US Economic Outlook:
Will the sentiment decline generate a recession?

September 2011

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Consumer and corporate sentiment deteriorated in August
Consumers getting more worried about jobs…

**Consumer confidence wrt employment**

- Jobs Plentiful: Present
- Fewer Jobs: Expectations 6 Months Hence

Source: Conference Board, DB Global Markets Research
…and have less appetite for buying a house…
…and despite record low mortgage rates mortgage purchase applications are at a 15-year low

Source: MBA, DB Global Markets Research

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Companies also getting more worried

Business conditions getting worse

% respondents  % respondents

Source: Conference Board, DB Global Markets Research
Corporates cut hours in August. Are we breaking the up-trend seen so far during this recovery?

The sentiment decline and associated tightening of financial conditions have raised the probability of a recession to 50%.

Recession probability as predicted by MPF FCI (DB)

Source: FRB, MPF FCI, DB Global Markets Research
The US economy was slowing even before sentiment declined.

Source: Chicago Fed, DB Global Markets Research
Consensus view on US growth has eased

Bloomberg survey median GDP growth forecasts

Ann. %chg.

2011

Ann. %chg.

2012

Source: Bloomberg Finance LP, DB Global Markets Research

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Conclusion

**Sentiment decline a problem:** Corporates and consumers likely to hold back spending as long as this uncertainty persists. Our model says there’s a 50% chance we will get a recession.

**Economy weak even before sentiment declined:** Housing recovery delayed further. Means more balance sheet repair is needed in the household and banking sectors.

**Bottom line:** Expect more weak data in the near term. As we go into 2012 growth should move up, but the problem is that we have a fiscal drag in 2012, which could be as high as 1%.
Where has growth come from during this recovery?
The business cycle is driven by cyclical components of GDP, but cyclical components only 20%-25% of GDP

Cyclical components of GDP*  
Non-cyclical components of GDP**

*Real residential investment, consumer durables, BFI and change in pvt. inventories  
**GDP minus real residential investment, consumer durables, BFI and change in pvt. inventories

Source: BEA, DB Global Markets Research
This diagram shows the cyclical components of GDP. During this recovery real estate (=the orange and red parts below) have so far added very little to GDP growth. 

(Composition of discretionary spending: 60-yr average)

Key question: When will the existing housing market be healthy enough to trigger builders to build more buildings and hence contribute to GDP growth?

US economy currently flying on one engine

Source: BEA, DB Global Markets Research

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So far, this recovery has mainly been driven by consumer durables and capex.

Discretionary spending (average since 2009 Q3)

- Consumer Durables
- Residential Investment
- BFI Equipment & Software
- Nonres structures
- Business inventories

Source: BEA, DB Global Markets Research
What will drive growth going forward?
An important driver of growth during this recovery has been auto sales.

Source: Haver Analytics, DB Global Markets Research
The number of cars per household has been around 2 for the past 30 years

Source: Census, DB Global Markets Research
Used car prices at all-time highs – suggests there is strong demand for autos in the economy

Manheim used car vehicle value index

Source: Manheim, Haver Analytics, DB Global Markets Research
Another important driver of growth during this recovery has been capex BFI: Equipment & software

% of GDP


Snap-back in production

Source: BEA, Haver Analytics, DB Global Markets Research
US Housing Outlook
Housing and the recovery

The housing market affects the recovery through three channels:

1) Impact of falling home prices on construction/homebuilding

2) The impact of falling home prices on households’ balance sheets and hence consumer spending

3) The impact of falling home prices on banks’ balance sheets and hence credit extension
Foreclosures peaking this year

Forecasts

- Homes in foreclosure (ls)
- Foreclosure started (per qtr, ls)
- Numbers of housing units in foreclosure (rs)

Source: MBA, DB Global Markets Research

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### Shadow inventory high but coming down

Number of mortgage loans outstanding and delinquency rates

<table>
<thead>
<tr>
<th></th>
<th>Current data</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of loans (mlns)</td>
</tr>
<tr>
<td>Total</td>
<td>47.0</td>
</tr>
<tr>
<td>Subprime</td>
<td>3.7</td>
</tr>
<tr>
<td>Prime</td>
<td>43.2</td>
</tr>
<tr>
<td>Agency</td>
<td>39.0</td>
</tr>
<tr>
<td>Alt-A</td>
<td>2.2</td>
</tr>
<tr>
<td>Jumbo</td>
<td>1.5</td>
</tr>
<tr>
<td>Option Arm</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Loan Performance, DB Global Markets Research
Depressed household formations delaying the housing recovery

Source: Census, DB Global Markets Research

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Getting closer to “normal”

<table>
<thead>
<tr>
<th>Year</th>
<th>Case-Shiller, composite 10</th>
<th>FHFA purchase</th>
<th>Constant quality new home price</th>
<th>FHFA purchase: DB forecasts</th>
<th>Case-Shiller futures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>1.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Uses owners' equivalent rent from CPI

Source: Census, FHFA, BLS, NAR, DB Global Markets Research
US Banking
Charge-offs mainly in real estate

All FDIC institutions: composition of net charge-offs: Q2 2011

- Credit Cards, 31%
- Real Estate, 49%
- Commercial & Industrial, 9%
- Other Loans to Individuals, 7%
- All Other Loans & Leases, 4%

Source: FDIC, DB Global Markets Research
Mortgages, CRE and Construction loans account for 43% of bank loans

Loan portfolio composition (Q2-2011)

- Residential Mortgages: 26%
- Commercial real estate loans: 14%
- Construction: 4%
- Commercial & Industrial: 17%
- Credit cards: 9%
- Agriculture: 1%
- Leases: 1%
- All other loans: 20%

Source: FDIC, DB Global Markets Research
Real estate prices have come down significantly – CRE prices so far down around 50% from their peak in 2000

Note: The CRE index is nationwide and covers office, apartment, industrial, and retail. The index is designed to track same-property realized round-trip price changes based purely on the documented prices in completed, contemporary property transactions. The index uses no appraisal valuations.

Source: S&P, MIT, DB Global Markets Research
Small banks have more commercial real estate loans than large banks

![Real estate commercial loans](image)

Source: FRB, DB Global Markets Research

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Health of small and medium-sized banks is important for the macro economy

Total assets held by large domestic banks as % of total assets of all commercial banks

Source: FRB, Census, DB Global Markets Research
Employment in small businesses not doing well – is the source the health of the small banks?

- 10% of job losses were in small businesses
- 40% of job losses were in small businesses

Source: BLS, NY Fed, DB Global Markets Research
US Outlook
Summarized
Job openings trending up

Source: JOLTS, DB Global Markets Research

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Most job openings are in education and health services

Vacancy share

<table>
<thead>
<tr>
<th>Fraction of job openings, 3m MA</th>
<th>Manufacturing</th>
<th>Trade, transportation and utilities</th>
<th>Education &amp; health services</th>
<th>Govt</th>
<th>Construction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Trade, transportation and utilities</td>
<td>20</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Education &amp; health services</td>
<td>15</td>
<td>15</td>
<td>20</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>Govt</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>5</td>
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<tr>
<td>Construction</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: JOLTS, DB Global Markets Research

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Federal spending over the past 100 years.
Keep expectations low for Obama’s speech later this week

Source: usgovernmentspending.com, CBO, OMB, DB Global Markets Research

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US Outlook Summarized

US downgrade/European uncertainty has damaged consumer sentiment and corporate sentiment.

Sentiment has also reduced the momentum in the economy and delayed recovery in the housing market and banking sector.

Bottom line: Expect more weak data in the near term. Growth expected to go up as we go through 2012 but fiscal drag of up to 1% is a potential problem. Keep expectations low for Obama speech later this week.
Is the US the new Japan?
# A comparison of the US with Japan in the 1990s

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>Deflation/deflation expectations</td>
<td>✓</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>Rigid labor market, product market, and financial system, dampening ability to innovate</td>
<td>✓</td>
</tr>
<tr>
<td><strong>3</strong></td>
<td>Poor demographics</td>
<td>✓</td>
</tr>
<tr>
<td><strong>4</strong></td>
<td>Poor profitability in the corporate sector</td>
<td>✓</td>
</tr>
<tr>
<td><strong>5</strong></td>
<td>Multi-year non-performing loan problem in the banking sector</td>
<td>✓</td>
</tr>
<tr>
<td><strong>6</strong></td>
<td>All balance sheets in the economy in bad shape (government, household, banking, and corporate)</td>
<td>✓</td>
</tr>
<tr>
<td><strong>7</strong></td>
<td>Long trend decline in stock prices</td>
<td>✓</td>
</tr>
<tr>
<td><strong>8</strong></td>
<td>Long trend decline in home prices</td>
<td>✓</td>
</tr>
<tr>
<td><strong>9</strong></td>
<td>Fiscal and monetary policy not able to solve problems</td>
<td>✓</td>
</tr>
</tbody>
</table>

Source: DB Global Markets Research
US corporate sector in much better shape than Japan in the 1990s

Corporate profits as a share of GDP

% of GDP

US*  Japan

% of GDP

Source: BEA, Japan Ministry of finance, Japan Cabinet Office, DB Global Markets Research

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Investment Implications
Fed outlook

Fed Options:
- Operation Twist
- Promise to keep balance sheet constant for 2 years
- Minutes from August 9 meeting: "In choosing to phrase the outlook for policy in terms of a time horizon, members also considered conditioning the outlook for the level of the federal funds rate on explicit numerical values for the unemployment rate or the inflation rate"
10y fair value is currently 3.20% in the weekly model

Equation:
\[ T10 = c \cdot 2Y \cdot \text{Business cycle} \]

<table>
<thead>
<tr>
<th>Coeff.</th>
<th>Jan-00</th>
<th>Jan-02</th>
<th>Jan-04</th>
<th>Jan-06</th>
<th>Jan-08</th>
<th>Jan-10</th>
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<tbody>
<tr>
<td>3.12</td>
<td></td>
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<td></td>
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<td></td>
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<tr>
<td>0.40</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>0.09</td>
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</tbody>
</table>

(89.85) (36.97) (5.04)

Note: t-stats in parentheses

Source: FRB, DB Global Markets Research
The quarterly model suggests 10y fair value is 3.20%

10yr yield forecast model with fiscal variables

Equation:
\[
T10 = c + \text{Debt to GDP} \times -0.005 + \text{Output gap} \times 0.27 + \text{Inflation expectations} \times 2.27
\]

Note: t-stats in parentheses

Source: FRB, BEA, DB Global Markets Research

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Investment implications summarized

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond markets</td>
<td>Weak economy weighing on rates but rates are far below fair value – suggests there is a significant “fear” premium in long rates. Operation Twist likely to push long rates further down.</td>
</tr>
<tr>
<td>Stock markets</td>
<td>Expect more weak data in the near term and hence downside risk to equities/risky assets. But equities tend to trough at the bottom of a slowdown/recession.</td>
</tr>
<tr>
<td>FX</td>
<td>Expect a dollar decline as the Fed stays on hold until 2013. European developments important for EUR/USD.</td>
</tr>
<tr>
<td>Commodities</td>
<td>Chinese growth prospects continue to be key. If growth slows to below trend then commodity prices could come under pressure.</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>EM benefiting as a “parking spot” while things are bad in the US and Europe. Expect this to continue. But some EM asset prices starting to look bubbly.</td>
</tr>
</tbody>
</table>
## Rules of thumb for the US economy

### Cumulative impact on GDP growth and unemployment rate after 1, 2, and 3 years

<table>
<thead>
<tr>
<th>Experiment</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>10% decline in the dollar</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.4</td>
<td>1.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>-0.1</td>
<td>-0.4</td>
<td>-1.0</td>
</tr>
<tr>
<td><strong>$10 increase in oil prices</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>-0.2</td>
<td>-0.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>20% increase in stock market</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>0.4</td>
<td>0.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>-0.1</td>
<td>-0.3</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Note: Percent change from baseline. All experiments assuming constant real funds rate.
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Deutsche Bank Securities, Inc.

- Torsten Slok joined Deutsche Bank Securities in the fall of 2005 and is a senior member of the Global Economics Team.
- Mr. Slok’s Economics team was ranked No. 1 in fixed income research by Institutional Investor in 2010 and 2011. Slok currently serves as a member of the Economic Club of New York.
- Prior to joining the firm, Mr. Slok worked at the OECD in Paris in the Money and Finance Division and the Structural Policy Analysis Division. Before joining the OECD he worked for four years at the IMF in the Division responsible for writing the World Economic Outlook and the Division responsible for China, Hong Kong, and Mongolia.
- Mr. Slok studied at University of Copenhagen and Princeton University. He has published numerous journal articles and reviews on economics and policy analysis.
Appendix 1

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