

2009 Economic Outlook for Treasurers

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As we look at the U.S. and global economy entering 2009, I think the most important and obvious point worth making is that we are in the grips of what is a severe and synchronized global downturn. The downturn looks to us to be producing GDP contraction of something in the range of five to six percent in the two-quarters around the turn of the year 2009 for the United States, and the news elsewhere doesn't look much better. This depth and synchronization of a downturn we think is a reflection of the global economy being hit by some very powerful negative shocks. The credit event wasn't purely a U.S. housing market downturn, but the credit event was the unwinding of credit availability and easy terms across the world. I think the world is also reeling from the effects of what was a dramatic rise and inflation in energy prices last year.

Unfortunately, it looks to us that this adjustment has got a fairly long way to run. We would look toward the first half of 2009 as one in which we continue to stay in the grips of this economic downturn. I think that the good news from our point of view is that we do see a path towards beginning to get recovery in the second half of the year. I think that part of that path is coming from very aggressive actions on policy makers across the world to try to heal the crisis mode in funding markets and try to provide opportunities for credit to flow. There is some beneficial improvement we have already been seeing on that front. We think there are more initiatives to come. On top of that, there is an aggressive move on the part of policy makers to provide support for demand in terms of monetary-ease — fiscal-ease. I think that combined with what has been a cushion from falling energy prices, and combined from what we think is going to be aggressive and ultimately overshooting cost cutting on the part of corporates across the world, we do see a scenario where you can be beginning to get growth again as we turn towards the summer and fall of 2009.

That story is not by any means assured, and we are going to be watching very carefully to see that the medicated efforts in markets do produce results in the form of flattening home sales, flattening car sales, and some improvement in access to credit for corporates and households as we go through the first half of the year.

A final point that I want to make in this brief summary of the outlook is that a return to economic growth may sound like an optimistic message about the latter part of this year, but I think that the hole that we are digging in terms of the depth of this economic downturn does make it very important to recognize that a return to growth is not a return to health. We are likely to see the U.S. economy move its unemployment rate up somewhere in the range of eight and one-half to nine percent before the economic downturn is over. We are likely to see underlying budget deficits remain very high for sometime to come, and we are likely to be living with inflation which will probably be tipping below one percent even excluding the volatility in energy prices. To us, this is a very troubling scenario as we think beyond the next six to nine months, and even if we do get some growth going. What it tells us is the economy is going to have enormous forces weighing it down in terms of underutilized resources; in terms of a still difficult time for balance sheets, both public and private, to get back to something normal. I think the underlying message here is that the pain and cost of this serious and deep economic downturn is going to linger quite a way here. Our basic view is that the economy will get out of recession sometime later this year, but will not get out of the cost that will need to be paid for the damage that is being done. We think that the most clear-cut way you will see that is in an economy that as it goes forward is probably not going to be able to generate the kind of growth and wealth creation that we have seen in the past. We believe that the economy is making a downshift in the United States; something in the range of two percent underlying growth. To recognize how big a shift that is, most economists would have estimated trend growth in the U.S. at three and one-half percent or so as we entered this decade. So I think there is a deep economic downturn we are in the midst of now. It is going to cause a very serious hole for us to dig out of. We think there is a decent chance that we begin to dig out of it

later this year, but unfortunately I don't think that we are going to have the kind of momentum and sustained strength that would be necessary to really get us back to something healthy anytime soon. I think that we will pay an ongoing price in our performance for that.

I think the first half of 2009 will be an environment in which the pace of contraction and growth will remain fairly close to what we saw at the end of last year. There will be, I think, some important rotations. I think the adjustment in labor markets; the adjustment in businesses in cutting back on spending is going to intensify in the early part of 2009. Our hope is that as that intensifies and keeps a very serious recession in place, there is some signs that financial healing is promoted by government policy, and that the dramatic collapse in consumer durable spending that is taking car sales and taking home sales and other big ticket items down, doesn't get followed by a rebound, but does start to level off here as we have some improvement in incomes with fiscal policy and lower energy prices, and there is some fading of fears. Things are going to continue to be pretty seriously negative in terms of the overall pace, but we are hoping for a rotation in growth that to some degree sets the stage for a return to growth later in 2009.

I think that in the next two or three months the important signs will come from the financial market. Signs that we are consolidating mortgage rates lower than where they were in the fall of 2008; signs that the funding markets are functioning at activity in commercial paper and looking out toward corporate bond markets are working, and that those forces are beginning to put into place a stabilization at very low levels in home sales and things like car sales. That consumer confidence is beginning to bottom out. That is, I think, what you would expect over the next two to three months in an environment in which production, hiring, and corporate spending continue to contract. If that does happen, the flattening out in durable spending; the improvement in financial conditions, combined with stimulus coming in, should set the stage for improvement later on in the summer and fall.

We think there are two broad forces at work in currency markets. I think the fact that the two forces are not necessarily aligned, it is one of the issues that creates what I think will continue to be some significant volatility in markets. The first force, of course, is the recession, and the sense that the recession has broadened, and the sense that the recession is telling us how dependent countries outside the U.S. were on easy credit. I think that as we are beginning to see that story play out and create quite a bit of stress outside of our borders, the dollar and the yen, which have been two significant funding currencies, have been getting the most significant benefits. We think that when you begin to see signs that the economic downturn globally is beginning to abate, to some degree that is going to be the point at which the dollars rise that we have been living through in recent months, will probably begin its end. I think that cyclical story is a very important one. It has not played out. We think that it has at least two or three more months to go, but we think that sometime in 2009, the cyclical arrow is going to point it back in favor of those countries which are more benefiting from cyclical recovery and growth, and a little bit of increased risk appetite. Now, against that backdrop we are going through some very significant regime shifts here and structural changes. I think those forces work against those countries which have been the big beneficiaries as drivers of financial activity in the world. Clearly the United States; clearly the United Kingdom, and a few other industrial countries are at the center of that. We do believe that the structural force that is likely to play out here over time is going to be one that is going to be towards weaker dollar and weaker sterling in global markets. So I think unfortunately the structural story is going to be one which will be very powerful, but may be difficult to time in context of the cyclical forces, which if we are right at some point in the next few months are going to actually turn in a different direction.

I think the cyclical is probably going to dominate the 2009 story, but I would keep very close attention to what I think plays out here and our views about the unpleasant arithmetic lying ahead for the U.S. and I think for the U.K. and other countries to watch, which I think are ultimately negative for their currencies.

There is a multitude of things that are happening here. I would divide the efforts that are going on here in two basic baskets. One basket is to try to help with the stresses that are playing out on balance sheets of financial institutions, particularly banks that are suffering losses here. In some sense the fed's borrowing facilities or to try to provide healthy liquidity there, the Fed and the Treasury's attempts to recapitalize through TARP is part of that. I would argue that certainly the bad bank or aggregator bank idea, which is going to be announced it looks like sometime in the next few weeks, is a step in that direction, which is to try and get the significant losses off of the bank balance sheets. To try and make sure they are not in a position where they are under so much stress that they can't do normal operations. Certainly there is stress there. Recognizing though that banks are not able to pick up the slack from all of the deterioration in financial conditions outside the banking system, Fed and Treasury are in a mode of also trying to support specific markets which have been impaired. I think that we have seen enormous initiatives work through the system in terms of the commercial paper facility that the Fed has set up. The facility to buy mortgage backed securities which is directly attempting to help bring mortgage rates down in the economy has had some positive results from there. A program which is about to get launched called the T-A-L-F, the TALF, which is designed to provide a facility as such that issues of asset backed securities for consumer lending can actually package those loans into securities without taking much risk on their books. That, I think, is also a template which may be applied to commercial real estate, and

potentially even the municipal bond market looking forward. That I would not suggest is certain to happen, but the Fed and Treasury and FDIC are looking at that. They are both attempts to try and improve the position of bank balance sheets to make sure that banks don't pull back too hard, and then in the commercial paper and the mortgage market and in the asset backed security market for consumer lending, policy is trying to work so that new activity can continue here even though many of the participants in those markets have effectively been unable to provide liquidity and sources of financing.

You are in an environment that has a deep economic downturn and has aggressive policy actions, credit markets tend to differentiate which is to say that the poor quality credits tend to lose access and see their spreads widen very dramatically. The better quality credits do see spread widening, but that is more than offset by the fall in risk free interest rates. In September and October with the crisis in funding markets, credit deteriorated in an undifferentiated fashion. One of the things that we think has started to happen, and we expect to continue to happen, is more differentiation to take place in the credit markets. I think the better quality credits as we go forward with the Fed continuing to be very aggressive and maintain zero interest rates, are going to be having much better opportunities in a relative sense here. So we think we are starting down the road towards an environment where those companies that have been able to manage their positions relatively well will see the benefits of that in a more differentiated credit market with very low risk free interest rates.

Continue to hit home the point that we think we are in the midst of a very acute economic downturn now. We think there are some good chances for getting out of that spiral of activity going down over the next six to nine months, but I would caution to continue to not equate a return to growth to a return to health, and to understand that the damage that is being done in this economic downturn is going to be an issue for performance, an issue for markets, an issue for the health and wellbeing for the U.S. economy, I think for many years to come here. We are going to trade, I think, an acute problem over the next year for a chronic set of problems that will create, I think, enormous challenges to both policy makers and participants in the private sector as well.

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