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After the Great Recession: *the Great Recovery?*

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The recession seems to be over

➢ Global recovery in China, Europe, and even Japan in Q2 2009

Meanwhile, in the U.S.:

• Turned the corner – growth almost certainly resuming as we speak (Q3 2009)

• Worst downturn since WWII – even a partial rebound could deliver startling % growth rates

• 4% drop in GDP vs. 3% trend growth implies we are at least 7% below potential

It’s still too soon to declare victory – even if the recession’s over, the recovery could have plenty of false starts…

Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.

- Winston Churchill, *Speech in November 1942*

Now the focus is on next year's rebound

Forecasts of 2010 GDP growth rates

% growth year-to-year		**Jan-09**	**Apr-09**	**Oct-09**
Blue Chip*:	**U.S.**	2.4	1.8	2.5
Global Insight:**	**U.S.**	2.2	1.4	2.1
	Canada	2.5	1.9	2.1
	World	2.6	1.8	2.5
IMF:	**World**	3.0	1.9	3.1

- Predictions picked up after a dismal spring, but the consensus outlook is still bleak – no V-shaped recovery
- Most historical data says the harder you go down, the faster you bounce back up

* Consensus of about 30 leading forecasters

** Prominent independent economic consultant

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We forecast a slightly more vigorous rebound

(% Change at annual rate)	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2008	2009	2010	2011
			Forecast									
Real US GDP and Components												
Gross domestic product	**-6.4**	**-1.0**	**3.0**	**2.5**	**3.2**	**3.5**	**4.2**	**4.5**	**0.4**	**-2.6**	**3.0**	**4.2**
Personal consumption expenditures	0.6	-1.0	1.8	1.1	2.6	3.0	3.7	3.5	-0.2	-0.8	2.3	3.7
Business Fixed Investment	-39.2	-10.9	-2.6	-3.0	0.7	3.6	7.0	10.3	1.6	-18.0	0.7	11.5
Residential Investment	-38.2	-22.8	0.0	11.0	15.8	11.5	18.1	21.5	-22.9	-21.8	9.8	19.7
Government purchases	-2.6	6.4	1.7	2.1	1.9	2.2	2.1	2.4	3.1	1.9	2.3	1.9
Change in inventories	-114	-159	-81	-30	-8	6	15	23	-25.9	-96.1	9.1	51.9
Exports	-29.9	-5.0	5.4	3.4	5.6	7.6	8.7	10.2	5.4	-12.0	5.5	9.5
Imports	-36.4	-15.0	10.0	4.9	5.6	7.3	8.1	9.3	-3.2	-15.6	5.4	9.1
Real disposable income	0.2	3.8	-1.4	1.1	1.8	2.4	2.2	2.5	0.5	0.8	1.6	5.1
Personal saving rate (%)	3.7	5.0	4.4	4.4	4.4	4.5	4.5	4.5	2.7	4.4	4.5	3.8
Corporate profits w IVA & CCAdj	22.8	24.9	3.9	13.4	15.9	11.3	-8.0	8.3	-11.8	-8.1	9.8	7.2
Unemployment rate %	8.1	9.3	9.6	9.9	10.0	9.7	9.5	9.0	5.8	9.2	9.5	8.3
Housing starts (thous. units)	**528**	**539**	**548**	**698**	**644**	**744**	**855**	**954**	**901**	**578**	**799**	**1419**
GDP price index	1.9	0.0	1.1	0.2	1.0	0.7	0.7	0.6	2.1	1.3	0.7	1.3
Consumer Price Index: CPI-U	-2.4	1.3	3.4	1.4	1.1	1.2	1.0	1.0	3.8	-0.5	1.5	1.5
CPI-U excl food & energy	**1.5**	**2.4**	**1.4**	**0.9**	**1.0**	**1.0**	**0.9**	**0.8**	**2.3**	**1.6**	**1.1**	**1.3**
Foreign Exchange Rate	111.1	107.1	103.6	102.8	101.7	101.4	101.1	100.9	99.8	106.2	101.3	102.4
(Broad trade-weighted value of US$)												
Refiners' cost of imported oil ($/b)	40.5	58.4	65.9	66.1	67.4	68.9	70.3	71.9	92.3	57.7	69.6	72.0
Federal Funds Rate	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.9	1.9	0.2	0.4	2.7
Ninety-day Treasury Bill Rate	0.2	0.2	0.2	0.2	0.3	0.6	0.9	1.2	1.4	0.2	0.7	2.7
3-month LIBOR	1.6	1.1	0.5	0.4	0.6	0.8	1.1	1.5	3.3	0.9	1.0	3.0
10-year Treasury Note Yield	2.9	3.5	3.4	3.9	4.1	4.3	4.5	4.7	3.7	3.4	4.4	4.9
Credit Spreads (avg. basis points over Treasuries)												
10yr AAA	202	159	91	84	83	81	80	78	252	134	80	74
10yr A	329	264	157	148	145	143	140	137	305	225	141	130
10yr BAA	538	426	265	245	241	236	231	227	368	369	234	215

Forecast prepared in September, 2009

The U.S. – in the eye of the storm

It's been a global financial crisis and a global recession, but the U.S. is still key to the outlook:

- 25% of world GDP
- Biggest, deepest markets for both financial and real assets
- Hyperactive policy-makers

"You can always count on the Americans to do the right thing, after they've tried everything else" *(Winston Churchill again)*

Global policy response was unprecedented

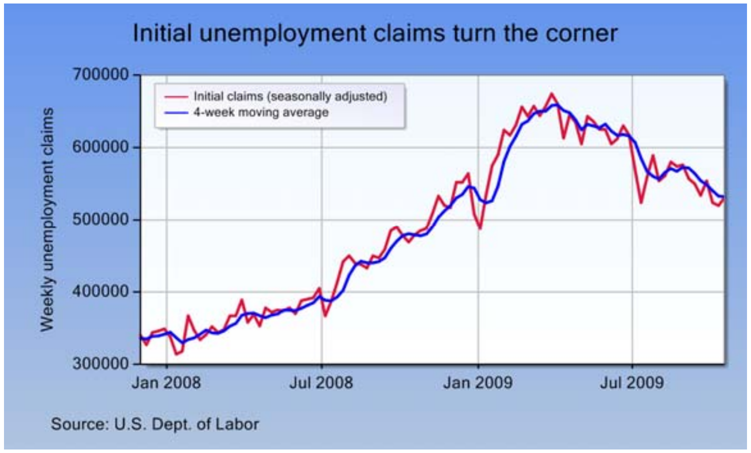
Monetary policy:

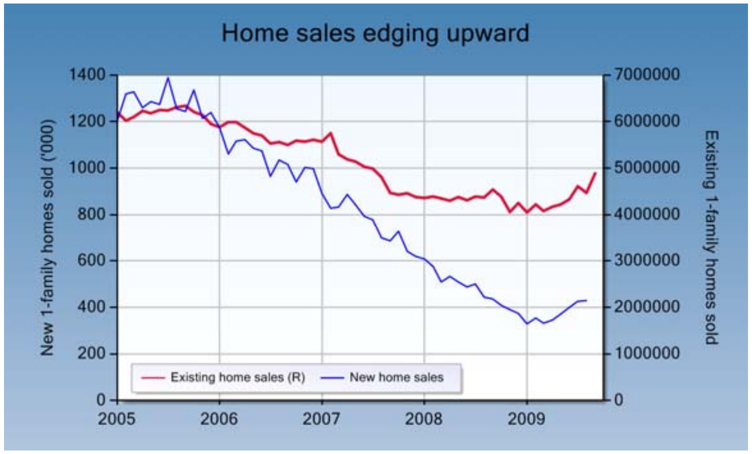
- All major Central banks drove short-term rates close to zero, and then pumped money by the trillion directly into the financial system
- They can't make anyone spend it or lend it, but they did avert a 1930s-style contraction

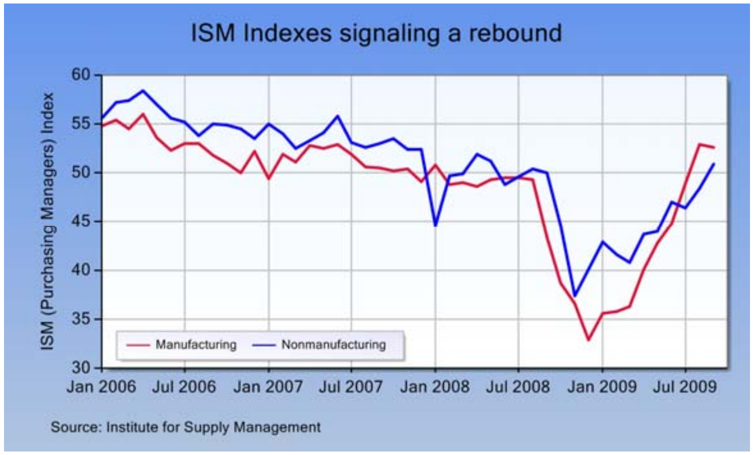
Fiscal policy:

- All G-20 countries (and most others) boosted their economies through tax cuts and spending adding up to almost 2% of world GDP
- Stimulus mitigated the severity of the recession, but it was hard to do it quickly, and it may prove even harder to undo it when the need is past

The worst is behind us…







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Key issues: 1) Housing

Bottoming out, but what about growth next year?

- Sales rising off the bottom
- Home-builder sentiment improving
- Even prices showing signs of life

But…

- The tide of Alt-A mortgage defaults isn’t over
- Everything still depends on job growth

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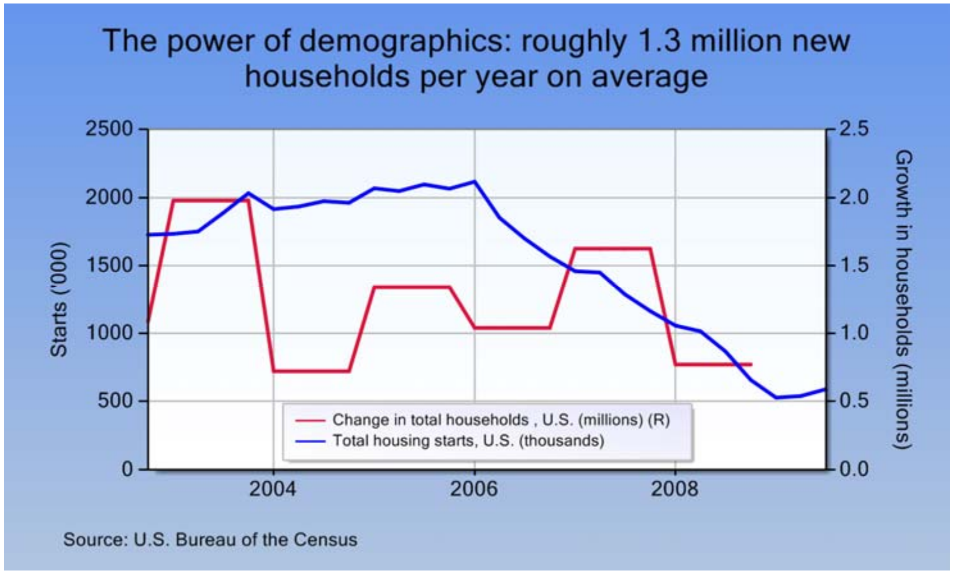
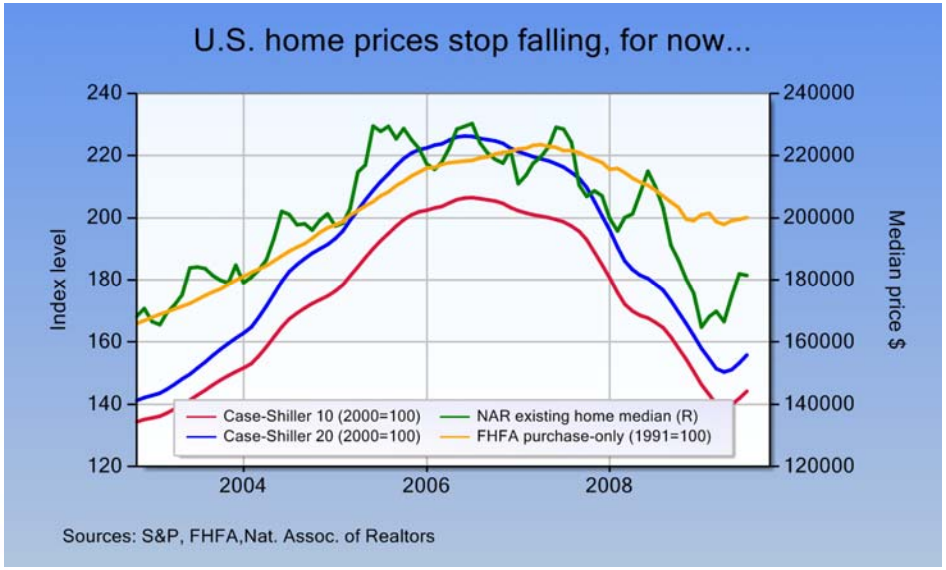
Housing sector should contribute to growth

Normal household formation will fill up the vacant housing stock quite soon.

A recovery tends to release additional pent-up demand for separate living-space.





Home prices have turned up recently, especially in the most depressed markets.

Even if this is only temporary, it's still a huge improvement over the past two years.

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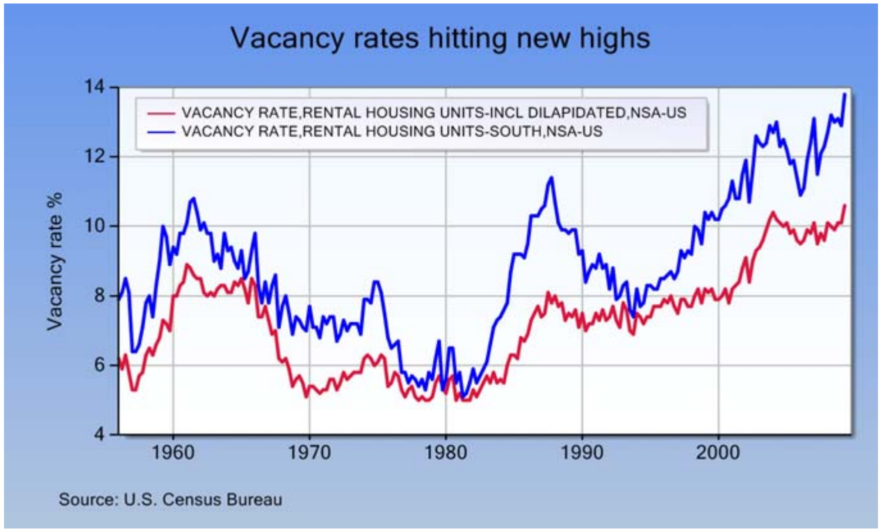
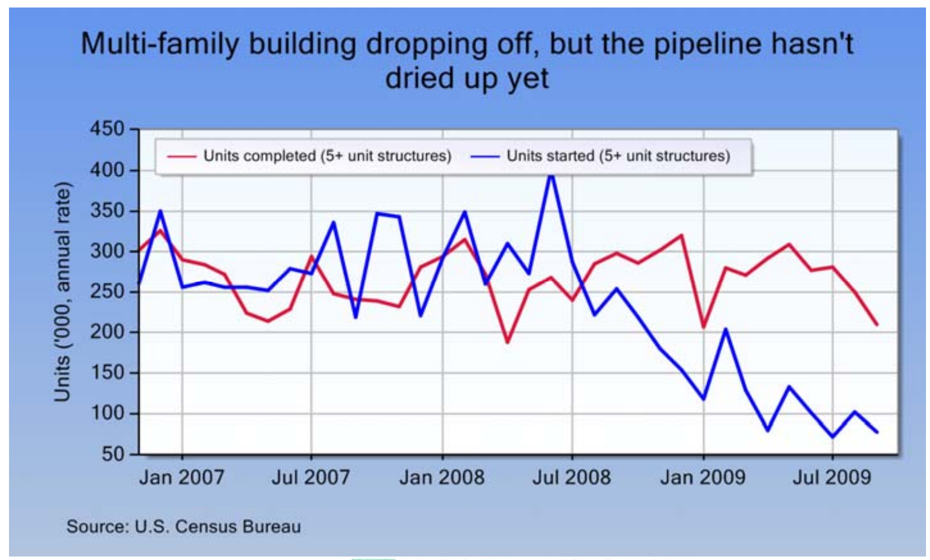
Recovery in multi-family a bit further off



Record residential vacancies, especially in the regions where most of the new building took place during the boom (includes single-family for rent)

Completions still feeding available supply, though now probably just about to fall quite sharply



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Key issues: 2) Consumer spending

…depends on employment, incomes and human behavior

- Consumers are poorer than a few years ago. It's unclear how fast they will try to rebuild their wealth:
  - <u>Fast</u> means depressed consumption for at least a couple of years
  - <u>Slowly</u> means a more normal rebound, probably quite vigorous given how much we cut back in the recession

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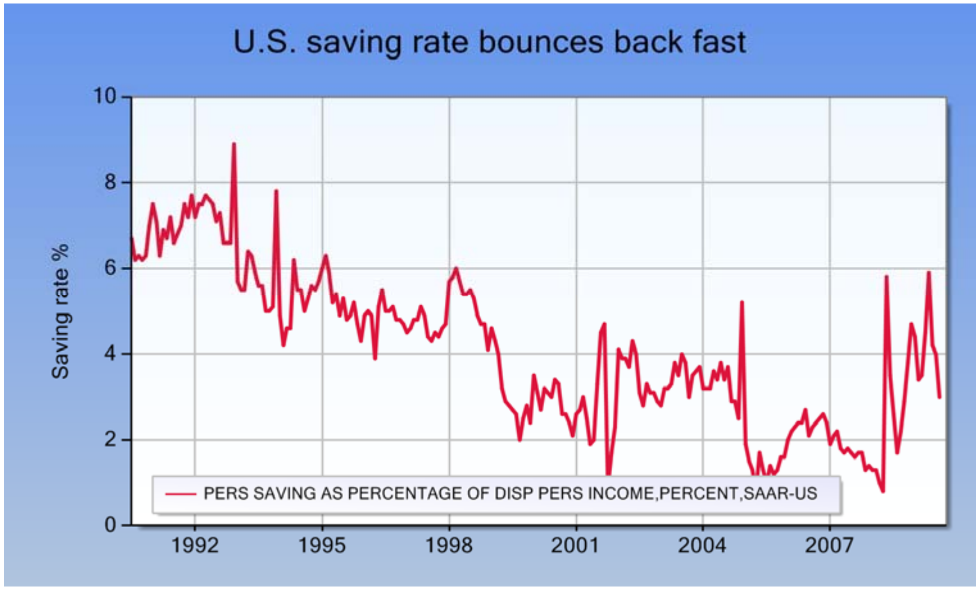
Consumer saving unlikely to inhibit growth



- U.S. consumers are saving more
- The big question now is whether the saving rate will continue to head on upward, slowing overall spending growth
- We think probably not…

Forces pushing up saving:

1. Lost wealth (homes and equities) – likely to get better going forward
2. Job insecurity – should abate as the economy recovers
3. Lack of credit for major purchases – probably easier to get as credit markets revive
4. Desire to reduce debt after traumatic cycle – voluntary "deleveraging"

The first three should lessen as time passes; the last is a wild card

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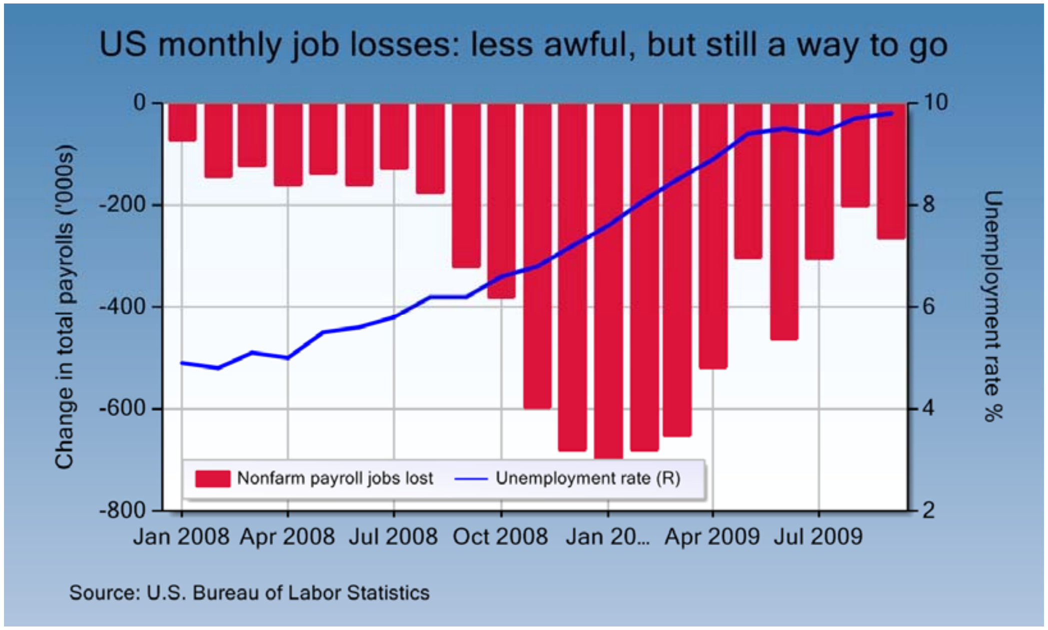
Key issues: 3) Jobs

Went down fast, should come back fast…

- ➢ Businesses fired people unusually rapidly in this cycle, even faster than sales fell
- ➢ This may mean they have to start hiring again as soon as demand picks up
- ➢ In most cycles employment turns up soon after the recession ends – except for the 2 most recent recoveries

Bleak job market is still the biggest risk



Few silver linings so far:

- Leading indicators (weekly hours, temp hiring) still look weak
- Revisions aren't consistently positive
- Unemployment will drift higher until job gains >100k

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Key issues: 4) The jump-start

1. Inventories – a big deal, but one time only
2. Fiscal stimulus – huge, but can't last for ever (though stimulus part 2 is possible if the pessimists are right…)

Can these two forces jump-start growth?

- *A market economy normally grows, and growth feeds on itself unless some channel of spending or lending is blocked*

Our best bet is close to best case outcome

- Nothing loses elections like unemployment – governments have tried everything as their prospects worsened
- "Everything" will stop the slide: decent growth in the U.S. helps to sustain a shaky expansion in Europe and Japan
- Effects on consumer and government behavior may linger: less consumption, more government spending, but overall still likely to outperform consensus expectations
- Lenders will get back to business when growth makes borrowers creditworthy again, despite some dislocations

Worst case

- Fiscal stimulus fizzles out in 2009, failing to revive confidence and merely accelerating a rise in saving; auto and home sales fade as incentives end
- Banks remain fragile and credit markets anemic
- Housing slump continues
- Revival has to wait until:

  (a) the bulk of fiscal stimulus arrives in 2010

  (b) unemployment over 10% and an imminent election concentrate minds in Washington (and around the world) to get serious about an even bigger economic boost

Even then, depressing doesn't mean Depression

A downbeat alternative

- The IMF's projections suggest that the U.S. could stumble along with anemic growth in 2010
- They emphasize the magnitude and impact of financial-sector losses (cumulating to >$4 trillion)
- Slow growth implies rising U.S. unemployment through 2010: three years of job losses, with ripple effects on export-dependent countries
- They anticipate several more sub-par years as credit constrains growth and consumers rebuild wealth

No great worries about inflation

- The trillions being added to the world's money supply will cause inflation only when they are spent
- Even then, money won't create inflation when unemployment is high – no wage-price spiral is likely when workers are still desperate
- Central Banks may welcome a little extra inflation just to be sure a recovery is for real, but then they will turn on a dime and tighten hard
- Oil is always a wild card – headline inflation could be ugly when global demand drives oil prices back up
- Budget deficits don't cause inflation, but they may raise the odds of a policy mistake

Implications for equities

- Equities "normally" bottom several months before the end of a recession
- We think this recession ended in June/July 2009, implying that the low is well behind us

But…

- There's not much normal about this cycle

On the positive side:

- We see a good chance that U.S. economic growth will beat consensus expectations (inventories, auto sales, housing, exports)
- Profit margins should recover to recent highs as global competition holds down wages

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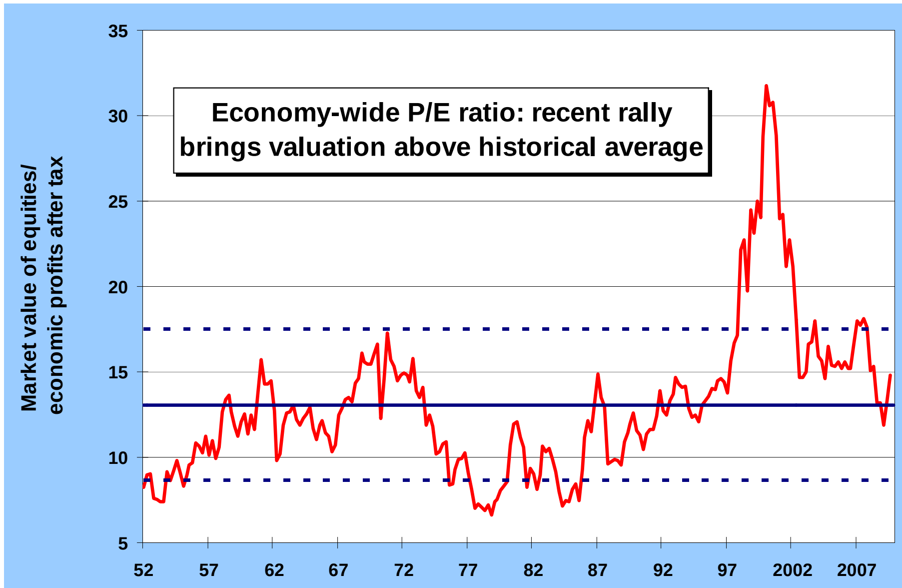
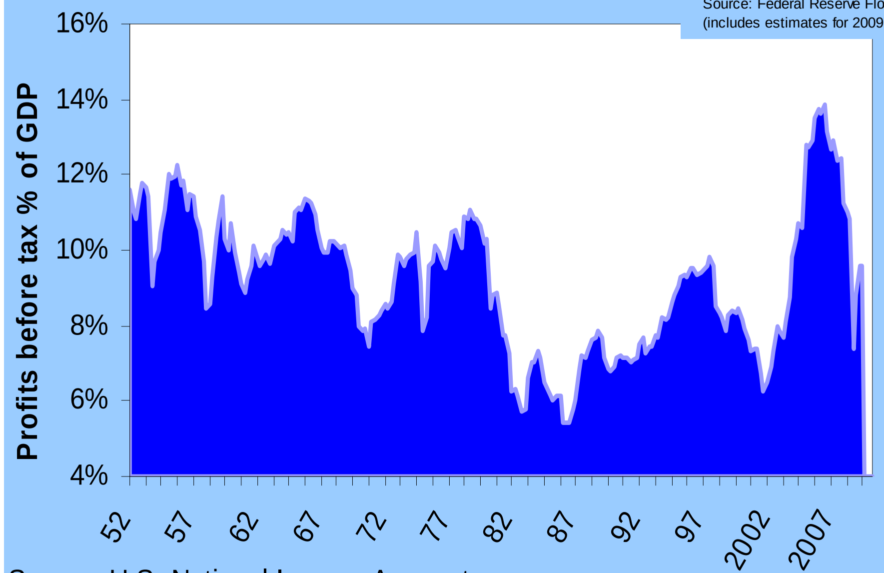
Equities no longer obviously cheap

Stock prices a little above average relative to current-quarter economic profits…



Source: Federal Reserve Flow of Funds, National Income Accounts (includes estimates for 2009 Q3)



Source: U.S. National Income Accounts

… if profits rebound to their recent record share of GDP there could be room for big gains

But if the profit share reverts to its mean, the outlook is much bleaker

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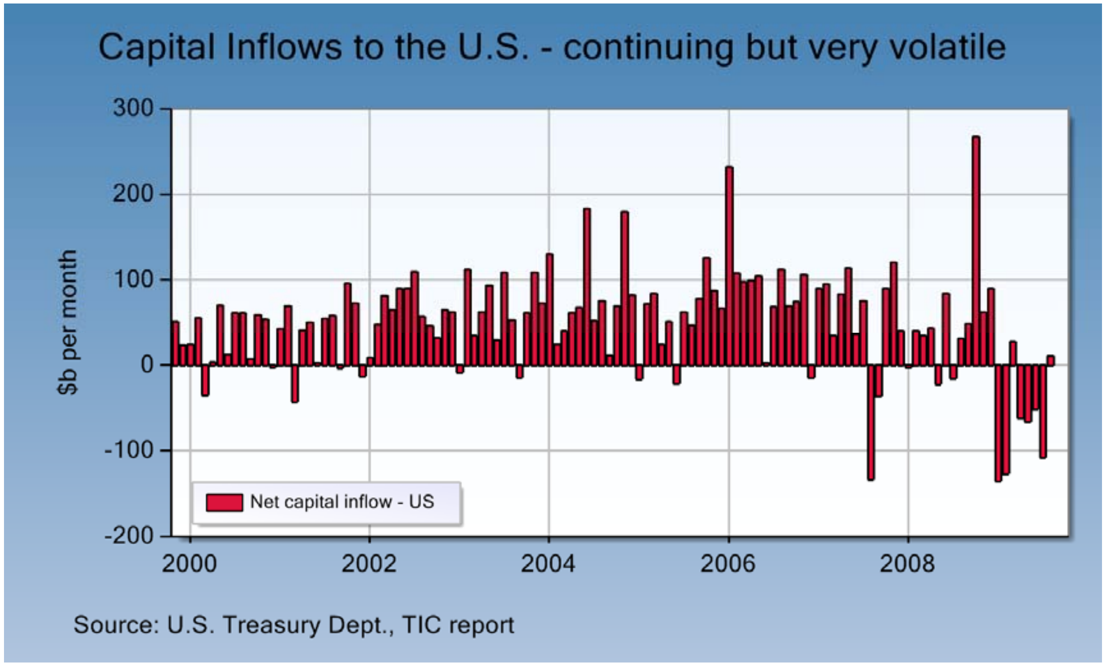
China: helping to drive a global recovery

- Huge fiscal stimulus – comparable to U.S. in relation to size of domestic economy
- Most important: authorities took their foot off the financial brakes, and lending surged. Despite recent statements they are unlikely to tighten meaningfully any time soon
- Already growing strongly (subject to caveats about statistics), and still accelerating
- Fiscal situation and trade surplus leave room for almost unlimited support to aggregate demand
- Key issue is transition to more consumer spending

Global capital flows: a risk for the future, but not the present



The financial crisis brought a flood of short-term money into the U.S., not all recorded in the official data but evident in the appreciation of the USD.

- Waning fears of global depression reversed some flows and unleashed rhetoric about the need for an alternative reserve currency, but for now the complainers are also buyers.

- A real reversal of sentiment would be a big event, leading to sharply higher U.S. interest rates and a weaker USD – but precisely for that reason it seems very improbable.

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“Nobody knows anything”*

Any forecast requires heroic assumptions about factors that are simply not predictable:

- U.S. saving rates have jumped – they might go on up, or they might not
- When jobs and income growth make people more creditworthy, lenders may ease standards, or they may not
- Other negatives (commercial real estate, state & local govt budgets) could weigh more or less heavily

Don’t believe anyone who claims to know – they could turn out to be right, but it isn’t knowledge

* William Goldman: Adventures in the Screen Trade

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