



The U.S. may not formally be in a recession today, but many individuals and businesses continue to struggle. Unemployment remains high and GDP growth is slow. Uncertainty regarding future taxes, the cost of health care and the impact of current and potential regulations dampens real investment and hiring. Yesterday, Fed Chairman Ben Bernanke described the outlook for the U.S. economy as “unusually uncertain.” In many parts of the country, real estate values remain under pressure with little chance of improvement in the near term. There are real concerns that the U.S. economy may slip back into recession producing the ‘double dip’ that is getting much attention.

Is a double dip likely? Those inclined to say no focus on the strength in capital spending and exports. China and emerging market countries continue to spend enticing U.S. firms to produce more. Industrial production remains strong, the largest financial firms have considerable liquidity, and securitization is returning suggesting that financial markets are getting healthier. Those who say yes focus on expectations of sustained high unemployment and the fact that consumers are de-leveraging and not spending as much. The crisis in state budgets will presumably exacerbate the problem by forcing layoffs and subsequent declines in future spending, both of which will put downward pressure on real estate values. Deflation will appear leading to a downward spiral. What is your view?

Breaking News

- President Obama signed the Dodd-Frank Financial Reform bill into law yesterday saying it contains “the strongest consumer financial protections in history.”
- The Wall Street Journal reported that Moody’s, S&P and Fitch no longer allow their ratings to be included in certain bond registration statements. The Dodd-Frank bill apparently contains provisions stating that ratings firms may be held legally liable for the quality of ratings. The implication is that investors would have legitimate claims if the ratings were ultimately inaccurate. Ford Motor’s financing arm pulled an offering of securities backed by auto loans because, while it was legally required to include ratings in its offering documents, the rating agencies wouldn’t give their consent.
- President Obama will soon name the Director of the Consumer Financial Protection Bureau (CFPB). The CFPB is authorized to write and enforce rules related to how financial products are offered. It will have a \$500 million budget and considerable independence.

Economic News

Yesterday, the 10-year Treasury rate fell to just over 2.88% while the 30-year Treasury rate fell to 3.89%. At the same time, fed funds futures signaled that there was only a 4% chance that the Fed would increase the fed funds rate by 0.25% by March 2011. Rates are now at their lowest in the past 15 months. Consider the shape of the Treasury yield curve.



Source: WSJ online

The yield curve is flat through one year. Rates rise gradually through three years, and then increase more sharply. Flat rates are consistent with an extended slow growth environment. Rates will eventually rise as the economy heats up.

The Federal Reserve has held the federal funds rate target at 0 – 0.25% for a long time. It has also purchased over \$1.5 trillion in longer-term bonds to help keep mortgage rates low. If it was necessary to ease monetary policy, Ben Bernanke stated that the Fed could reduce the rates it pays on bank's reserves. Most economists believe this would have little impact. If you believe in a double dip, you likely believe that interest rates are headed lower.

Deal of the Day

The Dodd-Frank bill permanently raised deposit insurance to \$250,000 and made the increase retroactive to January 1, 2008. The number of insured depositors at the six banks that failed during this period fell to 500 from approximately 10,000. The banks are:

Hume Bank (Missouri)

First Priority Bank (Florida)

ANB Financial (Arkansas)

The Columbian Bank & Trust (Kansas)

IndyMac Bank (California)

Silver State Bank (Nevada)

The retroactive coverage primarily benefits IndyMac's depositors who will now receive roughly \$170 million from the FDIC's Deposit Insurance Fund. Depositors at the other 5 banks will receive around \$10 million.

On September 6, 2008, the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship. Prior to that, many banks had purchased preferred stock issued by these GSEs. In order to preserve capital, Treasury eliminated dividends on the preferred stock. Banks holding the stock then wrote down their investments thereby depleting capital. Given that the preferred stock was rated as investment grade at the time of the conservatorship, many investors may have been misled into believing that the dividends were safe. Given the precedent with retroactive deposit insurance coverage for IndyMac depositors, perhaps Treasury should repay banks and other holders for their losses on Fannie and Freddie preferred stock. Perhaps this would provide a more even treatment of preferred stock investors since the onset of the crisis.

Upcoming Events

- On Friday, the Committee of European Banking Supervisors is expected to announce the results of stress tests conducted on 91 banks operating in the European Union. The stress tests will presumably indicate potential capital needs in the event of a severe recession and/or sharp drop in values of bonds held by many banks. It appears that the banks will disclose the amounts and nature of sovereign debt that they own.
- A bill to extend unemployment benefits for up to 99 weeks passed the Senate. The House will vote today and President Obama will sign the bill into law soon thereafter.