



SPECIAL COMMENTARY

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The Evolution of the Economy, Credit & Economic Policy

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After more than a year of recession and a decline greater than forty percent in some financial indices, are we making any progress to the upside? To identify progress we first identify where we are now in the economy.¹ Second, we address the question of whether we have reached a bottom, and which indicators we can use to gauge the economy's potential recovery. Finally, how can we measure progress in our policy efforts to address both economic and credit issues and if there are signs of progress at the regional level within the Sixth Federal Reserve District.

Our results suggest that we have made very little progress with the economy remaining in a deep recession. Alternatively, we do see progress in selected credit markets but only where the Federal Reserve appears to be directly involved. Unfortunately, the regional story remains disappointing.

Where are we now?

Our most recent forecast shows a deeper and longer recession than we witnessed in either 1990 or 2001, perhaps similar to our experience in 1973-75. In Figure 1 we illustrate our baseline expectations for real GDP. Real final sales are expected to remain negative throughout 2009. Inventory swings and declines in imports might produce a positive GDP figure before then, but we now believe the recession will last through the third quarter of this year while job losses and rising unemployment will likely carry over into next year. Federal government spending makes a significant positive contribution to our positive fourth quarter estimate for GDP.

Throughout this financial crisis there have been endless comparisons between today's environment and the 1930s. We feel a more apt comparison is the deep 1973-1975 recession, a period that also dealt with an oil price shock, a housing collapse and a banking crisis (Figure 2). This more recent recession, and not the Great Depression, provides a template for our outlook.

The current recession will take time to play out, and the economic stimulus package and financial sector reform efforts will reflect the outside policy lags familiar to policymakers. We have incorporated a very large stimulus effort into our baseline

¹ As prepared for the Federal Reserve Bank of Atlanta, Debate & Confirm: 2009 Banking Industry Outlook. February 19, 2009. The author would like to thank Sam Bullard, Azhar Iqbal, Gary Schlossberg, Kim Whelan and Adam York.

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forecast. Our expectations are that the infrastructure spending and the tax cuts will boost income growth and spending by the third quarter of this year. The bulk of the impact from the stimulus package will not likely affect the economy until late this year or next year.

Figure 1

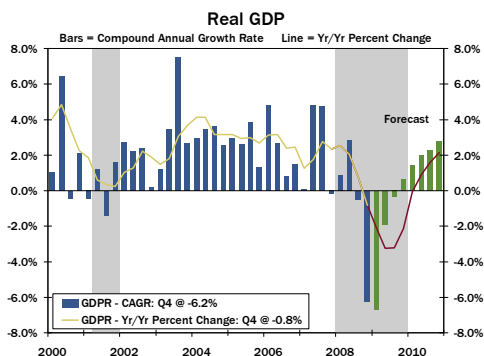
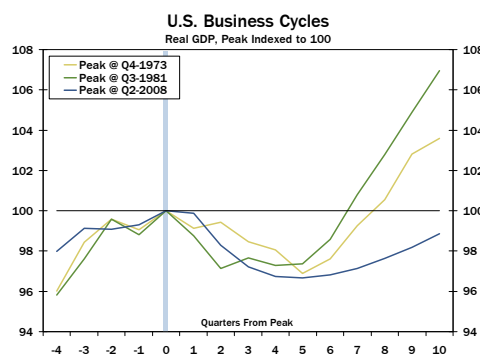


Figure 2



Source: U.S. Department of Commerce and Wachovia

For bankers and regulators, the pattern of GDP does not suggest an easy way out this year. First, in contrast to the historical pattern of housing, we expect housing starts will not recover neatly in line with the economic cycle. Traditional economic recoveries since WWII have been led by Federal Reserve policy easing that brought down interest rates and thereby kick-started housing. In this cycle however, housing continues to go through a long-term correction that reflects a fundamental revaluation of the proper price and credit availability associated with home buying. Second, in accordance with historical patterns, we expect that non-residential construction will lag the business cycle due to the negative impact of lowered economic expectations, energy prices and corporate profits.

Second Issue: A Bottom? – Consumer Spending & Real Final Sales

Has the economy reached a bottom? In addition, are there indicators that we can use to gauge the economy’s potential recovery? Consumer spending (Figure 3) will likely remain weak throughout 2009. We do expect some improvement during the year as motor vehicle sales should gradually improve. On a long-term basis, this pace is still well below the nearly 17 million unit pace averaged earlier in the decade. This would suggest a challenge for bankers and regulators in terms of the financing of auto inventories and the size and quality of associated asset-backed securities. Consumer spending will also likely remain constrained for other goods and services, particularly discretionary purchases such as leisure and travel, and big-ticket items like furniture and home electronics.

Figure 3

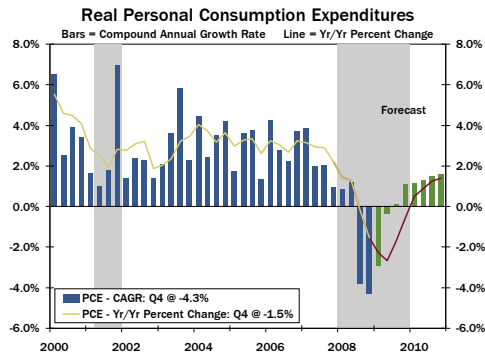
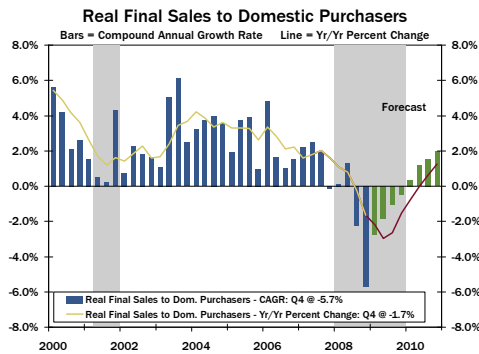


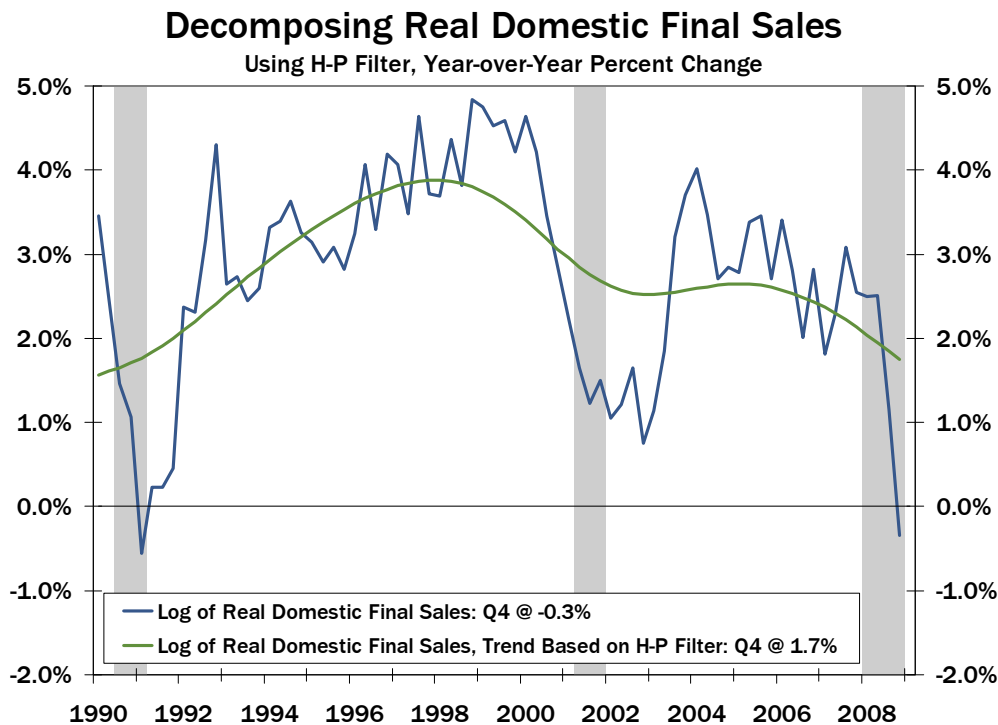
Figure 4



Source: U.S. Department of Commerce and Wachovia

A second component of real domestic final sales, business fixed investment, also tumbled during the fourth quarter of last year as firms struggled to realign production capacity with dramatically weaker global economic growth. For 2009, recent weakness in non-defense capital goods orders suggests continued weakness in capital spending and thus domestic final sales (Figure 4). No bottom is apparent for business equipment investment. In Figure 5, we use a mathematical technique, the Hodrick-Prescott filter, to suggest a separation between trend and cycle components of any time series. In this diagram we can see the rapid collapse in final sales relative to trend in the current recession. There is no sign of a bottom here. Tighter credit conditions are playing a role in reining in investment outlays, but the bigger problem here is that businesses simply have too much idle capacity.

Figure 5



Source: U.S. Department of Commerce and Wachovia

For bankers and regulators, the obvious implication of such weak spending would suggest that credit-financed consumer purchases and thereby retail vacancy rates will be under continued pressure. For example, we have already seen rising retail vacancy rates, particularly for neighborhood centers tied to recent housing developments. Bankruptcies at a long list of such easily recognized names as Circuit City, KB Toys, Goody's, Steve & Barry's and Linen & Things have made the consumer problems more visible.

The economy's free-fall amid a severe credit squeeze and pressure to deleverage are complicating efforts to pinpoint the depth of this recession and the timing and strength of the next recovery. Consumer weakness has also driven the decline in state/local sales tax revenues, which has aggravated municipal government deficits. These deficits have already been hit by personal income and property tax revenue declines. Deficit problems have led to credit quality issues (for example in California) that have raised issues for both bankers and regulators.

Indicators of the Eventual Bottom and Recovery

We focus on four key, non-financial time series to provide an initial impression of the state of the economy. First, the pattern of initial jobless claims in recent months suggests that large significant job losses will continue and that there is no signal here for a bottom in the economy. For bankers and regulators, continued job losses suggest continued upward pressure on office and retail vacancy rates.

For a second indicator, we estimate employment losses in this recession will exceed those of the recent recessions back to the 1957-1958 recession (Figure 6). These estimates suggest continued pressure on consumer credit lines as well as retail vacancy rates.

Figure 6

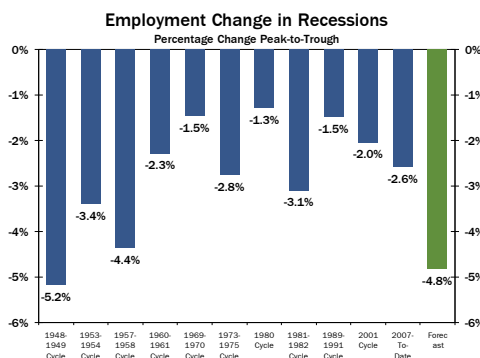
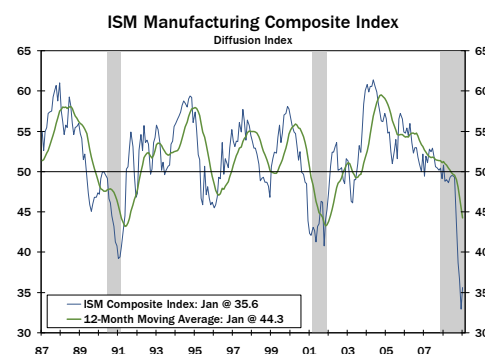


Figure 7



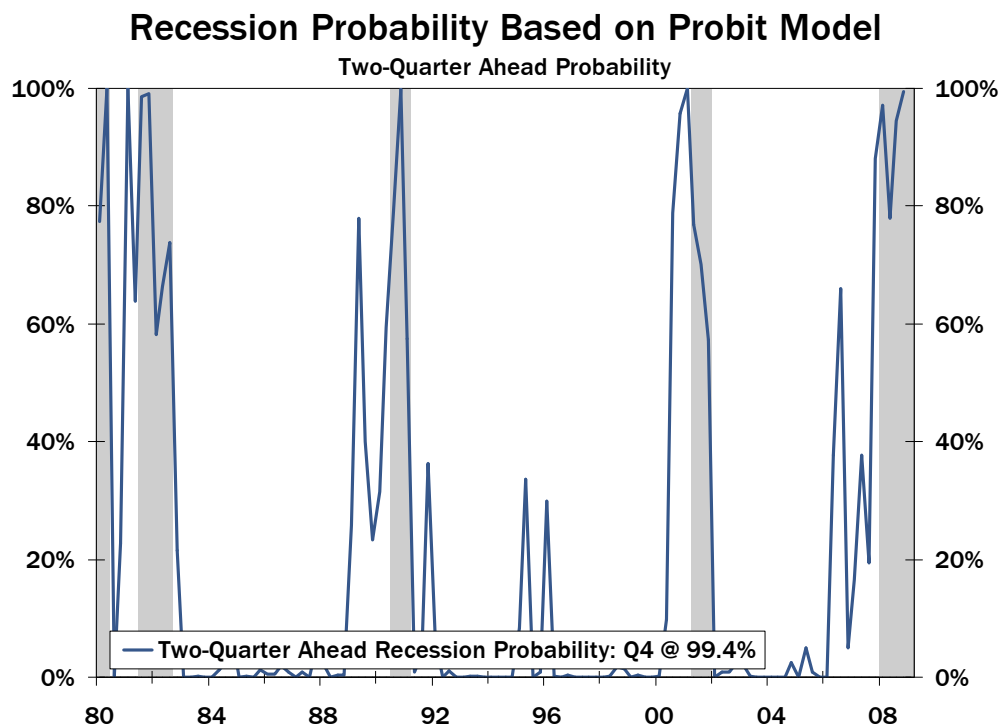
Source: Institute for Supply Management, U.S. Department of Labor and Wachovia

As a third indicator, the Institute for Supply Management (ISM) index illustrates the rapid decline in the manufacturing sector's fortunes in recent months (Figure 7). This weakness is consistent with the recent weakness of industrial production reported on February 18 and the sharp decline in exports also reported recently. For bankers and regulators, the weakness in the manufacturing sector is consistent with the rise in industrial vacancy rates since early 2007.

Finally, for business investment, we look to orders of non-defense capital goods, ex-aircraft orders, as an indicator of recovery. Over the last three months these orders are still down by double-digit percents, with no clear sign of a turn.

So far we do not estimate a quick recovery in the economy. We use a probit model to estimate the probability of a recession during the next two quarters.² Results from our model are illustrated in Figure 8 and suggests the probability of a recession is almost 100 percent for the first and second quarters of this year based upon data available through the fourth quarter of last year.

Figure 8



Source: Wachovia

Measuring the Progress – or Lack of it – of Policy Efforts

Our third issue to address is how much, if any, progress we have made. Is the economy improving? Are credit markets functioning any better since the Federal Reserve opened up its credit facilities? In a traditional business cycle, Federal Reserve policy easing on the scale of the last year would have elicited more of a response in economic activity than what we have seen in this cycle. The culprit, we would argue, has been the dramatic deterioration in both the availability and pricing of credit.

Over the short run, as for the availability of credit, we have seen a rapid rise in the net percentage of banks that have tightened credit according to the Federal Reserve's Senior Loan Officer Survey. As for pricing, we have also seen a rapid rise in bank spreads in the same survey. In the private markets, for example the commercial mortgage market, bank direct lending and securitization comprise some 75 percent of all credit to the market. While we have already seen tighter bank credit, as for securitization, commercial mortgage-backed securities were issued at a pace of

²John Silvia, Sam Bullard and Huiwen Lai, "Forecasting U.S. Recessions with Probit Stepwise Regression Models," *Business Economics*, January 2008.

\$20-25 billion per month in 2007, while current issuance is now effectively zero. The inability to finance commercial mortgages is a constraint on bank asset and fee growth for the year ahead.

In the long run, increased federal deficit financing poses a threat to long-term interest rates and financial stability, though less from increased inflation fears than one might expect. Instead, the increased supply of Treasury securities and the same loss of confidence in U.S. economic policy that helped destabilize the dollar and send U.S. interest rates climbing in the 1970s are the greatest threats. This bond supply effect over time is likely to offset the liquidity supply impact of Fed easing in the short-run.

Moreover, an unwinding of the “flight” capital, propelled by financial turmoil of the past eighteen months, could complicate the outlook in this cycle. Treasury yields could rise from unusually low levels sooner than they did during the two previous weak economic recoveries, while, in contrast, yields on non-Treasury securities (high-grade corporate bonds) could buck increases in government rates, as risk premiums continue to diminish.

A Policeman on Every Corner

Policy progress does appear in the decline in the TED spread and other short-term liquidity spreads such as the LIBOR to federal funds rate spread (Figure 9). As for liquidity, we appear to be mirroring the pattern of police patrols. At each corner where a policeman is stationed, we witness a decline in crime. In every market where the Fed focuses its liquidity facilities, such as short-term instruments as well as ABS and MBS, liquidity premiums decline. However, wherever the Fed is not engaged (no market policeman), such as corporate bonds, spreads have not returned to more normal levels (Figure 10). Fortunately investment grade bond issuance has increased as investors are seeking yields in this market as long-term Treasury rates offer very low historical yields. In contrast, high-yield issuance remains minimal with wide yield spreads.

Figure 9

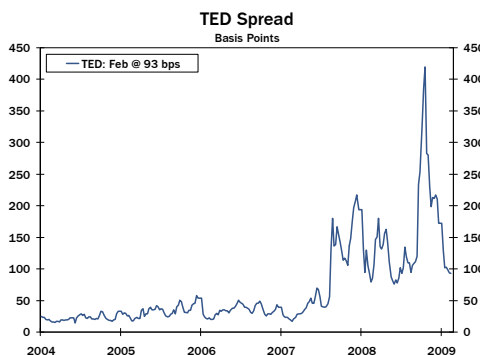
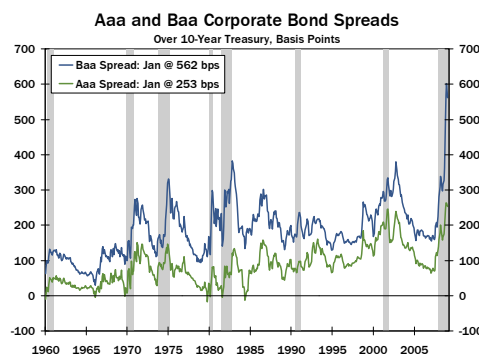


Figure 10



Source: Federal Reserve Board and Wachovia

Financial fundamentals remain an issue for bankers and regulators. As illustrated in Figure 11, there was a rapid rise in credit spreads for both 5-year and 10-year AAA CMBS associated with the Bear Stearns collapse by mid-2008 and then a sharp jump with the Lehman Brothers collapse in September of last year. For both policy makers and bankers, the break in spreads during last year presents an interesting problem. The break is significant in both size and duration, suggesting that the market equilibrium spread is unlikely to return to levels common before the break.

In this case, owners of paper issued between 2005 and mid-2007 would be permanently at a loss. In economics we would consider the market equilibrium pricing of the earlier period as unstable, made possible only by the perceptions of low risk and high liquidity prevalent in the market at that time. With the destruction of these perceptions the market equilibrium of the 2005 to mid-2007 ended, and is unlikely to return. As of now, the CMBS market is searching for a new equilibrium for pricing and issuance.

The current recession marks the end of the era of abundant and cheap credit, just as the 1973-1975 recession marked the end of the era of abundant and cheap energy. Bankers and policymakers are quickly adjusting to this new reality. With the securitization market still largely frozen, banks will likely continue to closely scrutinize anything they add to their balance sheets.

Figure 11

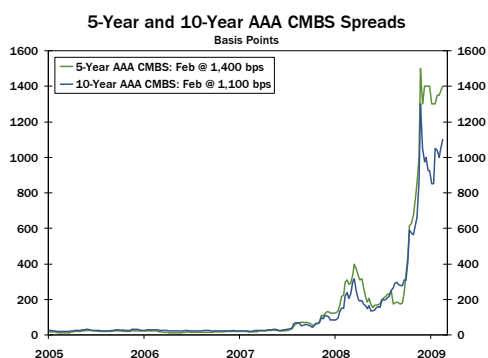
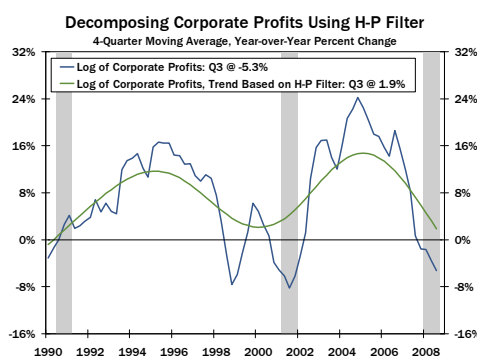


Figure 12



Source: U.S. Department of Commerce, Wachovia Securities and Wachovia

The significant slide in profits remains in place (Figure 12). Profit growth has broken far below its trend value in a pattern similar to the weakness in profits of the 2001 recession. Weaker profits are another issue for bankers and regulators. Weak profits suggest weak business credit and thereby higher delinquencies and eventually defaults. For the bond markets, weaker profits have historically been associated with weaker high-yield bond performance. We believe risk premiums throughout the bond market are attractive compared to the “rich” Treasury sector, despite their decline from last fall’s peak. Sizable yield premiums on an array of higher quality taxable and tax-exempt securities provide an alternative to Treasuries for many investors.

Housing Market: Real-Side Correction? Continued Financial Deterioration

One positive sign for improvement in the housing market is the recent decline in the outstanding inventory of existing homes for sale (Figure 13). In part, this decline may represent the clearing out of some foreclosures. The bottom line, as we see it, is still a decline in inventories and thereby a reduction in the downward pressure on home prices.

However, financial deterioration continues as evidenced by the continued rise in fixed-rate mortgage delinquency rates for both prime and subprime mortgages (Figure 14). History here is not on our side. Delinquency rates tend to peak late in the business cycle and in particular, actually peaked after the 2001 recession ended. Our expectation is that delinquency rates will peak late, or even well after the business cycle turns.

Figure 13

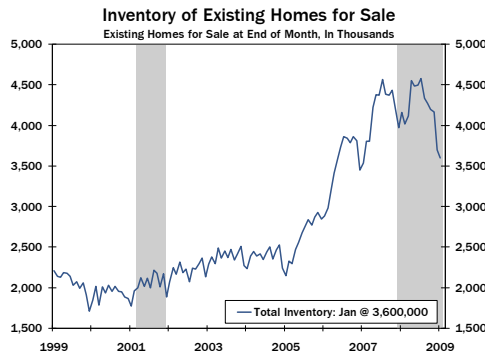
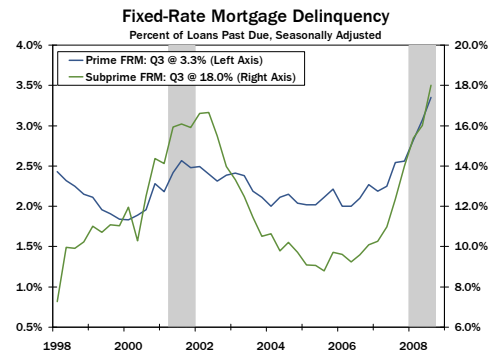


Figure 14

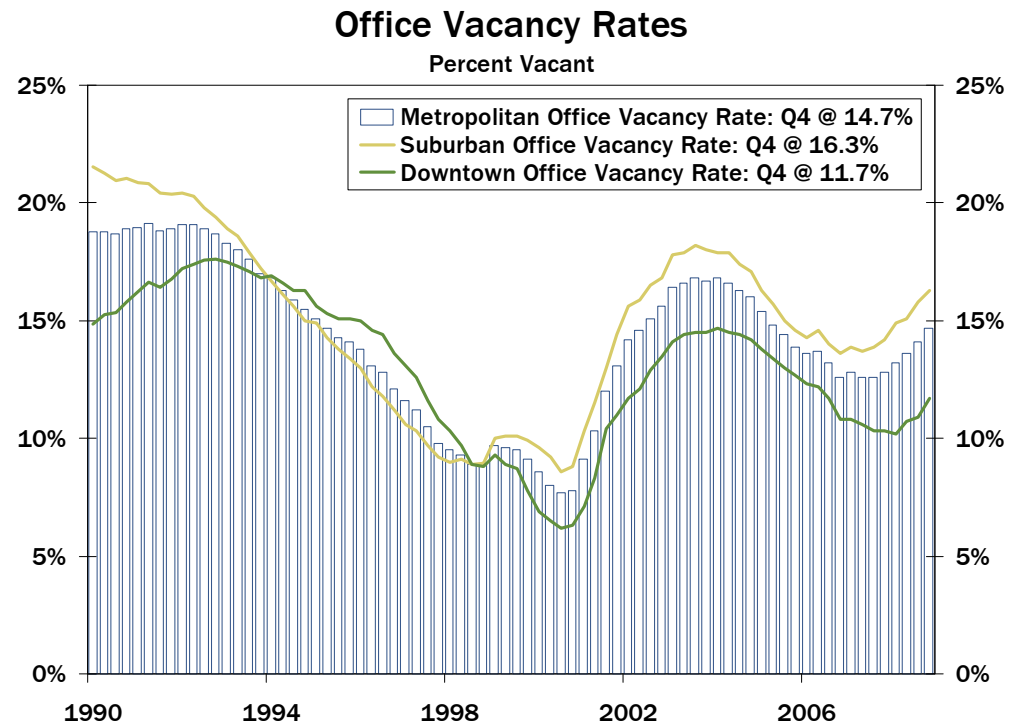


Source: National Association of Realtors, Mortgage Bankers Association and Wachovia

Commercial Vacancy Rates: Another Signal of Little Progress

Office vacancy rates are on the upswing, as would be expected in any recession period in which job losses are so large and widespread (Figure 15). Unfortunately for both bankers and regulators, office vacancy rates appear to peak long after the end of the recession (note the 2001 experience). We would expect the recovery of 2010 to be similar, with job gains initially being very limited and persistently high office vacancy rates for a sustained period. This suggests weaker revenue on rents for bank creditors and thereby a deterioration of credit quality at the margin.

Figure 15



Source: CB Richard Ellis and Wachovia

Regional Progress? Sixth District: Florida & Georgia – Not Much Progress

In the case of Florida, the upswing in housing permits and home prices during the 2003-2006 period was an overshooting on the upside relative to demographic fundamentals, rather than the establishment of a new equilibrium. This is a significant challenge to the banks and regulators in this state as home values plummet and drive delinquencies and to a higher level, sustained for a longer time, than experienced in recent recessions. In the Georgia case, the rapid gains in housing starts during the 2003-2006 period was not as pronounced as in Florida but still reached a much higher level than in the 1990s recovery.

Figure 16

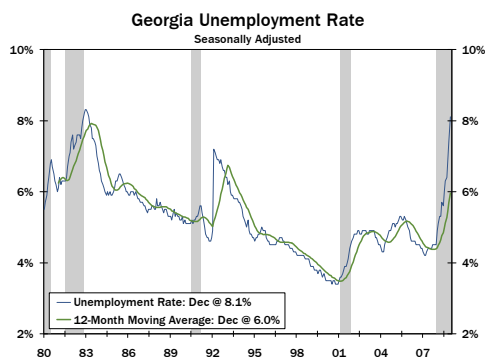
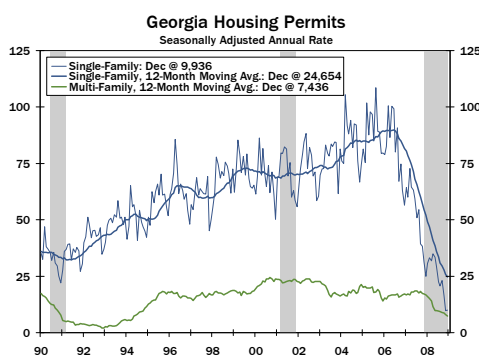


Figure 17



Source: U.S. Department of Commerce, U.S. Department of Labor and Wachovia

What was especially distinctive in Georgia was the lack of a home price jump during the 2004-2007 period. Unfortunately, home prices have dropped sharply in 2008, but the extent of the decline may suggest less of a credit problem than Florida has experienced.

Figure 18

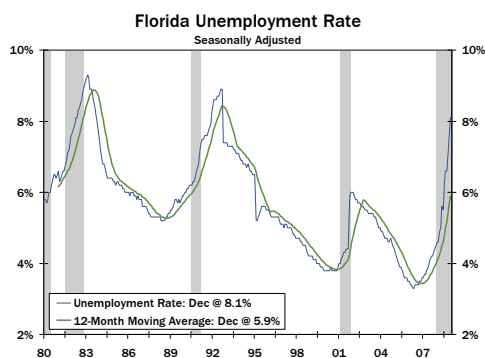
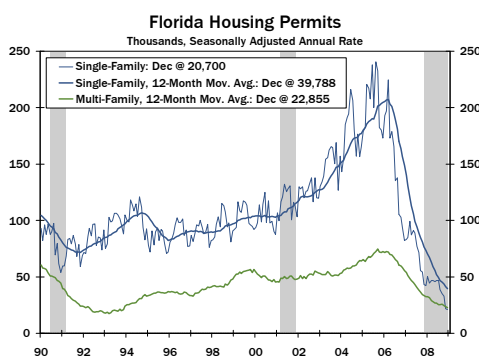


Figure 19



Source: U.S. Department of Commerce, U.S. Department of Labor and Wachovia

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