Economic Outlook for the Third Quarter of 2008

The economy shrank by .3% in the third quarter of 2008 according to the advanced estimate. Most analysts expect a revision toward an even weaker performance. Unemployment, which normally lags economic performance, increased to 6.5% in October from 6.1% in September. Nonfarm payrolls declined by 1.2 million since the beginning of 2008, with more than 500,000 cut in just the past two months. Dismal sales figures and weak manufacturing data suggest further increases in the unemployment rate to as much as 7% early in 2009 and 8% by the end of 2009. Consumers are facing declining income, declining wealth, deteriorating credit conditions, job fears, and very low confidence. Investment spending continues to fall led by a continued slide in residential investment and weaker non-residential investment. Declines in imports outpace the declines in exports, offering some help to GDP. Government spending is the only component of aggregate demand left to keep the economy from a very pronounced economic slide. Inflation pressures are easing as the economy grinds downward and oil prices weaken.

Monetary policy continues to pump liquidity in the short term market to bring down the Fed Fund rate. The 1% target may fall to 0% by the end of the year. Traditional Fed policies aimed at short term interest rates and increased bank reserves are impotent in this economy. More dramatic moves to ease long term rates have not yet been put on the table, but are absolutely necessary to revive the housing market and investment spending. Even the early attempts to use the $750 billion "recovery" fund to purchase toxic mortgages has been revised to seek more direct ways to stimulate bank lending. Consistent and sound strategies to revive the housing market and stabilize financial institutions must be forthcoming. Consumer confidence and sentiment are at rock bottom with declining equity and home values, lost jobs, heavy debt burdens, and little confidence in government plans to improve the situation. The gloomy sentiment that permeates the economy poses a danger of becoming a self fulfilling prophecy as consumers and investors withdraw, causing further declines in the economy.

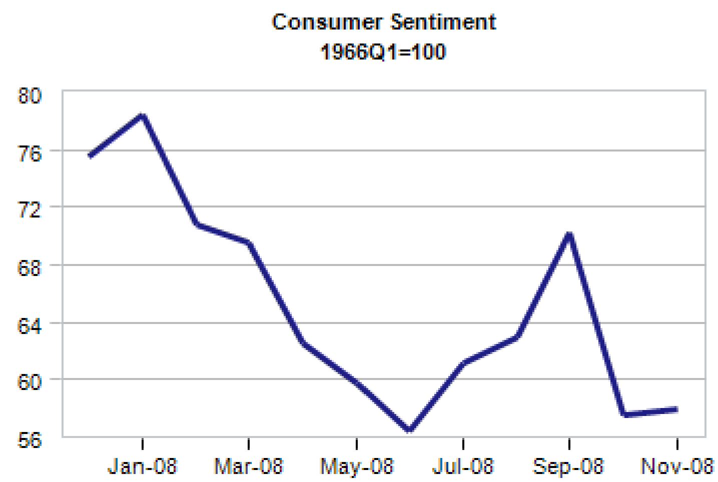
Analysts, to include the Federal Reserve economists, are revising forecasts of economic activity downward. Fourth quarter real GDP is likely to fall at least 1% on a seasonally adjusted basis. Unemployment will edge up toward 6.8% by the end of the year with no real improvement in housing. The Fed Fund rate will move to 0% with little easing in long term rates. Bank lending will improve but credit standards will remain high. The only good news in the near future is a lower inflation rate but there may be a new concern for deflation.

We Need Good News –Low Confidence Holds the Economy Back

Consumers are tightening their purse strings, and those that are spending are switching to discount retailers and lower-cost items. Even if the credit crisis is resolved by the government's latest plan to inject capital into the banking system, the recession will continue through at least into late next year. Consumers have neither the money nor savings to lead the way to a recovery. The expected pullback in business investment spending on top of diminished residential business investment will continue in the fourth quarter GDP data. The global nature of the downturn limits the ability of exports to play a major role. It will take some time for businesses and consumers to regain their lost confidence in the economy even after fundamentals stabilize.

Sentiment is currently dismal, judged by any of the popular measures. The graph below illustrates the movement of the University of Michigan Consumer Sentiment Survey. The same pattern occurs in other measures of confidence. A new recovery plan must convince households and businesses that it will work until economic improvements occur.

University of Michigan Consumer Sentiment Index



Long Run Economic Adjustments - Fed Projections Show Weakness Into 2011

The Federal Reserve provides economic projections four times a year offering insight into longer run economic conditions. The majority of the Federal Open Market Committee appears to see unemployment remaining high into 2011, with growth remaining weak into 2010. The consensus forecast of the committee calls for unemployment in the 7.1%-7.6% range in 2009 and the 6.5%-7.3% in 2010. Only in 2011 do any officials bring unemployment down around the 5% level set as an optimal target.

GDP projections by Fed officials have been downgraded to weak growth into 2010. At the October meeting, the consensus forecast for economic output in 2009 fell in a range of -0.2% to 1.1% next year and between 2.3% and 3.2% in 2010. The target for long run sustainable growth is in the 2.75% to 3% range.

Fed officials projected inflation, measured by the price index for personal consumption expenditures, to fall between 1.3% and 2% in 2009, excluding the extreme forecasts. Inflation should slow to a range between 1.4% and 1.7% by 2011.

We are All Keynesians Now – Time for the Spender of Last Resort

Traditional monetary policy works through the banking system by increasing bank reserves with the intended consequence of increased bank lending. Bank lending to businesses and households fuels spending and aggregate demand. In the Great Depression, banks hoarded reserves while households hoarded cash to the point that liquidity vanished. Keynesian thought entered to offer an alternative to monetary policy though planned spending by the government sector to directly boost aggregate demand. The current economic situation appears to be the classic example of the Fed's inability to "push on a string." Easy money conditions have not resulted in expanded loans and credit availability. There is a disconnection between Fed policy and bank loan expansion to the point that we may be left with only Keynesian alternatives.

Plans to spend $750 billion in an economic recovery plan must be revised to add more direct stimulus to the economy. Real estate values must be stabilized, loans must be forthcoming, and consumers must spend again or the government must spend the funds directly to boost aggregate demand. We have yet to see a plan that will accomplish the key objectives of stimulating spending and time is running short. We need either a Keynesian plan to boost direct government spending or a measured plan to get funds to sound banks that are willing and able to make diligent loans. A key problem with current plans is the use of funds to help troubled banks, who are least likely to use the funds for loans rather than prop up shaky reserve positions. We are all waiting on a good plan to repair stability in financial institutions and pump the prime for economic growth.

Summary of Recent Economic Data

GDP and Growth – How bad is the economic turn down?

- The advanced estimate of Real GDP declined 0.3% in the third quarter at an annualized rate, slightly better than the consensus expectation for a 0.5% drop. More recent data suggests that the advanced estimate will be adjusted downward. Over the past year, real GDP increased 0.8%, which is well below the economy's potential growth of 3%.

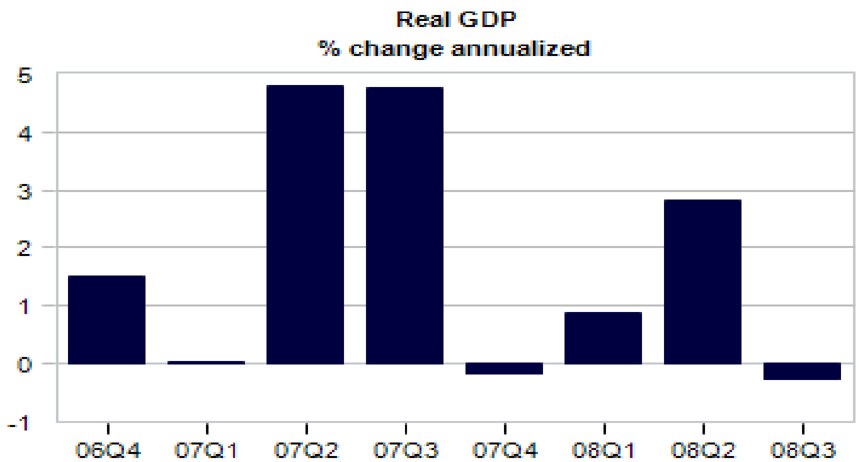
- Third quarter growth is the weakest year-over-year growth since the U.S. economy at the end of the recession in 2001.

- Consumer spending, business investment, and investment in housing all fell from the second quarter to the third. Inventories, trade and government were all positives for growth.

- Real final sales of domestic product, defined as real GDP minus the change in inventories, is a measure of demand for U.S. goods and services. The 0.8% annualized decline in real final sales of domestic product in the third quarter is the first decline since the end of 2005 and is the largest decline since the 1990-1991 recession. Over the past year, real final sales increased only 1.3%.

- The bar chart below illustrates GDP growth since the fourth quarter of 2006. Growth is now clearly weaker than last spring, which some analysts thought was the "bottom" of the current recession. Currently, there is no bottom in sight.

Chart 1: Real GDP % Change by Quarter



Consumer Spending – the consumer is tapped out.

- The decline in consumer spending of 3.1% in the third quarter suggests that a deeper decline in GDP may be forthcoming. The third quarter decline in personal consumption expenditures is the largest decline since 1980 and subtracted 2.3 percentage points from growth.

- Total retail sales fell 2.8% in October following a revised 1.3% decline in September (originally -1.2%). Sales excluding autos fell 2.2% after falling 0.5% in September. Drug stores and restaurants were the only major segments to post gains. Core sales fell 0.5%, slightly less than September's 0.6% decline. Consumer spending sets an important pace for the economy since it represents approximately two-thirds of aggregate demand.

Investment – declines in residential investment are spreading.

- Third quarter fixed investment fell 1.9% at an annualized rate, subtracting 0.8 of a percentage point from growth. Investment in equipment and software fell 6%, although investment in nonresidential structures rose 8%. Housing investment fell

19%, the 10th straight double-digit decline. Investment in residential structures is now down 42% from its peak.

- The change in inventories added 0.6 of a percentage point to growth in the third quarter, after subtracting 1.5 points in the second. The outlook for business investment spending remains dour. New orders for core capital goods, which are a proxy for business investment spending, fell 1.5% in September following an even larger decline in August.

Government – how much more is necessary?

- Government spending was also a major contributor to GDP in the third quarter, as it is expected to be throughout the next year. Real government spending rose 6% annualized in the third quarter, adding 1.2 percentage points to growth. Federal spending continues to increase strongly, especially for defense. State and local government spending grew at much lower rates.

Trade (X – M) – the deficit gets better.

- International trade continued to provide a positive boost to the economy. While the trade balance remains negative, the increase in net exports adding 1.1 percentage points to growth in the third quarter. Imports fell 2% annualized, while exports rose 6%, both adding to growth. Even so, third quarter net trade growth fell behind the contribution of 2.9 percentage points in the second quarter.

- Annualized percentage change in real GDP components appear in Table 1.

Table 1. GDP Annualized % Change by Components per Quarter

	08Q3	08Q2	08Q1	07Q4	07Q3	07Q2	07Q1	06Q4
Annualized % chg quarter ago								
Real GDP	- 0.25	2.83	0.87	- 0.17	4.76	4.79	0.05	1.50
Consumption	**- 3.1**3	1.22	0.87	0.96	2.02	1.97	3.86	3.71
Fixed Investment	**- 5.60**	**- 1.69**	**- 5.65**	**- 6.19**	**- 0.94**	3.02	- 3.44	- 7.58
Fixed Res Investment	**- 19.12**	**- 13.28**	**- 25.03**	**- 27.01**	**- 20.58**	**- 11.55**	**- 16.22**	**- 19.48**
Fixed Nonres.investment	**- 0.97**	2.47	2.40	3.41	8.75	10.35	3.38	- 1.02
Exports	5.90	12.28	5.09	4.41	23.02	8.78	0.62	15.62
Imports	**- 1.88**	**- 7.25**	**- 0.79**	**- 2.31**	3.01	- 3.66	7.72	2.00
Government	5.84	3.94	1.93	0.81	3.82	3.94	0.89	1.59

Source: Bureau of Economic Analysis
Drags on GDP appear in bold type.

Manufacturing and Production – weak spending by consumers and global recessions are taking a bigger toll.

Durable and Capital Goods – aircraft orders provide most of the support.

- New orders for manufactured durable goods rose in September by 0.8% following a 5.5% decline in August. September's increase includes a nearly 30% increase in orders for nondefense aircraft. Orders excluding transportation were down 1.1% over the month and core capital goods orders fell 1.4%.

- Durable goods orders increased in September following a large decline in August. New orders increased in four of the past five months. Shipments increased 0.2% following a 4.2% decline in August. Increased orders should not be taken as a signal of reemerging strength in manufacturing. The increase was due solely to a bounce back in aircraft orders. The increase in motor vehicle orders reflects a bounce back in industrial production of autos in September but is unlikely to last given the weakness in auto sales.

- New orders for core capital goods are much weaker than overall orders. Core goods orders fell 1.4% in September, which represented the sixth decline in the last nine months.

- Both unfilled orders and inventories rose 0.4% over the month. Unfilled orders excluding transportation fell for the first time since June 2007. The ratio of inventories to shipments remained steady at 1.63 months in September and the ratio of unfilled orders to shipments held at 3.97 months.

Capacity Utilization, Factory Orders, and Inventory – the slowdown reaches deeper into the economy.

- Overall capacity utilization fell to 76.4% in October from 80.4% in March. Capacity utilization in manufacturing fell to 73.8 from 78.5. Lower capacity utilization is consistent with a slowing economy.

- Factory orders fell 2.5% in September following a 4.3% decline in August. Orders excluding transportation were down 3.7%. The drop was mainly due to a large decline in nondurable goods orders, reflecting falling prices of petroleum and other commodities. This decline brought manufacturing shipments down by 2.8%. Unfilled orders continued an upward climb, rising by 0.4% over the month. Inventories contracted by 0.7%.

- Total business inventories fell 0.2% in September. Retail inventories increased 0.2% despite a 0.3% decline in retail auto inventories.

- Manufacturing inventories decreased 0.7%, while wholesale inventories fell 0.1%.

- Retail inventories increased 0.2% in September, despite a 0.3% drop in retail auto inventories. Retail inventories excluding autos increased 0.4%. Among non-auto categories, the largest gain was in general merchandise stores, followed by building materials dealers.

- The total I/S ratio increased to 1.29 in September. The manufacturer I/S ratio increased to 1.29 from 1.26. The retail I/S ratio increased to 1.5 from 1.48. The wholesale I/S ratio increased to 1.12 from 1.1. Higher I/S ratios suggest cuts in production next period as inventory adjustment takes place.

Sales – getting worse in a hurry.

Business Sales – the slump is widespread.

- Total business sales were down 2.0%, with the largest decline in manufacturing. Manufacturer sales decreased 2.8%, while retail and wholesale sales each declined 1.5%.

Retail Sales – the pullback signals a poor performance in GDP going into 2009.

- Despite a small gain in sales in the first weeks of November, the ICSC weekly chain store sales index fell below its year-ago level for the first time in five and a half years. Year-over-year growth fell to -0.1%, the first year-ago decline in the index since April 2003. The ICSC noted that the benefit to sales from lower gasoline prices was being offset by rising unemployment. Unemployment trends will continue to put a squeeze on spending.

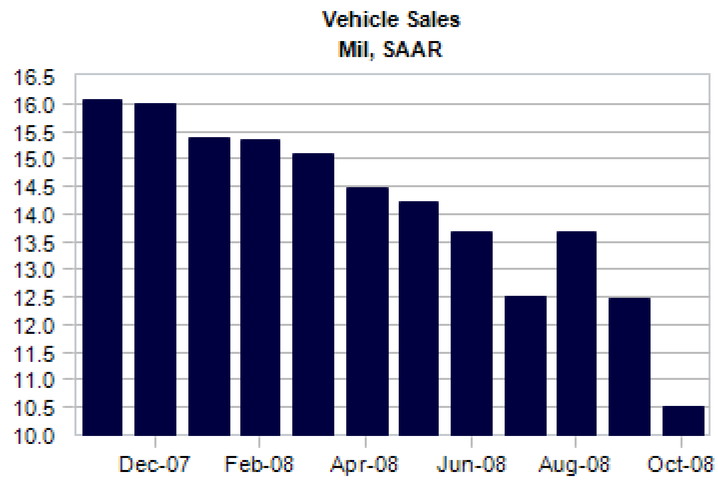
- Year over year, sales fell 4.1% in total, the biggest sales decline since the late 1960s. Core sales were 1% above their year-ago level, but even that was the slowest growth since September 2001 and the second slowest on record back to 1993.

Vehicle Sales – Dismal is too optimistic as a description.

- Vehicle sales fell to 10.5 million units on a seasonally adjusted annualized basis, the lowest pace since February 1983. The industry needs a pace of about 16 million to remain profitable. On a per household basis, the pace of sales is considerably lower than it was during the worst of the early 1980s recession.

- The meltdown in the auto industry has less to do with competition than to weak consumer wealth and confidence and access to credit. Tight credit standards due to the inability of lenders to securitize their loans hurt auto purchases. The erosion of consumer conditions due to deteriorating household balance sheets and weakening employment conditions are first felt in durable good sales. Dealers are also having trouble financing their inventory.

- Vehicle sales are down 34% from a year ago. Declining sales are especially damaging to the industry due to the high fixed cost components for both capital and labor. Every manufacturer has seen large declines on a year-ago basis, ranging from 45% for General Motors to 23% for Ford. The chart below illustrates the monthly decline in vehicle sales since November 2006.



Household Credit – conditions have never been worse.

- Credit conditions deteriorated further in the third quarter as consumer finances remain stretched and jobs disappeared, according to data from CreditForecast.com. The delinquency rate for household credit is nearly 300 basis points above its 2005 low.

- Defaults increased nearly six-fold since the end of 2005. The increase in the third quarter did moderate but the second quarter contained the largest quarterly increase in the dollar default rate on record.

- Auto credit quality continues to deteriorate. The total dollar delinquency rate moved above its 2001 recession high a year ago and has risen further since. Loss rates are well above recessionary highs.

- Bank credit card dollar delinquencies are rising but not as much as other forms of consumer credit.

- Total household debt rose at a 5.1% rate compared with a year ago. However, debt growth dropped to a little over 2% at an annual rate in the third quarter. Growth in household debt was led by student loan lending, although bank card and mortgage lending grew slightly faster than average.

- The slowdown in mortgage borrowing growth intensified in the third quarter. Year-over-year growth was the slowest in over seven years. Quarterly growth had dropped to under 3% so far this year despite acceleration in home equity loan growth.

- Household credit conditions have arguably never been worse. Household liabilities that are in delinquency and default totaled $825 billion at the end of September. This is equal to 7.1% of all liabilities. Just two years ago there were just over $320 billion in delinquent and defaulting loans, accounting for only 3.5% of liabilities. The erosion in household quality is evident across all loan types and in nearly every corner of the country.

Labor and Employment – unemployment lags economic activity suggesting that conditions will get much worse.

- The pace of job losses intensified in October, and the unemployment rate soared to 6.5%, a 14-year high. The monthly change in the unemployment rate appears in the table below.

	Oct '08	Sep '08	Aug '08	July '08	June '08	May '08	Apr '08	Mar '08
Unemployment Rate (%)	6.5	6.1	6.1	5.7	5.5	5.5	5.0	5.1
% Change in Average Hourly Earnings	0.2	.02	0.4	0.3	0.3	0.3	0.1	0.3

- Job losses in September and October totaled 524,000, the largest two-month decline of the current cycle. Unemployment lags economic activity, which means the 6.5% rate is the beginning of bad news for the economy.

- Payroll employment fell by 240,000, the 10th consecutive decline, and there was a net downward revision of 179,000 jobs to the prior two months. Payrolls in private industries plunged 263,000, the largest decline since November 2001.

- The economy lost 1.2 million jobs this year. About half the decline came in the last three months as businesses respond to shrinking demand and tighter credit with deeper cost-cutting.

- The rise in the unemployment rate was driven less by the decline in employment, which fell by 297,000, than by the rise in the number of unemployed workers to 603,000, the second-largest monthly increase this cycle.

- Nonfarm productivity grew 1.1% (seasonally adjusted annual rate) in the third quarter following a 3.6% increase in the second quarter. Third quarter productivity grew despite the contraction in GDP. Over the past year, productivity grew by 2%.

- Nonfarm business unit labor cost growth in the third quarter was stronger than expected, up 3.6%. Unit labor costs increased 2.3% over the past year.

- Manufacturing productivity fell 1% in the third quarter, with a 3.3% increase in durable productivity and a very large 7.3% decline in nondurable productivity.
- Overall, manufacturing unit labor costs rose 6.1% in the third quarter. Durable unit labor costs rose 2.6%, and nondurable costs rose 11.8%.
- Hourly compensation rose 4.7% in the third quarter, but real compensation fell 1.9%. Average hourly earnings rose 0.2% in October after a similar rise in September. The average workweek held at 33.6 hours. It has drifted down from 33.8 a year ago, consistent with a weakening labor market.

Inflation – the level remains high but inflation pressures are vanishing

- Consumer prices measured using the personal consumption expenditure price index rose 5.4% annualized in the third quarter, up from 4.3% in the second, in part because of higher food and energy prices. The Federal Reserve's preferred inflation measure, the core PCE deflator, which excludes food and energy prices, was up 2.9% in the third quarter compared to 2.2% inflation in the second quarter.
- The top-line consumer price index stayed flat for September 2008 compared to August, while the year-ago percentage change was 4.9%, down from 5.4% in August. The core CPI increased by 0.1% for the month and is up by 2.5% from one year ago, about the same rate of increase as August. The 0% monthly inflation for the top-line CPI in September is slightly lower than expectations, and is symptomatic of both falling energy prices and depressed consumer demand as the recession worsens.
- Producer prices declined by their biggest margin in the 61 year history of the data series in October as the free fall in energy prices continues to ripple through the economy. On a month-to-month basis, producer prices for finished goods fell 2.8 percent as prices of finished energy goods plummeted 12.8 percent and finished food goods prices declined 0.2 percent. On a year-to-year basis, finished producer prices grew 5.2 percent—while still inflated, the year-to-year measure is at its lowest level since September 2007. The news of the dramatic fall in producer prices followed last week's announcement that import prices fell 4.7 percent in October from a year earlier.
- Producer prices for energy products are now beginning to reflect the recent declines in energy costs. Large declines were seen in prices for petroleum products, particularly gasoline and diesel fuel. Prices for finished energy products fell by 12.8%, while prices for intermediate and crude energy products fell by 10.6% and 24.9%, respectively.
- The Personal Consumption Expenditure index fell to 4.2% on a year ago basis from the 4.5% rate in September and August. While the index remains high in an absolute sense, pressures for declining prices are mounting. When volatile food and energy components are excluded from the PCE index, the core rate increased only 2.4%. The table below provides monthly changes in the PCE index and the core PCE index.

Personal Consumption Expenditure (PCE) Deflator Index Movement

Personal Consumption Expenditure Deflator	Oct '08	Sept '08	Aug '08	July '08	June '08	May '08	Apr. '08	Mar. '08
PCE Deflator % change year ago	4.2	4.5	4.5	4.1	3.5	3.4	3.4	3.5
Core PCE Deflator, % change year ago	2.4	2.5	2.5	2.3	2.2	2.2	2.2	2.1
PCE Deflator, change month ago	0.1	0.0	0.6	0.8	0.5	0.2	0.3	0.1
Core PCE Deflator, change month ago	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.1

Source: Bureau of Economic Analysis

Housing – no end to the turmoil in sight

- The NAHB housing market index fell even further in November, setting a record low. The housing market index fell from 14 in October to 9 in November. Both present sales of single-family homes and prospective buyer traffic have fallen further, to single digits. Expected single-family sales for the next six months remain unchanged. The bottom to the market index must be approaching, since it is impossible for the index to turn negative. The HMI is also down by 52.6% compared to November 2007.

- The index for present single-family sales also fell from 14 to 8 in November, declining by 42.9% for the month. The index is also down by 55.5% from November 2007.

- The index for single-family sales expected in six months remained unchanged at 19, but is still down by 20.8% from November 2007.

- The index for prospective buyer traffic fell from 11 to 7 in November, a 36.4% decline for the month, and also down by 28.8% from November 2007.

- Both the 10-city and 20-city composite S&P/Case-Shiller house price indices posted their greatest year-ago rates of decline on record in August. The 10-metro house price index decreased 17.7% from a year ago. The 20-metro index decreased 16.6%. On a month-ago basis, rates of decline were largely unchanged between July and August. In August, the 10-city composite fell by 1.1% and the 20-city composite fell by 1.0%.

- The S&P/Case-Shiller 10-city composite index fell by 17.7% from August 2007, a slight acceleration from July's 17.4% drop. Prices fell at a rate of 1.1% between July and August, unchanged from a month ago.

- The 20-city composite fell 16.6% from a year ago, the greatest rate of decline on record. The month-ago pace of decline also accelerated modestly, falling 1.0% in August compared with July's 0.9% drop.

- Year-over-year sales on new single-family homes were down by 33%. For the third quarter, new-home sales were down by an annualized 28%, slightly worse than the 27% in the second quarter, but not as bad as the 44% in the first quarter.

- Although sales were still soft, slower residential building is slowly improving the inventory situation. The level of inventories has been descending nonstop for more than one year, for a 25% y/y decline in September. The months of inventory have been volatile lately, but are trending down. Months of inventory fell from 11.4 in August (a cyclical peak) to 10.4 in September (the lowest reading since February). The median months on market, however, continued to climb to a cyclical peak of 9.1 months.

- Prices are eroding fast. The median new house price was slightly down month over month in September, when adjusted for seasonal factors. On a year-over-year basis, however, the median price was down by 9%. For the second quarter, the median new-home price was down an annualized 14% from the first quarter and down 7% y/y.

- The large supply of heavily discounted existing homes available for sale continues to drag down the new-home market. The National Association of Realtors reported that 35% to 40% of existing homes sold in September were sales of foreclosed units. This estimate does not capture all the distressed properties on the market, only those that were listed with a realtor. A large number of properties are auctioned off by banks as well. Moreover, many of these distressed homes are fairly new, and thus highly competitive with the homes builders are trying to sell. As a result, builders are discounting.

- Construction spending for September came in at $1.060 trillion, a decline of 0.3% from August and down 6.6% from September 2007 as total construction—particularly for residences—continues to decline in the wake of a declining economy. Private construction increased by 0.1% for the month, but private residential construction fell by 1.3% from August to September. Total public construction also fell for the month. With the financial crisis still restricting credit to new projects, total construction will most likely decline in the coming months also.

Sentiment and Confidence – could it be any lower?

- The Conference Board index of leading indicators surprised to the upside, rising 0.3% in September. A large increase in the money supply masked sharp falls in stock prices and residential building permits and greater layoff activity. Despite the increase, a larger downward revision to August weakened the trend: Leading indicators over the past three months contracted at their fastest rate since 1990.

- Despite the 0.3% rise last month, the index has fallen by an average of 0.4% over the last three months. The index has broken free from a narrow range held since the start of 2008 and is on a weakening path.

- From its January 2006 high, the index is down 3.7%, surpassing the 3.6% peak-to-trough decline recorded for the 2001 recession.

- The weakened path of the leading index also indicates that the slowdown will persist, while year-over-year declines in the coincident index verify the damage done to the economy.

- Already, the Conference Board's leading indicators have fallen as much as in the 2001 recession.

- The Conference Board index of consumer confidence tumbled in October to 38 from September's 61.4 (upwardly revised from 59.8). The expectations component of the index fell the most, dropping to 35.5 from 61.5. The present situation fell to 41.9 from 61.1. Assessments of labor market conditions fell sharply, especially the expectations for future jobs. This puts the index at its lowest level on record back to 1969.

- The University of Michigan Consumer Sentiment Index was essentially unchanged in November, according to preliminary data, coming in at 57.9 compared with October's 57.6. This left the index near its lowest level since June. The current conditions component rose, while expectations fell modestly. Inflation expectations fell because of tumbling gasoline prices.

- In November, preliminary data for the Michigan Index show that a 3-point increase in the current conditions component of the index was partly offset by a 1.3-point decline in the expectations component.

Budget Deficit – we haven't seen anything yet.

- The U.S. budget deficit is set to balloon to about $1 trillion in fiscal 2009, which started on October 1. According to budget rules, the purchase of stock by the federal government counts as an outlay. Therefore, the purchase of an equity stake in banks as part of the financial rescue package will lead to an enormous budget deficit this year.

- The Treasury Department took a $115 billion equity stake in banks in October, leading to the enormous increase in the deficit for the month. Even excluding the TARP, spending continues to increase rapidly, above the rate of inflation, for both defense and nondefense items. The soft economy is boosting spending on income-support programs such as unemployment insurance. At the same time, revenues are dwindling because of the recession. Revenues are particularly weak for corporation income taxes. Another stimulus package, as seems likely, will further add to the budget deficit over the next two years.

- With falling revenues, the TARP, spending gains, and likely fiscal stimulus, the deficit in fiscal 2009 and 2010 will be about $1 trillion each year. This would be a record in nominal dollars, far eclipsing the $455 billion deficit in fiscal 2008. As a share of GDP it would be about 7%, a new post-World War II record.

- Over the long run, the retirement of the baby boomers will result in greater outlays on Social Security and Medicare. The United States is expected to see large federal deficits over the long term, of around 3% of GDP.

International – we get some relief from exports.

- The U.S. trade deficit narrowed to $56.5 billion in September. This marks the second straight month of declining gross exports and gross imports.
- Exports decreased by 6% to $155.4 billion in September, while imports decreased by 5.6% to $211.9 billion.
- The trade deficit in goods narrowed by 2% to $69.6 billion in September, while the trade surplus in services grew by 9.6% to $13.1 billion.
- Net imports of petroleum in September fell by 9.8% to $32.1 billion. Crude oil sold for an average of $103.90 per barrel in September, down 10.9% from August's average of $116.61 per barrel.
- The trade deficit with Canada, the U.S.'s largest trading partner, widened 3.2% to $7.8 billion from a revised deficit of $7.6 billion in August. The trade deficit with Mexico, the U.S.'s second-largest trading partner, narrowed by 16% to $4.9 billion.
- The trade deficit with China widened by 9.6% to $27.8 billion, and the trade deficit with Japan widened by 17.3% to $5.6 billion.
- The narrowing of the overall trade deficit by 4.4% is matched by a broad appreciation of the dollar over the month, particularly against the euro and the Mexican peso.
- September's trade data are most notable for the accelerating fall in overall trade rather than the small narrowing of the deficit. A global recession means less trade.
- Lower crude oil prices are being felt in other areas. Exports of goods connected to high oil prices are also lower. Drilling and oilfield equipment exports are down 36% since last month and organic chemicals exports, including petrochemical exports, are down 28.8% since last month. Naturally, net exports from OPEC nations are also lower, down 30.4% since last month.
- Several factors influenced capital flows to the U.S. in September. Flight to safety was an important motivator as private foreign investors increased their holdings of U.S. Treasury bonds and notes, GSE debt, and equities. At $66.2 billion, net foreign purchases of long-term U.S. securities in September was at a comfortable level given that the monthly U.S. trade deficit has been hovering in the $56 to $62 billion range for quite some time. More U.S. Treasury debt will be issued to finance bank recapitalization and other bailout plans, and much of this debt will end up in the hands of foreign buyers. The recent dramatic climb in the trade-weighted U.S. dollar (nominal broad index) indicates that flight to safety considerations probably also influenced international capital flows in October.