

## NATIONAL FORECAST DESCRIPTION

### **The Forecast Period is the Second Quarter of 2009 through the Fourth Quarter of 2012**

While the recession may not be over, many economists can see its conclusion on the horizon. Their case was given a bit more credence on the last day of July when the U.S. Department of Commerce released its advance estimate of a 1.0% annual decline in real GDP for the second quarter of 2009. This drop was significantly lower than the 1.5% retreat most economists had expected. And it was much less than the 2.1% decline forecast by IHS Global Insight in its July 2009 forecast. While the positive GDP release may convince some that prosperity is just around the corner, they should proceed down that street with caution.

First, they need to be reminded this is the Department of Commerce's first estimate of real output for the second quarter of 2009. There will be a couple more estimates made before it becomes final. Then the final estimate will be subject to revisions. While an argument can be made that the estimate may be revised up, recent history has proven otherwise. The same release that showed real GDP shrank just 1.0% in this year's first quarter, also showed that most recent quarterly estimates have been revised down, which means the recession has been more severe than had been originally thought. For example, it was previously reported that real GDP fell at a 0.5% pace in the third quarter of 2008, but the newest estimates is that it plunged at a 2.7% clip. The new data show real GDP's dive in the fourth quarter of last year was shallower than had been reported earlier, -5.4% versus -6.3%. However, it was the exception. The previous estimate of real GDP growth for the first quarter of 2009 was scaled down from a 5.5%-decline to a 6.4%-drop.

Second, significant risks remain that could put the economy on a lower growth trajectory. Acknowledging these risks, IHS Global Insight has prepared an alternative forecast that considers the economy may be weaker than in its *Baseline Scenario*. IHS Global Insight believes the weaker scenario has a 20% probability of occurring. This simulation assumes the financial crises worsens, which sends the economy into a downturn nearly twice as deep as any other since the Great Depression. Credit markets remain clogged, both domestically and across the world and the housing recession drags on. Consumers retrench sharply. Capital spending drops as firms scuttle long-term projects due to the bleaker outlook. The economy receives no relief from exports, as foreign economic growth is also in peril. Real GDP contracts 3.3% in 2009 and 0.9% in 2010. In comparison, in the *Baseline Scenario* it declines 2.8% in 2009 and increases 1.5% in 2010. Peak to trough, real GDP drops 5.1%, which is much worse than the losses during the 1973-75 and 1981-82 recessions. The economy sheds 8.9 million jobs, causing the unemployment rate to peak at 11.4% in the second half of next year.

Third, the recovery, while preferable to the alternative, should not be oversold. Several imbalances in the economy point to a tepid recovery more like the one that followed the mild 2001 recession. Indeed, even the real GDP begins growing in the second half of this year, other indicators of the economy's health will take a while longer to improve. For example, the U.S. unemployment rate is forecast to keep rising until it peaks at 10.3% about a year after real output recovers. And employment is anticipated to recover slowly, so that by the end of 2012 the unemployment rate is still well above the level considered full employment. The weak job market will make consumers wary of spending beyond their means. Businesses will also be reluctant to spend, and, as a result, real business investment will be suppressed through most of next year. However, it does recover nicely after that. The recovery is scheduled to arrive this year, but it may not feel like a recovery until next year.

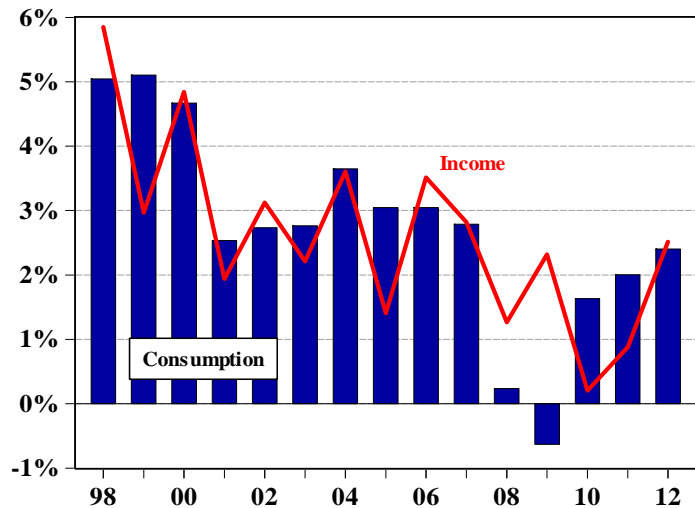
## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** Real consumer spending is expected to retreat further this year after a disappointing performance last year. In 2008, real consumer spending grew just 0.2%, which was its weakest performance since 1991. Real spending is forecast to decline in 2009 by 0.6%—its first drop since 1980 and its worst decline since 1974. As a result of this weakness, spending will be a drag on the economy, reducing real GDP growth by almost one-half percentage point in 2009. This is a significant change from the 2001 downturn when real consumption actually offset the decline in business investment, and helped to make it one of the mildest recessions on record. In contrast, the current recession is shaping up to be one of the worst slowdowns and the recovery will be the most subdued in the post-war era. Forces restraining future spending include further

job losses, tight credit conditions, and reduced household wealth. Real GDP is expected to pick up speed this fall, but the economy is expected to continue shedding jobs through the beginning of next year. The unemployment rate peaks at over 10% in the second quarter of 2010 and declines gradually, as businesses are hesitant to increase payrolls until they are convinced the economy is back on solid footing. The slow job growth causes consumer confidence to remain below levels experienced during the first half of the decade. The slow job recovery also exacts a toll on real disposable personal income. Specifically, it grows 2.3% in 2009, 0.2% in 2010, 0.9% in 2011, and 2.5% in 2012. Interestingly, income grows faster than spending in each year. This is a relatively rare phenomenon. It had been common for consumers to outspend their incomes. For example, the 2001 recession was mild because consumers increased spending 2.5% that year although their income rose just 1.9%. The decade's biggest gap between spending and income took place in 2005, when the former grew by 3.1% and the later advanced by 1.4%. Low interest rates, low credit standards, and healthy household balance sheets allowed consumers to spend beyond their means. Fueled by soaring home values, total U.S. household net worth swelled from 5.2 times of disposable income in 2002 to 6.5 times disposable personal income in 2006. Over this same period, outstanding mortgage debt as a percentage of disposable income rose from 82.2% to 108.3%, as consumers tapped into their home equity to finance their spending binge. The housing market implosion has turned housing values south, so this source of financing will be limited in the near future. One consequence of the subdued consumer spending is the U.S. personal savings rate, which is expected to rise to a high of nearly 5% of disposable personal income in 2009.

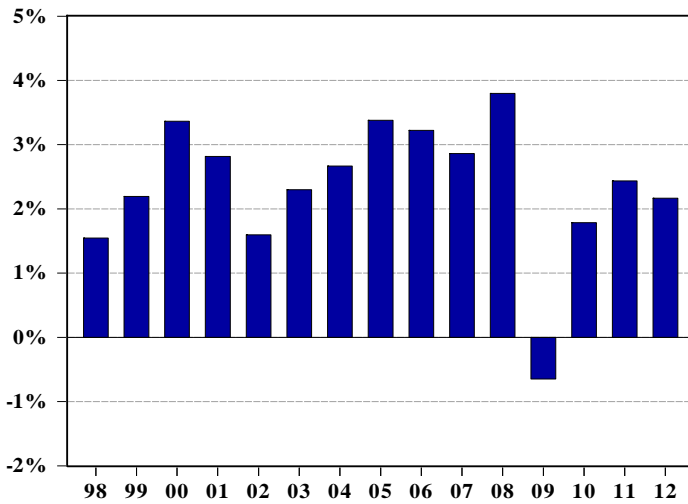
**Inflation:** The recent torrent of government spending has led to fears that it will be followed by a flood of inflation. While prices have picked up, several factors point to moderate inflation over the short term. Last year, concerns about adequate energy supplies sent the price of oil to a peak of nearly \$150 per barrel. The energy component of the Consumer Price Index (CPI) grew at a 29.3% annual rate in last year's third quarter, which helped push the overall CPI to a 6.2% annual pace—its fastest since late 1990. Much has changed since last summer. Nearly a year later, the price of oil is between \$60 and \$70 per barrel and the energy component of CPI is down almost 30%. After this year, energy prices will once again begin to rise, but much more modestly than they did in the 2003-2008 period because of the anticipated sluggish growth in global demand. In addition, huge amounts of excess capacity in product

### U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

## Consumer Price Inflation



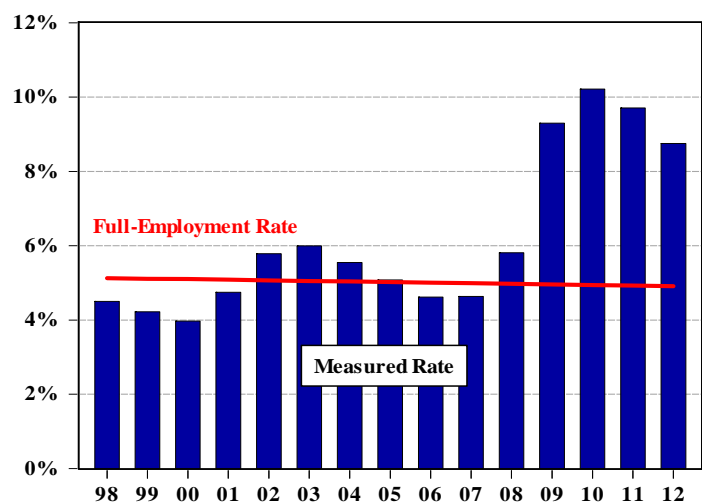
Source: Global Insight

markets contribute to the outlook of tame inflation. Currently, the factory operating rate is about 66%, which is well below the 80% to 85% rate associated with rising prices. Furthermore, near-term operating rates are not expected to reach these levels. Labor markets are expected to remain slack over the forecast period. This is important because labor costs have a significant impact on core inflation (the CPI less its volatile food and energy components). With high unemployment, businesses will have to pay less to hire and retain workers. As a result, nonfarm labor costs are expected to rise by 2.1% this year, but less than 1% in 2010 and 2011, and by just 1.2% in 2012. These rates are well below those experienced prior to the recession. The low labor costs will help keep the core inflation rate below 2% over the next few years. Even after adding the energy and food components into the core rate, total consumer inflation remains under 3%.

**Employment:** June marked a reversal in the recent trend of declining monthly job losses. Since peaking at 741,000 jobs in January 2009, monthly job losses had fallen steadily to a low of 322,000 jobs in May 2009. However, job losses jumped up to 467,000 in June. This loss reflects large declines in the manufacturing, professional and business, and construction sectors. Manufacturing employment shed 136,000 jobs in June. Since the recession's start, this sector has lost 1.9 million jobs. One of the hardest hit manufacturing industries has been motor vehicles and parts. Since December 2007, it has dropped by 335,000 jobs, which is about one third of its base. Over this same period, U.S. construction employment has lost 1.3 million jobs, including the 79,000-loss it suffered in June. Large job losses were not confined to the goods-producing sectors, however. The nation's professional and business services payroll shrank by 118,000 jobs in June, bringing its recession-period decline to 1.5 million jobs. Since the recession began in December 2007, total U.S. nonfarm employment has fallen by 6.5 million jobs. Despite the uptick in job losses in June, the U.S. civilian unemployment rate rose just one-tenth of a percentage point from 9.4% to 9.5%. Unfortunately, it is expected to go much higher over the next year and peak at 10.3% in the second quarter of 2010. This increase results from continued job declines, despite the anticipated end to the recession in the fall of 2009. It should also be pointed out that even after job losses cease, the job market is expected to remain

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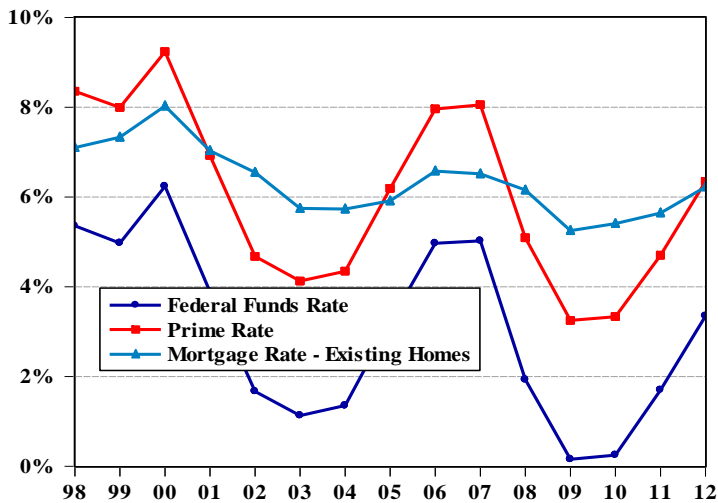
## U.S. Civilian Unemployment Rate



Source: Global Insight

weak. Annual nonfarm employment growth is expected to remain under 2.0% through 2011. Given the low job growth, the unemployment rate is expected to improve slowly. After peaking in 2010, it averages nearly 10% in 2011 and is still nearly 9% in 2012. It continues falling over the next two years, but in 2014 it is forecast to be in the area of 8%, which is well above the 5% to 6% consistent with full employment. The high unemployment rate is likely to keep wage gains modest, which should keep a lid on future inflation.

### Selected U.S. Interest Rates



Source: Global Insight

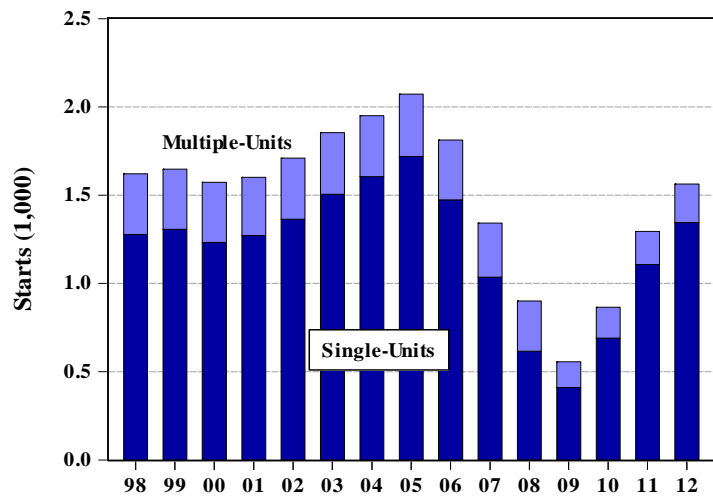
**Financial Markets:** The Federal Open Market Committee (FOMC) maintained its 0.0% to 0.25% target for its federal funds rate during its most recent meeting. The FOMC based its decision on the facts that the U.S. economic contraction is slowing and inflation remains subdued. The FOMC did make some modifications to its extensive array of quantitative easing programs based on the improved functioning of financial markets in the second quarter. It did not make any changes to its targets for direct purchases of government-sponsored enterprises, mortgage, or U.S. Treasury debt. For the most part, the FOMC is sticking with its policy to keep interest rates low for an extended period. There are two reasons for this course of action.

First, the massive stimulus the Federal Reserve has pumped into the economy has just started to slow the rate of contraction and stabilized conditions in the financial markets. Second, the Federal Reserve stated clearly that inflation is expected to remain subdued, despite the recent increase in energy and commodity prices, due to “substantial resource slack.” This forecast assumes the federal funds rate will be held near 0.0% through mid-September of 2010. It will be raised gradually thereafter. Consumer credit declined by a relatively modest \$3.2 billion in May. This development brings both good and bad news. The good news is the steep decline in consumer credit since last fall is now in the process of decelerating. The bad news is credit extended by finance companies dropped by a sharp \$6.8 billion, and credit available through securitized pools declined by an even steeper \$9.9 billion. The drop in credit extended by finance companies indicates possible funding pressure at auto loan companies, which is no surprise given the May bankruptcy of Chrysler and June bankruptcy of GM. There was also a decline in the credit available through securitized lending. The bottom line is that the consumer credit situation is slowly improving, but not as quickly as would be desirable in terms of supporting efforts to stimulate consumer spending.

**Housing:** While it is still too early to declare the housing sector in recovery, there are signs that it is stabilizing. This is important because it is impossible to draw a line under the financial crisis until housing recovers. Promising indicators include home sales, housing starts, and permits. It appears lower home prices and attractive mortgage interest rates are making home ownership more affordable, which is causing Americans that can still get credit to buy homes despite fears about rising unemployment and reduced household wealth. Not all of the news about housing is positive, however. Most notably, housing prices continue to slide in the first quarter of this year. According to the Federal Housing Finance Agency, “The purchase-only Housing Price Index calculated using home sales price

information from Fannie Mae and Freddie Mac-acquired mortgages was 0.5 percent lower on a seasonally-adjusted basis in the first quarter than in the fourth quarter of 2008.” This drop marks the seventh consecutive quarter-to-quarter decline in the index. From the beginning of 2008 to the first quarter of this year, the index has dropped 7.1%. Looking forward, it is predicted the index will drop 3.1% from the fourth quarter of 2008 to the fourth quarter of 2009, and retreat another 5.3% by the end of 2010. It does not post a four-quarter gain until the second half of 2011. Thankfully, housing starts are expected to turnaround more quickly. Housing starts bottom out at about one-half million units in the second half of this year, then begin to grow gradually. It takes until the end of next year for housing starts to top one million units and the second quarter of 2012 to reach 1.5 million units.

## U.S. Housing Starts

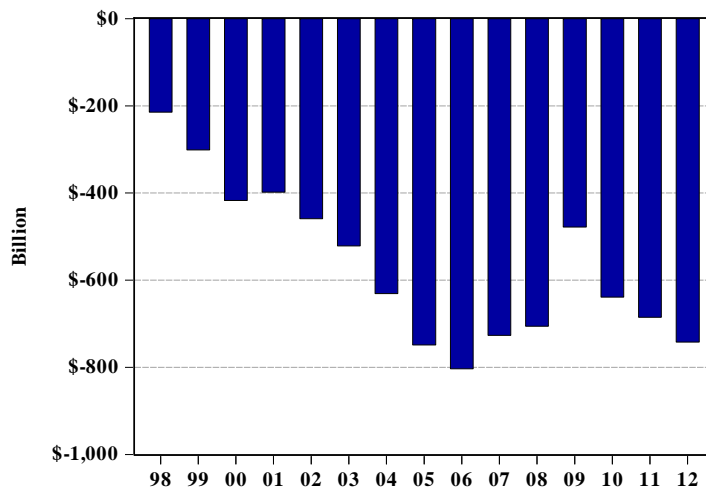


Source: Global Insight

**International:** One thing the world’s largest economies have in common is that they are in recession. One thing they do not have in common is how they will recover. Europe is expected to have an “L-shaped” recovery. There are growing fears that Europe’s recovery will not only start after the U.S. recovery, but it will be weaker. There are several reasons for this disappointing outlook. First, because this region’s economy is much more dependent than the U.S. on exports, its recession will be deep. Second, banking problems in Europe are as bad, if not worse, than in the U.S. In addition, they are not nearly as far along as the U.S. toward solving their financial troubles. Third, the region’s fiscal and monetary response to its recession has been more measured than in the U.S. China has a risk of experiencing a “W-shaped” recovery. While China has been the first major economy to improve, the

recent softening of exports suggest it may still face challenges. In fact, after rebounding strongly, China’s purchasing managers’ index has begun to flatten out in recent months. The large government stimulus program has had a strong impact on capital spending, but almost no impact on retail sales and consumer spending. The liquidity injections into the economy have helped out but are beginning to moderate. China is forecast to grow 7.2% this year and 8.3% next year. Nevertheless, it remains vulnerable to a “double-dip” recession if growth falters when the massive stimulus wears off, consumer demand does not grow rapidly, and exports fail to expand at a double-digit pace. Japan’s economy must clear

## U.S. Current Trade Deficit

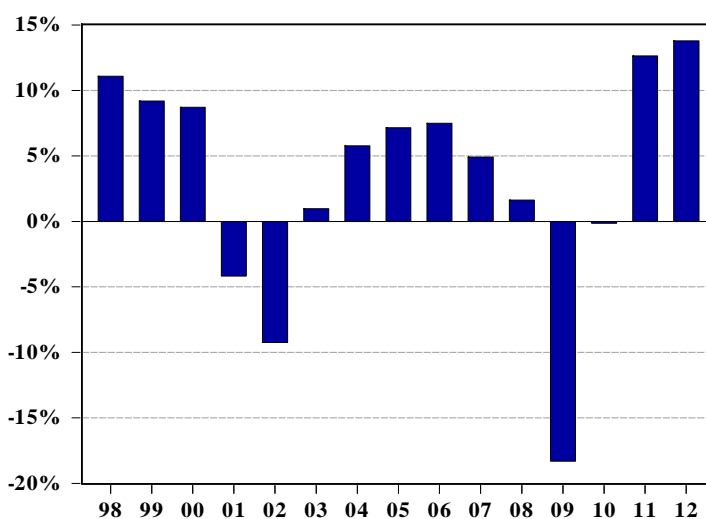


Source: Global Insight

several high hurdles in the near future. Its recession probably ended this spring. However, the second and third quarters of 2009 are likely to be flat. Domestic demand remains weak, with fixed investment and construction spending falling, and consumer spending moving sideways. In addition, deflation still plagues the world's second largest economy. While its government has promised large amounts of fiscal stimulus, it is only likely to amount to 2.0% to 2.5% of its GDP. Japan's real output is expected to drop 6.8% this year and rise just 0.9% next year. Even after the global business cycle improves, continued structural problems in Japan will threaten an extended period of anemic growth. The U.S. current account trade deficit is forecast to improve this year, the result of lower oil prices. After this year, however, the nation's trade deficit begins to grow. Specifically, it is \$478 billion in 2009, \$639 billion in 2010, \$685 billion in 2011, and \$742 billion in 2012.

**Business Investment:** Despite reports that show nonresidential construction investment rising for four consecutive months, a sustained recovery in this spending category is not imminent. This conclusion results from two anomalies that surface upon a closer look at the data. First, the data reveal a surge in manufacturing construction and a run-up in power construction. The manufacturing surge results from a massive buildup in refinery construction. This expansion began in 2008, when spending levels exceeded those of the previous 11 years combined. A large decline in this category over the next 12 months is likely. A spike in oil and gas pipeline construction fueled the recent gains in power construction. These gains are from projects that are winding down. Outside of refinery construction and oil and gas pipeline construction, private nonresidential construction is contracting. The outlook for spending on structures over the next two years is grim because underlying conditions are weak. Spending on nonresidential structures is forecast to drop during the first six quarters of the forecast. Real investment on nonresidential structures retreats 17.9% this year and by 14.2% next year. This decline is deep and wide. For example, in 2010, every major investment category, except for mining and petroleum structures, drops at a double-digit pace. Real spending on equipment and software is expected to tumble nearly 19% this year—its largest annual drop since 1947. Inventory investment is forecast to shrink again this year, before rising in 2010. Overall, real business investment is projected to drop about 18% in 2009, experience no growth in 2010, increase 12.6% in 2011, and rise 13.8% in 2012.

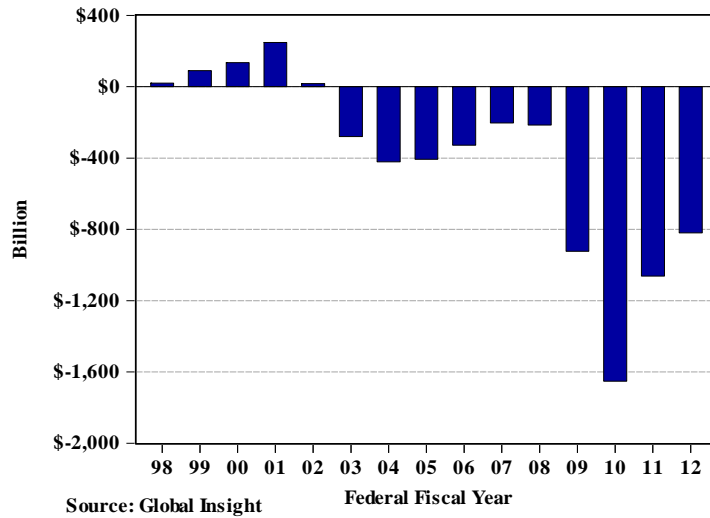
**Real Business Investment**



Source: Global Insight

**Government:** The full fiscal stimulus package is valued at around \$787 billion over ten years. It is assumed that \$561 billion of the total will be injected during the first two calendar years. The \$561 billion breaks down into \$143 billion in personal tax cuts, \$97 billion in personal transfer payments (e.g., food stamps, extended unemployment insurance), \$88 billion in corporate tax cuts, \$149 billion in transfers to states, and \$82 billion for infrastructure and other spending. The stimulus is projected to increase 2009 GDP growth by 0.9 percentage point and next year's growth by 1.2 percentage points. It is also expected to create or save just under 2.5 million jobs by the end of next year, which is slightly lower than the three million jobs estimated by the Obama administration. Despite the boost to jobs, the

## U.S. Federal Government Surplus Unified Basis



predicted peak-to-trough decline in nonfarm employment is still well above seven million jobs and the nation's unemployment rate will rise above 10%. The U.S. Treasury has \$700 billion in budget authority under the Troubled Asset Relief Program. This forecast assumes the Treasury spends only \$650 billion. This amount is assumed to be distributed as follows: \$57 billion to the auto sector, \$518 billion to the financial sector, and \$75 billion for the housing plan. The stimulus package, financial bailout costs, and recession will take the federal budget deficit to \$1.6 trillion in 2009 and \$1.2 trillion in 2010. (It was less than one-half trillion dollars in 2008.) Keep in mind that these figures do not include the costs of other

proposed programs, such as universal health care, or another round of stimulus spending. The deficit is expected to drop below one trillion dollars after 2010, as the economy recovers and stimulus spending ends. However, the lasting effects of the recession can be seen in the national debt. For the first half of this decade the amount of publicly held debt as a percentage of GDP hovered near 35%. In 2009, it is expected to jump to 58.9% of GDP and to 65.2% in 2010. Unfortunately, the ratio of publicly held debt to GDP is expected to creep even higher over the next few years. The need to service this debt will put upward pressure on interest rates.