U.S. Macro Outlook 2010: A Year of Recovery

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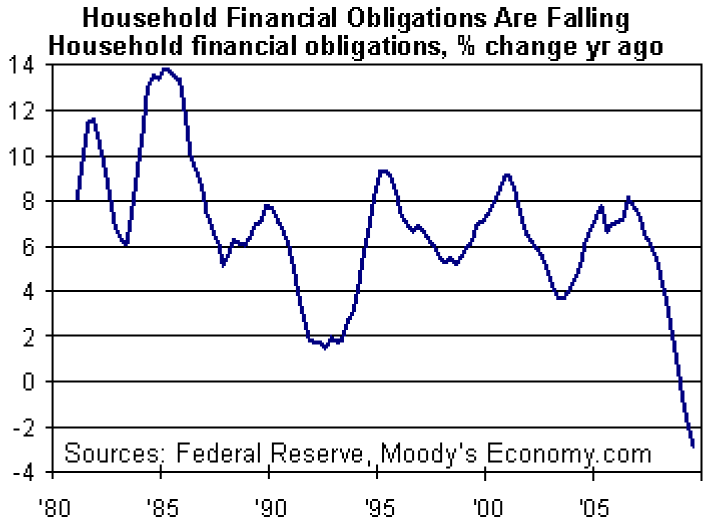
- The recovery has taken on a brighter hue because of encouraging jobs data.
- Fewer workers are being laid off, but for the recovery to gain traction, firms must soon resume hiring.
- Policymakers are taking steps to fend off threats to the recovery—the fragile job market, rising foreclosures, and the credit crunch.
- With the financial system still impaired, the Federal Reserve will not soon end its extraordinary measures.
- Despite enormous problems, prospects are good that the next decade will be better than this one.

The economy is slowly but steadily recovering. Real GDP is on track to have grown by a respectable rate of more than 3% during the second half of this year, and the job market is finally stabilizing after two years of massive losses.

The recent employment data are especially encouraging. Job losses are abating, and leading indicators have turned up, including more temp jobs and hours worked. The better data have not changed the outlook—job growth is expected to resume by early 2010 and be strong enough by this time next year to bring down unemployment—but it does raise confidence in this outlook.

Perhaps because of the more stable job market, the key Christmas shopping season seems a bit brighter. Consumers do appear more relaxed, particularly compared with last Christmas. The saving rate, which had soared last year, has stabilized. Higher-income households in particular are buying again, not with gusto, but with some strength as the run-up in stock prices rebuilds their nest eggs. Household net worth has increased by some $5 trillion since its nadir a year ago, and household financial obligations are falling for the first time in the 30 years for which data are available.



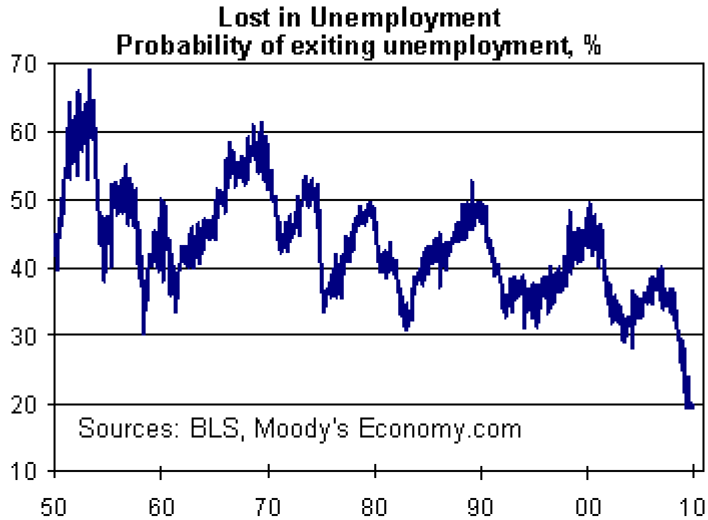
It is also helping matters that policymakers seem willing to aggressively combat the serious threats to the recovery. Fiscal policymakers are likely to enact even more temporary tax cuts and spending increases to support the job market, and the administration is continually adjusting its mortgage modification program in an attempt to make it more effective at forestalling foreclosures. The Federal Reserve has signaled it is unlikely to raise interest rates until unemployment has definitively moved lower, and it is pursuing various efforts to jump-start credit markets.

The economy will not come roaring back in the coming months, but odds are that by the end of 2010, the tentative and fragile recovery will have evolved into a self-sustaining economic expansion.

Job creation

How quickly and gracefully the economy makes this transition depends on whether businesses soon resume hiring. Declining initial claims for unemployment benefits suggest firms are curtailing layoffs—thus the improved jobs numbers. Yet, judging by the stubbornly high number of people receiving continuing, extended and emergency unemployment benefits, hiring is at a standstill.

For those who lose their jobs, this means it is extraordinarily difficult to land a new one. The probability of an unemployed worker finding a job in a given month has plunged to less than 20%. During the worst of the 2001 recession, the probability was close to one-third. During the downturns of the 1950s, it was nearer to one-half.



Recognizing the economic and political threat that statistics like these pose, the administration and Congress are working on a jobs package that could include more benefits for those who will lose their jobs in 2010, more aid to hard-pressed state and local governments, increased funding for the Small Business Administration, a job tax credit for small businesses, and some additional spending on infrastructure and weatherization projects.

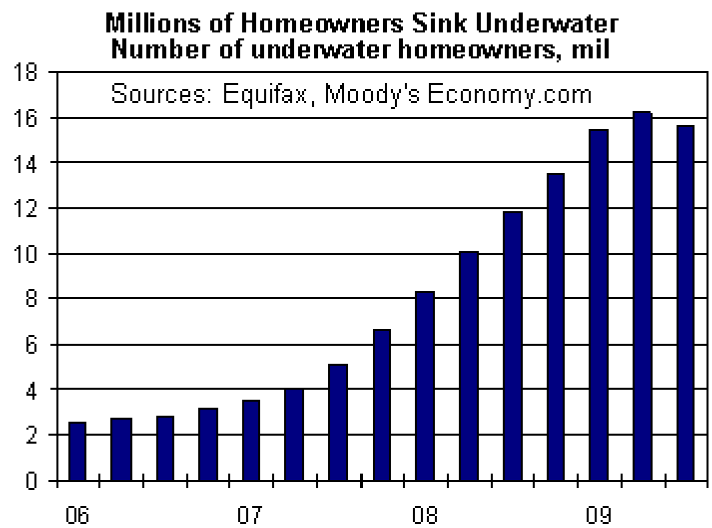
How big a package ultimately is passed depends on the job numbers in the next few months; better numbers will result in a smaller package. It is assumed that a package costing about $100 billion in 2010 and $50 billion in 2011 will become law, on top of the almost $50 billion to extend the homebuyer tax credit and various other expiring stimulus provisions that passed a few weeks ago.

Initial claims will provide a good benchmark for whether the job market is sticking to script. Claims peaked early in the year at nearly 650,000 per week. They are now running closer to 475,000. They need to fall back to 400,000 per week to signal that losses are abating and unemployment is stabilizing. Claims of 350,000 would be consistent with enough job growth to meaningfully reduce unemployment.

Foreclosure crisis

The foreclosure crisis is also weighing on the recovery. Double-digit unemployment, combined with an estimated 15.6 million underwater homeowners—one in five homeowners—is pushing sky-high mortgage defaults and serious delinquencies even higher.

With close to 10 million homeowners more than 20% underwater, strategic defaults are also on the rise. Strategic defaulters have the financial resources to make their mortgage payments but have concluded that they have little prospect of actually owning their homes and that they could probably rent a similar home for less than their mortgage payment.



House prices stabilized this past summer, but this will prove fleeting. The first-time homebuyer tax credit, the Federal Reserve's successful credit-easing efforts to get fixed mortgage rates down below 5%, and mortgage servicers' slow implementation of the administration's loan modification plan, known as HAMP, have all helped firm house prices. The tax credit has been expanded and extended into next year, but the Fed has made it clear it will end its credit-easing by March, and mortgage servicers are likely to begin foreclosing on homes as they conclude it does not make sense to put many homeowners into HAMP. Foreclosure sales to third parties and short sales are expected to increase next spring and summer, depressing house prices again.

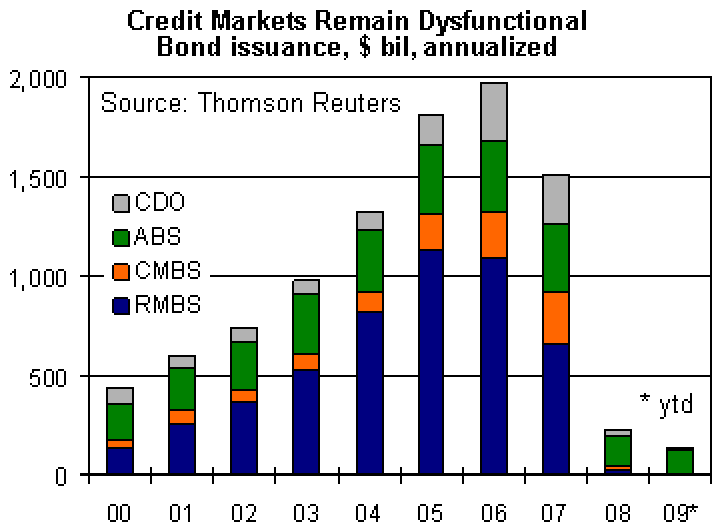
The economy does not work well when house prices are declining. The home is still the most important asset on most household balance sheets, and banks and other creditors will remain reluctant to extend loans to consumers and small-business owners as long as they do not know what their homes are worth.

The administration continues to adjust HAMP to make it work more effectively. Most recently, policymakers have focused on increasing the number of temporary modifications that become permanent—all modifications are temporary for at least three months to ensure that the homeowner is committed to remaining current on the new loan. If this effort falls short, which is entirely possible given the serious impediments to the program, and falling house prices early next year seem to be undermining the recovery, then the most effective adjustment would be to add incentives to reduce mortgage principal.

It is assumed that policymakers will do just enough to limit house price declines next year to no more than an additional 10% as measured by the Fiserv Case-Shiller Home Price Index. Price declines should be most severe in the next few months and abate by next fall. Anything worse than that, and the economic recovery could falter.

Credit crunch

Although the financial system is stable, it is far from normal. Hundreds of small banks are failing or are on the brink, and the structured finance market—the market for securitized mortgages, credit cards, small-businesses loans, and other consumer credit—remains largely dormant. Small banks are particularly important to small businesses in small communities, and without a functioning structured finance market, banks lack the capital and the will to originate more loans. Credit is the mother's milk of economic activity; unless credit flows more freely, the recovery will not gain traction.



Most notable is the plunge in credit card lending. The number of bank credit cards has plummeted from a peak of 425 million in the summer of 2008 to 335 million this November, and card credit lines are shrinking. The number of cards in circulation hasn't been this low in about a decade. Steadily declining bank, commercial and industrial lending to businesses is also telling. This rapid deleveraging is driven in part by the desire of consumers and businesses to reduce their debt loads, but it is mostly driven by creditors who are less willing and able to extend credit.

With credit so impaired, the efficacy of monetary policy to support the recovery has been severely compromised. This suggests at the very least that the Fed will not raise interest rates until the end of 2010, at the earliest. It also suggests that the Fed may have to increase its commitment to credit easing—the purchasing of Fannie Mae and Freddie Mac securities to lower mortgage rates—which is scheduled to end in March. It may also need to extend and expand its efforts to get the structured finance market going again via TALF—a program that provides cheap, nonrecourse loans to investors in order to buy securitized debt—which is set to expire next summer.

Although monetary policymakers desperately would like to, they will not end these extraordinary measures if the credit crunch is not lifting. Commercial and industrial loans outstanding are a good barometer of whether credit is ample. They are now dropping at a stunning record pace of over 15% annualized. C&I

loans don't need to be growing again before the recovery gains traction, but they do need to be stabilizing.

Outlook

Real GDP is expected to weaken from its annualized pace of more than 3% during the second half of 2009 to closer to 2% during the first half of 2010. This growth will be fast enough to end net job losses by early next year, particularly given that the federal government will be hiring hundreds of thousands of temporary workers to conduct the 2010 census. However, this rate of growth will not be enough to keep unemployment from rising, at least not right away. The jobless rate is expected to peak at 10.6% in the third quarter of 2010.

The Federal Reserve and fiscal policymakers will provide just enough additional support to ensure that the recovery does not back-track into recession early next year and becomes self-sustaining by this time next year. Real GDP is expected to accelerate to 2.5% during the second half of 2010.

Even stronger growth, of almost 4%, is expected in 2011. This rate hinges on the view that the wrongs now weighing on the economy will largely be righted by then. Progress is slowly being made: Households are rapidly deleveraging; inventories of manufactured goods are being drawn down; the surfeit of vacant homes and commercial real estate is set to decline, given how extraordinarily weak construction is now; and the financial system is quickly digesting the trillions of dollars in bad credit decisions it made. By the end of 2011, the unemployment rate is expected to have fallen to nearly 9%.

There are some obvious reasons to be very nervous about the economy's prospects longer run. It will be years before the more than 8 million jobs lost in the past two years are regained and the economy returns to full employment. The nation's fiscal problems feel overwhelming, particularly given the dysfunctional budget process. And little progress seems to have been made on big problems with huge economic implications such as global warming and terrorism. Despite all this, however, prospects are good that the economy will perform much better in the coming decade.