Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter[*]

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I. Outlook Brightens As Near-Term Risks Diminish

In November I suggested that the mid-term election outcome, the initiation of the second round of quantitative easing and the pending recommendations of President Obama's Fiscal Commission might collectively mark a significant pivot point in the financial and political history of the United States. This might still turn out to be the case, but for the time being attention is focused on the lame-duck Congress and the Obama-Republican tax deal to extend the Bush tax cuts.

I voiced hope that President Obama's Fiscal Commission would be able to muster the super-majority of 14 votes and that Congress would respond by adopting, in principle, the thrust of the Commission's recommendations. Admittedly, this was an altruistic view and one, predictably, that did not come to fruition. The recommendations of the co-chairs, Erskine Bowles and Alan Simpson, were met by immediate rejection from liberal Democrats and a fair amount of criticism from conservative Republicans. Thus, it was not surprising that the Commission's final vote was 11-7 — the super majority was not attained and the lame-duck session of Congress will not vote on them. Thus, this aspect of fiscal policy has been deferred to the next Congress.

However, a compromise on extension of the Bush tax cuts, which expire at the end of this month, appears to be coming together and seems likely to be enacted in spite of enormous and emotional opposition from liberal Democrats. The proposal includes a temporary two-year extension of all of the income, dividends and capital gains tax rate cuts and a 35% estate tax rate with a $5 million exemption per person. It also includes extension of

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extended unemployment benefits for 13 months, through the end of 2011, and cuts payroll taxes for individuals during 2011 by two percentage points at an incremental cost of about $120 billion. The "making work pay" tax credit would not be extended, which would save $61 billion. Other miscellaneous tax credits would be extended at a cost of $20 billion in 2011. In addition, businesses would be able to expense for tax purposes 100 percent of the cost of capital investments made during 2011, which would defer $100 to $150 billion in taxes to future years. The proposal is more expansive than anticipated and in that regard is responsive to Federal Reserve Chairman Bernanke's appeal for stimulative fiscal policy to accompany quantitative easing. However, the short run consequence will be an even larger federal budget deficit than previously expected, rising from about $1.25 trillion in fiscal 2011 to $1.35 trillion.

Incoming data reports have generally reflected very modest improvements in economic activity, but what is really important about these reports is that they do not support fears of pessimists that a double-dip recession could be in the offing. For example, although consumer confidence remains at levels usually experienced only in recessions, nonetheless gradual improvement is occurring. In addition, consumer disposable income and spending growth is accelerating gradually and surveys suggest that holiday retail sales will be stronger this year.

Notwithstanding this flow of better news, substantial risks remain that could slow recovery. Foremost among these risks is the moribund housing market and the prospect of further home price declines over the next year. Other risks include renewed eruption of the European financial crisis, overheating in China and other emerging nations, competitive currency devaluations coupled possibly with trade and capital restrictions, the onset of deflation, and possible renewed financial stress for the largest U.S. financial institutions as they contend with the ongoing fallout of the housing bubble, falling housing prices and litigation aimed at shifting credit losses from investors to issuers of mortgage backed securities.

In my opinion, while these risks bear close watching, they are more likely to result in uneven and sluggish economic growth than renewed recession. In other words, I think the fiscal and monetary policy mix that is being put into place is likely to move the U.S. economy toward a self-reinforcing virtuous circle of slowly improving growth and slowly diminishing unemployment.

However, major economic imbalances are as intractable as ever and there is little on formulating policies in the near-term that would deal effectively with these imbalances. For example, while the Obama-Republican tax deal will contribute importantly to igniting sustainable growth, it will worsen the federal deficit by nearly $1 trillion over the next 10 years off a base line projection that already was projected to take the public debt to GDP ratios deep into the danger zone. In that regard, tax reform will have to be front and center on the political agenda in coming months.

There are at least two other imbalances that will be exacerbated. There is nothing in the tax deal that addresses growing income inequality in the U.S. and, if anything, extension of the Bush tax cuts and continued Wall Street facilitated speculation in financial assets and commodities could worsen this imbalance. In addition, U.S. trade and current account imbalances are still huge and are sure to worsen as growth picks up.

So, at the risk of being cynical, it is looking to me that aggressive monetary and fiscal policy may be on the verge of once again creating a sustainable cyclical recovery. But, many fundamental imbalances remain and, if not addressed, will continue to erode the strength and resilience of the U.S. economy over time.

In this month's letter I review and comment on key components of the U.S. economy: GDP growth, employment, consumers, housing, business activity and inflation. I also include updates on key issues and risks that I have discussed in depth in previous letters: long-run U.S. fiscal policy, the European financial crisis, and developments in emerging economies, particularly China.

II. Drivers of GDP Growth

As we were taught in introduction to macroeconomics, GDP is the aggregate of spending by consumers, businesses, government and trade with the rest of the world. As of the third quarter of 2010, consumer spending was 70.3% of GDP, business spending was 13.9%, government spending was 19.5%, and trade was -3.8%, which means that imports exceeded exports. Clearly, changes in consumer spending are the single largest driver of GDP.

1. Consumers — 70.3%

Consumer spending depends on disposable income and the saving rate. If disposable income rises, spending will rise by the same percentage, provided that the saving rate remains unchanged. Spending can rise at a faster rate than income if the saving rate declines. This is what happened prior to the Great Recession because of easy access to debt and rapidly growing housing and financial wealth.

During the Great Recession consumer spending dropped sharply because disposable income fell as unemployment increased, hours worked decreased and the rate of growth in wages slowed. Spending also slowed as consumers raised their saving rate and began to reduce their debt burden.

The government intervened to support the economy and consumers by significantly increasing its spending. Much of this increase occurred through transfer payments to consumers, such as unemployment benefits, and through reductions in taxes. The overall effect was to replace much of disposable income lost through unemployment and underemployment. While these fiscal policy actions helped maintain a higher level of aggregate demand, the consequence was a rapid escalation in the deficit and in the ratio of public debt to GDP. Although this is the inevitable and necessary consequence of stabilizing and restarting the private economy, simultaneously, because of the sheer magnitude of the intervention, it is sowing seeds of future economic problems that will flow from excessive levels of public debt to GDP. Excessive consumer reliance on debt was a major factor driving the severity of the Great Recession and similarly excessive government reliance on debt will create instabilities and economic challenges in the future.

In normal recessions, government intervention not only supports aggregate demand during the downturn it also helps restart the private sector economic engine. As the private sector revives, government support can be reduced.

The Great Recession differed in two significant respects from a normal recession. First, job and income losses in the private sector were far greater. That fact alone required much greater government intervention to achieve stabilization and restart the private sector. While there is debate among economists, it is generally agreed that although government stimulus far exceeded levels committed during past recessions, this much greater amount was simply inadequate to restart the private sector.

Second, the explosion of consumer debt during the bubble period leading up to the Great Recession severely impaired the ability of consumers to spend at the same rate out of income. No longer could the record high level of debt service be financed out of income and additional borrowing to accomplish the same need simply became unavailable. Thus, consumers were forced to cut spending to a much greater extent. This was reflected in a jump in the saving rate from 2.1% in 2007, the year before the Great Recession, to 4.1% in 2008 and 5.9% in 2009. Over the first ten months of 2010 the savings rate has averaged 5.8%. This indicates that the saving rate has stabilized and is not likely to be a significant factor constraining spending growth going forward.

This is progress of a sort, but consumer spending growth will remain weak until unemployment declines and hourly wage rates stabilize or begin to rise. The labor market is still weak. Unemployment remains high at 9.82% in November, down only slightly from its high of 10.15% in October 2009. The modest improvement in official unemployment is misleading when one adjusts for the decline in the labor force participation rate over the same interval from 65.0% to 64.5%. The adjusted unemployment rate, assuming a constant labor force participation rate, shows an increase from 10.67% in October 2009 to 10.88% in November 2010. Over this same period the rate of increase in hourly wages fell from 2.29% to 1.61%, which is a new low. The only piece of good news on the employment front is that hours worked per employee are rising and, thus, the rate of growth in average weekly wages is rising, from 0.51% in October 2009 to 2.81% in November 2010.

My optimism, perhaps “hope” would be a better word, now is that the new round of federal stimulus will translate into a gradual improvement in the labor market. Once unemployment begins to fall, the higher aggregate income and spending that will result should become self sustaining. Still, the likelihood is for gradual, not rapid, improvement in employment, income and spending. Thus, GDP growth should accelerate to an “above trend” level in coming quarters but substantial excess capacity will remain in the economy for a very long time.

2. Business Spending and Investment — 13.9%

Business investment consists of nonresidential, residential and change in inventories.

Change in inventories is generally slightly positive, but almost negligible, over the business cycle, but can oscillate wildly at different points in the cycle. When an unanticipated drop in demand occurs of the sort that happened at the onset of the Great Recession, inventories grow rapidly on an involuntary basis. Businesses respond by cutting production below the level of demand with the intent to reduce inventories. But when demand revives inventory cutting zeal usually has gone too far and businesses reverse course and increase production above the level of demand to restore inventories to "normal" levels. Because the shock to aggregate demand was huge during the Great Recession the inventory cycle had much greater amplitude. In the third quarter of 2010 inventory accumulation accounted for 0.8% of GDP, rather than a cycle-neutral figure of close to zero and accounted for 1.3 percentage points of the 2.5% real GDP growth. In other words, inventory accumulation accounted for half of GDP growth in the third quarter. The recovery in inventories is just about over and thus will not contribute significantly to GDP growth in coming quarters. (See **Table 1** below for a quarterly snapshot of the effect of inventories on annualized quarterly GDP growth over the 2009-2011 time period.).

Residential investment accounted for 2.4% of GDP during the third quarter of 2010. This is substantially below the cycle-neutral level of about 4.5%. In a typical cycle, housing investment is one of the very first sectors to revive and helps create jobs and income that stimulate broader growth in the private economy. Unfortunately, extreme overbuilding during the housing bubble resulted in an extremely large excess supply of homes, which will take years, not months, to absorb. While it is unlikely that residential investment will shrink further — it pretty clearly has bottomed out — residential housing investment will not contribute materially to GDP growth until the excess supply is worked off.

Thus, the only sector of business investment that is likely to contribute to GDP growth in coming quarters is nonresidential, which currently accounts for 10.5% of GDP. Nonresidential investment can be further subdivided into structures, which, like residential housing, has been declining, and equipment, which has been growing rapidly. Recent growth in equipment has been concentrated in information processing equipment and software and in transportation equipment.

3. Government — 19.5%

State and local governments account for approximately 60% of spending, which, because of the Great Recession and balanced budget requirements, has been declining over the last several quarters. The federal government accounts for the remainder. Federal government spending in the GDP accounts includes only spending on goods and services and omits transfer payments. Thus, the percentage is considerably lower than the numbers normally cited for federal government spending as a percentage of GDP. Total federal government spending during fiscal year 2010 was $3.46 trillion (about 24% of nominal GDP), while the annualized third quarter figure included in GDP was only $1.09 trillion (about 8% of nominal GDP).

Overall, growth in government consumption and investment spending has not had a material impact on GDP growth. Growth in government spending has occurred almost entirely in transfer payments and entitlement programs, which are not included directly in the measurement of GDP but only indirectly through the spending activities of recipients, primarily consumers.

4. Trade (Exports — Imports) — -3.8%

The U.S. imports far more than it exports. The trade deficit peaked at 5.8% of GDP in 2006, fell sharply during the Great Recession, but has been growing steadily once again since mid-2009. In the long run, having a large negative balance of trade is healthy. Simply put, what it means is that we are consuming more than we are producing and this over-consumption is financed by foreigners. Also, over the long run a large trade deficit exerts downward pressure on the currency and creates the potential for periodic currency crises.

A persistent trade deficit can result from overvaluation of the dollar, uncompetitiveness of U.S. products in global markets, U.S. policies that promote consumption over investment, trade tariffs and other artificial barriers. One obvious cause is the Chinese policy of pegging its currency to the value of the dollar and deliberately maintaining a peg that favors Chinese exports to the U.S. Certainly, China is running a very large trade surplus with the U.S. But, interestingly, China's trade balance with the rest of the world is close to neutral. The yuan peg to the dollar should result in Chinese trade advantages with other nations besides the U.S., but that is not what the data show.

In any event, if the U.S. wants to increase the rate of GDP growth, it must find ways to reduce the balance of trade deficit. Prospects of that occurring any time soon don't appear to exist in spite of President Obama's exhortations to the contrary.

5. Summary

The purpose of going through this litany of the components of GDP is to make it clear that there are very few opportunities to accelerate real GDP growth. Trade is negative, government is close to neutral and the impact of investment is limited by its overall size and the acute oversupply of residential and nonresidential structures. Thus, the only available engines for real GDP growth acceleration in the next few quarters are consumer spending and business equipment investment.

Consumer spending will be sustained by government transfer payments and tax reductions, but long-term growth acceleration will have to come from increasing employment and increasing income. It might also come from a reduced consumer saving rate, but I am doubtful about this because the searing experience of the Great Recession and continuing high unemployment and underemployment probably has embedded a sense of frugality which is not likely to moderate for a long time to come.

III. Near-Term U.S. Macro Economic Outlook

The near-term economic outlook looks a little better. The Obama-Republican tax deal eliminates a major risk factor and will provide consumers and businesses with a much greater degree of certainty. The stock market continues to perform well. Profits of larger business are strong. However, the labor market is still struggling, housing is extremely depressed and small businesses are not faring nearly as well as larger ones. Thus, the story of the outlook is one of diminishing risks and fitful improvements in a handful of sectors. Overall, GDP growth should reaccelerate from the recent slower rate, but enormous excess capacity in the economy is likely to persist for several years.

Details follow for GDP growth, employment, consumer spending, housing, business activity and inflation/monetary policy.

1. GDP

The "second estimate" of third quarter GDP growth was 2.5% versus the "advance estimate" of 2.0%. Consumer spending accounted for 2.0% (annualized quarterly rate of growth was 2.8%) versus the advance estimate of 1.8%. This was the strongest consumer spending quarter since the fourth quarter of 2006. Inventory accumulation added 1.3% versus the "advance estimate" of 1.4%. The other major change from the advance estimate was that net exports subtracted a smaller 1.8% versus the initial estimate of 2.0%. An increase in government expenditures accounted for most of the remaining difference.

	Advance Estimate	Second Estimate	Difference
Personal Consumption	1.79%	1.97%	.18%
Private Investment			
Nonresidential	.91%	.96%	.05%
Residential	-.80%	-.75%	.05%
Inventories	1.44%	1.30%	-.14%
Net Exports	-2.01%	-1.76%	.25%
Government	.68%	.81%	.13%
Total	**2.01%**	**2.53%**	**.52%**

Although inventory accumulation is unlikely to contribute much to GDP growth in the fourth quarter and the contribution of fiscal stimulus has turned negative, the recovery in consumer spending is encouraging and seems likely to be sustained.

Table 1 shows Bank of American's (B of A) and Goldman Sach's (GS)

Table 1: GDP – Effects of Fiscal Stimulus & Inventories

- *Fiscal Stimulus (Federal + State & Local) turned negative in 2010 Q3 and Averages -0.8% to -1.3% of GDP in 2011*

	Bank of America					Goldman Sachs				
Quarter	Actual/ Fcst	Stimu- lus	Net	Inven -tory	Net	Actual/ Fcst	Stimu- lus	Net	Inven- tory	Net
2009Q1	-4.9%	-0.6%	-4.3%	-1.1%	-3.2%	-4.9%	-0.6%	-4.3%	-1.1%	-3.2%
Q2	-0.7%	1.1%	-1.8%	-1.0%	-0.8%	-0.7%	1.1%	-1.8%	-1.0%	-0.8%
Q3	1.6%	1.4%	-0.2%	1.1%	-1.3%	1.6%	1.4%	-0.2%	1.1%	-1.3%
Q4	5.0%	1.2%	3.8%	2.8%	1.0%	5.0%	1.2%	3.8%	2.8%	1.0%
2010 Q1	3.7%	1.6%	2.1%	2.6%	-0.5%	3.7%	1.6%	2.1%	2.6%	-0.5%
Q2	1.7%	0.2%	1.5%	0.8%	0.7%	1.7%	0.2%	1.5%	0.8%	0.7%
Q3	2.5%	-0.7%	3.2%	1.3%	1.9%	2.5%	-0.7%	3.2%	1.3%	1.9%
Q4	2.5%	-1.2%	3.7%	-0.1%	3.8%	2.5%	-1.2%	3.7%	-0.0%	3.7%
2011Q1	2.0%	-1.5%	3.5%	-0.1%	3.6%	2.5%	-1.5%	4.0%	0.2%	3.8%
Q2	2.2%	-2.0%	4.2%	0.1%	4.1%	3.0%	-2.0%	5.0%	0.1%	4.9%
Q3	2.4%	-1.9%	4.3%	0.1%	4.2%	3.0%	-1.9%	4.9%	0.6%	4.3%
Q4	2.7%	-2.0%	4.7%	0.0%	4.7%	3.5%	-2.0%	5.5%	0.3%	5.2%

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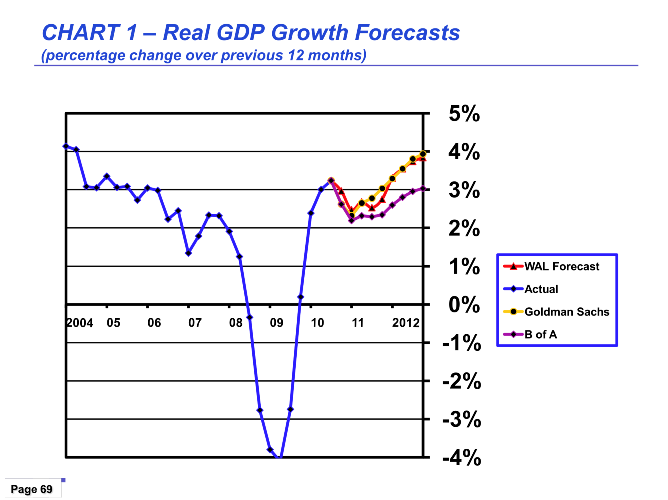
GDP forecasts quarterly for 2010 and 2011 and nets out the impacts of government fiscal stimulus and inventory accumulation. The title of **Table 1** asserts that fiscal stimulus will subtract 0.8% to 1.3% from GDP growth in 2011. This includes an estimated benefit of 0.5% to 1.0% from the Obama-Republican tax deal. Originally, GS expected the fiscal drag in 2011 would average 1.8% of GDP and the details in the table still reflect that assumption. GS and B of A will probably revise upward their estimates of headline GDP growth and downsize the amount of fiscal drag in 2011. When these adjustments are made the net GDP real rate of growth in 2011 after adjusting out the effects of fiscal stimulus and inventory accumulation will be well above trend. However, because of the way in which GDP growth numbers are compiled, less fiscal drag in 2011 will probably result in greater fiscal drag in 2012. So, it will be very important for the handoff to the private sector to take place and "get legs" so that we do not experience yet another growth slowdown in 2012.

Reflecting the revival in consumer spending but prior to the announcement of the Obama-Republican tax deal, both B of A and GS had increased their estimates of GDP growth over the next several quarters. These estimates will be revised higher soon to incorporate the anticipated effects of the recently announced federal tax program.

Importantly, after netting out the transitory effects of government stimulus spending and changes in inventories, adjusted GDP is positive and rises over time to a level sufficient to begin reducing excess capacity in the economy. In other words, both forecasters expect the private sector recovery to proceed; however, the extent of the improvement will be obscured somewhat by the top line published GDP number for several more quarters because it will include the negative drag from shrinking government stimulus, but that impact will now be less than previously anticipated.

Chart 1 shows my GDP growth forecast, as well as the GS and B of

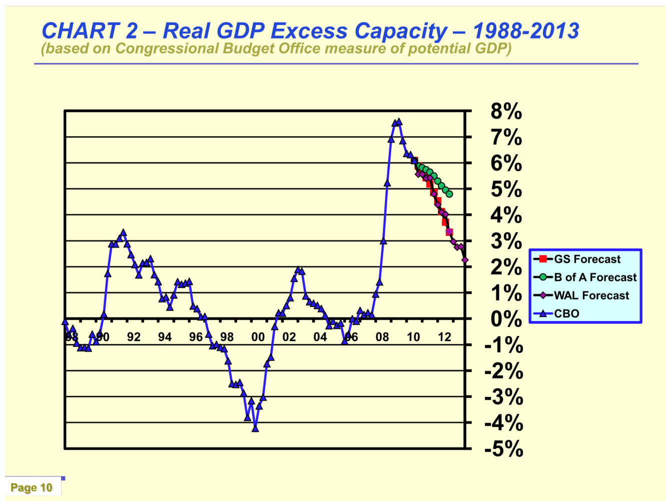


A forecasts. The revised GS forecast and my scenario reflect a slowdown in growth in 2011 and then an acceleration in growth during 2012 to nearly 4%. While my forecast includes an estimate of the proposed new federal fiscal program, the GS and B of A forecasts do not and are likely to be revised higher. When those revisions occur it is likely that my forecast will be slightly less optimistic than GS's.

The Federal Reserve revised its forecast at the November FOMC meeting. While the Fed reduced its optimistic GDP growth forecast once again, it still remains at the high end of forecast range. The Fed expects real GDP growth to be between 3.0% and 3.6% in 2011 (WAL 2.6%; GS 2.4%; B of A

2.3%) and 3.6% and 4.5% in 2012 (WAL 3.6%; GS 3.6%; B of A 2.8%).

Chart 2 shows how the GDP output gap has fluctuated since 1988 and



includes a three-year forward forecast. The Congressional Budget Office (CBO) estimates and publishes quarterly data for potential full-employment GDP. The CBO data series begins with the first quarter of 1949 and is projected through the fourth quarter of 2020. The oscillations in the output gap over time tell an important story.

Potential growth in real GDP depends primarily upon labor force growth and labor productivity, although the CBO considers an array of other factors in computing its estimates of potential GDP. I estimate that potential GDP growth is approximately 2.7% annually, while CBO estimates that is should be about 2.4% annually over the next four years.

The story that **Chart 2** tells is that there is substantial excess capacity in the economy and it is much greater than what occurred after the recession of the early 1990's. Based on CBO's estimate of potential GDP and the second estimate of third quarter 2010 GDP, the level of excess capacity was 6.1%.

The real story, however, is that it will take a long time to reduce excess capacity. By the end of 2012 excess capacity falls from 6.1% to 4.8% based on B of A's GDP forecast and CBO's estimate of full employment potential

GDP. If GS's GDP forecast is substituted for B of A's, excess capacity declines from 6.1% to 3.3% by the end of 2012. Excess capacity declines to 3.4% by the end of 2012 based on my forecast and to 2.3% by the end of 2013. Although probably pretty meaningless because the dependability of forecasts declines over longer forecast periods, my GDP growth forecast still indicates a GDP gap of 1.5% (employment gap is similar at 1.3%) by the end of 2015.

The reason that excess capacity is important is that it signals that supply exceeds demand and generally when that is the case downward pressure exists on prices in the form of disinflation, that is, a declining rate of inflation. When the actual level of inflation is low, as it is currently, substantial and sustained excess capacity could lead to an outright decline in the general level of prices — deflation.

2. Employment

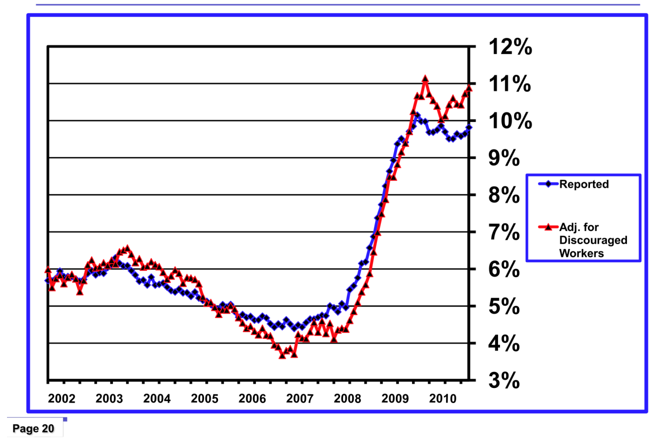
The November employment report was very disappointing. The market expected payrolls to increase 150,000 compared to the reported increase of only 39,000. Private payrolls increased 65,000. The unemployment rate rose to 9.8% and has now risen 0.3% since July.

Over the first eleven months of 2010 total payroll employment has grown an average of 86,455 per month. About 100,000 to 115,000 people enter the labor force each month. Thus, it is not surprising that the unemployment rate is edging up and it would be even worse were it not for the exit of discouraged workers from the labor force. As it is, the unemployment rate has risen from 9.69% in January to 9.82% in November.

Adjusting the unemployment rate to include discouraged workers paints a bleaker picture. This adjustment can be calculated by determining what the labor force participation rate would be in a normal situation. Because of the demographic changes that are occurring in the age distribution of workers as time passes, the labor force participation rate is currently declining very gradually. I calculate that the participation rate has declined from 65.68% at the beginning of the Great Recession in December 2007 to 65.20% in November 2010. However, the actual participation rate in November 2010 was 64.52%. The difference amounts to 1.6 million workers who really should be counted as unemployed. It seems likely that when labor markets improve these discouraged workers will attempt to reenter the labor force. Adjusting for discouraged workers, the unemployment rate would have been 10.9%, not the actual reported rate of 9.8% in November.

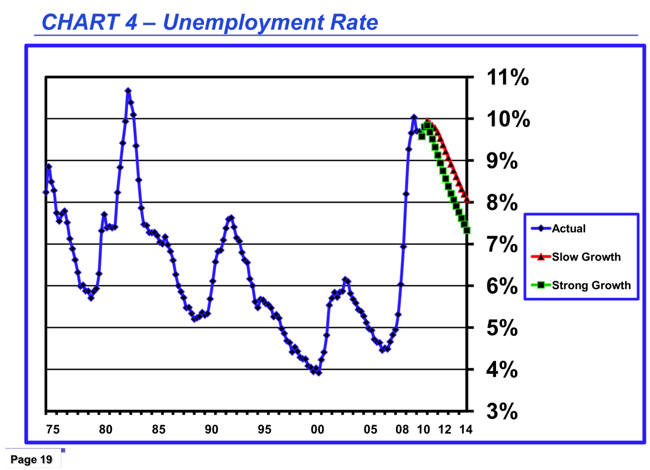
As can be seen in **Chart 3**, the adjusted unemployment rate that in-

CHART 3 – Reported Unemployment Rate & Adjusted for Discouraged Workers



cludes discouraged workers peaked at 11.1% in December 2009. It then improved to 10.0% in April 2010, which was coincident with the surge in optimism that labor markets were turning around. However, since April the adjusted unemployment rate has deteriorated to 10.9%, while the official unemployment rate has improved marginally from 9.86% to 9.82%. You can also see a pattern in **Chart 3** where the adjusted unemployment rate is higher than the reported rates during and just following a recession. The relationship reverses when reported unemployment is low, which implies that during times when jobs are easier to get, some individuals who would not normally seek employment enter the labor force.

Although the November employment report was very disappointing, it affirmed that the severe deterioration in the labor market has ended. That is the good news. The bad news is that rapid recovery is unlikely and unemployment will remain at an extremely high level for a long time to come. And, because discouraged workers will gradually reenter the labor force as the economy recovers, it is likely that the unemployment rate will fall gradually as shown in **Chart 4**.



Once again the Federal Reserve's unemployment rate forecast is on the optimistic end of the forecast spectrum. The Fed expects unemployment to fall to between 8.9% and 9.1% by the end of 2011(WAL 9.3% to 9.8%; GS 9.3%; B of A 9.7%), to 7.7% to 8.2% by the end of 2012 (WAL 8.6% to 9.2%; GS 8.5%; B of A 9.3%), and to 6.9% to 7.4% (WAL 7.9% to 8.6%) by the end of 2013.

3. Consumers

Consumer spending accounts for approximately 70% of GDP, so it bears close scrutiny. Consumer spending depends on earned income, investment income, government transfer payments, pensions and an ability to monetize wealth. At an economy wide level, aggregate consumer spending also depends upon the number of employed workers, average hours worked and the average hourly wage rate.

In normal times growth in real consumer spending is fairly stable, averaging about 3.03% annually over the last 26 years. This is derived from a 0.9% annual rate of increase in the labor force and a 2.0% gain in real incomes due to productivity growth. The difference is due to a steady decline, until recently, in the saving rate.

Real disposable income growth has averaged 2.84% annually over the last 26 years. Spending growth has exceeded income growth because consumers through much of the last 26 years were able to tap wealth through access to credit. A steady decline in the consumer saving rate during most of the last 26 years was a direct result of a spending growth rate that exceeded the disposable income growth rate.

Since the onset of the Great Recession in December 2007, this has all changed. Real disposable income, in spite of a significant increase in government transfer payments, has grown only 1.14% annually. Real consumer spending has actually declined at a -0.16% annual rate over the same period as consumers have retrenched and paid down debt and increased savings. The saving rate has increased from 2.1% in 2007 to 5.8% in 2010.

Over the first ten months of 2010 real disposable income growth has accelerated to a 2.14% annual rate while real spending growth has been 2.30%. The somewhat higher spending growth rate relative to income growth has resulted from a modest decline in the saving rate from 5.9% in 2009 to 5.8% in 2010. Unless the savings rate decreases further, gains in real consumer spending will track gains in real disposable income very closely going forward.

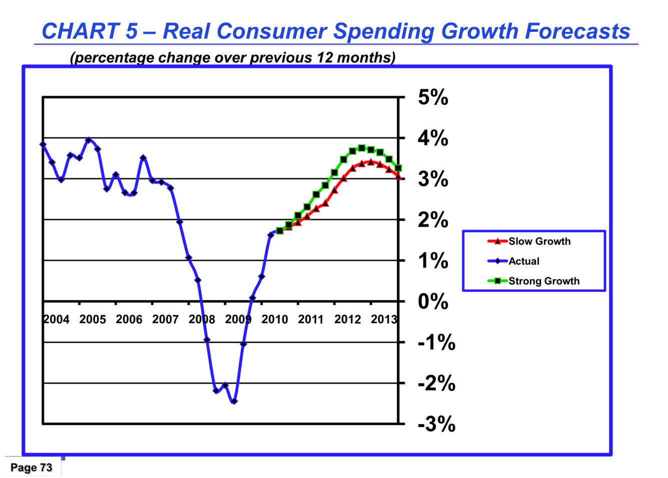
Pessimists point out that the consumer debt ratio is still extremely high and that de-leveraging will depress growth in consumer spending. The household debt to disposable income ratio has fallen from a peak of 130.2% in the third quarter of 2007 just before the onset of the Great Recession to 118.6% in the second quarter of 2010 compared to the pre-1980's level of about 65%. The nominal amount of consumer debt over this period has fallen 1.23% while nominal disposable income has risen 8.41%. What this points out is that the consumer debt ratio can continue to fall as long as debt rises less rapidly than income. This is called "growing out of the problem".

And, here is the important point — the saving rate does not need to increase further to reduce the consumer debt ratio. To see why this is so a little numerical example will help. Suppose nominal income increases 3% (this is very low by historical experience but is what has occurred over the last year in a high unemployment and low inflation environment). Suppose further that the saving rate remains unchanged at 5.8% so that nominal income and nominal spending increase by exactly the same percentage. Finally, assume that the average interest rate on the nominal stock of consumer debt is 5%.

Running the numbers, the nominal amount of debt remains relatively constant, as savings approximately offsets interest expense, but nominal income increases. The result is that the consumer debt ratio falls over the next year from 118.5% to 115.0%. Even this decline is probably understated because interest expense on nonmortgage debt is deducted from the estimate of savings in the national income accounts (mortgage interest is not deducted), which results in a degree of double counting. Adjusting for this would lead to a further decline in the consumer debt ratio to 113.2% in a year's time.

Again, the important point is as follows: Consumer debt de-leveraging can and will continue but this will not require any further increase in the saving rate. This, in turn, means that spending growth will probably closely track income growth in coming months. In fact, spending growth could exceed income growth slightly, courtesy of a somewhat reduced savings rate, but consumer de-leveraging would still occur, just at a slightly slower pace. Thus, the consumer balance sheet healing process will continue and that is a very good thing in the longer run. However, we have now moved into a phase of the cycle where balance sheet repair will be less of a headwind to growth in economic activity. Because of the importance of consumer spending to GDP growth, this is an important development and provides considerable support for a more optimistic outlook.

Chart 5 shows that consumer spending growth is not likely to converge

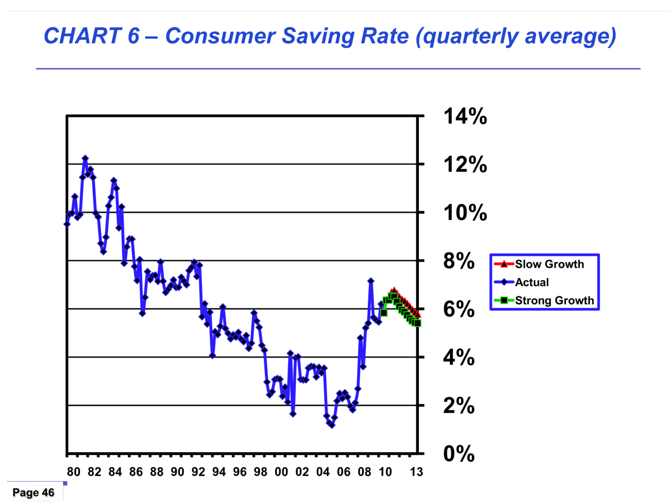


to the long-term norm of real income growth of about 2.85% until mid-2012.

The rise to a 3.5% growth rate in 2012 is predicated on the assumption of strong employment and income growth as the economy improves. By 2014 the spending growth rate slows to a long-term norm consistent with a stable saving rate in the range of 6% to 7%. If the savings rate stabilizes around the current level of 5.8%, the spending growth rate would be a little higher.

Over the longer run aggregate consumer spending will depend on the level of unemployment and that will depend in turn on the overall health of the economy.

Since employment growth is likely to occur slowly and wage growth will remain under pressure the odds strongly imply that spending growth will be relatively weak as consumers continue to reduce reliance on debt. The forecast of the saving rate in **Chart 6** indicates that the savings rate will



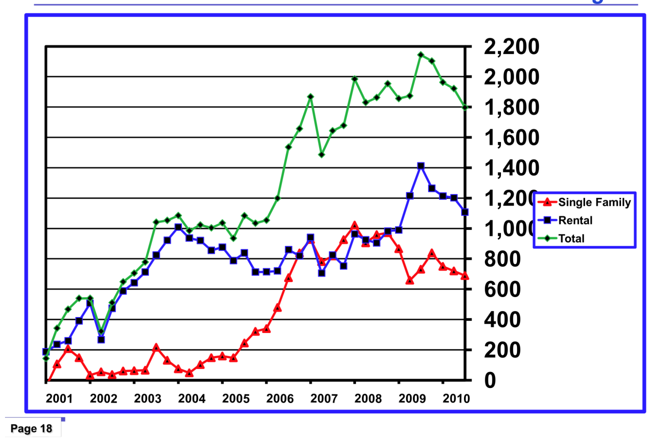
increase by about another percentage point over the next year and then gradually fall back to the recent level of 5.8% as unemployment declines.

Some believe the saving rate will move to a higher level of 7% to 9% that prevailed during the 1980's. Were that to occur, it would delay the recovery in consumer spending growth and extend the length of time required for the economy to return to full employment. Based on recent experience, this now seems unlikely and as explained above is not necessary to improving the quality of consumers' balance sheets over time. I would note in passing that Goldman Sach's believes the savings rate has peaked and expects that it will decline modestly. This accounts in part for GS's more optimistic outlook.

4. Housing Investment

In a typical business cycle, investment in housing construction is a driver of economic recovery. That is not the case this time. Overbuilding during the bubble years lead to far greater than normal inventories of vacant homes and apartment units. **Chart 7** shows that inventories, while declining slowly,

CHART 7 – Number of Units Above 1994-2000 Average

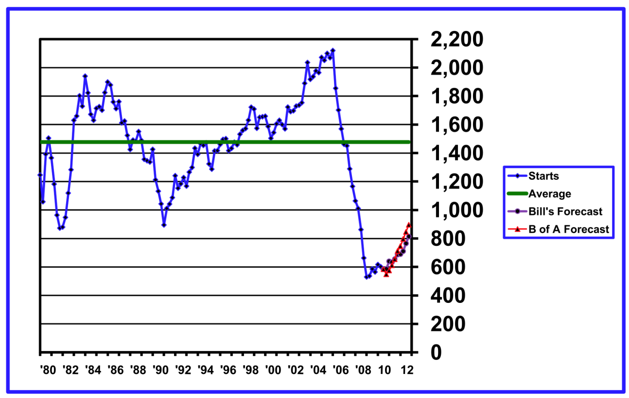


are still approximately 1.8 million units above normal levels.

New residential homes sold in October amounted to an annual rate of 283,000, the second lowest amount ever reported by the Census Bureau since it began keeping records in 1963. (The lowest amount was 275,000 units reported in August 2010.) New residential building starts were 519,000 in October — 436,000 single family homes and 83,000 multi-family rental units. See **Chart 8**.

The difference between single family starts and sales is huge and in the wrong direction. The data clearly show that the tax credit program boosted sales temporarily but also boosted construction temporarily. Now that the tax credit program has ended, both sales and construction have fallen back to very low levels. If the policy objective was to reduce inventory, this surely

CHART 8 – Housing Starts (quarterly average)



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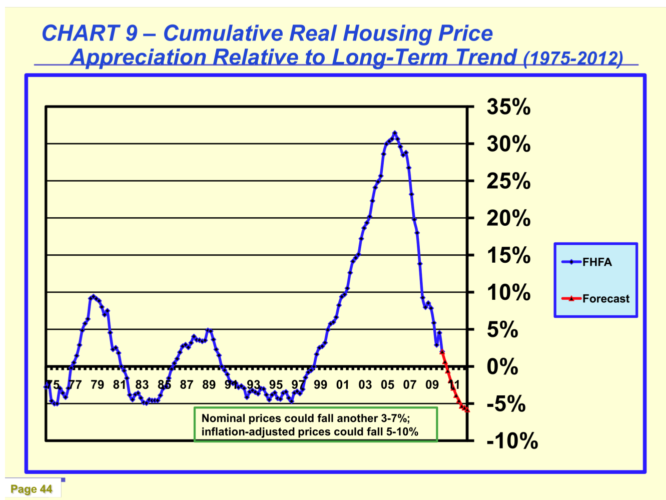
was not achieved as excess inventory of single family homes has been stuck in the 600,000 to 800,000 range for the last six quarters. Because of the significant inventory of excess vacant homes most now expect that housing construction and sales will remain weak for an extended period of time. Both a forecast I generate and one that Bank of America produces indicate that housing starts have probably hit bottom but will not rise appreciably until 2012. The data in **Charts 7** and **8** certainly support that conclusion.

With softness in the housing market continuing and the artificial prop of the tax credit program gone, a resumption of declines in home prices, which had stabilized or even increased a little, is underway. The Case-Shiller housing price index has now declined for three consecutive months. The decrease of 0.8% reported in November for the month of September exceeded expectations. Housing prices declined 2.0% in the third quarter, or at an annualized rate of approximately 8%.

While the Case-Shiller housing price index (HPI) covers the 20 largest urban markets, the Federal Housing Finance Agency (FHFA) HPI covers approximately 300 markets. While the geographic coverage is broader in the FHFA HPI, it includes only homes with mortgages guaranteed by Fannie Mae and Freddie Mac and thus omits many homes, particularly higher-priced homes. Nonetheless, the FHFA HPI declined a near similar 1.6% in the third quarter. Historically, while the Case-Shiller and FHFA HPI's have tracked each other reasonably well, the Case-Shiller HPI has been much more volatile. For example, nominal homes prices, according to the FHFA HPI have declined 14.0% (the inflation-adjusted decline has been 17.8%) since the index peaked in the second quarter of 2007. The Case-Shiller HPI peaked earlier in the second quarter of 2006 and nominal prices have declined 28.7% since then.

According to my analysis of the long-term trend in inflation-adjusted housing prices, prices are about where they should be currently (see **Chart 9**). Because interest rates are very low, however, measures of affordability



imply that prices are already at very attractive levels. Unfortunately, more stringent mortgage underwriting is an offsetting factor. However, the real problem with housing lies in excessive inventory and a feeble new household formation rate courtesy of the high rate of unemployment and underemployment. Or, simply put, supply greatly exceeds demand. And when this occurs, there will be ongoing downward pressure on prices. Goldman Sachs (GS) recently revised its forecast of housing prices to a decline of 5.0% over the next year versus its previous forecast of a 3.0% decline. While GS's forecast is tied to the Case-Shiller HPI, mine is tied to the FHFA HPI. I currently expect housing prices to decline 2.7% over the next year. However, having said that, I believe the balance of risks is tilted in the direction of a greater decline.

There are two negative consequences of falling housing prices that could interfere with or limit acceleration in economic growth. First, there will be no substantive increase in residential housing construction until excess inventory declines substantially and housing prices stabilize. Second, declining home prices mean that this component of consumer wealth will continue to shrink. This will continue to impact consumer confidence negatively and will continue to constrain spending based on accumulated wealth. Again, this simply confirms that reacceleration in consumer spending and growth in GDP will progress more slowly than in recoveries from previous recessions.

5. Business Activity

The Institute of Supply Management (ISM) manufacturing index has been one of the few consistent rays of sunshine from the private sector. Although this index peaked at 60.4 in April, it has remained quite strong and came in at 56.6 in November. The ISM nonmanufacturing index strengthened to 55.0 in November from 54.3 in October.

Strength in manufacturing over the last year has had two drivers. I have already mentioned the first which is inventory restocking, which was the inevitable result of cutbacks in production that greatly exceeded declines in demand during the free-fall days in late 2008 and early 2009. It was inevitable that as demand recovered depleted inventories would have to be restored. But that process is nearly over.

The second driver of manufacturing strength has been exports. China's aggressive infrastructure investment has been an important contributor as has a significant revival in international trade, which is analogous to the domestic inventory cycle. But, China's rate of growth is slowing a bit and is likely to slow further as China tightens monetary policy in response to an overheating economy and emerging internal inflationary pressures.

A business activity measure compiled by Goldman Sachs has also continued hold up well after softness during the summer following a very strong spring.

All-in-all, these data points and analysis indicate that growth in business activity is likely to decelerate some in coming months but an outright decline seems like a low probability event at the moment.

6. Inflation

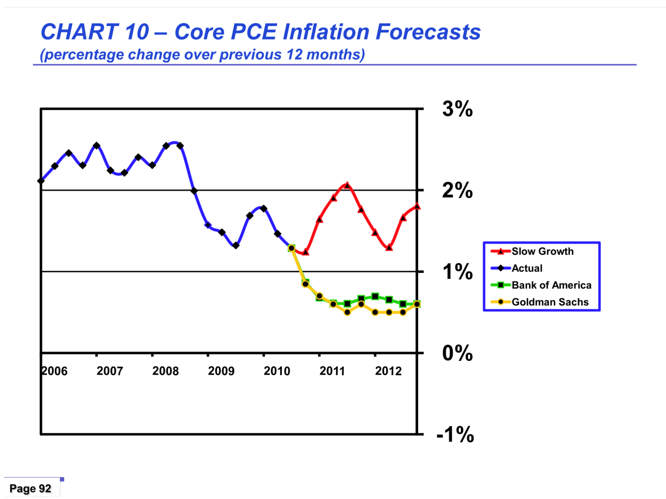
Inflation is not a threat now and will not be for some time to come. But, every time a new stimulus program is announced, whether it was quantitative easing or the recent Obama-Republican tax deal, the initial market reaction is that inflation risks have increased. This is reflected in rising interest rates. In the immediate aftermath of the Federal Open Market Committee's announcement to purchase $600 billion in U.S. Treasury securities over the next several months, the 10-year Treasury note rate rose from 2.53% on November 4, 2010 to 2.95% on December 6, 2010, the day before President Obama announced his tax deal with the Republican leadership. In the two days following that announcement the 10-year Treasury note rate skyrocketed to 3.26%. Importantly, the 2-year Treasury rate, which rose slightly from 0.33% to 0.42% following the quantitative easing announcement increased sharply to 0.63% in the aftermath of President Obama's announcement. At least for the moment, the market is sensing that the tax deal will become law, will accelerate economic recovery and will increase the threat of inflation.

Nonetheless, the greater near-term risk is that of deflation, not inflation. There is no doubt that that fear prompted the FOMC's quantitative easing program. Also, President Obama has been very explicit that further fiscal stimulus is necessary to avert the possibility of the economy falling back into recession. Were that to happen, there is little doubt that Barack Obama would end up being a one-term president. That might still occur, but the tax deal lessens the probability of that outcome by increasing the odds that the economy strengthens in coming months.

The potential consequences of deflation were examined in detail in the ***August 2010 Longbrake Letter***. Those consequences, were deflation to take hold, would be severe, so there is little surprise that policymakers are pulling out all the stops. While policy intervention is likely to avoid the entrenchment of deflation, it is less clear to me that the market's anxieties about rising inflation are merited. Thus, my sense is that the market is going through another one of its periodic knee-jerk reactions, which momentum will carry further for a time, but that in due course falling measured inflation and the slow pace and acceleration in economic growth will reassert themselves as the main story and inflation anxieties will subside.

Based on the unusually high output gap, I expect core measures of inflation, which exclude food and energy prices, to continue edging down over the next two years. Although core inflation could dip below zero for a few months, I do not expect sustained deflation to establish itself. I am increasingly confident in that view because of the Fed's decision to engage in a new program of quantitative easing and because of the breadth of the Obama-Republican tax deal. Nonetheless, the size of the output gap and the slowness of economic recovery will place ongoing downward pressure on prices and with core measures of inflation already below 1% — the core CPI was 0.6% and the core CPE index was 0.9% in October — there is not much downside buffer in place before inflation turns into deflation.

Chart 10 shows various forecasts for price inflation in core personal



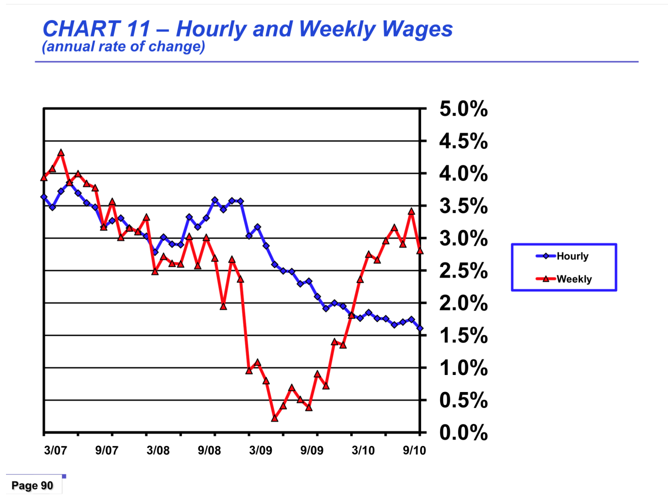
consumption expenditures (PCE). The core PCE measure excludes volatile food and energy prices. Both the Goldman Sachs and Bank of America forecasts project declining inflation over the next 18 months to close to zero but not below. Interestingly, my own model projects that core PCE will remain above 1% over the next two years. Obviously, with core PCE inflation already below 1% and substantial slack still present, I do not have much confidence in my model's forecast. However, my model does imply that there is likely to be downside stickiness to further price adjustments.

The consensus inflation forecast, which I believe will be scaled down over time, anticipates both total and core inflation will edge up from recent low levels and be in a range of about 1.5% to 2.0% over the next two to three years. The Federal Reserve's inflation forecast is also optimistic in the sense that inflation edges up and remains well above deflation territory. The Fed's forecast for total PCE inflation is 1.1% to 1.7% in 2011; 1.1% to 1.8% in 2012 and 1.2% to 2.0% in 2013. Its forecast for core PCE is similar but slightly lower: 0.9% to 1.6% in 2011; 1.0% to 1.6% in 2012 and 1.1% to 2.0% in 2013.

If the Fed were truly confident about its own inflation forecasts, there arguably would not have been need to initiate a quantitative easing program to purchase $600 billion in Treasury securities. Chairman Bernanke has been emphatic about the importance and correctness of the Fed's quantitative easing policy in the face of enormous criticism. Importantly, he has left the door open for additional purchases beyond the $600 billion should economic growth continue to languish below the full-employment potential trend level. In other words, Bernanke is determined to bring unemployment down by pushing real GDP growth above the long-term trend full-employment potential rate. It is clear to me that the Fed will complete the entire $600 billion in purchases. What is less clear is whether there will be additional purchases. The intense criticism leveled at the policy reduces that prospect as does the announcement of a broad-based fiscal stimulus program. But, if the economy does not gain momentum, Bernanke has been about as clear as he can be without saying so in direct pointed language that the amount of purchases will be increased beyond $600 billion.

When prospects for inflation are analyzed it is customary to focus on the size of the gap between aggregate demand and aggregate supply. That gap is extremely high currently and is significantly disinflationary. The core PCE inflation rate peaked at 2.6% in July 2008 eight months after the onset of the Great Recession. The core rate has declined steadily since then reaching 0.9% in October 2010 and is forecast by Goldman Sachs and Bank of America to fall to about 0.5% during 2011 and hold at that low level through 2012.

There is another measure that is a good precursor of trends in inflation. That measure is the change in the hourly average employee wage rate (see **Chart 11**). It is a measure of spending power of consumers. When that measure is declining as it is currently it not only affects consumer purchasing power it has a powerful impact on buying plans. Consumer expectations for further restraint in wage growth reinforce cautiousness and frugality in buying. This in turn leads to loss of pricing power and greater focus on



discounting and pricing specials.

Hourly wage growth peaked at 3.6% in February 2009 more than a year after the start of the Great Recession. Since then growth in wages has fallen precipitously to 1.6%. Since adjustment in wages lags increases in unemployment, some further shrinkage in wage growth seems probable and reinforces the likelihood of further disinflation in various measures of inflation.

IV. Key Issue Updates

1. President's Fiscal Commission

Because of political agendas the President's Fiscal Commission did not obtain the 14-4 super-majority required to bring the recommendations immediately to Congress for a vote. However, a majority of 11-7 endorsed far reaching recommendations to reform the tax code and reduce the federal deficit in the next few years to approximately 2% of GDP.

Last month I was hopeful that good policy would trump politics, but that was not to be. In the meantime, the lame-duck session of Congress is focused on extension of the Bush tax cuts, which have now morphed into a broader-based fiscal stimulus program. Although liberal Democrats are outraged, they have little choice politically but to acquiesce. President Obama has taken a pragmatic approach, as opposed to an ideological one, to serve the best interests of the American public in accelerating economic recovery as he puts it. But, assuming the economy does improve, it will improve his prospects for reelection in two years time. Not all Democrats are opposed to the tax deal. For example, the Third Way, which is a moderate business-sensitive Democratic think tank, issued a press release immediately supporting the president's program.

While the tax deal is critical in the near term to get the economy growing faster, to reduce unemployment more quickly and to avert the threat of deflation, it will exacerbate the longer-term threats of run-a-way federal deficits, exploding inflation rates and potential federal government insolvency. Thus, once the new Congress is seated, it will be absolutely imperative for the Administration and the Congress to engage in serious discussions about tax reform and move forward as quickly as possible to structuring and enacting into law far-reaching reforms. In my experience this will need to happen in 2011 because it will become much harder to deal with highly controversial public policy issues in the presidential election year of 2012. However, that said, the two-year extension of the Bush tax cuts will tend to delay resolution and could well push serious tax reform into 2012 and into an atmosphere that will be more highly charged with political advantage seeking.

The Fiscal Commission has served a useful purpose by framing well the extent of the problems and the options for reform that are available to address the problems. Thus, I have no doubt that tax reform will be a major topic for discussion. One can hope, and I have a lot of that these days, that President Obama will continue his leadership, just as he did in the deal to extend the Bush tax cuts. He can do that by laying out a specific set of recommendations in his January State of the Union address and follow that up quickly with draft legislation. This is more feasible now that the president has had the courage to challenge the ideology of the liberal wing of the Democratic Party. That is not to insinuate that the ideology of fair allocation of the tax burden is wrong. Rather, it is to make the point that the breadth and enormity of the deficit and tax structure problems transcend ideology and call for bipartisan solutions and compromises. Again, I have a lot of hope.

2. European Sovereign Debt and Financial System Troubles

Europe's currency and sovereign debt issues like small brush fires continue to break out but so far firefighters have been able to contain them. As each fire breaks out European nations rush to put it out before it spreads. So far this has been a successful strategy. But, it is eerily similar to the episodic financial crisis in the U.S. that began in February of 2007 with the failure of New Century, followed by periods of quiet and then yet another crisis, which seemingly was contained and resolved, only to be followed by another crisis a few weeks later. Ultimately, we know how this on again, off again crisis culminated in a spectacular conflagration during September and October 2008. In fact, the series of crises were not isolated events at all but were outbreaks of a much more virulent and pervasive disease that had poisoned the entire financial system. This pattern is repeating in Europe. The recent crisis involving Ireland may have been quelled for the moment, but the disease remains and there are more victims whose turn is coming. Ultimately, survival of the European Union in its current form is very much in question.

The latest episode involved Ireland which had guaranteed all bank debt at the height of the meltdown in global financial markets in 2008. This commitment has backfired badly as otherwise reasonably managed fiscal affairs have been trumped by guaranteed bank credit losses that have driven the government deficit to 32% of GDP. Interestingly, the Irish problem is not one of raising cash immediately but one of loss of confidence that signals that when the government needs cash in a few months it would not be available. That forced the Irish government to arrange a $113 billion financial support package from the European Union's (EU) Financial Stability Facility (EFSF) and the International Monetary Fund (IMF). As part of the package, Ireland must find $8 billion in savings in 2011 and $20 billion over the next three years designed to reduce the size of the government's deficit. Savings will involve cuts in social programs and raising the much-cherished low corporate tax rate. With this done the crisis passed, at least momentarily. If parliament does not approve the savings required by the EU and IMF, that failure would trigger a general election. At the moment none of Ireland's politicians, including opposition parties, appears enthusiastic about forcing a general election.

The EFSF loan to Ireland amounts to 17.7 billion euros. These funds will be raised through private bond offerings that are guaranteed by EFSF participants who are not recipients of loans. Ireland was a participant, but now that it is receiving a loan it is relieved of its financing commitment to the EFSF. What this means is that the EFSF's lending capacity declines not only by the amount of the loan but also by the amount of Ireland's 7 billion euro quota to support the EFSF. The total size of the EFSF originally was 440 billion euros, but discounting for overcollateralization to achieve an AAA rating on bonds, the available amount for lending is 360 billion euros. That amount is further reduced by 24.7 billion euros as a result of Ireland's bailout. If Greece, Portugal, Spain and Italy need loans, lending capacity would shrink to just 180.7 billion euros. This math is hardly confidence building which has led to some discussion about increasing the size of the EFSF. But that would fall almost entirely upon France and Germany and raises the very real question of whether, if came to this sorry turn of events, these two countries would be willing to step up to preserve the euro and the European Union.

While the spotlight was on Ireland there were whiffs of contagion in the air as bond rates rose in other countries perceived by investors to be vulnerable. Heading the list was Portugal, but Italy, Spain and even Belgium became targets.

There are two general problems driving the European sovereign debt crisis. First, there is the legacy of profligate government policies that have undermined a country's trade competitiveness. That is the Greek problem. Normally, a solution to this kind of problem is to restructure sovereign debt for some fraction of its face value and devalue the currency to restore trade competitiveness. Both solutions are unavailable within the European Union. First, it is impossible to devalue a currency when that currency is shared with other countries. Second, restructuring sovereign debt would have contagion effects that would negatively impact other European countries and could even foster an implosion in the European financial system.

A second general problem was run-a-way speculation in housing financed by bank lending. Now that the bubble has burst, prices are plummeting and bad debts are piling up in the banks. This is Ireland's problem. Ireland chose to socialize those loses by transferring bank debt to the public balance sheet. Not to do so would involve failure of many banks and could trigger significant contagion and broader consequences.

Spain is a much bigger economy, more than twice the size of Greece, Ireland and Portugal combined. Spain's problems are considerable and entail both lack of trade competitiveness and excessive speculation in housing. While housing prices soared to unimaginable levels during the bubble they have not yet fallen very much. I am not particularly knowledgeable about why housing prices remain high in Spain in the face of substantial overbuilding and a huge excess supply of homes. But, it could be as simple as not forcing builders/investors to sell inventory at what the market will pay and permitting inventory to be carried at book value through evergreen loans. Thus, there are substantial embedded, but unrecognized losses in Spain's caja's. Most of these institutions passed the stress tests conducted last July, but one has to wonder exactly what kind of accounting and valuation rules were applied.

In any event, it looks like it will only be a matter of time before Spain is in the cross-hairs of crisis. If and when a Spanish crisis erupts, its outcome will depend upon whether the stronger European countries, particularly Germany, are willing to step up and bail out the weaker countries to preserve the euro. As one pundit quipped — Spain is too big to fail, but it is also too big to save. Authorities assert that if it comes to a threat of failure, a way will be found to save it. But one has to wonder whether German politics will permit it to shoulder the financial difficulties of the weaker European countries and a deeply flawed financial system. In other words, would German politics enable Germany's leadership to do what Ireland's leadership did in guaranteeing all bank debt. And, we now know that the Irish decision was probably not a sound one and has had significant political consequences. Recent utterances by Angela Merkel have been ambiguous and can be interpreted that German should not be counted automatically to step up to save the euro, if worst comes to worst.

3. China and the U.S. Dollar

When global trade crashed by 30% practically overnight after the failure of Lehman Brothers in September 2008, Chinese officials moved expeditiously to put into place a massive stimulus program that focused on internal infrastructure investment and development. This policy required massive amounts of raw materials and was a major factor in the rapid recovery in global trade and more generally in global economic recovery, particularly in emerging economies.

Chinese officials must create at least 25 million jobs annually to accommodate the massive migration of labor that is moving from rural to urban areas. In the short run the easiest way to accomplish this is through exporting goods to other countries and investing in infrastructure, plant and equipment internally. A cheap renminbi relative to the dollar has been a key policy tool to assuring the global competitiveness of Chinese exports.

However, by linking the renminbi to the dollar the Chinese become hostage to U.S. monetary policy. Because of the depth of the recession in the U.S. and the great difficulty policymakers have had in getting a sustainable self-reinforcing recovery underway, the Federal Reserve has felt it necessary to pursue an aggressively easy monetary policy, including the recent quantitative easing program to buy $600 billion in U.S. Treasury securities. This action will flood the U.S., and global, economies with additional liquidity. In the U.S. a good deal will go into financial assets, which is what the Fed wants to happen. But some of it will find its way abroad through a cheaper dollar, provided that impacted foreign countries respond to the cheaper dollar by pursuing their own easy monetary policies.

In the case of China, the transmittal of the U.S. easy monetary policy is direct, rather than indirect, because of the renminbi-dollar peg. The Chinese money supply automatically grows as China buys dollars to maintain the peg. In this case the monetarist caution that too much money chasing too few goods will result in inflation is all too true in China. Inflation is on the rise in China as its economy overheats from an excess in demand over supply and these pressures are rising rapidly. Financial property speculation is already at a fever pitch. These facts led Chinese officials to announce they will tighten Chinese monetary policy in 2011. An obvious way to tighten monetary policy would be to let the renminbi appreciate in value but this would decrease exports. Alternatively, China can raise interest rates or impose various capital and lending controls.

It will be important to watch what Chinese policymakers do because whatever policies they decide to adopt will have consequential impacts on the U.S. and other countries.

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