# Economic & Market Review

**Gross Domestic Product (GDP) growth declined significantly in the first quarter of 2009, following a contraction of 6.3% in the fourth quarter of 2008.**

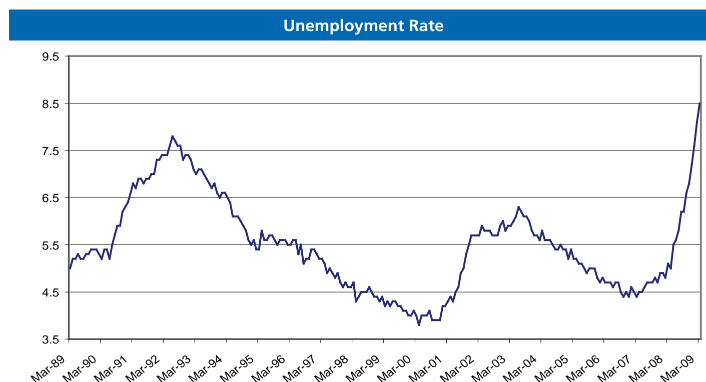
The ramifications of the financial crisis spread further into the real economy, which caused the labor market, housing, consumption, manufacturing and exports to deteriorate further. These effects highlighted the grim realization that the U.S. is likely experiencing its deepest recession since World War II.

As bad as the economic data has been throughout the first quarter, the environment has shown some signs of stabilization. Consumer spending has turned slightly positive; housing activity has begun to pick up; credit availability has improved modestly; equity markets have improved; and banks should benefit from first-quarter capital market activity. The markets also are benefiting from the implementation and announcement of additional simulative programs, including Quantitative Easing (QE) and the Public- Private Investment Program. While we do not expect these developments to lead to significant near-term improvement in the economic data, we are seeing signs of stabilization or at least a slowdown in the pace of decline.

**The labor market continued to deteriorate, and the downward trend accelerated in the first quarter.**

Each month of the first quarter saw an average job loss of 685,000, which is significantly higher than the 425,000 monthly average of the fourth quarter. We have now experienced 15 consecutive months of job loss, bringing job loss to approximately two million in the first quarter and approximately five million since the recession began. The unemployment rate rose by 1.3% in the first quarter to 8.5%. This was the largest quarterly rise in unemployment since the recession began and the highest unemployment rate since 1983. (See graph below)

Initial jobless claims have continued to increase, with the most recent four-week moving average at more than 650,000, a level not seen since the 1970s. Continuing claims also increased to a record high in the first quarter, reiterating that people are unemployed longer as new jobs are more difficult to find. The weakness in labor markets has contributed to further declines in the outlook for consumers. We believe that consumer confidence will remain weak, and growth expectations will be subdued until labor markets begin to stabilize.




Source: Bloomberg

**Personal spending rebounded in the first quarter of 2009, following a 4% annual rate of decline in the third and fourth quarters of 2008.**

Real consumer spending is likely to have increased at a 1.6% annual pace in the first quarter. The increase in spending was a surprising positive, given the continued weakness in labor markets, the further destruction of wealth and increased savings rates. The increase was likely a result of one-time benefits, such as lower taxes paid, which could continue through April. As these benefits wear off, it is likely that the weakening trends in the labor market will reduce consumption.

Business spending has remained very weak as companies hoard cash, which is a main driver of accelerated layoffs and sharp inventory declines in the first quarter. The inventory decline is one key driver of declining growth in the first quarter. Through the first two months of the year, durable goods orders continue to point to a sharp decline in capital investment, with core capital goods orders down 45% and shipments down 35%. Other signs of stabilization are the Institute of Supply Management manufacturing index, which has increased four months in a row, and the March data showing strong increases in new orders and new export orders. While these readings are still well below a level that would provide sustainable growth, they are signs of improvement.

**While home prices continue to fall, we see signs that activity in the housing market is increasing.**

Home prices continued to decline throughout the first quarter, with the most recent Standard & Poor's (S&P) Case-Shiller Composite 20 City Home Price Index down 19% year over year and 29% below its peak in 2006. The price index has now retraced back to 2003 levels. The decline in prices continues to reflect the tight credit environment and the ongoing rise in delinquencies and foreclosures.

The U.S. Treasury and the Federal Reserve (Fed) increased their commitment to purchase mortgage-backed securities to $1.25 trillion and have begun to purchase up to $300 billion in U.S. Treasuries to lower mortgage rates and improve credit availability. The Home Affordable Refinancing Plan will greatly expand the ability of borrowers to refinance. Mortgage rates have declined to below 5%, and the government will continue to support lower mortgage rates to stabilize the housing market. These programs will enable a significant number of borrowers to lower their debt burden, and they will help slow the pace of foreclosures while enticing new homebuyers to reduce the overhang of housing inventory.

The lower mortgage rates have led to an increase in mortgage applications each week in March; an increase in new, existing and pending home sales in February; and an increase in building permits and housing starts. While prices will continue to decline over the near term, these are all signs that activity is increasing in the housing market.

The Federal Open Market Committee (FOMC) held rates at a range of 0% to 0.25% and started down the path of alternative methods to improve liquidity and access to credit, including quantitative easing (QE).

The FOMC remains committed to keeping the funds rate low by saying, "Weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period of time." The main goal of keeping interest rates low for an extended period is to ease credit availability for businesses and consumers. The FOMC and U.S. government continued to use all available tools to contain the recession and restart financial markets.

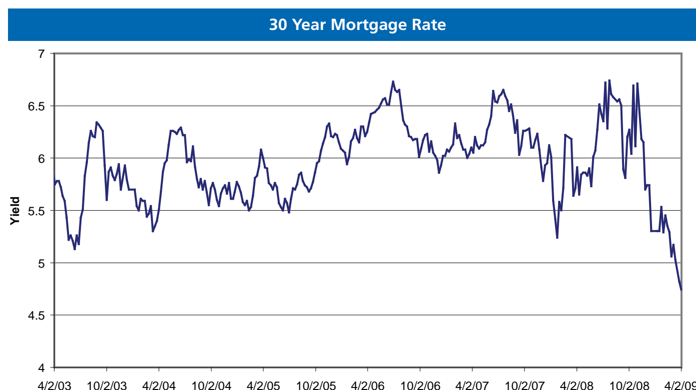
In the first quarter, Congress passed a $787 billion fiscal stimulus package, which included tax cuts and spending to bolster social safety net programs such as unemployment insurance. The FDIC guaranteed all new bank debt for the next three years to enable cheap funding under the Temporary Liquidity Guarantee Program.

Other programs established in the first quarter include:

- Troubled Asset Loan Funding (TALF), which provided easier access to consumer loans (auto loans, student loans, etc.). The TALF program was later extended to non-agency mortgage-backed securities (MBS) and commercial MBS.
- Issuance of new asset-backed securities.
- The Public-Private Investment Program, which is meant to provide liquidity for distressed loans and securities on company balance sheets.
- New and extended QE programs from the FOMC involving MBS, agency debentures and U.S. Treasuries.

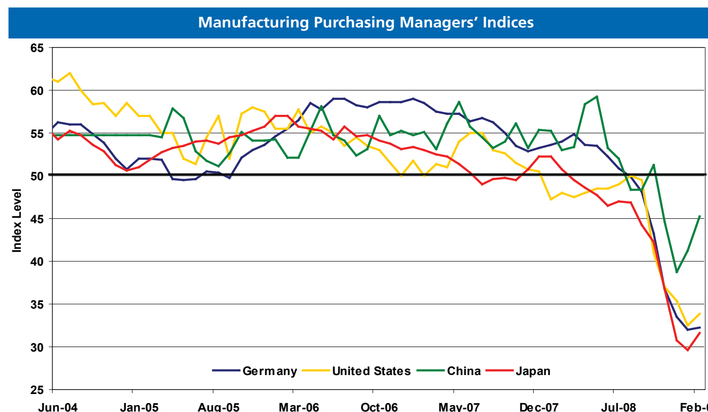
The QE programs began when the Fed committed to purchase $500 billion of MBS and $100 billion of agency debentures, with the ultimate goal of lowering mortgage rates. As the quarter went on and purchases were not having the desired impact, the Fed increased its MBS purchase commitment to $1.25 trillion, increased its agency debenture purchase commitment to $200 billion, and initiated a program to purchase up to $300 billion of U.S. Treasuries. The goal was to lower mortgage rates and other consumer and corporate borrowing rates.

The purchase of $300 billion in U.S. Treasuries will absorb about one-third of the supply over the next six months and has helped to lower mortgage rates below 5%. (See graph below)




Source: Bloomberg

**It has become increasingly evident to global central banks that this is not just a U.S. recession, but a global recession.** Global manufacturing levels have declined significantly, and GDP growth remains substantially negative for most developed nations. (See graph below) We have seen signs recently, however, that the rate of decline is beginning to stabilize. Consumer spending in the U.K. has managed to hold up reasonably well; the most recent Purchasing Managers Index (PMI) readings in the U.K. and Europe have shown positive composite and new-order measures; and the last three months of income-from-operations business surveys in Germany appear to have stabilized. Because many of the central banks were slow to initiate monetary policy actions, we saw a significant number of actions in the first quarter.




Source: Bloomberg

The Bank of England (BoE) cut its targeted rate by another 150 basis points to 0.50%, as the global financial crisis led to deeper recession concerns. This is the lowest targeted rate for the BoE since its establishment in 1694. The BoE also began a QE program, purchasing bonds with maturities between five and 25 years, with the primary

focus of increasing the monetary base and keeping medium-term inflation expectations in line with its target. This is different from the U.S. FOMC focus of keeping rates low for credit easing, and it also appears the BoE may hold rates lower for a shorter period of time than the U.S. There is some concern that the measures may be too expansionary, and the BoE has stated it would either sell back some assets or raise the target rate if this were the case. With GDP expected to be significantly negative, it is unlikely that the BoE will face this concern in the near-term.

The European Central Bank (ECB) cut its target rate by another 100 basis points to 1.50% in the first quarter and has subsequently cut another 25 basis points in April. The ECB has been reluctant to lower rates or implement "non standard" measures. At the April meeting, however, it agreed to announce some non standard measures at the next meeting. This is likely the ECB's way of buying time to see if the recent stabilization could result in a trend; the ECB is not likely to unveil an aggressive QE program to ramp up money supply soon.

The Bank of Canada (BoC) cut rates by 100 basis points to 0.50% in the first quarter, describing conditions in the Canadian economy as dire. Against this backdrop, the BoC concluded that the overnight rate could conceivably head lower and that the use of quantitative easing is a possibility. The framework for any QE programs will likely be outlined in the April 23 meeting.

**Market volatility continued in the first quarter, but liquidity has improved as markets begin to stabilize.**
The S&P 500 Index fell further in the first quarter, ending down another 11.01%, but this was substantially higher than the lows hit in March. After reaching a low of 676 March 9, the S&P 500 rallied about 18% to end the quarter. The yield curve steepened by 42 basis points during the quarter, as the spread between two-year Treasuries and 10-year Treasuries ended the quarter at a positive 187 basis points. The 10-year Treasury Note increased by 45 basis points to end the quarter at 2.66%, while the two-year note increased just three basis points to end the quarter at 0.79%.

The rise in interest rates was partially offset by the tightening of credit spreads, leading to modestly positive performance for higher-quality bonds. The Barclays Aggregate Bond Index was up just 0.12% during the quarter, while the more credit-sensitive Barclays High Yield Bond Index was up 5.98%.

## Outlook

**Our outlook calls for economic readings to remain weak in the near term, but to improve during the second half of 2009. We expect credit spreads to tighten through the end of 2009.**
First-quarter GDP is expected to remain substantially negative and will likely remain negative through the first half of 2009. The positive impacts from falling energy prices, lower mortgage rates and greater access to credit should allow consumers and businesses to eventually start spending, leading economic growth to improve later this year. Until then, consumer spending will remain weak, as confidence readings remain near historic lows and consumers shift from borrowing to saving.

**The FOMC continues to create more ways to provide liquidity and extend further access to capital.**
We believe this will provide the basis for positive GDP growth later this year. Credit spreads typically lead a fundamental recovery by about nine months, so we expect credit spreads to tighten throughout 2009. The yield curve should remain steep, as the front end will be held down for the foreseeable future, while further Treasury issuance keeps the long end from rallying much further. We expect yields on the 10-year U.S. Treasury Note to trade between 2.50% and 3.00% during the second quarter of 2009 and trend toward 3.00% to 3.50% by year end.

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