



Quarterly Economic Report – 4th Quarter 2009

What a Difference a Year Makes – But Headwinds Remain

The year, 2009, which started with bad news feeding on bad news, managed to reverse itself and struggled into recovery mode by December. The negative feedback loop of job losses, leading to weaker consumer spending leading to more job losses, appears to have ended. To slow the debilitating loop, governments globally resolved in 2009 to use any means to restore liquidity and halt the flight to safety (and away from risk). That marked the first step to recovery. With equities rallying and economic data supportive, the year-end enthusiasm was perhaps overdone. But, a modestly bullish projection built on slow, restrained growth over the next two years could be sustainable. If consumers spend, if businesses hire and invest, and if banks lend, the economy will grow. There are however still significant headwinds which remain especially in employment, credit strains, and real estate which will pummel meaningful progress. Financial markets, which have been equally maligned and relied upon to get the economy moving, will undoubtedly retain our focus from a lending and a regulatory perspective.

Jobs: The rate of job destruction slowed significantly in 4Q, but roughly eight million jobs have been lost since the recession began. If payrolls rise by 200,000 a month, it will require 3.5 years to regenerate that number of jobs. Meanwhile, growth in the working age population has generated a need for another 8 million jobs. Clearly this amounts to a major headwind. Growth in the realm of 5-6% GDP for a few years could makeup this deficit but that will only materialize if inflation does not threaten. Meanwhile, available governmental support mechanisms have been severely weakened. The Department of Labor estimates with the jobless drain, 40 states unemployment funds will be broke within 2 years. Currently, 24 states are depleted and have borrowed \$24 billion from the federal government. This borrowing carries its own costs into 2010 and beyond.

Nonetheless, jobless claims have slowed steadily and in December 2009 rose to pre-recession levels. The 4-week claims average has declined, but mostly due to exhaustion of benefits. Corporations have yet to meaningfully start the hiring process, although corporate layoff forecasts are the lowest since 1999. Business is still in the enviable, but usually short-lived, cycle when profits outpace capital needs and the need for new hires. One of the only areas showing job increases in 4Q was utilities due to the harsh weather. The census in 1Q will add temporary workers also. Neither of these opportunities will appreciably increase the momentum for the consumer to return.

Consumers: The consumer remains negative and cautious. Job losses have restrained normal US consumer gluttony. The consumer fared poorly in 2009 as private sector wages income fell 4.9% y-o-y in the first 11 months, although disposable income grew 1.3% thanks in large part to lower tax payments and unemployment income. A sustainable economic recovery will eventually require job gains, not transfer payments from government.

Housing Credit: On top of job concerns for the consumer, banks tightened credit considerably. Small business also got caught in the credit crunch and, since it accounted for a third of job growth in the last two expansions, credit has to be recognized as a critical factor. Credit is improving but remains limited. Even national realtors report a historically high level of “cash” deals as a result.

Bank lending should be relaxed over time which in turn will reinforce a rebound. Federal support of banks (except for bonuses to the bankers!) should remain supportive. Looser credit will bolster consumer spending and small business and the positive cycle will advance. The consumer has had significant assistance from the federal government on housing, but this can not extend indefinitely and has had its own negative effect on monetary policy and the overall market, the impact of which is yet to emerge.

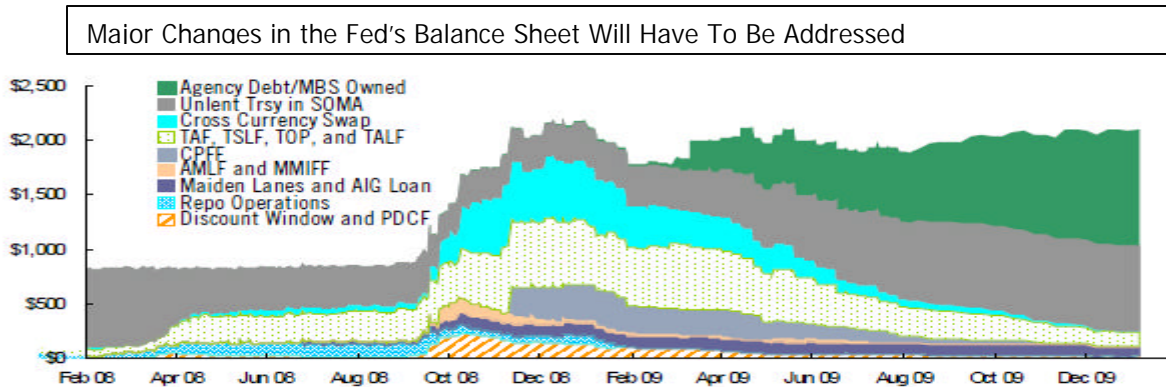
Effectively, the mortgage market has been nationalized. Nearly 9 of 10 mortgages being written are financed by FNMA or FHLMC which are now wards of the state. The Fed is buying \$1.25 trillion in mortgage backed securities

– the equivalent of 6.25 million mortgages! These purchases were made to support economic activity by keeping long-term interest rates low, according to the chief of the NY Fed trading desk. This has had the effect of keeping mortgage rates low and slowing the fall of house prices. Now however, the Fed is scheduled to stop buying mortgage backed securities in March 2010. This could raise long term rates and mortgage rates quickly. To counter this possibility the Treasury has raised the ceiling for Fannie and Freddie to buy mortgages with the public's credit card. Weaning from governmental support has to be done and will be delicate. It could result in another wave of foreclosures.

The growth seen in the last quarter of 2009 has been real and the economy is stirring but some portion of the growth has come from expensive governmental support. Weaning ourselves from the various support mechanisms both monetary and fiscal at the right time and the right way is the focus of all the current 'exit strategy' angst. A process complicated by the political stage on which it is playing out.

The various weaning processes represent major headwinds themselves. The form of the 'exit strategies' remain uncertain, and uncertainty smothers market incentives and economic growth. It will be critical as 2010 unfolds to see if strategies are created and communicated effectively. In the mortgage area, the December FOMC minutes indicated a concern for the effect of continued mortgage buying. Reversals from this market will have a great impact on long rates and must be planned carefully. In 3Q-2010 the Bush tax cuts will end along with some stimulus programs, both of which will be a drag on the economy. Markets have to be prepared for their absence or alternatives. The ultimate impact of health reform legislation is already a drag on small business spending and job growth. The expansion in Afghanistan is more than a peripheral uncertainty, as well as its effect on the national deficits. Public pressure to offer a plan for future fiscal policy is intensifying, which adds uncertainty. Deficits are a major focus at all levels of the economy. Their very long impact is well understood by the populace. Add other major areas, such as financial regulation, and the markets will continue to roil.

Economists have proffered a natural outgrowth of the accumulation of stimulus programs. The lending has increased the size of the Fed's balance sheet materially, funded on reserves. Paying interest on that amount will decrease its income and ability to repay the Treasury and could ultimately lead to a negative net interest margin for the Fed as rates increase. This is a bubble no one wants to see pop.



Source: Citi Investment Research and Analysis, Federal Reserve

As 2010 begins, the negative self-perpetuating cycles of 2009 have slowed to a halt. The positive factors are taking hold, but it will be months before positives take the lead. As jobs continue to improve and confidence and some certainty emerge, a more encompassing positive cycle will return. Good news builds on good news. The key question will remain as to whether we can extract ourselves and the economy from the artificial supports which helped shorten the cycle but which must end. Addressing and weakening the headwinds is imperative to forward meaningful growth.