

Economic Flash Report

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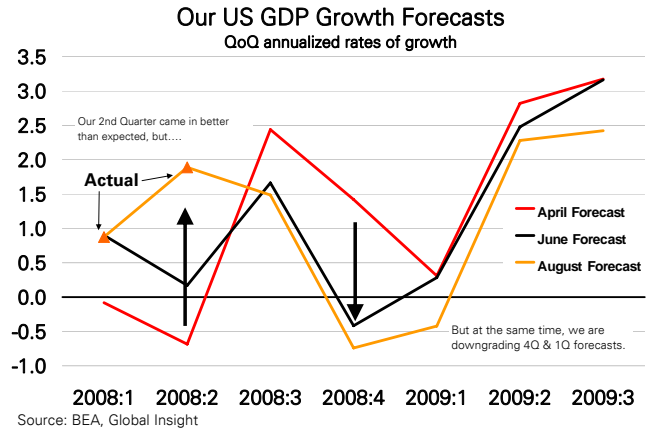
Volume 6

The Economic Flash Report is a RREEF publication which provides updates on recent economic trends. Please contact Alex Symes at alex.symes@rreef.com or Alan Billingsley at alan.billingsley@rreef.com if you have any questions.

- The US economy is experiencing recessionary or near-recessionary conditions.
- Mid-year fiscal stimulus is providing only temporary benefits, although net exports will continue to aid the economy.
- Canada is slowing down, but the intensity should not be the same as in the US.

Overview:

Since our last Economic Flash Report in June, we learned through statistical revisions that the US economy contracted during 4Q2007. Although this does not declare an official start to the recession, it is a strong indicator that the US economy will eventually be declared in recession officially. In the same report we found that economic conditions held steady through the spring, indicating that the fiscal stimulus is underway and, as we expected, net exports are giving a temporary boost to the economy. Economic activity remains lethargic as we enter our eighth straight month of job losses. The housing market remains weak and even as oil weakens, off 24% from its high in July, overall inflation is still a risk. With the double threat of inflation and overall economic weakness, the Fed will likely keep the rates steady through October and possibly into next year.



Forecast Changes:

Our perspective on current economic activity is becoming more 'W' shaped, reflecting a mid-2008 boost in economic growth due to tax rebates. At the same time our forecast is still for a modest recession and a recovery in 2009. Fiscal stimulus should be complete and the lower Fed funds rate should be felt in the greater economy during the third quarter of this year. This leads us to believe that the third quarter will have positive GDP growth, while economic activity will contract in the fourth quarter and into the first quarter of 2009. We should experience stronger, but still below trend growth by the second half of 2009.

Description:	July 2008 (YoY, ths of jobs)
Healthcare	368.1
Government	351.0
Leisure & Hospitality	211.0
Education services	123.4
Social assistance	63.4
Transportation & Utilities	-17.6
Wholesale trade	-22.3
Pro. & Bus. services	-39.0
Information	-44.0
Financial activities	-118.0
Retail trade	-180.1
Manufacturing	-383.0
Construction	-457.0
Total Nonfarm	-67.0
Office-using Employment	-201.0
Housing Related Employment	-8904.6

Labor Markets:

Employment remains weak, with the largest job losses coming from the construction sector. Current statistics show over 450k job losses year to July and RREEF Research estimates that we will continue to lose around 80k per month for the remainder of the year. For the most part, the expected sectors are losing the most employees. Residential, non-residential and public construction projects are taking hits and employment in these sectors are not likely to recover in the near-term. The office-using sector, financial services, business services, the information sector and certain parts of the government sector, are also on the decline. Absolute job losses from these sector match that of construction, but in percentage terms, the office-using sector should perform better. The office-using sector should also rebound well before construction, in late-2008/early-2009.

Inflation:

The era of the 'great moderation' may be coming to an end and inflation is once again a concern to the US and global economy. Historically, the best tool to fight inflation is the tightening of monetary policy through Fed funds rate hikes. However, with the current weakness in the economy, the Fed is unlikely to do so for the next few months and the Fed funds futures reflect this opinion. Currently, inflationary pressures are coming mostly from globally elevated prices in raw materials rather than accelerated wage increases, but this may change in the coming months. Commodity prices recently stabilized and it is possible that they have reached a new equilibrium with global demand. However, there are a multitude of factors affecting prices and forecasts are notoriously unreliable. Higher inflation is likely to stick around for a few years. For more on RREEF Research's view on inflation, see our newly published report, "US Real Estate Market Prospects in an Era of Elevated Commodity Prices."

The GSEs

Like many other market participants, Freddie and Fannie have encountered problems in raising capital over the past year. This is unfortunate timing because both are significantly under-capitalized, and their solvency is in question. Fannie and Freddie are imperative to the recovery of the US housing market, but they are not able to do so in their current state. To improve their ability to raise capital, the Department of the Treasury recently reiterated its backing of both entities and in July presented a plan to extend credit and purchase stock if absolutely necessary. The market is increasingly believing that a take-over by the government will happen as Freddie's stock is currently implying yields over 15% (although dividend drop is in the future).

Either from the government or the market, but both GSEs must raise capital. Although it is unlikely that default rates of conforming loans will exceed 2.0% and both GSEs are within their current reserve requirement (which is debated), the net demand for mortgages are estimated to grow at around \$600 billion per year even within current housing market conditions. With this in mind, the GSEs collectively must increase capital at a rate of \$10 billion per year to maintain their reserve requirements and the amount needed may increase for 2008-2009 as underperforming loans become marketed to market. Fortunately, the Treasury is in a position to afford a bail-out of the GSEs and the total amount needed would be small in comparison to that needed during the financial disasters of the previous two decades.

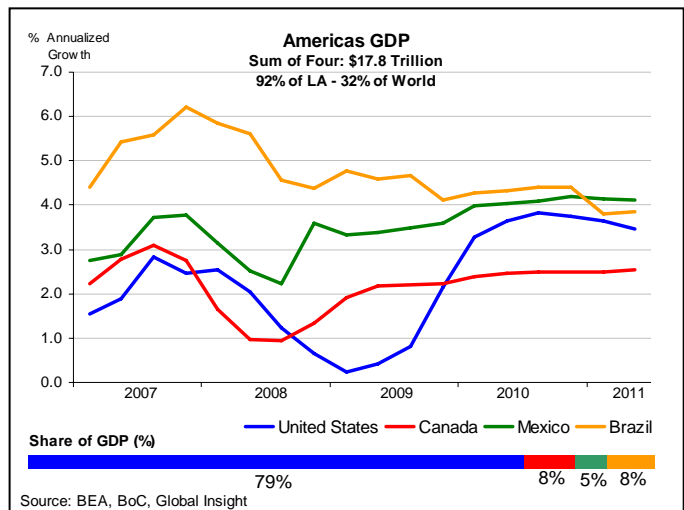
(For more information on the GSEs, see "Fannie, Freddie, Sheila and Hank," DB Global Markets Research 21 July 2008, https://gm.db.com/global_markets/publications/global_perspectives/gep_21july.pdf)

The Americas:

The Canadian economy is slowing along with the US, but not quite to the same degree. Canada's economy is polarized geographically with the natural-resource rich west continuing to outperform the manufacturing and service based east. The strong loonie relative to the US Dollar and the general slowing of the US economy is weakening Canada's comparative advantage on its largest trading partner in manufacturing and retail sales. While boosting economic growth in the west, higher oil is translating to slower car sales. Lower sales along with poor business strategy among the 'Big-Three' are negatively affecting manufacturing in the more populous eastern providences of Canada. Additionally, higher prices at home due to a stronger currency is increasing the number of Canadians heading south of the boarder, hurting retail sales at home.

As with Canada, Mexico relies heavily on the United States for trade and the US slowdown is affecting the economy both directly and indirectly. Exports to the US are roughly equal to one-third of Mexican GDP and economic growth will be directly affected by a slower US economy. The indirect effect is through slower remittance growth from Mexican workers in the US. Remittances add \$24 billion to the economy, boosting consumption by 4%, and growth will slow in the near-term as US job growth also slows (especially from construction). As a energy exporter, higher oil prices will cushion the Mexican economy. Mexico should also see a boost in manufacturing over time as transportation costs work in its favor relative to Asia.

Brazil is less connected to the US through trade compared to the NAFTA members, and although it is highly connected to the slowing EU economy, the Brazilian economy is positioned well in relation to the rest of the world. Natural resources drive the Brazilian economy, and even in an environment of slowing global demand, will continue to aid the economy. Agriculture, of which Brazil is a strong exporter, is experiencing elevated global demand and domestic demand for general consumption continues to be robust as well. Employment growth continues to be strong as over 300k jobs government registered jobs were created in June alone. Brazil will experience some slowing in the near-term as export demand slows, but domestic demand remains strong and commodity prices elevated and so there should be a cushioning effect in the near-term.



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