



## Economic Outlook 2009

### Gross Domestic Product

Advance estimates<sup>i</sup> released by the Bureau of Economic Analysis (BEA) indicate that real gross domestic product (GDP) weakened in 2008 with an increase of only 1.3% on an annual basis. This is lower than the 2.0% increase in 2007 and the 2.9% increase for the full year 2006. Economic activity showed generally weaker performance throughout 2008. Real GDP increased only 0.9% in the first quarter followed by an increase of 2.8% in the second quarter. GDP began its decline in the third quarter, falling 0.5%, and followed this with a 3.8% decline in the fourth quarter. The decline in real GDP growth marks the beginning of a recession that has most likely been the result of further deterioration in the housing markets, a subprime mortgage crisis that has had a systemic impact throughout financial markets despite easing of monetary policy, and financial instability in the banking system.

Highlights from the GDP report include the following:

- Real personal consumption expenditures increased 0.9% in the first quarter and 1.2% in the second quarter. For the third and fourth quarters, real personal consumption expenditures decreased 3.8% and 3.5%, respectively. Significant declines in durable goods consumption, particularly automobiles, contributed to the declines in real personal consumption expenditures.
- Nonresidential fixed investment declined 1.7% and 19.1% in the third and fourth quarters, respectively, as compared to increases of 2.4% and 2.5% in the first and second quarters.
- Residential fixed investment declined substantially throughout 2008, falling 25.1%, 13.3%, 16%, and 23.6% on a quarterly basis. This coincides with weak real estate markets throughout the year, including continued declines in housing prices and sales as well as markedly slower construction activity.

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- Real exports of goods and services declined by 19.7% in the fourth quarter, following increases of 5.1%, 12.3%, and 3.0% in the first three quarters of the year, respectively. Imports, a subtraction from GDP, decreased for 2008, falling by 0.8%, 7.3%, 3.5%, and 15.7% in each quarter.

## The Federal Reserve

After ending 2007 at roughly 4 ¼%, the Federal Reserve's Federal Open Market Committee (FOMC) continued to ease monetary policy during 2008 with further reductions in the federal funds rate to historic lows. By the end of January 2008, the FOMC had dropped the federal funds rate to 3%. In response to the continued economic weakness and deteriorating conditions in the credit and financial markets, the FOMC eased rates at each of its meetings, resulting in the federal funds rate ending the year at virtually 0%. In its press release associated with its December 16, 2008 meeting, the FOMC indicated the following:

*Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further.*

*Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters.*

*The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.*

*The focus of the Committee's policy going forward will be to support the functioning of financial markets and*

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*stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity.*

As in our last assessment, the impact of the continued correction in the housing markets and the attending impact upon the credit markets and financial system have yet to be fully felt in the economy. The spillover effects of these factors may well be significant, forcing the Federal Reserve to find other methods by which to implement liquidity in the markets and to explore other policy actions intended to stimulate the economy.

### **Other Highlights**

The consumer price index (CPI) <sup>ii</sup> decreased roughly 13.0% for the fourth quarter at a seasonally adjusted annual rate as a result of significant declines in energy prices. For the twelve months ending in December 2008, the CPI rose 0.1%. For the fourth quarter, the core CPI (all items less food and energy) fell 0.3%. For 2008, the core CPI increased 1.8%. It is interesting to note that based on the CPI inflation figures for the full year 2008 (1.8%) real interest rates as measured by the federal funds rates (effectively 0% as of December) are negative.

The unemployment rate increased dramatically in 2008, rising from 4.9% in the first quarter to 5.3% in the second quarter to 6.0% in the third quarter and, finally, to 6.9% for the fourth quarter<sup>iii</sup>. For December 2008, the unemployment rate reached 7.2% as compared to 5% in December 2007. Total nonfarm

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payroll employment averaged roughly 137.9 million in the first quarter and 137.7 million in the second quarter. Total nonfarm payroll employment averaged 137 million and 135.8 million in the third and fourth quarters, respectively. Total nonfarm payroll employment decreased by roughly 2.9 million from 138.1 million in December 2007 to 135.2 million in December 2008.

After beginning the year at roughly \$92 per barrel, West Texas Intermediate (WTI) oil prices rose rapidly during 2008, spiking to nearly \$150 per barrel in the middle of the summer. For the first quarter, oil prices ended the quarter at roughly \$105 per barrel. For most of the second quarter, WTI oil prices rose to over \$134 per barrel. When the economy began to feel significant pressures from the ailing banking sector and financial markets in the third quarter, oil prices began to fall and ultimately ended the quarter at just over \$100 per barrel. As economic woes continued to manifest in the fourth quarter, oil prices continued to slide, falling to just over \$40 per barrel in December. As a result of the slide in oil prices, OPEC decided at its 151<sup>st</sup> Extraordinary Meeting in Oran, Algeria to cut production by 4.2 million barrels per day effective January 2009. The decrease in production was intended to stabilize prices at levels sufficient to ensure continued investments needed to maintain adequate energy supplies in the medium to long-term<sup>iv</sup>.

It is likely that energy prices will remain at moderate levels well into 2009, despite the cut in production by OPEC. Tempered economic growth will likely continue to dampen demand for oil supplies. The deeper and the longer the economic slowdown continues, the more oil consumption is likely to decline, thus easing pricing pressures further, despite OPEC production cuts. However, continued geopolitical risks in the Middle East could create an additional premium in the price of oil. Therefore, the risks to economic activity stemming from energy prices seem balanced for the coming quarters.

## **Economic Outlook**

Economic growth weakened considerably in 2008, dragged down by a banking crisis and continued contraction in the real estate markets that negatively impacted consumer sentiment and spending, particularly in the fourth quarter. Despite the

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Federal Reserve's continued aggressiveness in promoting accommodative monetary policy combined with liquidity measures by the Treasury and fiscal stimulus and financial assistance actions by the Congress and the Administration of President Bush in the second half of 2008, the banking and financial system crisis continued to negatively impact economic activity both domestically and internationally and prompted fears of a systemic financial meltdown. The panic created by the pending financial "disasters" and rising unemployment manifested itself in a continued substantial decline in equity markets in which investors showed little confidence in the stimulus efforts by the federal government.

As a result of these past actions combined with proposals by the incoming administration of President Obama, economic activity is likely to remain weak in 2009. These factors suggest that the risks to the economy remain weighted heavily towards a protracted recession in the coming quarters with the preponderance of evidence pointing towards severely depressed economic growth, higher unemployment, reduced consumer spending, and the risk of rising inflationary pressures.

Our assessment and expectations for the economy include the following:

- Despite the Federal Reserve's continued accommodative monetary policy, real estate activity will continue to contract in the year ahead. Whilst the foreclosure rate may fall in the coming year, the inability of purchasers to find financing will continue to suppress activity in the real estate markets. As a result of the unavailability of financing and the need to liquidate properties, real estate prices are likely to continue to adjust more towards fundamental valuations.
- Oil prices (WTI) are likely to stabilize in the \$35-\$55 per barrel range, possibly rising above the upper end of this range during the second quarter and the summer driving season.
- Inflationary pressures are likely to remain at levels above recent trends, which would be consistent with slower

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economic growth, a weakening dollar, and the massive increase in the money supply associated with fiscal spending and stimulus programmes. Inflation is likely to increase in 2009 with the core CPI increasing by roughly 3%. The impact of the economic stimulus packages from 2008 that served to increase the money supply substantially may well have an adverse impact upon inflationary pressures beyond our expectations. This places the rate-setting FOMC in a precarious position of confronting higher inflation during a period of slowing economic growth and could result in a stagflation economic environment in the United States in late 2009 or 2010.

- We anticipate real GDP growth of  $\frac{1}{2}\%$  - 1% for the full year 2009.
- The Federal Reserve is limited in its ability to ease monetary policy, given that the current federal funds rate is, effectively, 0%. The federal funds rate will likely remain at dangerously low levels in 2009 with the Fed's next move likely an increase possibly towards the end of the year.
- Unemployment is likely to increase to at least 10% for 2009.

## Conclusion

Real GDP decreased at an annual rate of 3.8% in the fourth quarter 2008 but still managed to increase by 1.3% in 2008 on a year-over-year basis. Unemployment has increased substantially in the last twelve months, most noticeably in the second half of the year when the financial crisis began. The financial instability confronting the banking system has yet to be fully understood and revealed and may well require additional massive bailout funds from the federal government. Based on our assessment of the state of the economy in the fourth quarter, conditions are likely to remain unfavourable for economic activity for much of 2009. As such, the risks are weighted more towards continued recessionary trends during the first half of the year or weak economic growth accompanied by some increase in inflationary pressures.



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<sup>i</sup> The BEA GDP press releases state the following with respect to advance estimates: The Bureau emphasized that...“advance” estimates are based on source data that are incomplete or subject to further revision by the source agency.

<sup>ii</sup> Based on data from the Consumer Price Index press releases by the Bureau of Labor Statistics, United States Department of Labor.

<sup>iii</sup> Bureau of Labor Statistics, United States Department of Labor, The Employment Situation press release.

<sup>iv</sup> OPEC press release following the 151<sup>st</sup> (Extraordinary) Meeting of the OPEC Conference in Oran, Algeria on December 17, 2008.

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