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A New Year Brings More Policy Measures

- We expect policy in 2009 to focus on three areas in addition to recent Fed initiatives: (1) offsetting or at least cushioning the decline in private sector consumption and investment through a large fiscal stimulus package of at least \$600 billion and as high as \$800 to \$900 billion, (2) refocusing efforts on clearing bank balance sheets of illiquid or troubled assets and recapitalizing those same institutions, and (3) working against an undershoot of home prices through principal writedowns and lower mortgage rates.
- The next several weeks are likely to be full of policy announcements including a final decision on the amount of fiscal stimulus, a request for the remaining TARP funds including a plan for use of those funds, and an agreement to stabilize the automakers.
- An avalanche of positive policy news has already arrived over the past few weeks, including 1) an impressive set of intervention-minded nominees for economic posts in the Obama administration, 2) new uses of TARP funds including today's auto bailout, 3) rising estimates for fiscal stimulus in early 2009, 4) significant mortgage market intervention, 5) massive Fed stimulus, and 6) announcements of fiscal and monetary stimulus elsewhere in the world.
- The policy stimulus in train has helped financial markets to improve somewhat, with asset prices generally higher (though far below levels earlier in the year) and measures of financial distress improving gradually, albeit unsteadily. This has occurred despite an economic outlook that remains grim: fourth-quarter real GDP is tracking a bit weaker than our forecast of a 5% (annualized) decline, and risks may be skewed to the downside of our -3% call for the first quarter as well.

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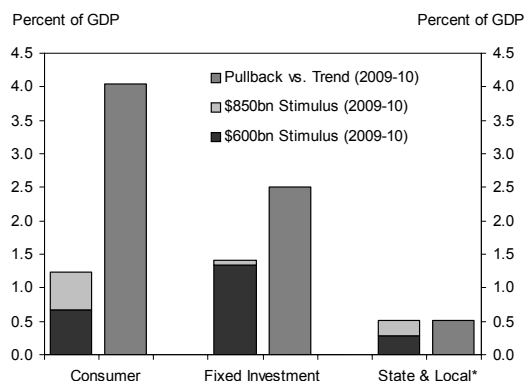
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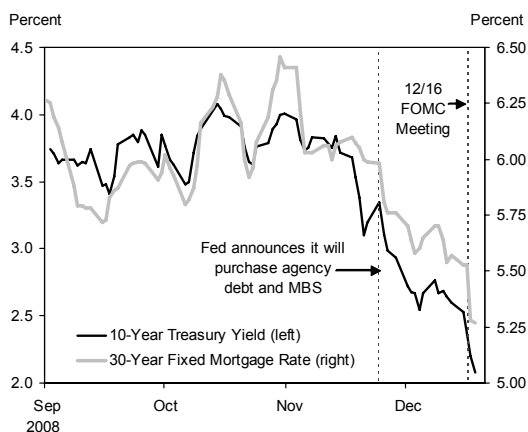
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Stimulus Fills Some Gaps More Than Others



Source: Our calculations.
* Drag in State & Local sector denotes an assumed \$150bn budget deficit to be closed through spending cuts and tax hikes.

Intervention Pushes Yields Down



Source: Federal Reserve Board. Bankrate.com.

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I. Policymakers Try to Ward off the Grinch

Financial markets have improved somewhat in recent weeks, with asset prices generally higher (though far below levels earlier in the year) and measures of financial distress improving gradually, albeit unsteadily. This has occurred despite an economic outlook that remains grim: fourth-quarter real GDP growth is tracking a bit weaker than our forecast of a 5% (annualized) decline, and risks may be skewed to the downside of our -3% call for the first quarter as well.

Pedal to the Metal on Policy

Instead, the big shift in views has come on the policy axis. Market sentiment was at its worst in late November, with the S&P 500 hitting its low just a couple of days after Treasury Secretary Paulson suggested that he would leave use of any further TARP money to the next administration. Alongside the failure of a fiscal stimulus plan to pass in the post-election Congressional session, the implication was that policy would be more or less “on hold” until late January. Markets deteriorated swiftly and sharply following these comments, as investors adopted a pessimistic view of the policy outlook to match their already-pessimistic views on the economy.

However, this policy pessimism proved unfounded. Since the November nadir in the equity market, we have seen an avalanche of positive policy news:

1. A stream of well-regarded nominees for economic posts in the new administration. President-elect Obama plans to bring on board a slew of experienced policymakers who generally are sympathetic to aggressive government intervention to support the economy, including former Treasury

Secretary Lawrence Summers as chairman of the National Economic Council and New York Fed President Timothy Geithner to head the Treasury.

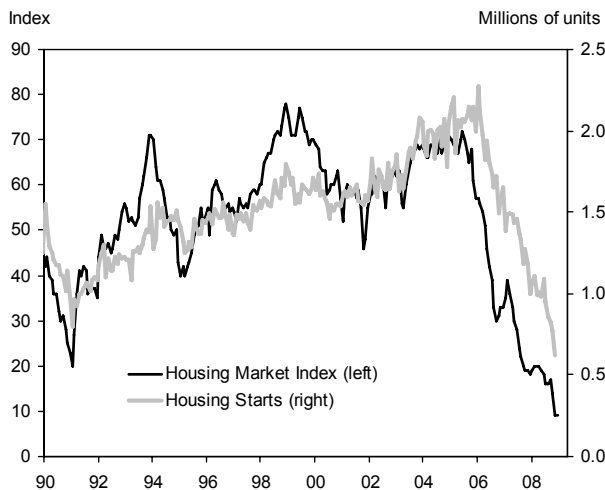
2. A resumption of the use of TARP funds. Only a few days after Paulson’s announcement, he reversed course and contributed TARP funds alongside the Fed to backstop losses on \$306bn of troubled assets in Citigroup’s portfolio. Today, President Bush announced that TARP funds would be provided to US automakers; the \$17.4 billion commitment means that all funds from the first tranche have been allocated, with \$4 billion required from the second.

3. A steady bidding up of 2009 fiscal stimulus. Media chatter has suggested a steadily rising target for the size of the Obama administration’s fiscal stimulus package, with numbers as high as \$1 trillion reportedly being discussed.

4. Help for housing and mortgage markets. With housing still in free fall (Exhibit 1), the key step here was the Fed’s announcement that it would buy \$100bn of agency debt and \$500bn of agency mortgage-backed securities in coming weeks. This has already induced a drop of more than 100 basis points (bp) in conforming mortgage rates and a surge in refinancing applications, as well as knock-on effects in the Treasury market that have contributed to lower yields (Exhibit 2). News reports this week suggested that the Federal Home Loan Banks could be another vehicle for government officials to push down conforming rates still further.

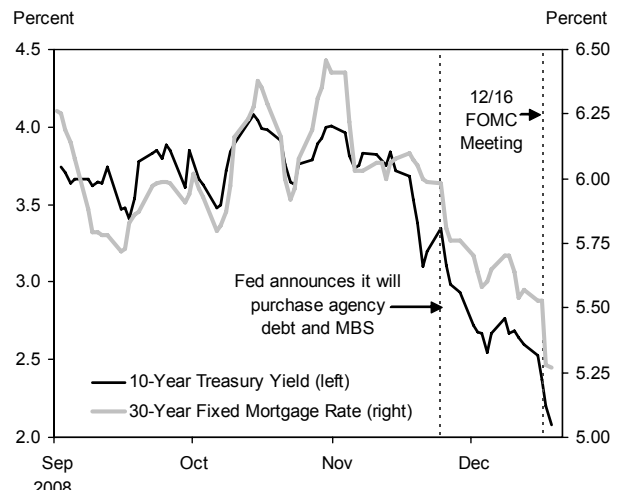
5. Massive Fed liquidity provision. The Fed announced its intention to launch a Term Asset-

Exhibit 1: Housing Still in Free Fall



Source: National Association of Home Builders. Department of Commerce.

Exhibit 2: Intervention Pushes Yields Down



Source: Federal Reserve Board. Bankrate.com.

Backed Securities Lending Facility early in 2009 to restart consumer and small business lending, an approach which could be expanded to other asset classes if it proves successful. This week's no-holds-barred policy statement from the Federal Open Market Committee took rates to near-zero, committed to hold them there for "some time," acknowledged the Fed is considering other potential "ways of using its balance sheet to further support credit markets and economic activity," and bluntly stated that it will "employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability."

6. Actions elsewhere in the world. In addition to the policy response in the United States, officials in other major economies have announced large policy rate cuts and fiscal stimulus packages—although particularly in the case of Europe we think more still needs to be done.

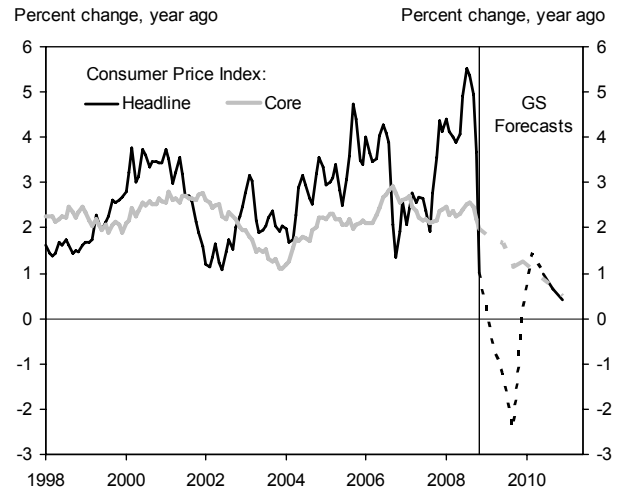
But Will It Work?

The key questions for the US outlook are: how quickly will these measures help to regenerate growth, and will that growth be sufficient to ward off a pernicious deflationary spiral? In the near term, things are likely to remain tough. As noted above, risks to our growth forecasts appear skewed to the downside over the next quarter or two. And the modest revival in markets may be conditioned in part on expectations about fiscal stimulus that are becoming quite optimistic—after all, the \$1 trillion number mooted in the press was just framed as a possibility, and Congress might well balk at a package that large in any case.

Nonetheless, the potent holiday cocktail of monetary and fiscal stimulus that is in train suggests that risks to our growth forecasts may be skewed to the upside beginning in mid-2009—the first time in several months we can recall talking about "upside risk" to anything but unemployment. More growth will be sorely needed, as the economy will be operating far below potential at that point with an output gap that is exceeding large.

Regardless of the precise figures we or others expect for growth, the economy appears set to operate well below potential for several years, quite possibly five or more. Even if the economy turns on a dime in mid-2009 and begins growing at a well-above-trend 5% rate—much more optimistic than our forecast or almost any other—it would take two to three years of growth at that rate to soak up all the slack that will have emerged by then (see Wednesday's *US Daily*, "A Big Window Between Inflation and Deflation," for a more thorough explanation).

Exhibit 3: Inflation Headed Much Lower



Source: Department of Labor. Our calculations.

The persistence of a high level of unutilized resources of is of particular concern given rapidly plummeting inflation (Exhibit 3). In theory, the Fed can always prevent deflation if it prints money (expands the supply of reserves) with sufficient gusto and uses those reserves to lend against or buy assets. But will the Fed be willing to do that in practice—and will Congress, the ultimate source of its authority, let it? At this point our answer to this question is "yes." That said, we have little doubt that deflation, not inflation, will be the primary concern of financial markets over the next few years.

The economic data to be released over the coming week (all on Tuesday or Wednesday) are unlikely to shift views substantially. The most important will be any data or anecdotal information regarding holiday shopping: have retailers' aggressive discounts been able to stabilize spending? News on home sales and prices is apt to remain glum, but the basic direction of this sector remains clear and the data tend to be less reliable at this time of year in any case given seasonally lower levels of transactions. Durable goods orders are apt to post another decline, and jobless claims to remain elevated. In short, holiday cheer will have to be found somewhere other than the economic data.

Andrew Tilton

II. A New Year Brings More Policy Measures

We expect policy in 2009 to focus on three areas in addition to the Fed's quantitative easing outlined in the previous section: (1) offsetting or at least cushioning the decline in private sector consumption and investment through a large fiscal stimulus package; (2) refocusing efforts on clearing bank balance sheets of illiquid or troubled assets and recapitalizing those same institutions; and (3) working against an undershoot of home prices through principal writedowns and lower mortgage rates.

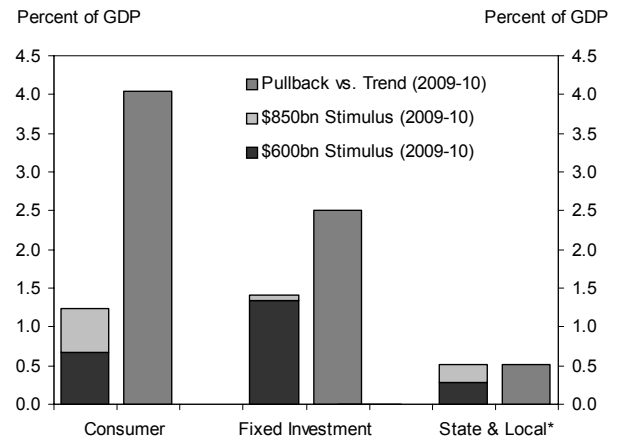
The next few weeks are likely to be full of policy announcements: the request for TARP funds must carry with it a plan for use of those funds and this seems likely to include new foreclosure mitigation efforts; an agreement to stabilize the automakers appears to be forthcoming and could set a precedent for assistance to non-financial sectors; and lawmakers are busy compiling the fiscal stimulus legislation expected to reach the House floor the week of January 5, as noted in Exhibit 1.

Exhibit 1: The Busiest January in Memory

Date	Event
January 6, 2009	The new Congress convenes; stimulus considered
January	Congress likely to consider final installment of TARP funds and requirements for their use
January 20	President-elect Obama takes office
Late January	Economic stimulus legislation likely to be enacted
February 2	Preliminary budget submitted to Congress
February	Possible Obama State of the Union Address
February	Temporary ABS Liquidity Facility (TALF) target implementation
March	Formal budget submitted; Congressional budget process for FY2010 begins
March 31	Deadline for automakers to prove financial viability under Treasury loan agreement
April-May	2010 budget resolution finalized
April 30	Term Securities Lending Facility (TSLF), Commercial Paper Funding Facility (CPFF); and Money Market Investor Funding Facility (MMIFF) scheduled to expire (these are likely to be extended if financial stress persists)
June 30	FDIC Temporary Liquidity Guarantee Program (TGLP) scheduled to expire (no debt issued after this date guaranteed)
September 18	Treasury Temporary Money Market Guarantee Program expires
December 31	Treasury authority to purchase GSE securities expires (requires legislation to extend)

Source: FDIC; Federal Reserve; Treasury. Our estimates.

Exhibit 2: Stimulus Fills Some Gaps More Than Others



Source: Our calculations.

* Drag in State & Local sector denotes an assumed \$150bn budget deficit to be closed through spending cuts and tax hikes.

Fiscal Stimulus: How Big and Where to Spend?

Apart from efforts to stabilize the housing market and financial system, the various programs that comprise a fiscal stimulus package will be a major focus in early 2009. We have written on the stimulus effort several times in recent weeks, with the following conclusions¹:

1. It will be big, but \$1 trillion may be too much for Congress to swallow. We assume a minimum size of \$600 billion over two years and it is conceivable that the final package could total more than \$800 billion, perhaps even approaching \$900 billion. While the media have reported on several occasions that a \$1 trillion package is being considered, we suspect such a large package would meet congressional resistance.

2. If the size increases, most of that increase comes through tax cuts: Exhibit 2 compares our expectations for the composition of two stimulus packages—totaling either \$600 billion or \$850 billion—with the drag on growth we expect in the two largest components of GDP, namely consumer expenditures and business fixed investment. Infrastructure has been the most discussed component of the legislation, but is harder to scale up as the bill grows. We assume that it would make up around half of a \$600 billion two-year package (or around 1.3% of GDP) compared to a drag from investment of around

¹ For more see the “Putting Some Numbers on Fiscal Stimulus Legislation” December 11 *US Daily Comment*.

2.5%, and around one-third of an \$850bn package. This would offset about half of the estimated investment drag. Tax cuts and benefit programs aimed at the consumer, on the other hand, could easily grow to accommodate larger amounts but will still offset only a fraction of the drag from consumer spending of around 4% of GDP.

3. A good deal of stimulus gets pushed into 2010. Policymakers are focused on providing as much stimulus as possible in 2009, but some will likely spill into 2010. Some of this may be by design: concern over a sluggish recovery justifies stimulus spread over the two-year period. Some of this may turn out to be accidental: lawmakers are targeting investment in areas such as infrastructure and technology that will require significant advance planning. Politics may also dictate the timing of stimulus, given the midterm election in November 2010. Given this, we expect the stimulus package to be spread roughly equally over the 2009-2010 period, with at least a small part of the spending pushed into later years.

4. State and local assistance will be generous. States are likely to face a large budget gap in 2009 and 2010—the National Governors Association recently suggested it could total as much as \$200 billion over those two years—which they would need to close through spending cuts or tax increases. In a stimulus package of \$600 billion, we would expect something like \$80 billion in assistance, through increased federal Medicaid payments and direct grants. As the amount of stimulus being considered increases, this segment is apt to grow disproportionately. In addition to fiscal assistance, policy efforts may target the municipal bond market. Spreads on highly rated municipal bonds have widened considerably (300bps over the 30-year Treasury) and some Democratic lawmakers have been pushing the Fed and/or Treasury to intervene.

TARP Dollars Grease the Printing Press?

Once the Treasury formally requests the third and final installment of TARP the program is likely to refocus, at least in part, on its original purpose of asset purchases. One important feature of policy in 2009 seems likely to be even greater coordination between the Treasury and Fed on the use of TARP funds:

1. Treasury’s capital meets the Fed’s balance sheet. The Federal Reserve’s and Treasury’s recent coordinated effort to stabilize the availability of consumer credit through the Temporary Asset Backed Security Liquidity Facility (TALF) seems to be an important sign of things to come. In the case of TALF, the Treasury has committed \$20 billion in capital to a \$200 billion Fed facility. Treasury capital secures the loans funded mainly from the Fed’s balance sheet.

This allows the Treasury to expand the TARP’s operation much further than if direct purchases were made, which would count dollar for dollar against the \$700 billion limit on the program. (Exhibit 3 shows TARP commitments to date). As the Fed seeks to expand its balance sheet rapidly, TARP capital could become an important tool in allowing it to take on risky assets without bearing substantial risk of its own.

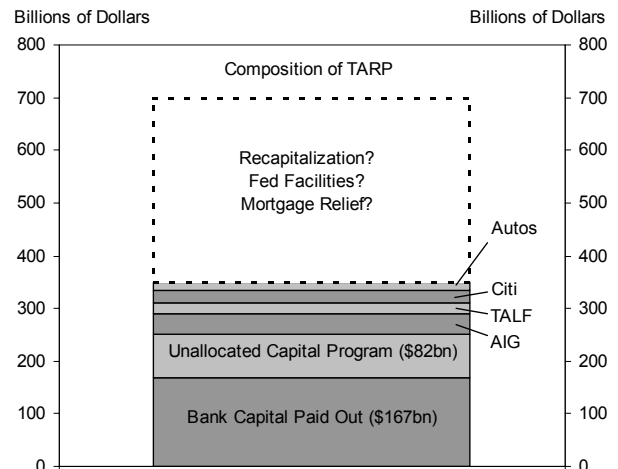
2. TARP buys mortgage debt after all? The joint Treasury-Fed initiative also appears important because it seems to open the door to the purchase of non-governmental securities (i.e. assets other than Treasuries or agency debt). While the TALF will make non-recourse loans using ABS as collateral, allowing private holders of these assets to share the risk of future losses, it will not purchase the securities. However, this does not rule out future facilities making outright purchases if TARP capital bears the risk for most losses.

3. Non-financial debt enters the mix. Of the liquidity programs established by the Fed, FDIC and Treasury, only the Fed’s commercial paper facility is open to non-financial firms directly. TARP is limited to financial institutions, but the ongoing effort to stabilize the Detroit-based automakers is testing these limits. Treasury announced today that it will lend to the companies through TARP. Although the transaction has some strings attached related to financial viability, it may set a precedent for other non-financial sectors. While the automakers are a somewhat special case from a political perspective, it is unlikely this will be the last request for non-financial borrowing out of TARP.

Mortgages: Still Looking for a Silver Bullet

It has been more than a year since the Bush administration first unveiled mortgage modification

Exhibit 3 : \$450 Billion Left to Go



Source: U.S. Treasury. Our calculations.

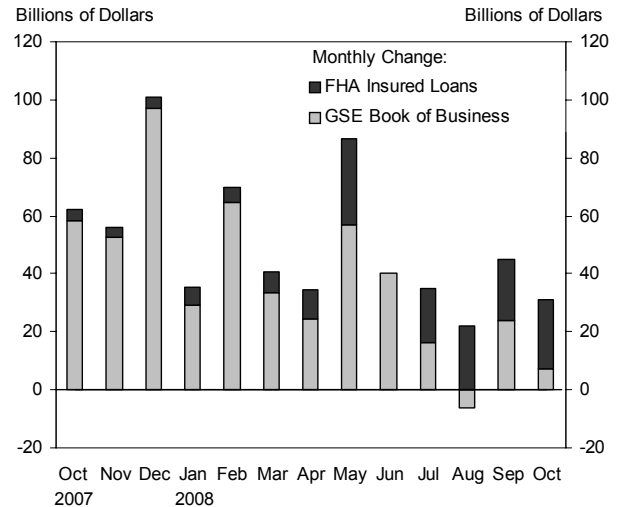
proposals aimed at delinquent mortgages. Over the next year it is likely that much more aggressive steps will be taken to reduce mortgage principal for underwater borrowers, while further incentives are put in place for home purchase:

1. The Fed pushes down conforming rates...The Fed has already begun to acquire GSE debt and the announcement of future MBS purchases is already having its intended effect—the average rate on a conforming 30-year fixed mortgage is 60bps lower than it was at the original announcement. However, Treasuries have fallen even more over the same period and the spread over the 10-year is at historically wide levels (Exhibit 4). Fed efforts to narrow that spread could plausibly push the rate below 5%.

2. ...while the Treasury funds modifications and perhaps further mortgage rate reductions.... Several plans are under consideration to create additional incentives to purchase property. Chief among them is the possibility that the Treasury would purchase agency mortgage backed securities (MBS) specifically to lower the rate for purchase transactions—a rate even lower than the broader conforming rate that has declined in recent days as a result of the Fed’s separate MBS announcement. Tax incentives, including a credit for purchase or bonus interest deductions are being considered in Congress.

It also seems clear that the next administration will pursue a mortgage modification program using TARP funds. Given the high reported redefault rates seen in modification programs that target monthly payment reductions, the momentum now seems to be behind principal writedowns to address the underlying cause for many foreclosures: negative equity. We see a voluntary program as most likely, perhaps with a post-

Exhibit 5: Will the GSEs Make a Comeback?

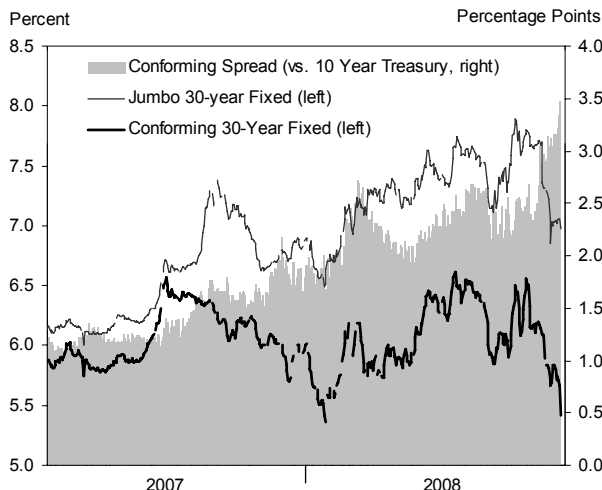


modification guarantee to stabilize balance sheets and incentivize lenders, and additional funds to make the previously enacted FHA refinance program more attractive. That said, Congress may also consider mandatory approaches. One likely candidate is the reemergence of bankruptcy “cram down” legislation in early 2009, which would allow bankruptcy judges to write down principal to the current value of the property.

3. ...and the GSEs regain their dominant role? Since federal regulators placed Fannie Mae and Freddie Mac into conservatorship their status has been unclear and their book of business has grown more slowly than usual, partially offset by increased FHA activity (Exhibit 5). The next administration seems likely to formalize the Treasury’s guarantee of the GSEs, but a credible government backstop may depend on Congress as well; the Treasury’s authority to purchase debt or equity securities issued by the GSEs extends only through the end of 2009 and will require legislation to extend.

Alec Phillips

Exhibit 4: Mortgage Rates Dropping but Spreads Wider than Ever



Source: Freddie Mac. Federal Reserve Board. Wall St. Journal.

THE US ECONOMIC AND FINANCIAL OUTLOOK

(% change on previous period, annualized, except where noted)

	2007	2008 (f)	2009 (f)	2008				2009			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
OUTPUT AND SPENDING											
Real GDP				0.9	2.8	-0.5	-5.0	-3.0	-1.0	1.0	1.0
Year-to-year change	2.0	1.2	-1.6	2.5	2.1	0.7	-0.5	-1.5	-2.4	-2.0	-0.5
Consumer Expenditure	2.8	0.2	-1.7	0.9	1.2	-3.7	-4.5	-2.5	0.0	1.0	1.0
Residential Fixed Investment	-17.9	-20.5	-9.4	-25.1	-13.3	-17.6	-15.0	-10.0	-5.0	0.0	2.5
Business Fixed Investment	4.9	1.8	-12.7	2.4	2.5	-1.5	-20.0	-15.0	-15.0	-12.5	-10.0
Industrial Production, Mfg	1.7	-2.4	-8.2	-1.1	-4.1	-8.8	-14.0	-10.0	-6.0	-3.0	-2.0
INFLATION											
Consumer Price Index				4.3	5.0	6.7	-9.3	-3.9	2.4	1.7	1.0
Year-to-year change	2.9	3.8	-1.0	4.2	4.3	5.3	1.5	-0.6	-1.2	-2.4	0.3
Core Indexes (% chg, yr/yr)											
CPI	2.3	2.3	1.5	2.4	2.3	2.5	2.0	1.8	1.7	1.1	1.2
PCE*	2.2	2.2	1.4	2.2	2.3	2.4	2.1	1.9	1.6	1.2	1.0
Unit Labor Costs (% chg, yr/yr)	2.7	0.6	1.1	0.0	0.1	1.4	0.7	0.9	1.8	1.1	0.6
LABOR MARKET											
Unemployment Rate (%)	4.6	5.8	8.4	4.9	5.3	6.0	6.8	7.7	8.3	8.7	9.0
FINANCIAL SECTOR											
Federal Funds** (%)	4.24	0.13	0.13	2.61	2.00	1.81	0.13	0.13	0.13	0.13	0.13
3-Month LIBOR (%)	4.98	1.53	1.00	2.78	2.77	3.12	1.53	1.25	1.00	1.00	1.00
Treasury Yield Curve** (%)											
2-Year Note	3.12	0.90	0.75	1.62	2.77	2.08	0.90	0.75	0.75	0.75	0.75
5-Year Note	3.49	1.40	2.20	2.48	3.49	2.88	1.40	1.70	1.90	2.00	2.20
10-Year Note	4.10	2.40	3.20	3.51	4.10	3.69	2.40	2.75	3.00	3.10	3.20
Profits*** (% chg, yr/yr)	-0.6	-8.1	-25.0	1.8	-6.4	-7.8	-20.0	-30.0	-30.0	-25.0	-12.5
Federal Budget (FY, \$ bn)	-162	-455	-1,000	-	-	-	-	-	-	-	-
FOREIGN SECTOR											
Current Account (% of GDP)	-5.3	-4.7	-3.1	-5.0	-5.1	-4.8	-3.9	-3.3	-3.1	-3.0	-2.9
Exchange Rates											
Euro (\$/€)**	1.46	1.40	1.45	1.55	1.56	1.44	1.40	1.30	1.40	1.43	1.45
Yen (¥/\$)**	112	90	90	101	107	107	90	90	90	90	90

* PCE = Personal consumption expenditures. ** Denotes end of period. *** Profits are after taxes as reported in the national income and product accounts (NIPA), adjusted to remove inventory profits and depreciation distortions.

NOTE: Published figures are in bold

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