

Is a U.S. Recovery Taking Root?

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Chairman Bernanke stoked investor spirits last week by stating that *"the sharp decline in economic activity may be slowing."* Indeed, the seeds of an economic recovery might finally be germinating in response to massive policy fertilization.

After the worst quarter in 28 years, personal spending apparently turned up in Q1 as a result of a reduction in withheld income taxes and an increase in tax refunds (*Chart 1*). Another increase is likely in April when withholding rates will be cut further due to the "Making Work Pay" tax credit. Consumer confidence also appears to have bottomed, albeit at microscopic levels. The less-sour mood stems from the recent rally in equities, which largely reflects improved bank earnings. Still, as BoA's warning of higher loan losses attests, the lift in equities and confidence remains fragile.

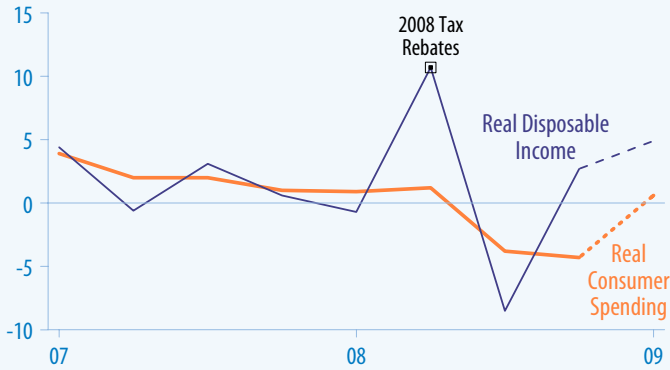
Most of the fiscal stimulus is yet to come. According to USA Today, only about 8% of the \$787 billion stimulus plan has been spent to date (largely on public works and financial aid to states). The roll-out of infrastructure programs should help stem the tide of job losses later this year.

The massive monetary stimulus could reap even bigger dividends than fiscal policy. Since September, the Fed has slashed overnight rates to near zero and more than doubled the size of its lending facilities. The quantitative easing (QE) program shifted into overdrive at the March 18 policy meeting when the Fed pledged to greatly expand its purchases of agency MBS/debt and initiate purchases of longer-term Treasuries (for the first time since the 1960s), potentially doubling its balance sheet again. As a result, the money supply has soared, with the narrow M1 measure growing at an annual 14% clip since November (versus zero a year ago) and the broader M2 aggregate climbing at a 9% rate. Strong money growth and a steeply-sloped yield curve almost always foreshadow an economic recovery (*Chart 2*).

QE has helped relieve supply pressures on longer-term rates and reduced corporate credit spreads (*Chart 3*). Ten-year Treasury rates remain slightly below their mid-March level of 3% despite massive issuance and an easing in risk aversion. Recently, several large banks have been able to issue bonds

CHART 1
Q1 SPENDING LIFTED BY TAX CUTS

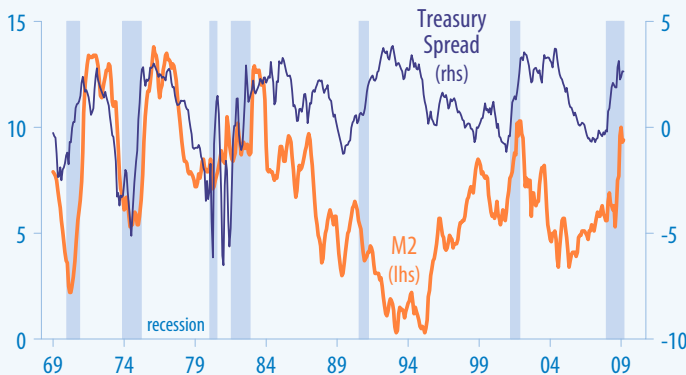
United States (q/q % chng.: a.r.)



09:Q1 = estimate

CHART 2
FAST MONEY USUALLY SPARKS A RECOVERY

United States

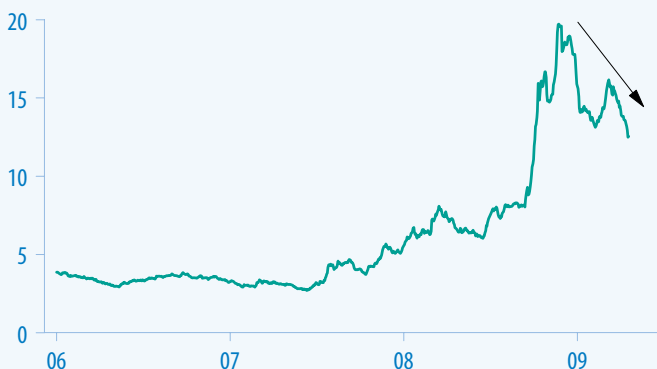


Treasury Spread = 10-year - Fed Funds (ppts) M2 = (y/y % chng)

CHART 3
IMPROVING RISK APPETITE

United States (ppts)

B-Rated Corporates - 10-Year Treasury Spread



without the FDIC's backstop, a sign of growing investor confidence. The Fed's MBS purchases have led to record-low fixed mortgage rates—including a sizeable drop in jumbo mortgage rates to pre-crisis levels of 6.4%. Record housing affordability, along with the \$8,000 first-time homebuyer tax credit, has put a tentative floor under home sales and single-family starts. Meantime, a surge in mortgage refinancings is putting extra change in consumers' pockets and in bank coffers. Still, bank lending has declined for the past three months, as demand remains weak and credit standards remain tight amid "deteriorating loan quality and rising delinquencies," according to the Beige Book.

Commodity prices have perked up since mid-March, reducing the risk of deflation. Equity markets have bounced more than 25% from their lows. Unfortunately, the one asset price that hasn't stabilized yet is housing (Chart 4). And with the moratorium on foreclosures now lifting, prices are likely to slide further before some balance returns to the market (though the government's foreclosure mitigation program will help). A

sustained increase in home sales is sorely needed to put a floor under prices. This means the Fed will need to maintain, if not expand, its QE program, as lower house prices risk undoing the fragile gains in credit and financial markets.

Continued massive job losses could also delay the recovery. Unfortunately, outside of a modest slowing in jobless claims and layoff announcements, there is little to suggest the spate of job losses—the worst in half a century—is ending. Rising joblessness has also added to consumer angst, lifting the savings rate. Stress in commercial real estate markets will also extend the recession. Consequently, an upturn in the ratio of coincident-to-lagging economic indicators (a hallmark of past recoveries) remains elusive (Chart 5). (See the January 16th Feature "Recovery Signposts" for more details.) Rapid inventory liquidation also tends to mark the end of a downturn, and here there is a little more room for optimism once we get past a likely massive drawdown in Q1 and GM's planned 9-week shutdown of 13 plants in mid-May.

Bottom Line: The massive policy stimulus finally appears to be gaining some traction, thawing credit markets and reducing longer-term rates. Barring another financial shock, the stimulus should spur some expansion by year's end. Until then, however, a slowing in job losses and house price declines is sorely needed before the current green shoots can blossom.

CHART 4
STILL A BUYERS' MARKET
United States

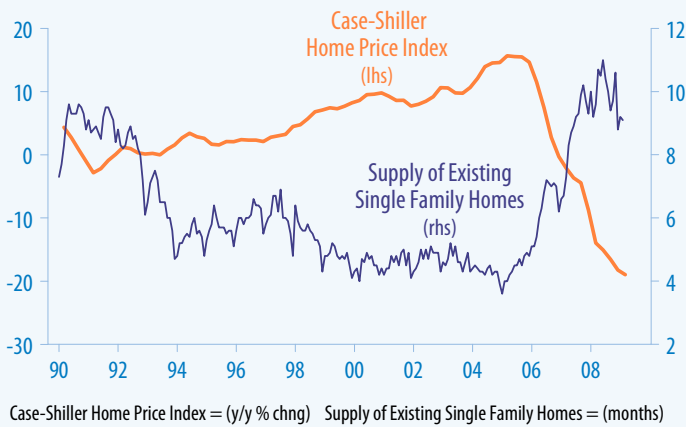
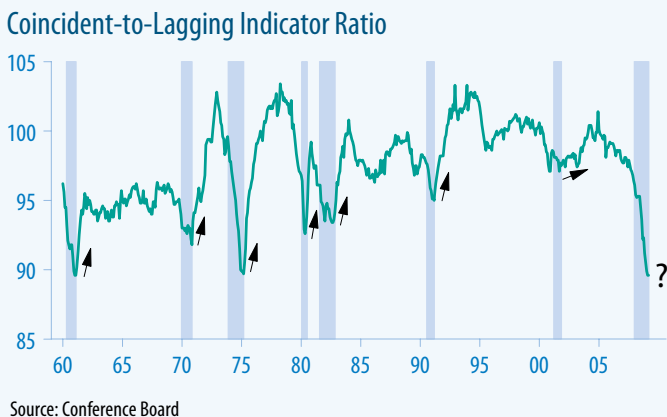


CHART 5
FOOL-PROOF RECOVERY GUIDE
United States



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