

The Economic Outlook: An Imperfect '10

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Data as of February 23

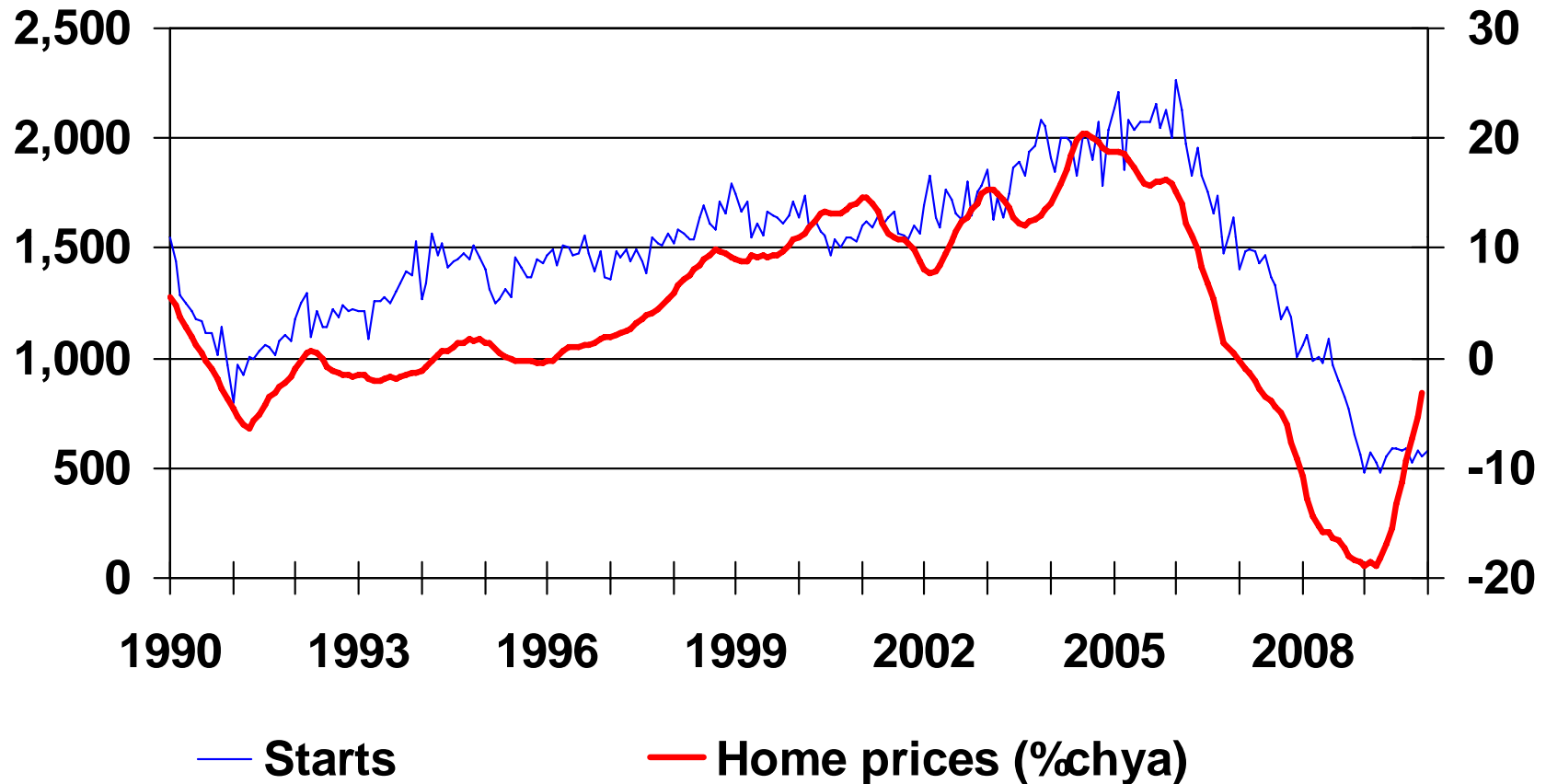
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The U.S. Hits Bottom

- **The recession appears to have ended in the third quarter**
- **Housing had been in recession for three years, subtracting over a percentage point from GDP growth in both 2007 and 2008.**
- **But seems to be stabilizing.**
- **Overseas partners are recovering, helping exports**
- **The fiscal stimulus has helped boost the economy, especially consumer and government spending.**
- **The financial system appears to be stabilizing.**
- **But private nonresidential construction is still plunging.**
- **The recession has been the longest and deepest since the 1930s.**
- **But the recovery is likely to be slow and uneven.**
- **And an even deeper and longer recession is possible if the financial markets lock up again, oil prices jump, or consumers remain scared.**

The Housing Market Cycle

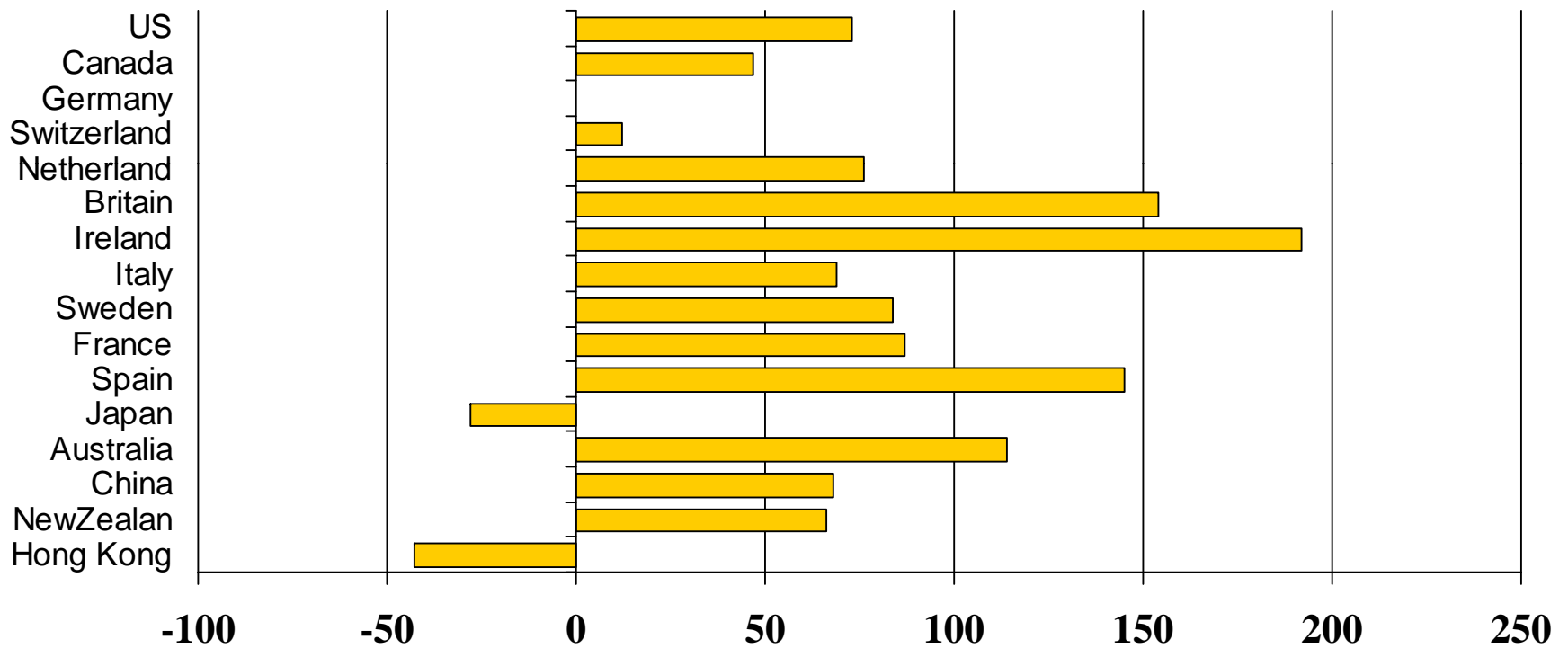
(Housing starts (1000) and 12-month % change in home prices (S&P/Case-Shiller))



Source: Standard & Poor's and Census Bureau

Bubbles Were Almost Everywhere

(Percent increase in home prices, 1997-2005)

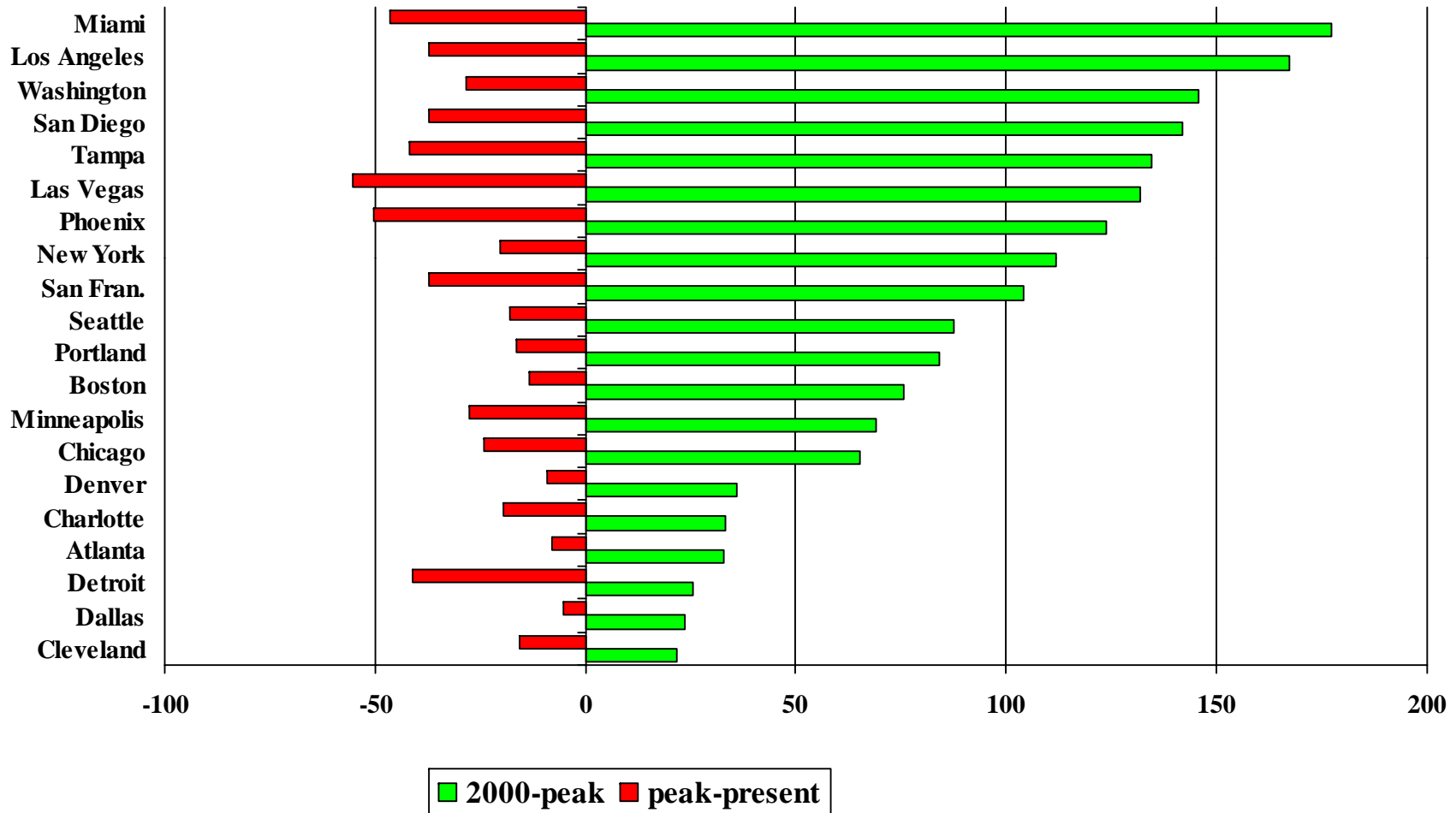


Source: Mortgage Bankers' Association and Standard & Poor's

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Those Who Bubbled Highest Burst Loudest

(Percent increase in S&P/Case-Shiller home price index, December 2009)



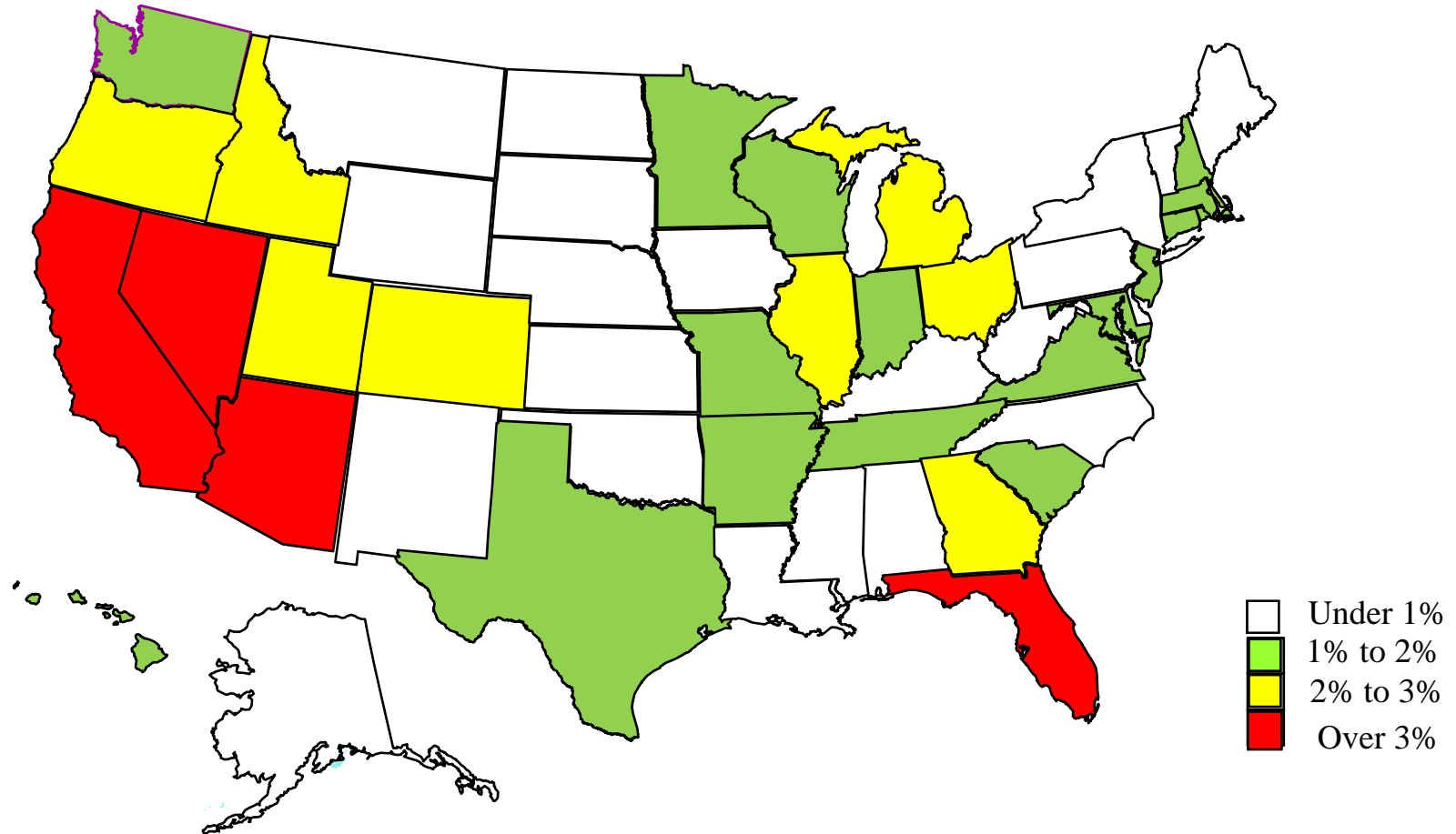
Source: Standard & Poor's

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Foreclosures Are Concentrated

(Percentage of homes in foreclosure, 2009)

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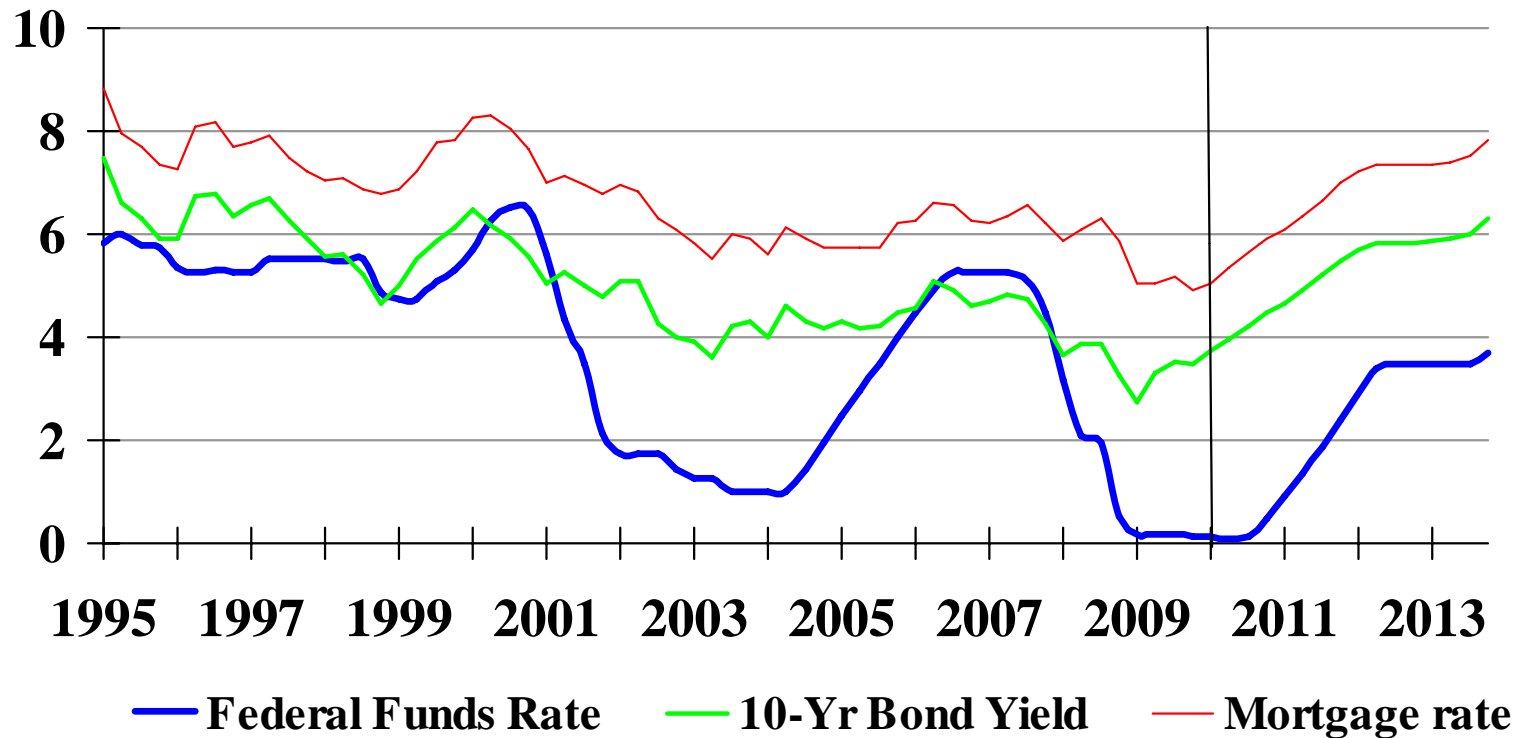


Source: RealtyTrac

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The Fed Didn't Stop At Nothing

(Percent)

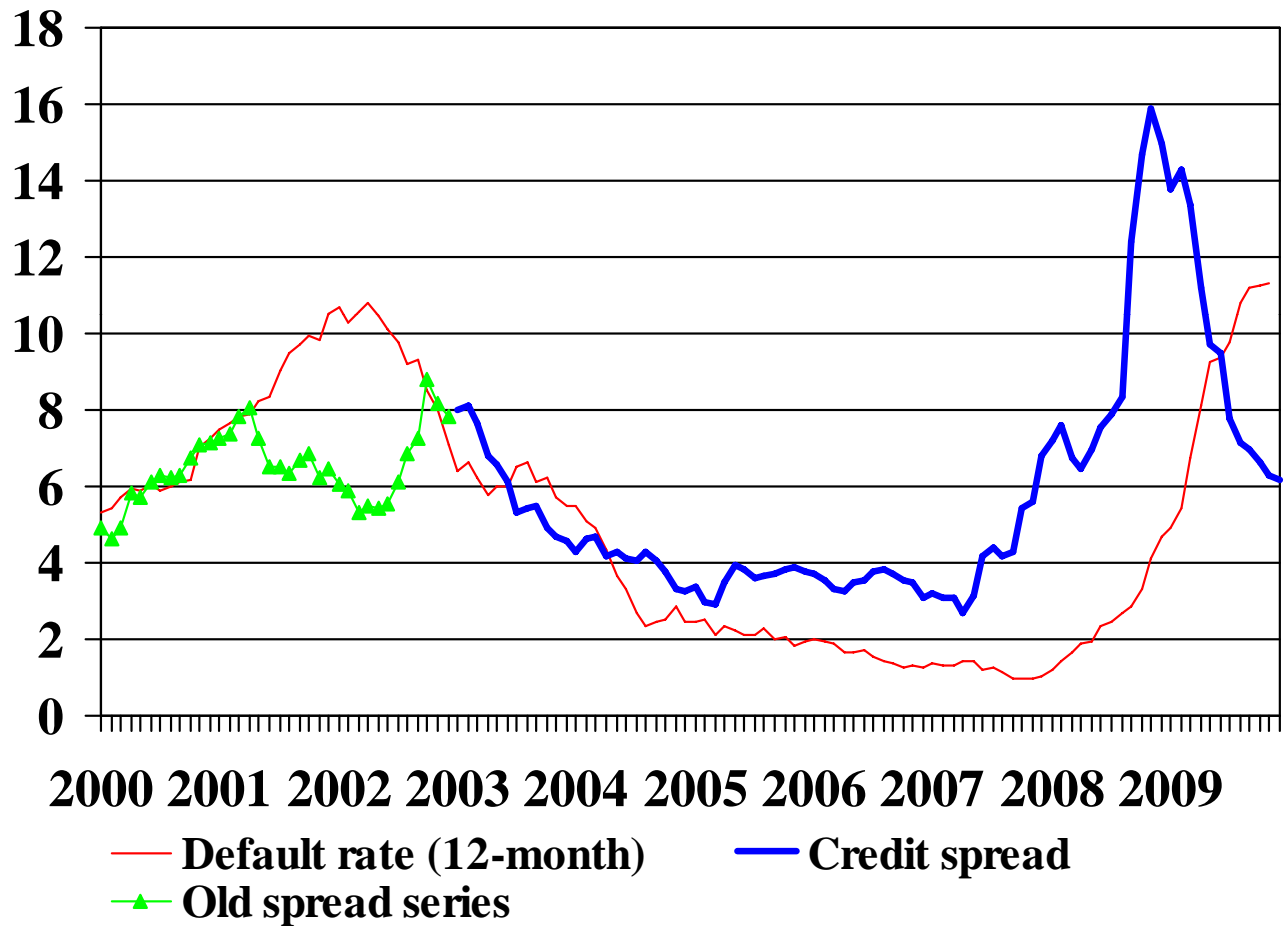


Source: Federal Reserve

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Quality Spreads Are Narrowing From Record Highs

(Spread over Treasury yields, percentage points)

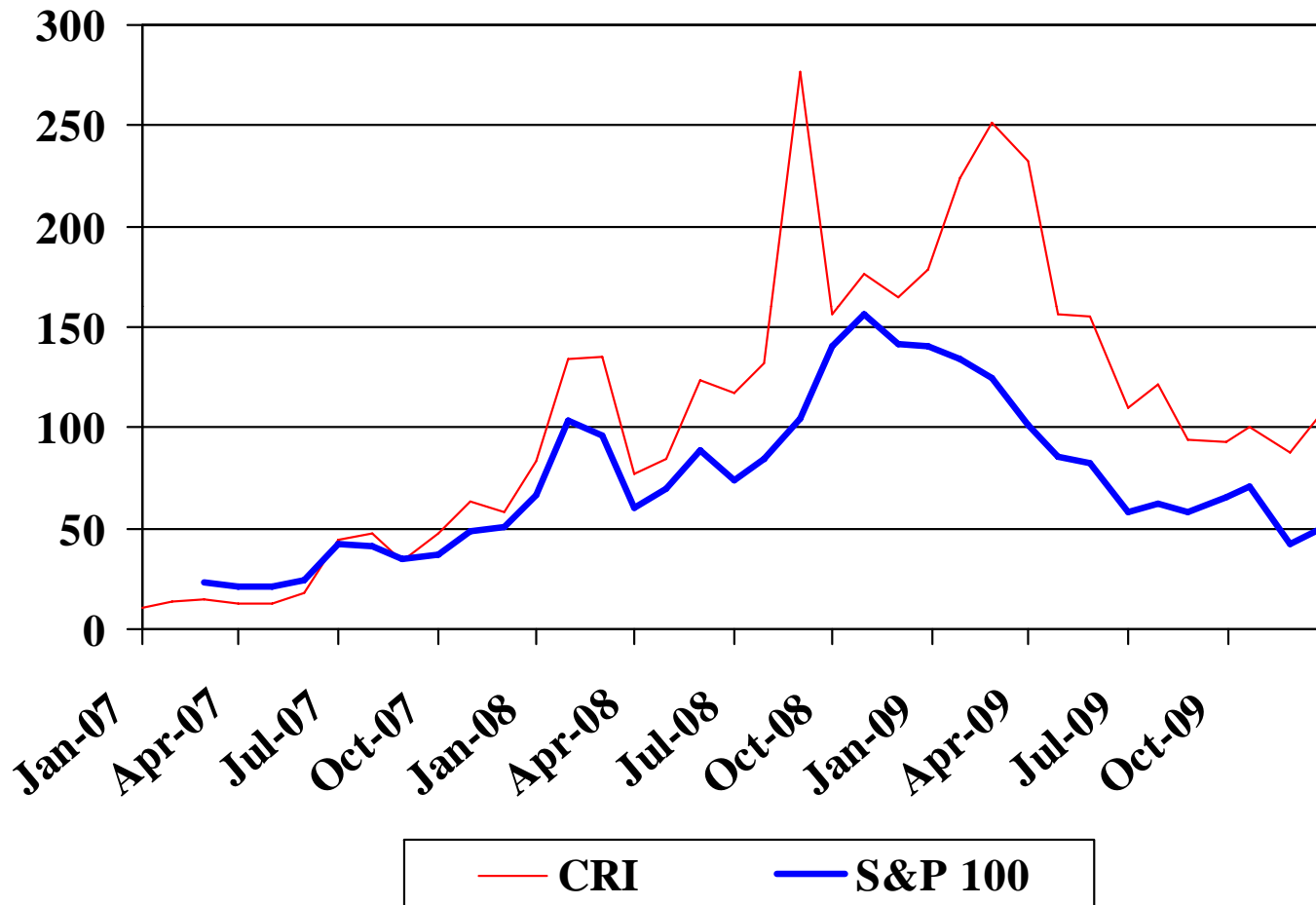


Source: Standard & Poor's Global Fixed Income Research

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Credit Default Insurance Rates Are Coming Down

(Counterparty Risk Index, basis points)

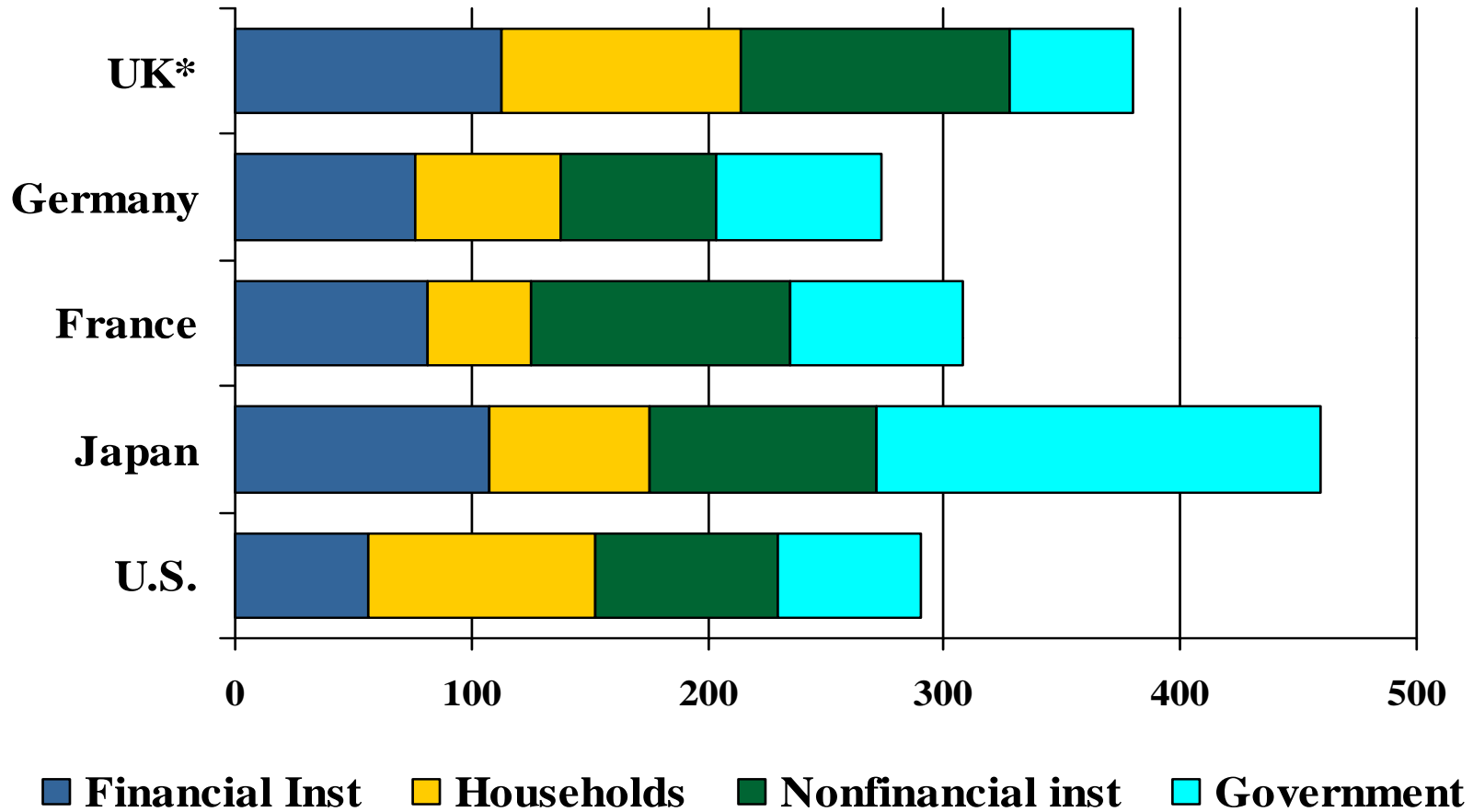


Source: Credit Default Research, Standard & Poor's

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US Debt Is Actually Moderate

(Percent of GDP, 2008)



Source: McKinsey Global Institute

* Adjusted for international bank support

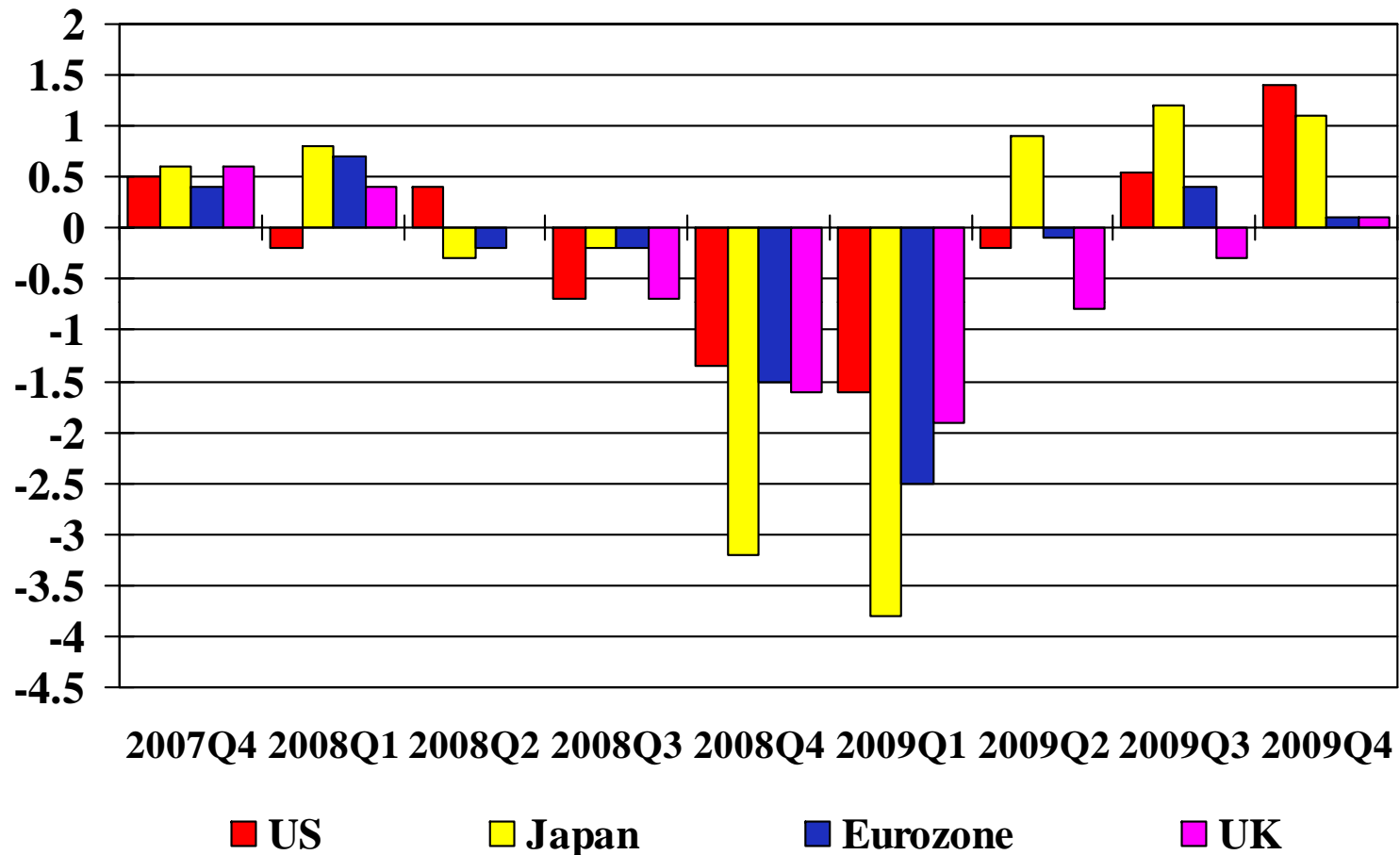
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Synchronized Sinking

- **Industrial countries went into recession in 2008**
- **Real GDP fell in the U.S., Japan, and Europe and softened in Asia**
- **Developing countries looked like they might escape**
- **Until commodity prices plunged in Q4**
- **We expect world GDP to recover, by 3.8% in 2010 from -0.9% in 2009**
- **The most synchronized world recession in history**
- **Followed by a synchronized recovery**

All Fall Down

(Percent change in real GDP, quarterly rate)

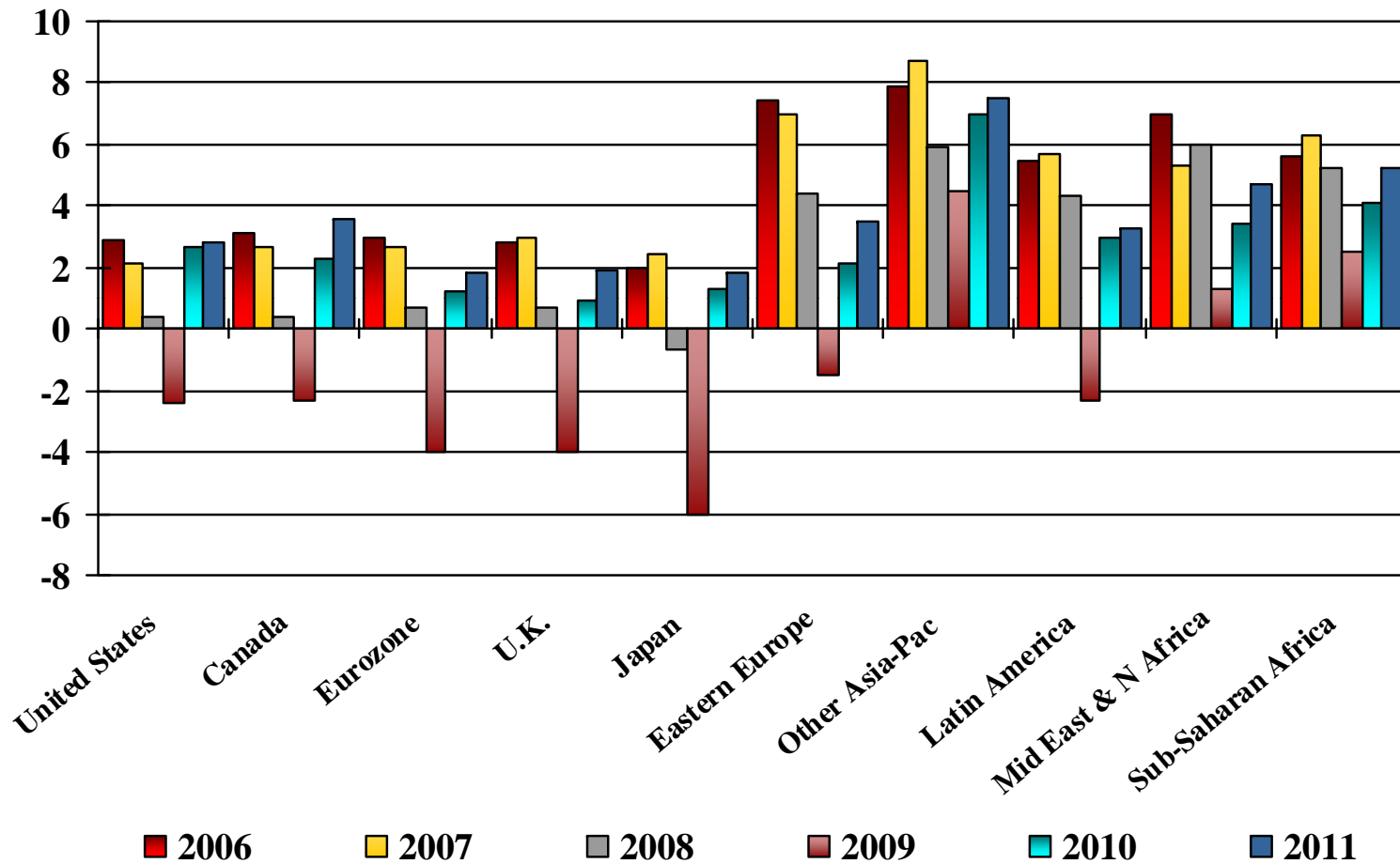


Source: Global Insight

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Synchronized Sinking

(Real GDP, % change)

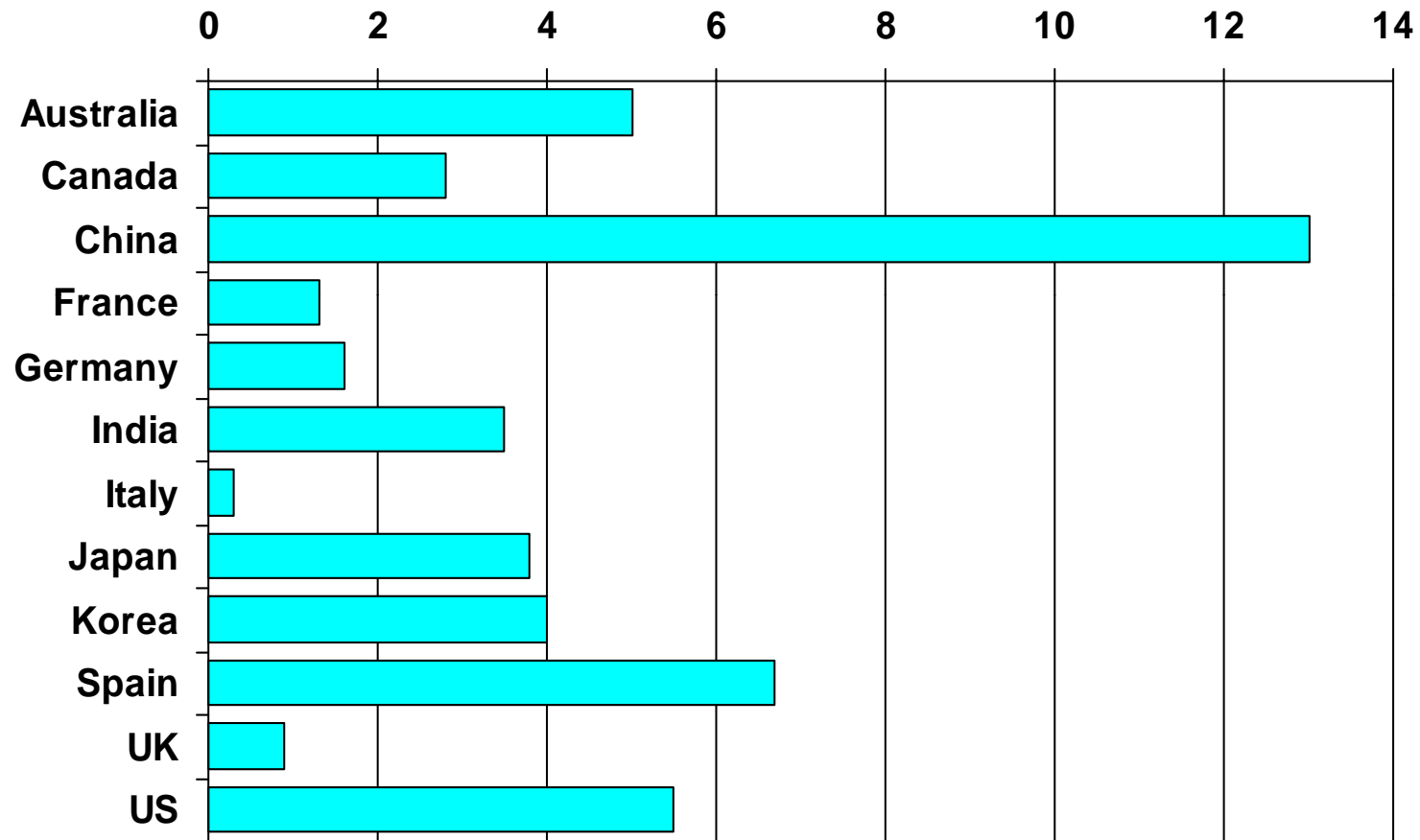


Source: Global Insight and Standard & Poor's

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Fiscal Stimulus Packages Varied Widely

(Packages passed in Q4 2008- Q1 2009, percent of GDP)

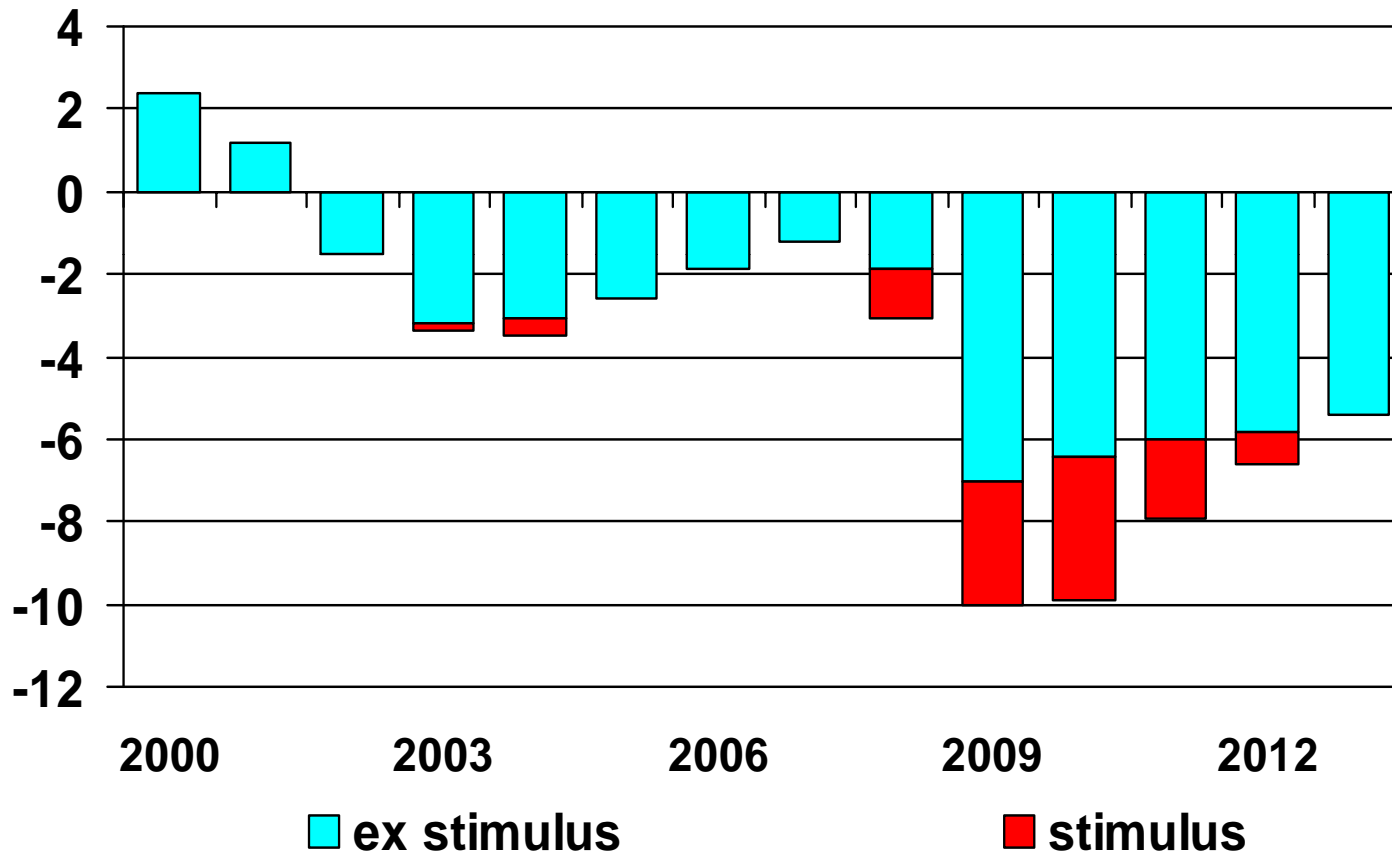


Source: Standard & Poor's CRISIL

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Deficits Are Mostly Cyclical

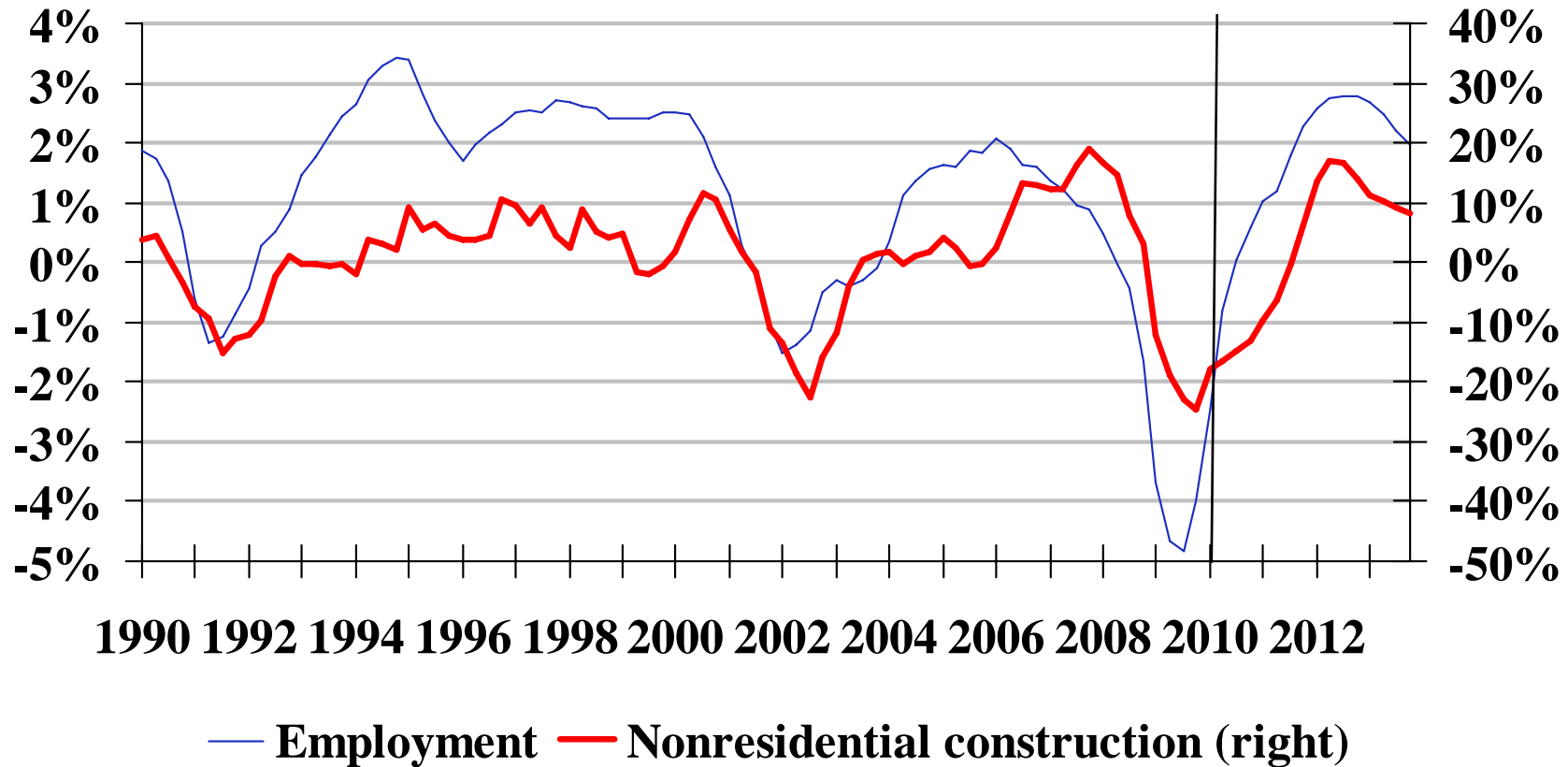
(Government deficit as % of GDP, fiscal years)



Source: Standard & Poor's.

Weaker Employment Is Hurting Construction

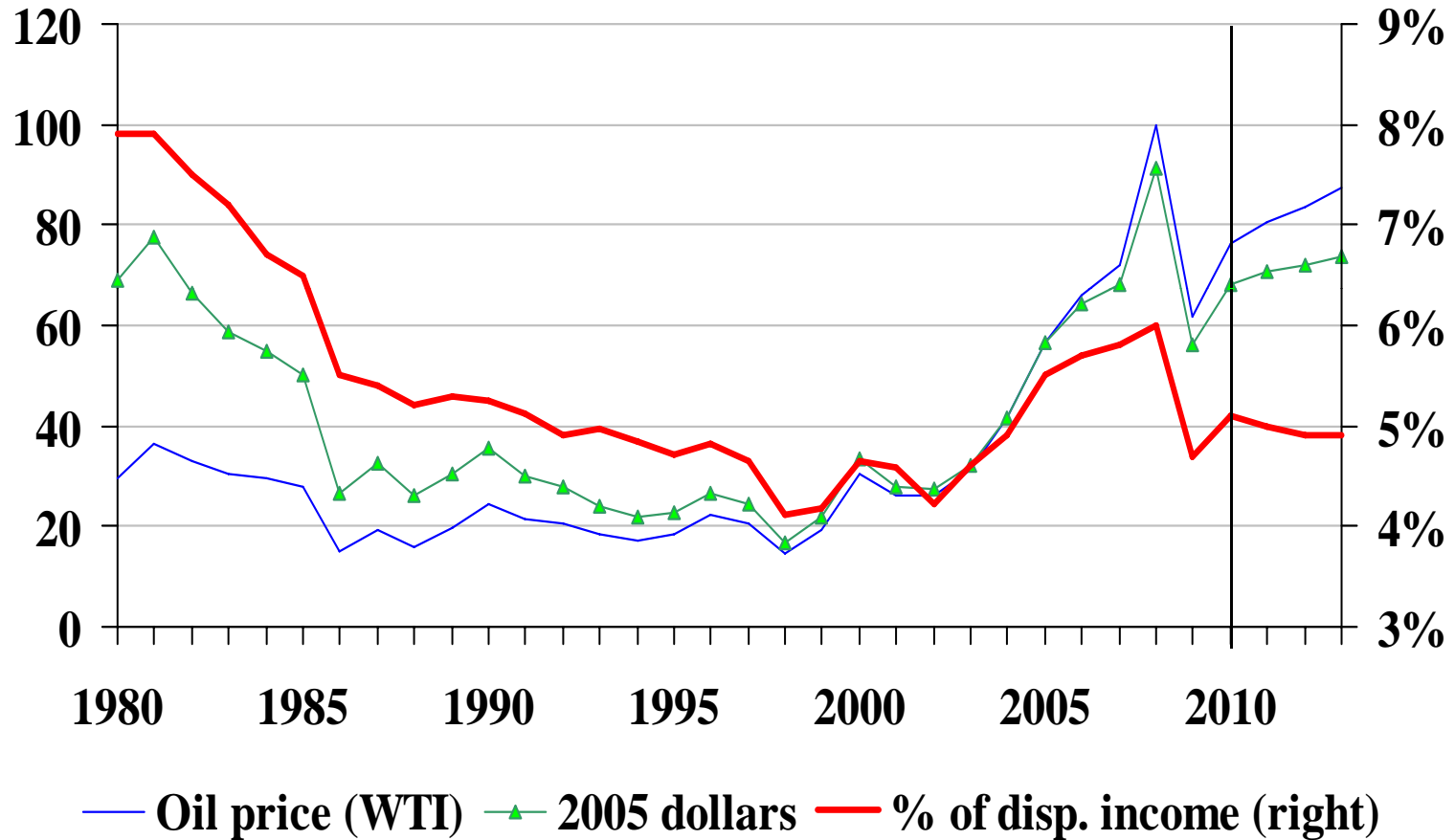
(4-quarter percent change)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, S&P projections

Oil Prices Have Dropped

(\$/barrel, WTI and deflated by CPI; household energy purchases as percent of disposable income)



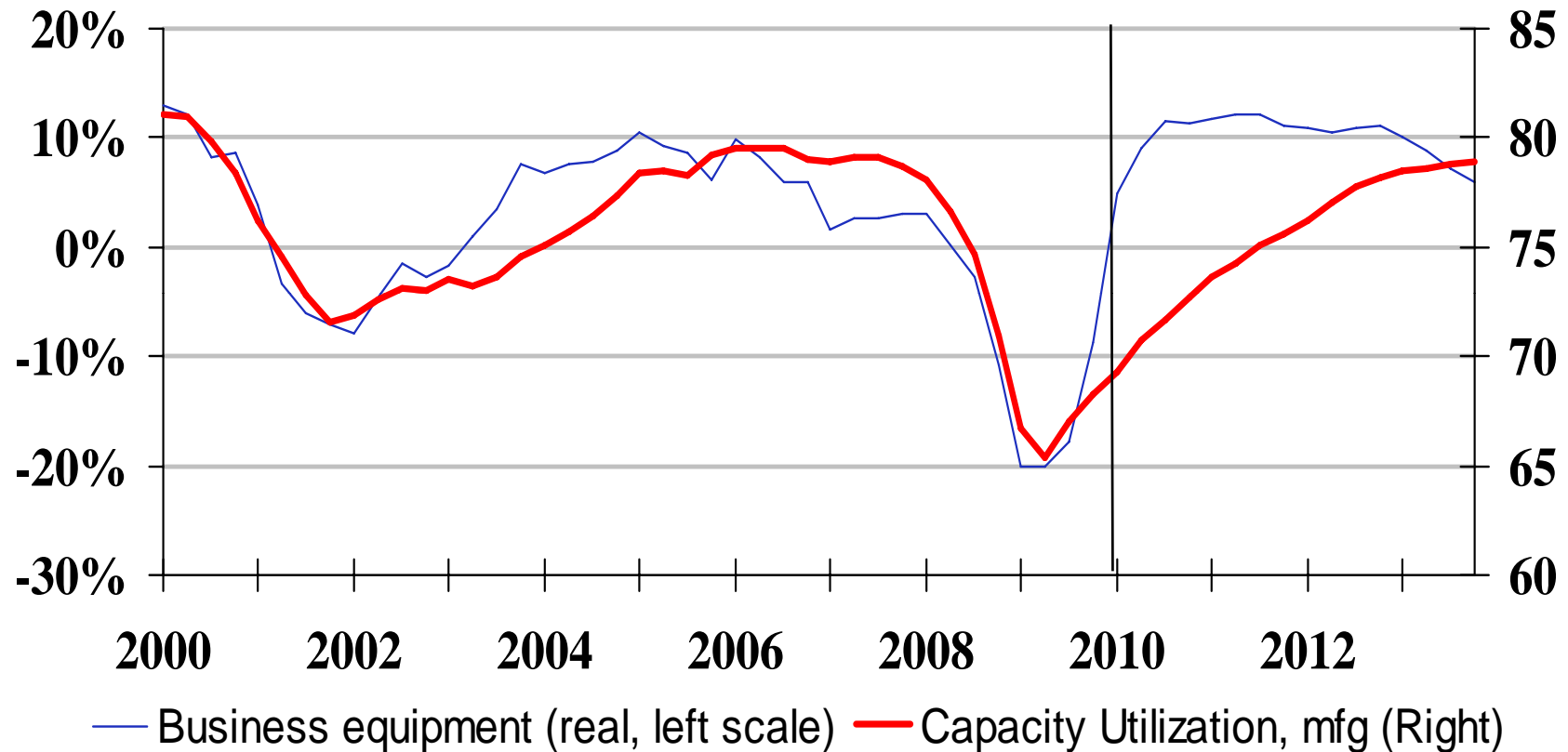
Source: Bureau of Economic Analysis

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Equipment Spending Follows Capacity Needs

(4-quarter percent change)

(Percent)



Source: Federal Reserve, Bureau of Economic Analysis

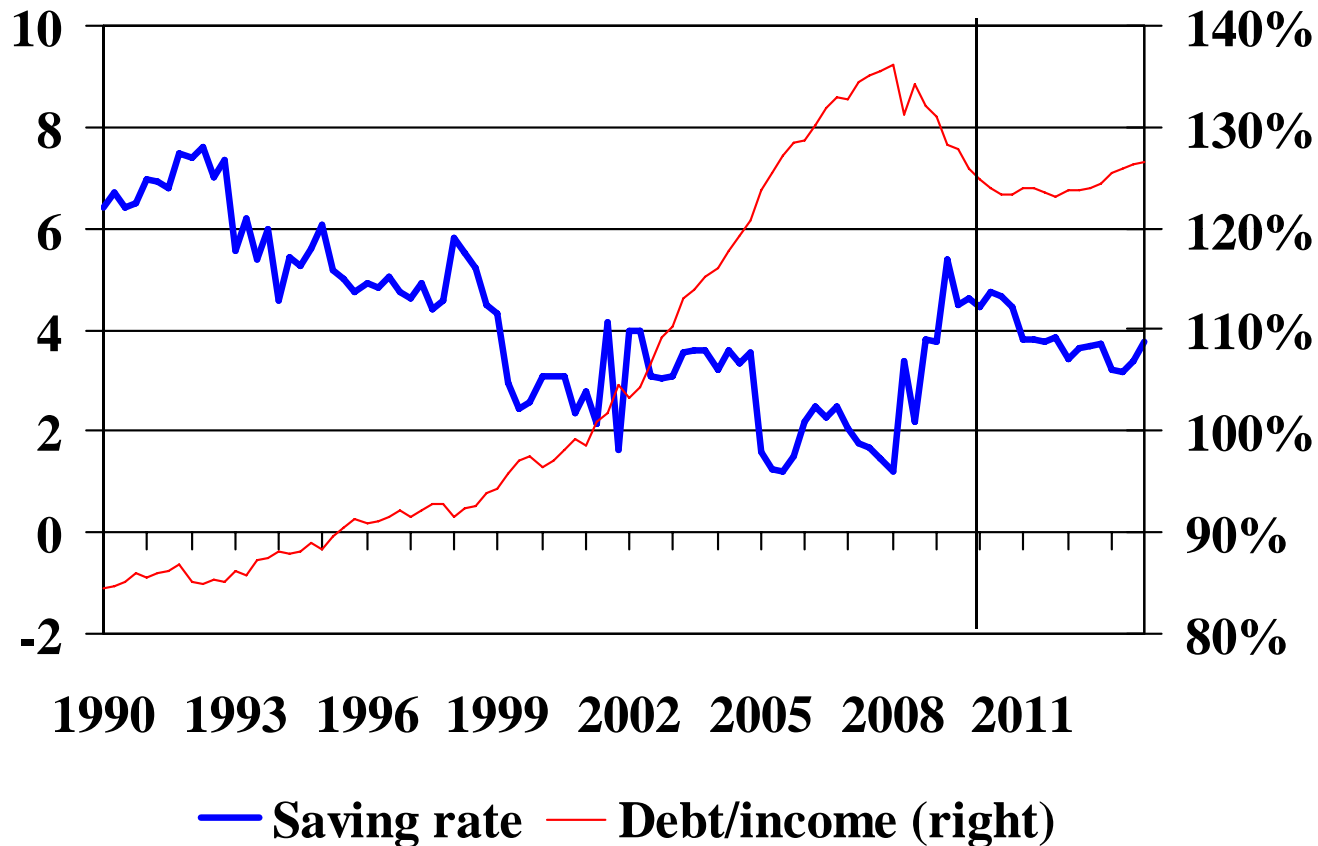
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Can the Consumer Keep Spending?

- **Consumer spending led recent expansions**
- **But wealth is down because home prices have dropped and**
- **Stocks are still down sharply from their 2007 peak**
- **Borrowing is more difficult, and home equity loans much less available**
- **Confidence has dropped and unemployment risen**
- **Consumers are likely to continue to save more and borrow less**
- **Falling oil prices gave back some purchasing power, but that is now reversing**
- **Stimulus package provides some income boost**

No Savings, But Lots of Debt

(Percent of after-tax income)

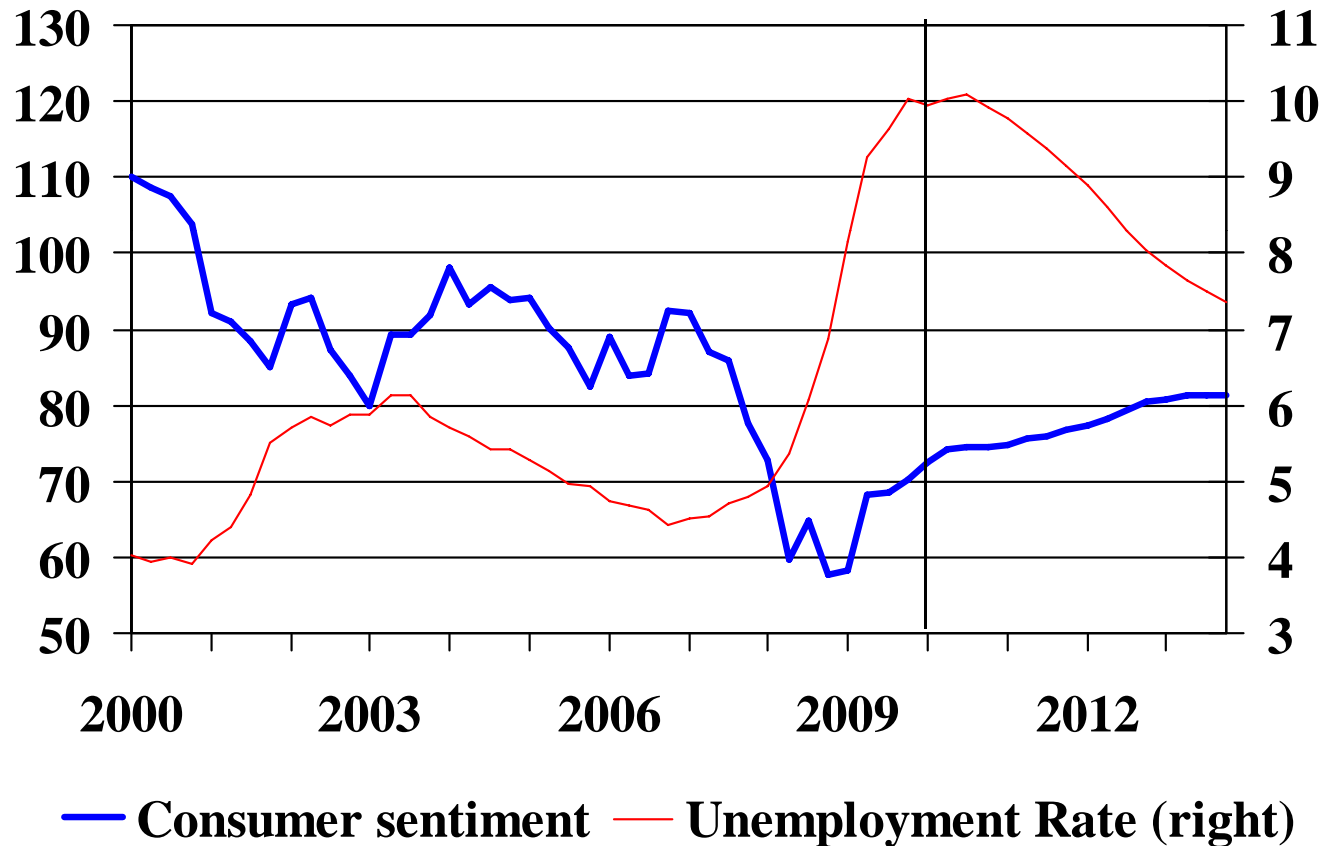


Source: Bureau of Economic Analysis and Federal Reserve

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High Unemployment Scares Consumers

(Percent)

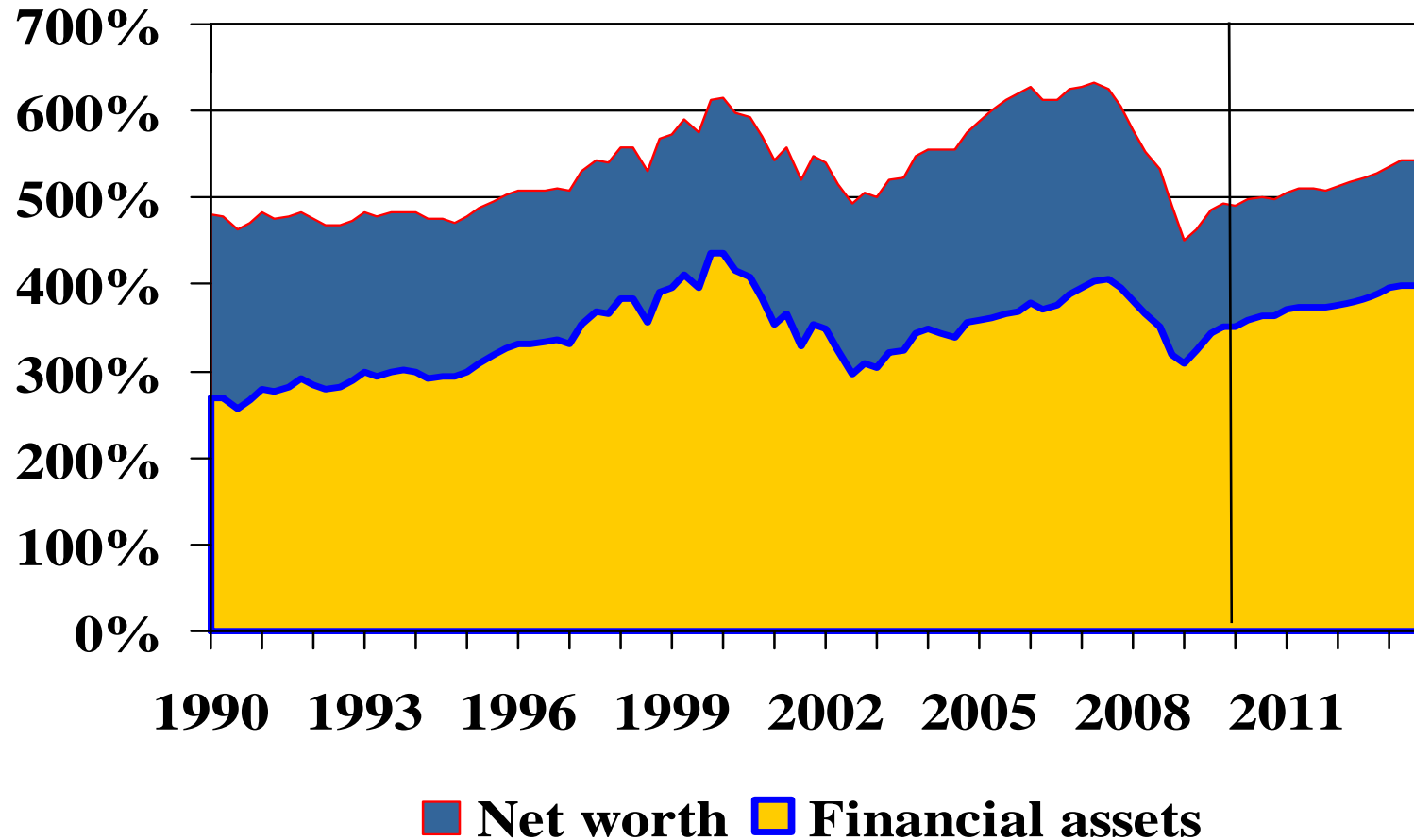


Source: Bureau of Labor Statistics and University of Michigan Survey Research Center

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Wealth Slides With Home and Stock Prices

(Percent of after-tax income)

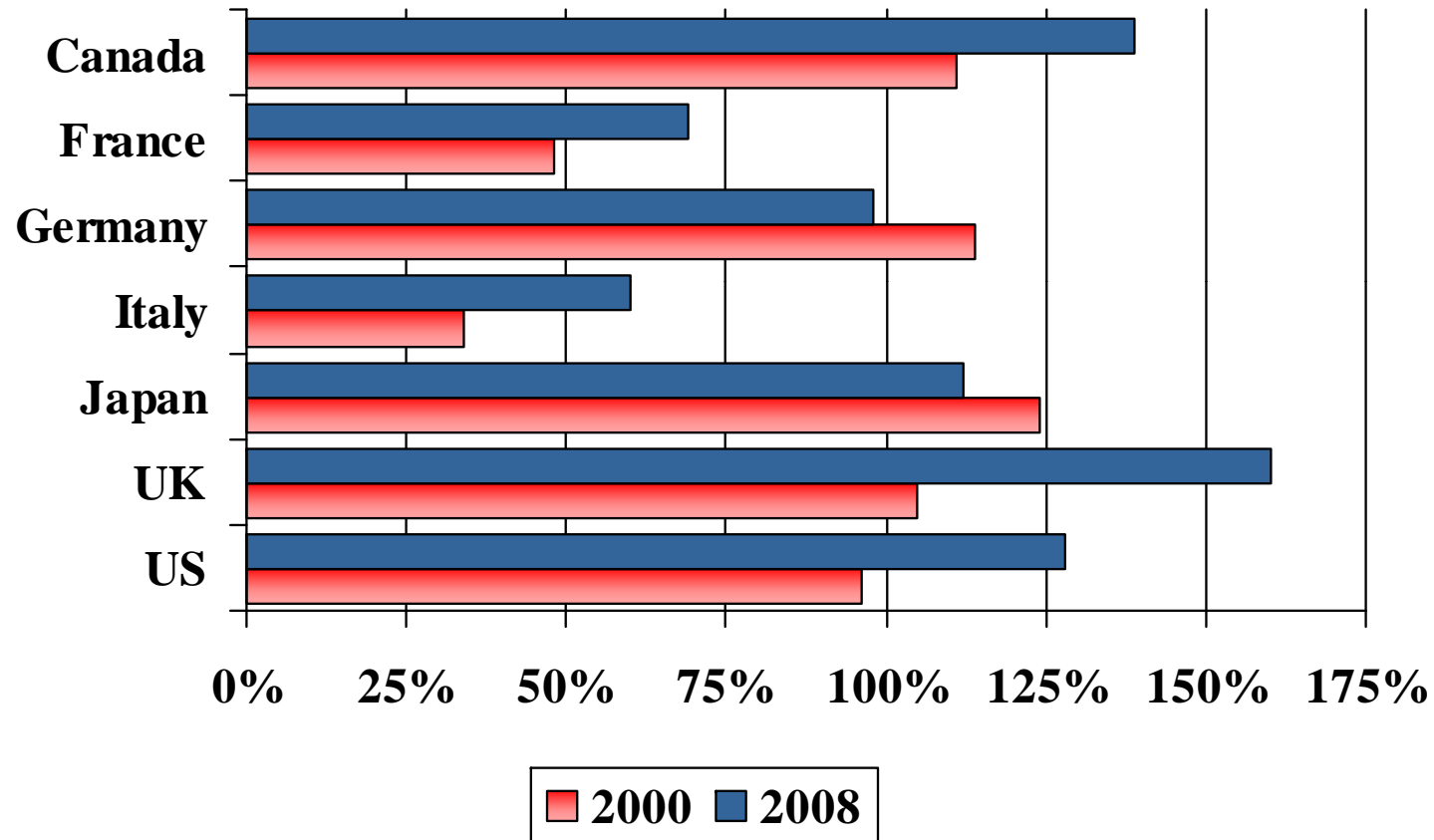


Source; Federal Reserve

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Household Debt By Country

(Percent of income)



Source: McKinsey Global Institute

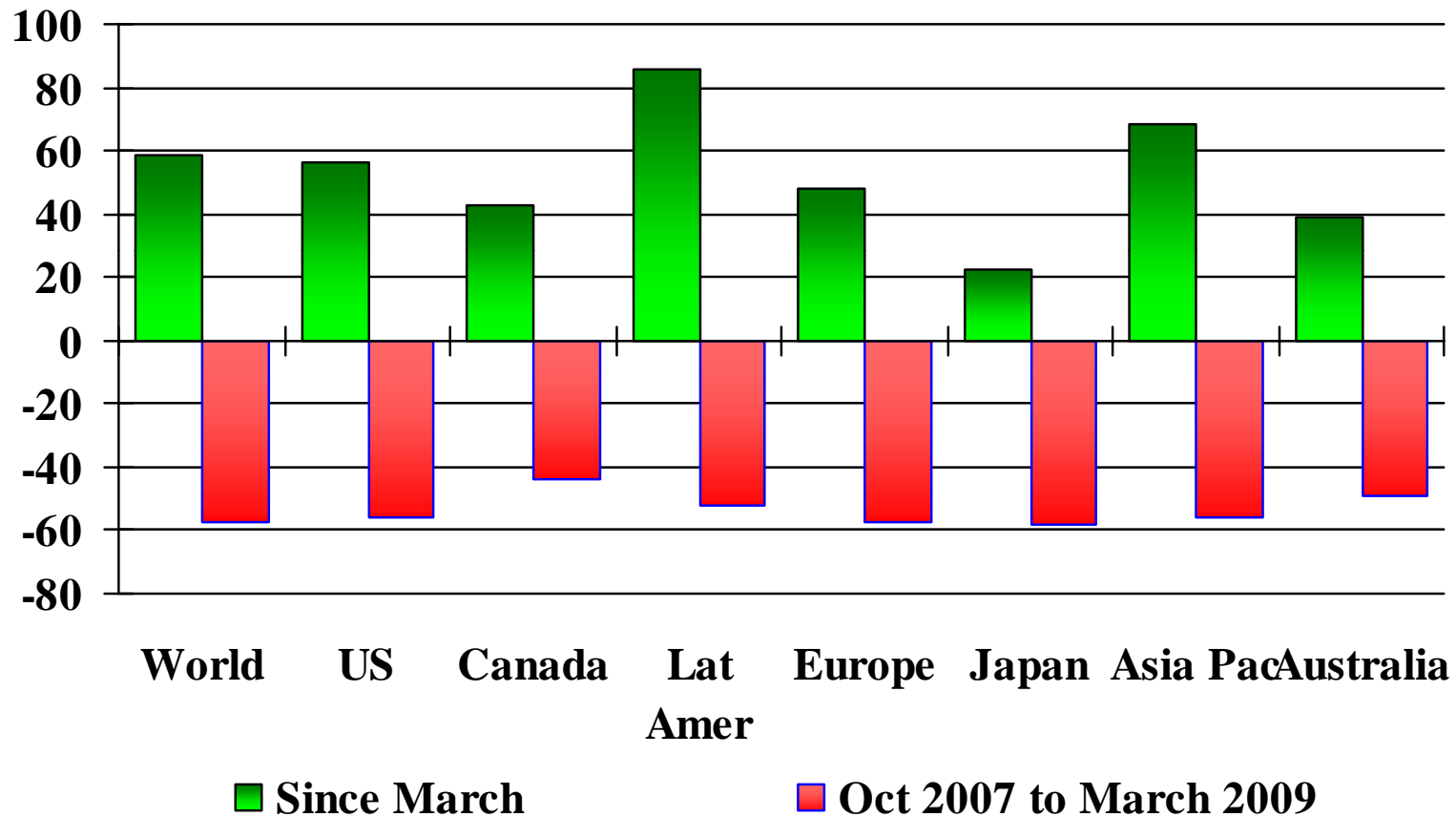
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Bigger Than The Average Bear

- **A great run from 1982 to 2000**
- **But the secular bear began in 2000**
- **Two largest bear markets since the depression**
- **Earnings were negative in Q4 for first time in history**
- **Stocks were overdue for a correction**
- **We think the rally will continue**
- **But a near-term correction is likely.**
- **The long-term cycle probably has another bear in it.**
- **World stock markets have become synchronized**

Everybody's Down

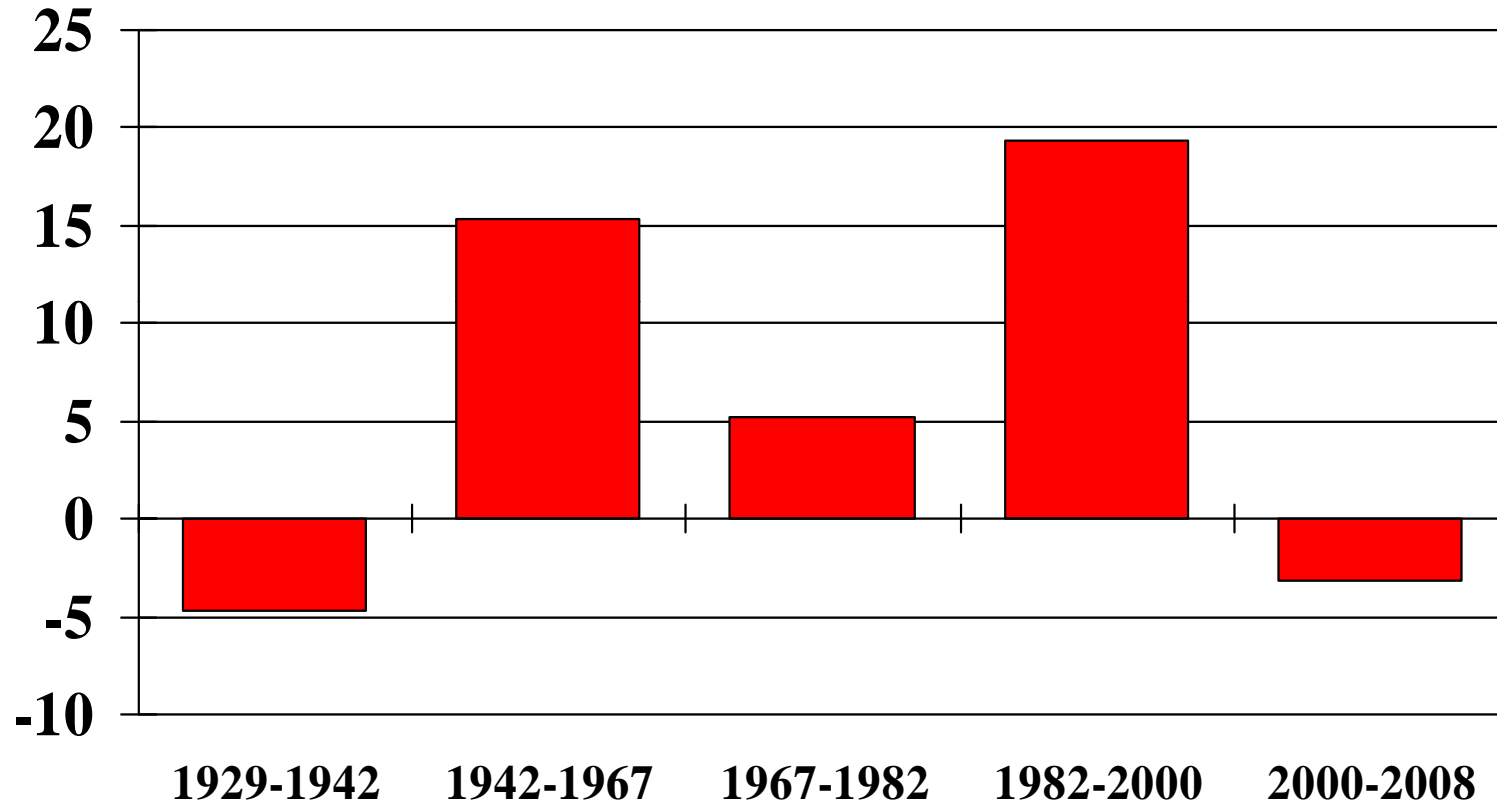
(Percent change in stock prices, Feb. 10)



Source: Standard & Poor's

Stocks Cycle

(Annualized total return, S&P 500)



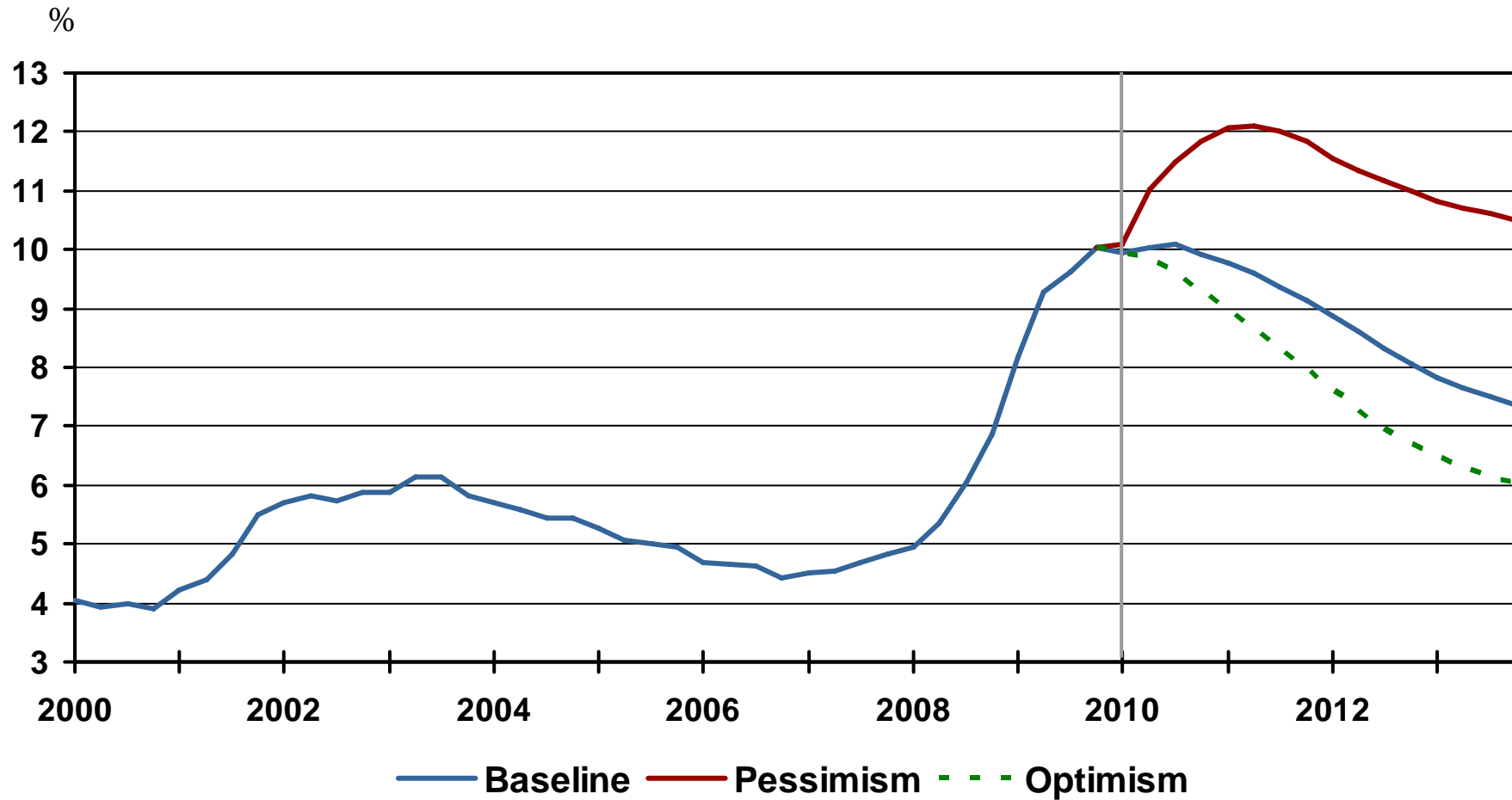
Source: Standard & Poor's Index of 500 Common Stocks

Bottom Line: The Economy Will Recover Slowly

- **The recession is the longest and deepest since the 1930s**
- **Fiscal stimulus will support the recovery**
- **But recovery is likely to be slow because of financial markets and switch to higher savings**
- **If financial markets lock up again**
- **Home prices continue to fall**
- **And oil prices continue to rise**
- **The recession could be longer and deeper**
- **With the risk of a “lost decade” similar to Japan in the 1990s**

Risks to the U.S. Economy

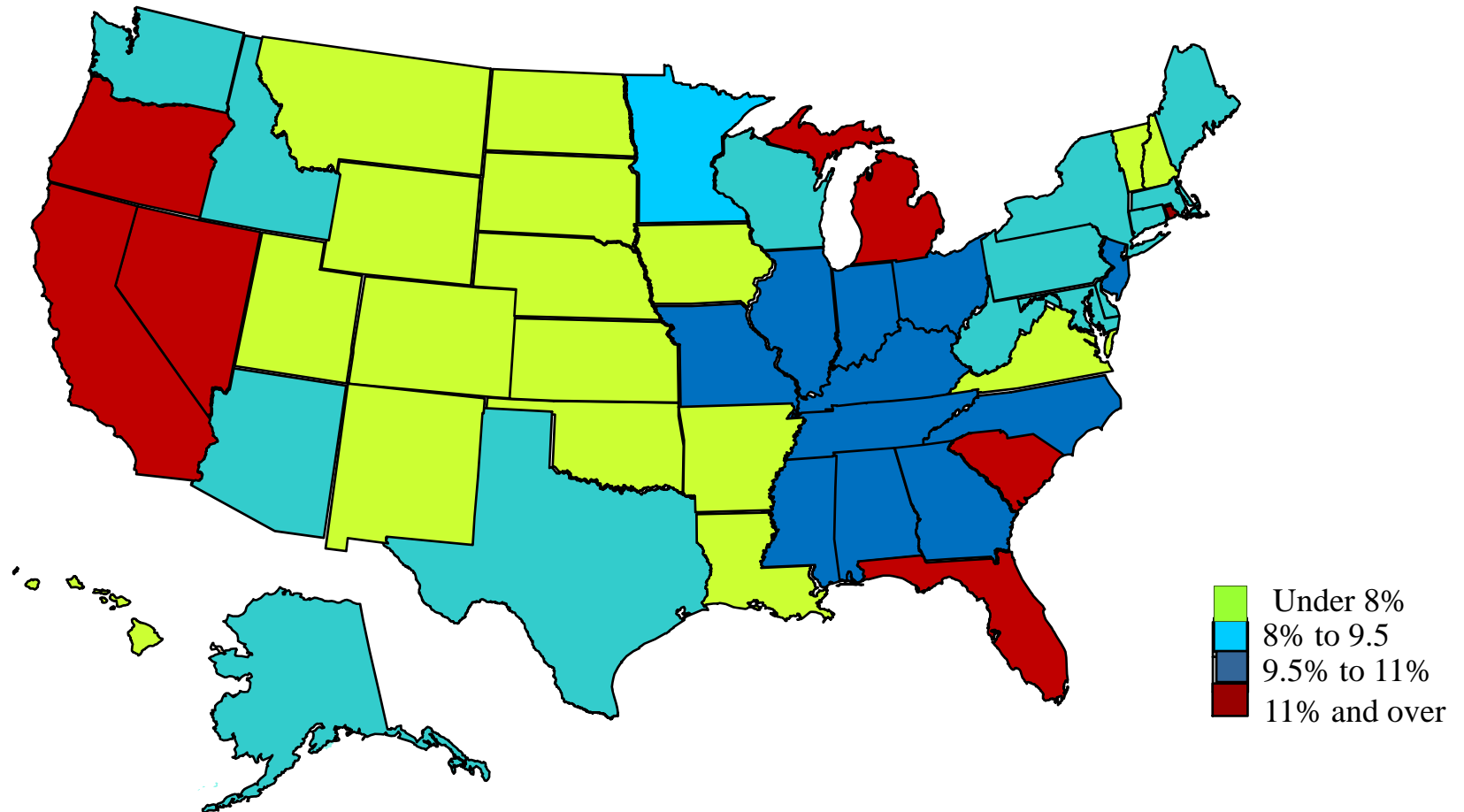
The Unemployment Rate



Source: U.S. Bureau of Labor Statistics (BLS), Standard & Poor's projections.

Unemployment Rates Are High

(November 2009)



Source: BLS

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