

January 30, 2009**Peter E. Kretzmer**
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646.855.1045**U.S. Economic & Financial Forecast—February 2009**

- The U.S. remains in a severe recession as we near the midpoint of 1Q 2009. While final sales declined almost 5% annualized last quarter, production declines did not keep up, and inventory-to-sales ratios rose. GDP declined 3.8% annualized in 4Q 2008, with a 5.2% drop expected this quarter. We project 2.4% GDP decline for 2009, with surging unemployment and declining corporate profits. Key trading partners are in recession (UK, the Eurozone & Japan), or are slowing appreciably (China & most emerging markets).
- While the business cycle peak is dated December 2007, steep GDP decline did not begin until 4Q 2008. As housing decline continued and a final spike in energy costs weakened consumer spending, the abrupt intensification of financial stress in August-September was the key blow, with turmoil spreading into the money market fund industry, the commercial paper market grinding to a halt, and Libor spreads abruptly widening to historic levels. Credit conditions tightened further with the 30 percent collapse in equity markets from August through November.
- Treasury's direct capital injections into U.S. banks and temporary guarantee of senior debt, and the Fed's primary commercial paper (CP) facility and the early stages of further monetary easing, including direct purchases of agency mortgage-backed securities, have led to limited credit improvement. Libor spreads have narrowed, and the CP market has improved. Recently, mortgage and corporate yields have also begun to ease. However, credit conditions remain abnormal, and financial markets are unlikely to heal fully while home prices are still falling. The Obama Administration is contemplating a "bad bank" solution to the troubled asset problem.
- Led by collapsing vehicle sales, consumer spending fell more than 3.5% annualized in 2H 2008. Consumer confidence continued to decline in January, as households adjusted spending to large declines in household net worth and continued large-scale job destruction. While a rise in real consumption in November, following 5 consecutive monthly declines, indicated some relief from large energy price declines, consumer spending weakened further in December and January, and is expected to decline at a 1.5% annualized pace in 1H 2009. We expect gradual recovery thereafter, restrained by ongoing household deleveraging.
- Led by transportation equipment, nonresidential fixed investment fell almost 20% annualized in Q4. Amid tight credit conditions, plummeting profits and weak final demand, we expect double-digit declines in capital spending all year. Production declines have picked up this quarter, along with the largest job losses since the early 1980s; we expect unemployment above 8.5% by midyear. Housing activity will decline rapidly through 1H 2009 before gradually stabilizing ahead of home prices. The degree of foreign economic weakness is another blow to the outlook for domestic production, with significant export declines likely this year.
- Recent sharp declines in commodity prices and growing economic slack have substituted deflationary fears for inflation pressures. But the Fed has moved aggressively, lowering its funds rate target to a range just above zero, and directly supporting troubled financial markets, adding bank reserves and aggressively expanding its balance sheet. President Obama and his majority in Congress are working on a huge stimulus bill, including infrastructure outlays, expanded unemployment assistance, large block grants to states, significant energy-related spending, further mortgage relief and various middle-income tax measures. Passage this month is nearly certain.

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Economics
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		2008	2009	2010	2011	Q108	Q208	Q308	Q408	Q109	Q209	Q309	Q409	Q110	Q210	Q310	Q410	Q111	Q211	Q311	Q411
GDP	% y/y	1.3	-2.4	1.8	3.5	2.5	2.1	0.7	-0.2	-1.7	-3.2	-3.0	-1.6	0.2	1.7	2.4	2.8	3.2	3.5	3.7	3.8
	%q/q ann					0.9	2.8	-0.5	-3.8	-5.2	-3.2	0.5	1.6	2.2	2.6	3.1	3.5	3.6	3.8	3.8	3.8
Nominal GDP	% y/y	3.5	-1.3	2.9	4.4	4.7	4.1	3.3	1.7	-0.3	-1.8	-2.3	-0.6	1.4	2.9	3.5	3.9	4.1	4.4	4.5	4.6
	%q/q ann					3.5	4.1	3.4	-4.1	-4.2	-2.2	1.5	2.8	3.5	3.6	4.0	4.3	4.6	4.6	4.5	4.7
Private consumption	% y/y	0.3	-1.5	2.1	3.3	1.5	1.3	-0.2	-1.3	-2.1	-2.6	-1.3	0.1	1.2	2.1	2.4	2.7	3.0	3.2	3.4	3.5
	%q/q ann					0.9	1.2	-3.8	-3.5	-2.3	-0.7	1.3	2.0	2.4	2.6	2.8	3.2	3.3	3.5	3.6	3.6
Nonres fixed investment	% y/y	1.8	-12.0	-9.1	2.8	6.2	4.2	1.6	-4.4	-7.8	-11.7	-14.9	-13.6	-13.1	-11.3	-7.8	-3.7	-0.4	2.5	4.2	5.1
	%q/q ann					2.4	2.5	-1.7	-19.1	-11.5	-13.5	-15.5	-13.7	-9.6	-6.3	-1.0	2.5	3.6	5.0	5.7	6.1
Residential fixed investment	% y/y	-20.8	-19.3	2.8	8.1	-21.3	-21.6	-20.6	-19.7	-21.1	-22.0	-19.7	-13.7	-4.3	2.3	6.0	7.6	8.3	8.1	8.0	7.8
	%q/q ann					-25.0	-13.3	-16.1	-23.6	-30.5	-16.8	-6.0	2.0	5.0	8.7	8.4	8.2	8.0	7.9	7.7	7.6
Gov't consumption/investment	% y/y	2.9	4.1	6.0	3.1	2.6	2.6	3.1	3.4	3.8	3.8	3.8	5.1	5.9	6.4	6.2	5.4	4.4	3.4	2.5	2.0
	%q/q ann					1.9	3.9	5.8	1.9	3.5	4.0	6.0	7.0	6.5	6.0	5.2	4.0	2.5	1.8	1.8	1.8
Domestic final sales	% y/y	0.0	-2.2	1.7	3.3	1.1	0.8	-0.2	-1.5	-2.3	-3.1	-2.5	-1.0	0.3	1.4	2.2	2.7	3.1	3.3	3.4	3.5
	%q/q ann					0.1	1.3	-2.2	-4.9	-3.3	-1.8	0.0	1.2	2.0	2.5	3.0	3.4	3.3	3.4	3.6	3.6
Net exports ¹	\$ bn chn00	-388	-367	-408	-443	-462	-381	-353	-356	-360	-365	-369	-374	-386	-400	-416	-431	-438	-443	-445	-447
	%q/q ann.	1.4	0.2	-0.4	-0.3	0.8	2.8	1.0	-0.1	-0.1	-0.2	-0.1	-0.2	-0.4	-0.5	-0.6	-0.5	-0.2	-0.2	-0.1	-0.1
Stockbuilding ¹	\$ bn chn00	-21.1	-59.0	-11.0	35.3	-10.2	-50.6	-29.6	6.2	-45.0	-80.0	-63.0	-48.0	-32.0	-18.0	-4.0	10.0	22.0	34.0	40.0	45.0
	%q/q ann.	-0.2	-0.3	0.4	0.4	-0.1	-1.4	0.7	1.2	-1.8	-1.2	0.6	0.5	0.6	0.5	0.5	0.5	0.4	0.4	0.2	0.2
C/A balance	\$ bn	-670	-550	-630	-720																
	% of GDP	-4.7	-3.9	-4.3	-4.7																
Industrial production ²	% y/y	-1.8	-5.4	2.6	3.9	1.9	0.1	-3.0	-6.0	-7.7	-7.3	-4.9	-1.4	1.2	2.5	3.1	3.5	3.7	3.8	3.9	4.0
	%q/q ann					0.5	-3.5	-8.9	-11.5	-6.9	-1.8	1.2	2.1	3.2	3.4	3.9	3.7	3.9	3.9	4.2	4.2
Unemployment rate ²	ave. level	5.8	8.5	8.8	8.4	4.9	5.4	6.1	6.9	7.9	8.5	8.7	8.8	8.9	8.9	8.8	8.7	8.6	8.5	8.3	8.1
CPI ²	% y/y	3.8	-0.9	1.6	1.0	4.2	4.3	5.3	1.5	-0.4	-1.2	-2.4	0.4	1.8	1.7	1.5	1.3	1.1	1.0	1.0	1.0
	%q/q ann					4.3	5.0	6.7	-9.2	-3.5	1.7	1.7	1.8	1.9	1.3	1.1	1.0	1.2	0.9	0.9	0.9
Core CPI ²	% y/y	2.3	1.5	1.3	1.0	2.4	2.3	2.5	2.0	1.7	1.6	1.1	1.4	1.4	1.4	1.3	1.2	1.1	1.0	0.9	0.9
	%q/q ann					2.5	1.9	3.2	0.4	1.5	1.4	1.3	1.4	1.5	1.3	1.1	1.0	1.0	1.0	1.0	1.0
PCE deflator	% y/y	3.3	-0.4	1.3	0.8	3.5	3.7	4.3	1.7	0.1	-0.6	-1.5	0.3	1.5	1.4	1.2	1.1	0.9	0.8	0.7	0.7
	%q/q ann					3.6	4.3	5.0	-5.5	-3.0	1.5	1.4	1.5	1.6	1.1	0.8	0.8	1.0	0.6	0.6	0.6
Core PCE deflator	% y/y	2.2	1.3	1.1	0.7	2.2	2.3	2.3	1.8	1.6	1.4	1.0	1.2	1.2	1.1	1.1	1.0	0.9	0.8	0.7	0.6
	%q/q ann					2.3	2.2	2.4	0.6	1.3	1.2	1.1	1.2	1.3	1.0	0.8	0.8	0.9	0.6	0.5	0.5
Federal govt surplus ³	% of GDP	-3.2	-8.4	-7.5	-5.7																
Federal govt debt ^{3,4}	% of GDP	38.6	46.9	52.9	56.2																
Federal funds rate (eff.) ⁵	%	1.9	0.2	0.8	2.7	3.2	2.1	1.9	0.5	0.1	0.2	0.3	0.3	0.3	0.5	0.9	1.5	2.0	2.4	2.9	3.5
3-month Libor rate ⁵	%	2.9	1.1	1.3	3.0	3.3	2.8	2.9	2.7	1.4	1.2	1.0	0.9	0.9	1.0	1.3	1.8	2.3	2.7	3.2	3.8
2-year Treasury yield ⁵	%	2.0	1.2	2.2	4.1	2.0	2.4	2.4	1.2	0.9	1.0	1.3	1.5	1.8	2.0	2.3	2.8	3.3	3.8	4.3	4.8
5-year Treasury yield ⁵	%	2.8	2.1	3.1	4.6	2.7	3.2	3.1	2.2	1.8	1.9	2.1	2.4	2.7	2.9	3.2	3.6	4.0	4.4	4.8	5.2
10-year Treasury yield ⁵	%	3.7	2.9	4.0	5.1	3.7	3.9	3.9	3.3	2.7	2.8	3.0	3.2	3.5	3.8	4.1	4.4	4.7	5.0	5.3	5.5
30-year Treasury yield ⁵	%	4.3	3.5	4.6	5.5	4.4	4.6	4.4	3.7	3.2	3.4	3.6	3.8	4.1	4.5	4.8	5.0	5.2	5.4	5.6	5.7

Notes: ¹ 2nd line is contribution to GDP growth ² Quarterly levels are calculated as averages of monthly s.a. figures
³ By fiscal year ⁴ End of period ⁵ Quarterly averages of monthly rates/yields Sources: Haver Analytics and Bank of America estimates

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