

DWIGHT ASSET MANAGEMENT COMPANY LLC

# Economic Update



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Following four consecutive quarters of declining economic output, real GDP is set to expand by roughly 3% on average for the final two quarters of 2009. Just about all of this growth can be traced back to various fiscal and monetary policy support programs, but under their protective cast the economy is in fact healing. In 2010, the economy will still be convalescing, but real GDP growth of 2.5–3% seems likely. We are on the lookout, however, for potential shocks that could set the recovery process back. Should that happen, we expect policymakers to administer additional stimulus.

The list of potential shocks is long, but the one that we spend the most time thinking about is a policy mistake. Our concern is not based on low regard for the skill sets of key macro policymakers, but the realism that accurate forecasting near big inflection points is almost impossible. Indeed, the range of forecasts on Bloomberg for 2010 real GDP growth is -0.1% to 4.0%. Similarly, FOMC-member 2010 GDP growth projections range from 0.8% to 4.0%. These varied opinions will be a challenge for consensus-style decision making. The likely outcome is that monetary policy will be tightened either too quickly or too slowly. A Goldilocks outcome is unlikely.

One thing that most economists seem to agree on is that the outlook for inflation is troubling. In the near term, disinflation is expected to prevail because of the extensive amount of excess capacity at home and abroad. In 2010, we expect core consumer inflation to slip below 1% and possibly approach 0%. This is not a pernicious outcome as long as long-term inflation expectations do not react. Fortunately, it takes a lot of force to shift long-term inflation expectations, as demonstrated by their persistently narrow range during the crisis. Still, not since the 1930s have we experienced such a sharp rise in unemployment coincident with very low core inflation rates. Thus, there is a danger that a double-dip scenario could spark a wage-price negative feedback loop that leads to deflation. Having witnessed the destruction caused by house price

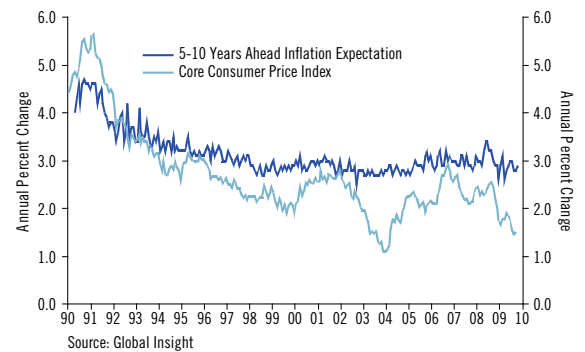
deflation, we do not want to entertain the thought of economy-wide deflation.

Nor do members of the Federal Open Market Committee (FOMC) or any other person charged with overseeing the economy. This is why there has been an unprecedented effort to halt the turmoil in the financial markets and re-inflate the economy. The fact that the economy is now in recovery mode is a great relief—even if the recovery is likely to be characterized by slow growth and high unemployment. In fact, a slow, sustained recovery is better than a rapid recovery because it will allow the Fed more time to calibrate monetary policy.

Removing the extraordinary degree of monetary accommodation will ideally be accomplished over an extended period because a rapid adjustment could send the economy into a tailspin. During *continued on the following page*

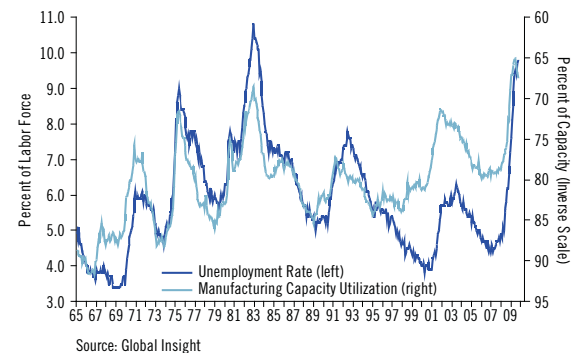
## University of Michigan Inflation Survey

Long-Term Inflation Expectations Are Still Contained



## Unemployment & Capacity Utilization Rates

Excess Slack Is Putting Downward Pressure on Inflation



► 2010, we expect the FOMC to take some slack out of the reins, but we do not expect them to pull back on the bit. By this we mean that the Fed will seek to mop up excessive liquidity without stifling credit creation. Today, the Federal Reserve's balance sheet is about \$2.2 trillion, and it may reach \$2.5 trillion early next year. In September 2008, just prior to the failure of Lehman Brothers, it was about \$900 billion. Similarly, excess reserves are currently \$850 billion compared to about \$50 billion in September 2008. As the Fed's market liquidity programs are reduced or canceled, excess reserves will be reduced, but they will still exceed \$500 billion. To extinguish additional reserves, the Fed will need to engage in asset sales. We highly doubt that the Fed will seek to do this before it is abundantly clear that labor and capacity utilization rates are recovering and deflation risks are receding.

Instead, we expect the Fed to take some of the slack out of the reins by lending out (reverse repo) some of the bonds it holds and otherwise encouraging banks to commit to keeping excess reserves at the Fed. Only if market conditions are conducive do we expect the Fed to raise the federal funds rate by paying a higher interest rate on reserves.

Historically, explosive growth in the monetary base has been associated with a surge in inflation. The reason inflation has continued to fall is because the velocity of money has collapsed. This is evidenced by the fact that M2 money supply has not risen simultaneously with the surge in excess reserves, which are part of the monetary base. If the velocity of money—the speed with which money circulates through the economy—were to recover too quickly, the Fed would need to dampen it or shrink the monetary base. Those fearing rapid inflation, however, are worried that the Fed will not act quickly enough or that the FOMC's actions will not have the desired effect, given they will be working with many previously untried tools.

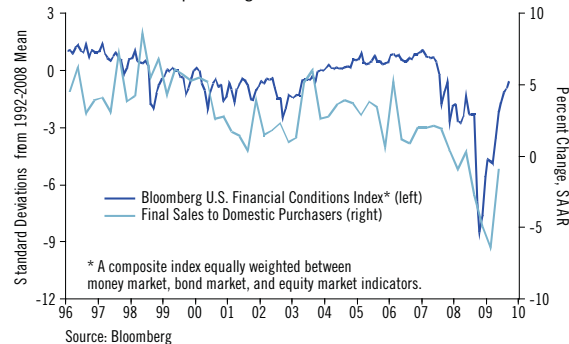
The good news is that we are still a long ways away from the point where inflation will become a threat, so policymakers have plenty of scope to remain accommodative in 2010. It bodes well for economic growth next year that recoveries in the financial markets and global economies are becoming mutually reinforcing. Indeed, the Bloomberg Financial Conditions Index for the United States is now just 0.6 standard deviations below the neutral level, compared to 8.5 standard deviations below normal a year ago. Granted, credit creation will remain muted because commercial banks are still reluctant to lend and the shadow banking system is dysfunctional, but the credit crunch is clearly easing.

Also pointing to a recovery is the index of leading economic indicators, which has risen for six consecutive months, as has the ratio of the coincident to lagging indices, itself a leading indicator. Meanwhile, the Institute for Supply Management's purchasing

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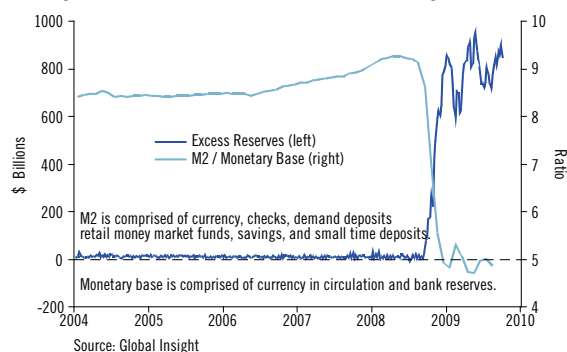
### Financial Conditions & Domestic Demand

A Virtuous Feedback Loop Has Begun to Take Hold



### Federal Reserve Banks: Excess Reserves

The Surge in Excess Reserves Has Not Caused a Similar Surge in M2



▶ manager indices have rebounded to levels consistent with expansion in the manufacturing, construction, and service sectors. A significant portion of this growth reflects the need to slow the pace of inventory destocking following excessively sharp cutbacks, but inventory rebalancing is expected to help generate endogenous growth by putting people

back to work. Generating increased labor income is really the key to not only a sustained recovery but also a successful transition from assisted living to independence. At this time, the labor market is still far from fulfilling this obligation, but we believe it will in 2010...barring an exogenous shock or a disastrous policy mistake. ■

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