

Perna's Perspective

by Nicholas S. Perna, PhD

Democrats warned that if the debt ceiling isn't raised, the government would cease to function. How would you be able to tell?" –Jay Leno

The "Great Recession" has been followed by the "Not So Great Recovery." The downturn, which started in December 2007, officially ended in June 2009. So far, real GDP has recovered all of its losses and now stands above the pre-recession level. At more than 12,500, Dow Jones (DJ) has regained better than 80% of what it lost. (How long the Dow Jones will keep these gains is another matter.) Profits are higher than pre-recession levels. But jobs are very different story, getting back 1.8 million (20%) of 8.7 million lost jobs.

During the first half of this year, GDP growth slowed to about a 2% annual rate. Jobs were essentially flat in May and June. This seems to be part of a global slowdown that may also be affecting China. It is still improbable that the U.S. is headed back into recession, but slow growth seems increasingly likely. Housing shows no signs of recovering while state and local governments are shedding workers at a rapid pace -- 350,000 over the past year.

At this point (mid-July), I'm quite sure that the debt ceiling will be extended. Not doing so runs the risk of global financial chaos. I'm more concerned about the growing financial market nervousness over public debt. Concern has spread to Italy's ability to meet its obligations. Italy is much larger than Greece and is capable to doing much more damage to the global economy. Closer to home (and just a few miles from where we spend the summers), several small Rhode Island municipalities are staggering under the weight of pension obligations. Keep your fingers crossed that we don't get caught in a bout of credit contagion.

Before we get too morose, there are a number of major positives. Prospects for slower economic growth have brought commodity prices down. Oil has dropped from \$115/barrel a couple of months ago to \$95 at present. Cotton and corn are both down. This should help keep overall inflation low.

U.S. growth should pick up a bit in the second half of this year, thanks to lower oil prices and an easing of the global supply disruptions following the Japan earthquake. U.S. automakers have ramped up production schedules for the second half.

Interest rates are also low with the benchmark U.S. Treasury note hovering around 3%. This rate yields a lot of information. For starters, it says that bond markets don't believe that the Treasury will have to default on or about August 2. Otherwise, risk premiums would be rising on the hitherto "riskless" Treasury bond. Furthermore, markets are betting that low inflation will be with us for quite some time, as evidenced by the spread between the 3% 10-year coupon note and the 0.5% TIPS. As I've mentioned many times, this spread reflects market expectations of future CPI inflation.

Given the outlook for a slow recovery and moderate inflation, the Federal Reserve is in no hurry to raise interest rates. In my forecasts, I've postponed the first FOMC tightening to June of next year. By the end of 2012, the Fed funds rate will be in the vicinity 1.5%. Also, I think the Fed will wait until then to start unwinding the Quantitative Easing program by selling its vast holdings of Treasury and mortgage-backed securities. These were bought over the last couple of years to bring long-term yields down and to bring in mortgage spreads. If the economy weakens enough, the Fed may have to launch QE3!

That 10-year Treasury bond yield of 3% seems unsustainably low for an economy likely to see 3% GDP growth and 2% inflation --

not to mention large trade and budget deficits. Some upward pressure is inevitable and I see yields rising to about 3.5% this December and around 4.5 % by the end of next year. Meanwhile, yields could be held down – maybe even driven lower for a while – if a “flight to quality” emerges, should European debt problems intensify and the U.S. muni bond markets get more nervous. I’m not sure who said it first, but sometimes the return **OF** the principal is more important than the return **ON** the principal.

For credit unions, this interest rate outlook has its pluses and minuses. Low short-term rates mean that cheap funding will be available for awhile longer. However, so will the modest yields available on investments. Credit unions could also benefit if credit concerns cause depositors to move out of money market mutual funds and into insured deposits.

Rising long-term yields are a mixed blessing. They mean higher returns on new loans and investments. However, they can also erode the value of interest-sensitive securities in the portfolio. My advice is to start paying close attention to interest rate sensitivity analyses of your assets and liabilities.

Have a great summer!



Nick Perna is Resident Economist, Members United Corporate. He specializes in economic analysis, forecasting and strategy. Dr. Perna has served as an economist for the Federal Reserve Bank of New York, General Electric and a number of major banking institutions. The *Wall Street Journal* and *BusinessWeek* have each twice cited Dr. Perna as one of the top economic forecasters in the United States. He has served as an economics professor at Williams College and New York University, and currently teaches an economics course at Yale University. In addition, he has also appeared on *The NewsHour with Jim Lehrer*, CNN, CNBC, the *NBC Nightly News*, ABC Radio and NPR’s *All Things Considered*.