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Securities Industry and Financial Markets Association

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ECONOMIC OUTLOOK

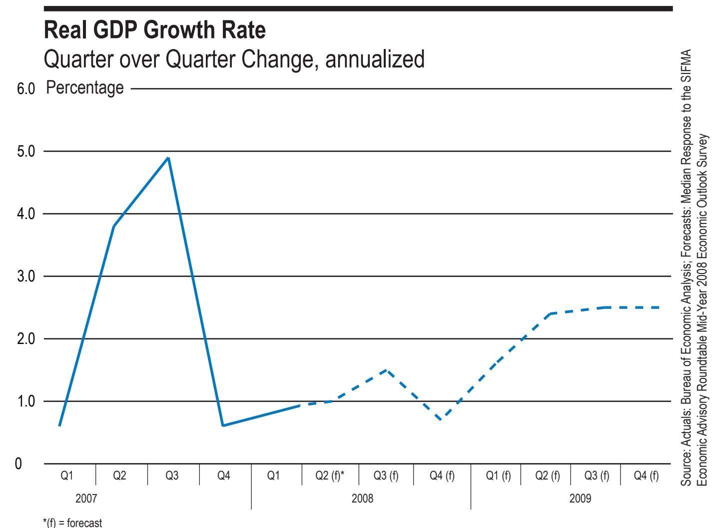
The Economic Outlook: Below-Trend Growth in 2008, Pace to Quicken in 2009; Fed on Hold

Members of the Securities Industry and Financial Markets Association's Economic Advisory Roundtable expect the pace of U.S. economic growth to be subdued for full-year 2008 but begin to pick up in 2009.[1] Housing sector weakness, tight financing conditions, rising commodity prices, aggressive central bank actions to support market liquidity, and the effect of fiscal stimulus provide the backdrop for the economic outlook.

The Roundtable was unanimous in its opinion that the Federal Open Market Committee (FOMC) will hold the target Fed funds rate unchanged at 2.00 percent at the upcoming June 25-26 meeting. Furthermore, the panelists do not expect the target rate to change until late this year or, more likely, next year. When the Federal Reserve does move, the strong, though not unanimous, view is that the next move will be an increase of 25 basis points. The panelists generally expect the June 25-26 meeting's accompanying statement to continue the emphasis on economic growth risk but with an indication that the risk is diminishing. The statement is also expected to increase its focus on the risk of inflation and inflationary expectations.

Forecast Highlights

THE ECONOMY The median forecast is for gross domestic product (GDP) growth of 1.6 percent for full-year 2008 and 1.9 percent in 2009.[2] Growth is expected to remain anemic at 1.0 percent[3] in the second quarter, pick up in the third quarter supported by the stimulus package rebate checks and then fall back in the fourth quarter as the effect of the rebates subsides. The survey panelists expect approximately 40 percent of the rebate to be spent, with the balance either saved or used to pay down debt. Furthermore, about 80 percent of the Economic Advisory Roundtable members anticipate that the rebate checks will add more than 0.5 percent to GDP growth in the second half of this year. The median forecast for full-year 2009 reflects GDP growth picking up later in 2009, reaching 2.5 percent in the second half.

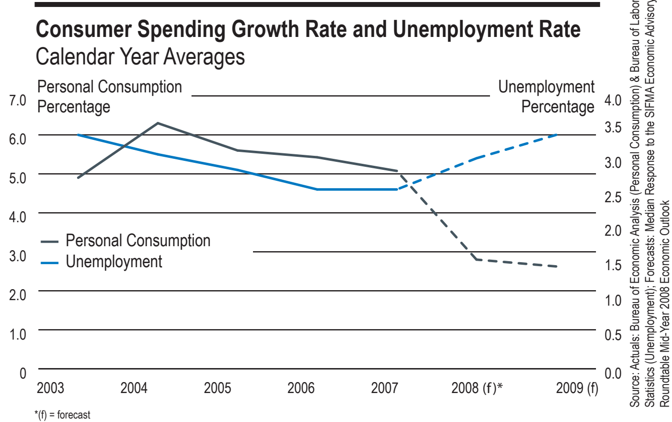


The median consumer spending forecast calls for an increase of 1.6 percent for full-year 2008 and 1.5 percent in 2009, with employment and income growth cited as the dominant drivers. The median forecast envisions nonfarm payrolls shrinking in full-year 2008 but growing modestly in 2009, as corporate profit and economic growth headwinds ease next year. The reduced purchasing power resulting from higher energy and food prices also serves as a drag on consumer spending. The panelists consider the housing wealth effect to be another constraint on consumer spending, but less of a significant factor than previously, as the housing correction begins to wind down.

1 The survey was conducted the week of June 9 - June 16, 2008. The forecasts discussed in the text and appearing in the accompanying data table are medians of the 18 individual members' submissions.

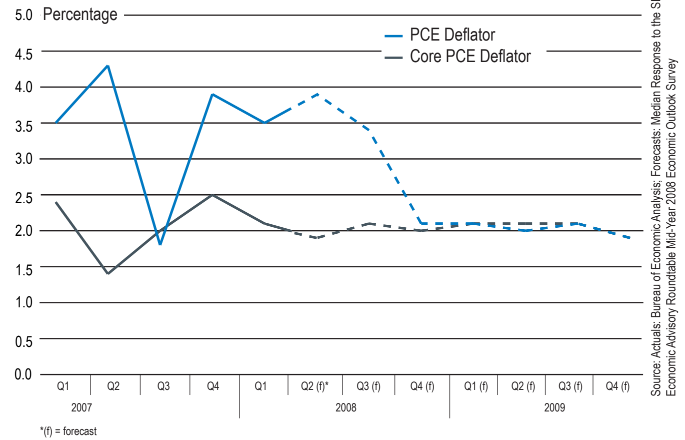
2 The full-year 2008 GDP growth forecasts ranged from 1.0 percent to 2.1 percent.

3 The second quarter 2008 GDP growth forecasts ranged from -1.0 percent to 2.2 percent.



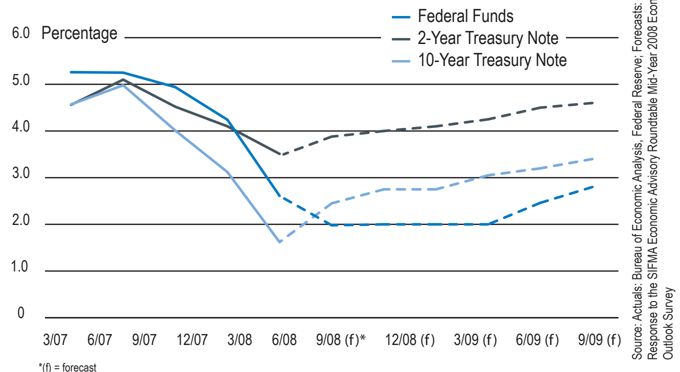
Business capital investment growth is expected to be slower in full-year 2008 and 2009 than in 2007.[4] The panelists cited diminished U.S. demand as the most important factor in their investment spending outlook, and opined that investment spending is unlikely to gain momentum until consumer spending recovers. Tighter borrowing conditions and reduced cash flow and profit growth will also restrain business capital spending. That effect may be contained as corporations have been able to strengthen their financial positions during the recent and protracted period of strong profit growth. In addition, productivity gains have been maintained which will serve to boost investment spending as demand picks up. It should also be noted that the Economic Stimulus Act of 2007 provided for approximately $50 billion in accelerated depreciation benefits which serves as an incentive for business capital investment.

The panelists expect inflation pressures to remain prominent in 2008, but ease in 2009. The median forecast is for "headline" inflation, as measured by the widely followed personal consumption expenditures (PCE) deflator, to reach 3.3 percent for full-year 2008 and decline to 2.2 percent in 2009.[5] The median forecast for the core PCE deflator is 2.1 percent for full-year 2008 and 2.0 percent for 2009, close to the Federal Reserve's forecast.[6] The Roundtable's forecast suggests that higher commodity prices are not having a significant effect on core inflation readings. The panelists identified energy, labor costs, and inflation and inflationary expectations as significant considerations in their inflation outlooks. Relatively low inflation expectations, confidence in Fed policy and the competitive landscape in global labor markets have helped anchor wage and price setting patterns, and global competition has kept inflationary pressures in check thus far. The cumulative effect of monetary policy easing to respond to current credit market conditions may, however, be a source of inflationary pressures over the longer term, but those policies are expected to be withdrawn as the economy recovers.



INTEREST RATES As noted, the Roundtable's unanimous view is that the Federal Reserve will maintain the current 2.00 percent target Fed funds rate at the upcoming June 25-26 meeting and the median forecast projects the Fed funds rate to begin rising in the latter half of next year.[7]

As of June 16, the end of the survey period, the 10-year U.S. Treasury yield was 4.27 percent, up 43 basis points over the preceding month. The median forecast for the year-end 2008 10-year Treasury note yield was 4.10 percent, with inflation and inflationary expectations, investor risk appetite and Fed policy cited as the three most important drivers.[8]



4 The full-year 2008 business fixed investment forecasts ranged from -1.8 percent to 5.6 percent for 2008.

5 The full-year 2008 PCE deflator forecasts ranged from 2.8 percent to 3.8 percent.

6 The full-year 2008 core PCE deflator forecasts ranged from 1.8 percent to 2.3 percent.

7 Although the respondents expect the target Fed funds rate to be unchanged at the June 25-26 meeting, there was diversity of opinion about the Fed funds rate a year from now. The second quarter 2009 Fed funds rate forecast ranged from 1.0 percent to 3.5 percent.

8 The forecasts for the 10-year Treasury yield at the end of the third quarter 2008 ranged from 3.5 percent to 4.6 percent and for year-end 2008, 3.3 percent to 4.9 percent. The 30-year fixed-rate mortgage forecasts ranged from 4.6 percent to 6.6 percent at both the third-quarter-end and year-end 2008.

Slightly over half of the survey respondents expect the LIBOR-to-Treasury spreads to tighten from current levels, a third expect spreads to remain at current elevated levels, and the balance expect further widening. Those expecting tighter spreads anticipate the market beginning to "calm down," while those who foresee further widening point to the need for banks to replenish capital to reduce risks implicit in the heightened spreads.

Elevated Energy Prices Dominant Risk to Economic Growth; Housing Weakness Present But Subsiding as Source of Risk

The panelists identified energy prices as a leading source of downside risk to the forecast, noting that the economic impact of higher energy price risk is now building. While the prolonged decline in the housing sector and an extended credit correction continue, the risks are considered less prominent risks than at the beginning of the year. The general view was that the housing situation is approaching a "bottom" and thus housing-related risk is seen as beginning to subside or becoming less of an economic growth forecast risk.

Commodity Price Surge Demand Driven

The Roundtable's consensus view was that rising global demand was the dominant driver of surging commodity prices. Panelists commented that the supply response to higher prices is limited in the short term, or, in economic terminology, supply is price inelastic over the short term. Panelists commented that the value of the dollar is a factor but its influence is often exaggerated. A soft dollar may prevent some demand adjustments in non-dollar countries, and it may dampen supply responses. However, panelists noted that the assumption of a direct mathematical link between the dollar and commodity prices is inaccurate.

Panelists placed an approximately 50 percent probability on oil prices remaining in the current range, with a roughly equal probability that oil prices will fall to the $75 to $100 range or rise to the $175 to $200 range by year-end. The higher energy price scenario could have the effect of reducing GDP growth by an estimated 100 to 125 basis points, while the lower energy price scenario envisions an increase of 75 to 85 basis points.

In addition to energy, higher food prices have been a prominent economic factor. The respondents commented that higher food prices are due to a combination of three influences: ethanol mandates, which have pushed corn prices higher; elevated energy prices; and rising global demand. Of those three factors, rising global demand was seen as the most significant.

Housing Recovery Slated for 2009

The housing-related drag on the economy is expected to persist through most of 2008 and into 2009. Housing prices have been the transmission mechanism to work off excess housing inventory, ultimately bringing supply and demand into closer balance. Most respondents expect housing prices to "hit bottom" and begin to recover nationally some time in 2009, with the majority expect housing sales to begin rising in the second half of 2008 and the balance expecting recovery in 2009. As housing sales gain traction and housing inventories recede, the demand for new construction would be expected to increase. There was a roughly even split between those who expect housing construction to begin to turn around in 2008 and those that expect a 2009 turnaround.

A critical variable in the housing outlook is the pace of foreclosures. The rising rate of foreclosures adds to the housing supply on the market and places downward pressure on prices. The majority of the panelists expect proposed legislative and policy responses to the current situation such as expansion of Federal Housing Administration (FHA) programs to mitigate the severity of this by reducing the foreclosure rate, although some indicated such programs will have little effect due to lender reluctance to book credit losses or because the size of the programs is insufficient to address the scope of the problem.

Expiration of All Bush Tax Cuts Would Slow Economy

The panelists believe the expiration of all of the Bush administration tax reductions, including the reduced capital gains and dividends tax rate, would have a substantial and immediate effect on economic growth unless they are replaced with alternative measures to boost growth. More than half of the respondents expect that, as a direct result of the expiration of the tax reductions, GDP growth would be cut by at least half a percentage point in the first year alone. These projections assume that there would be no other offsetting tax reductions. Furthermore, the respondents commented that the longer term effect would be even a more negative economic factor.

Divergent Opinions on Corporate Bond Credit Spreads: More Expect Tightening

Although there were diverse views, more survey respondents expected investment-grade spreads to tighten than expected spreads to widen over the next six months. A spread tightening scenario is consistent with an expectation that the financial sector, a significant portion of the investment grade universe, will make progress in its capital raising programs. Higher Treasury yields and a resumption of more normal investor risk appetites were also cited as reasons for the expectation of narrower investment grade spreads. The

panelists expecting spread widening based their views on anticipated slower economic and corporate profit growth.

Similarly, more respondents expected high-yield corporate bond spreads to tighten than widen during the second half of 2008. Those anticipating narrower high-yield spreads believe that reasonable expectations of rising default rates are now fully priced in. A widening high yield spread view is based on concerns over the effects of slower economic growth, tighter profit margins for the more speculative bond issuers and reduced credit availability and investor demand for more credit risk sensitive investments.

Central Bank Actions Have Eased Credit Market Stress; Economic Slowdown Most Significant Risk to the Markets

Respondents were nearly unanimous in their opinion that there has been a "somewhat improved tone" in the markets. Reduced systemic risk in response to the Federal Reserve's aggressive provision of liquidity through the developments of new and expanded facilities over the first half of the year was the most frequently cited reason for this improvement. In addition, the respondents identified capital raising by leveraged institutions as an important reason for the improved market tone.

The panelists indicated the most significant risk facing the credit markets is a further slowdown in the economy and recessionary risk. Other prominently mentioned risk factors were wider than anticipated credit losses and an accelerated pace of deleveraging. While liquidity was cited as a concern, panelists indicated the liquidity risk was now diminished compared to earlier in the year.

Securities Industry and Financial Markets Association Economic Advisory Roundtable Forecast

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

	2007	2008	2009
Real GDP (yr - to - yr)	2.2	**1.6**	**1.9**
Real GDP (4Q - 4Q)	2.4	**1.1**	**2.2**
CPI (yr - to - yr)	3.1	**4.1**	**2.6**
CPI (4Q - 4Q)	4.0	**4.0**	**2.3**
Core CPI (yr - to - yr)	2.3	**2.3**	**2.2**
Core CPI (4Q - 4Q)	2.3	**2.2**	**2.3**
PCE deflator (yr - to - yr)	2.5	**3.3**	**2.2**
PCE deflator (4Q - 4Q)	3.4	**3.3**	**2.2**
Core PCE deflator (yr - to - yr)	2.1	**2.1**	**2.0**
Core PCE deflator (4Q - 4Q)	2.1	**2.0**	**2.1**
Personal Consumption	2.9	**1.6**	**1.5**
Nonresidential Fixed Investment	4.7	**2.8**	**1.0**
Housing Starts (millions)	1.0	**1.0**	**1.0**
Real State & Local Gov't. Spending	2.0	**1.7**	**1.5**
Current Account Deficit ($ billions)	738	**650**	**600**
New Home Sales (millions units)	0.8	**0.6**	**0.7**
Existing Home Sales (millions units)	5.6	**5.0**	**5.2**
Nonfarm Payroll Employment (millions)	1.10	**(0.43)**	**0.55**
Unemployment Rate (cal. yr. avg.)	4.6	**5.4**	**6.0**
S&P 500 Index Price (year-end)	1,468	**1,470**	**N/A**
Federal Budget (FY, $ billions)	(162)	**(400)**	**(398)**

Quarter-to-Quarter % Changes in Annual Rates

	2008				2009			
	I	II	III	IV	I	II	III	IV
Real GDP	0.9	**1.0**	**1.5**	**0.7**	**1.6**	**2.4**	**2.5**	**2.5**
CPI	4.3	**4.5**	**4.6**	**2.5**	**2.3**	**2.2**	**2.3**	**2.2**
Core CPI	2.5	**1.8**	**2.3**	**2.1**	**2.3**	**2.3**	**2.3**	**2.2**
PCE deflator	3.5	**3.9**	**3.4**	**2.1**	**2.1**	**2.0**	**2.1**	**1.9**
Core PCE deflator	2.1	**1.9**	**2.1**	**2.0**	**2.1**	**2.1**	**2.1**	**1.9**
Personal Consumption	1.0	**1.5**	**1.9**	**0.2**	**1.1**	**1.8**	**2.1**	**2.2**
Nonresidential Fixed Investment	(0.2)	**(0.1)**	**(2.2)**	**(0.3)**	**0.7**	**1.3**	**1.8**	**2.7**

Interest Rates (monthly average %)

	Sept. 08	Dec. 08	Mar. 09	Jun. 09	Sept. 09
Fed Funds	**2.00**	**2.00**	**2.00**	**2.46**	**2.80**
2 Year Treasury Note	**2.75**	**2.75**	**3.05**	**3.20**	**3.40**
10 Year Treasury Note	**4.00**	**4.10**	**4.25**	**4.50**	**4.60**
30 Year Fixed-Rate Home Mortgages	**6.20**	**6.25**	**6.28**	**6.43**	**6.46**

Exchange Rates (monthly average)

	Sept. 08	Dec. 08	Mar. 09	Jun. 09	Sept. 09
Yen/Dollar	**105**	**107**	**107**	**106**	**106**
Dollar/Euro	**1.55**	**1.51**	**1.49**	**1.47**	**1.46**

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