



# US Economy and Financial Market Outlook

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## TARP HAS STRAYED FROM ITS ORIGINAL MISSION

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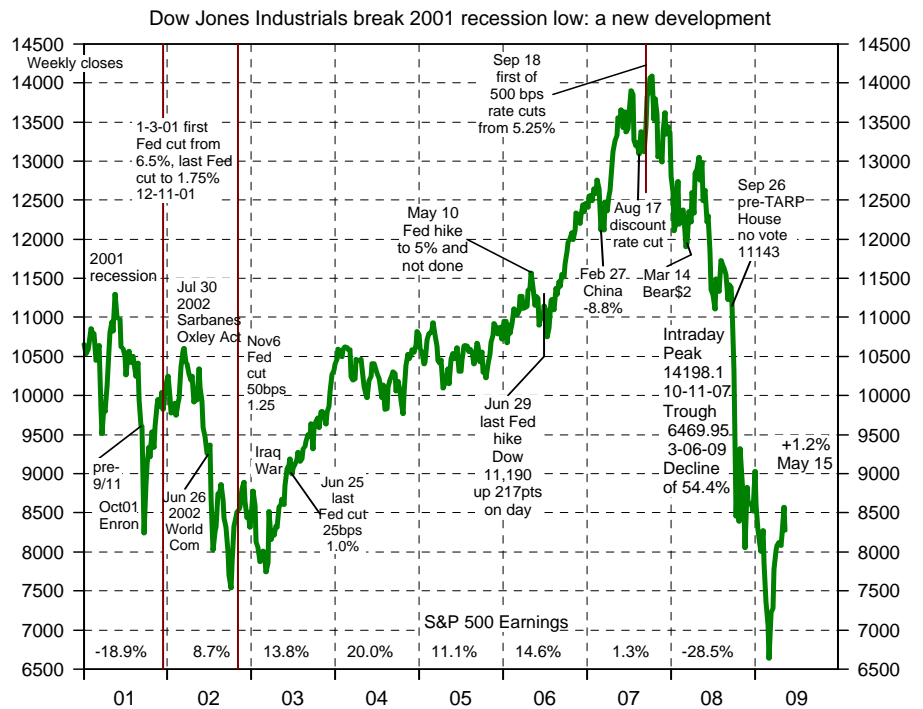
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The Government's Troubled Asset Relief Program (TARP) keeps changing its focus. That may not be a bad thing, and it has achieved one purpose in bolstering confidence in the banking system, while achieving mixed results on its other purpose which is to get credit flowing in the economy again. Credit spreads have narrowed since last fall, but credit is not flowing as freely as it once did partly because economies in recession have sharply reduced demand for short-term credit.

Last fall, when the credit markets were frozen and it looked like speculators were going to drive Wall Street firms and banks out of business, the \$700 billion

TARP program was implemented to instill confidence in the banking system. Starting with Bear Stearns in March 2008 it seemed as if the speculators' game was to reduce the shares of





bank stocks to pennies at which point customers would stop dealing with the banks, and the banks would lose their funding and go under. The game has changed now, and no one believes these banks will go bankrupt. This was true even before the Government released the generally positive stress test results of the 19 largest bank holding companies on May 7. Citigroup shares were \$0.97 on March 5 and are about \$3.50 today. Bank of America shares were \$2.53 on February 20 and are about \$10.80 today.

The aim of the program last September was to get credit flowing in the economy again as the illiquid mortgage-related debt on banks' balance sheets was a constraint on new lending. After the Lehman bankruptcy on Monday, September 15 followed by the Government takeover of AIG after the market closed on September 16, stocks came back later in the week on hopes for a bank bailout. The market's hopes for a bank fix have soared and plummeted many times since September. Who can forget the day that the House voted down the TARP bill on Monday, September 29 sending the Dow industrials down 777 points or 7.0% for the day? Before that no vote, at the Friday, September 26 close, the Dow industrials were still at 11,143 or down just 16.0% for the year. The inability to get a quick bank fix hurt the world economy, the recession deepened and the Dow industrials ended 2008 at 8,776.39 down 33.8% for the year.

But what happened to TARP along the way? On September 20, the Treasury originally intended the \$700 billion should be used to purchase banks troubled assets. In October, Treasury jettisoned that idea and instead used the money to take a stake in the banks. Treasury announced the TARP Capital Purchase Program on October 14 and said 9 banks had voluntarily agreed to participate. If

you can't get the toxic assets off the banks' books, you can shore up their capital by having the Government take an equity stake. Moreover, the banks were to use the Government money to make loans and get credit, the life-blood of the economy, flowing again. The Treasury is serious about its desire to get credit moving again. It has the top 21 TARP recipient banks reporting on the amount of loans they make every month. Increasing credit is a laudable goal, but it should still be kept in mind that commercial & industrial loans are a lagging indicator of recovery. In the last two recessions, commercial & industrial loans outstanding were still falling two years after the recession ended.

Conclusion: The TARP was created to get toxic assets off the books of banks and free up their balance sheets so they can lend again. But another important reason for the TARP was to make the banks look money good so short-sellers and hedge funds would stop trying to reduce their share prices to pennies and effectively put them out of business. While the stock market was falling last year and early this year and financial company share prices were falling closer to zero, the overall stock market fell more than any time since the Great Depression hurting business and consumer confidence. This postponed the day of recovery from recession. The track record of stocks and economic recovery show that stocks bottom 2-5 months before the end of the recession. If stocks bottomed on March 6 this year, the recession will end sometime between May and August.

*(Christopher S. Rupkey)*



## The Double-Dip Scenario: It's Not Just a Party Foul

To anyone outside of economists the term double-dip indicates someone has just committed the party foul of dipping the same finger food twice. No matter what the term “double-dip” means to you, however, I think we can all agree it's a pretty undesirable event.

The double-dip we are referring to is of the economic variety in which **the U.S. economy enters a tepid recovery only to be shocked back into recession.** The most famous double-dip episode in our country's past is of course the back-to-back recessions of the early 1980's. The country was first driven into recession in January 1980 by imposed credit controls (a brilliant scheme to fight inflation), emerged in July 1980 (the credit controls were lifted in a matter of a few months when the government realized the harm they had done), and then was thrown back into recession one year later when restrictions on the money supply and sky high interest rates became the Volker-Fed's last resort to tame out-of-control inflation. When all was said and done, the double-dip recession brought an end to the Age of Inflation.

Since the early 1980's worries over a double-dip resurfaced following the 2001 recession, aptly named the “jobless recovery”, which prompted a weak, rather than rapid post-recession recovery. Indeed, any time economists expect a weak recovery you can bet talk of a double-dip recession will arise just as it has today. **Forecasters are unanimously<sup>1</sup> predicting a weak recovery beginning in the second half of 2009 and a U.S. economy on shaky ground leaves it very vulnerable to**

**external and internal shocks** – be it an oil supply shock or serious pandemic, for example.

This time around, the reasons given for a possible double-dip scenario vary. Would it be caused by rampant inflation from an excessive money supply or fading government stimulus? Either scenario seems just as likely as the next, with a distinct possibility of some combination of the two.

### The Inflation-Induced Double-Dip

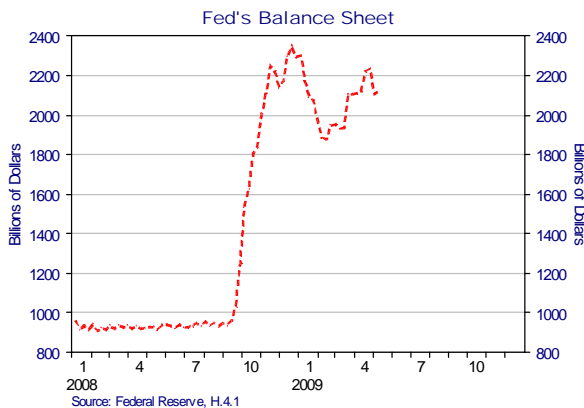
To say that excess liquidity causes runaway inflation is too general of a statement. Really **it's what's done with the excess and under what economic circumstances that determines its influence on inflation.** Money velocity, or the speed in which money changes hands, is the key. In an economy that is racing along, too much money changing hands rapidly can quickly lead to an undesirable growth in prices. In this case, to meet the increase in demand suppliers ramp up production and as factories near capacity, producers must increase prices to further expand output.

Speaking of money changing hands...just as the old saying goes, “if a tree falls in the woods and no one is around to hear it, does it make a sound?”, so goes “if there's a ton of money laying around and no one is willing to lend it or spend it, does it cause inflation?” The latter is where we find ourselves today. **The propensity for America's households to consume has fallen drastically over the recession.** The most direct way to see this is through the rapid rise of the personal savings rate. To be sure, the personal savings rate has always risen during recessions as consumers are scared into building precautionary savings. But today's increase has been particularly rapid and the higher savings rate implies that at least on the consumer side, money velocity is very weak indeed.

<sup>1</sup> According to the May 2009 survey of Blue Chip Economic Indicators, the consensus forecast calls for a -2.8% drop in GDP in 2009 followed by a +1.9% growth rate in 2010.



In terms of lending, banks have got a tight grip on cash, lending it out in a trickle to each other as well as to businesses and consumers because **uncertainty surrounding the future of the U.S. economy has greatly increased the need for so-called “rainy day” funds.** The Fed even began paying interest on reserves to create the incentive for reserve holders to keep the money on deposit with the Fed rather than lend it out. Without the multiplier effect of bank lending, the money supply has not ballooned alongside the Fed’s balance sheet, which itself has doubled over the past year. If you add in further commitments of the Fed to purchase securities via the Term Asset-Backed Securities Loan Facility (TALF) then the balance sheet could reach upwards of \$4 trillion before all is said and done.



The sheer size of **the un-borrowed reserves of the Fed’s balance sheet poses a great inflation risk should money velocity begin to return.** All banks have to do is draw on those reserve balances as soon as they are willing to start making loans again. This means **the money supply has the potential to blow up practically overnight.** Even Atlanta Fed President Dennis Lockhart recently stated<sup>2</sup>, “...there is reasonable concern related to the growth of the balance sheet of the central bank in response to economic difficulties that we are having, that this could in the long term fuel inflation.”

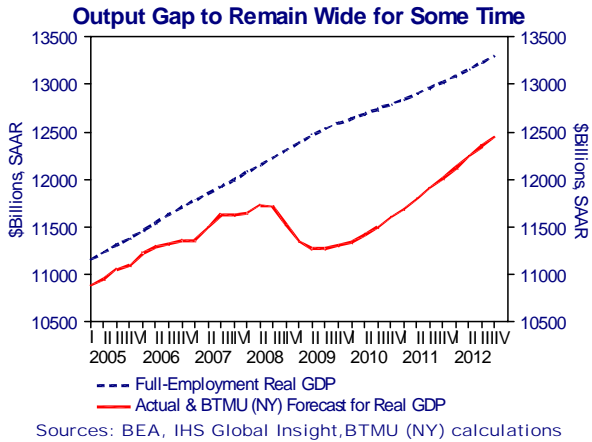
As we will discuss, however, there is no evidence of inflation as yet because the economy is just too weak to foster it.

#### Output Gap is Enormous

Our factories today find themselves in a very difficult situation. Faced with the sudden and unexpected drop-off in demand both domestic and abroad toward the end of 2008, factories have been forced to cut back on production and spare capacity is more than abundant, to say the least. From a tight 81.6 percent in August 2006 to 69.3 percent in March 2009 (an all-time low for records dating back to 1967), **the ultra low capacity utilization rate implies an enormous output gap, which makes it extremely difficult for inflation to get a foothold.**

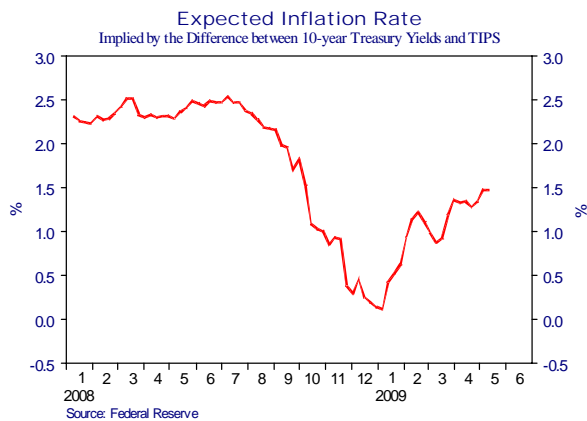
As shown in the next graph, based on full employment (aka optimal) real GDP estimates provided by IHS Global Insight and the BTMU (NY) forecast for real GDP, the U.S. economy will still be operating approximately 9 percent below its full potential by the end of 2012.

<sup>2</sup> Comments to the press when speaking in Paris on March 26, 2009.



### Real Risk Remains

Gap or no gap, however, what matters more is that inflation expectations remain in check. **Investors are showing signs of renewed concern over higher inflation.** The expected inflation rate as implied by the spread between the yield on 10-Year Treasury Notes and 10-Year Treasury Inflation-Protected Notes has been widening since the start of the year, perhaps in anticipation of a U.S. recovery.



To be sure, a stronger-than-expected recovery would pose a risk to the inflation outlook. And **higher inflation expectations may imply that investors are wary of how well the Fed can drain excess reserves from the economy before inflation takes hold.** Coming off the money accelerator for the Fed can be tricky.

For one, the lag time between changes in monetary policy and inflation can be substantial. This means that the Fed has to be ready to jump at the first hint of a pick-up in the economy – something that we are on the verge of even as we pen this report. But with all the new fangled auction facilities and purchases of assets, **getting out in a timely and non-disruptive fashion may prove to be difficult.** Unwinding its balance sheet before credit markets have fully recovered could cause the cost of credit to skyrocket and lending to freeze up once again. Wait until too late, and hyperinflation could rear its ugly head and send the economy into recession again.

**Fed rhetoric of late has focused on the available tools for soaking up excess money** as it tries to instill investor confidence that it has a solid exit strategy and won't let inflation get the upper hand. There are three likely exit strategies the Fed could follow:

1. Pay a higher interest on reserves – this strategy, which was already employed last year, failed to keep the benchmark interest rate from falling below the Fed's target rate.
2. Drain reserves through reverse repos – this function takes cash out of the system by lending long-term securities to investors in exchange for cash.
3. Issue their own debt – the Fed has begun talking about selling Treasury bonds or mortgage-backed securities in exchange for cash.

What's **most likely is that the Fed would employ to some extent all three of these options**, but for the Fed to be successful in preempting a surge of inflation, they will have to begin when the labor market is still shedding jobs and the unemployment rate is still rising. This ultimately makes for a tough battle with



Congress because **politicians may not fully understand that the labor market lags economic growth and will resist the Fed taking away the punch bowl as what they will see to be too early.**

#### Ever Mindful of Japan

Drawing from Japan's experience with its so-called "Lost Decade", fundamental factors that support the banking system had not been repaired before the government's fiscal measures were withdrawn. The Japanese government cut public expenditures and at the same time raised taxes and subsequently Japan's economy contracted severely in 1998. **Policymakers may turn to Japan's experience to bolster their argument if they think the Fed's withdrawal fiscal stimulus is too early.**

#### Fading Stimulus-Induced Recession

With a U.S. recovery on shaky ground starting this summer, the end of various government stimuli could at the very least cause the economy to go through various fits and starts. At the very worst, it could throw the economy into recession again. **The most likely path to a double-dip under this scenario could well be via housing and household income.**

#### A Helping Hand for Housing

The housing market, which has been the bane of this country's existence over the past 13 quarters, has finally begun to show signs of stabilization. Two factors involved in finding that stability have been brought about by government intervention: historically low mortgage rates and an \$8,000 first-time home buyer tax credit.

In an effort to drive mortgage rates down, thus spurring refinance activity and helping to move

millions of homeowners from a variable to a fixed-rate mortgage, the Fed has been purchasing long-term bonds. In March, the Fed announced its intention to purchase up to \$300 billion in long-term bonds, aiming to end the program some time in September. Further, in its stimulus plan passed earlier this year the government expanded the first-time home buyer tax credit to \$8,000 (unlike prior tax credits it does not have to be paid back). The tax credit is available to qualified home buyers through the end of November. According to preliminary numbers from the IRS, approximately 1.4 million taxpayers are believed to have claimed the credit thus far.

Both of these programs are slated to end before the end of the year, when unemployment, and therefore foreclosures, is still rising. Our concern is would housing activity take a leg down at that time after finally having found a bottom earlier this year and enjoying sales gains throughout the summer? **Home-related spending is a big driver of the U.S. economy and a sudden drop off in this category would no doubt cause growing pains.**

#### Household Income Holding Up Through Transfers

The labor market creates about 63 percent of personal income through wage and salary disbursements and other labor (medical and non-medical) income. Another 15 percent of personal income comes from government transfer payments. While the labor market has shed more than 5.7 million jobs since the start of recession, leading to an annual decline in personal income of -0.3 percent in Q1 2009 compared to annual growth of +3.6 percent in Q1 2008, government transfers were up +12.1 percent annually in Q1 2009.

The increase in transfers thus far has come primarily from an increase in unemployment



insurance, tax refunds, which the IRS has reported are 30 percent higher than last year, and cost-of-living adjustments for Social Security payouts. In Q1 2009, wages and salaries fell by -\$73.6 billion while government transfers increased by +\$94.0 billion. **No wonder spending stabilized and posted its first gain after falling by more than -4.0 percent over the second half of 2008.**

Starting in April, more help from this year's stimulus package kicked in with the 2-year Making Work Pay tax credit creating higher take-home pay via changes in the calculation of the social security tax withholding formula. Then this month, a [one-time \\$250 check](#) is being sent to 52 million individuals collecting social security.

All of this adds up to **an incredible boost to household income at a time when wages are under severe pressure from an ever-increasing unemployment rate** (8.9% in April and rising). Yet while some of the government transfers will remain in place throughout 2009 and much of 2010, the one-time social security payout of \$250 will have faded by the third quarter, to the tune of \$13 billion. In addition, no further cost of living adjustments are

expected for social security until 2012. Will the payback period when government transfer payments fizzle out come at a time when the labor market and household income are on the rebound? If so, then a government withdrawal may not be so messy, but **fading stimulus is a legitimate concern given the fact that the U.S. labor market isn't expected to begin adding jobs until late this year.**

#### May History Not Repeat Itself

It's typical that economists would begin talking about double-dip recession scenarios when a U.S. recovery has yet to be announced. After all, we practice the dismal science so **if we are going to provide good news that the U.S. is on the cusp of recovery then we naturally have to follow up with reasons why the recovery may not take hold.** We see the double-dip debate, with inflation/deflation arguments deeply embedded, as being the predominant discussion among economists throughout this year, and possibly throughout 2010 if indeed a weak recovery plays out.

*(Ellen Beeson Zentner)*



Appendix I

U.S. Macro Forecast, May 2009\*

	2007		2008				2009				2010		2007	2008	2009	2010
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
<b>Components of Real GDP, Annualized Growth Rate</b>																
Gross Domestic Product	4.8	-0.2	0.9	2.8	-0.5	-6.3	-6.1	-1.8	0.8	1.6	1.9	2.9	2.0	1.1	-2.8	2.0
Gross Domestic Product (Nominal)	6.3	2.7	3.5	3.9	3.4	-5.8	-3.2	-2.5	1.0	2.3	2.9	4.1	4.8	3.3	-1.5	2.8
Total Consumption	2.0	1.0	0.9	1.2	-3.8	-4.3	2.2	0.2	2.4	2.2	1.9	2.0	2.8	0.2	-0.2	2.1
Nonresidential Fixed Investment	8.7	3.4	2.4	2.5	-1.7	-21.7	-37.9	-15.2	-10.6	-3.6	3.0	9.5	4.9	1.6	-19.2	1.1
Residential Fixed Investment	-20.6	-27.0	-25.0	-13.3	-16.1	-22.7	-38.0	-28.0	-16.7	7.6	14.7	17.4	-17.9	-20.8	-24.4	7.3
Nonfarm Inv. Change (\$B 2000)	19.2	-20.6	-17.9	-55.1	-33.3	-31.1	-111.7	-133.8	-92.6	-59.4	-49.3	-31.7	-3.7	-34.3	-96.4	-17.6
Exports	23.0	4.4	5.1	12.3	3.0	-23.6	-30.0	-7.2	-7.7	-1.7	3.0	4.0	8.4	6.2	-14.3	0.7
Imports	3.0	-2.3	-0.8	-7.3	-3.5	-17.5	-34.1	-8.9	0.8	5.5	6.3	5.9	2.2	-3.5	-15.0	4.6
Federal Government	7.2	-0.5	5.8	6.6	13.8	6.9	-4.0	7.0	4.5	2.0	1.6	-1.6	1.6	6.0	4.3	1.0
State & Local Government	1.9	1.6	-0.3	2.5	1.4	-2.0	-3.9	-2.0	-1.0	-1.0	-0.4	0.5	2.3	1.1	-1.6	-0.4
<b>Other Economic Measures</b>																
(% Change, SAAR)																
**Core PCE Price Index	2.1	2.5	2.3	2.2	2.4	0.9	1.5	1.5	0.5	0.5	1.0	1.4	2.2	2.2	1.0	1.1
Industrial Production	2.1	0.9	0.2	-4.6	-9.0	-12.9	-19.2	-5.4	-2.4	0.5	2.7	3.4	1.5	-2.2	-10.2	1.4
Unemployment Rate (%)	4.7	4.8	4.9	5.4	6.1	6.9	8.1	9.1	9.4	9.8	9.9	9.8	4.6	5.8	9.1	9.7
Housing Starts (Mil. units SAAR)	1.298	1.151	1.053	1.025	0.876	0.660	0.523	0.520	0.525	0.600	0.690	0.770	1.341	0.903	0.542	0.833
Oil Prices, West Texas Crude (\$/Bbl.)	75.2	90.9	97.8	124.0	118.3	58.0	42.7	55.0	55.0	57.0	58.0	58.0	72.2	99.7	52.4	58.3

\*Updated May 13, 2009

\*\*Annual figures for Core PCE Price Index are presented as Q4/Q4

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May 2009

Monday	Tuesday	Wednesday	Thursday	Friday
				1/ <b>ISM Manufacturing Survey</b> for April <b>Factory Orders</b> for March <b>Motor Vehicle Sales</b> for April <b>University of Michigan Consumer Sentiment</b> for April, Final
4/ <b>Construction Spending</b> for March  <b>Pending Home Sales</b> for March	5/ <b>ISM Non-Manufacturing Survey</b> for April  <b>ISM Semiannual Outlook</b>	6/ <b>ADP National Employment Report</b> for April  <b>Job-Cut Announcements</b> for April	7/ <b>Chain Store Sales</b> for April  <b>Consumer Credit</b> for March  <b>Productivity</b> for Q1, Preliminary	8/ <b>Employment Report</b> for April  <b>Wholesale Trade</b> for March
11/	12/ <b>International Trade</b> for March  <b>Federal Budget</b> for April	13/ <b>Import/Export Prices</b> for April  <b>Retail Sales</b> for April  <b>Business Inventories</b> for March	14/ <b>Producer Price Index</b> for April	15/ <b>Industrial Production</b> for April <b>NY FRB Mfg. Survey</b> for May <b>Consumer Price Index</b> for April <b>Treasury International Capital Data</b> for March <b>University of Michigan Consumer Sentiment</b> for May, Preliminary <b>Philadelphia FRB Survey of Professional Forecasters</b>
18/ <b>Housing Market Index</b> for May	19/ <b>Housing Starts</b> for April	20/	21/ <b>Leading Indicator</b> for April  <b>Philadelphia FRB Survey</b> for May	22/
25/  <b>Memorial Day</b>	26/ <b>Richmond FRB Mfg. Survey</b> for May <b>Consumer Confidence</b> for May <b>S&amp;P/Case-Shiller Home Price Index</b> for March <b>Chicago FRB National Activity Index</b> for April	27/ <b>Existing Home Sales</b> for April	28/ <b>Kansas City FRB Mfg. Survey</b> for May <b>New Home Sales</b> for April <b>Chicago FRB Midwest Mfg. Index</b> for April <b>Durable Goods Orders</b> for April	29/ <b>Gross Domestic Product</b> for Q1, Preliminary <b>Corporate Profits</b> for Q1, Preliminary <b>Agricultural Prices</b> for Mid May <b>University of Michigan Consumer Sentiment</b> for May, Final <b>NAPM-Chicago</b> for May <b>NAPM-NY</b> for May