



Provided by Dreyfus Chief Economist

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We expect (1) a gradual calming of widespread concerns about an economic depression since we believe that policymakers have a correct diagnosis of the financial and economic risks and are taking proactive monetary and fiscal policy actions to reduce them in a basic policy stance of “whatever it takes,” (2) the deepest U.S. recession, G-7 recession and global recession of the Postwar period, (3) rising unemployment rates and falling capacity utilization worldwide, (4) global rebalancing with a drop in current account deficits in consumption-led economies and a drop in current account surpluses in export-led economies, (5) domestic rebalancing, (6) proactive monetary and fiscal stimulus worldwide, (7) an increased supply of financial liquidity from the Fed’s elastically expanding balance sheet, (8) a gradual recuperation of the financial sector as it moves from semi-orderly deleveraging to orderly deleveraging, (9) extremely low interest rates worldwide in the coming year, (10) the continuation of an intense global inventory liquidation in early 2009, which should ease as the year progresses, aiding the transition from recession to recovery, (11) a cyclical trough in the U.S. recession around mid-2009, followed by a

sluggish economic recovery as deleveraging persists during the expansion, (12) a rise in the U.S. budget deficit in 2009 to about \$2 trillion—12% or more of U.S. GDP, (13) a permanent upward shift in Federal spending as a share of GDP and persistently high budget deficits, (14) low inflation worldwide with brief temporary episodes of consumer price deflation due to the global recession and the past drop in commodity prices, (15) the avoidance over the next several years of both a sustained deflation in consumer prices and a major inflation acceleration, and (16) rising protectionist risks as global unemployment continues to rise.

The current cyclical downturn should be the longest and deepest U.S. recession, G-7 recession and global recession of the postwar period. The peak-to-trough decline in U.S. real GDP is likely to be deeper than either of the two worst prior postwar recessions, the 1973-1975 recession and the 1981-1982 recession. The 1973-1975 recession was the closest precedent to this recession. There was an oil price shock, surging commodity prices, worldwide recession, severe financial crisis, intense inventory liquidation with plunging commodity prices, aggressive

monetary ease and eventual economic recovery.

The current recession has had two phases. For about the first nine months of 2008, the U.S. economy was in a borderline recession, so marginal that there was a debate about whether or not the economy was in recession. In mid-September 2008, Lehman Brothers filed for bankruptcy, triggering a waterfall decline in the U.S. and global economies that has persisted until the present. The widespread thesis that other countries could decouple from the U.S. recession proved incorrect. Many banks worldwide do much of their short-term funding in dollars and were quickly impacted as the financial crisis dried up the availability of that funding. The volume of trade dropped, exacerbated by restricted availability of trade credit. In addition, commodity prices dropped sharply, weakening the revenues of commodity exporters. Currently, the U.S. and global economies remain in the inventory liquidation phase of the waterfall economic decline. The decline in global economic activity in late 2008 and early 2009 was extremely severe. We expect very sharp declines in real GDP to be reported in many countries for the first

quarter of 2009, with declines continuing in the second quarter. The result should be severe declines in real GDP measured from full-year 2008 to full-year 2009, whether or not the economies continue to decline through the second half of 2009.

Even as there are tentative signs that the weakness in consumer demand has begun to diminish somewhat, we believe that inventory liquidation remains quite intense. As a result, the unemployment rate is rising across the globe. The sharp inventory correction worldwide should slow by the second half of 2009. As a result, we believe that a cyclical recession trough in the U.S. is likely to be reached near mid-2009. However, the end of economic decline is not likely to signal the return of prosperity. We expect a borderline recovery in the second half of 2009, so tentative that there should be a debate about whether or not the economy has begun a sustainable expansion.

Economic variables such as employment, corporate profits and tax revenues should remain at extremely depressed levels well beyond the period of actual economic decline. The current level of key cyclical indicators is so depressed that an improvement is likely in the coming months, given the strong policy stimulus and the eventual exhaustion of inventory liquidation. The slowing of the pace of inventory liquidation is nearly always a key component of the transition from economic decline to economic expansion. There are two characteristics of nearly all inventory corrections: (1) they tend to be unstoppable when they are underway and (2) they are always temporary. This one should be no different.

During the second half of 2009, we expect many economic indicators to begin a weak recovery. We would regard this as more of a rebound from a violent negative extreme than as the emergence of new sources of major strength. The question is likely to be "when will the real recovery begin?" Very few economic indicators will

be returning to normal levels any time soon, but they should begin to rise from extremely depressed to merely weak levels as we move through the year.

For example, the new auto sales rate may reach its extreme cyclical low this spring, with less severe weakness thereafter as government policy towards the Detroit auto companies is defined and the Term Asset-Backed Securities Loan Facility (TALF) program begins to facilitate the availability of auto credit to credit-worthy borrowers. Current auto sales and production are running below the trend of scrappage rates. While the pace of sales and production should remain quite weak, we expect somewhat less weakness in the second half of 2009. Similarly, we expect that the ISM and other purchasing managers' indices around the world should begin to rise somewhat in the second half of 2009 as inventory liquidation eases.

We anticipate that in the U.S., the official recession trough as defined by the National Bureau of Economic Research is likely to occur around mid-year 2009, followed by a weak recovery. For an economist, a recession trough occurs when the economy stops declining further, whether or not the subsequent expansion is strong or weak. Normally, the unemployment rate keeps rising in the initial stages of expansion. We expect a subpar recovery, with the unemployment rate likely to move into the 9% to 10% range before its cyclical peak. We expect a worldwide pattern of low capacity utilization, very high unemployment rates and difficulty in restarting substantial economic expansion. We anticipate an economic expansion that will feel like a recession.

We expect the economic recovery after this recession to be weaker than normal. One reason is the severity of this cycle's global financial crisis. A second reason is the severity of the housing bust and the related negative wealth effect. Consumer

balance sheets have been badly damaged. In the environment of a weak labor market, the desire to borrow more in order to spend is likely to be limited. We expect the supply of credit to credit-worthy borrowers to improve over the next year as financial stresses ease. There will be substantial credit demand for refinancing debt originally incurred to finance past purchases. However, the recovery in the demand for credit for new spending by both consumers and corporations is likely to be quite limited.

The basic macroeconomic policy of the U.S. today is "whatever it takes" to calm the financial crisis and generate an eventual transition from recession to economic recovery. There are multiple aspects of this basic "whatever it takes" policy: (1) a zero target for the Federal funds rate with a pre-commitment that the FOMC "anticipates that economic conditions are likely to warrant exceptionally low levels of the Federal funds rate for an extended period," (2) a major expansion of the Fed's balance sheet via both "credit easing" lending programs and purchases of mortgage agency securities and Treasury securities, (3) mortgage loan modification programs, (4) Keynesian fiscal stimulus, (5) introduction of the Troubled Asset Relief Program (TARP) and Public-Private Investment Program (PPIP) to reduce financial system stress, and (6) changes to multiple rules including guidelines for mark-to-market accounting, standardization of credit default swaps and possibly the uptick rule.

There are both short-term consequences and long-term consequences of the various aspects of this basic policy. We believe that the most probable short-term consequence of the "whatever it takes" set of policies is that the U.S. will not repeat the depressionary precedent of the 1930s. We believe that, unlike the 1930s, the policymakers' diagnosis of the debt deflation risk is correct and their prescription is broadly correct, despite the

long-term risks of unintended consequences. We also believe that the prolonged Japanese deflation after the Nikkei bubble will not be replicated in the U.S. Unlike the slow and relatively passive response of Japanese policymakers to the threat of deflation after the Nikkei bubble, U.S. policy is very proactive and aggressive.

Some analysts are worried that persistent deleveraging in the aftermath of the consumer debt expansion and the boom/bust pattern in housing creates a serious risk of depression. We do concur that a secular peak has been reached in housing and consumer leverage and that the negative wealth effect will be a powerful drag on the economy. We agree that a longer-term deleveraging of the consumer should prove necessary over the coming years. However, in our opinion, much of it is likely to occur in the form of slow growth of consumer and housing credit in the future, consistent with a domestic rebalancing of the U.S. economy. The private sector deleveraging is likely to be extended over a prolonged period of time. The decision of policymakers to substantially expand public sector debt should help stretch out the process of private sector deleveraging over a multiyear period.

Recent budget proposals embody a permanent upward shift in likely Federal spending and budget deficits. The U.S. faces a major upward shift in Federal spending as a share of GDP of about four percentage points from an average of 20.7% for the last 40 years to 24.5% in 2019, according to CBO estimates. Debt held by the public as a share of GDP is forecast by the CBO to double from 40.8% in 2008 to 82.4% in 2019 due to persistently high budget deficits. "From 2010 to 2019, the cumulative deficit under the President's proposals would total \$9.3 trillion, more than double the cumulative deficit projected under the current-law assumptions embodied in CBO's baseline," according to the Congressional

Budget Office's just released report "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook," available at www.CBO.gov. We believe that the CBO forecast of minus 3% for 2009 year-over-year real GDP growth is roughly consistent with most up-to-date forecasts for the U.S. economy, which generally incorporate severe weakness in early 2009.

Federal spending as a share of GDP is rising, persistent budget deficits are likely, and the Fed is monetizing Treasury debt and generating a rapidly expanding money supply. Does that mean that a dramatic future acceleration of inflation is unavoidable? Not necessarily, in our view. In the near term, Federal spending is replacing deficient private sector demand. Private sector demand growth may be sluggish in the next economic expansion as excess consumer leverage and the legacy of the housing bust restrain the long-term growth of mortgage and consumer credit. In the aftermath of a severe global recession, it is likely to be some years in the future before Federal spending creates excess demand for goods and labor above the capacity of the global economic system to supply them. The Fed is flooding the financial system with liquidity because the financial system has been disrupted and that liquidity is therefore not translating quickly into increased spending. While money supply has been growing rapidly, velocity has been dropping sharply due to the disruption of the financial system. Gross monetary policy is very easy, but monetary policy net of the stresses in the financial system is much less so.

The Fed's decision to purchase Treasury securities with the intent of driving down Treasury yields is a profound event, given the history of Fed/Treasury relations. In 1951, the Fed broke loose from the Treasury's insistence that the Fed hold down the yield on Treasuries, which the Fed feared would create a sustained

upward shift in inflation. It was an event that strengthened the Fed's independence. For details on the Fed's battle for independence, see "The Treasury-Fed Accord: A New Narrative Account" in the Federal Reserve Bank of Richmond Economic Quarterly, winter 2001.

We believe that the Fed's policy of purchasing a preannounced amount of Treasury securities in a short period of time is an attempt to front-load this new source of monetary ease into the coming months to fight the recession. By buying large amounts of both Treasury securities and mortgage-backed and Agency securities, it is trying to drive down mortgage rates immediately both by holding down Treasury yields and by narrowing the spread of mortgage yields above Treasury yields. We believe that the short run objective is to prevent house prices from overshooting fair value on the downside. Lower mortgage rates should help stimulate the volume of mortgages issued for refinancing and for the purchase of new and existing homes. It should help the transition later this year from the recent sharp decline in house prices to a phase of increased transactions at depressed prices, in keeping with the L-shaped pattern we expect in house prices. Mortgage rates have dropped below 5%, affordability for conventionally-financed homes has improved substantially and there is already increasing evidence of rising transaction volume in response to substantially lower house prices.

Note that the Fed's pre-commitment to purchase Treasury securities occurred after a 27-year decline in Treasury bond yields. Ten-year Treasury bond yields reached a secular peak at 16% in September 1981 and a possible secular low near 2.1% in December 2008. Subsequently, an upward shift in expected future Federal spending and deficits contributed to a rise in 10-year Treasury bond yields above 3%. The Fed's announcement initially reduced Treasury yields but did not drive yields back down

to their December 2008 lows. The average maturity of the Treasury debt has drifted down at a time when estimates of the long-term path of budget deficits and Treasury financing have shifted sharply higher. Since the large budget deficits will persist, the fall in the average maturity of Treasury debt is unlikely to prove sustainable over the coming years. There will be very large government financing needs both in the U.S. and overseas. In the short run, the Fed can contribute to a temporary scarcity of long-term Treasury securities, but can hardly do so in the long run given the outlook that high budget deficits will need to be financed even after the economy enters an economic expansion.

The path from deflation to inflation passes through the reflation of real economic activity. We do not expect significant inflationary pressures in the next several years. By the time the current recession ends, the supply of labor and productive capacity will be in substantial excess in both the U.S. and abroad. There is generally little inflationary pressure in the early part of an economic expansion because excess capacity and the spreading of labor and non-labor costs over increased production tend to dampen the upward pressure on unit labor costs and unit non-labor costs.

Is Federal Reserve policy too easy? One perspective is that the demand for hoarded liquidity has increased during the financial crisis because of increased risk aversion. The Fed has been increasing the liquidity supply to match that increase in demand. Despite rapid growth in the money supply and the Fed's balance sheet, it is not at all clear that the Fed is creating much excess liquidity. If risk aversion calms, the demand for hoarded liquidity will drop, potentially making some of that liquidity excessive relative to

the demand for it. However, many of the Fed's credit easing programs permit those who have borrowed from the Fed to reduce their borrowings if they wish. Therefore, much of the adjustment to a reduced desire to hoard liquidity would occur automatically due to private sector decisions to release their liquidity back to the Fed as risk aversion eases. In this way, a drop in the demand for hoarded liquidity need not result in excess liquidity.

It is controversial whether Federal Reserve policy is too easy or even too tight. The answer is crucial to key investment decisions. The Taylor Rule provides a framework for judging monetary policy. We are not going to detail the complexities of the Taylor Rule, but the basic ideas are simple. First, monetary policy should be easy if inflation is too low and should be tight if inflation is too high. Second, monetary policy should be easy if there is a great deal of excess capacity in the goods and labor market and tight if current output is already near the maximum output possible. Some economists have attempted to judge what the appropriate 2010 Federal funds rate should be based on reasonable estimates of inflation and the output gap. Some of these estimates have been close to minus 7%. It is not practical to get the Federal funds rate below zero, so that implies that a zero Federal funds rate would at that time be about 700 basis points too tight. It is likely that the Fed staff have done similar calculations, especially since one of these studies was done by Laurence Meyer of Macroeconomic Advisers, who is a former Federal Reserve Governor.

We believe that this analysis strengthens the case that the Fed has had sound reasons for its decision to generate rapid growth of the money supply and its balance sheet. Not everyone agrees. Some argue that the Fed is creating a

major inflation risk for the future. One version of this view is that current policy is too easy for current conditions and will quickly generate inflation. We believe this view is incorrect, given the large excess supply of goods and labor worldwide. Another version of this view is that current policy may be appropriate for now, but that you cannot count on the Fed to tighten quickly enough in the future when it becomes appropriate. This is a legitimate concern, but in our view, it is very much premature.

There are implications for the dollar from this debate about how easy Fed policy is and how inflation-prone the economy is. If Fed policy proves to be merely anti-deflationary in a deflation-prone context, current Fed policy need not create major weakness in the dollar. Serious dollar weakness would be much more likely to occur if U.S. inflation is destined to soar over the next several years. We do not think that that outlook will prove correct. Given his inflation-targeting mindset, Chairman Bernanke is trying to prevent the global and U.S. recession from generating any sustained consumer price deflation or permanently locking in deflationary expectations. We believe that cyclical forces remain deflationary and that the Fed has a cyclically appropriate policy.

Mr. Hoey's comments are provided as a general market overview and should not be considered investment advice or predictive of any future market performance.

Mr. Hoey's views are current as of the date of this communication and are subject to change rapidly as economic and market conditions dictate. Contact Dreyfus or your advisor for current information about Mr. Hoey's views of the economy and the markets.