

The economy emerges from a severe downturn, poised for positive growth in the second-half of 2009. Reduced inventory liquidation provides material near-term lift to growth.

Underlying inflation remains subdued. While sizable economic slack points to further disinflation, the stability of longer-term inflation expectations is crucial.

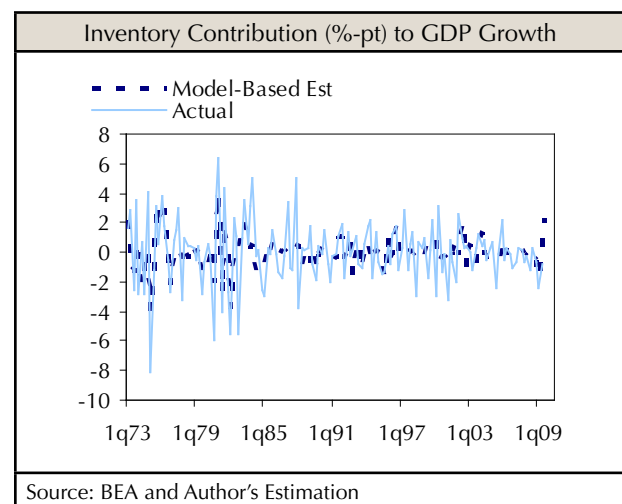
The Fed balance sheet continues to adjust to more normal market functioning. As the economy expands modestly, the trajectory of underlying inflation probably determines the timing of policy normalization. Our forecast still calls for the first 25bps hike to occur in 3q10.

General weakness in the US Dollar persists presumably as a result of improvements in financial market and economic conditions. But clear-cut explanations to the recent Dollar moves remain elusive.

In-line with our forecast, the string of negative US growth figures since 2008 is on track to flip into positive territory by the second-half of 2009 and into 2010. Furthermore, consistent with our May 2009 publication, entitled "Predicting When Recessions Come to an End", the current recession in the US, which began in December 2007, most likely ended somewhere in between June and September 2009.

Incoming indicators suggest that economic growth appears to be tracking roughly 3% in 3q09. But the bulk of the positive contribution should come from the change in inventories as firms reduce the pace of inventory liquidation from previous quarters. And supportive fiscal measures are also contributing to select categories of consumer spending on average. Moreover, government initiatives on housing--indirectly and indirectly--seemed to have provided a reasonable lift to housing demand as inventories get worked-off. But when the foregoing

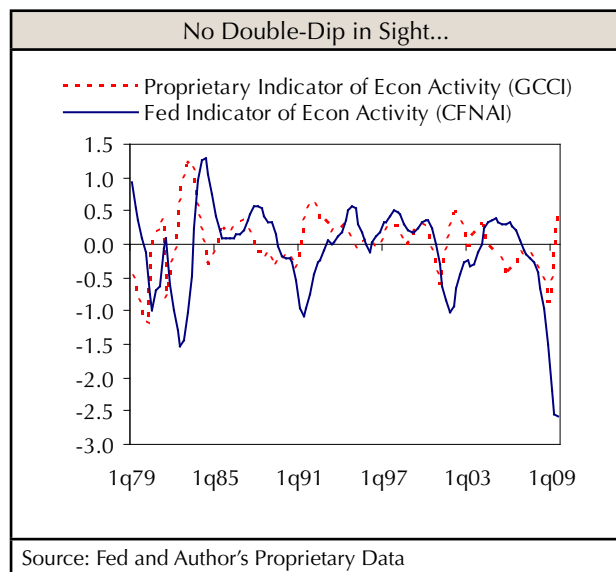
ad-hoc factors begin to subside in 4q09 and 2010, many have begun to wonder about the risks of a "double-dip" growth scenario (i.e., positive growth followed by negative growth).



US Macro Forecast										
(%)	4q08	1q09	2q09	3q09E	4q09E	1q10E	2q10E	3q10E	2009E	2010E
Real GDP (ar)	-5.4	-6.4	-1.0	3.2	1.8	2.4	2.8	3.6	-2.6	2.5
Real PCE (ar)	-3.1	0.6	-1.0	1.7	0.6	1.3	1.4	2.5	-0.8	1.3
Unemployment Rate (avg)	6.9	8.1	9.2	9.6	9.9	10.0	9.8	9.5	9.2	9.6
Total CPI (oya)	1.5	-0.2	-0.9	-1.5	1.2	2.3	2.4	2.1	-0.4	2.2
Core PCE Price Index (oya)	2.0	1.7	1.6	1.3	1.2	1.2	1.0	1.0	1.5	1.1
End of Period (%)	4q08	1q09	2q09	3q09	4q09E	1q10E	2q10E	3q10E		
Target Fed Funds Rate	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.50		
Note: Over-a-year-ago (oya); annual rate (ar); average (avg)										
Source: Actual data sources and UOB forecast										

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Our forecast, however, does not anticipate a double-dip scenario in 2010. But our prevailing outlook continues to expect only a modest recovery in 2010, probably in the neighborhood of around 2.5% on average. The foregoing projection suggests that the unemployment rate, which is anticipated to peak in early 2010 at around 10%, is unlikely to improve materially. As a corollary, the degree of economic slack is also not expected to subside markedly.



While the typical slack-inflation relationship implies further downward pressure on underlying inflation in the coming quarters, there are also valid reasons to dilute this association. Uncertainties over the estimation of potential growth and the changing labor market dynamics imply more caution in the preceding trade-off. (My February 2009 Note, "Overemphasis on Unemployment in Forecasting Inflation can be Misleading", discusses this topic.) Another crucial variable in the debate on inflation is the behavior of inflation expectations. At this time, the various measures on longer-term inflation expectations have been reasonably stable. As a result, we maintain our forecast for core PCE inflation to settle roughly in the 1% neighborhood in 2010.

But our forecast of modestly positive growth coupled with tepid core inflation in 2010 should not be taken as an indication that the "coast is all clear". Indeed, there are still unsettled considerations on the horizon. For instance, the financial regulatory and supervisory framework remains intensely debated at this juncture. The risks associated with fiscal management and tight credit conditions are also important. While the commercial real estate sector continues to deteriorate, other categories

of fixed investment spending¹ have shown tentative signs of improvement. Nevertheless, our forecast expects the continued loosening in financial market conditions, and the ongoing recovery and stabilization in most categories of aggregate demand to keep the US economy expanding into 2010. Assuming the foregoing forecasts materialize, the follow-up question would surround the timing of Fed policy normalization. The subsequent section discusses the recent Fed meeting in September and assumptions behind the policy forecast in 2010.

The FOMC² Shifts Gingerly...

The Federal Open Market Committee's (FOMC) decision to maintain the target fed funds rate between 0% and 0.25%, and rehash the conditional commitment "for exceptionally low levels of the federal funds rate for an extended period" at the conclusion of its September 22-23 meeting was unsurprising. The overall tone of the accompanying statement is also uncontroversial, essentially offering an olive branch to doves and hawks.

In comparison with the prior meeting in August, the September statement differs mostly on two fronts. First, the Committee lifts its near-term economic assessment, recognizing that the economy has "picked up following its severe downturn" as financial market conditions "improved further" and the "housing sector has increased". Second, the Committee decides to stretch-out the \$1.45 trillion in agency (debt and mortgage-backed securities) purchases to 1q10 from its initial schedule of completing them by year-end.

But equally important, the post-meeting statement also preserves the medium-term assessment that the economy is "likely to remain weak for a time". This is partly shaped by the guarded backdrop in consumer spending and the continuing pullback, albeit at a "slower pace", in business investment and employment.

The slightly shorter inflation assessment paragraph in the September statement, which omits commodity prices but adds inflation expectations, appears rather harmless at this juncture. The key phrase that the "Committee expects that inflation will remain subdued for some time" remains untouched, but the additional reference

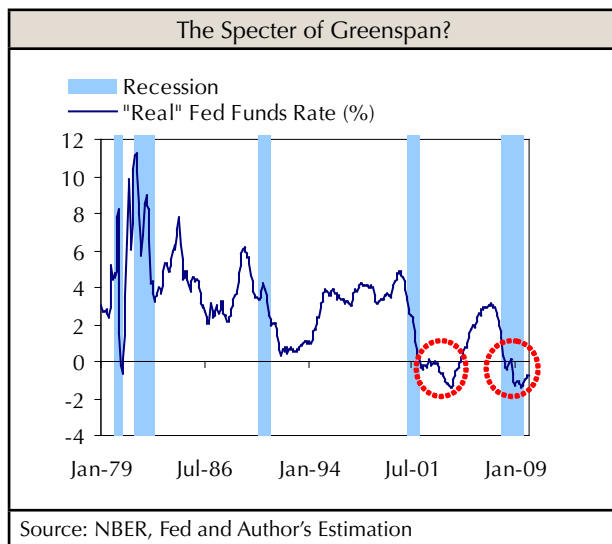
¹ See the author's July 28 Note, "The Inherent Relationships of Fixed Investment Categories".

² The text in this section has been extracted from the author's September 24 FlashNote. The author's September 18 and June 25 publications, "The Intricate Fed Balance Sheet" and "The Fed Still Has Plenty to Chew On", respectively, discuss exit strategies and other related considerations.

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that “with longer-term inflation expectations stable” instigates some speculation. The reinsertion of “inflation expectations” as a reference (the “inflation expectations” reference last appeared in the August 2008 statement) might lay the groundwork for the Committee to rely less on the economic slack vis-à-vis inflation argument per se when it decides to normalize monetary policy eventually. With a modest recovery assumption, the gradual diminution of resource slack per se is unlikely to be a sufficient variable in determining when the Committee decides to normalize the target funds rate.

Instead, the timing of the first rate hike would probably be linked to where underlying or core inflation settles in 2010, in my judgment. Indeed, if core inflation drifts below 1% in 2010 (which is not our baseline forecast), policy normalization would probably occur only in 2011. And a crucial variable in shaping the trajectory of core inflation is the behavior of longer-term inflation expectations. Thus far, the various measures of longer-term inflation expectations still appear reasonably well-anchored. Therefore, assuming core PCE inflation stabilizes around the 1% threshold in 2010 and the unemployment rate peaks at roughly 10% in early 2010, I continue to anticipate the first 25bps hike to occur in 3q10.



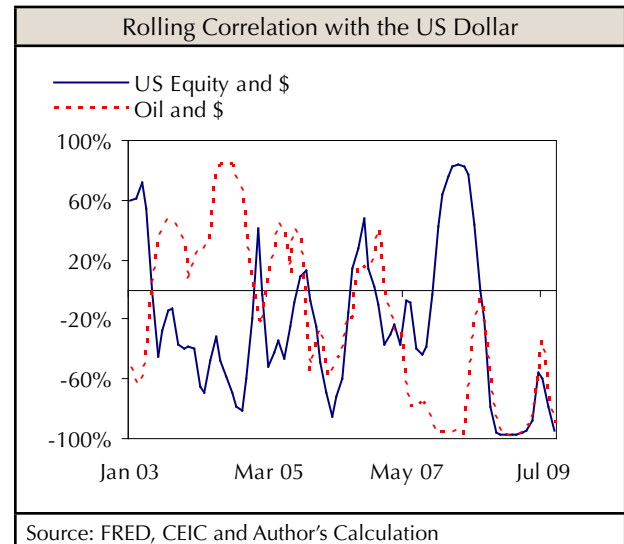
With regards to the agency purchase program, the “Committee will gradually slow the pace of these purchases...to promote a smooth transition in markets...by the end of the first quarter of 2010”. Accordingly, the NY Fed press release elaborates that purchases of agency debt, with a residual amount of around \$70 billion, will be “gradually” reduced in “size” and “frequency” from “once per week” at this time to “once every two

weeks at some point during the first quarter of 2010”. The weekly “amount” of agency MBS purchases, with just under \$390 billion remaining, would be “gradually” reduced commencing with the reporting week beginning September 24, 2009.

US Dollar Weakness...Reasonable but Puzzling

The Dollar real and nominal trade-weighted indexes, against major and broad trading partners, continued to languish over the last three months through September. But the pace of decline seemed to have subsided from several months ago. And in general, the broad Dollar indexes (nominal and real) have fallen by less than the major indexes, and nominal Dollar indexes have also declined slightly more than real indexes since the end of 2008.

In recent months, the aforementioned Dollar weakness on average has closely tracked the price action in US equities and crude oil prices inversely. That is to say, as the S&P 500 and WTI oil price rise, the major trade-weighted nominal Dollar index typically falls. Evidently, this negative relationship intensified in the fall of 2008, and after a temporary let-up thereafter, it has reverted to the former levels of negative correlation lately.

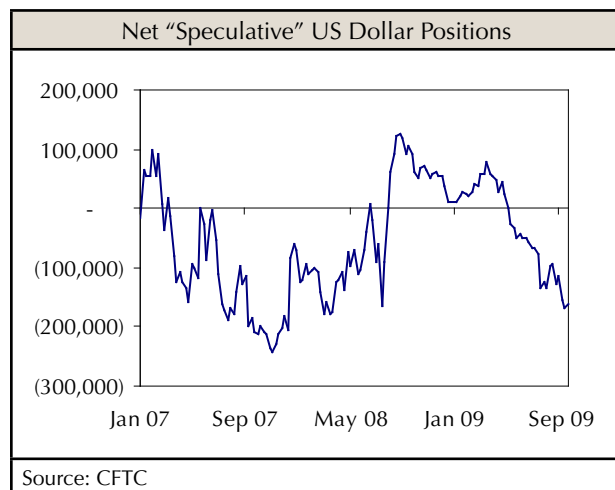


While one might be able to attribute the Dollar selling to reduced levels of risk aversion as the US economy together with the global environment improve, US Treasury yields by-and-large have not sold-off recently. If investors generally have been taking more risk in a compelling fashion, one would expect asset reallocation trades to move away from Treasuries toward riskier assets like equities and commodities. But the monthly 10-

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year Treasury yield has actually fallen by around 30bps since June 2009. So, it is still unclear if the so-called flight-away-from-safety argument is the key explanation to the recent weak Dollar moves. Furthermore, net short “speculative” Dollar positions against six major currencies have also increased noticeably since May 2009. Perhaps, short-term speculative pressures might have also played some role in the Dollar weakness. Overall, while a weaker Dollar seems reasonable as general conditions (economy and market) improve from last fall, one might not be able to attribute this to any straightforward driver at this time.

Nevertheless, another simple, though vague, explanation to the weak-Dollar and strong-equity-and-commodity trade is that recent price action has been primarily driven by “transitory” technical trading. If valid, this could imply that major currency pairs on balance should continue to trade in very broad ranges for now. As evidence on the economy, government policies and mar-



ket conditions accumulates, however, the fundamental drivers of the US Dollar would eventually become more transparent, leading naturally to longer-term and more sustained positioning.