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The proposition that the US economy is slipping into a recession has indeed engulfed economists across the globe into a vivacious debate for several months now. Many in fact argue that the economy is already in a recession for weeks or even months now.

This report will begin with how a subprime crisis followed by a housing bubble collapse in 2006 has translated into a widespread economic slowdown. In order to assess the severity of the current economic downturn, we will look deeply into the recent movements of housing and labor markets, retail sales, industrial production, and private consumption before evaluating Federal Reserve's recent moves to stimulate the economy. The report will conclude with a growth and interest rate outlook for the current quarter and year half.

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THE US SUBPRIME CRISIS: THE FORCES BEHIND

Low interest rates evoked increased subprime lending and thereby housing bubble.

Having emerged more than two decades ago, subprime mortgage lending began to expand in the US in the mid 1990s, and even more rapidly in the beginning of the current decade. In 2001, the Wall Street Journal reported a tripling in the number of outstanding subprime mortgages from 1995.

The expansion of subprime lending was facilitated by many factors such as increases in capital made possible by securitization and development of the secondary markets, technological innovations that reduced the costs for lenders of assessing and pricing risks, and deregulation of the banking industry. These factors in the wake of low interest rates before 2004 (a practice aimed to soften the blow from the collapse of the dot com bubble) increased the appetite for mortgage based securities, in turn spurring increased subprime lending. The subprime borrowers lured by home ownership entitlement continued to borrow heavily.

Hence low interest rates and thereby massive prime and subprime lending lead to an economic bubble in many parts of the US housing market from 2001 to 2005. This was characterized by rapid increases in the valuations of real estate and during this time all was good for both subprime borrowers and lenders. Rising property value meant positive equity for homeowners who were able to use the increased value of their property to refinance their homes with lower interest rates.

However the housing bubble could not have continued to balloon indefinitely.

As the Federal Reserve followed a cycle of interest rate hikes to combat inflation from June 2004 to June 2006, the home prices began to decline leaving homeowners with negative equity - a mortgage debt higher than the value of the property. Thus home owners were unable to meet the financial commitments and lenders were left without a means to recover their losses. Subsequently after years of easy profits, a chain reaction of delinquency, default and foreclosures began to rip through the subprime mortgage industry.

The losses faced by the mortgage industry soon started to cut across other sectors of the economy. Banks and stock markets suffered tremendous losses as billions of dollars were wiped off share prices while the credit markets underwent a period of re pricing and tighter lending standards have been developed. Consequently investment has significantly declined. It is interesting to note that some of the other worst-hit industries have only the vaguest connection with lending or mortgages. Alongside, soaring prices for energy and other commodities have reduced the real household incomes, dampening private consumption. These developments together have aroused strong fears of an economic recession hitting the US economy.



THE CURRENT US ECONOMIC SLOWDOWN: A RECESSION OR NOT?

A leaked report quotes a draft of the IMF's World Economic Outlook which is due to be published shortly, that the US economy "*remains very weak, certainly close to a possible recession.*"

The proposition that the US economy is slipping into a recession has indeed engulfed economists across the globe into a vivacious debate for several months now. While some economists are certain about a recession, others are doubtful. Some argue that the current economic slowdown may be a placid and brief recession and anticipate that the economy may start recovering in the latter part of 2008.

However as job creation, consumer spending and industrial production continue to decline in the wake of a slumping housing market and a severe credit crisis, economists and policy makers become more and more confident of a recession. Many in fact argue that the economy is already in a recession for weeks or even months now.

In late January many economists at the World Economic Forum in Switzerland conceded that the US economy had entered a recession. Likewise last week the US Treasury Secretary Henry Paulson expressed concern of a *sharp* economic turndown. At the same time OECD has stated that the *US economic growth is grinding to a halt* and former Federal Reserve Chairman, Alan Greenspan warned of the *worst* financial crisis since World War Two.

But to what extent does the current economic data confirm these recession trepidations?

The National Bureau of Economic Research (NBER) determines the period and the turning (peak and trough) points of business cycles in the US. By NBER's measure the last US recession lasted from March to November 2001.

According to NBER a recession is defined as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. While GDP estimates are available only quarterly, the other economic indicators are given monthly. Therefore, though GDP is the single best measure of economic activity, NBER places strong emphasis on the latter four to evaluate the performance of the economy on a month to month basis.

Though most economic indicators are currently performing much better than in earlier recessions, the decline depicted by them has been sizeable. The GDP growth for the last quarter of 2007 was recorded at 0.6%.

Following the movement of monthly economic indicators for January and February (pg 4-7), we expect the GDP growth to decline for at least the 1st Quarter of the year.



Housing Slump is by no means over yet.

According to the data released by the Census Bureau housing starts and building permits have dropped further in February with building permits recording the biggest monthly decline since January 1995. On an annualized basis the building permits fell by 7.8% to 978,000 (lowest since September 1991) while housing starts decreased to 1,065,000 units. Starts of single-family homes fell by 6.7%, while starts of multi-family homes improved by 14%. The NAHB Housing Market Index remained unchanged at 20 in March. While this is two points above the record low reached in December, home builders remain cynical.

These numbers thus depict an intensifying housing recession, signaling that the housing downturn is not over yet. Residential investment reached a 25 year low in the second half of 2007 and the drop in housing starts along with that in building permits recorded in January and February certainly signals another huge decline in residential construction activity for the first half of this year.

Retail sales and industrial production have recorded substantial declines.

High energy and commodity prices have substantially eroded the purchasing power of households. This coupled with tighter lending standards by banks have resulted in a decline in retail sales for February which fell 0.6%. However when sales had surged slightly in January fears of a recession had slightly pacified, but Fed's February report has once again made the economists skeptical.

The falling sales were led by the auto dealers. Retail sales excluding autos declined 0.2% as auto dealers witnessed a 2% drop in their sales, the strongest drop since June last year. The diminishing sales are also indeed reflective of a housing slump sifting through the economy as a strong decline was recorded in stores related to the housing market like the home furnishing and electronic stores as well as stores selling building materials. Sales at the furniture stores have fallen for the seventh consecutive month.

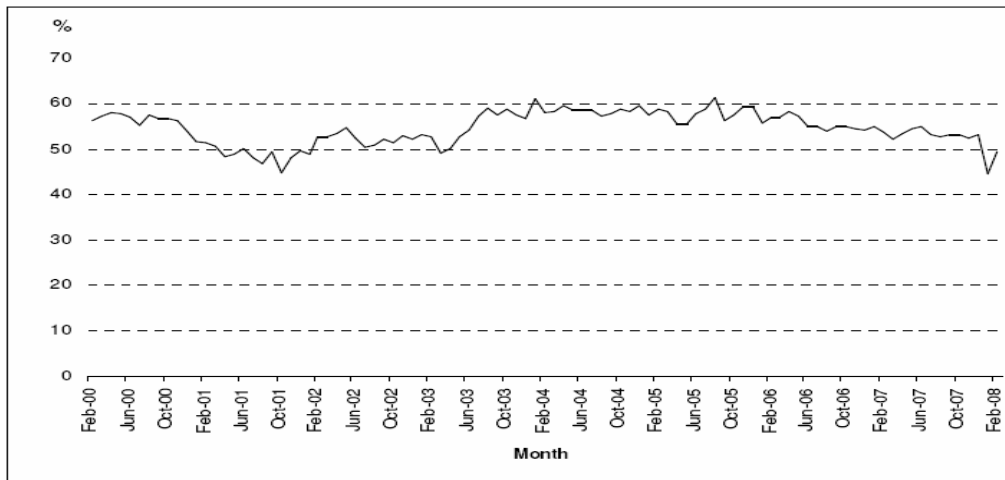
At the same time industrial production has also recorded a sizeable fall of 0.5%, the biggest decline since a 0.6% fall recorded in October. The major decline came from utilities' output which fell 3.7% while manufacturing output also recorded a 0.2% drop. Once again, the strongest declines were reported in the auto sector and housing related industries.

ISM Non-Manufacturing Index supports recession concerns.

The ISM Non-Manufacturing Index is a composite index based on four equally weighted indicators – employment, supplier deliveries, new orders, and business. As indicated by the movement of the Index, non-manufacturing sectors in the country have also been in contraction for the past two consecutive months.



Figure 1: ISM Non-Manufacturing Index (%), Jan'00 – Feb'08



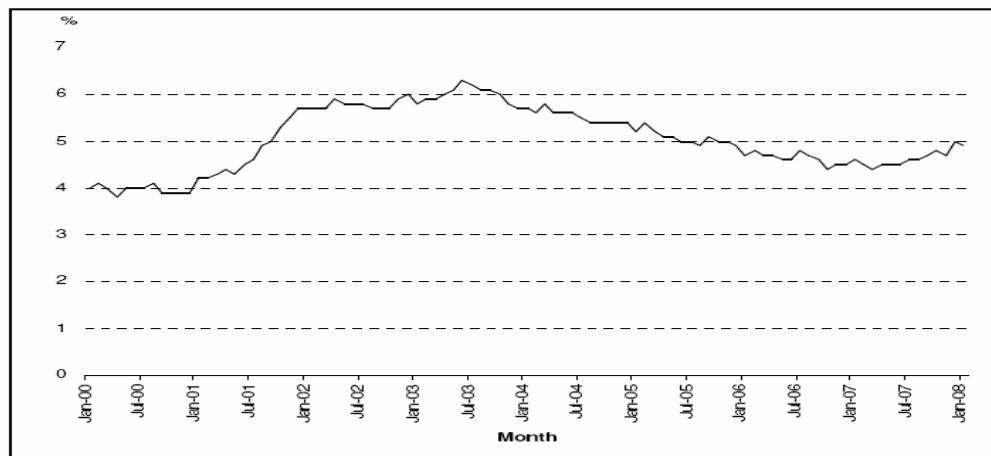
Source: Bloomberg

The index slumped sharply from 53.2% in December to 44.6 % in January and regained in February reaching 49.3%. However, it remains below 50 for a second month indicating contraction in the services sector. The last time the index reached below 50 was towards the end of 2001 recession.

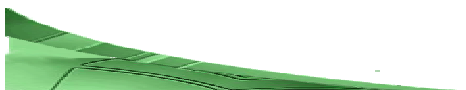
Weaknesses in the labor market are the mirror image of these developments.

While there are signs of weakening in the employment market, it has yet to contract significantly to be comparable to the rates that existed at time of previous recession. This however can be due to time lags as labor market generally responds to economic slowdown in a time lag of about 3-6 months.

Figure 2: Unemployment Rate (%), Jan'00 – Jan'08



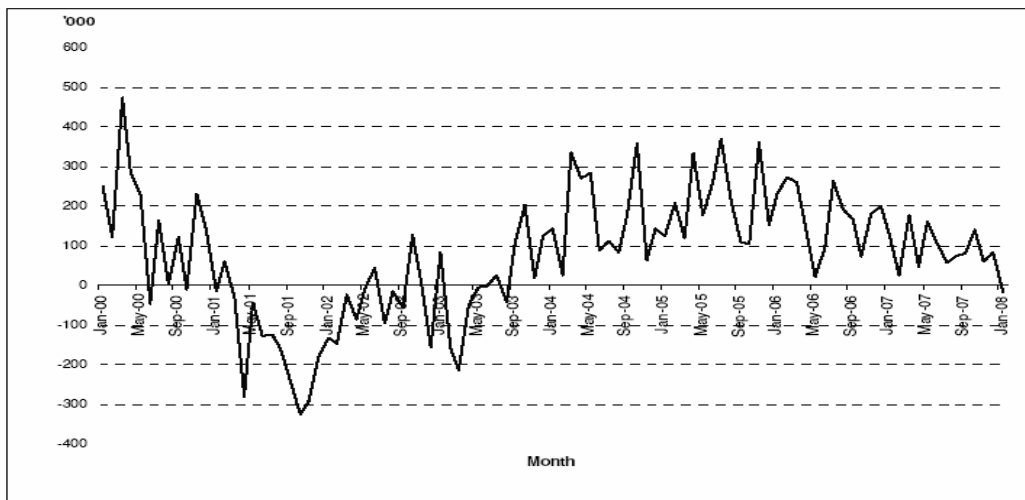
Source: US Dept. of Labor





Nevertheless the Labor Department revealed that jobless rolls rose to 2.835 million in the week ended 1st March, the highest since September 2005. The current weakness is also attributable to the downturn of the housing and auto industry. In the past 12 months the automakers have cut their payrolls by 7.5% or 75,000 while the construction sector has witnessed a more striking fall. Since the peak in April 2006, the decline in all housing-related employment (residential construction, manufacturing, retail and financial services) totals 640,000. The monthly job growth of 50,000 only two years ago has now turned into an equally strong decline.

Figure 3: Non-Farm Payroll Employment ('000), Jan'00 – Jan'08



Source: US Dept. of Labor

In all other sectors, the labor market has, at least so far, slowed more gradually. In fact, payroll employment in the services sector has hardly shown any signs of weakening (Figure-4).

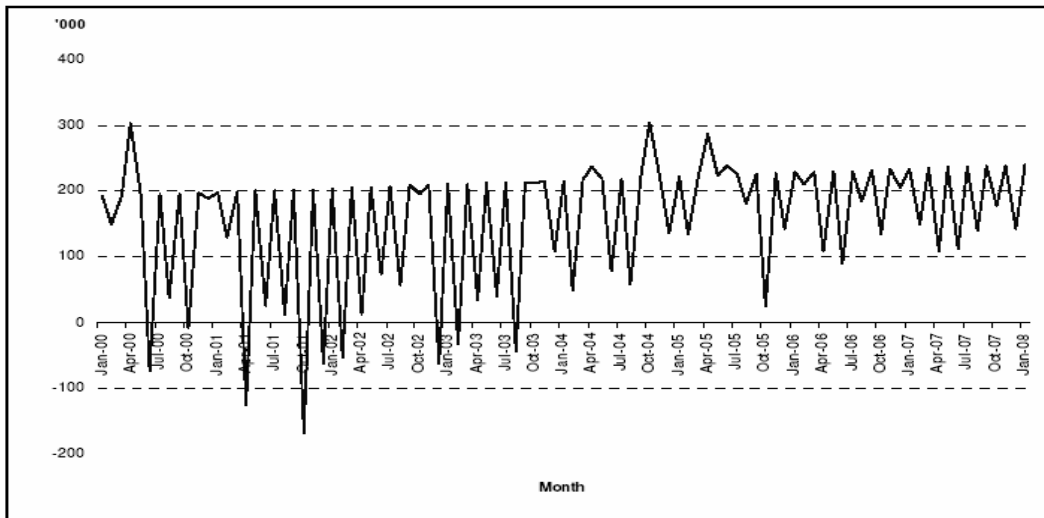
Risks facing the economy impinge private consumption expenditure.

With an ongoing recession in the housing market and the challenges facing the auto industry it is clear that the downside risks for the US economy will continue to increase in the current year. Tighter lending standards have already set off a decline in nonresidential construction, further weakening the labor markets. Alongside energy and commodity prices have remained high while equity and home prices have witnessed steep drops. All these factors have eroded the households' purchasing power reflected in the declining private consumption expenditure. This is a rather disturbing phenomenon: The private consumption is a determining factor of the economy's GDP growth as it accounts for about 72% of the economy.



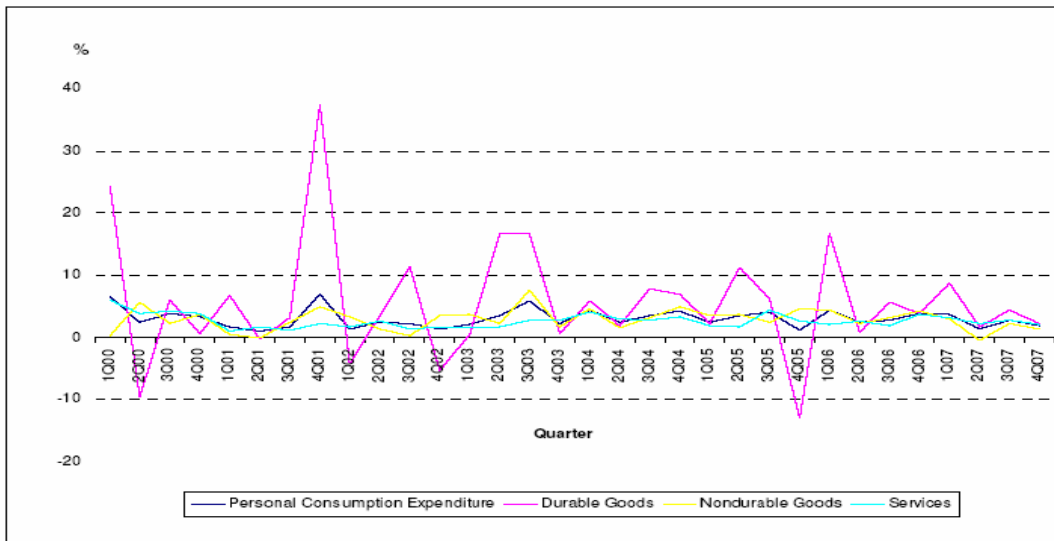


Figure 4: Payroll Employment ('000) in the Services Sector, Jan'00 – Jan'08



Source: US Dept. of Labor

Figure 5: Annualized Growth of Private Consumption Expenditure. 1st Q'00 – 4th Q'07



Source: Bloomberg



FEDERAL RESERVE TAKES ACTION: IS IT TOO LATE?

The Federal Reserve has been cutting its benchmark interest rate since September 2008, stating that the steps are *“designed to bolster market liquidity and promote orderly market functioning ... essential for the promotion of economic growth.”*

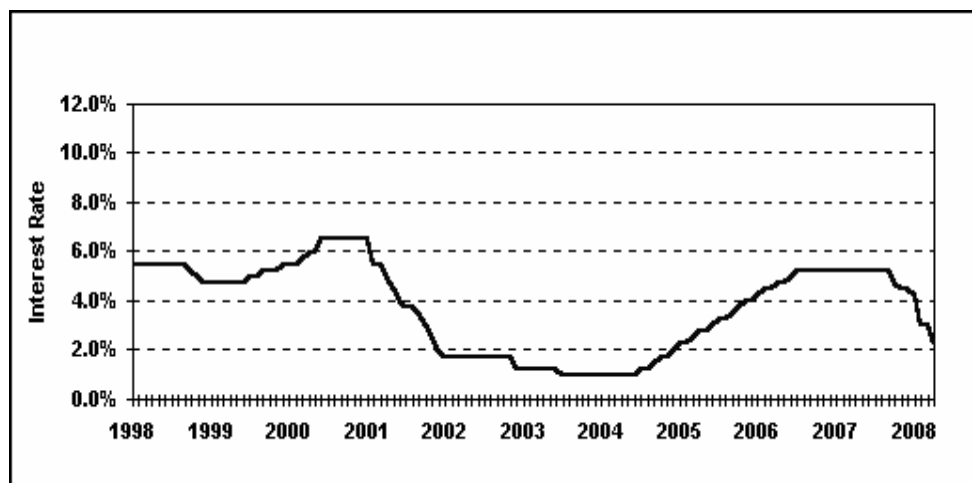
Despite Fed's aggressive monetary accommodation economic and financial conditions have continued to deteriorate.

Though the American subprime crisis had started to hit the economy in late 2006, it was not until mid August 2007 that the Fed decided to change its gear and reduce interest rates to provide impetus to the slowing economy.

The Fed had kept interest rates high for too long despite the bursting of the housing bubble, citing inflation as its primary concern. However during this time record numbers of housing foreclosures, bank write-offs, falling net worth and job losses slowed down the economy substantially. Soaring prices for energy and other commodities compounded the strains facing the economy. Investors started to shy away from the American equity markets which witnessed new lows on heavy volumes.

In order to correct these market functions and support economic growth the Fed has been taking rigorous steps for past few months. Since August the central bank has reduced the discount rate from 6.25% to 2.50% while since September its federal funds rate, a key overnight bank lending rate, has been lowered to 2.25% from 5.25%, including a 75 bps emergency cut in January. Furthermore in November the Fed promised more-than-the usual year-end liquidity and said it would lift limits on how much can be lent to any one bank.

Figure 6: Federal Funds Target Rate (%) 1998-08



Later the Fed established the Term Auction Facility (TAF) to provide funds over a longer period to a wider range of banks to meet temporary shortages of funds. In March the Fed announced the Term Securities Lending Facility (TSLF) that shall accept a broader range of collateral, including mortgage backed securities.


Despite five interest rate cuts in the past six months and Fed's frequent efforts to increase liquidity into the markets the economic and financial indicators have been deteriorating. The US remains on the brink of a recession, if it is not already engulfed in one.

Since the September rate cut the economy has substantially declined as the 4th quarter GDP showed anemic growth of 0.6% and the quarterly earnings reached a five year low. In February the biggest monthly job cuts were recorded in five years while the housing industry continued to witness falling prices, lower sales and rising rates of foreclosures. Retail sales and industrial production have declined significantly. Amid the credit market collapse, one of the most revered financial institutions on Wall Street sold itself for a fraction of its value while the stock markets remain impervious to rate cuts. Since the first rate cut on 18th September 2007 the S&P 500 NASDAQ and Dow Jones Index have all declined. Though stocks initially recoiled after the first cut, leading to record highs for the Dow and S&P 500 in early October and to a multi-year high for the NASDAQ around late October, they have been on a slide ever since.

Figure 7: SPX, NASDAQ, DJIA Indices, Mar'07-Mar'08



Source: Big Charts, CNN Money



The Wall Street reaction can be primarily due to the economy not being able to pick up since the rate cuts. However it could be similar to what happened in 2001-02 when the Fed cut rates aggressively to stimulate the economy after the collapse of the dot com bubble, 9/11 and 2001 recession. The stock reaction to that was delayed, but ultimately positive.

Nevertheless these changes indicate that the Fed has waited too long to start cutting rates. Most consumers may have already been tapped out while injecting excess liquidity does not seem to do much good either as colossal credit is outstanding. It's likely that Fed's actions may not lend any significant support to economic growth at least in the first half of the current year.

Fed's aggressive rate cuts may increase inflation expectations.

The aggressive policy change by the Fed now sets up conditions for inflation later – in fact in its most recent statement the Fed noted that *inflation expectations have risen and uncertainty about inflation outlook has increased.*

Though headline inflation remained unchanged in February at 4.0% favored by a 0.5% decrease in energy prices while core (non-food non-energy) prices were also unchanged at 2.3%, the numbers are still high. And Fed's actions in terms of reducing interest rates and increasing liquidity may increase inflationary expectations, ultimately reviving inflation. Also injecting excess liquidity could easily recreate the conditions that initially created the housing market asset bubble.

IS THE 'R' WORD THE RIGHT WORD?

Fears of a recession hitting the US economy are rightly justified. Despite strong efforts by the Fed to stimulate the economy, the scenario has not displayed any significant improvement. The low interest rates mean low credit costs for only strong credit quality borrowers as banks refuse to remove the *freeze* from lending. Investment in real estate as well as machinery and equipment may diminish in the months to come. Subsequently the economy may face falling employment and incomes.

GDP growth for this quarter is likely to be lower and the economy may be said to be in a recession. Consequently we expect the Fed to cut its rate further in the next meeting but by not more than 75 bps. Thus the Fed rate will continue its move towards the 1% level that persisted before the Fed started interest rate hikes from June 2004. Nevertheless we expect the *recession*, if it does happen; to be mild and short lived as the Fed cuts coupled with a fiscal stimulus will begin to show the impact by the second half of the year.



Economic Snapshot

Fiscal year 07-08														
	Units	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb
<u>Inflation</u>														
Headline Inflation	%	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3	8.7	8.8	11.9	11.3
Core inflation	%	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5	6.9	7.2	7.8	8.1
Food inflation	%	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7	12.5	12.2	18.2	16
Non-food inflation	%	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4	5.9	6.3	7.3	7.8
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05	9.05	9.09	9.09	9.38
6 month	%	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12	9.21	9.29	9.29	9.61
12 month	%	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39	9.4	9.49	9.44	9.87
<u>External Sector</u>														
Export	Mln US\$	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	1,593	1,524	1,500	1,642	1,625
Import	Mln US\$	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	2,555	2,864	2,910	3,271	2,856
Trade balance	Mln US\$	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1,231)
<u>Remittances</u>	Mln US\$	457	520	513	537	505	495	489	516	580	505	479	557	502
<u>Forex Reserves</u>	Mln US\$	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354	15,807	15,589	15,074	n.a



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