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Economic Update

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October 21, 2011

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We believe that the most likely outlook for the world economy is a global growth recession, rather than either a full-scale global recession or a strong economic expansion. This outlook assumes a gradual shift towards appropriate cyclical economic policies in key countries. For Europe overall, we expect European economic activity to be flat to declining somewhat over the next several quarters, with an economic stall in key core countries and continuing recessions in several peripheral countries. That assumes a semi-orderly process of resolving insolvency and contagion risks in Europe. We believe that it is an open question whether European economic weakness will be substantial enough to be labeled a recession for the overall European economy. That should depend on the quality of European policymaking over the next several months. Across the global economy, we do not expect economic declines except in some European countries. In the U.S., we regard a subpar economic expansion as much more likely than a full-scale recession. In most emerging markets, growth should decelerate somewhat due to the lagged impact of

higher inflation and interest rates combined with the effects of the developed market slowdown. However, unlike the developed countries, most emerging countries are not burdened by debt overhangs. Many emerging countries should have the flexibility to ease monetary policy as inflation slows. Overall, this combination of regional trends should result in a global growth recession.

We believe that the global economy is “rebalancing down” after a failure to correct both global imbalances and the imbalances within the Eurozone single currency bloc of very disparate countries. Private sector income growth is weak in most major developed economies due to debt hangovers, fiscal consolidation, global labor cost competition and the subordination of economic growth to other policy priorities in many developed countries.

With the strong secular demand for commodities in emerging countries and vulnerable income growth trends in developed countries, cyclical fluctuations in energy and food prices are having a powerful effect

on the pace of global economic activity. We believe that the current global growth recession reflects (1) the lagged effect of the commodity price surge from mid-2010 to mid-2011, (2) the direct and indirect effects of the European financial crisis, and (3) widespread policy uncertainty as multiple economic policies in many countries remain in a state of flux. We expect that a lower level of commodity prices should eventually cushion the weakness in real income growth and contribute to continued expansion within the context of a global growth recession.

In Europe, the economy is weaker than in the U.S. Recessions are underway in southern Europe as governments have lost access to funding from the markets and are subject to forced fiscal consolidation. In addition, some "soft core" economies are suffering from credit stresses. Demands for higher capital ratios are motivating attempts to shrink bank balance sheets in some countries. In 2008, the European Central Bank tightened monetary policy into a worsening financial crisis due to a focus on reported inflation, which is a lagging indicator. They just did the same thing in 2011. In contrast, the U.S., U.K., Brazil, and other countries have eased monetary policy on a conviction that elevated inflation will decelerate in response to the global economic slowdown. Eventually, we expect the ECB to follow with a belated unwind of its 2011 policy tightening.

The intermediate-term outlook for Europe is challenging, due in part to the mathematics of fiscal sustainability. While we believe that the long-term trend growth rate of real GDP in the U.S. is close to 2.5%, it is probably about 1% for Europe. With the ECB likely to hold the average inflation rate in Europe

near 2%, nominal GDP may average no more than a 3% growth rate over the coming years. Countries with sovereign bond yields well above that level may face substantial challenges, especially if their real GDP growth rates fall short of the European average. Even if current financial stresses can be managed, a crucial problem for many European countries in the long run is the prospect of persistently low economic growth at a time of demographic aging.

A key problem has been the delay among European policymakers in deciding how to deal with peripheral government debt and its impact on European financial institutions. We expect that these decisions will eventually be made. In the meantime, however, we believe that the lagged effect of this delay should weaken the European economy. Germany, which faces serious long-term issues with an aging demographic, has supported both a single mandate on inflation at the ECB and a balanced budget rule, which they refer to as a "debt brake." Even before the financial stresses intensified, these priorities had made European economic policy relatively tight. We expect that the most likely result of tight monetary policy, tight fiscal policy and European financial stresses is that overall economic activity in Europe should be flat to somewhat lower over the next several quarters. Despite economic declines in the peripheral countries, the magnitude of the overall European economic weakness may be limited by sound economic fundamentals in several countries at the core of Europe, large countries which have a heavier weighting in the calculation of overall economic activity in Europe.

The outlook for the global economy depends crucially on the severity and duration of European financial stresses. We expect neither a disorderly

financial meltdown nor a clean orderly resolution of these stresses. Given the slow speed of European decision-making by various policymakers, we expect a semi-orderly stop-and-go process which averts the worst-case outcome but reduces European financial stresses only gradually over time.

To prevent liquidity stresses from creating solvency problems, Europe needs a lender of last resort to illiquid but solvent financial institutions and illiquid but solvent sovereigns with credibility based on three characteristics: (1) unlimited buying power, (2) an ability to act, and (3) a willingness to act. The EFSF is limited in size and subject to political constraints. The willingness of the ECB to act as an aggressive lender of last resort is constrained both by its own mandate and by the reluctance of the European governments to provide it with reliable political support to act. This issue is linked to (1) the “no-bailout” concept in Europe, (2) resistance to a “transfer union” whereby wealthier countries would subsidize poorer countries, and (3) the ECB’s attempt to maintain a “separation principle” between monetary policy and liquidity support for the financial system during a financial crisis. Eventually, European leaders should make choices necessary to solve this problem and prevent the break-up of the euro, but it is likely to be only a “semi-orderly” process with alternating phases of optimism and pessimism.

In the aftermath of past debt booms in a number of developed countries, the deleveraging process is moving at differing speeds in different countries. In the U.S., deleveraging of the non-financial corporate sector has been substantial and the financial sector has strengthened its balance sheet despite profit challenges. The bank stress test in the U.S. was well-designed and has helped stabilize the financial sector.

The downward adjustment in U.S. house prices has weakened consumer net worth and reduced the value of collateral. The deleveraging of the U.S. consumer has shown greater improvement from a debt-service-to-income perspective than from a debt-to-net-worth perspective. A combination of low interest rates and a period of low consumer debt growth have substantially reduced the ratio of consumer debt service to income. This helps explain why auto sales have continued to trend higher despite low confidence and widespread recession forecasts. The severe weakness in auto sales in prior years has aged the auto fleet and contributed to pent-up demand for new cars. This is in sharp contrast to the usual pre-recession conditions. Auto sales have recovered from the sub-basement to the basement and we believe that their vulnerability to a substantial decline is limited. We believe that U.S. auto sales are more likely to rise than fall. A similar “basement thesis” applies to other cyclical categories, notably including capital spending (although its rate of increase may slow somewhat). Housing is a special case, still stalled at a sub-basement level, with residential investment as a share of GDP now severely depressed. However, after a decline from over 6% of GDP to about 2% of GDP, a substantial further decline in residential construction appears unlikely and some gradual improvement is likely over the next several years. While the vast majority of jobs destroyed in the housing sector are unlikely to return, the formation of new households appears to have passed its cyclical low. Rising household formation should contribute to a gradual improvement in the housing sector over the next several years.

Many key cyclical sectors are still depressed and appear more likely to rise than fall. As a result, we

expect a sustained but subpar economic expansion in the U.S. While U.S. economic growth in 2011 overall should be somewhat below normal trend growth of about 2.5%, the economic stall in the first half of 2011 is likely to be followed by near-trend growth in the second half of 2011. We expect economic growth in 2012 to run at a near-trend or slightly-below-trend pace. We do assume passage, following prolonged political wrangling, of legislation to mitigate the currently scheduled fiscal tightening in 2012. Real spending should be able to grow in line with real income growth. While nominal income growth is sluggish, falling inflation and easy monetary policy should help support the growth in real consumption.

We make a distinction between gross monetary policy and net domestic monetary policy. Gross monetary policy in the U.S. is aggressively stimulative, indicated by: (1) a low real yield measured against core inflation, (2) a low real yield measured against reported inflation, (3) a low real yield measured against expected inflation, (4) a low natural rate of interest (nominal interest rate minus nominal GDP growth), (5) precommitment to a zero policy rate, and (6) successive rounds of quantitative easing. Net domestic monetary policy is only mildly stimulative, once adjusted for the eroded debt capacity of households as well as the problems in the monetary and credit transmission mechanism. Those who believe that massive excess reserves will generate a major acceleration of inflation have a “dry tinder” view of the monetary transmission mechanism, while we have a “damp firewood” view of the monetary transmission mechanism. While there are massive excess reserves in the U.S. financial system, we do not believe that they will be quickly mobilized into credit and spending growth for three reasons. First, many consumers have negative

housing equity, reduced net worth and/or low credit scores, so a lower level of interest rates has had only a limited effect in stimulating consumer and mortgage borrowing. Second, we believe that financial intermediaries are still somewhat risk-averse. Third, regardless of the views of financial intermediaries, financial regulation has been engaged in a major procyclical regulatory tightening, offsetting much of the easy stance of gross monetary policy. Adjusted for these factors, we regard net domestic monetary policy in the U.S. as only somewhat stimulative. We believe that the U.S. financial sector is now in a “damp firewood” phase, not a “dry tinder” phase.

We believe that Federal Reserve policy is designed to engineer a gradual “nominal fix” for excessive debt-to-income and debt-to-net-worth ratios in the private sector. Real growth near 2.5% and inflation near 2% would generate a growth in nominal GDP (real growth plus inflation) of about 4% to 5%, a normal pace for the U.S. economy. If the accumulation of new debt is weak, which seems likely, this “nominal fix” should gradually improve debt ratios in the private sector over a period of years.

In the U.S., pressures to deal with current and future budget deficits come from public opinion and politics, but not from financial market pressures. The U.S. faces little difficulty in financing its current budget deficits today at low Treasury yields. This makes the current U.S. fiscal situation different from the fiscal situation in many European countries.

We believe that a short-term stimulus bill of about one-third the size of the proposed \$447 billion jobs bill is likely to pass. Fiscal tightening is currently

scheduled in the U.S. for 2012, due largely to expiring tax cuts. We believe that this will be substantially ameliorated, notably by a likely extension of the 2% payroll tax cut.

We are skeptical whether a large multiyear deficit reduction deal can be reached in the U.S. prior to the Presidential election. We believe that the best fiscal policy would be (1) avoiding near-term fiscal tightening, (2) establishing a credible path to a stabilization of the debt-to-GDP ratio, and (3) passing a pro-growth reform of corporate and individual taxes, holding down tax rates by broadening the tax base. However, the two political parties sharply disagree about fiscal policy and we expect continued fiscal uncertainty in the U.S. The budget deficit is likely to be near the top of the public agenda during the election period. The U.S. budget deficit problem may not be solved, but it is no longer being ignored.

The policy flexibility in the emerging market countries is one reason we regard a global growth recession as more likely than a full-scale recession. Many emerging market countries do not share the external debt burdens and the internal debt burdens which are creating problems for many developed countries. They have fiscal flexibility, if needed. In addition, as commodity price weakness generates a peaking in their inflation rates, they can choose to lower their policy rates. This has already occurred in Brazil, Turkey and Indonesia. There is likely to be some weakness in the growth rates of emerging economies in the short run due to the negative growth surprise from the developed countries. But at a time of financial weakness and deleveraging in the developed world, the stronger finances and favorable long-term fundamentals in the emerging countries should help limit the downward pressures on the world economy.



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