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Economics as Strategic Input to Business Decision-Making

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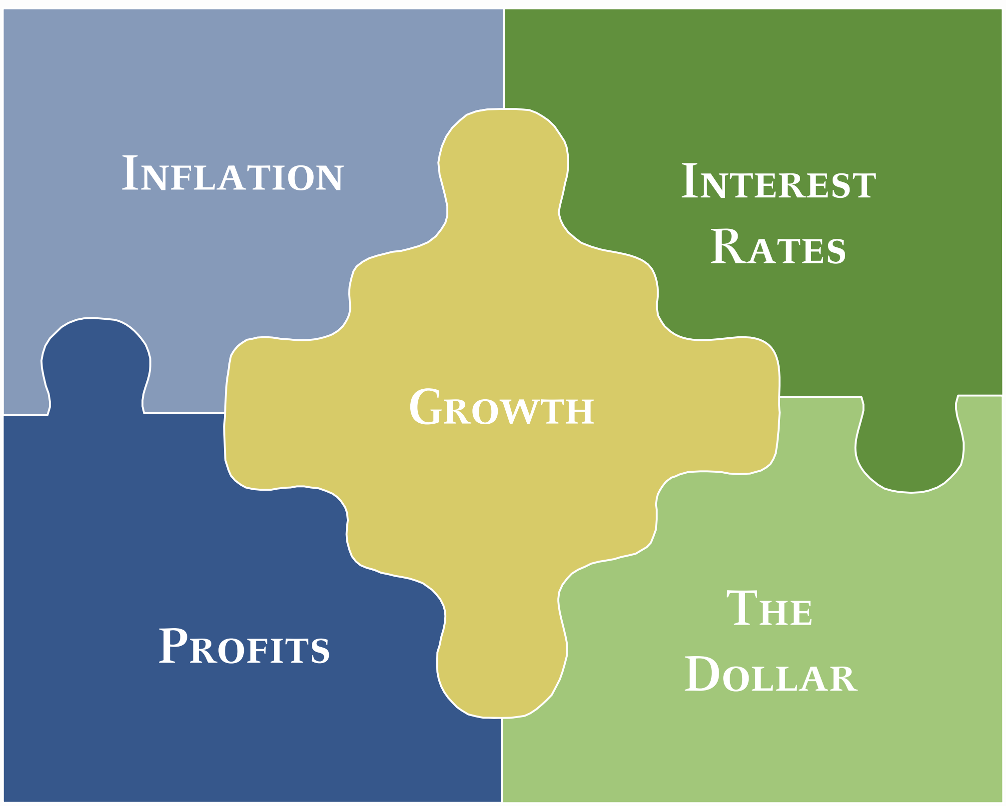
Often the biggest misses in bank strategy have little to do with the day-to-day management of the bank. Instead, these miscues often reflect the difference between actual and expected economic outcomes which drive the underlying success of our customers. Five aspects of the economy provide the strategic input to any tactical banking outlook. We will review each of these factors in turn with the goal of highlighting useful benchmarks to track actual and expected economic performance.[1] These five aspects are:



Source: Wachovia

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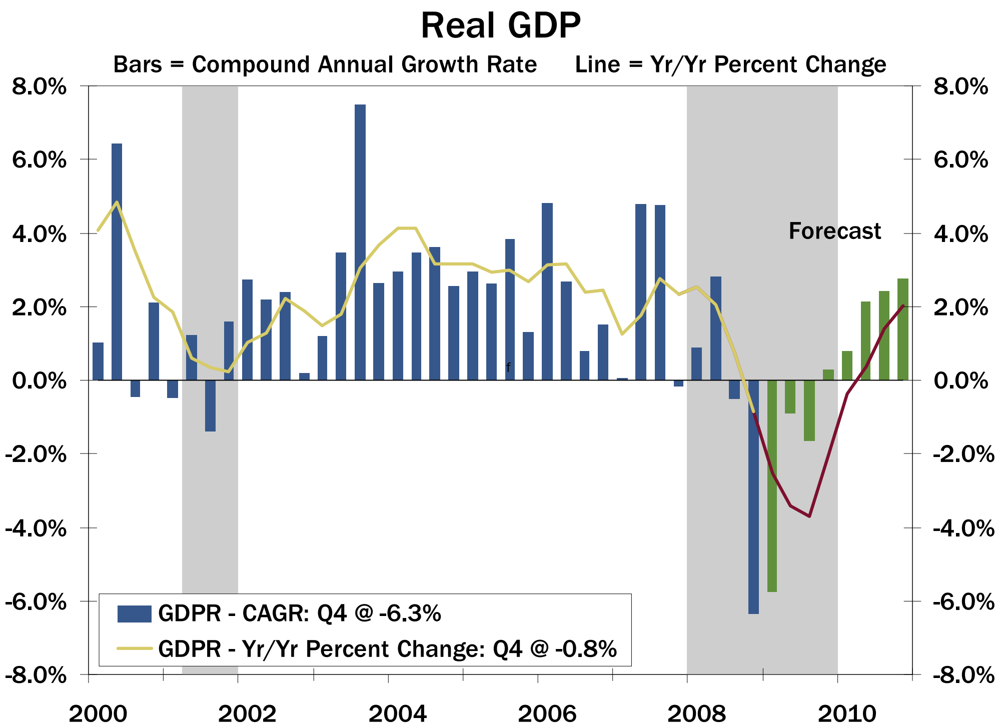
[1] A prior version of this report was first published on March 17, 2009.

Growth: Where Are We and Where Are We Going?

Discerning where we are in the economic cycle and when trends begin to change is a core task of any strategic vision. The state of the economy drives top line revenue. The overall pace of economic growth is most-often benchmarked as the year-over-year growth rate of real gross domestic product (GDP) (Figure 1). On a monthly basis, the pace of employment growth provides clues to the pace of GDP growth. Employment serves as the primary input to estimates of personal income. A second monthly gauge of GDP is industrial production, which serves as the primary gauge of the nation's output.

Figure 1



Source: U.S. Department of Commerce and Wachovia

As for changes in economic trends, two indicators provide practical guidance. These two series are initial jobless claims and the Institute for Supply Management's manufacturing survey. A weekly survey of first time unemployment claims comes out every Thursday morning. Claims are very sensitive to changes in firms' willingness to retain workers. Over the history of economic cycles, a rapid rise in claims above the 500,000 level has been a typical sign of economic weakness. Second, the Institute for Supply Management (ISM) index provides a simple monthly benchmark for break even for the manufacturing portion of the economy. A value above 50 means manufacturing is expanding. If the index is below 50, then manufacturing is contracting. The ISM indicator provides subcomponents of production, new orders, employment and supplier deliveries that provides additional detail for looking into the intricacies of the business cycle.

Recent economic weakness reflects the abrupt decline in consumer outlays during the quarter as well as crumbling residential construction and declining trade.

Consumer spending is being hurt by income and labor market fundamentals. Household net worth has declined due to losses in equity markets and declining home values. Looking ahead, spending for big-ticket items such as automobiles and household furniture is expected to remain weak in coming quarters. Slower job and income growth will also curb consumers' willingness to spend during the recovery in late 2009 and early 2010. The outlook is for several more quarters of negative growth and a slow, shallow recovery.

Longer Term Influences on Growth and the Strategic Vision

Demographic trends provide a basis for longer-term strategic planning. Over the last forty years there has been a consistent shift in population growth from the Northeast and Midwest to the South and the West. This population shift drives expectations of the type and size of retail and wealth management services for clients.

The upper Midwest and the Northeast will continue to shed population, as baby boomer retirees and job seekers alike seek opportunities in the Sunbelt and the West. Meanwhile, the growth of the Hispanic population suggests gains in household size and therefore gains in single-family housing demand will eventually return.

Another observable demographic trend is the rising returns to education. Mean family income data from the Federal Reserve's Survey of Consumer Finance show that income growth for high school graduates and those that fail to graduate is far slower compared to those who even obtain some college education. Rates of joblessness are significantly lower among the population with higher education. This suggests that banks will increasingly benefit from educated households with rising income as a source of deposits and high credit quality loans in the years ahead.

Figure 2

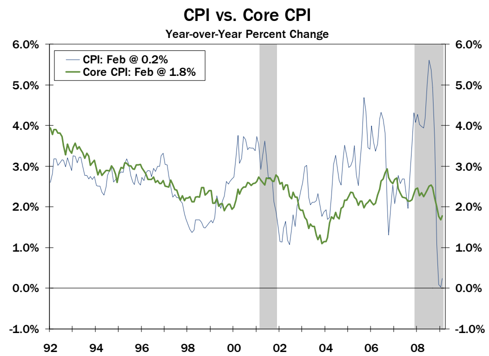
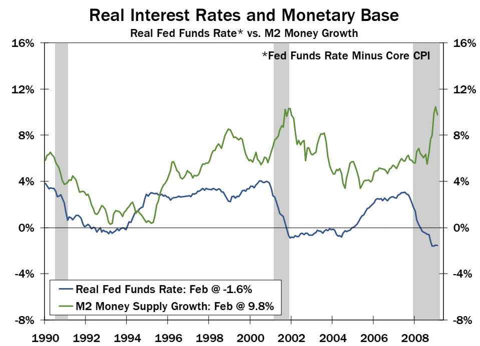


Figure 3



Source: U.S. Department of Commerce, Federal Reserve and Wachovia

Inflation: Second Fundamental and a Driver of Interest Rate Expectations

Inflation, as measured by the Consumer Price Index (CPI), provides a baseline for both business leaders and policymakers at the Federal Reserve (Figure 2). The CPI simply measures the rate of increase in the prices of a fixed basket of goods. Rising inflation tends to lower the real value of money and thereby prompts the Federal Reserve to raise rates to slow the economy to slow inflation pressures. In recent months inflation has declined on a year-over-year basis. This has allowed the Federal Reserve to execute and maintain its easy monetary policy.

A leading indicator of inflation is the ISM prices-paid index which indicates the balance of firms that are paying higher or lower prices. Again, 50 is the breakeven point between rising and falling prices paid. One long range inflation predictor is the unit labor costs index. For example, slower growth in unit labor costs signals reduced inflation pressures ahead.

Interest Rates: The Short and Long of It

Monetary policy sets the pace for short-term rates (Figure 3). These rates reflect the Fed's twin goals of full employment and price stability. In the short-term, the Fed sets the funds rate as the benchmark rate to achieve its growth and employment goals. Longer-term, however, we suspect the Fed remains cautious on the inflation outlook and moves the funds rate to achieve its longer-run inflation target.

Longer-term interest rates reflect the influence of growth and inflation expectations as well as the balance of credit demand, especially to finance federal deficits, and the needed credit supply coming from abroad. Easy monetary policy in the form of low rates is used to increase demand for money and stimulate the economy.

Corporate Profits: Income to Shareholders, Funds for Real Investment

Profits are the incentive for investment in the real economy (Figure 4). They drive the interests of shareholders who seek income from their investments. Meanwhile, profits are the source of funds for future investments and economic growth. Profits are a signal for economic action and reward.

In the short run, one indicator of future profits is the direction of change for capacity utilization. Increases in capacity utilization tend to be associated with higher profits as firms spread their fixed costs over a higher pace of output. Over the business cycle, another indicator of the direction of corporate profits is the ratio of prices to unit labor costs. As prices rise relative to unit labor costs profit margins tend to rise.

Figure 4

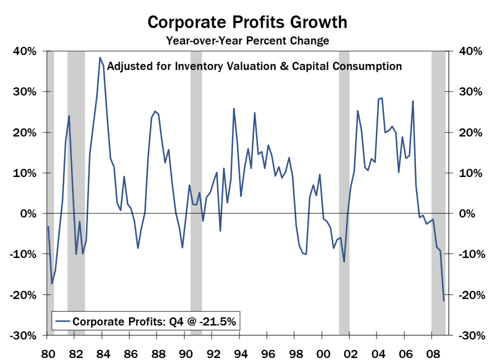
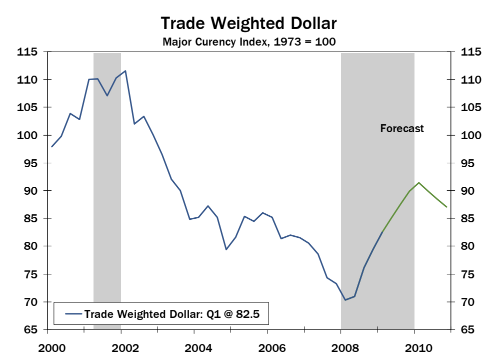


Figure 5



Source: **U.S. Department of Commerce, Federal Reserve and Wachovia**

Dollar: Relative Growth, Interest Rates and the Current Account

Exchange rates are one of the most complex prices in economics since the exchange rate is a relative price of one currency in terms of another. Therefore, the path of any exchange rate over time reflects the relative changes in interest rates and economic growth expectations between the two countries. One standard measure of the "dollar" exchange rate is the Federal Reserve's Major Currencies index, which measures the dollar's value against seven major foreign currencies (Figure 5). For the bank's customers, changes in the dollar's value have a significant impact on the cost of imports and the competitiveness of exports abroad.

As you would expect, indicators for future values of the dollar would be any indicators of change in expected interest rates or growth rates between countries. For example, interest rate differentials between the United States and most major foreign countries reflect the likely change in U.S. interest rates relative to interest rates abroad. A second influence is the current account deficit with reflects the relative flow of goods and financial capital. Unfortunately the deficit for the U.S. is relatively large and likely to depress the value of the dollar over the long run. However, in the short run, dislocations in credit markets have given foreign investors a flight to safety incentive to buy U.S. securities, particularly Treasuries, which has definitely benefited the dollar. In addition, recent dislocations in credit markets, which should keep new issuance of fixed income products depressed for some time, will give foreign investors fewer U.S. securities to purchase, which will weigh on net capital inflows.

Summary: The Interplay of Economic Factors over Time

For the longer-term outlook, there is a delicate balance between foreign investors' willingness to purchase U.S. assets, the returns on those assets and the risk of currency loss on those assets. Net capital inflows to the U.S. (demand for dollars) are expected to fall short of the current account deficit (supply of dollars) in the years ahead. Will that push up interest rates or push down the dollar? Will the Federal Reserve tolerate higher inflation as an alternative to accepting the weaker growth associated with higher interest rates and a weaker currency? For decision-makers, the five economic drivers of performance are not only changing over time but so is the interplay between these factors. In our opinion, these are the risks and rewards of strategic thinking.

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