



## STATE OF THE ECONOMY 2010 OUTLOOK

### Gross Domestic Product

Advance estimates<sup>i</sup> released by the Bureau of Economic Analysis (BEA) indicate that real gross domestic product (GDP) contracted by 2.4% on an annual basis in 2009 over the prior year. For 2008, real GDP increased by 0.4% on an annual basis as compared to a 2.1% increase in 2007. The economy continued to contract sharply during the first and second quarters of 2009, falling 6.4% in the first quarter and 0.7% in the second quarter. This continued the trend begun in the second half of 2008 when real GDP contracted 2.7% in the third quarter and 5.4% in the fourth quarter<sup>ii</sup>. Economic activity showed signs of improvement in the second half of 2009 with real GDP increasing by 2.2% in the third quarter and by 5.7% in the fourth quarter. The continued recessionary trend in real GDP in the first half of 2009 was characterized by even further deterioration in the housing markets, continued tight credit markets following financial instability in the banking system late in 2008, waning consumer demand and confidence, and rising unemployment as businesses adjusted to lower demand expectations.

Highlights from the GDP report include the following:

- Real personal consumption expenditures declined in 2009 by 0.6% following a decline of 0.2% in 2008. After a 0.6% increase in the first quarter and a 0.9% contraction in the second quarter, real personal consumption expenditures showed improvement with increases of 2.8% and 2.0% in the third and fourth quarters, respectively.
- Nonresidential fixed investment declined 17.9% on a year-over-year basis in 2009, showing substantial contraction in the first three quarters and a modest increase in the fourth quarter.
- Residential fixed investment continued to drag on the economy with a year-over-year decline of 20.4% in 2009 as compared to a 22.9% decline in 2008. Residential

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fixed investment declined in the first half of the year before showing recovery in the second half. This mirrors continued weak real estate markets throughout the year with housing prices falling further.

- Real exports of goods and services declined by 9.9% in 2009 as compared to a gain of 5.4% in 2008. Real imports of goods and services also contracted in 2009 by 14.2% as compared to a 3.2% contraction in the prior year. Both exports and imports contracted substantially in the first half of 2009 then rebounded sharply in the second half, perhaps as businesses made investment in inventories in anticipation of modest expectations for the holiday shopping season.
- Real government consumption expenditures and gross investment continued its expansion in 2009, increasing 1.9% as compared to an increase of 3.1% in 2008. This comes as the federal government continues massive spending programmes, some of which are associated with the stimulus packages passed in late 2008 and early 2009.

### **The Federal Reserve**

The Federal Reserve's Federal Open Market Committee (FOMC) continued its accommodative monetary policy originally institute in 2008 following the crisis in the credit markets, with the federal funds rate at virtually 0%. At its first meeting in 2009, the FOMC suggested that continued weak economic conditions, which were expected to persist for some time, warranted continued low interest rates. By August, the Federal Reserve indicated that its data suggested economic activity had started to level out and maintained abnormally low interest rates as well as its programme to provide liquidity to credit markets through purchases of mortgage backed securities, agency debt, and Treasuries. In its press release associated with its December 16, 2009 meeting, the FOMC indicated the following:

*Information received since the Federal Open Market Committee met in November suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some*

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*signs of improvement over recent months. Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment, though at a slower pace, and remain reluctant to add to payrolls; they continue to make progress in bringing inventory stocks into better alignment with sales. Financial market conditions have become more supportive of economic growth. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.*

*With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.*

*The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period.*

As in our last two assessments, we believe that 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, despite efforts by the Federal Reserve and other federal agencies. Further, with rates low and the FOMC seeing signs of a pickup in economic activity, it is only a matter of time before the FOMC begins to remove its overly accommodative monetary policy stance in favour of higher interest rates. Should the FOMC wait too long, there is a high probability that the massive amounts of liquidity placed in the markets through operations at the Federal Reserve will result in quick and dangerously destabilizing rises in inflation.

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## Other Highlights

The consumer price index (CPI) <sup>iii</sup> rose 2.7% at a seasonally adjusted annual rate for the twelve months ending December 2009 as compared to a 0.1% increase for the same period 2008. The upturn in inflation was largely the result of increases in energy prices. For the twelve months ending December 2009, the energy index increased 18.2% as compared to a decline of 21.3% in 2008. For 2009, the core CPI (all items less food and energy) rose 1.8%, mirroring the increase in 2008. 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 and 2009, real interest rates as measured by the federal funds rates (effectively 0%) are negative<sup>iv</sup>.

After ending 2008 at roughly 7.2%, the unemployment rate increased substantially in 2009, rising to 8.1% in the first quarter, 9.2% in the second quarter, 9.7% in the third quarter and, finally, to 10% for the fourth quarter<sup>v</sup>. The fourth quarter average unemployment of 10% is double the 5% unemployment rate in December 2007, when the recession is estimated to have begun. At the end of 2009, roughly 40% of the 15.4 million unemployed had been unemployed for at least twenty-seven weeks. Whereas job losses started the year at over 600,000 per month (the monthly average for the first quarter was 691,000), by December monthly job losses had declined to over 60,000 (with the fourth quarter job loss average at 69,000). Job losses were heaviest in construction and manufacturing, both industries which were severely impacted by weak economic conditions. These industries have lost roughly three million jobs combined since December 2007. Healthcare services, however, continued to add jobs throughout 2009, bringing total jobs gains in the industry to over 630,000 over the last two years.

After falling to about \$41 per barrel at the end of 2008, West Texas Intermediate (WTI) oil prices rose steadily over the course of 2009. By the end of the first quarter, oil prices had risen to approximately \$48 per barrel. Prices continued to rise to nearly \$70 at the end of the second quarter, despite continued weak demand resulting from continued weakness in the broader economy, and to \$76 by the end of the third quarter where prices seemed to stabilize for the fourth quarter. The steady rise in prices is still far below oil's 2008 peak of

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nearly \$150 per barrel in the middle of the summer. OPEC decided at its 155<sup>th</sup> Extraordinary Meeting in Luanda, Angola to maintain its production levels with no changes. The conference noted that the outlook for the first half of 2010 remained grim with the worldwide economic contraction the worst since the 1940s. In addition, 2009 marked the second consecutive year in which oil demand declined, the first instance since the early 1980s oil glut<sup>vi</sup>.

It is likely that energy prices will remain at recent levels well into 2010, given continued tempered economic growth that should further depress demand for oil supplies. It remains to be seen if current prices have found equilibrium with economic growth at continued low levels globally or if recent prices will further constrict world demand for goods and services. Overall, the risks to economic activity stemming from energy prices seem balanced for the coming quarters.

### **Economic Outlook**

Economic growth weakened considerably again in 2009 as a result of lower consumer confidence, substantial increases in job losses, and lower business investment. Despite the rise in economic activity in the fourth quarter 2009, economic activity is likely to remain subdued in 2010. The risks to the economy remain weighted towards continued weak economic activity in the coming quarters with the preponderance of evidence pointing towards further declines in economic growth, sustained high unemployment, tepid 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 at a reduced pace in the year ahead. 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 \$60-\$80 per barrel range, possibly rising above the upper end of this

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range during the second quarter and the summer driving season.

- Inflation is likely to increase in 2010 with the core CPI increasing by roughly 2¼%.
- We anticipate real GDP growth of 1% - 2% for the full year 2010.
- The federal funds rate will likely remain at low levels for the first half of 2010 with the Fed's next move likely an increase towards the middle of the year. The federal funds rate will end the year at roughly 1%.
- Unemployment is likely to remain in the 9%-10% range for 2010.

## Conclusion

Based on our assessment of the state of the economy in the fourth quarter of 2009, conditions are likely to remain unfavourable for economic activity for much of 2010. As such, the risks are weighted more towards continued weak economic growth accompanied by some increase in inflationary pressures and continued high unemployment.

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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> Real GDP declined 0.7% in the first quarter 2008 then increased by 1.5% in the second quarter before falling into recession in the third quarter.

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

<sup>iv</sup> The 1, 2, and 3-year Treasury rates are also below the inflation rate, implying negative real rates.

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

<sup>vi</sup> OPEC press release following the 155<sup>th</sup> (Extraordinary) Meeting of the OPEC Conference in Luanda, Angola on December 22, 2009.