

Economic Update



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The term recession seems inadequate to describe this downturn. Depression seems more appropriate, but historians will tell you that the depressions of the 1920s and 1930s were marked by double-digit declines in real gross national product. Indeed, the reason the term recession was adopted after the Great Depression was to avoid the negative connotations associated with the word depression, and to distinguish milder downturns from more crushing ones. Our forecast for a peak-to-trough decline in real GDP of 3.6% points to the deepest contraction in real output in the post-World War II era. Were it not for an unprecedented level of government support, I am certain that I would be writing about a depression rather than a recession. Then again, I would probably be unemployed, which reminds me of the old joke: A recession is when your neighbor loses his job. A depression is when you lose your job.

While the collapse in economic activity is striking, the reaction by public authorities is even more extraordinary. Congress has agreed to appropriate more than \$1 trillion to directly support the economy, and the public balance sheet has also been used to extend trillions of additional dollars in guarantees and loans to support our financial system. The Federal Reserve, Treasury, and Federal Deposit Insurance Corporation (FDIC) have skillfully responded to this crisis by designing a variety of programs aimed at shoring the financial markets—we shudder to consider the state we would be in had they not done so. Still, in this process, the influence of the Fed and the FDIC appears to have extended beyond the levels envisioned in their charters. Mission creep is unavoidable given the consequences of inaction, but it will have to be addressed as part of the redesign of the regulatory architecture.

Congress, meanwhile, has been putting on quite the theatrical show in an effort to please voters and deflect blame. Unfortunately, some of the rhetoric coming from Washington has stoked panic conditions and diluted the impact of policies designed to stabilize the system. Nonetheless, in the first quarter, Congress passed the President's

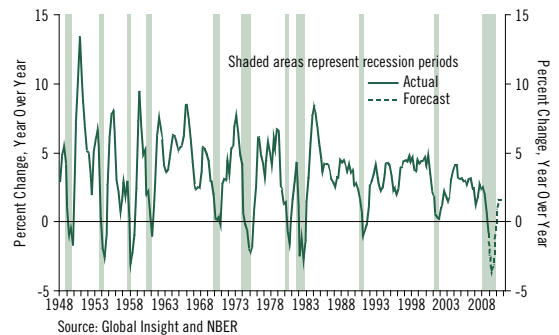
Economic Recovery and Reinvestment Act of 2009, a \$787 billion fiscal stimulus plan. This package should provide meaningful support for the economy starting in the second quarter of this year. In addition, Congressional Democrats endorsed President Obama's ambitious and expensive budget proposal aimed at overhauling the government's role in healthcare, energy, education, and the environment.

According to the Congressional Budget Office (CBO), the federal budget deficit will reach \$1.8 trillion this fiscal year (assuming that the budget is fully enacted), and it will not shrink below \$650 billion in the visible future. In other words, huge fiscal deficits are expected to become structural rather than cyclical. The expected persistence of huge deficits points to an equally-massive increase in the public debt. The CBO expects publicly-held

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Real Gross Domestic Product

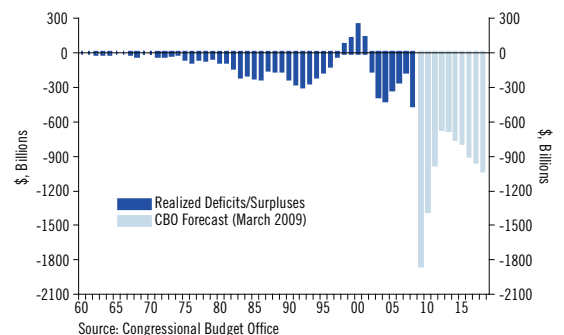
A very long and very deep recession



Source: Global Insight and NBER

Federal Budget (Fiscal Years)

CBO estimates based on the president's budget



Source: Congressional Budget Office

- ▶ Treasury debt to surge from 41% of GDP in 2008 to 70% in 2012. Even if the budget is reduced significantly, the CBO still has a base-line estimate of 62%—not since World War II has there been an increase of this magnitude.

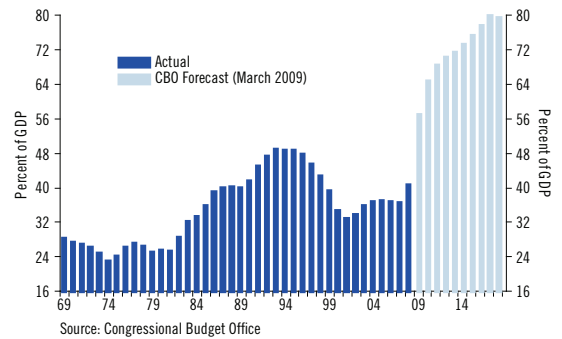
Not surprisingly, the Treasury is under significant pressure to come up with funding for the economic stimulus and financial system support programs. In the first quarter, record Treasury issuance put some upward pressure on interest rates, but because of continued safe-haven demand and little private sector issuance, the auctions were fully subscribed and interest rates did not rise significantly. Nonetheless, at the March Federal Open Market Committee (FOMC) meeting, the Fed agreed to begin actively buying Treasury securities in addition to expanding the purchasing program for mortgage-backed bonds and agency debentures.

The Fed's stated goal is to increase the level of monetary stimulus. The beneficial and probably purposeful side effect is that the Fed's actions have driven down the conforming mortgage rate to a level that encourages the vast majority of mortgage holders to refinance their loans. Moreover, new government policies to ease lending standards should help many mortgage holders who were previously restricted from refinancing because of high loan-to-value ratios. Ideally, the refinancing of mortgage loans will slow the foreclosure rate, reduce downward pressure on house prices, and relieve some of the bad debt problem at financial institutions.

The overarching goal of the myriad financial support programs is to significantly loosen the credit crunch. The Treasury's plan is to use the Public-Private Investment Program to remove some of the bad debt on banks' balance sheets, while simultaneously using the Capital Assistance Program to plug holes in the capital base at systemically important banks. Other support programs, particularly in the housing arena, will hopefully keep performing loans performing and further reduce the bad debt problem. If the Financial Stability Plan works, then credit conditions should significantly loosen, and the government will be

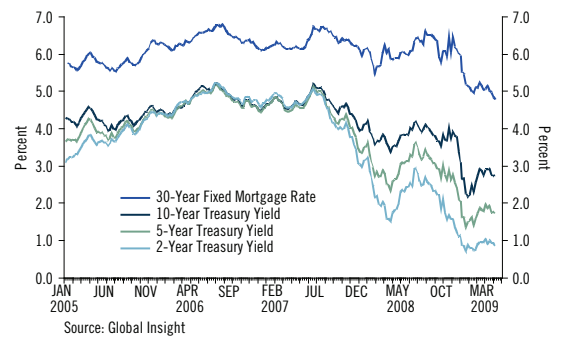
Federal Debt Held by the Public

CBO estimates based on the president's budget



Key Borrowing Rates

Fed buying has reduced rates



able to transfer its role as capital provider back to the private sector. Skeptics rightfully point to the numerous problems with the Treasury's plan, but we believe public policy is finally moving in the right direction and that, in time, it will be successful.

We also believe the economy has entered a new phase in the economic cycle that brings it much closer to the bottom. During the first quarter, real consumption increased slightly following a collapse in the second half of last year. This is an important development because, if sustained, business managers will finally be able to bring their output level back in line with demand. Before, business managers could not cut capacity, inventories, and labor quickly enough because demand was falling at an even faster pace.

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► Real GDP growth, which plunged at a 6.3% annualized rate in the fourth quarter of 2008, is likely to fall at close to a 5.5% pace in the first quarter of 2009, before shrinking again at a 1–2% annualized rate in the second quarter. Over the summer, though, we expect the level of real GDP to reach a trough and begin to expand again in the second half of this year at roughly a 1.5–2.5% pace.

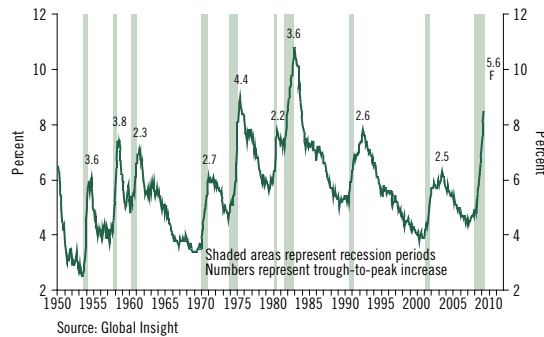
The labor market continues to experience dramatic declines, and it is the biggest risk to our outlook for stable consumption. During the first quarter, the average monthly decline in nonfarm payrolls was 685,000, and the unemployment rate increased to 8.5%. To date, more than 5 million jobs have been lost, and the unemployment rate has risen more than four points from its low. Looking ahead, we expect the unemployment rate to reach 10%, while total job loss reaches 7.5 or 8 million. Thus, we believe we are about two-thirds to three-quarters of the way through the labor market correction.

It is not unreasonable to wonder how we can expect real consumption to stabilize or increase in an environment where jobs are still being destroyed and wage and salary income is falling, particularly given that, with the level of wealth destruction that has occurred, investment income is also on the decline. Households are more focused on saving rather than buying, and even if a consumer wants to buy a durable good, access to credit remains severely impaired. All of these points are valid and are key reasons why we expect real consumption growth to be slow for several years to come.

Nonetheless, we expect consumption to expand. Real disposable incomes are rising, providing the wherewithal for consumption to increase despite the above-mentioned constraints. Government transfer payments, tax relief, and disinflation have

Unemployment Rate

The unemployment rate is on track for a record increase



lifted real disposable income and should continue to do so, on balance, for the next few quarters. As long as inflation does not pick up markedly during this period, consumption should expand. Ideally, in 2010, income growth will start to pick up just as government support begins to fade. This transition will have to be monitored closely because a failure here could result in a double-dip for the economy.

In summary, we believe the economy is headed for a turn this summer, but we characterize our view as cautiously optimistic. Once the economy turns, we believe economic growth will remain constrained for at least a couple of years and possibly longer. We are greatly concerned about the public deficit and the debt outlook for our country, and we are concerned that politics might interfere with prudence when it comes time for the Fed, the Treasury, and the FDIC to unwind their support policies. We hope that policymakers across all governments will be ever mindful of the long-term consequences of their actions and focus on the long-term protection of the economic and financial system which, despite current humbling conditions, is truly great. ■

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