

US WEEKLY ECONOMIC UPDATE



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US Economic and Investment Perspectives

Will Growth Rebound in Second Half After Bleak Start to 2009?

Consensus forecasts for the US economy are universally bleak. Most analysts expect GDP to drop by at least 4% to 5% in the fourth quarter of 2008, followed by additional declines of about 2% to 4% in the first half of 2009. With poor visibility beyond the next six months, the forecasts vary widely for the second half of 2009, but most analysts expect modest positive growth.

It's hard to disagree with the consensus outlook for the first half of 2009 given the grim state of the economy. Yet despite the dismal statistics and gloomy sentiment readings there remains a wide range of potential outcomes for 2009 because the second half of the year is harder to predict.

Restoring growth will be challenging. Payroll employment has dropped by over 1.2 million over the past three months, and accelerating layoffs in recent weeks suggest that actual job losses will remain high or escalate into early 2009.

Growing concern about jobs and income has made consumers unresponsive to sales incentives (i.e. price declines), while shoppers are also shunning credit. Reluctance to use credit is evident in a 5% decline in retail sales over the past three months to a record low relative to monthly personal income (**Display 1**). Meanwhile, companies across many industries have pulled the plug on capital spending budgets and more cuts look imminent.

At this writing, a new threat has emerged. On December 11, the Senate failed to pass a bill that would provide temporary financing to US auto companies. We believe that this greatly increases the risk of triggering a deeper and longer downturn than we are currently forecasting. If the Bush administration does not offer emergency aid soon, the odds will increase that one or more of these key manufacturing firms will be forced to file for bankruptcy. The additional shock in terms of lost

jobs and output would be devastating to an economy that is already mired in a sharp decline.

If aid to the auto industry is settled in a positive way, it could help stabilize the economy in the short run and lay the groundwork for a broader recovery later in 2009. In fact the US economy has sometimes recovered faster than expected from hard landings in the postwar period, especially when aggressive monetary and fiscal policy actions were implemented. Of course, the nature of the current contraction is different from many previous downturns, but even the harsh effects of a credit crunch are not insurmountable.

Display 1: Spending Collapse Deepens Retail Sales Relative to Personal Income



Source: Bureau of Economic Analysis, Census Bureau and Haver Analytics

For example, in March 1980 the Carter administration imposed credit controls aimed at slowing the growth in supply of credit in the system. At the time, the US economy was limping along, battered by a near-doubling in the price of oil to a record in 1979, and a relatively weak consumer sector that was struggling with high levels of debt and rising loan delinquencies.

Credit controls made a profound impact on the economy. People stopped using credit and consumption immediately collapsed. Sales of big-

ticket items, such as cars and household appliances, posted record declines. Businesses slashed payrolls and production.

Just after the credit controls were installed, Paul Volcker, who was Chairman of the Federal Reserve at the time, said: “No one had ever seen anything like it ... within a matter of days the economy collapsed.” Indeed, the economy contracted 7.8% annualized in the second quarter of 1980, the second sharpest decline in the postwar period.

The economic scenario that has unfolded since the collapse of Lehman Brothers in September has parallels to 1980. The supply and use of credit has shrunk abruptly and dramatically. Plunging consumption has led businesses to slash payrolls, capex and production. And just as in 1980, these blows hit an economy that was already battered by a record oil shock in the first half of the year.

The events of early 1980 were unprecedented—as was the subsequent rebound. In July, the Carter administration removed the credit controls and the economy soared in the next two quarters, confounding experts and policymakers by posting average annualized growth of 8% in the fourth quarter of 1980 and the first quarter of 1981.

Policy Strategies for Sustainable Growth

The growth path in 2009 will surely play out differently than in 1980 for the simple reason that it’s harder to reignite the flow of credit from a market-induced contraction than from a crunch triggered by a government decree. But the economy today has the benefit of massive monetary stimulus and the promise of massive fiscal stimulus in 2009 from President-elect Barack Obama.

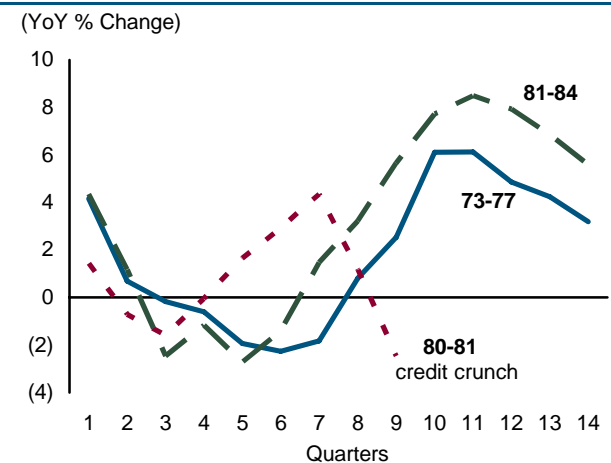
Display 2 shows the real GDP paths following the credit crunch of 1980 and the aggressive monetary and fiscal policies of the severe and long recessions of 1973–75 and 1981–82. In 1980, the sharp rebound had no staying power, because monetary policy was quickly relaxed and then tightened as the economy recovered. Moreover, no fiscal actions were taken in 1980 to help jump start the economy.

In contrast, after the deep downturns of the mid-70s and the early 1980s, the recovery was more powerful and sustainable because aggressive easing

of monetary policy was later accompanied by large doses of fiscal stimulus. In 1975, the fiscal stimulus amounted to about 1.5%–2% of GDP, and the 1981–82 stimulus, when fully implemented, was close to 3.5%. Media reports suggest that Obama’s economic team is considering a stimulus plan estimated at about 3.5% of GDP, or at the upper end of packages that have been enacted in the past.

Display 2: Real GDP Paths Following Massive Fiscal Stimulus and Credit Crunch

Real GDP



Source: Bureau of Economic Analysis and Haver Analytics

The historical record on combined monetary and fiscal stimulus packages is encouraging—evidence suggests that, given time, the strategy works.

Of course, the downturn will still be painful and could ultimately inflict as much damage as the recessions of the mid-70s and early 1980s, which lasted 16 months and triggered peak-to-trough declines of between 2.5% to 3% in real GDP. But our research suggests that the velocity of a downturn does not diminish the velocity of a rebound. Thus, we believe that the economy has the potential for a much stronger rebound in the second half than consensus estimates suggest, as long as policymakers stick to their promises to prevent a collapse of the auto industry and deliver the impetus for economic growth.

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