



U.S. Economic Update

Presented to:

Firefighters' National Credit Union Summit

October 4, 2010

San Antonio, TX

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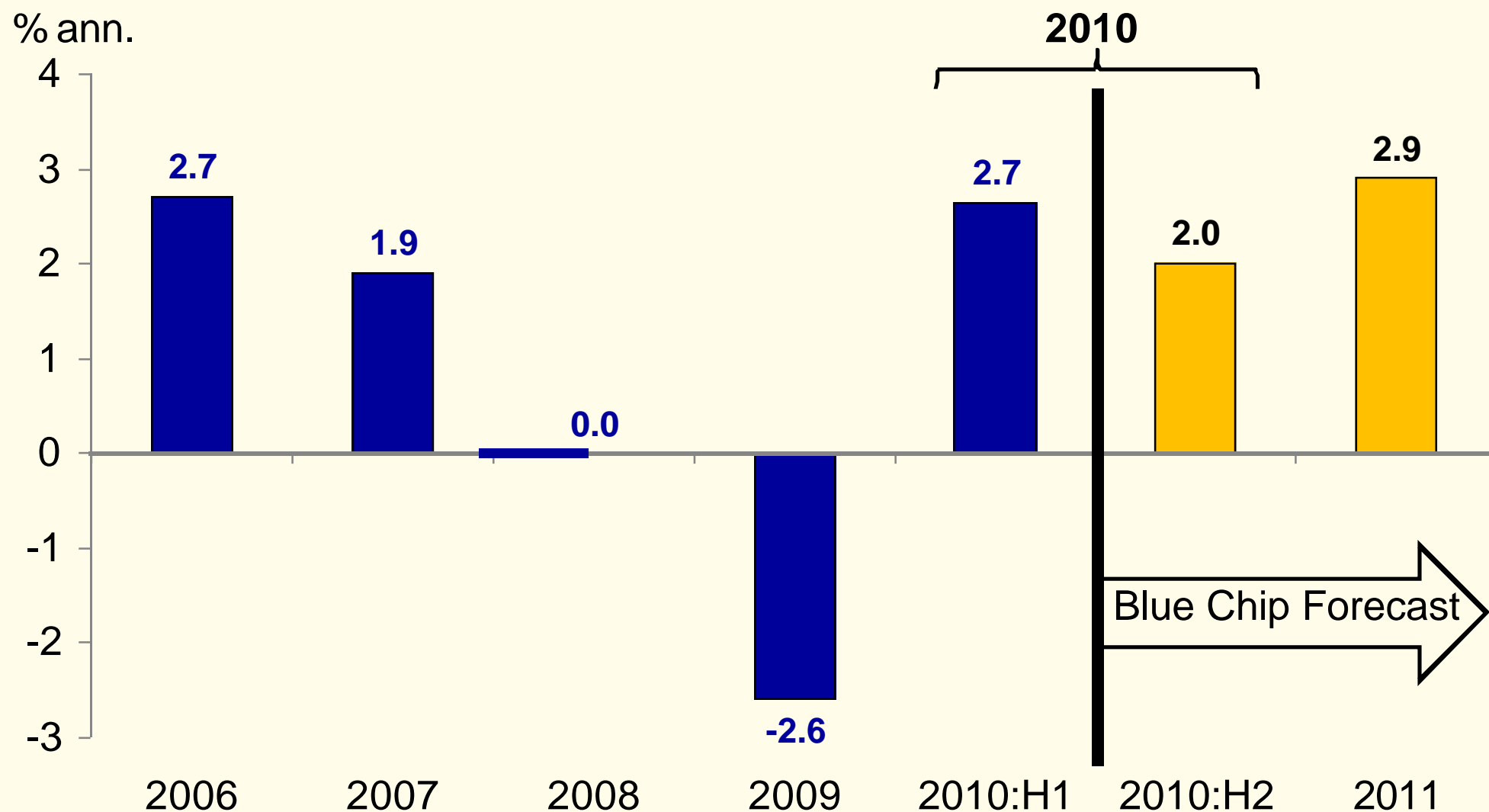
Federal Reserve Bank of Dallas



Summary

- Recession “officially” ended June 2009
- Recovery continuing but has slowed notably
 - Consumer confidence still low
 - Housing double-dip
- Recovery increasingly vulnerable to shocks
- Low inflation with declining inflation trend, rising deflation “tail-risk”
- Ample liquidity in capital markets
- Limited policy options

Sub-par U.S. Recovery



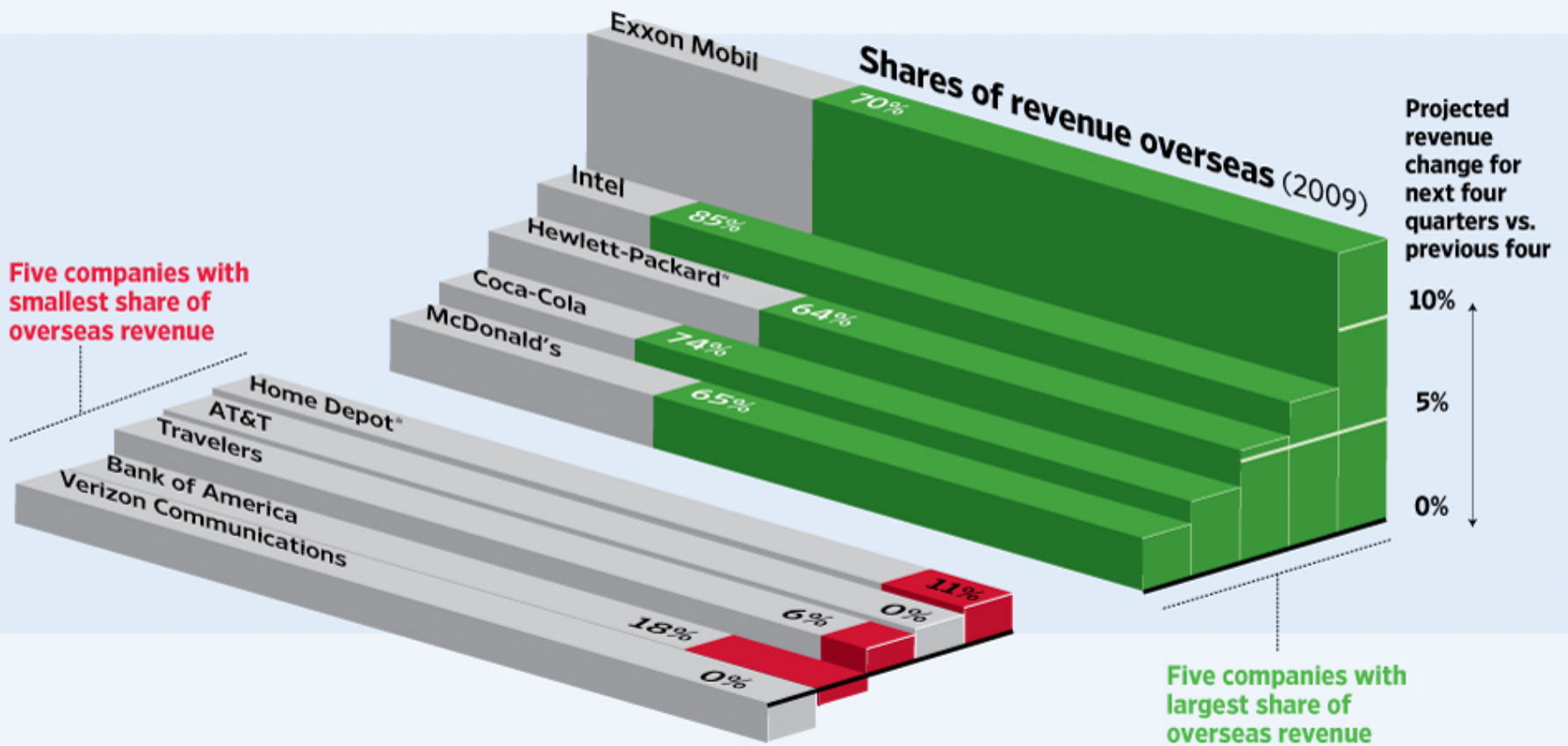
Source: Bureau of Economic Analysis, Blue Chip September 2010 survey

"Divided by a Two-Track Economy"

Wall Street Journal, 9/8/10

Divergence

An analysis of the 30 companies in the Dow Jones Industrial Average finds those with a large portion of revenue abroad are expected to fare better than those dependent on the U.S. economy.

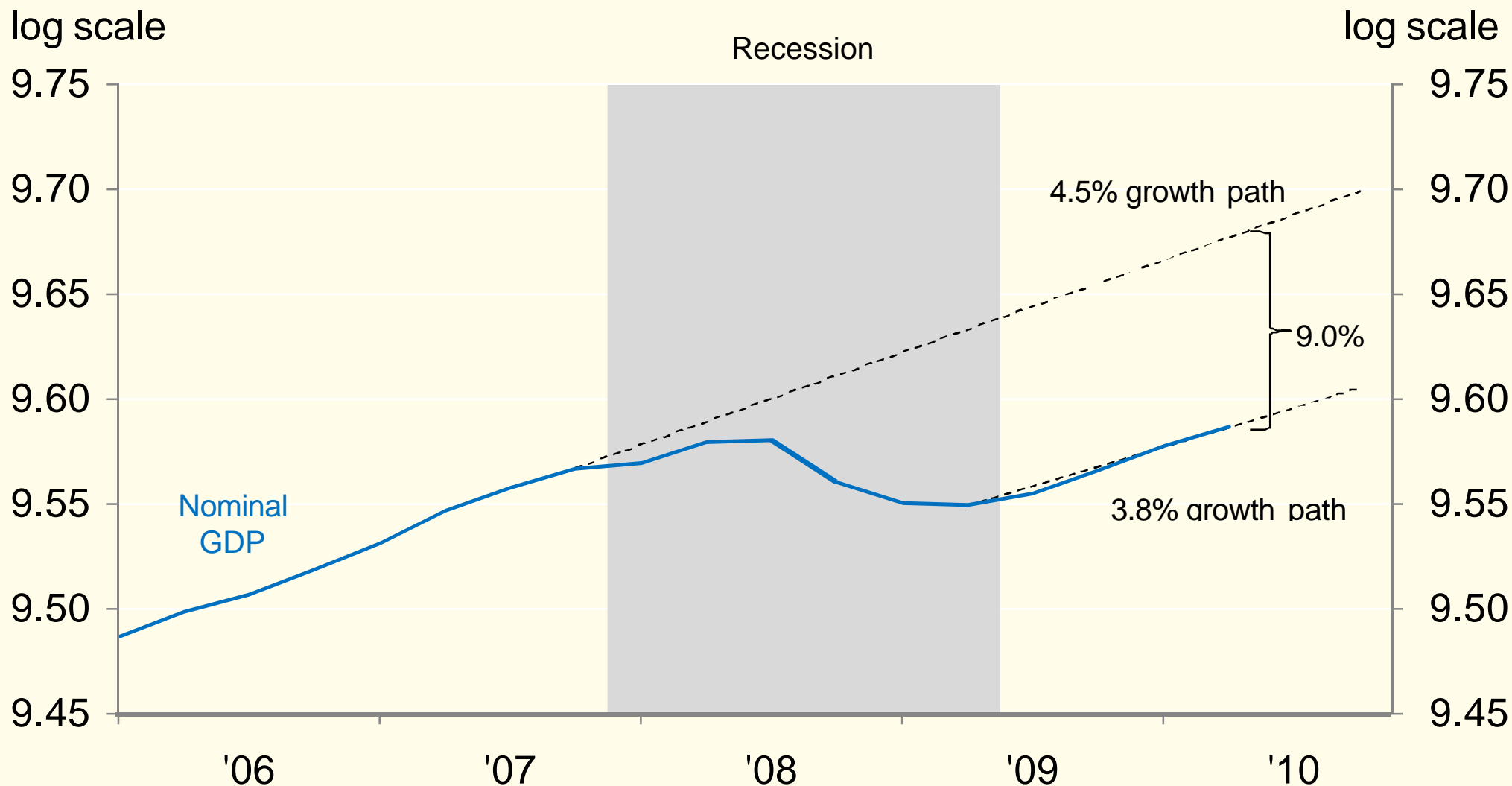


Sources: company filings, Revere data, Thomson Reuters

*Four quarters ended Jan. 31, 2010 Note: IBM has 64% of sales overseas but is not shown

Source: *Wall Street Journal, 9/8/10*

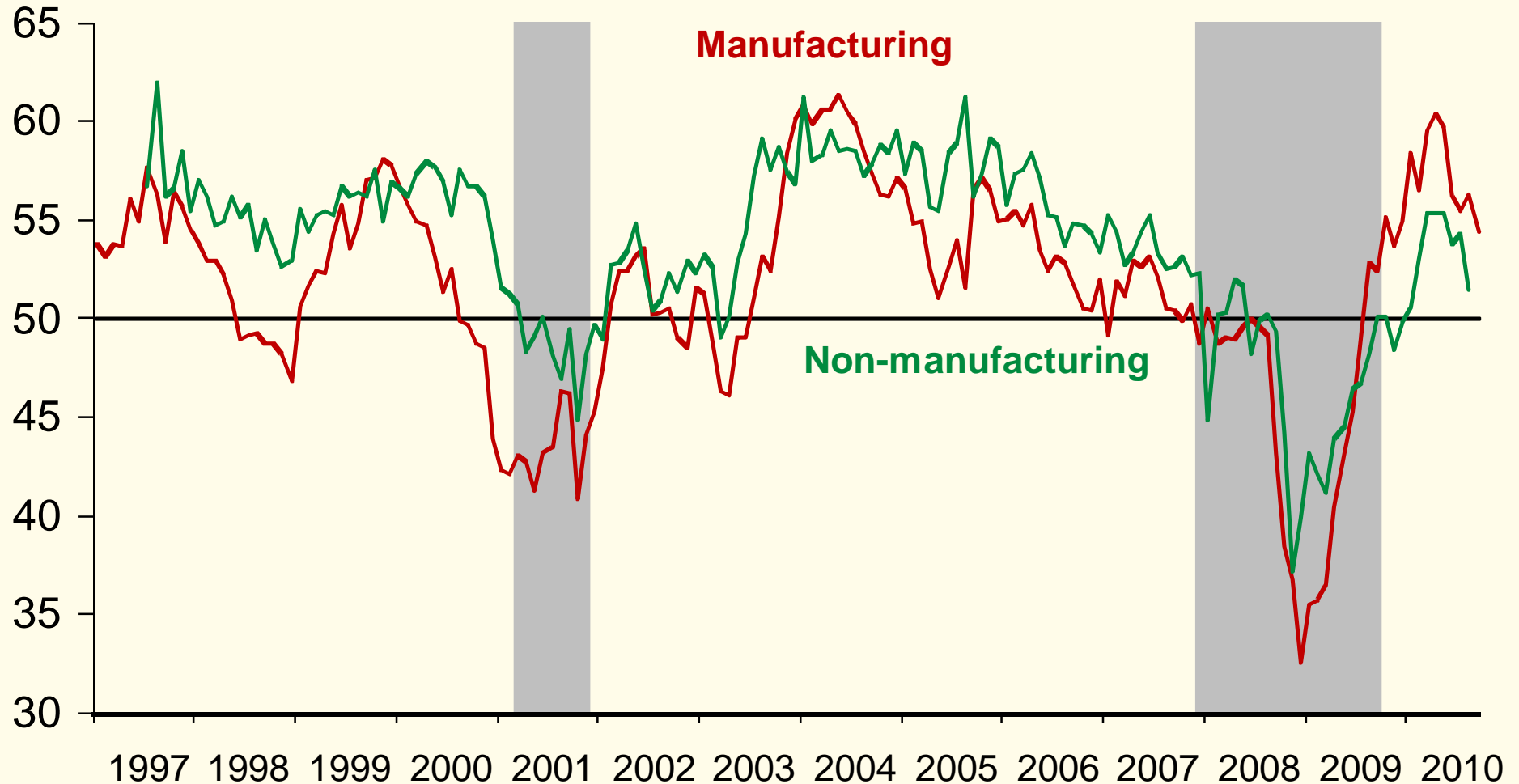
Nominal Sales Revenue and Income Streams Take a Substantial Hit



Source: Evan Koenig

Manufacturing Expanding; Services Growth Slowing

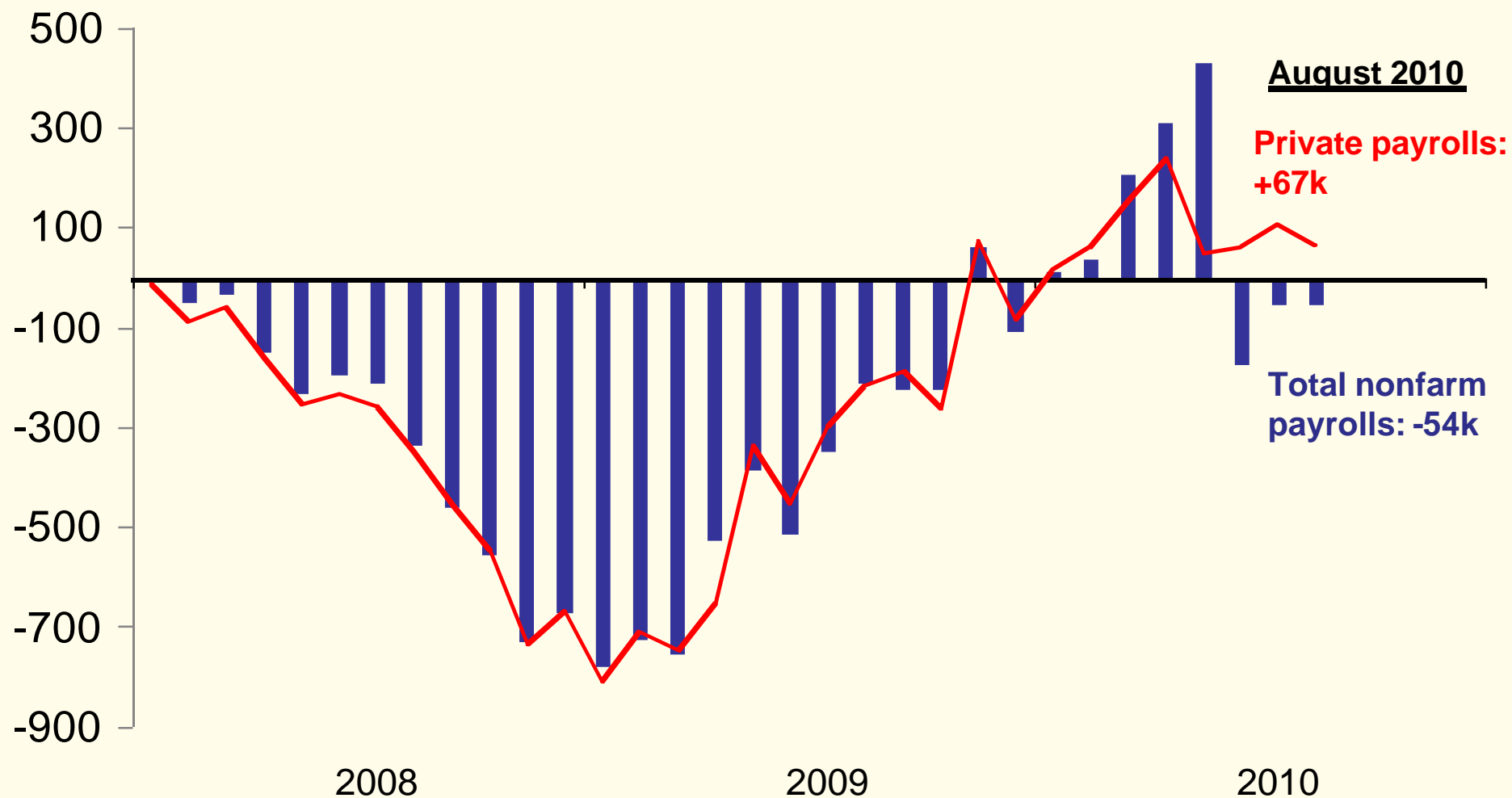
50+ = Expanding



Source: Institute for Supply Management

Private Payrolls Expanding Very Slowly

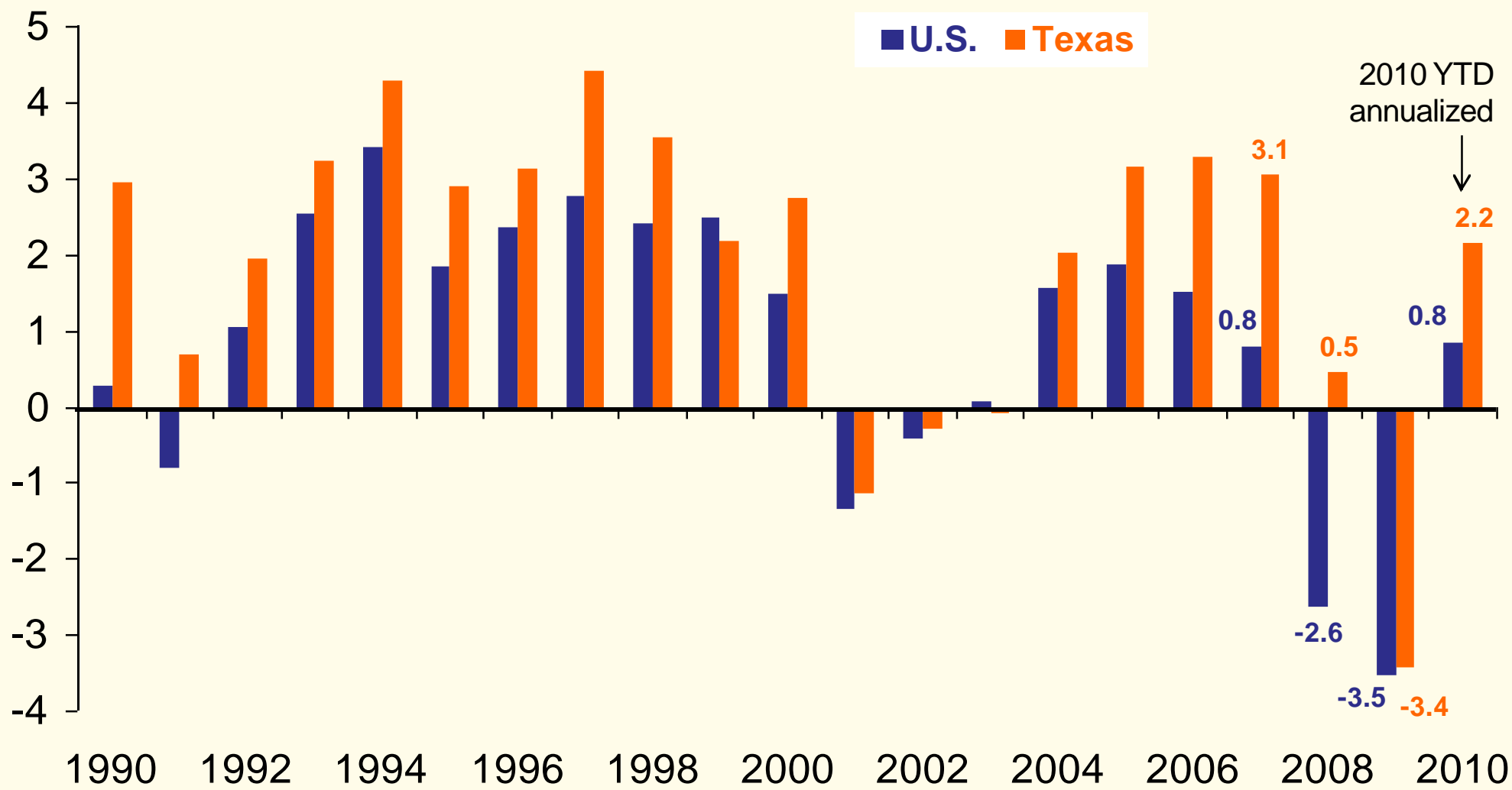
Thousands, SA



Source: Bureau of Labor Statistics

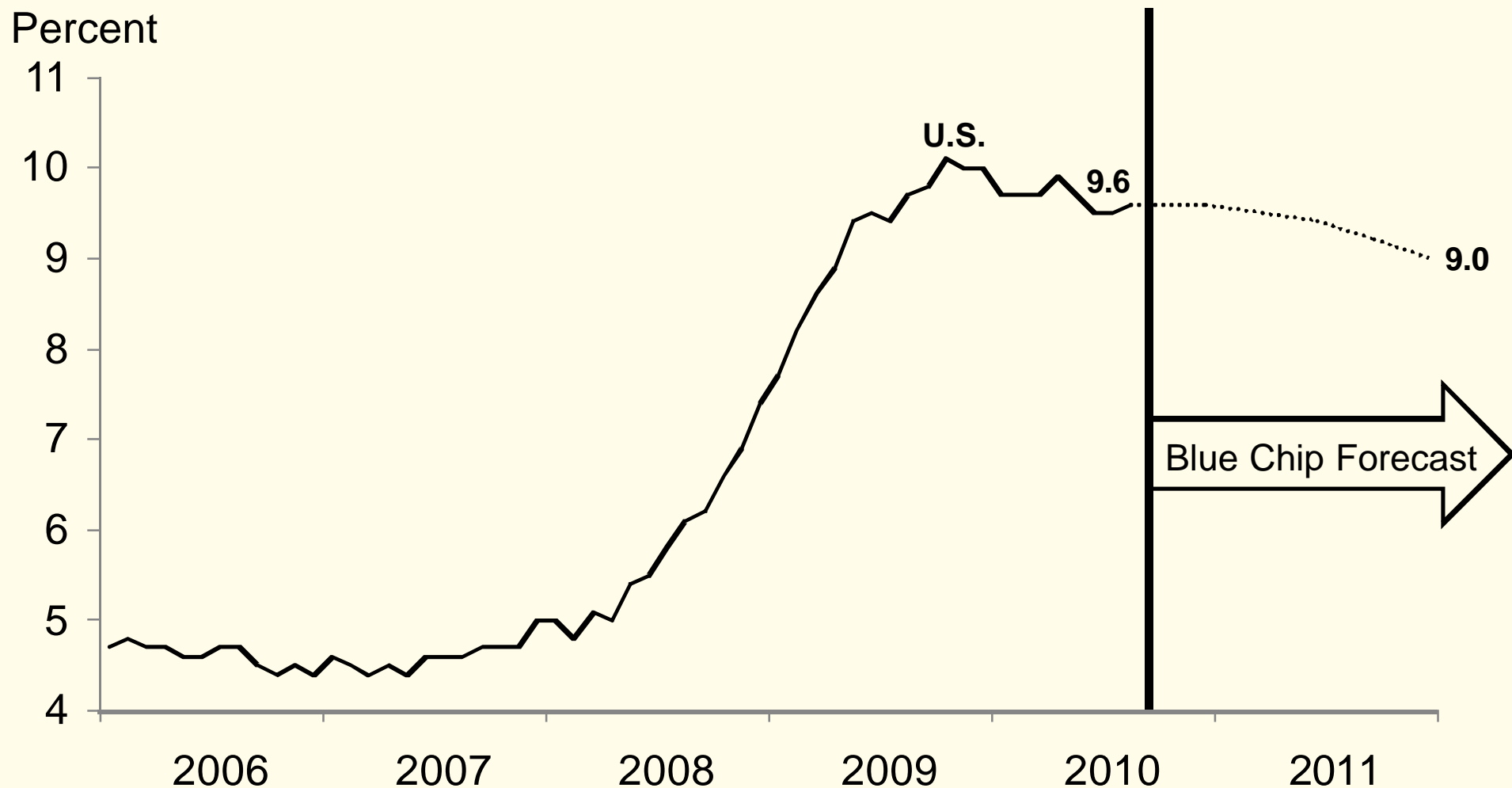
Nonfarm Employment in Texas Rebounds

Dec/Dec, % SAAR



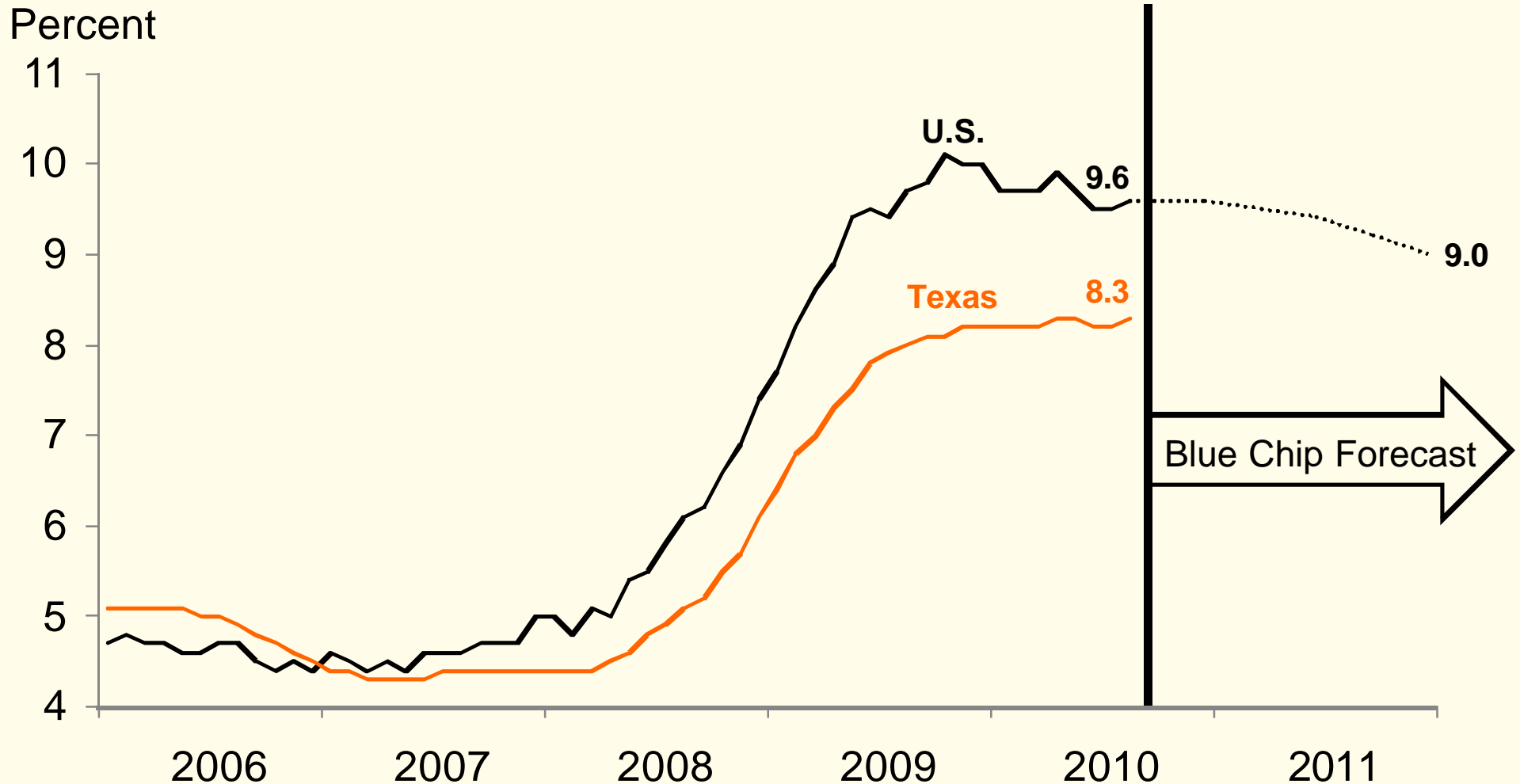
Source: Bureau of Labor Statistics, Texas Workforce Commission

Unemployment Rate Stays High



Source: Bureau of Labor Statistics, Blue Chip September 2010 survey

Unemployment Rate Stays High

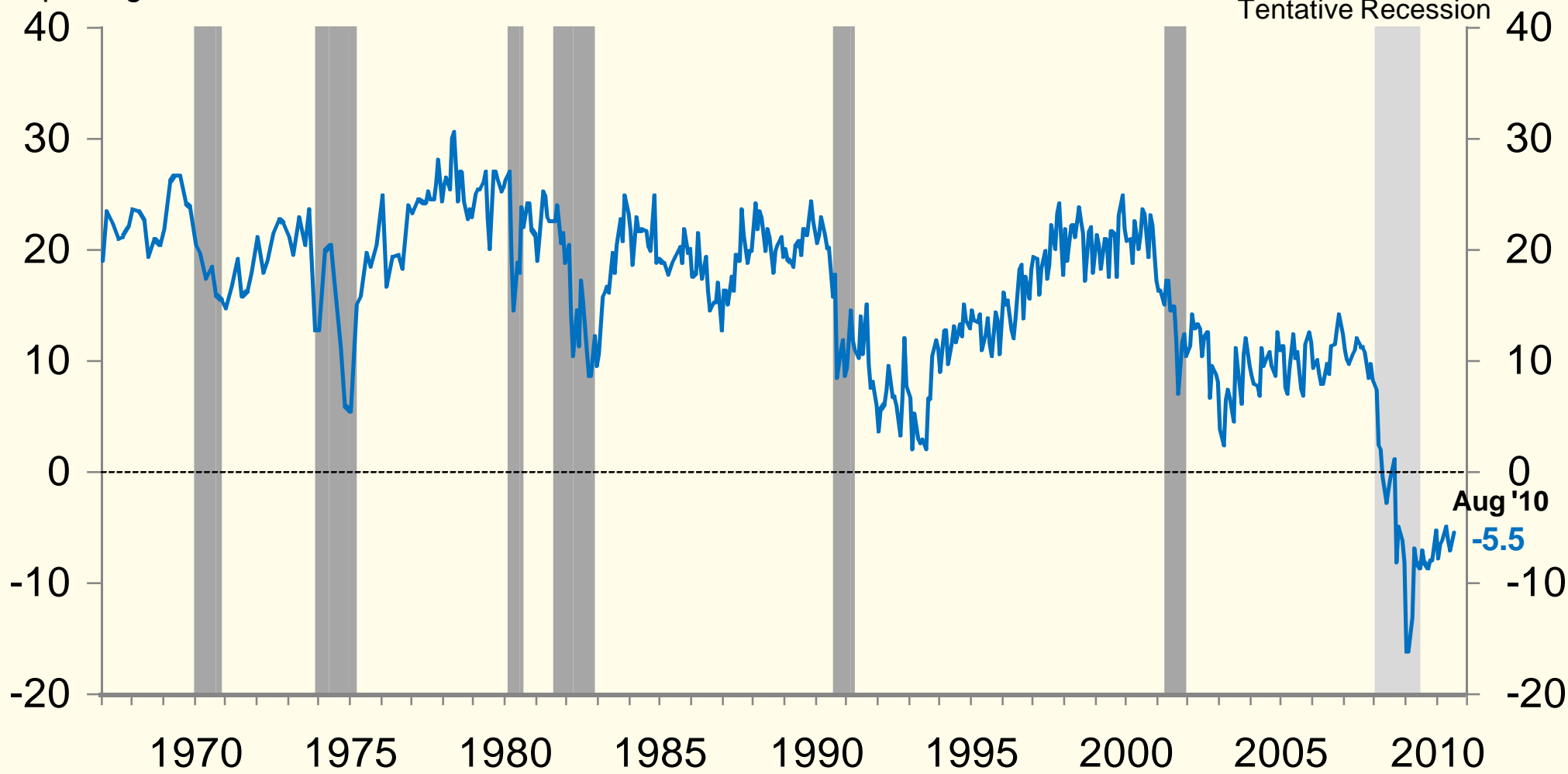


Source: Bureau of Labor Statistics, Blue Chip September 2010 survey

Uncertainty Contributes to Unprecedented Pessimism Regarding Income Growth

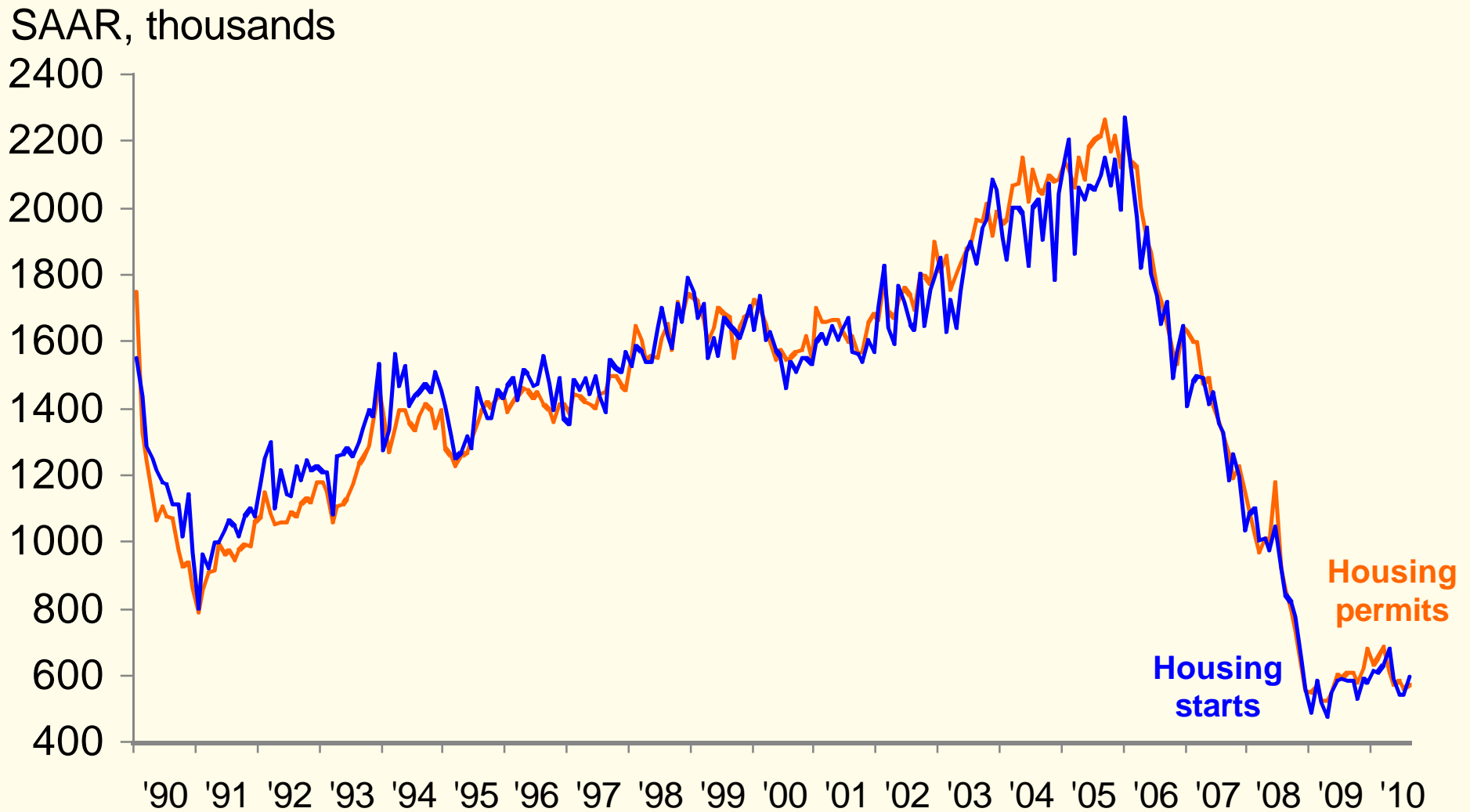
(Conference Board 6-month Income Expectations)

Net percentage
expecting increase



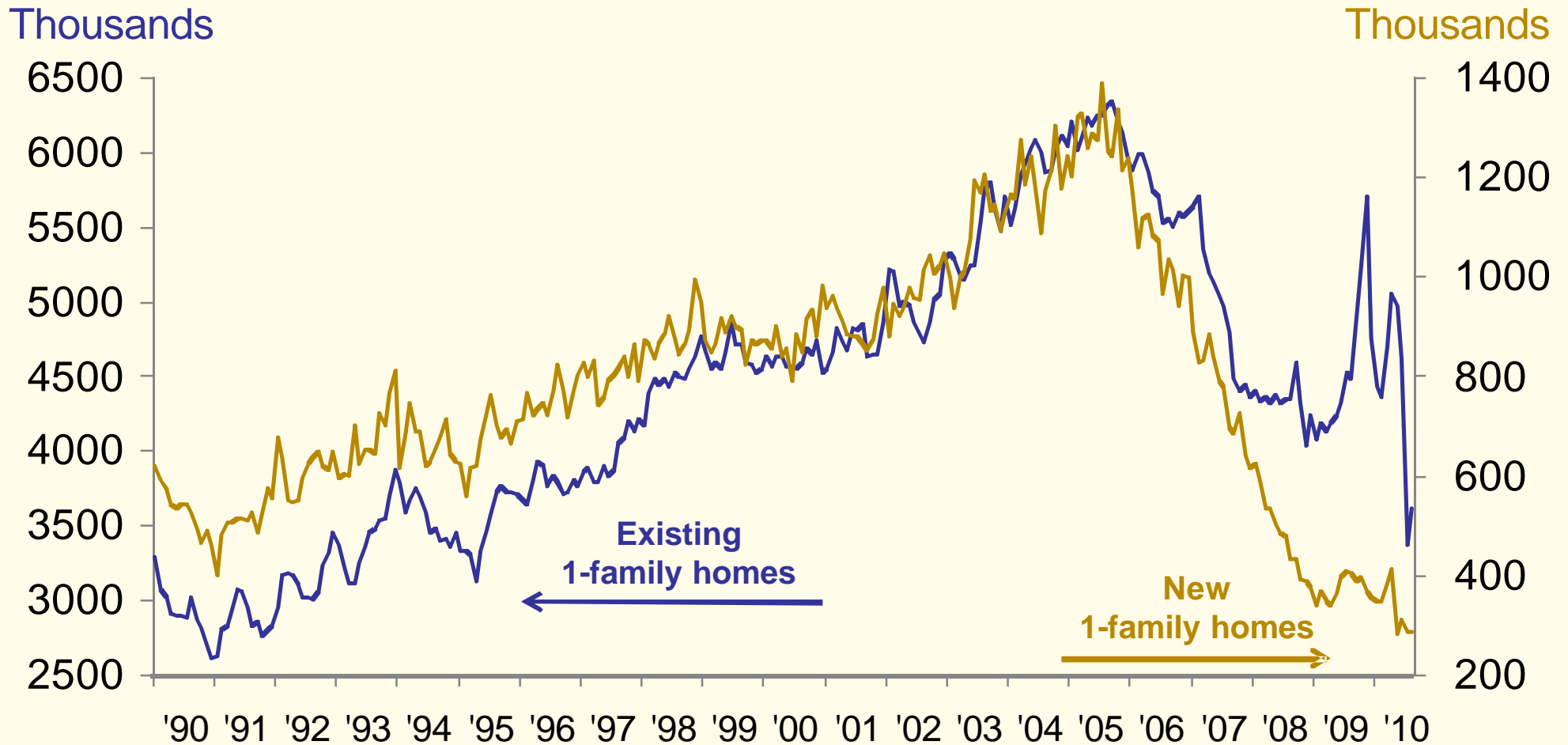
Source: Evan Koenig

Housing Permits & Starts Stagnant



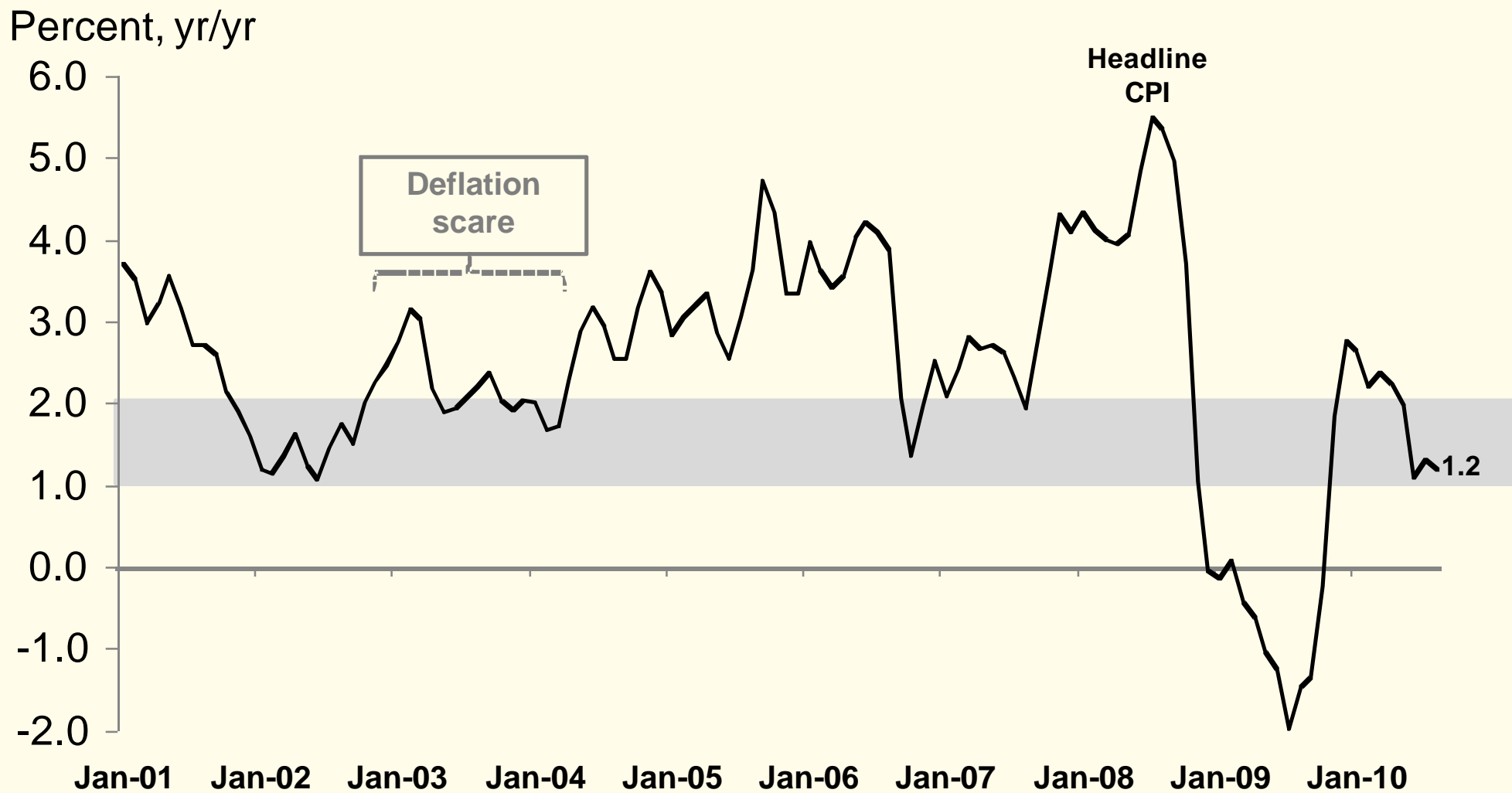
Source: Census Bureau

Home Sales Still Falling



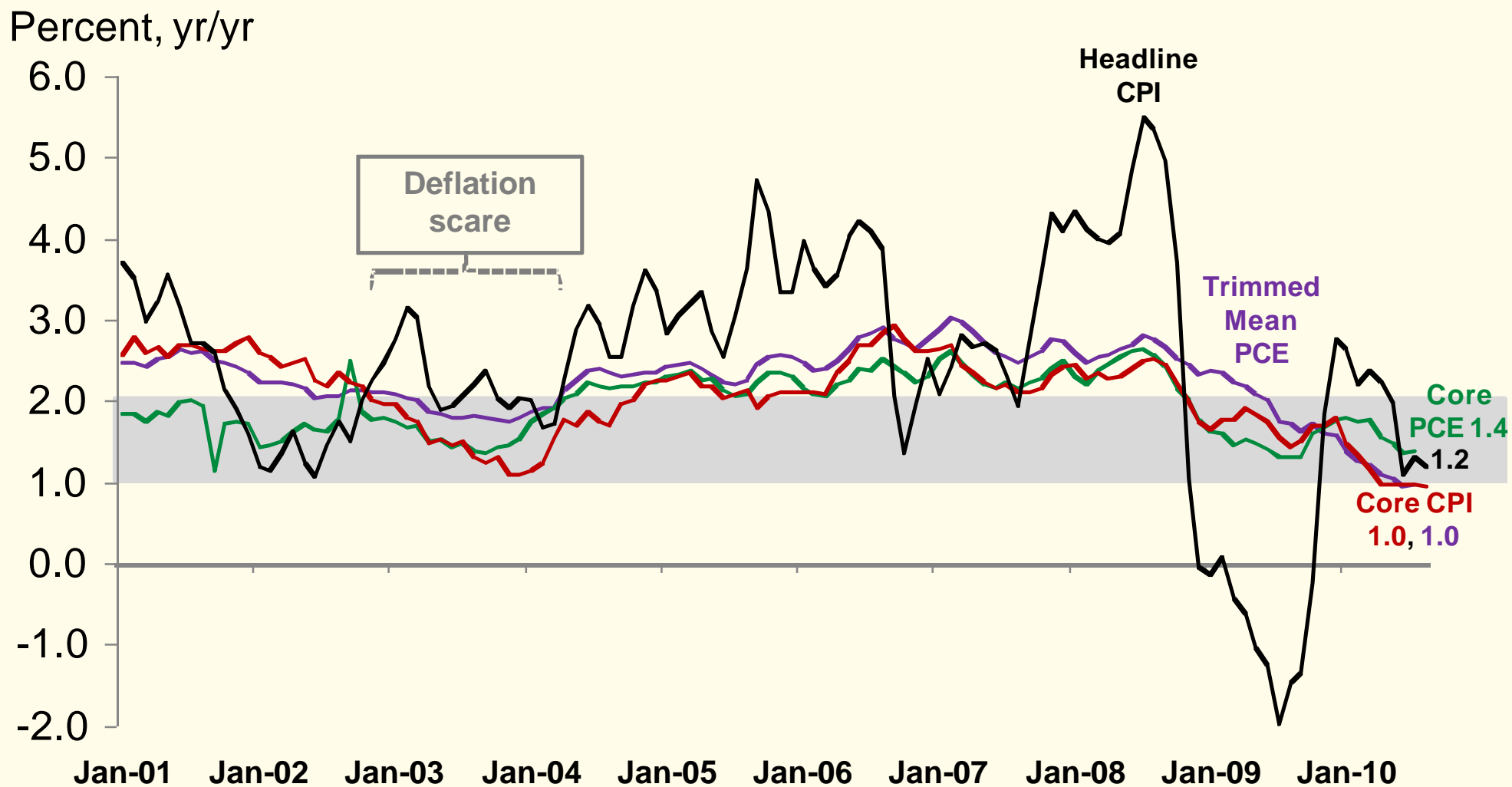
Source: Census Bureau, National Association of Realtors

Inflation Very Subdued



Source: Federal Reserve Board, Dallas Fed, BEA, BLS

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Source: Federal Reserve Board, Dallas Fed, BEA, BLS

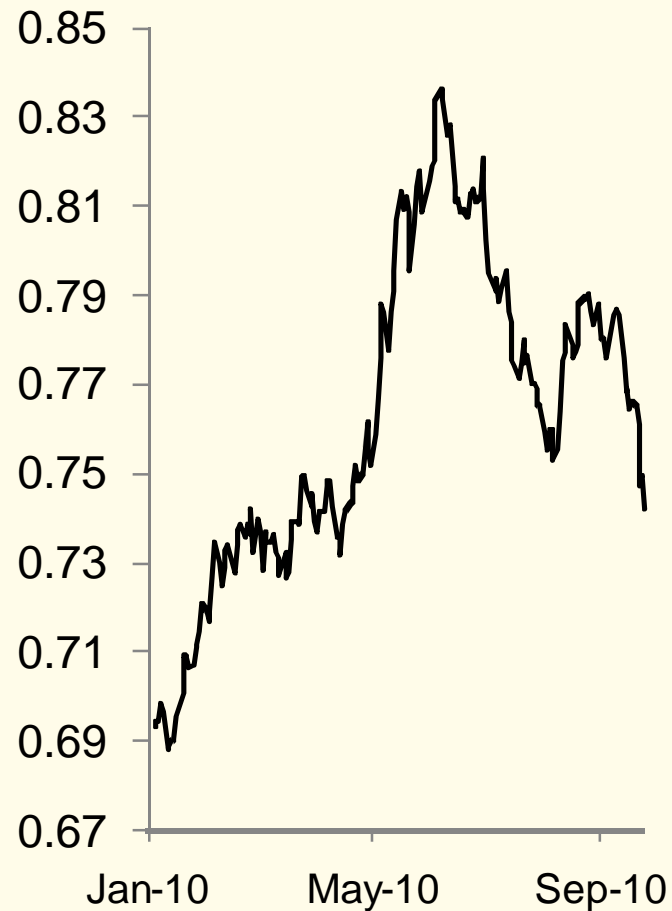
S&P/GS Commodity Price Index Unchanged for 10 Months



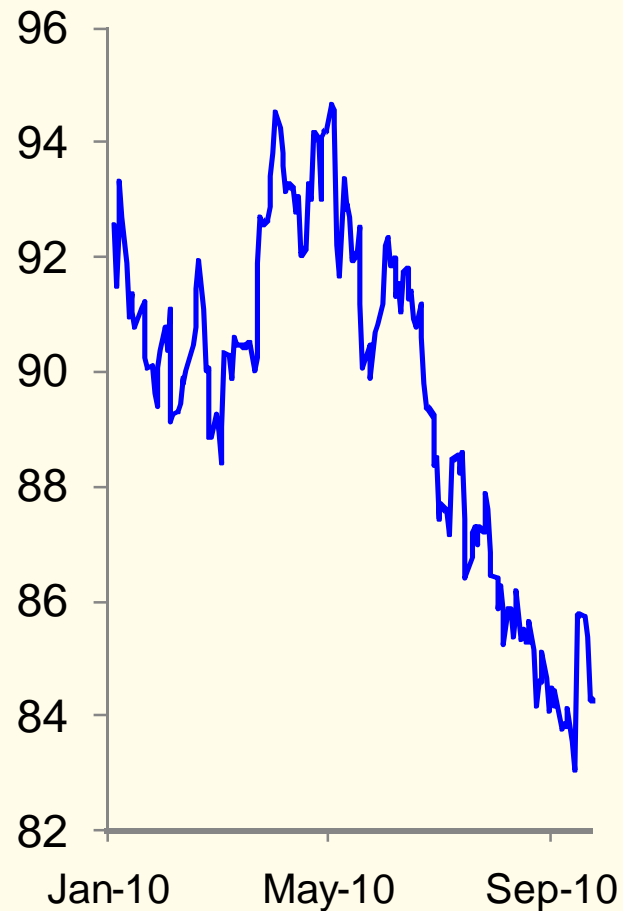
Source: Standard & Poor's, Goldman Sachs

Currency and Gold

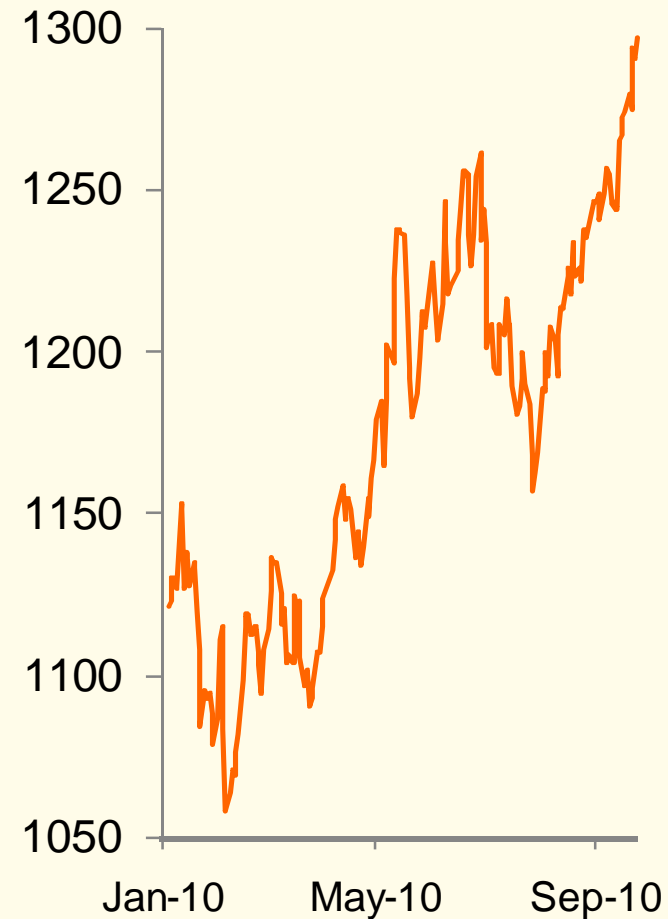
Euro/\$US



Yen/\$US



\$US/Troy oz. gold



Source: Federal Reserve Bank of New York, *Wall Street Journal*



Ample Liquidity in Capital Markets

Record Low Yields for Microsoft

3yr debt, \$1 Billion, 0.875% coupon

Only 25 bp above Treasuries

5yr debt, \$1.75 Billion, 40 bp above Treasuries

10yr debt, \$1 Billion, 55 bp above Treasuries

30yr debt, \$1 Billion, 83 bp above Treasuries

Source: *Wall Street Journal*, 09/23/10



Monetary Policy



Conventional vs. Unconventional

Conventional monetary policy

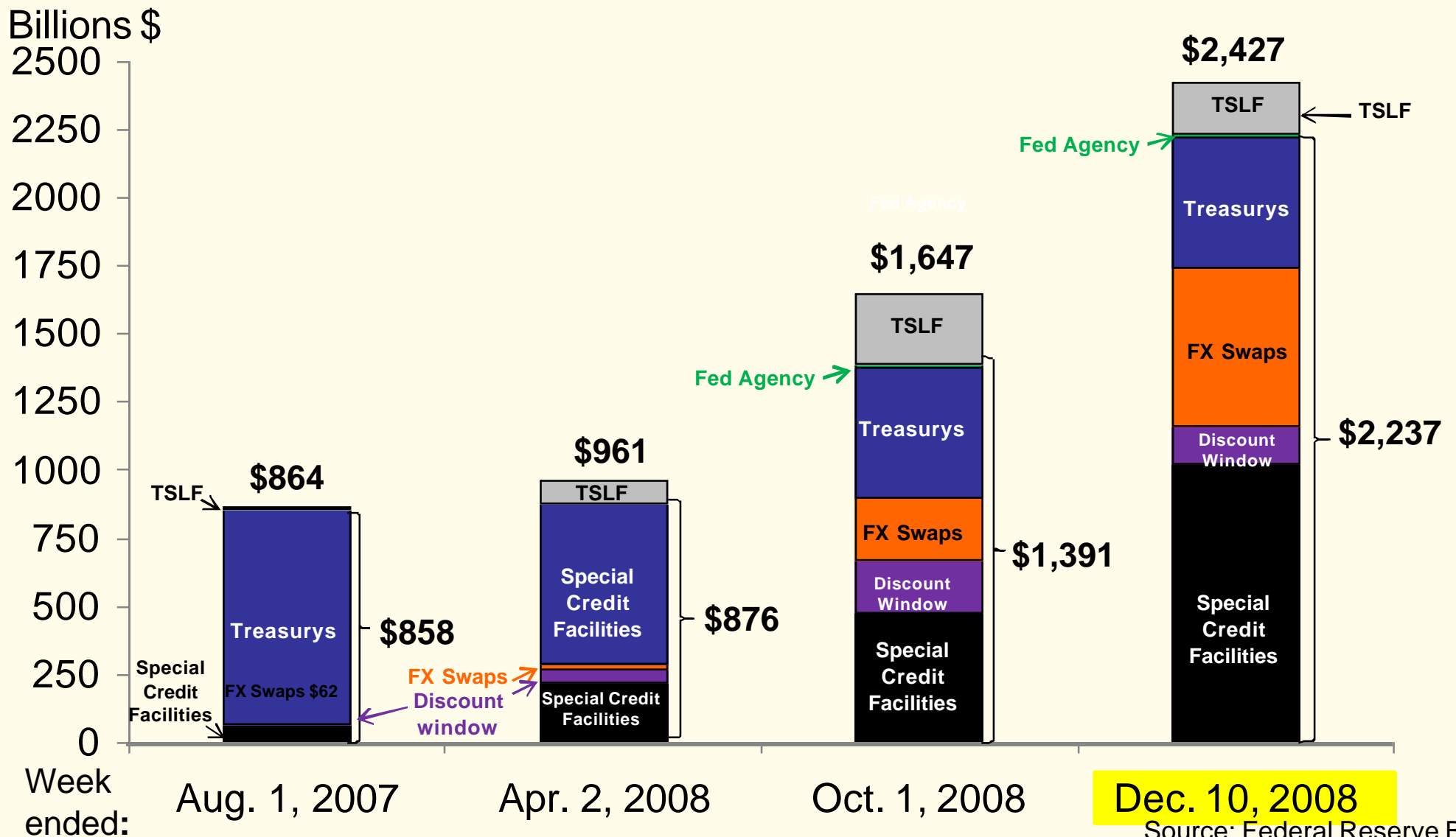
Lower Fed Funds Rate in response to:

- Fall in GDP growth
 - Falling inflation
 - Rise in unemployment rate
- } Standard Taylor Rule

Unconventional monetary policy

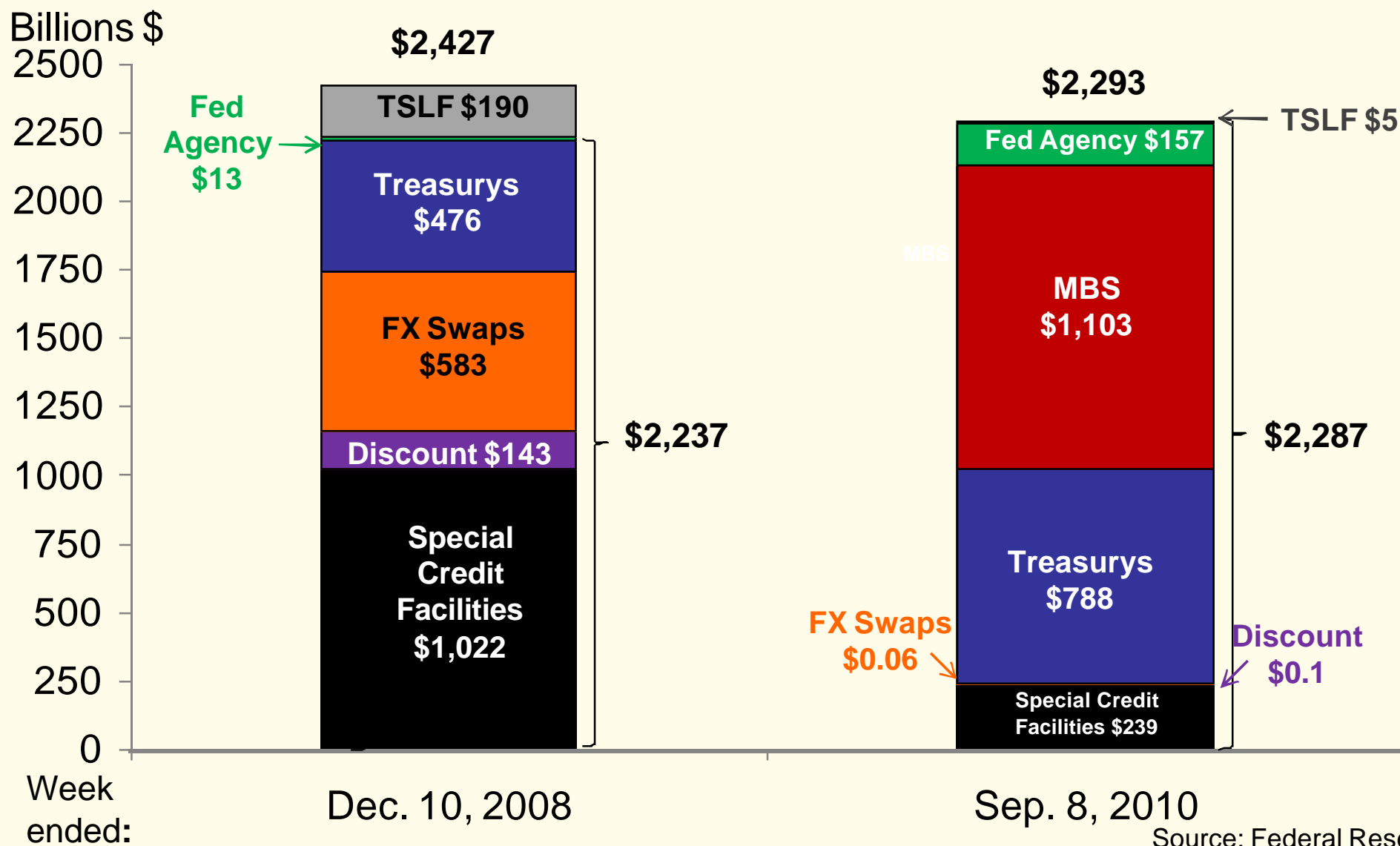
- Special direct lending programs aimed at unblocking credit channels in specific sectors
- Large Scale Asset Purchases (LSAPs)

Fed Balance Sheet Outstanding: Economy Still on Life Support



Source: Federal Reserve Board

Fed Balance Sheet Outstanding: Economy Still on Life Support



Source: Federal Reserve Board



Changing Lags and Impact of Monetary Policy

As monetary policy becomes less and less conventional:

- Longer lags
- More uncertain lags
- Reduced impact
 - Deleveraging
 - Increased government policy uncertainties
 - TBTF monopoly power
 - Bank capital shortfalls
 - “Post-Bubble Disorder”



FOMC Statement: Sept. 21, 2010

- Policy on hold
- Offsetting balance sheet shrinkage through additional asset purchases
- Quantitative NEUTRALITY,
not Quantitative Easing
- Prepared for more accommodation if needed to:
 - Support economic recovery
 - Return inflation toward level associated with price stability

Transmission of Quantitative Easing to the Economy

Lower Treasury Bond Rates

Lower corporate bond yields
Lower mortgage rates

Lower dollar

- Improved export sales and US GDP

Higher asset prices rebuild balance sheet net worth

- Higher equity prices
- Higher housing prices
- Higher prices of bond portfolios

Improved consumer and business confidence

- Reduced need to de-lever
- Banks more willing and able to lend



Interference Mechanisms and Drawbacks

- Risk premiums
- Gauging impact
 - How much to buy?
 - What to buy?
 - How long to provide results?
 - Intended vs. unintended results
- Exit strategy



There are usually only two models
(or states) of the economy.

A. Stability and growth

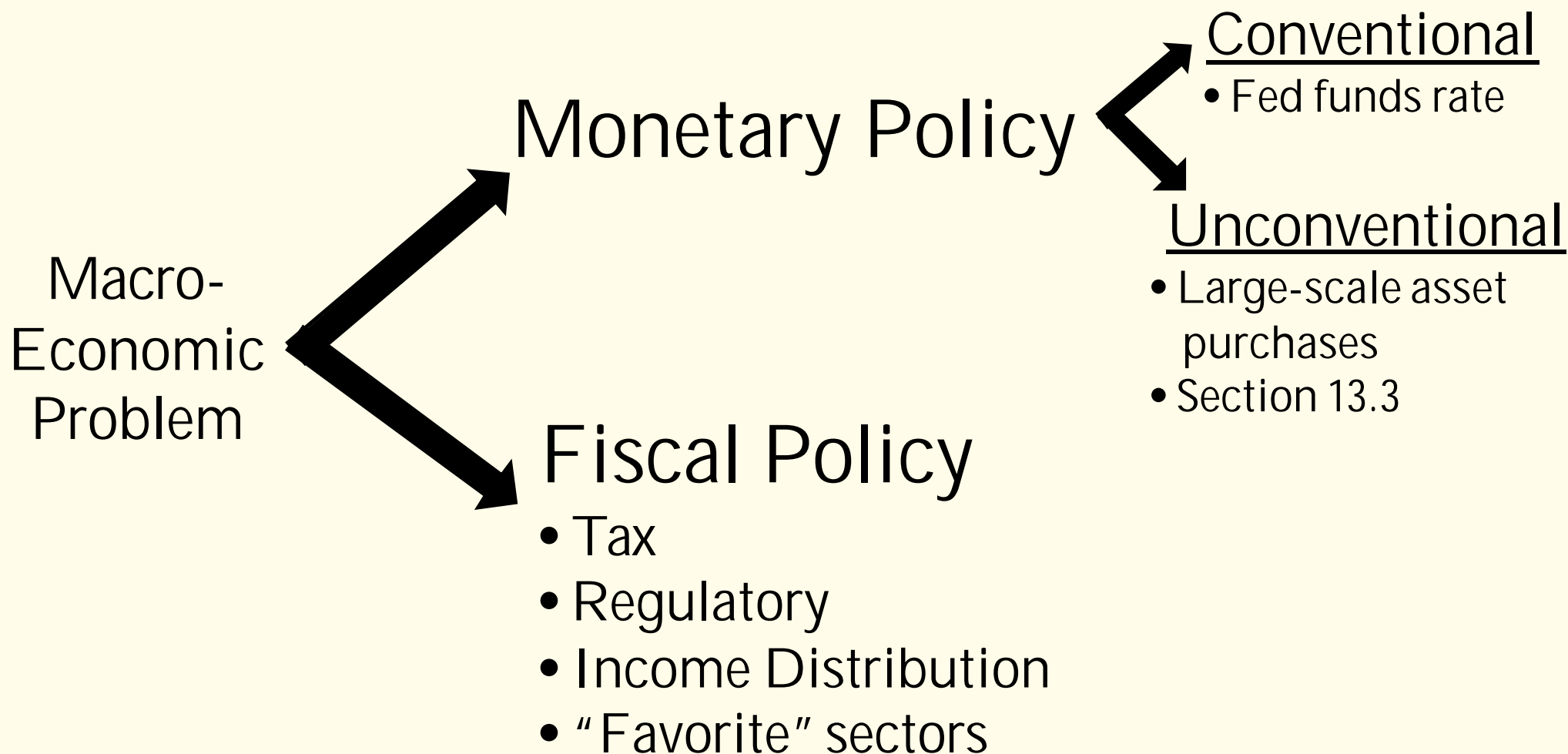
B. Instability, contraction and deleveraging

Recently, a third state may be emerging:

C. Stasis/stagnation --

A "Post-Bubble Disorder" characterized by
sluggish growth and deleveraging

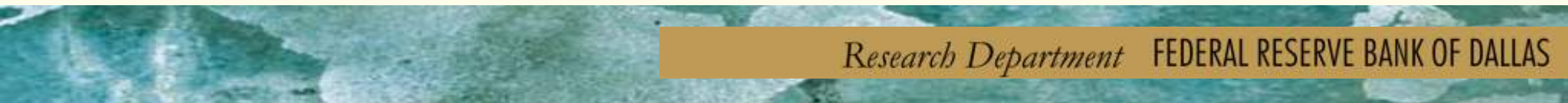
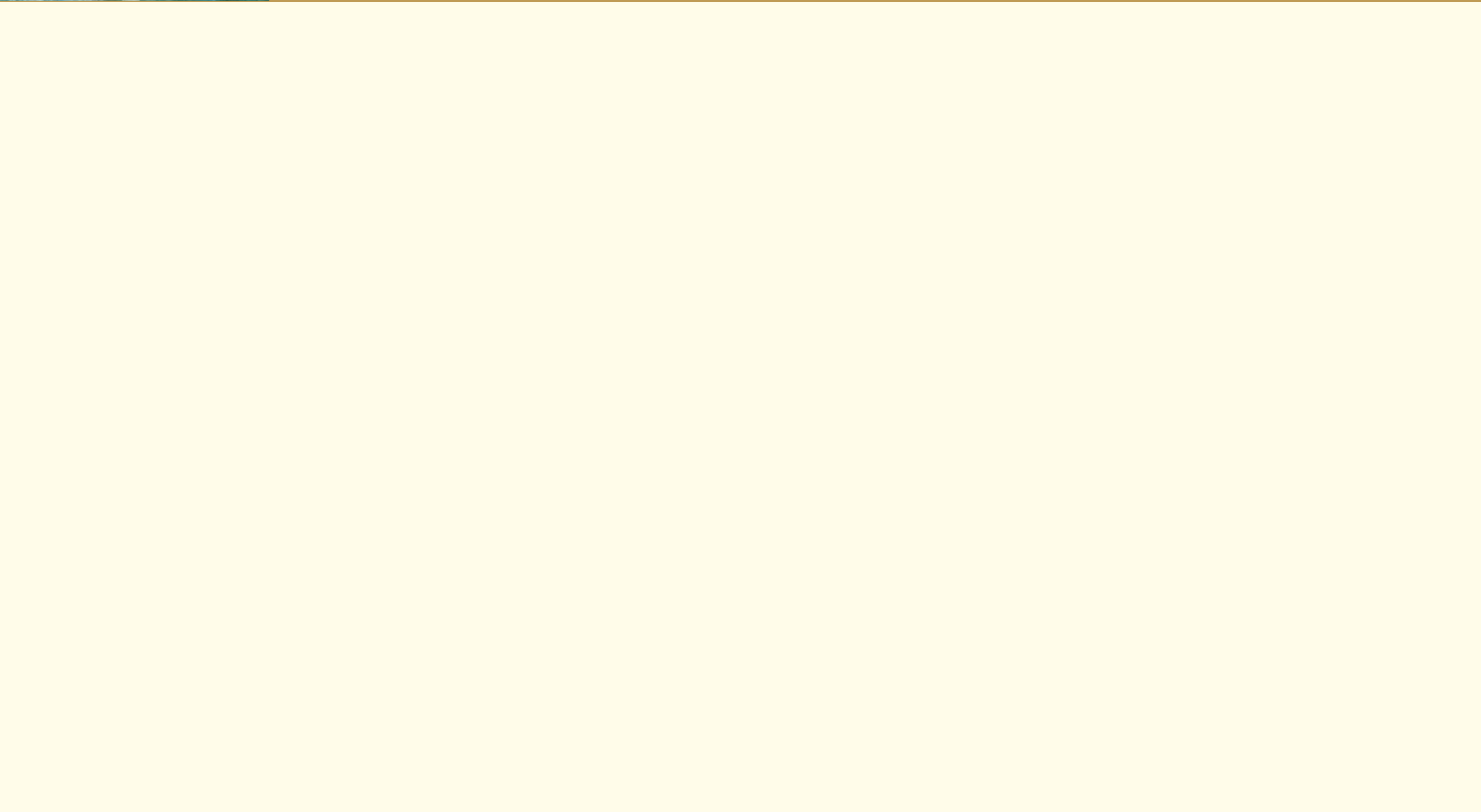
Policymakers' Dilemma

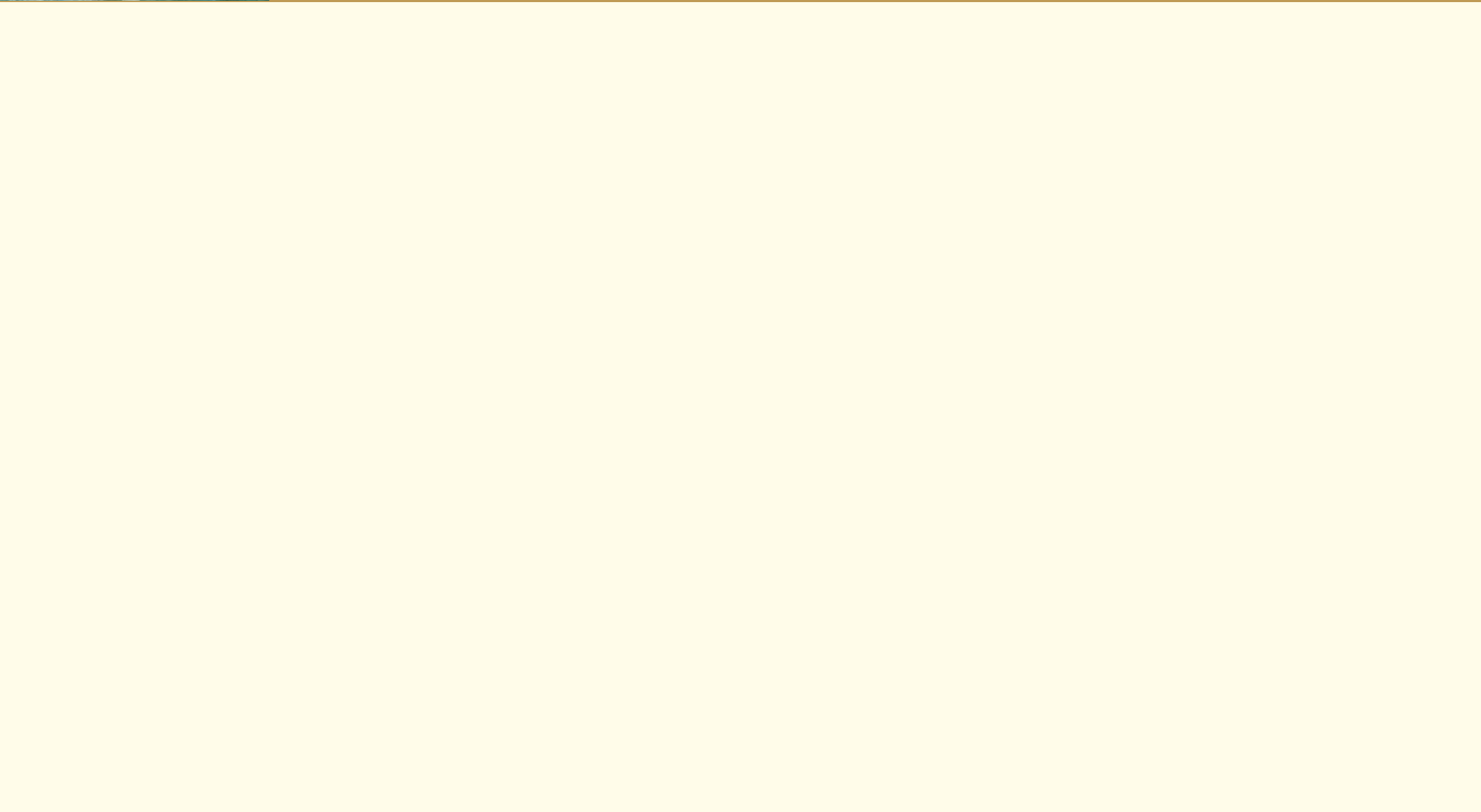




Conclusion

- Recession “officially” ended June 2009
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EXTRA STUFF



Hail Mary Options: Pick the Least-Bad

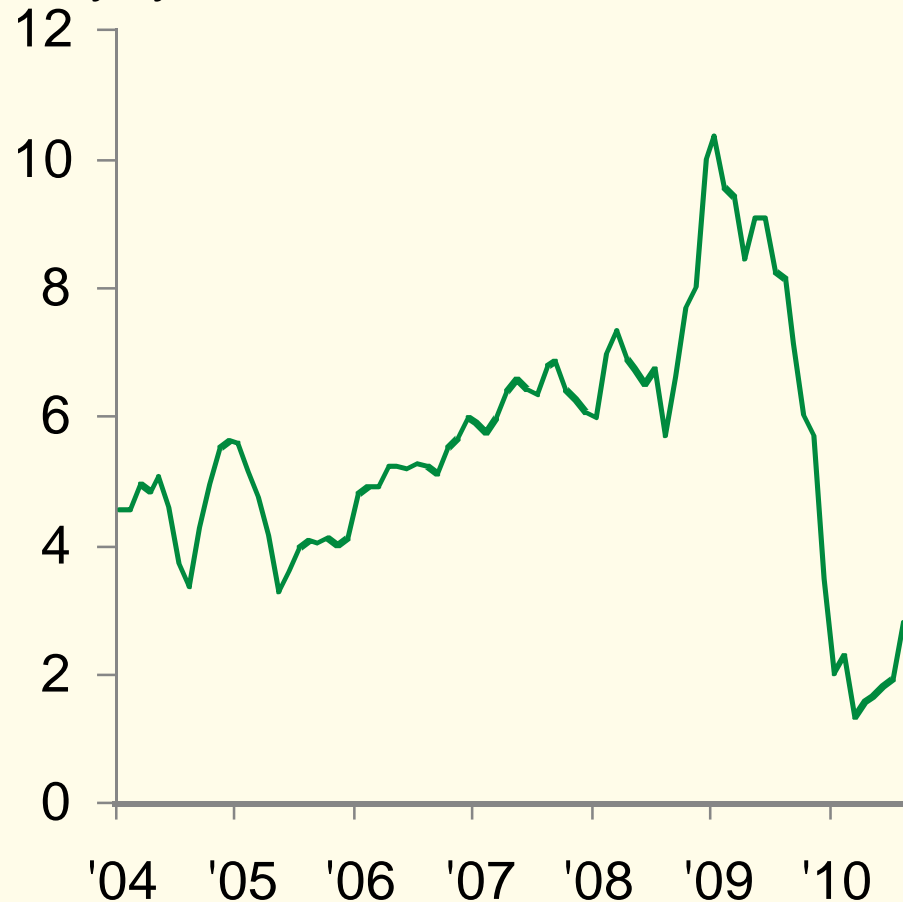
- Infrastructure spending
- Tax cuts; Payroll tax holiday on first \$20k
- Long-term investment program funded through Build America and municipal bonds, and a national infrastructure bank
- Reduce Interest on Reserves and Excess Reserves
- More Quantitative Easing
- **DO NOTHING**, or close to nothing

The Empirical Record

Money Supply and Demand

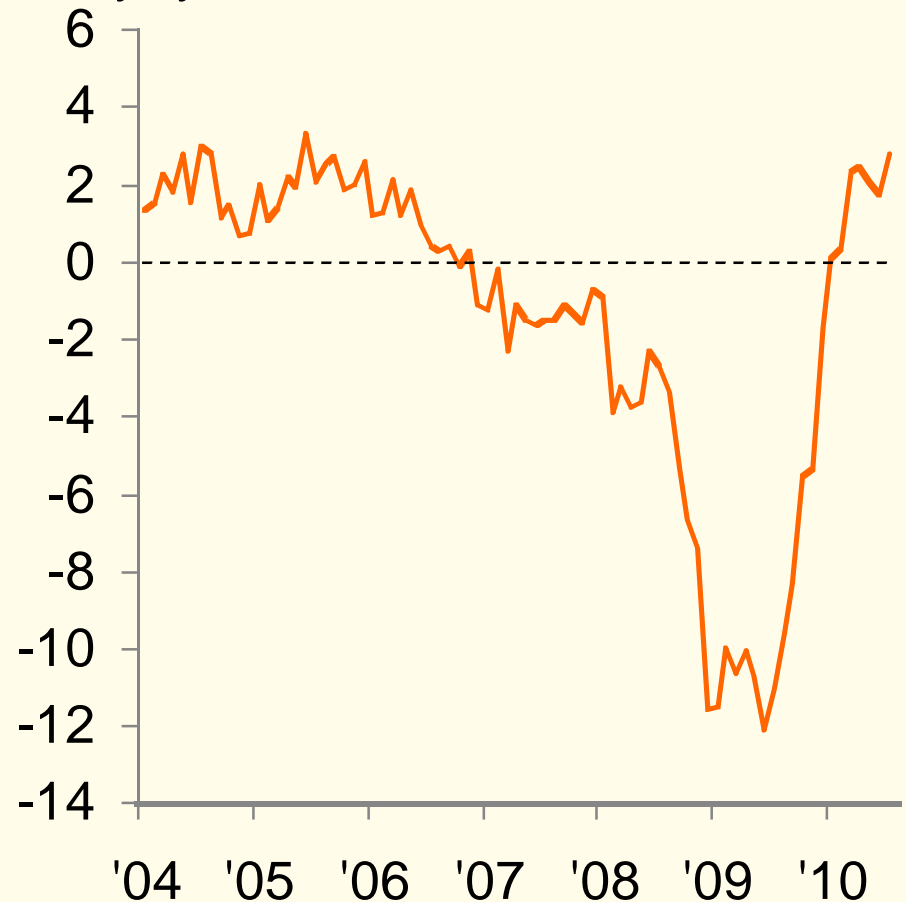
M2 growth

%, yr/yr



M2 Velocity growth

%, yr/yr

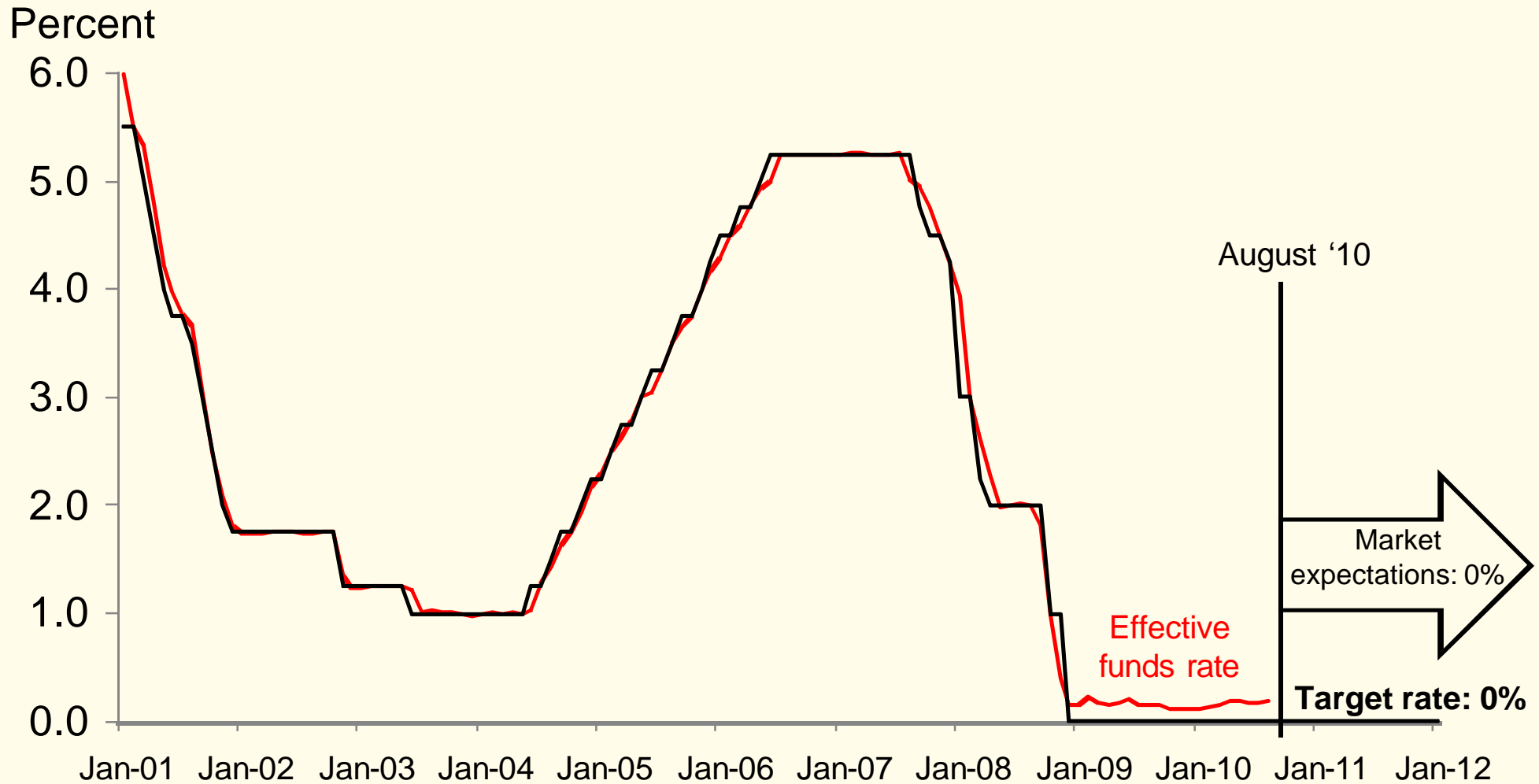


Source: Federal Reserve Board

The Empirical Record

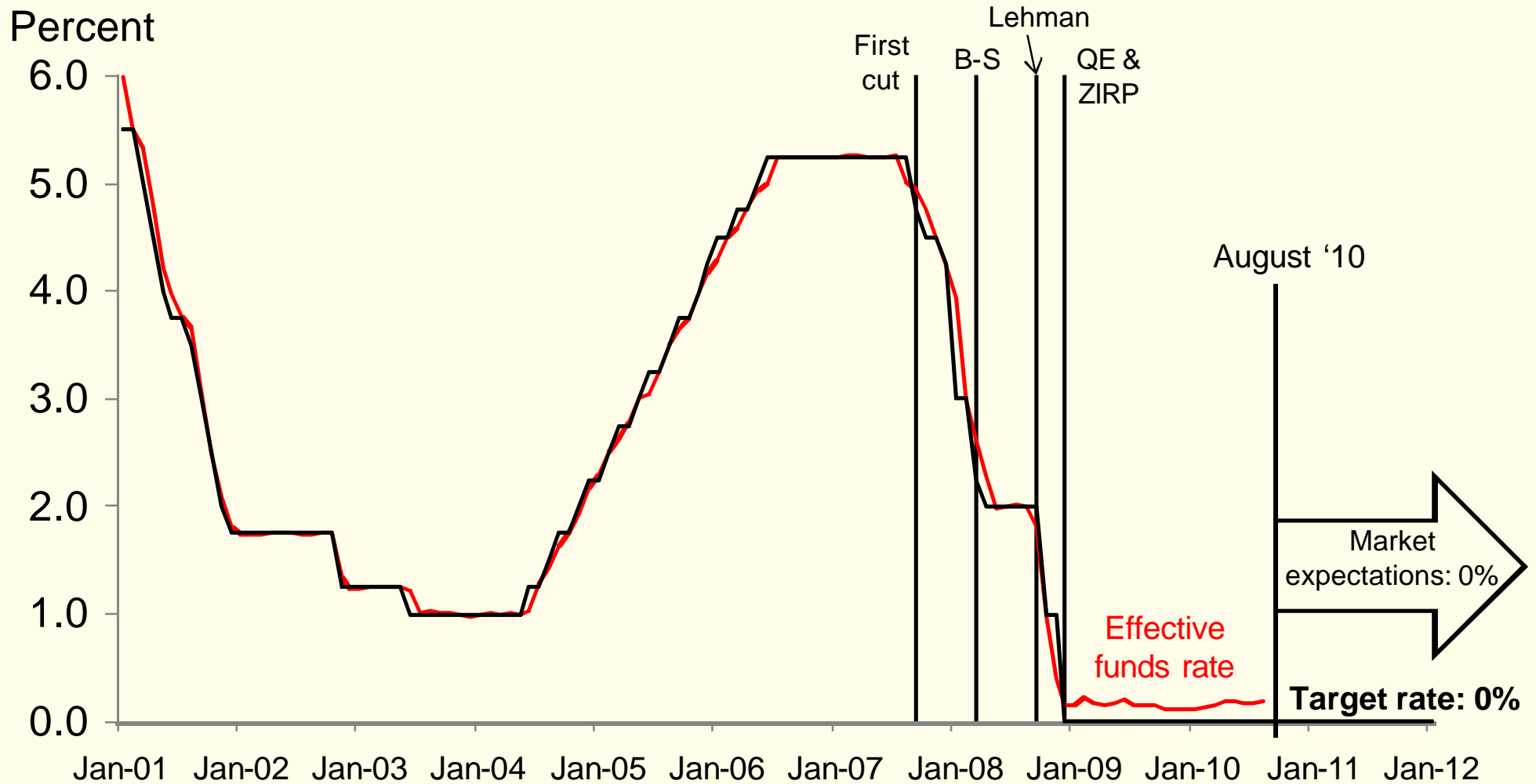
	(Annualized % chg)	36 months prior to crisis	36 months post crisis	3-year Avg.
ü _x	Money Stock: M2	5.36	5.53	6.31
	Adjusted Monetary Base	3.32	34.22	20.18
	Velocity (M2/ Nom. GDP)	0.42	-3.80	-3.00
ü _x	Nominal GDP	5.95	1.33	3.45
	GDP Price Deflator	3.26	1.34	2.42
ü _y	PCE Headline Inflation	2.78	1.68	2.43
	PCE Core Inflation	2.27	1.78	2.15

Fed Funds Rate



Source: Federal Reserve Board

Fed Funds Rate




Source: Federal Reserve Board



Global Backdrop

- Slowing recovery
- Strong emerging Asia
- Weak Europe with exception of Germany
- Sputtering U.S. recovery



“The System should always be engaged in a ruthless examination of its past record.”

- Chmn. Wm. McChesney Martin
FOMC Minutes, 11/26/68

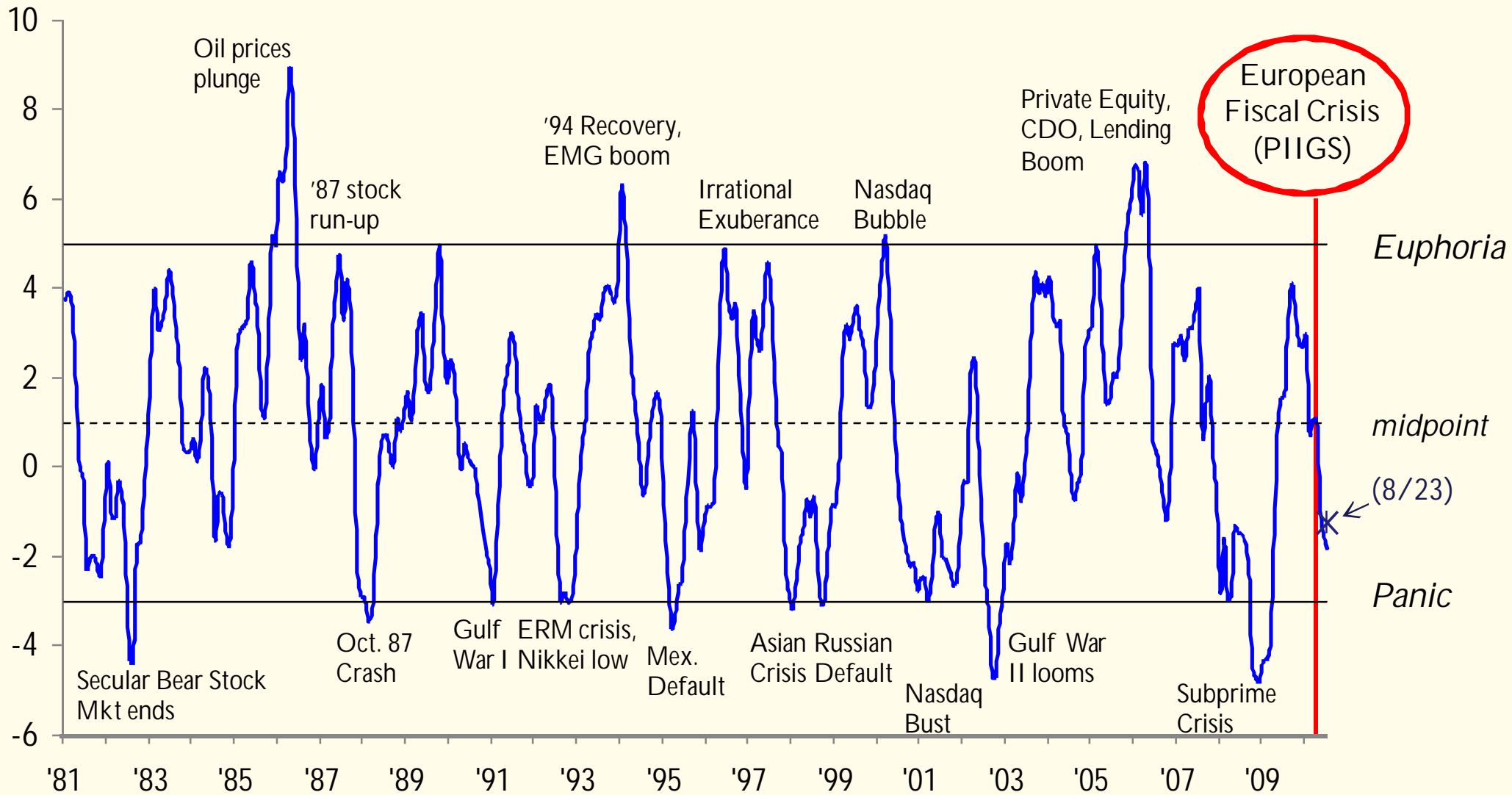


THE Lessons for the Future
GREENSPAN ERA

BY TONI LAPP, SENIOR WRITER

FEDERAL RESERVE BANK OF DALLAS

CS Global Risk Appetite Index: August 2010





Timeline

Summer 2006	Housing prices peak
Spring 2007	Irrational complacency
Summer 2007	Financial wake-up calls
Oct. '07-Feb. '08	Recession begins, but many unaware; Housing problem “contained”
Mar. '08	Bear Stearns collapse
Sep. '08	Fannie & Freddie receivership Lehman bankruptcy AIG collapse, with banks and other financial firms believing “we’re next”
Oct. '08	TARP



August 2010 Board Meeting

- Economic growth slowing further
- Growth much less certain
- Consensus takes a percentage point off Q2 growth forecast (now 1.0 – 1.5%)
- Increases possibility of double dip
- Economy approaching “stall speed” (from likelihood of 1:50 to 1:7)
- Inflation even more subdued



Only Logical Explanation

- Slower growth, accompanied by:
- Continued disinflation with increasing probability of deflation

(Cloudy, with a chance of meatballs: Requires an unconventional umbrella)



"Why I'm Not Hiring"

WSJ Op-ed, August 9, 2010

- "When you add it all up, it costs \$74,000 to put \$44,000 in Sally's pocket and to give her \$12,000 in benefits."
- \$44k gross salary costs Sally \$15k and her employer an additional \$15k in taxes and fees
 - Companies are conscripted by gov't and forced to serve as tax collector, and so lose control of big chunk of cost structure
 - This year, health coverage cost up 28% for lesser plan, partly due to federal taxes through insurance providers



"Why I'm Not Hiring"


WSJ Op-ed, August 9, 2010

"A life in business is filled with uncertainties, but I can be quite sure that every time I hire someone my obligations to the government go up. From where I sit, the government's message is unmistakable: Creating a new job carries a punishing price."

- Michael P. Fleischer

President, Bogen Communications Inc.

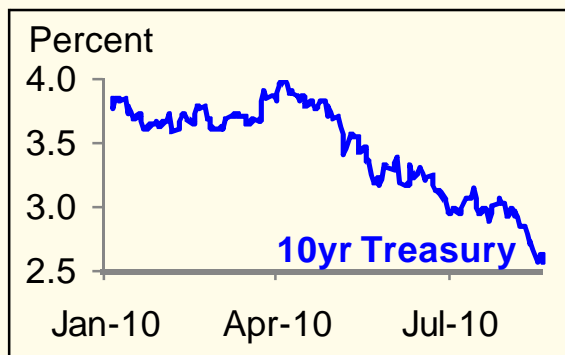
Ramsey, NJ



Is the credit market on the
verge of opening up?

Markets for Business Finance: YTD USD Corporate Bond Issuance

- IBM 3-year, 1% coupon, \$1,500 M
 - McDonald's 10-year, 3.5% coupon, \$450 M
 - Anadarko 30-year, 6.2% coupon, \$750 M
-
- Treasurys 10-year, 2.58% (Aug. 19, 2010)
1-year, 0.25% (Aug. 19, 2010)



Source: BofA Merrill Lynch Global Research, Federal Reserve Board



“Century Bonds”: 100-Year Corporate Bonds

Monday, Aug. 24, 2010:

Norfolk Southern Corp.

100-year issue, 6% coupon, \$250 M



“You should be issuing as long a debt as possible,
because all-in rates are very low.” – WSJ, Aug. 23

The Century Club

Companies that issued Century Bonds in the past:

Anadarko Petroleum Corp.

Apache Corp.

Burlington Northern Santa Fe Corp.

Coca-Cola Enterprises Inc.

Federal Express Corp.

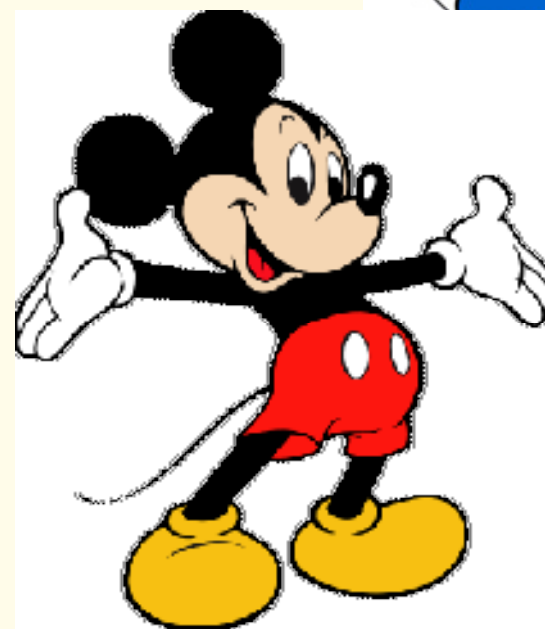
Ford Motor Co.

International Business Machines Corp.

Motorola Inc.

Norfolk Southern Corp.

The Walt Disney Co.





Some Disquieting Investment Flows

Over the last 36 months:

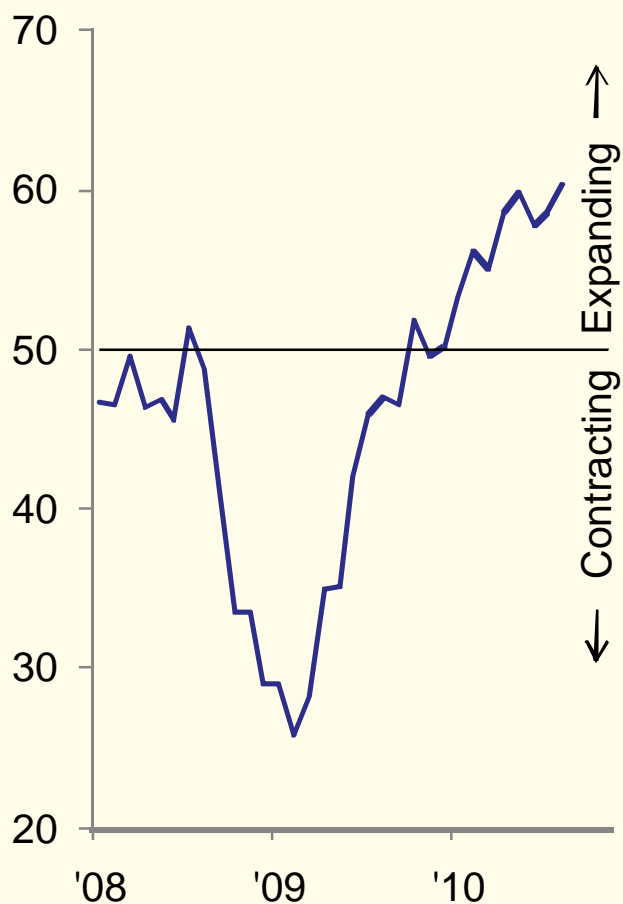
- Net purchases of Equity Mutual Funds: -\$245 B
 - Net purchases of Bond Mutual Funds: +\$609 B
-

Only a small increase in interest rates from their current record lows will significantly reduce the “value” of this bond portfolio and could “spook” investors.

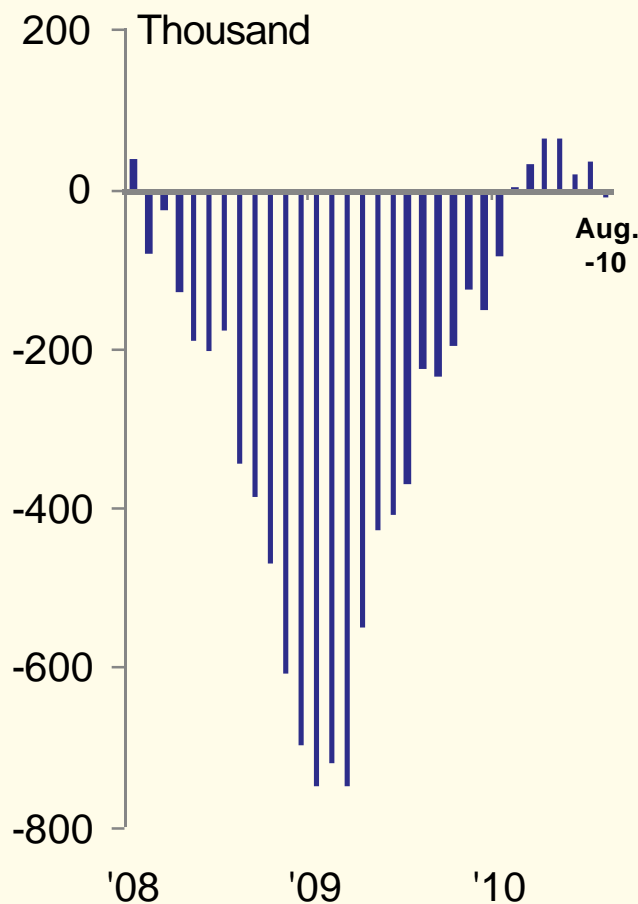
"Factory Growth Buoy Markets"

Wall Street Journal, 9/2/10

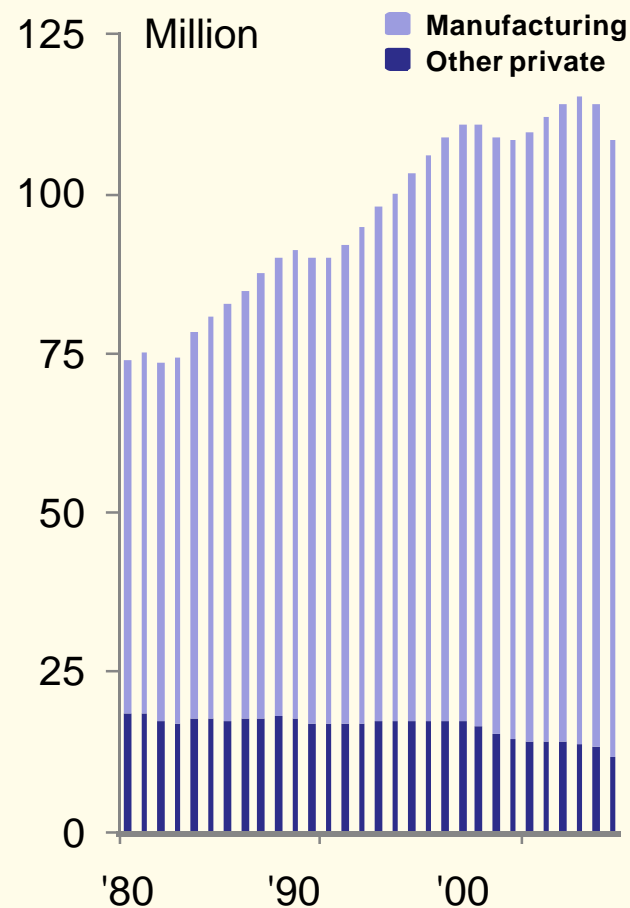
ISM manufacturing employment subindex



Private-sector jobs, estimated net monthly change



Total jobs in July of each year, seasonally adjusted

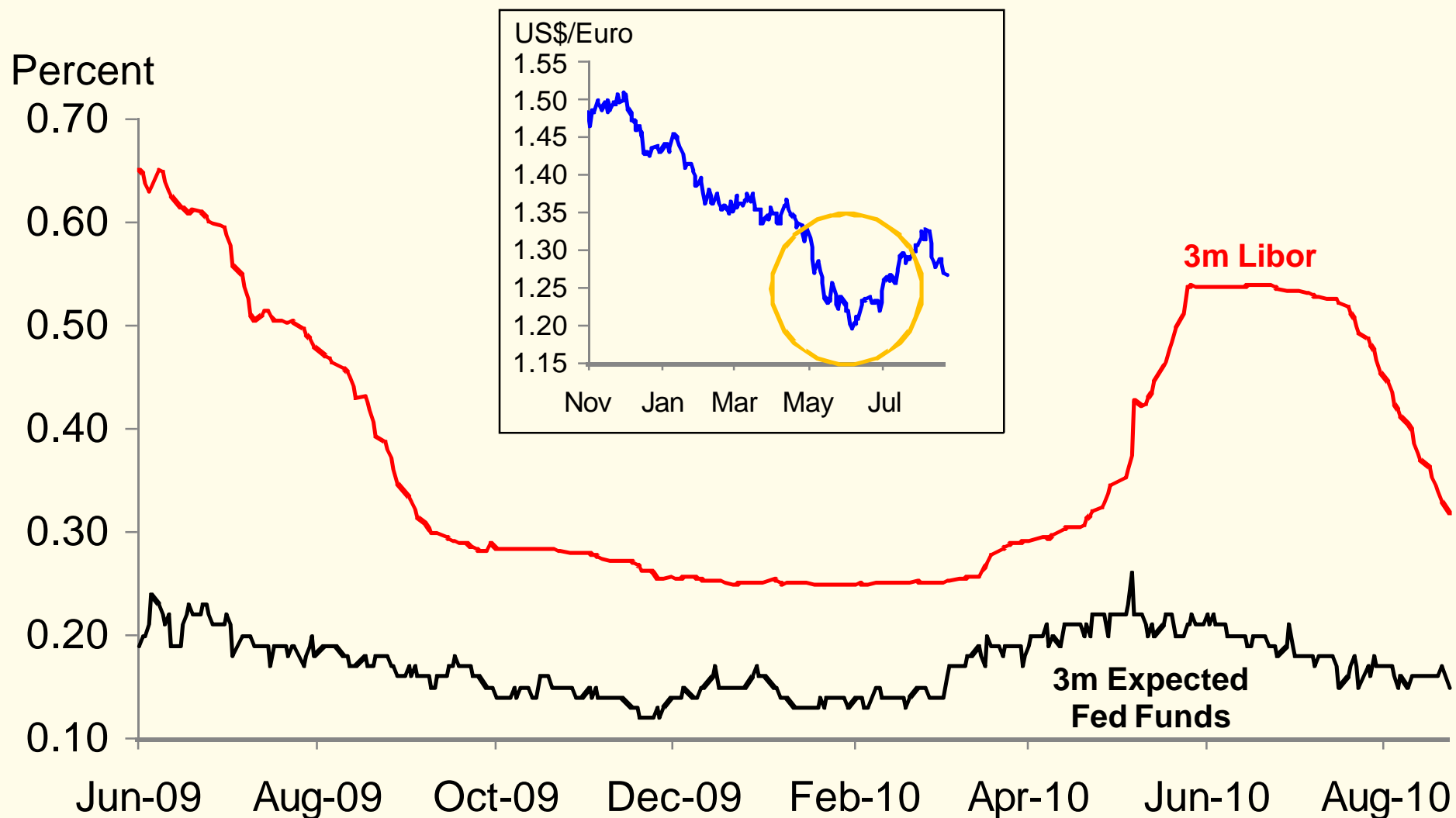


Source: Institute for Supply Management; ADP/Macroeconomic Advisors; Labor Department



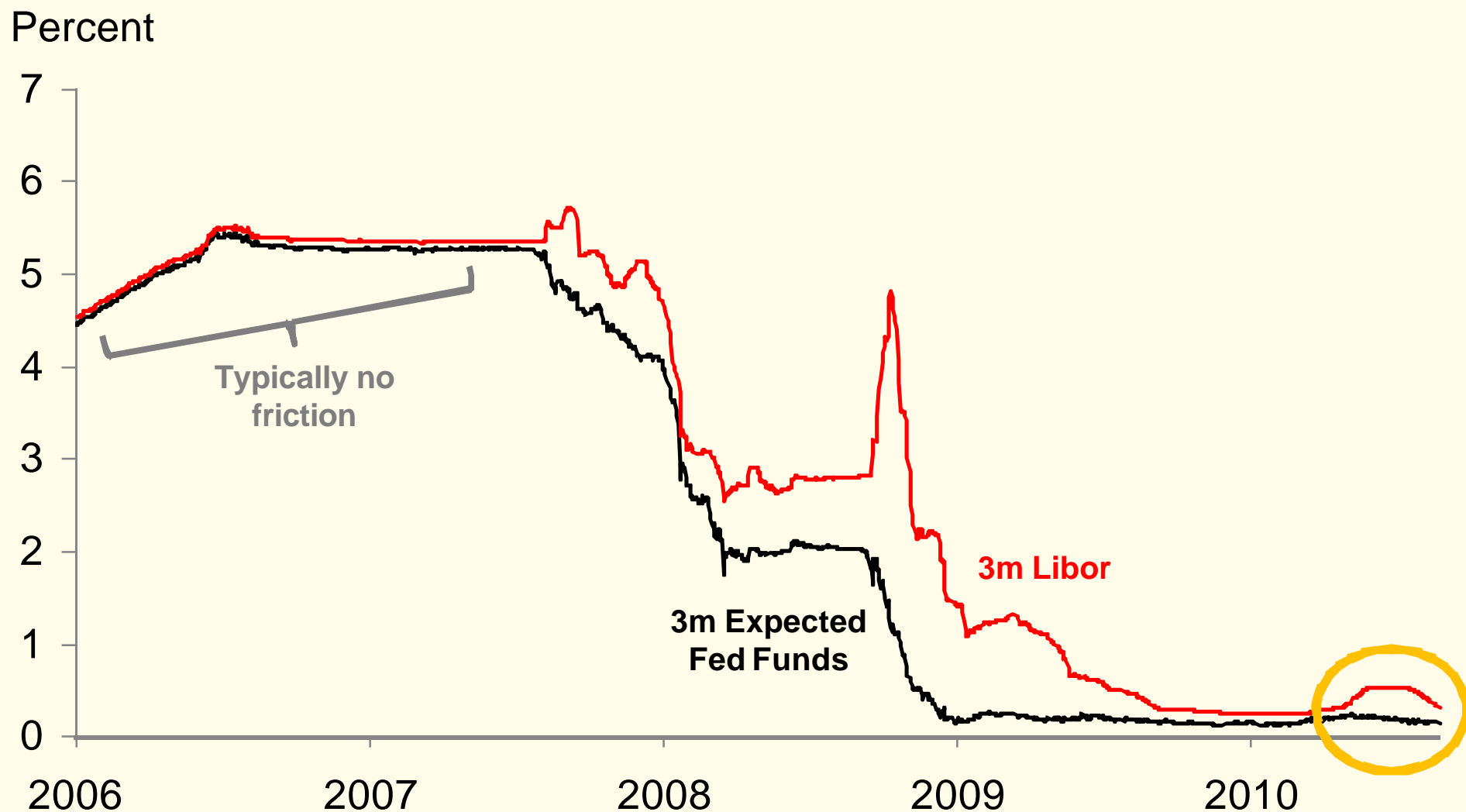
Back of Tray

Some Friction in Interbank Market: 3-Month



Source: *Financial Times*

Some Friction in Interbank Market: 3-Month

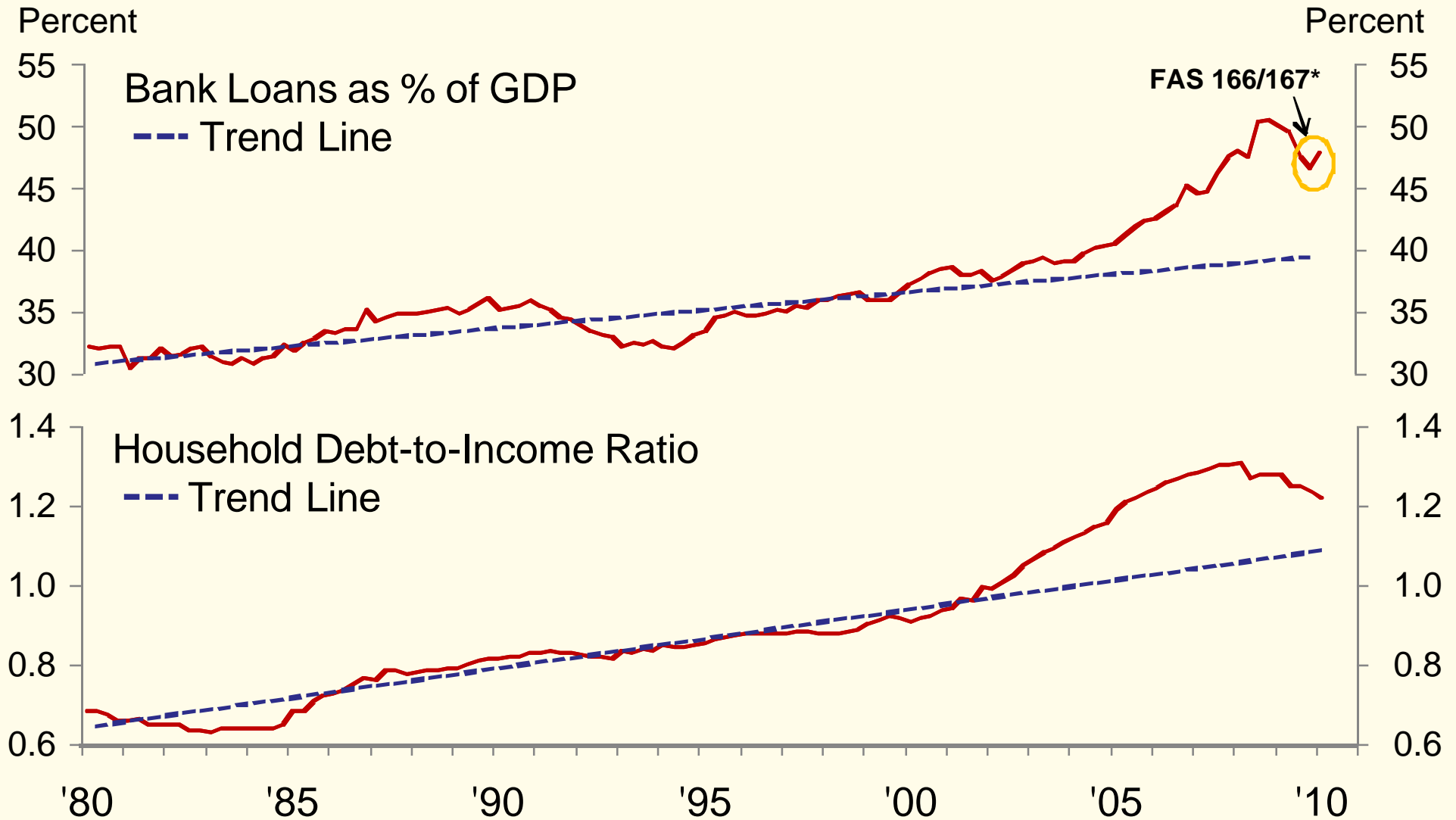


Junk Bond Spreads



Source: Merrill Lynch, Federal Reserve Board, Moody's

More Deleveraging to Go



Source: BCA Research 2010 (Martin Barnes), Federal Reserve Board, BEA

*Some securitizations moved onto balance sheets