				
3Q	1.1	2.8	4.72	1318
4Q	2.1	2.6	4.56	1416
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2007				
1Q	0.6	2.6	4.56	1407
2Q	3.8	2.3	5.10	1514
3Q	4.9	2.2	4.52	1497
4Q	0.6	2.3	4.10	1479
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2008				
1Q	0.9	2.4	3.51	1317
2Q (F)	1.0	2.3	3.95	1370
3Q (F)	2.0	2.2	4.15	1410
4Q (F)	1.5	2.2	4.25	1445
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2009				
1Q (F)	2.0	2.2	4.35	1470
2Q (F)	2.5	2.2	4.40	1490
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F—Forecast				

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expectations remain tame – though some recent upcreep bears close watching – and rates of resource utilization will likely ease further as demand remains subpar, helping keep labor costs and prices in check.

- Considerable risks attend this forecast. The housing and credit slumps could prove more enduring and damaging, especially if people become unduly pessimistic about the outlook for house prices, causing these prices to undershoot fundamentals. And the risks of inflation expectations becoming unmoored by persistent increases in energy prices can not be dismissed.

Monetary Policy Outlook

- The current environment is a difficult one in which to make monetary policy.
- The economy is struggling to cope with the profound housing and credit shocks and with a relentless run-up energy prices layered on top, which adds to downside growth risks and upside inflation risks.
- Against this backdrop, the choices confronting policymakers – weaker growth and/or higher inflation in the short-run – are unpleasant.
- On balance, we see the Federal Reserve remaining on hold for now.
- To be sure, the Fed is keenly aware that considerable downside risks to growth remain. But they've eased a lot already to offset those risks, the funds rate is below estimates of "neutral," much of the impact of these rate cuts is yet to be felt, fiscal stimulus is in the offing, and recent signs of improvement in the credit markets and the relative resiliency of the economy are encouraging. Moreover, while inflation expectations remain broadly in check, there have been some disquieting hints recently of a bit of deterioration, and policy-makers are very sensitive to any signs that the public's faith in their inflation-fighting credibility may be wavering.
- At present, this remains a small risk. So we don't expect the Fed to raise rates anytime soon, probably not before 2009, until they become confident that the downside risks to growth stemming from the housing slump, the credit crunch, and the energy price spike have faded.

Fixed Income Outlook

- Treasury yields have backed up substantially over the past few months as fears of a financial-market collapse and a deep economic downturn have abated, and risk appetites have recovered somewhat.
- Most of these rate movements reflect improved perceptions of real growth prospects rather than deteriorating inflation expectations, as evidenced by the sharp rise in real yields and pronounced flattening of the yield curve.
- On the whole, these moves are consistent with what has been our base-case view: that the worst economic/financial outcomes would be avoided, and prospects would gradually brighten, improving risk appetites.
- But recently, market sentiment may have swung too far, becoming too aggressive in the magnitude and timing of Fed tightening that it anticipates.

Equity Market Outlook

- Equities markets have been weighed down recently by growing concerns about a deteriorating growth/inflation mix resulting from the relentless rise in energy prices compounding the housing and credit slumps.
- Provided the economy is able to navigate these risks without untoward problems, as we expect, equities should benefit, as their valuations seem reasonable.
- But profit growth will likely slow further in the near-term as the economy struggles and because profit margins are wide by historical standards and competitive pressures may be starting to pressure those margins.

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