SIFMA
Securities Industry and Financial Markets Association

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ECONOMIC OUTLOOK

Economic Growth to Slow on Credit Market Uncertainty and Housing Contraction, Pick Up Pace in Second Half

Members of the Securities Industry and Financial Markets Association's Economic Advisory Roundtable expect the pace of U.S. economic growth to slow in the first half of 2008 but pick up in the second half of the year. In the year-end survey, the median forecast anticipates GDP to grow but at a below-trend pace of 2.1 percent in 2008 as the economy works through the housing sector contraction and the effect of credit market turbulence.[1] In addition, the median forecast has GDP growth in the current quarter dropping sharply to 0.9 percent. Housing sector deterioration, tight financing conditions, an accommodative monetary policy response to the credit market environment, a projected decline in the price of oil, and the combined effect of a lower dollar and global economic expansion provide the backdrop for the economic outlook. Employment and personal income trends are the principal drivers of consumer spending growth, but the weaker housing market, reduced credit availability and curtailed employment growth are also expected to dampen consumer spending. Business capital spending growth is expected to be slightly lower than the 2007 level, benefitting from solid corporate balance sheets and cash flow accumulation, but well below the growth rates of recent years.

The unanimous opinion of the Roundtable is that the FOMC will reduce the target Fed funds rate by 25 basis points to 4.25 percent at the upcoming December 11 meeting. While agreeing that the Fed will cut rates by 25 basis points, some respondents indicated a preference for a 50 basis point cut this time in order to open up the money and credit markets. Furthermore, the majority of the panelists expect the FOMC to continue to cut rates through the first half of 2008. The median forecast has the Fed funds rate at 3.50 percent at the end of the second quarter. Although the panelists expect the accompanying statement on December 11 to provide for flexibility, the strong consensus is that the policy statement will emphasize risks to growth while noting the presence of inflationary risks. The statement is also expected to acknowledge the current difficulties in the credit markets.

Forecast Highlights

THE ECONOMY The median forecast anticipates GDP growth of 2.2 percent for full-year 2007 and 2.1 percent in 2008.[2] Growth is expected to increase from the anemic 0.9 percent rate in the fourth quarter of 2007[3] and 1.5 percent in the first quarter of 2008 to 2.1 percent in the second quarter and 2.5 percent to 2.6 percent during the second half of 2008. Measured

1 The survey was conducted the week of November 27 – December 3. The forecasts discussed in the text and appearing in the accompanying data table are medians of the 16 individual members' submissions.

2 The panelists' estimates for GDP growth ranged from 1.4 percent to 2.9 percent for 2008.

3 The individual forecasts for fourth quarter 2007 GDP growth ranged from -0.2 percent to +2.0 percent.

fourth quarter to fourth quarter,[4] the median forecast is for 2.3 percent growth in 2007 and 2.1 percent in 2008.

The median forecast calls for consumer spending to increase by only 1.9 percent for full-year 2008, compared to the 2.7 percent rate in 2007, reflecting the cumulative effect of housing price deceleration and credit conditions. The consensus view is that employment and income growth are the dominant drivers of consumer spending, but the reduced purchasing power as a result of higher energy and food prices and the housing contraction are serving as drags on consumer spending. The effect of the drop in mortgage equity withdrawal in recent quarters on consumer spending has not been as severe as some anticipated as homeowners are still feeding off overall cumulative increases in housing values over the last several years. The median forecast sees the average monthly unemployment rate rising from the current low level over the next year, from 4.6 percent in 2007 to 5.0 percent in 2008,[5] and nonfarm payrolls increasing by about 1.06 million annually in 2008 compared to 1.51 million in 2007 as corporate profits and economic growth encounter housing and credit headwinds.

Growth in business capital investment is expected to slip modestly from 4.6 percent in 2007 to 4.4 percent in 2008, but will be much lower than the more robust capital spending growth rates of recent years.[6] The panelists cited three important factors in their investment spending outlook: U.S. consumer demand, global growth and borrowing conditions. Business investment is expected to benefit mostly from aggregate demand from global economic expansion and the lower value of the dollar. The median forecast projects the Euro to remain elevated at an exchange rate of 1.41 €/$ at the end of 2008. Tighter borrowing conditions and reduced growth in cash flow and profits will restrain business capital spending. The effect may be contained as corporations have been able to strengthen their financial positions during the protracted period of strong profit growth.

The price of oil is expected to decline from the current level but remain elevated by historical standards. At the time of the survey, the price of oil was above $90 per barrel. The median forecast has the price of oil declining to $80 per barrel by the middle of next year, slightly above the projected "equilibrium" price of $72 per barrel. Until recently, rising global demand and supply considerations were clearly the dominant factors in determining oil price levels, and the panelists still consider those to be the most important factors. Recent increases in the price of oil, mostly in 2007, have been linked to a risk premium, the weaker dollar and the financial return of an investment in oil as a commodity.

The panelists expect inflation pressures to ease. The median forecast of the panel is that "headline" inflation as measured by the widely followed PCE deflator will be 2.5 percent for full-year 2007 and will decline to 2.4 percent in 2008.[7] The core PCE deflator is expected to be 2.0 percent in 2007 and 1.9 percent in 2008, within the range that the Federal Reserve would deem acceptable.[8] Along with monetary policy, the panelists indicated that the lower value of the dollar and inflationary expectations are significant considerations in their inflation outlook. Relatively low inflation expectations and confidence in Fed policy have helped to anchor wage and price setting patterns, and global competition has kept the inflationary pressure in check. The projected

4 All growth rates are inflation adjusted, and annual comparisons are measured fourth quarter to fourth quarter.

5 The individual panelists' forecasts for the average unemployment rate ranged from 4.7 percent to 5.4 percent for 2008.

6 The individual panelists' forecasts for business fixed investment ranged from 3.1 percent to 6.3 percent for 2008.

7 The "headline" PCE deflator measured fourth quarter to fourth quarter is expected to decline from 3.2 percent in 2007 to 2.0 percent in 2008, according to the median response in the survey. The full-year 2008 "core" PCE deflator forecasts ranged from 1.6 percent to 2.3 percent

8 The individual panelists' forecasts for the increase in the core PCE deflator ranged from 1.6 percent to 2.3 percent for 2008.

below-trend growth rate and the dampening effect on inflation of weakened credit market conditions should contribute to more moderate inflation readings. The decline in the value of the dollar and the effect on commodity prices from rising demand as a result of global economic growth adds to inflationary pressures. The cumulative effect of monetary policy easing to respond to current credit market conditions may also be a source of inflationary pressures over the longer term.

Based on the median forecast, the Federal budget deficit is expected to widen modestly to $200 billion in fiscal year (FY) 2008, after five years of declining budget deficits. In FY 2007, the deficit came in at $164 billion.[9] Cyclical factors have been the dominant reason for the improved deficit outlook, having driven both corporate and individual tax revenues higher. The panelists believe that the cyclical benefits to the deficit are dissipating as corporate profit and economic growth rates are projected to be lower this fiscal year. The burden of large structural deficits in the out years remains a fiscal policy challenge.

INTEREST RATES As noted, the unanimous opinion is that the Federal Reserve is to reduce the Fed funds rate by 25 basis points to 4.25 percent at the upcoming December 11 meeting. The median forecast projects the Fed funds rate to be reduced to slightly below 4.00 percent at the end of the first quarter, declining further to about 3.50 percent by mid-year. These projections suggest that the Fed may cut the target Fed funds rate by an additional 75 basis points over the first half of next year in response to the credit market and growth risks.[10]

At the end of the survey period, December 3, the 10-year yield was 3.89 percent, with Treasury yields rallying on a "flight to quality" as a result of credit market volatility and heightened risk aversion. The median forecast expects the yield on the 10-year Treasury note to rise as economic growth picks up and the credit markets begin to regain their footing during the course of 2008. The median forecast has the 10-year Treasury yield at 4.00 percent at the end of the year, 4.10 percent at the end of first quarter of 2008, 4.20 percent at the end of the second quarter, and 4.45 percent a year from now.[11]

On December 3, the 2-year yield was 2.90 percent, affected by the credit market conditions and anticipation of a rate cut at the December 11 meeting. The median projection foresees the 2-year Treasury yield at 3.05 percent at the end of the fourth quarter, 3.30 at the end of the first quarter of next year, 3.40 percent at the end of the second quarter and 3.70 percent a year from now.

The interest rate projections indicate a slight flattening of the yield curve over the next year, the curve having steepened significantly over the second half of this year. The panelists believe that the long end of the yield curve will be most affected by Federal Reserve policy, along with inflation expectations and the flight to quality. Credit market conditions and the Fed's response are expected to be the dominant factors affecting the stability, level and direction of longer term benchmark Treasury yields.

Credit Crunch and Prolonged Housing Slump Dominant Growth Risks; Housing Contraction to Continue into Late 2008 or 2009

There is downside risk to the Roundtable's growth forecasts. More panelists agree it is more likely that real GDP growth falls short of their baseline forecast by one percent or more than exceeds

[9] The individual panelists' forecast ranged from -$125 billion to -$300 billion for FY 2008.

[10] Although the respondents expect the target Fed funds rate to be cut by 25 basis points to 4.25 percent at the December 11 meeting, there was diversity of opinion about the Fed funds rate in 2008. The Fed funds rate forecast at the end of the first quarter of 2008 ranged from 3.50 percent to 4.25 percent.

[11] The individual panelist forecast for the 10-year Treasury yield at the end of the first quarter ranged from 3.80 percent to 4.50 percent and 3.70 percent to 4.80 percent at the end of June 2008. The 30-year fixed-rate mortgage forecasts ranged from 4.25 percent to 6.40 percent at the end of the first quarter and 4.35 and 6.60 percent at the end of the second quarter.

the forecast by one percent or more. The leading sources of risk to their forecast are a prolonged decline in the housing sector and an extended and more severe credit correction.

The housing sector decline is expected to run through most of 2008 or beyond. Housing prices will be the transmission mechanism to work off the excess housing inventory on the market and bring supply and demand into closer balance. Although assigning specific dates to the beginning of the housing recovery is difficult, most respondents do not expect housing prices to "hit bottom" and begin to recover nationally until 2009. Home sales and construction will begin to turn around in the second half of 2008, according to the consensus, with some panelists expecting the recovery to begin earlier in 2008 and others believing it will not begin until 2009. Housing sales are forecast to dip to 5.8 million (5.1 million existing home sales and 0.7 million new home sales) in 2008 from 6.5 million units (5.7 million existing home sales and 0.8 million new home sales) in 2007, and housing starts are forecast to decline to 1.1 million units in 2008 from 1.4 million units in 2007.

Sunsetting Reduced Capital Gains and Dividend Tax Rates Reduce Economic Growth, Asset Values

The current reduced tax rates on dividend and capital gains enacted in 2003 are scheduled to "sunset" in 2010. The Roundtable's consensus view is that the result would be lower asset values and economic growth. The magnitude of the effects of sunsetting the lower rates would depend on the market and economic environment in 2010.

Corporate Profit Growth to Slow; Margins to Decline Modestly

In recent years, the consistent double digit corporate profit and margin growth exceeded expectations. From these elevated levels, the Roundtable consensus is that pre-tax profit growth should slow to low single digits, and the majority expects profit margins to contract modestly. The profit outlook is mostly influenced by economic growth, both U.S. and global, followed by operating margin trends. An additional constraining factor is the tighter borrowing conditions.

Divergent Opinions on Corporate Bond Credit Spreads

Corporate bond credit spreads for both high yield and investment grade sectors have been affected by credit market volatility, reduced liquidity and credit market repricing during the second half of the year after a period of historically tight and declining spreads. During the past month, spreads reached their widest levels since 2003. There are divergent opinions about the direction of spreads over the next year. Roughly equal numbers see spreads widening, narrowing and staying the same in both the investment-grade and high-yield bond sectors.

The panelists expecting spread widening base their view on anticipated slower corporate profit and below-trend economic growth and the cumulative effect of increased leveraged leading to slowly rising default levels closer to historic norms. The panelists that expect tighter credit spreads base that view on generally solid corporate balance sheets, a return of investor risk appetite and demand for credit products when the markets stabilize and liquidity recovers.

Equity Prices Expected to Rise in 2008

The panelists agreed that equity values will rise in the coming year. The median projection is for the S&P 500 to reach 1600 by year-end 2008, which would represent approximately a 9 percent increase from level at the end of the survey period. (On December 3, the S&P stood at 1471.) Fundamentals— Federal Reserve policy and corporate profit and economic growth—are driving panelists' assessment of the equity markets. The equity market outlook benefits from historically low interest rates and the expectation that the Fed will reduce rates in response to current credit market turbulence. Equity market growth, however, will be constrained by forecasted economic and profit growth trends, as well as tighter financing conditions.

The Securities and Financial Markets Association Economic Advisory Committee Forecast: December 10, 2007

(Inflation adjusted year-over-year percentage change unless otherwise specified. Forecast numbers appear in **bold**.)

	2006	2007	2008
Real GDP (yr - to - yr)	2.9	**2.2**	**2.1**
Real GDP (4Q - 4Q)	2.6	**2.3**	**2.1**
CPI (yr - to - yr)	3.2	**2.8**	**3.1**
CPI (4Q - 4Q)	1.9	**3.9**	**2.5**
Core CPI (yr - to - yr)	2.5	**2.3**	**2.1**
Core CPI (4Q - 4Q)	2.7	**2.2**	**2.0**
PCE (yr - to - yr)	2.8	**2.5**	**2.4**
PCE (4Q - 4Q)	1.9	**3.2**	**2.0**
Core PCE (yr - to - yr)	2.2	**2.0**	**1.9**
Core PCE (4Q - 4Q)	2.3	**1.9**	**1.8**
Personal Consumption	3.1	**2.8**	**1.9**
Nonresidential Fixed Investment	6.6	**4.6**	**4.4**
Housing Starts (millions)	1.8	**1.4**	**1.1**
Real State & Local Gov't. Spending	1.8	**2.2**	**2.1**
Current Account Deficit (billions $)[1]	811	**763**	**710**
New Home Sales (millions units)	1.0	**0.8**	**0.7**
Existing Home Sales (millions units)	6.5	**5.7**	**5.1**
Nonfarm Payroll Employment (millions)	2.26	**1.51**	**1.06**
Unemployment Rate (cal. yr. avg.)	4.6	**4.6**	**5.0**
S&P 500 Index Price (yr-end)	1,418	**1,496**	**1,600**
Federal Budget (FY, billions of $)	-248	**-164**	**-200**

[1]Current account deficit volume is calculated through 2007:Q3

Quarter-to-Quarter % Changes in Annual Rates

	2007				2008			
	I	II	III	IV	I	II	III	IV
Real GDP	0.6	**3.8**	**3.9**	**0.9**	**1.5**	**2.1**	**2.5**	**2.6**
CPI	3.8	**6.0**	**1.9**	**4.0**	**3.8**	**2.2**	**2.2**	**2.0**
Core CPI	2.3	**1.9**	**2.5**	**2.2**	**2.1**	**2.1**	**2.0**	**2.0**
PCE	3.5	**4.3**	**1.7**	**3.2**	**2.9**	**1.7**	**1.8**	**1.6**
Core PCE	2.4	**1.4**	**1.8**	**1.9**	**1.9**	**1.8**	**1.8**	**1.8**
Personal Consumption	3.7	**1.4**	**3.0**	**1.5**	**1.6**	**2.1**	**2.3**	**2.4**
Nonresidential Fixed Investment	2.1	**11.0**	**7.9**	**4.9**	**3.6**	**3.2**	**3.8**	**3.9**

Interest Rates (monthly average %)

	Dec. 07	Mar. 08	Jun. 08	Sept. 08	Dec. 08
Fed Funds	**4.25**	**3.90**	**3.50**	**3.50**	**3.63**
2 Year Treasury Note	**3.05**	**3.30**	**3.40**	**3.60**	**3.70**
10 Year Treasury Note	**4.00**	**4.10**	**4.20**	**4.28**	**4.45**
30 Year Fixed-Rate Home Mortgages	**6.08**	**6.00**	**6.05**	**6.10**	**6.20**

Exchange Rates (monthly average)

	Dec. 07	Mar. 08	Jun. 08	Sept. 08	Dec. 08
Yen/Dollar	**110**	**109**	**109**	**111**	**106**
Dollar/Euro	**1.47**	**1.48**	**1.47**	**1.44**	**1.41**

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