

E Themes on the Economy®

Finding Our Footing

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Remember the Fundamentals

Renewed financial market turmoil, further seizures in credit markets, the ongoing collapse in housing, and signs that the credit crunch may be spreading beyond residential real estate into the commercial side of the market have all given doomsayers plenty to pontificate upon in recent weeks. Add to that, data that consumer spending remained flat on an inflation-adjusted basis in January, coupled with the fact that employment contracted for its second consecutive month in February, and it is hard for investors to remain calm.

That said, panic is not only our enemy, but it is unwarranted. Comparisons between the current market environment and that of the 1970s are particularly naive and ill-informed. Unlike then, we don't currently have wage and price controls, most industries have been deregulated rather than regulated, and Ben Bernanke is not Arthur Burns, who answered more to President Nixon than his colleagues at the Fed during his tenure.

The flight to safety and related jump in commodity prices is particularly disturbing, as investors seemed to have lost all sense of the underlying market fundamentals. The supply of agricultural products, in particular, is not controlled by state-owned entities like we see in the oil industry, and can respond to increases in price.

This is especially true in the corn market, where one farm expert confided in me that at least \$1.50 in the price of corn per bushel is due to speculators meddling in the market rather than an increase in world demand. This is important, because it

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suggests that a bubble is forming in the corn market. Those who are buying corn to protect themselves from a downside correction in stock prices are going to get burned.

The same is true of the Treasury market, where the flight to safety has pushed yields so low that investors are currently accepting an inflation-adjusted loss on their holdings. At some point in time, they will want to do better and flee the Treasury market for other asset classes. The risk of a Treasury market correction is especially high over the longer haul, given the prospects for higher federal budget deficits and the downward pressure on prices (and upward pressure on yields) that they are likely to exert on the bond market.

Indeed, it is times like these that make legends (and billionaires) out of the Warren Buffets of the world. They take the time to look at underlying market fundamentals, invest where others are too afraid to place their bets, and wait for the market to rally.

So, take a breath, and pause for a moment to reflect on what we do know instead of

Facing Stagnation

Real GDP is expected to contract 0.1% in the first quarter, marking the second consecutive quarter of stagnation. Whether revisions yield the obligatory two quarters of negative growth to call it a recession is less important than acknowledging the economy is in trouble. Consumer spending hit a wall, while business investment slowed. Inventories were replenished, but those gains were more likely due to weak demand than a deliberate attempt by producers to restock. The only bright spot is trade, which is expected to improve in response to weak imports and persistently strong exports.

Prospects for the second and third quarters are significantly better. Refund checks will start arriving in early May and continue until July. This, coupled with a surge in mortgage refinancing and resets, should provide an extra boost to cash flow. Discounters are expected to do particularly well, as those living paycheck to paycheck are more likely to spend instead of save their rebate checks. Equipment spending should also pick up in response to accelerated depreciation schedules. On net, real GDP is expected to rise 1.7% and 3.2% in the second and third quarters, respectively.

Growth is expected to settle back into the 2% range in the fourth quarter, carried mostly by increases in equipment spending and trade. We could also see more fiscal stimulus, given that it is an election year, and everybody fears a loss if the economy is still weak in November.

Fed continues to ease. The Fed is expected to lower the fed funds rate by one half percent at their next meeting on March 18. Another half percent cut in rates is expected at their meeting at the end of April. This will put the fed funds rate at a low of 2% for the year.

what we don't know about markets and the economy today:

- The U.S. still has the most flexible and resilient economy that the world has ever seen. Real GDP, excluding the housing market, rose at a 3.5% rate last year, and remained positive in the first quarter. Indeed, most economists expect the economy to continue to post respectable gains outside of the housing market in 2008, despite some spillover from real estate into other sectors.
- Today's policymakers have learned from the past (Bernanke is probably one of the world's foremost economic experts on the Great Depression), and have proven a willingness to be creative in their approach to solving the problems that we face.
- And, election-year politics have helped to focus and unite Congress and the Administration in a way previously thought inconceivable.

As a result, credit conditions will ease, the broader stock indices will rally, and the U.S. economy will reaccelerate. The question is when? The answer is that nobody knows. However, given the agility that policymakers have shown in dealing with the crisis, conditions will likely improve sooner than most people are currently expecting.

The View from Washington

I have spent the better part of the last month traveling between Washington and Chicago to various on and off-the-record meetings with economists and policymakers. The most recent of these meetings was the Annual Policy Conference of the National Association for Business Economics, March 2-4, 2008.

The remainder of this report provides a general summary of those meetings, including the direction of policy and what it all means for the overall economy. The consensus among economists is fairly strong that economic growth will rebound in response to fiscal and monetary stimulus by mid-year. However, the extent to which those gains become self-feeding will depend heavily on how much policymakers can boost investor confidence in the future of the U.S. economy.

Full Risk Management Mode at the Fed

The Fed continues to justify its move toward a more transparent and "rule-based"

approach to policy making. However, members of the Fed have gone to great lengths to argue that those rules do not apply in today's crisis environment. Ongoing financial market problems, in particular, have made growth and stimulus a priority over reigning in inflation in the near term.

Indeed, it appears that policymakers have resigned themselves to the persistence of recent inflation in an effort to try to shore up the economy. The Fed's most recent economic outlook included a forecast for core inflation to remain above the Fed's "comfort zone" of about 2% through year-end.

As a result, the Fed is expected to lower rates by another percent between now and the end of April. Personally, I would like to see the Fed better utilize inter-meeting moves to shore up investor confidence, but that seems unlikely. Many Fed Presidents are now openly opposed to "surprise" inter-meeting moves as they fear it might undermine the Fed's credibility with financial markets in regard to inflation. In general, the regional Fed Presidents tend to be more hawkish or concerned about inflation, than their counterparts in Washington, D.C.

Separately, the Fed has dramatically expanded the role of the Term Auction Facilities (TAFs), and broadened their lending to include AAA-private label and agency debt, which includes lending to Fannie Mae and Freddie Mac. This should help banks and other financial institutions better manage their end of quarter financing needs and, ultimately, ease for consumers.

The "Term Securities Lending Facilities" (TSLFs), as the new lending instruments are called, are structured to more directly address the seizure in the mortgage-backed securities market. Uncertainty about the value of the underlying mortgages has forced selling by some brokers to cover loan payments, and scared other investors away from trading in the market entirely. This is despite a 93% payback on mortgage loans nationally, and even higher payback rates on the mortgage portfolios in question.

By trading mortgage-backed securities for the Fed's own holding of treasury bonds, the Fed hopes to instill its broader network of primary brokers with a greater willingness to trade these securities. The

result, in turn, should ease credit market conditions for mortgages more broadly, and bring down mortgage rates. This will increase the ability of homeowners to both buy and refinance, which is especially important for those living in the most overbuilt and fastest depreciating markets.

Four foreign central banks also agreed to join the Fed in their efforts to shore up investor confidence abroad and at home. This could eventually provide a lift for the value of the dollar against the Euro if it results in some sort of easing by the European Central Bank (ECB). Those closest to the ECB don't expect the bank to ease much before May. (The ECB has been reluctant to ease ahead of settling wage negotiations in Germany, which should be wrapped up by May.)

The Fed could also extend the time horizon of their loans from 28 to 90 days, which would give the market even more time to deal with the repricing of risk. The Fed would like to avoid becoming a *buyer* instead of a *lender of last resort*, as that would likely create even larger problems for the Fed to deal with down the road. All options, however, are on the table.

On net, monetary easing has already triggered a fairly substantial surge in mortgage refinancing and repricing of adjustable rate mortgages. This will not only limit the number of mortgage defaults and foreclosures going forward, but will also increase cash flow to those who need it most—middle- and lower-income households whose budgets have been disproportionately squeezed by rising food and energy prices.

Work done by Mesirow Financial suggests that the reduction in the debt-payments created by lower short-term rates and mortgage restructuring will generate between \$50 and \$90 billion in additional cash for consumers to spend by year end.

Strong-Arming by the Treasury

Election-year politics make for strange bedfellows, and Congress and the Administration came up with a remarkably fast fiscal stimulus package. Treasury Secretary Paulson deserves much of the credit, as he refused to allow much debate over the structure of the package. In particular, he limited the debate to a "quick" stimulus plan, which limited

discussions to tax rebates and investment incentives.

The fiscal stimulus plan is not targeted to address the subprime debacle per se, but will help limit defaults and foreclosures when it is married to earlier moves to lower short-term interest rates by the Fed. Indeed, the bulk of mortgage resets are expected to hit in May and June, just as homeowners are getting rebates.

Households earning up to \$150,000 are the primary recipients of the tax rebates, which will be distributed by the IRS between the first week of May and the first week of July. The largest beneficiaries, however, are expected to be those at the lowest end of the income strata—earning less than \$75,000 per household. These households are the most likely to spend instead of save the checks, as they are living closest to the edge of their budgets.

Depreciation schedules were also accelerated for small- and medium-sized businesses, which should provide a lift to investment on everything from trucks and light machinery to computers.

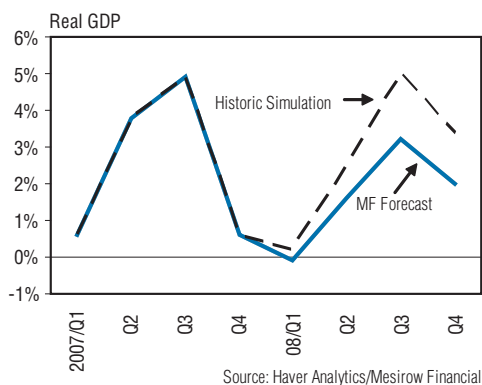
Separately, the stimulus package included a provision to lift the level of jumbo loans for Fannie Mae and Freddie Mac. This should ease credit conditions for the high-end of the housing market, and make it easier for those with larger adjustable-rate mortgages (mostly in California) to restructure their debt.

Paulson has also hinted at additional legislation on the housing front, some of which was announced today. He largely targeted lenders, encouraging a reduction in dividends and an increase in their capital positions to boost lending. He also proposed some changes to regulation that should help us avoid a repeat of the current situation down the road. He stopped short, however, of any type of immediate action, which disappointed many.

Some on Capitol Hill are proposing to resurrect the Home Owners' Loan Corp of the Great Depression to buy and refinance troubled mortgage loans. Many economists are sympathetic to such an approach. There are also proposals to boost tax cuts for home builders so that they can afford to hold properties that they might otherwise dump at firesale prices.

CHART 1

Stimulus and the Economy



There are those in the financial community pushing for an easing of the mark-to-market accounting rules which forced many firms to write-off significantly more than they would conceivably ever lose on prime mortgage portfolios. However, the Fed seems more open to the idea of easing up on regulatory burdens in the current environment, than the Treasury.

Other policy initiatives are targeted more directly at limiting future mortgage foreclosures. The Hope Alliance Now initiative claims to have rescued some one million homeowners from foreclosure since its inception late last year, mostly in California and Florida.

On net, about 40% (or about \$60 billion) of the stimulus package is expected to show up as actual spending in the latter part of the second quarter and start of the third quarter. Another 10% to 20% (\$15 to \$20 billion) will show up by the end of the year as consumers use the rebates to free up credit on their credit cards.

Then there is the increase in equipment spending associated with accelerated depreciation schedules, which is expected to be about \$30 billion. Most of those gains, however, will not show up until the fourth quarter, as businesses can't collect on those incentives until they actually pay their taxes for 2008 in the first quarter of 2009.

The Impact on GDP Growth

Historical relationships between fiscal stimulus, monetary easing, and spending suggest that real GDP growth should surge into the 5% range by the third quarter and hold above 3% in the fourth quarter. Ongoing credit market turmoil and

uncertainty over the effectiveness of policy, however, suggests that we should be significantly more conservative on the impact of those shifts on the economy than we were in the past. A further crunch in credit markets would be particularly detrimental to the outlook.

On net, real GDP is forecast to rebound to slightly above 3%, more than 2% below that predicted by historical relationships, in the third quarter. Growth in the fourth quarter is expected to settle into a 2% rate, supported largely by the pick-up in equipment spending associated with the fiscal stimulus package. (See Chart 1.)

The Impact on Financial Markets

The turn in equity markets should come in advance of the turn in the economy. The initial reaction to the Fed's recent moves to shore up market liquidity and investor confidence was encouraging. The Dow Jones Industrial Average (DJIA) jumped more than 400 points the day the Fed announced the expansion of its loans to AAA-private label and agency debt. One day, however, does not make a trend.

It would be reasonable to see the DJIA move back into the 13,000 range by year end given the forecast for a rebound in growth. Indeed, our internal models suggest a DJIA well above 14,000, but there is reason to be cautious given the ongoing problems in credit markets.

A Star Wars Moment

I will begin where I started, and remind you to focus more on what you know rather than what you don't know during times of financial crisis. Think of yourself as Luke Skywalker flying your X-Wing fighter in the first Star Wars movie (Episode IV for aficionados), with the weight of the Rebellion on your shoulders. You are their last hope at destroying the Death Star before it destroys them.

What do you do? You fly low so that the Empire gunners can't hit you. You turn off your missile guidance systems and rely on the most important asset you have, your own knowledge and instinct—the "Force." You take your best shot, and it hits its target. The Death Star explodes and Good triumphs over Evil, at least for a day.

Mesirow Financial Economic Forecast (Numbers as of March 13, 2008)

	2007(A)	2008	2009	2007:3(A)	2007:4(A)	2008:1	2008:2	2008:3	2008:4	2009:1
National Outlook										
Chain-Weighted GDP	2.2	1.8	2.4	4.9	0.6	-0.1	1.6	3.2	2.0	2.2
Personal Consumption	2.9	1.4	1.9	2.8	1.9	-0.5	1.3	3.2	1.1	1.7
Business Fixed Investment	4.8	4.1	2.9	9.3	6.9	-1.2	3.8	3.3	3.9	2.2
Residential Investment	-17.0	-20.3	-1.5	-20.5	-25.2	-27.0	-18.8	-10.6	-4.8	0.4
Inventory Investment (billions)	6.6	12.3	25.2	30.6	-10.1	10.4	6.3	11.5	21.0	21.0
Net Exports (billions)	-556.5	-462.1	-416.1	-533.1	-506.8	-493.0	-464.6	-450.2	-440.5	-426.3
Exports	7.9	8.0	7.2	26.2	4.0	5.5	6.4	6.3	8.0	7.8
Imports	1.6	0.6	3.5	4.8	-2.1	1.5	-1.2	1.6	4.0	3.3
Government Expenditures	2.0	2.2	1.6	3.8	2.2	2.0	1.3	1.6	2.0	1.7
Federal	1.7	3.5	2.1	7.1	0.9	5.7	1.4	2.2	2.5	2.1
State and Local	2.2	1.5	1.3	1.9	3.0	0	1.3	1.2	1.7	1.5
Final Sales	2.5	1.7	2.3	4.0	2.1	-0.8	1.8	3.0	1.7	2.3
Inflation										
GDP Deflator	2.7	2.3	2.2	1.0	2.7	2.7	2.2	2.2	2.2	2.6
CPI	2.9	3.6	2.2	2.8	5.0	4.4	2.7	2.0	2.5	2.4
Special Indicators										
Corporate Profits*	5.8	6.2	4.5	1.8	5.8	4.5	0.6	5.1	6.2	7.3
Disposable Personal Income	3.0	2.2	1.9	4.0	-0.3	1.4	8.0	1.5	-3.0	3.8
Housing Starts (millions)	1.34	0.97	0.99	1.30	1.15	1.00	0.99	0.96	0.95	0.96
Civilian Unemployment Rate	4.6	5.2	5.5	4.7	4.8	4.9	5.2	5.4	5.4	5.4
Employment	1.0	-0.5	0	-0.2	-0.5	-0.6	-1.0	-0.9	0.1	0.4
Vehicle Sales										
Automobile Sales (millions)	7.6	7.5	7.8	7.3	7.8	7.3	7.5	7.5	7.6	7.7
Domestic	5.0	5.1	5.2	4.9	5.2	5.0	5.1	5.1	5.1	5.2
Imports	2.5	2.4	2.6	2.4	2.5	2.3	2.4	2.4	2.5	2.5
Lt. Trucks (millions)	8.6	8.1	8.4	8.6	8.4	8.1	8.2	8.1	8.2	8.3
Domestic	7.1	6.7	6.8	7.2	6.9	6.7	6.7	6.6	6.7	6.7
Imports	1.5	1.5	1.6	1.4	1.5	1.4	1.5	1.5	1.5	1.6
Combined Auto/Lt. Truck	16.1	15.6	16.2	15.9	16.2	15.4	15.7	15.6	15.8	16.0
Heavy Truck Sales	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Total Vehicles (millions)	16.5	15.9	16.5	16.2	16.5	15.7	16.0	15.9	16.1	16.3
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	2 ⁵ / ₈	5 ¹ / ₈	4 ¹ / ₂	3 ¹ / ₈	2	2	2	2
10-Year Treasury Note	4 ⁵ / ₈	3 ³ / ₄	4 ³ / ₈	4 ³ / ₄	4 ¹ / ₄	3 ⁵ / ₈	3 ⁵ / ₈	3 ⁷ / ₈	4 ¹ / ₈	4 ¹ / ₄
Prime Rate	8	5 ¹ / ₄	5 ⁵ / ₈	8 ¹ / ₈	7 ¹ / ₂	6 ¹ / ₈	5	5	5	5
Corporate Bond AAA	5 ⁵ / ₈	5 ³ / ₄	6 ¹ / ₄	5 ³ / ₄	5 ¹ / ₂	5 ³ / ₈	5 ⁵ / ₈	5 ⁷ / ₈	6 ¹ / ₈	6 ¹ / ₄
Exchange Rates										
Yen/Dollar	118	106	109	118	112	107	106	103	106	107
Dollar/Euro	1.37	1.48	1.42	1.38	1.45	1.49	1.52	1.50	1.46	1.43

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2007, GDP was \$11,567 billion in chain-weighted dollars.

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