# The United States

## The Near-Term Backdrop In The US Has Become Increasingly Iffy

*Economic growth had been relatively modest through the first six months of 2008; however, the outlook for the next six months or so would likely be grim. Since financial market conditions have clearly worsened of late, this could potentially suppress the growth trajectory further.*

*The Fed has signaled the importance of using various liquidity programs and measures to address market strains, and the ongoing structural shift in Fed policy necessitates the consideration of all conventional and non-conventional policy options in the coming months.*

*While the target fed funds rate has been unchanged since April, more serious growth concerns recently have compelled an intermeeting cut of 50bps to 1.50%. Our forecast anticipates the target funds rate to head towards 1.00% by the end of 2008.*

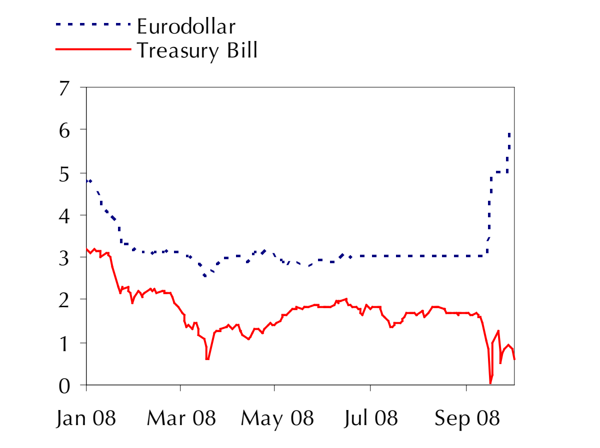
*While the greenback has generally appreciated against a broad array of currencies in recent months, the gains relative to its major trading partners have been more pronounced. But the trading environment is still expected to remain reasonably volatile.*

The US economy grew by almost 2% in the first six months of 2008. Interestingly, the headline growth figure still appears relatively modest despite continuing strains in the money market. The overall growth composition, however, was heavily supported by the contribution from net exports--more specifically, the marked contraction in imports and relatively solid growth in exports. Evidently, the boost from net exports, which aggregated to nearly 4% in the first-half of 2008, was the largest in almost three decades. Even though the net trade category had more than offset the decline in residential investment, the foregoing aggregate demand composition is clearly unsustainable. To be sure, the downside risks to our growth outlook have clearly intensified of late. In fact, the incoming evidence thus far implies that 3q08 real GDP growth could come-in slightly negative, which puts the second-half 2008 outlook about flat at best. Admittedly, the growth trajectory in 2009 remains hazy at this juncture; however, our baseline forecast anticipates the 4q09/4q08 growth figure to remain in the vicinity of less than 1%.

| US Macro Forecast | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| (%) | 1q08 | 2q08 | 3q08E | 4q08E | 1q09E | 2q09E | 3q09E | 4q08/4q07 | 4q09/4q08 |
| Real GDP (ar) | 0.9 | 2.8 | -0.4 | 0.4 | 0.3 | 1.0 | 0.8 | 0.9 | 0.8 |
| Real PCE (ar) | 0.9 | 1.2 | -1.8 | 0.3 | 0.4 | 1.0 | 0.6 | 0.1 | 0.7 |
| | | | | | | | | 2008 avg | 2009 avg |
| Unemployment Rate (avg) | 4.9 | 5.3 | 6.0 | 6.5 | 6.7 | 6.7 | 6.7 | 5.7 | 6.8 |
| Total CPI (oya) | 4.2 | 4.3 | 5.4 | 4.1 | 3.5 | 2.7 | 1.5 | 4.5 | 2.4 |
| Core PCE Price Index (oya) | 2.2 | 2.3 | 2.5 | 2.4 | 2.3 | 2.3 | 2.0 | 2.3 | 2.1 |
| | | | | | | | | | |
| End of Period (%) | 1q08 | 2q08 | 3q08 | 4q08E | 1q09E | 2q09E | 3q09E | | |
| Target Fed Funds Rate | 2.25 | 2.00 | 2.00 | 1.00 | 1.00 | 1.00 | 1.00 | | |
| Note: Over-a-year-ago (oya); annual rate (ar); average (avg) | | | | | | | | | |
| Source: Actual data sources and UOB forecast | | | | | | | | | |

The continued deterioration in labor markets, still lofty gasoline prices, tight lending standards and fragile financial market conditions are expected to weigh on consumer spending. Indeed, the incoming indicators suggest that real consumer spending could contract by around 2% in 3q08. The havoc in financial markets over the past several weeks (commencing with the Fannie and Freddie conservatorship announcement to the recent "Troubled Asset Relief Program" proposal), should it persist, would certainly raise the downside risks on the economy further. In general, US financial markets are still stuck in the high volatility cluster. But the task of quantifying the effects of the ongoing strains in financial markets on the overall economy is somewhat challenging.

3-Month Spreads have Blown-Out (%)

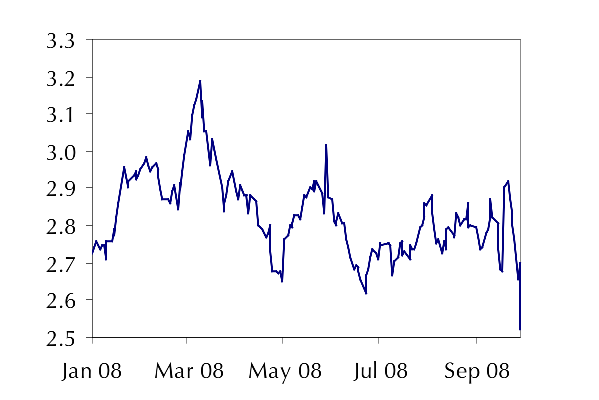



Source: Fed

Similarly, reduced demand expectations combined with the ongoing compression in profit margins should depress business capital spending and perhaps temper the incentive for aggressive inventory rebuilding. Also, the forward-looking indicator of nonresidential structures points to a more moderate growth trajectory. On the flip-side, however, the incoming guidance on residential spending appears to suggest that the pace of contraction could be less intense in the coming months. Likewise, the stabilization in home sales, while still somewhat hesitant at this stage, could ease the housing imbalance and limit the downside risks in home prices. Nevertheless, since total nonresidential investment and consumer spending account for over 80% of GDP, the overall economic backdrop is likely to remain soft for the time being. Indeed, the general recognition among policymakers is that "downside risks to the outlook…remain a significant concern".

Although headline inflation is poised to continue easing from an elevated level, the observed volatility in energy prices could present some complexities in the projection. However, the recent slide in inflation expectations and lower degree of pass-through are important offsetting factors, which should provide some solace to policymakers. Indeed, the Fed intermeeting statement recently (with the announcement of coordinated rate cuts of 50bps) also suggests that the Committee has toned down its near-term concerns on upside risks to inflation.

5-year/5-year Breakeven Inflation (%)




Source: US Treasury and Proprietary Data

## Fed Policy: Desperate Times Compel Desperate Action[1]

The Federal Open Market Committee, against elevated market expectations for a rate cut, maintained the target fed funds rate at 2.00% at its recent meeting on September 16. Then on October 8, the Committee announced an intermeeting rate cut of 50bps together with five other major central banks. The individual policy rates of the respective central banks are as follows: BoC at 2.5%; BoE at 4.5%; ECB at 3.75%; Fed at 1.5%; Riksbank at 4.25%; and SNB with a target range between 2% and 3%.

Unfortunately, the joint monetary policy action also has drawbacks. ***Firstly***, it could convey a sense of panic and confusion, which could potentially lead to a negative feedback in prices of riskier assets, partly because it might imply that the current situation is equally dire across these countries, and that investors could be instigated to shun risk exposures en masse. ***Secondly***, policy rates globally are at different levels; therefore, the costs of rate cuts are not equally distributed (since the target fed funds rate is now closer to the lower-bound, the costs and implications of further reduction by the Fed are obviously greater than, for example, BoE). And if the target funds rate pushes against the lower-bound much sooner than expected, while the economy continues to founder, it could spark additional policy concerns. ***Thirdly***, since

[1] The text in this section has been extracted mainly from my September 15, September 17, October 6 and October 9 publications.

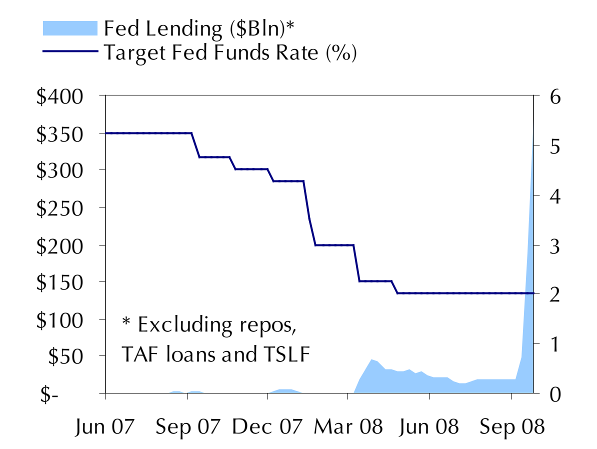
the monetary policy transmission process in the US remains clogged at this juncture (in light of impaired market functioning and unstable financial institutions), the intended effects of policy easing could be fairly muted or completely contradictory. And if so, this could further reinforce the negative psychology in markets.

The accompanying statement by the Fed essentially maintains the inclination to ease further at the upcoming meeting on October 28-29. Specifically, the Committee asserts that the unanimous intermeeting cut of 50bps (on both the target funds rate and discount rate) was "in light of evidence pointing to a weakening of economic activity and a reduction in inflationary pressures". The reference to inflation, which notes that the "decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation", appears to be more toned down from Chairman Bernanke's remarks at the NABE annual meeting on Tuesday.

The ominous emphasis on growth concerns combined with the repetition that the "Committee will monitor economic and financial developments carefully and will act as needed…" effectively leaves the door widely open for additional policy action. As such, I anticipate the target fed funds rate to be reduced by an additional 25bps to 1.25% at the October meeting, and another 25bps at the December 16 meeting to 1.00%.

That said, the overall conduct of Fed policy is not merely isolated to adjustments in the fed funds rate. The various liquidity provision programs and measures--while more targeted and appropriate in addressing market-related considerations--play a crucial role in complementing the available policy options of the Fed. Some of these actions are as follows: The Fed has recently enlarged swap lines with foreign central banks, announced the creation of the Commercial Paper Funding Facility, increased the size of TAF programs, commenced the payment of interest on reserves, approved applications of two major investment banks to become bank holding companies, introduced initiatives that allow banks to finance purchases of high-quality ABCP from money market funds, purchased agency notes from primary dealers, authorized secured lending to AIG under "unusual and exigent circumstances", widened the collateral base of lending facilities to primary dealers, increased the frequency and magnitude of TSLF and temporarily allowed banks to provide liquidity to their affiliates under Section 23A of the Fed Act.

Conventional & Unconventional Fed Policy Tools




Source: Fed

It is imperative to recognize that the Fed seeks to distinguish between macroeconomic concerns (funds rate adjustments) and market considerations (implementing other liquidity measures). Although one could contend that a lower target funds rate per se might boost confidence in the equity market supposedly, the evidence from the previous seven rate reduction episodes (since September 2007) is fairly mixed, and that the positive reaction in US equities, in most cases, was not sustained. Nonetheless, I continue to expect the Fed to further accentuate its approach of using the asset-side of its balance sheet to conduct the various liquidity provision programs and unconventional policy measures to combat the unprecedented strains in credit markets.

### Despite Recent Gains in the Dollar, the Trading Horizon Remains Vague

The broad and major trade-weighted (real and nominal) US Dollar indexes have recently chalked-up gains of at least 4% since June. The Dollar's increase against its major trading partners was roughly twice as much as compared to the other trading partners. Although the apparent strength in the market exchange rates of the greenback appears fairly broad-based, especially relative to the major currencies, the impetus was not overwhelmingly USspecific. In fact, reduced growth perceptions of US' trading partners and the abrupt revision in monetary policy expectations in these countries had probably been more prominent factors in the equation. For example, the recent banking sector woes in Europe have weighed on the European major currencies relative to the greenback.

Nevertheless, some major currency pairs were clearly more volatile than others. The recent market strains globally, which have evidently intensified, would further complicate any near-term forecast of the respective currency pairs. Furthermore, peculiar knee-jerk reactions and abrupt position adjustments in other market segments (such as commodities and equities) could also impact the US Dollar indirectly and unpredictably.

Perhaps, another important near-term factor that could sway the US Dollar meaningfully is the potential reaction of market participants to the various market-oriented announcements from US authorities. In particular, the market psychology surrounding these announcements and the sustainability of public sector programs in promoting market functioning are key factors. But since the evaluation of these US government programs is likely to take some time, the initial reaction of the US Dollar could fade, and eventually give way to a more volatile trading environment.

Separately, some have cautioned that the US fiscal deficit--as a result of these programs--could hurt the greenback significantly and broadly. Perhaps, the foregoing observation, in reality, might actually be quite contentious. Even though the US federal debt would be more bloated (but the budget deficit could actually narrow over time), the net effect on the US Dollar might still be somewhat ambiguous.