

1st Quarter 2010 Economic Commentary

The U.S. economic picture continued to improve during the first quarter of 2010. Business investment picked up, consumer spending increased, and the labor market showed signs of stabilizing. Both service and manufacturing industries expanded during the quarter. Service industries benefited from higher consumer discretionary spending, and manufacturers benefited as companies invested in equipment, replenished inventories, and exported more goods. Although the unemployment rate remains high, job growth turned positive during the quarter, signaling that the recovery is becoming more entrenched. In addition, financial market conditions remained supportive of economic growth. Equity prices continued to rise and credit spreads remained near pre-crisis lows despite the winding down of the Fed's special liquidity facilities.

Even with this positive momentum, headwinds remain, particularly for the fragile housing market. After showing signs of recovery in the latter half of 2009, home sales stagnated during the first two months of 2010. Although sales are expected to pick up again before the homebuyer tax credit expires at the end of April, this increase in demand may again prove transitory once the tax credit is gone. In addition, rising foreclosures are resulting in higher inventories and downward pressure on home prices. The commercial real estate market is also suffering as delinquencies rise, vacancy rates climb, and property values fall. Tight bank lending standards have exasperated the situation by making financing for new projects difficult to obtain. As such, depressed real estate conditions are likely to weigh on the recovery for awhile.

The Fed acknowledged these challenges at the March 16th FOMC meeting when it left the target range of the federal funds rate unchanged at 0.0-0.25%. The Committee stated that economic activity continues to strengthen but is likely to be moderate for some time. On the inflation front, the Committee believes that substantial resource slack and stable longer-term inflation expectations will keep inflation subdued. As such, the Committee chose to maintain its statement that conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period." Believing that the reiteration of the "extended period" language limits the Fed's flexibility to change policy as conditions improve, Kansas City Fed President, Tom Hoenig, dissented from the vote. Many analysts are looking for a change in this much watched phrase as a signal that the Fed is prepping the market for an eventual increase in rates. Although the Fed will likely remain on hold for most of 2010, they continue to formulate an exit strategy to gradually reduce monetary accommodation and drain the system of excess reserves. In addition to winding down the special liquidity facilities and ending the purchase of agency notes and MBS, the Fed raised the discount rate by a quarter point in February. They also continue to test reverse repos and develop the Term Deposit Facility for banks.

Financial regulatory reform was also in the spotlight during the quarter. The future structure of Fannie Mae and Freddie Mac remains in the news. The companies have been under government conservatorship since 2008 and their continued existence as GSEs remains uncertain as the government looks to overhaul the U.S. housing-finance system. Treasury Secretary Geithner told lawmakers that it would be a mistake to either abolish or fully nationalize Fannie and Freddie. He stated that the government needs a new housing finance system in which "we preserve the good but end what was too risky." Geithner also stated that while the GSE debt was not technically sovereign debt, "we are going to make sure that these institutions have the resources they need to meet their commitments past and future." Financial services reform was also a focus during the quarter as "the Dodd bill" called for the elimination of the "Too Big to Fail" scenario for large institutions. While parts of the bill (higher capital requirements, improved liquidity, etc) have positive implications for bank debt ratings, the limitation on future government support could negatively impact the ratings of many large financial institutions. Several large banks whose ratings benefit from implied government support could be pushed to second-tier, effectively cutting them off from money market funds and most other short-term funding sources. While it remains to be seen if the bill will be passed, it has the potential to cause some disruption in the ongoing stabilization of the financial markets.