

2nd Quarter 2010 Economic Commentary

The second quarter of 2010 proved to be a difficult one both in the U.S. and abroad. Negative news – including the European financial crisis, the BP oil spill disaster, and the ongoing debate over U.S. financial reform – dominated the headlines and contributed to ongoing economic uncertainty.

The attention of investors across the globe was focused on Europe during the quarter. Greece's inability to get its fiscal house in order threatened the financial stability of the entire Eurozone. In order to avert a sovereign debt crisis, European authorities in conjunction with the IMF orchestrated a \$145 billion emergency aid package for Greece. Despite the bail-out, fears of a regional economic meltdown grew, forcing the EU and IMF to approve another rescue package that makes nearly a trillion dollars in loans available to EU member countries in danger of going bankrupt. European bank regulators are also subjecting 91 EU banks to stress tests in order to boost confidence that Europe's banks would be able to cope with a worsening recession and withstand other shocks such as a sovereign default. The results of the stress tests are expected to be announced July 23.

The fear of a European debt contagion hit the U.S. at a time when the domestic economic recovery was hitting a soft patch. The rapid expansion in U.S. manufacturing began to wane in June as factories received fewer orders and demand for exports cooled. Service industries also expanded at a slower pace as consumer spending lost momentum due to a drop in consumer confidence brought on by continued weakness in the labor market. Lack of job growth, combined with the expiration of the homebuyer tax credit and high foreclosures, also resulted in declining home sales. In addition, financial market conditions became less supportive of economic growth during the quarter. Equity markets declined and credit spreads widened as concerns over Europe's fiscal health overshadowed reports of improved corporate earnings. As a result of the fear and uncertainty in Europe, investors flocked to US Treasuries as a safe haven and drove interest rates lower across the yield curve.

U.S. financial reform also weighed heavily on the market as investors pondered what the landmark legislation would hold for banks, credit card companies, and mortgage lenders. After a year of debate and much political rhetoric, the bank reform bill was passed by the Senate on July 15 and is expected to be signed into law by President Obama next week. The final version of the bill gives regulators broad authority to rein in banks, limit risk-taking by financial firms and supervise the derivatives market. It also creates a new consumer protection division to guard against lending abuses. To address "too big to fail", the bill establishes a system to wind-down a failing mega-bank while limiting the impact on the overall market. Opponents of the bill believe the final version is too vague, giving too much discretion to regulators and not establishing enough specifics to prevent another financial crisis. Given that regulators will be responsible for writing many of the specific rules and regulations of the bill, it will take months or even years before many of the bill's directives are enacted. As a result, the uncertainty surrounding financial reform is far from over.

Given the challenges still facing the economic recovery, the Fed left the target range of the federal funds rate unchanged at 0.00-0.25% at the June 23rd FOMC meeting. Although the Fed continued to anticipate a moderate recovery in economic activity through 2011, they acknowledged that the economic outlook had softened somewhat and that the pace of the expansion was expected to be slower than previously anticipated. In addition, inflation was expected to remain quite low in coming quarters due to substantial resource slack. Given slower growth and low inflation, the Committee judged it appropriate to reiterate their expectation that economic conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

Although the economic recovery continues in the U.S., it appears that the pace of growth is going to be slower than many had hoped. Given the fragility of the recovery and the lack of inflation pressure, the Fed is likely to remain on hold through most of next year.