SIFMA®
Securities Industry and Financial Markets Association

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ECONOMIC OUTLOOK

The Economic Outlook: Fed to Cut; Stimulus on Its Way

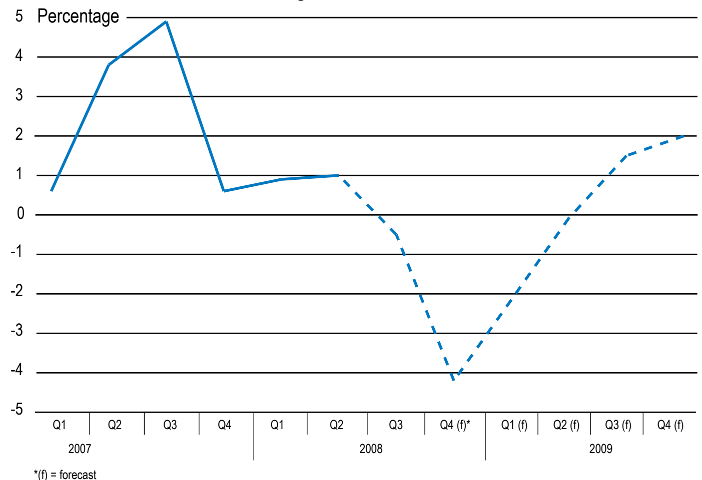
Members of the Securities Industry and Financial Markets Association's Economic Advisory Roundtable expect the current U.S. recession to continue into mid-2009, with subdued growth thereafter through the end of the year.[1] The current U.S. recession dominated all responses in the current economic survey. The perfect storm of financial market meltdown, credit market freeze and economic contraction are meeting head-on in a period of political transition and regulatory overhaul. Speculation over what the new administration and Congress will do in January 2009 is front and center, making attempts to forecast more challenging than at any time in recent memory. Housing sector weakness, frozen credit markets, falling commodity prices, aggressive central bank actions to support market liquidity, and the effect of an anticipated fiscal stimulus provide the backdrop for the economic outlook.

Forecast Highlights

MONETARY POLICY The Roundtable was unanimous in its opinion that the Federal Open Market Committee (FOMC) would cut the target federal funds rate, currently at 1.00 percent, at the upcoming December 15-16 meeting. The overwhelming majority expect a rate cut of 50 basis points, with the balance anticipating a 25 basis point cut. Furthermore, the median expectation is for the FOMC to hold the target rate at 0.5 percent, although a significant minority expect the rate to ultimately reach 0.25 percent.[2] As for the FOMC's assessment of risks to growth and inflation, panelists were split between those expecting little or no change and those expecting a greater emphasis on the downward risks to growth and inflation.

THE ECONOMY The median forecast is for gross domestic product (GDP) to fall at an annualized rate of 4.2 percent in fourth quarter 2008, resulting in full-year 2008 growth of 1.3 percent (year-over-year basis).[3] The economy is expected to continue to contract on a quarterly basis through mid-2009, with full-year 2009 GDP expected to fall 1.0 percent.[4] This translates approximately to an 18-month recession beginning January 2008, somewhat longer than the 16 month duration of the two longest postwar recessions. December 2007 was recently designated as the peak month of the previous economic expansion.[5]

Real GDP Growth Rate
Quarter over Quarter Change, annualized



Recent employment reports echo the negative expectations, with the U.S. Department of Labor reporting 533,000 job losses in November alone, with October and September

1 The survey was conducted from November 24 - December 5, 2008. The forecasts discussed in the text and appearing in the accompanying data table are the median values of the individual member firms' submissions, unless otherwise specified.

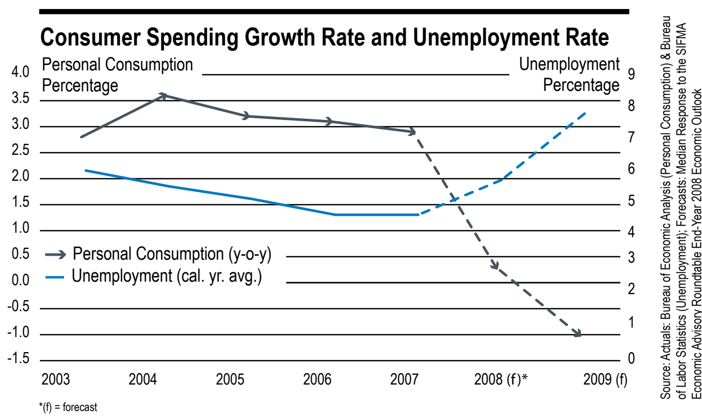
2 The forecast for the target federal funds rate ranged from 0.00 to 0.75 percent.

3 The fourth quarter 2008 GDP growth forecasts ranged from negative 5.0 percent to negative 3.0 percent and for full-year 2008 from 1.2 percent to 1.3 percent.

4 The full-year 2009 GDP growth forecasts ranged from negative 2.0 percent to positive 0.2 percent, with all respondents expecting growth to resume by third quarter 2009 ranging from 0.1 percent to 3.0 percent.

5 The National Bureau of Economic Research (NBER) recently identified December 2007 as the peak of the previous economic expansion, which began in November 2001 (http://wwwdev.nber.org/cycles/dec2008.html).

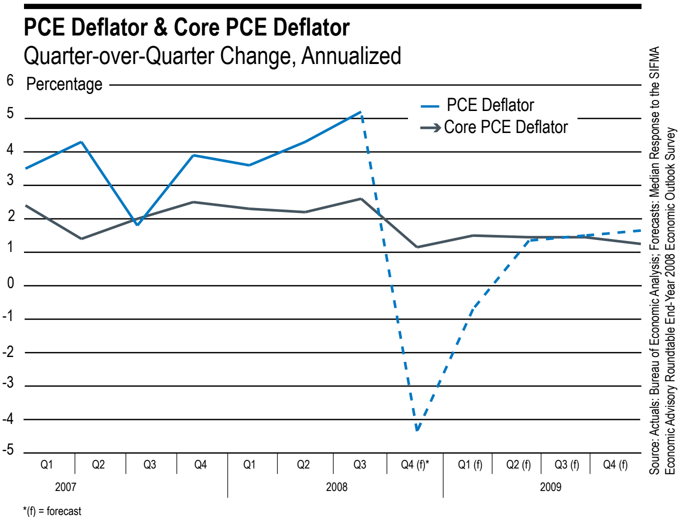
data revised downwards for a total of 1.276 million jobs lost in the three-month period. Survey respondents expect job losses to continue, reaching an estimated 2009 average unemployment rate of 7.8 percent from the current 6.7 percent.[6] Unsurprisingly, the median consumer spending forecast calls for a meager increase of 0.3 percent for full-year 2008 and a drop of 1.0 percent in full-year 2009, with employment and income growth cited as the dominant drivers of that decline.[7] The panelists also considered credit availability as another constraint on consumer spending, but along with the housing and equity wealth effects, not nearly as important. Energy and other commodity prices, which were a downside concern to economic health just six months ago, have reversed dramatically, and are now much less of a factor.



Business capital investment growth is expected to fall by a dramatic 7.2 percent in full-year 2009.[8] The panelists cited diminished U.S. demand and future uncertainty as the most important factors in their investment spending outlook. Tighter borrowing conditions, reduced cash flow, and reduced profit growth were also identified as restraints on business capital spending.

The inflation outlook has taken on a whole new dimension in the last few months. Disinflation and even deflation have become leading concerns as the standard levers of monetary policy became ineffective in the dysfunctional credit markets. While the mid-year Economic Outlook debated the threats posed by skyrocketing energy and food costs, the subsequent, even faster collapse of commodity prices and the distressed condition of financial markets make inflation a very distant worry, if a worry at all.

The median forecast for "headline" inflation, measured by the personal consumption expenditures (PCE) deflator, is 3.4 percent for full-year 2008, declining to 0.5 percent in full-year 2009.[9] The median forecast for the core PCE deflator is 2.2 percent for full-year 2008 and 1.7 percent for full-year 2009.[10] The panelists identified the level of slack in the economy and dramatic fall in energy and other commodity prices as the most significant considerations in their inflation outlooks.



INTEREST RATES As noted, the Roundtable's unanimous view was that the Federal Reserve will lower the target federal funds rate at the upcoming December 15-16 meeting.[11] As of December 5, the end of the survey period, the 10-year U.S. Treasury yield was 2.67 percent, down 106 basis points from the preceding month. The median forecast for the December 2008 average 10-year Treasury note yield was 2.85 percent, rising to 3.28 percent in June 2009 and to 3.78 percent at year-end 2009.[12] The weak economy and "flight to quality" were cited as the two most important drivers of falling rates, while inflation, inflationary expectations, Fed policy and foreign investor demand were also identified as important influences.

6 The full year 2009 average unemployment rate forecasts ranged from 7.4 percent to 8.5 percent. Job losses are forecast to total 1.4 million in 2009 following an estimated loss of 1.5 million in 2008.

7 The full year 2009 consumer spending growth forecasts ranged from negative 2.0 percent to positive 2.5 percent.

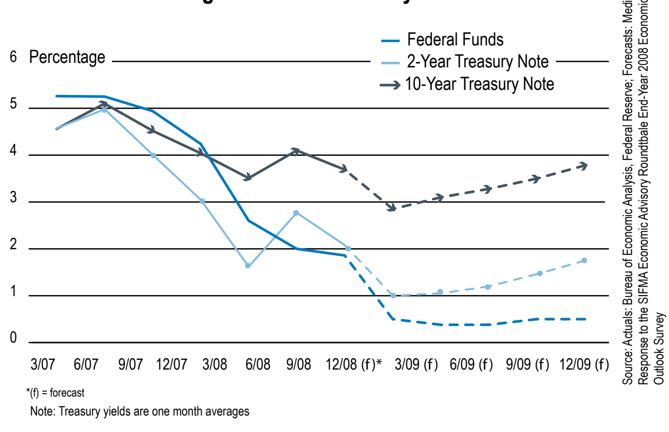
8 The full-year 2009 business fixed investment forecasts ranged from negative 12.8 percent to negative 2.2 percent.

9 The full-year 2008 PCE deflator forecasts ranged from 2.1 percent to 3.5 percent and from negative 0.9 percent to positive 1.8 percent for full-year 2009.

10 The full-year 2008 core PCE deflator forecasts ranged from 2.1 percent to 2.3 percent and from 1.1 percent to 2.0 percent for full-year 2009.

11 Although the respondents all expect the target federal funds rate to lowered at the December 15-16 meeting, there was diversity of opinion about how low a rate the Fed would ultimately target. The Roundtable's mean estimate was 0.50 percent, although the forecasts ranged from 0.0 percent to 0.75 percent.

12 The December 2008 average 10-year Treasury yield forecasts ranged from 2.50 percent to 3.95 percent and for December 2009, 1.95 percent to 4.75 percent.



Nearly 60 percent of the survey respondents expect the Treasury yield curve to steepen between now and mid-2009, with one quarter expecting it to flatten and the remainder forecasting no change. Survey respondents unanimously expect the TED spread, or Treasury-to-LIBOR, to narrow from its currently wide level. Three-quarters of the respondents expect both investment grade and high yield spreads to narrow from the very high current levels.

Monetary Policy Easing Expected to Continue; Quantitative Easing Next?

A new topic surveyed was the question of quantitative easing. Respondents identified quantitative easing as central bank purchases of government, agency or corporate debt securities; mortgage- or asset-backed securities; or equities. Most respondents believe the Fed has engaged in quantitative easing to some extent, with over 90 percent of respondents characterizing recent Fed actions as quantitative easing to a complete or great extent. One respondent commented that the Fed's expansion of its balance sheet had been to meet the large increase in demand for liquidity via its facilities, unlike the Bank of Japan, whose policy had been to push out more reserves than demanded at a zero percent interest rate. Most respondents identified a variety of Fed quantitative easing policies that they supported, pointing out existing commercial paper programs, the recently announced Term Asset-Backed Securities Loan Facility (TALF) program, and possible future purchases of longer-dated Treasury and other securities.

As for the possible future inflationary challenges of quantitative easing, slightly more than half of the respondents described the risk as posing little or no threat. Paraphrasing one respondent's commentary, there was no such threat in the face of shrinking risk appetites that have forced the Fed to provide the credit normally provided by the private system, in addition to rising unemployment, expanding economic slack and a global economy in a downswing. Of the minority view that there could be a moderate or substantial inflationary threat in the future, all agreed that quantitative easing was needed now. The potential risk identified was that the Fed might not be able to unwind such programs in a timely fashion in the future, as was the case in 2003-2004.

Fiscal Policy to Jump Start Economy: Most Favor Tax Cuts and Infrastructure Spending

The panelists generally favored tax cuts as the most stimulative among a range of possible policy moves, with roughly 75 percent citing a broad tax cut as among the top two recommended moves. A number of respondents also cited tax cuts targeted towards lower or middle income families as favored policy actions. Public works and infrastructure projects, extended unemployment benefits, and direct aid to local and state governments were also noted as important stimulative policies. It was noted that while most stimulative in the long run, infrastructure projects would take considerable time to get underway, and so more immediate support such as tax cuts and direct aid to states would be helpful as a bridge. Nearly all respondents commented that allowing the tax cuts slated to sunset in 2010 to expire only for those families making more than $250,000 would be somewhat negative, with some commenting that allowing any tax rates to rise in the current environment would dampen economic activity.

Impaired Credit Markets, Employment, Housing Dominant Risks to U.S. Economic Growth

The panelists identified dysfunctional credit markets and rising employment losses as dominant downside risks to economic growth, with housing and the global economic slowdown also cited. Falling housing prices were recognized as a continuing issue, impairing the credit market and driving economic weakness and layoffs, which in turn further weaken house prices.

Housing market outlooks varied greatly among survey respondents. The median outlook for housing sales and starts to bottom out were both in the second quarter 2009, although the range of expectations was from fourth quarter 2008 to first quarter 2010. Equally wide was the range of expectations for housing prices to bottom out, from first quarter 2009 to second quarter 2010, although the median was in fourth quarter 2009. The nearest bottom outlook was for the equity markets, expected in first quarter 2009, although within a range from fourth quarter 2008 to first quarter 2010. The wide range of forecasts reflects the great uncertainty surrounding these markets, and that falling housing prices lead much of the downturn.

Auto Industry

The survey respondents were split evenly over the issue of direct federal aid to the Detroit-based auto industry. Those who supported such aid favored federal loans over other possible alternatives such as direct equity ownership. Of

those who favored loans, however, all also favored requiring conditions such as restructuring, consolidation, and creditor seniority. Even those who did not favor direct aid agreed that action was required, such as pre-arranged bankruptcy. One respondent pointed out that one of the best things the government could do for Detroit was to revive the broader economy.

Oil Prices: Little Near-Term Chance of Significant Rebound

Panelists placed a roughly 40 percent probability on oil prices remaining in the current range below $50 per barrel and a 50 percent chance of oil prices returning to the $50 - $100 per barrel range through mid-2009. The remaining 10 percent was for prices to rise above $100 per barrel. The above-$100/barrel scenario would have the estimated effect of reducing GDP growth by roughly 50 basis points, while the sub-$50/barrel scenario envisions an increase of 50 basis points.[13] On a probability-weighted basis, respondents estimated that oil prices would only have a 20 basis point positive impact on GDP growth by mid-2009.

Government Program Impact: Generally Effective

The panelists had mixed views on the impact that the myriad government programs - designed to counter the credit and economic crises - would have on the economy, credit markets, bank balance sheets and housing markets. The direct equity injections into financial institutions, FDIC insurance of bank debt and commercial paper programs were ranked as most beneficial to credit availability. The equity injections, not surprisingly, were seen as impacting bank balance sheets positively. Current GSE and FHFA mortgage modification programs, contemplated non-GSE modification programs, and the easing of GSE and/or FHA lending also ranked highly in benefiting the housing markets. All of these programs were seen as supportive of economic growth.

The Original TARP: Still Waiting

Most respondents agreed that a government program to purchase or insure troubled assets, the original stated purpose of TARP, would have a significant impact on bank balance sheets and, to a slightly lesser degree, on credit availability; two thirds of respondents characterized the purchase of troubled assets as important or very important to addressing the credit crisis. Over 90 percent of respondents identified price transparency as a critical factor to the health of the credit markets.

13 The estimated positive impact of lower oil prices (below $50 per barrel) on GDP growth ranged from 25 to 250 basis points, while the negative impact of higher oil prices (above $100 per barrel) ranged from no impact to 200 basis points, or 2 percent lower growth.

SIFMA Economic Advisory Roundtable Forecast

Inflation adjusted year-over-year percentage change unless otherwise specified. Forecast numbers appear in **bold**.

	2008	2009
GDP	**1.3**	**(1.0)**
GDP (4Q - 4Q)	**(0.3)**	**0.5**
CPI	**3.9**	**0.2**
CPI (4Q - 4Q)	**2.3**	**1.2**
Core CPI	**2.3**	**1.7**
Core CPI (4Q - 4Q)	**2.1**	**1.4**
PCE deflator	**3.4**	**0.5**
PCE deflator (4Q - 4Q)	**2.2**	**1.1**
Core PCE deflator	**2.2**	**1.7**
Core PCE deflator (4Q - 4Q)	**2.1**	**1.4**
Personal Consumption	**0.3**	**(1.0)**
Nonresidential Fixed Investment	**2.6**	**(7.2)**
Housing Starts (millions)	**0.9**	**0.8**
State & Local Government Spending	**1.2**	**1.1**
Current Account Deficit ($ billions)	**663.1**	**407.0**
New Home Sales (millions units)	**0.5**	**0.5**
Nonfarm Payroll Employment (change in millions)	**(1.4)**	**(1.5)**
Unemployment Rate (cal. yr. avg.)	**5.7**	**7.8**
S&P 500 Index Price (year-end)	**887.5**	**N/A**
Federal Budget (FY, $ billions)	**(1,084.0)**	**(802.5)**

Quarter-to-Quarter % Changes in Annual Rates

	2008				2009			
	I	II	III	IV	I	II	III	IV
Real GDP	0.9	2.8	(0.5)	**(4.2)**	**(2.2)**	**(.1)**	**1.5**	**2.0**
CPI	4.3	5.0	6.7	**(7.0)**	**(1.1)**	**1.3**	**1.8**	**2.0**
Core CPI	2.5	1.9	3.2	**0.9**	**1.6**	**1.7**	**1.7**	**1.6**
PCE deflator	3.6	4.3	5.2	**(4.4)**	**(0.7)**	**1.4**	**1.5**	**1.7**
Core PCE deflator	2.3	2.2	2.6	**1.2**	**1.5**	**1.5**	**1.5**	**1.3**
Personal Consumption	0.9	1.2	(3.7)	**(4.0)**	**1.5**	**.3**	**1.4**	**1.8**
Nonresidential Fixed Investment	2.4	2.5	(1.5)	**(9.2)**	**(10.0)**	**(7.4)**	**5.0**	**(1.0)**

Interest Rates (monthly average %)

	Dec. 08	Mar. 09	Jun. 09	Sept. 09	Dec. 09
Fed Funds	**0.50**	**0.38**	**0.38**	**0.50**	**0.50**
2 Year Treasury Note	**1.00**	**1.05**	**1.20**	**1.46**	**1.75**
10 Year Treasury Note	**2.85**	**3.10**	**3.28**	**3.50**	**3.78**
30 Year Fixed-Rate Home Mortgages	**5.83**	**5.70**	**5.50**	**5.65**	**5.70**

Exchange Rates (monthly average)

	Dec. 08	Mar. 09	Jun. 09	Sept. 09	Dec. 09
Yen/Dollar	**93.00**	**92.00**	**95.00**	**97.50**	**100.00**
Dollar/Euro	**1.27**	**1.25**	**1.25**	**1.25**	**1.25**

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