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## Assumptions

Our baseline United States forecast relies on some critical assumptions. We assume that the TED spread, normalized by the treasury rate, will steadily decline to more normal levels. This is an assumption that the extraordinary high risk aversion of the past year will subside. We also assume that the rate of decline of the other developed countries' economies will slowly subside, and eventually those economies will see the initial stages of sustained growth. We expect US government expenditures will decline slightly, but government spending will remain at historically high levels.

Perhaps the most difficult assumption is what the Fed's monetary policy is likely to be. The Fed will feel compelled to walk a very narrow line as it attempts to avoid deflation and yet restrain inflationary expectations. This last point is quite interesting. It is my preference that the Fed aggressively attempt to encourage at least moderate inflationary expectations. This is because the risk of deflation is so serious. Be that as it may, we expect the Fed to attempt to control inflationary expectations and still resist deflation pressures. Consequently, we expect the Fed to keep its Target Federal Funds Rate relatively low throughout the forecast horizon. However, it is likely that the Fed will start increasing its target rate in 2010, with a program of very cautious incremental increases. This policy will contribute to economic weakness.

We would prefer a policy, advocated by economist Scott Sumner, of the Fed targeting nominal GDP growth of about five percent. This would clearly be significantly more expansionary than current policy. It would just as clearly be inflationary.

## Baseline Forecast

Given the relatively tight monetary policy and the extraordinarily high levels of leverage at banks, businesses, and consumers, it is not surprising that we expect consumption and investment to remain weak throughout the forecast horizon. Other developed countries will also have weak economies throughout the forecast horizon, which implies weak exports. It is tautological that weak consumption, investment, and exports imply a weak United States economy.

These trends imply that, while the third quarter of 2008 may have seen positive GDP growth (artificially boosted by the "Cash-for-Clunkers" program), economic decline will return and remain throughout 2010. In particular, 2009's fourth quarter is likely to be very weak on a seasonally adjusted basis. With unemployment high and the consumer still well over-leveraged, the Holiday Season will be very weak.

While we don't think that one positive quarter signals the end of a recession, the popular press may brand this a "W" recession. We think of it more as a dead cat bounce.

Jobs will continue to decline in 2010, but at a slower pace than prevailed throughout most of 2009. The unemployment rate will remain high, even as discouraged workers exit the labor force. Capacity utilization should slowly improve, although we don't expect it to soon approach levels consistent with vigorous recovery.

Bank charge-offs will remain alarmingly high, but they will slowly decline. Residential real estate markets appear to be near their bottoms, but there is no reason to expect to see any real residential real estate market strength in the coming year. Commercial real estate markets, by contrast, will likely continue to deteriorate. The weak real estate markets will continue to depress the construction industry, although public works projects remain strong.

Essentially, there will be no real economic strength in 2010 because overly-leveraged market participants will continue to retrench as they seek to improve balance sheets. These efforts will be hindered by an overly-tight monetary policy, weak incomes, continued job losses, weak residential real estate markets, and declining commercial real estate markets.

#### Scenarios

We provide two scenarios in addition to the baseline forecast. Each of these scenarios represents a forecast based on a specific economic shock. They are not the best or worst case. Our first scenario is one with a sharp reduction in risk aversion. We interpret the events of September 2008 as a switch from a good equilibrium to a bad equilibrium. Essentially it was a run on the world's financial markets. This scenario could be interpreted as a return to a good equilibrium.

Our second scenario represents the impact of another strong negative economic shock to our financial markets. This could be something like the failure of one or more major financial institutions. We feel that each of these scenarios is unlikely. However, it is worthwhile to consider the economic impact of significant, but low-probability, events.

#### Equilibrium shift Scenario

This scenario is characterized by a sharp decline in risk aversion. It is something like shifting to a pre-September 2008 equilibrium. Such a shift would likely be accompanied by a fairly aggressive policy of Fed tightening, as the Fed would attempt to restrain inflationary expectations.

With this scenario the job situation begins improving immediately. However unemployment does not decline as rapidly as one might expect, because of reentry of discouraged workers. Gross product growth would be relatively volatile in the short run, but renewed economic growth would be set in place by the end of 2010.

#### Financial shock Scenario

This scenario is characterized by a dramatic increase in risk aversion, modeled as an increase in the TED spread. The Fed's response would be to maintain a target federal funds rate at the existing level. Not surprisingly, this forecast is rather dismal. Job losses would continue at rates matching the highest we observed in 2008. The unemployment rate, however, would not rise as one might expect, because of discouraged workers and a declining labor force. Gross Domestic Product, economic activity, would decline at an alarming pace.