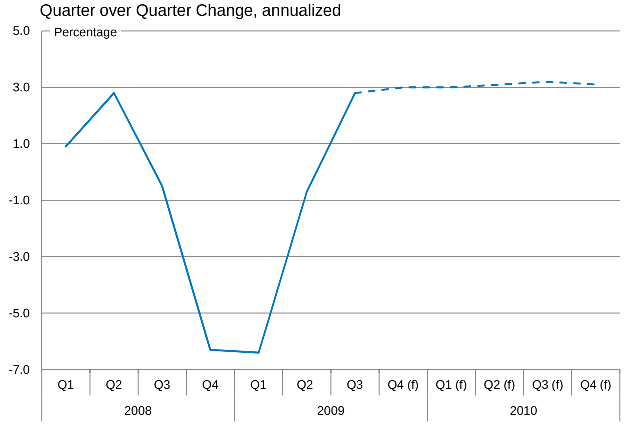
The Economic Outlook: Cautiously Optimistic

Members of the Securities Industry and Financial Markets Association's Economic Advisory Roundtable forecast that U.S. economic growth will continue to improve in the fourth quarter of 2009 and into 2010.[1] While cautiously optimistic about the generally positive trend of most economic indicators, the economists were restrained in their forecasts and demurred from predicting the level of rebound one might normally expect after a severe recession. The outlook warned of potential future challenges, particularly missteps in fiscal and monetary policies such as tax policy. Other concerns included the future path of oil prices, the global economy in general, and the recovery of private market confidence.

Forecast Highlights

MONETARY POLICY The Roundtable was unanimous in its opinion that the Federal Open Market Committee (FOMC) would not change its current 0.0 to 0.25 percent target federal funds rate at the upcoming December 15-16 meeting. Respondents were divided on when the FOMC would begin raising rates: while nearly half expected the FOMC to begin raising rates by mid-2010, the remainder expected no rate hike until late 2010 or the beginning of 2011.[2]

Real GDP Growth Rate
Quarter over Quarter Change, annualized



*(f) Forecast
Source: Actuals: Bureau of Economic Analysis; Forecasts: Median Response to the SIFMA Economic Advisory Roundtable Year-End 2009 Economic Outlook Survey

THE ECONOMY The median forecast called for gross domestic product (GDP) to fall 2.5 percent in 2009 on a year-over-year basis, and by 0.3 percent on a fourth quarter-to-fourth quarter basis.[3] On a quarterly basis, respondents expected GDP to rise 3.0 percent in the fourth quarter on an annualized basis and to continue steadily at a similar pace throughout 2010.

While the economy was forecasted to grow 2.8 percent in GDP on a year-over-year basis in 2010, and 3.2 percent on a fourth quarter-to-fourth quarter basis, the growth was not expected to mitigate the unemployment rate, which was expected to continue to persist at an elevated rate throughout 2010.[4] Full-year 2009 nonfarm payroll employment losses were estimated to total 4.5 million jobs;[5] while job recovery estimates for 2010 ranged widely, the median expectation was for a return to growth, albeit restrained, of 800,000 jobs.[6] Survey respondents expected the full-year average unemployment rate to be 9.3 percent in 2009 and 10.1 percent in 2010.[7]

Unsurprisingly, the median consumer spending forecast mirrored nonfarm payroll employment forecasts, with an estimate for a drop of 0.6 percent for full-year 2009 and a mild recovery to 2.0 percent in full-year 2010.[8]

[1] The survey was conducted from November 18 – December 2, 2009. The forecasts discussed in the text and appearing in the accompanying data table are the median values of the individual member firms' submissions, unless otherwise specified.

[2] The forecast for when the FOMC would begin raising rates ranged from June 2010 to early 2012.

[3] The full-year 2009 GDP growth forecasts ranged from negative 2.6 percent to negative 2.4 percent. On a quarterly basis, annualized GDP growth was estimated in a range from roughly -0.3 percent to -0.6 percent throughout 2009, with a median of -0.3 percent.

[4] The full-year 2010 GDP growth forecasts ranged from 1.9 percent to 3.6 percent, with annualized quarterly growth steady at roughly 3.0 percent throughout 2010.

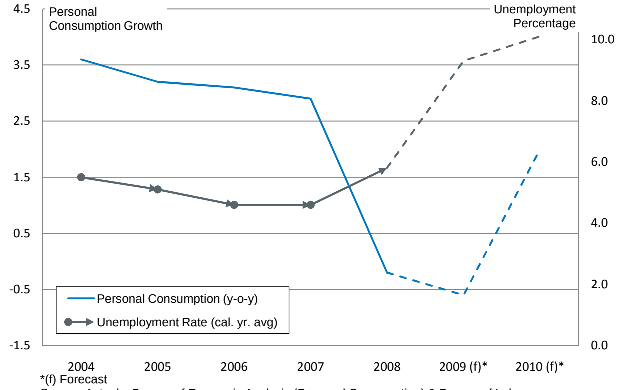
[5] The full-year 2009 payroll employment forecasts ranged from a loss of 6.1 million jobs to a loss of 3.6 million jobs.

[6] The full-year 2010 payroll employment forecasts ranged from a loss of 1.8 million jobs to a gain of 2.4 million jobs.

[7] The full-year 2009 average unemployment rate forecast was unanimous at 9.3 percent and for 2010 ranged from 9.5 percent to 10.6 percent.

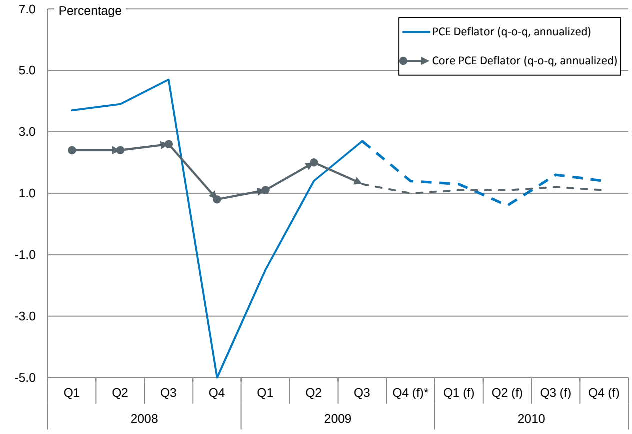
[8] The full-year 2009 consumer spending growth forecasts ranged from negative 0.7 percent to negative 0.5 percent and in 2010 ranged from growth of 0.8 percent to 2.5 percent.

Consumer Spending Growth Rate and Unemployment Rate
Calendar Year Averages



*(f) Forecast
Source: Actuals: Bureau of Economic Analysis (Personal Consumption) & Bureau of Labor Statistics (Unemployment); Forecasts: Median Response to the SIFMA Economic Advisory Rountable Year-End 2009 Economic Outlook Survey

PCE Deflator & Core PCE Deflator



*(f) Forecast
Source: Actuals: Bureau of Economic Analysis; Forecasts: Median Response to the SIFMA Economic Advisory Roundtable Year-End 2009 Economic Outlook Survey

Business capital investment growth was expected to fall by 17.8 percent in full-year 2009, with a milder decline of 0.3 percent in full-year 2010.[9] State and local government spending was expected to remain unchanged in 2009 and increase slightly by 0.3 percent in 2010, although forecasts for 2010 varied widely.[10]

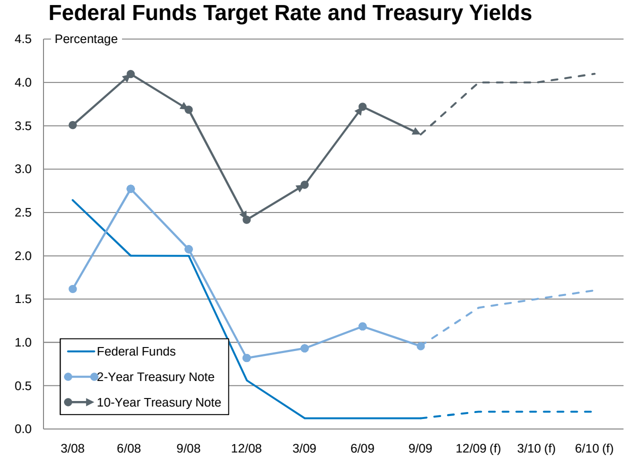
The inflation outlook remained subdued against the background of modest economic stabilization. Record-setting fiscal deficits and the Federal Reserve's balance sheet expansion have led to public debate and concern over potential inflation – or at least rising inflationary expectations. Respondents were nearly unanimous in their agreement, however, that the expanded Federal Reserve balance sheet did not pose near-term (six to 12 months) inflationary risk.

The median forecast for "headline" inflation, measured by the personal consumption expenditures (PCE) chain price index, was 0.2 percent for full-year 2009, rising to 1.8 percent for full-year 2010.[11] The median forecast for the core PCE chain price index was 1.5 percent for full-year 2009 and 1.2 percent for full-year 2010.[12]

Economic slack was ranked the most important factor in inflation outlooks, with Fed policy, global conditions and the value of the dollar also cited as important factors to inflationary expectations.

INTEREST RATES As noted, the Roundtable expected the Federal Reserve to continue maintaining its 0.0 to 0.25 percent federal funds target rate at the upcoming December meeting and for some time to come. As of December 2, the end of the survey period, the 10-year U.S. Treasury yield was 3.32 percent, up 1 basis point (bps) from end-September and 21 bps from end-June. The median forecast for the December 2009 average 10-year Treasury note yield was 3.5 percent, rising to 3.7 percent in June and 4.0 percent at year-end 2010.[13] Economic growth prospects and FOMC policy were cited as two of the most important drivers of the Treasury yields outlook, while inflation, inflationary expectations, and budget deficit trends were also identified as important influences.

Federal Funds Target Rate and Treasury Yields



Source: Actuals: Bureau of Economic Analysis, Federal Reserve; Forecasts: Median Response to the SIFMA Economic Advisory Roundtbale Year-End 2009 Economic Outlook Survey

Survey respondents were evenly split three ways over the future shape of the Treasury yield curve: 35

[9] The full-year 2009 business fixed investment forecasts ranged from negative 18.3 percent to negative 15.7 percent and for 2010 ranged from negative 5.9 percent to positive 3.3 percent.

[10] The full-year 2009 real state and local government spending forecasts ranged from negative 0.6 percent to positive 0.2 percent and for 2010 from negative 2.0 percent to a positive 5.1 percent.

[11] The full-year 2009 PCE deflator forecasts ranged from 0.0 to 1.9 percent and for 2010, from negative 0.1 percent to positive 2.5 percent.

[12] The full-year 2009 core PCE deflator forecasts ranged from 1.4 percent to 1.7 percent and for 2010, from 0.9 percent to 2.0 percent.

[13] The average 10-year Treasury yield forecasts ranged from 3.0 percent to 3.8 percent for December 2009; from 2.5 percent to 4.8 percent for June 2010; and from 3.3 percent to 5.5 percent for December 2010.

percent expected it to steepen between now and mid-2010; 30 percent expected it to flatten while the balance expected the yield curve to remain the same. Nearly 70 percent of respondents expected the TED spread (Treasury bill less LIBOR rate) to remain about the same in the next six months, with 20 percent expecting the spread to widen and the remaining minority expecting it to narrow.

Investment-grade credit spreads were expected to narrow over the next six months by over 60 percent of respondents, with 25 percent expecting no change and only five percent expecting spreads to widen. High-yield credit spreads expectations yielded a similar outlook, with over 60 percent of respondents forecasting further narrowing by mid-2010 and the remainder split between widening or unchanged spreads.

Monetary Policy: When the Great Unwind?

The survey asked a number of questions about both conventional monetary policy as well as the unconventional policy initiatives, such as the Federal Reserve's securities purchase programs for Treasury, agency and agency mortgage-backed securities.

On the conventional side, respondents predicted that the Federal Reserve would not begin raising its target rate before the end of 2010, with predictions ranging from 2Q'10 to 1Q'12. Against the backdrop of the FOMC's November 4 statement clarifying that resource utilization was among the economic conditions warranting exceptionally low federal funds rates for an extended period of time,[14] the survey asked what level of unemployment would allow the Federal Reserve to begin raising its target rate. While respondents forecasted 9.8 percent unemployment as the "trigger" level, many noted, however, that evidence of an improving trend was more likely to be the trigger than a specific unemployment rate and that increases in the target rate would ultimately be gradual.

On the topic of unconventional policies, respondents were asked to rank possible steps the Federal Reserve would take to reverse course. Considering the recent reverse repo test operations of U.S. Treasuries and agency direct obligations, totaling $1.0 billion as of December 14, reverse repos were, unsurprisingly, cited as the most likely first step by 80 percent of respondents. Paying interest on reserves was a possibility also frequently mentioned, as were directly selling assets back to the market or using a collateralized vehicle. Respondents commented that the Federal Reserve had sufficient time to reverse its policies "give[n] the time it [would] take to return the economy to full strength." One respondent also pointed out that raising the target rate and shrinking the balance sheet would be a coordinated effort.

Respondents were nearly unanimous in their opinion that the Federal Reserve's expanded balance sheet did not pose a near-term (six – 12 month) inflationary risk, citing persistent credit restraints, which in turn translated into an inability to transmit this expansion of the monetary base into inflation. Over 90 percent of respondents believed that inflation was not a worry for 2010.

Normalizing Private Credit Markets the Dominant Factor Promoting U.S. Growth

The normalization of private credit markets and self-correcting adjustments by business and real estate markets were ranked as the two most important factors supporting U.S. economic growth. Federal Reserve policies, conventional and unconventional, and fiscal policies were cited as important factors.

Upside risks to economic forecasts included unrecognized pent-up demand, sudden increases in bank lending and a v-shaped recovery. Downside risks included political risk, a sharp spike in oil prices, commercial real estate collapse and longer- or deeper-than-expected weakness in labor markets.

Fiscal Policy: A Mixed Bag

Respondents generally viewed the $787 billion stimulus package, CARS ("cash for clunkers") and homebuyer tax credits (federal and state) as having mixed results at best. It was believed that the various programs added to economic growth, providing 1.9 percent growth in 3Q'09 and 1.4 percent in 4Q'09. 2010 forecasts painted a different picture: respondents predicted that while the programs would add 1.0 percent growth in 1Q'10, the boost from fiscal policy would end by the second-half of 2010 and then become a drag of 0.1 percent in 4Q'10, as the stimulus program expired and projects were completed.

Commenting on potential future stimulus programs, respondents suggested the extension of unemployment benefits or other targeted job-oriented programs, infrastructure spending and support for state and local governments as possibilities.

Beyond 2010, respondents were very concerned about economic growth; even those who believed

[14] http://www.federalreserve.gov/newsevents/press/monetary/20091104a.htm

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that the stimulus program spending was reasonably back-loaded were concerned that growth would diminish as it was perceived that future household spending would be insufficient to maintain growth in the 3 percent range as the stimulus ended.

Sunset of Tax Cuts a Further Drag

On the other side of the fiscal policy coin was the sunset of the 2001 and 2003 personal tax cuts, which the Administration proposed should continue as currently scheduled for singles earning more than $200,000 and couples earning more than $250,000. Nearly 80 percent of respondents considered this proposal as negative for the longer-term growth of the U.S. economy, with one respondent noting that "the scheduled sunset of upper-end tax cuts. . . would trim 2011 growth by 1.5 to 2.0 points." Another pointed out that the uncertainty of the sunset itself would contribute a drag on growth in 2010. Many respondents assumed, however, that with or without the tax cuts' sunset, taxes would rise in the future.

Increase in Saving: How Far, How Soon?

Respondents were split over whether they expected a significant increase in the personal saving rate over the next two years; 60 percent expected no increase while the balance thought otherwise. A number of respondents anticipated the saving rate to approach five to six percent, noting that such an increase, while a drag on consumer spending and overall growth, would ultimately be positive for economic health.

When Will Housing Reach Bottom?

When asked to predict when several housing indicators would hit bottom, respondents were generally in agreement. Home prices were seen to have reached bottom in 3Q'09, although a significant minority (40 percent) believed prices would not bottom until at least 1Q'10. A greater consensus was reached about the outlook for housing sales, with 95 percent expecting sales to have bottomed before 3Q'09. Housing starts were seen to have reached bottom in 2Q'09, although some forecasted a bottom in 2010.

Employment Outlook

The employment outlook continued to be fairly negative, with 60 percent forecasting that the U.S. economy would not begin adding jobs until the first quarter 2010 and the balance anticipating job growth beginning in the second quarter instead. As for the unemployment rate forecast, 20 percent believed that the rate would peak in 4Q'09, with 40 percent anticipating a peak in 1Q'10 and 30 percent in 2Q'10. The remaining 10 percent were split between 3Q'10 and a very pessimistic 2Q'11. The unemployment rate peak was forecasted at 10.5 percent, within a range of 10.2 to 11.3 percent.

Oil Prices: Little Chance of Dramatic Change

Panelists placed a 68 percent chance on oil prices remaining in the current $50 - $100 per barrel range in 2010, compared to the 71 percent probability reported in the June survey.[15] While the chance of oil prices moving above or below that range were evenly split mid-2009, respondents favored the higher range more than two to one over the lower range. However, the $100+/barrel scenario would have the estimated effect of reducing GDP growth by approximately one-half percentage point, compared to the full percentage point drag predicted in the last survey; the sub-$50/barrel scenario envisioned a GDP increase of roughly 35 bps, compared to 60 bps in June.[16]

Support Programs: Generally Effective

The panelists were unanimous that the Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008 (EESA) had a positive or very positive impact on the financial system, with 95 percent also believing the same about the impact on the economy as a whole.

On December 9, Treasury Secretary Timothy Geithner extended the authority for TARP to October 3, 2010; panelists were split, however, over whether the authority for Treasury to make investments under TARP should have been extended past the December 31, 2009 expiry. Those who believed the extension was warranted opined that the extension would be at most symbolic, a strong signal to the market that a backstop was in place if needed through 2010.

Commenting on the program more generally, respondents noted that, while the program was and continues to be highly controversial, TARP was not only essential to saving the financial system, but that the downturn would have been much worse without it. It was also noted that TARP acted as a support in maintaining lending activity, which would have been much lower otherwise.

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[15] http://www.sifma.org/research/pdf/EconOutlook0609.pdf

[16] The estimated positive impact of lower oil prices (below $50 per barrel) on GDP growth ranged from 0 to 200 basis points, while the negative impact of higher oil prices (above $100 per barrel) ranged from 0 to 100 basis points less growth.

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Securitization Financing: TALF to the Rescue?

Survey respondents were nearly unanimous in their view that the Term Asset-Backed Securities Loan Facility (TALF) had a positive or very positive impact on the asset-backed (ABS) and commercial mortgage-backed securities markets (CMBS), as well as on the U.S. economy as a whole. Responses were mixed as to whether the program should be extended in duration, with the recommended length of extension ranging from first quarter to year-end 2010. Of those supporting an extension to the program, respondents mentioned CMBS as the collateral type to focus on, although some suggested residential mortgage-backed securities as well, which is not currently supported by TALF.

Securities Transaction Tax: A Very Bad Idea

Respondents were unanimous in their judgment that a securities transaction tax would have a negative impact on both the U.S. financial markets and economy. It was noted that there were a number of downsides to imposing such a tax: causing harm to financial intermediation and liquidity, two key ingredients for healthy economic performance; thwarting the ability of companies to tap capital markets during the recovery; pushing business activity overseas; and driving foreign investors out of U.S. markets. Participants noted that no compelling cost-benefit analysis had been made and that enforcing the tax would be impossible unless done globally.

SIFMA Economic Advisory Roundtable Forecast

Inflation adjusted year-over-year percentage change, unless otherwise specified.

	2009	2010
Real GDP	(2.5)	2.8
Real GDP (4Q – 4Q)	(0.3)	3.2
CPI	(0.3)	2.0
CPI (4Q – 4Q)	2.8	1.6
Core CPI	1.7	1.3
Core CPI (4Q – 4Q)	1.8	1.3
PCE deflator	0.2	1.8
PCE deflator (4Q – 4Q)	1.3	1.6
Core PCE deflator	1.5	1.2
Core PCE deflator (4Q – 4Q)	1.5	1.2
Personal Consumption	(0.6)	2.0
Nonresidential Fixed Investment	(17.8)	0.3
Housing Starts (millions)	0.6	0.8
Real State & Local Government Spending	0.0	0.3
Current Account Deficit ($ billions)	430.7	497.5
New Home Sales (millions of units)	0.4	0.5
Existing Home Sales (millions of units)	5.1	5.7
Nonfarm Payroll Employment (change in millions)	(4.5)	0.8
Unemployment Rate (calendar year average)	9.3	10.1
S&P 500 Index Price (year-end)	1,100.0	1,225.0
Federal Budget (FY, $ billions)	(1,417.1)	(1,368.0)

Quarter-to-Quarter % Changes in Annual Rates

	2009				2010			
	I	II	III	IV	I	II	III	IV
Real GDP	(6.4)	-0.7	2.8	3.0	3.2	3.0	3.2	3.1
CPI	2.2	3.3	2.5	3.0	1.8	1.0	1.8	1.8
Core CPI	2.2	2.4	1.3	1.6	1.1	1.2	1.2	1.2
PCE deflator	(1.5)	1.4	2.7	2.5	1.7	1.6	1.7	1.5
Core PCE deflator	1.1	2.0	1.3	1.4	1.0	1.1	1.1	1.1
Personal Consumption	0.6	(0.9)	2.9	1.7	1.8	2.0	2.1	2.6
Nonresidential Fixed Investment	(39.0)	(12.5)	2.3	(1.2)	1.3	3.0	4.4	5.4

Interest Rates (monthly average %)

	Dec. 09	Mar. 10	Jun. 10	Sept. 10	Dec. 10
Fed Funds	0.1	0.1	0.1	0.3	0.5
2 Year Treasury Note	0.9	1.1	1.2	1.6	1.8
10 Year Treasury Note	3.5	3.6	3.7	3.9	4.0
30 Year Fixed-Rate Home Mortgages	4.9	5.1	5.3	5.4	5.6

Exchange Rates (monthly average %)

	Dec. 09	Mar. 10	Jun. 10	Sept. 10	Dec. 10
Yen/Dollar	88.8	87.5	90.0	92.0	94.0
Dollar/Euro	1.5	1.5	1.5	1.5	1.4

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SIFMA Economic Advisory Roundtable 2009 Members

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