



Economic Update

Richard B. Hoey, Chief Economist, The Bank of New York Mellon Corporation

August 7, 2009

In our opinion, the U.S. recession is over, an outcome consistent with our forecast of a recession trough near mid-2009. We also believe that the global recession has ended, as the economic recovery, which began in Asia, spreads to most major countries. Real GDP should rise in most major countries during the third quarter of 2009. However, we expect the level of economic activity and employment in most countries to remain substantially lower than it was at the cycle peaks for an extended period of time. The news on the change in economic activity should be positive, but the news on the level of economic activity and employment is likely to remain negative.

We have high confidence in three major themes: (1) most policy authorities worldwide are “all-in” with powerfully stimulative policy, led by the U.S. and China, (2) the severe inventory liquidation in the U.S. is about to slow, and (3) there has been a major drop in the equity cost of capital and the debt cost of capital for most corporations, fostering corporate deleveraging via refinancing as a substitute for further downsizing.

The cyclical transition from the Great Recession to economic expansion is better understood as the exhaustion of severe weakness in residential construction, auto sales and production, and inventory liquidation rather than as the sum of a number of new sources of strength. However, we do expect the expansion to be sustainable, given the substantial easing of the credit crunch which has already occurred. Different aspects of the economy should improve at a different pace. Industrial production is likely to rebound immediately as the severe pace of inventory liquidation eases. In contrast, the labor market recovery is likely to be slow, with the peak in the unemployment rate likely

to lag by about three quarters, as is the normal cyclical pattern.

The economic evidence has been tracing out a classic recession trough pattern: (1) the leading indicators have risen for several months in a row, (2) the purchasing managers’ surveys have been rising in the U.S. and worldwide, (3) within the purchasing managers’ surveys, orders have been rising, (4) housing inventories have dropped and home sales, building permits and housing starts have risen, (5) the yield curve has steepened, with long-term yields rising, (6) corporate risk spreads have narrowed, (7) commodity prices have risen off their extreme lows, (8) the stock market has risen substantially, led by financial and cyclical stocks, and (9) the moving average of initial unemployment claims has dropped, even in those states where there are no auto plants to mask the underlying trend of improvement. Aggregate hours worked in the U.S. economy have declined for many months, but that decline came to an end in July 2009 with a flat reading for the overall economy and a rise of 0.4% in manufacturing. We believe this was the cyclical trough. In our opinion, the recession is over.

The past has been somewhat re-written by the GDP revisions: the economic decline during the Great Recession was substantially more severe than originally reported. This helps explain why labor market weakness has been so pronounced. Real GDP is now reported to have declined rather than risen in the third quarter of 2008. The two-quarter-long waterfall stage of the Great Recession in late 2008 and early 2009 was even more severe than originally reported, with real GDP declining at a 5.4% annual rate in the fourth quarter of 2008 and at a 6.4% rate in the first quarter of 2009. This two-

quarter waterfall decline phase of the recession transitioned to a mild decline in the second quarter of 2009, when real final sales were roughly flat. We believe that the second quarter of 2009 will mark the last quarter of declining residential construction, the last quarter of declining automobile production, the most severe inventory liquidation of the cycle and the last quarter of the Great Recession.

One of the reasons that we have been more optimistic than the economic pessimists that the Great Recession would bottom near mid-2009 has been that we do not expect a further major rise in the savings rate. While they expect the savings rate to continue a further upward shift to 10% or more with severe weakness in consumer spending as consumer behavior changes dramatically, we think that it is more likely that there will be a stabilization in the savings rate at roughly half that rate, near the level of the second quarter of 2009. There are good reasons to expect a somewhat higher savings rate now that the prior housing boom has been followed by lower house prices. However, we believe that many consumers who wish to raise their savings rate substantially will not succeed in doing so, largely for two reasons: (1) they will find it difficult to restrain their spending and (2) the growth in sustainable income should prove sluggish relative to their spending desires. In their own long-term self-interest, they should further increase their savings rate by further reducing their spending. We just don't think that they will change their behavior enough to reach the very high savings rates that the cyclical pessimists expect.

There are many conceptual and measurement problems with the reported savings rate. One of these is that the actual savings rate generally proves to have been higher than what was originally reported, due largely to persistent upward revisions in the original estimates of income. In the recent GDP revisions, the savings rate was revised up for twelve of the last twelve years. One result of this persistent pattern of initial underestimates of the savings rate is that analysts tend to overestimate how much the savings rate "must" rise and how

weak consumption "must" be. We do believe that restricted availability of mortgage credit and auto credit did weaken consumption spending when these restrictions were most severe during the worst phases of the credit crunch, just at the time when consumer net worth was dropping sharply. As these credit channels gradually open up, we expect that the savings rate should stabilize. Note that the drop in consumer net worth has probably ended. The government is borrowing heavily on behalf of many consumers who have a very low propensity to save out of income. At the same time, monetary policy is ensuring that the interest rates available to savers are quite low. Please note that we are not arguing for strong growth in consumption, but rather that it is not destined for severe further weakness that would prolong the recession.

If the economic expansion is beginning, how rapid is it likely to be? The normal Postwar pattern after such a severe recession would be a "Big V," with a powerful expansion at about a 5% or 6% annual rate in the first year. We do not believe that this is a realistic expectation for this recovery, because the deleveraging drag on the economy is real, even though we believe that it is less severe than the economic pessimists have argued. Our most likely case is that in the last half of 2009 and the four quarters of 2010, real GDP growth should average about 3% to 3.5%, possibly a touch higher. The "new normal" trend growth rate in the U.S. is likely to be in the 2% to 2.5% range. Thus, such a growth rate would be subpar relative to a traditional recovery after a severe recession, but would still represent somewhat above-trend growth. Although that is stronger growth than many have been expecting, it would be a somewhat sluggish rebound after such a severe recession. The unemployment rate should trend higher for about another three quarters, in keeping with the normal cyclical pattern. We would expect a peak in the unemployment rate sometime in early 2010 at or somewhat above 10%, followed by a very gradual decline. Even as cyclical uncertainties begin to fade, companies will face continued policy uncertainties, which are likely to restrain decisions to hire.

We expect some complex crosscurrents in inflation. Despite the recent weakness in the dollar and strength in commodities prices, core inflation should drift lower in response to excess capacity and weak wage inflation. For reported inflation, however, we expect a “headline head fake” due largely to volatile oil prices. The 12-month rate of change of the reported Consumer Price Index could rise about 400 basis points from about minus 2% this summer to about plus 2% at the end of 2009. However, this should largely be an artifact of the violent volatility of oil prices. In the 12 months

following a \$147 per barrel crude oil price in July 2008, reported inflation will be negative. In the 12 months following crude oil prices near \$30 per barrel in December 2008, reported inflation should rebound. This reacceleration of reported inflation will coincide with the rebound in economic activity in the second half of 2009, but will be more attributable to the oil price cycle than to the economic cycle.

In sum, there is no change to our outlook but the evidence in support of it has improved.



THE BANK OF NEW YORK MELLON

This report represents the general economic overviews of Mr. Richard Hoey, Chief Economist, The Bank of New York Mellon Corporation, and does not constitute investment advice, nor should it be considered 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.