Outlook for the Economy- Third Quarter 2009

The third quarter advanced estimate of 3.5% GDP growth exceeded expectations. Stimulus fed growth was robust partly because it bounced from such a low level. Revisions will bring the rate back closer to 3%. The initial GDP report assumed an $8.4 billion drop in nondurable goods inventories while the fall in inventories has already been revised to more than twice that amount. This revision with respect to third quarter inventories will deflate third quarter growth and help bolster fourth quarter growth numbers. Even though consumer spending is likely to be sluggish in the fourth quarter, business spending may pickup as firms commit to productivity enhancing capital investment rather than hiring. The 11% rise in core capital goods orders last quarter suggests that business spending is about to pickup.

Effects from government spending earlier in the year will continue to be seen in the fourth quarter. Real growth in the 2.4 to 2.7 percent range is most likely. Unfortunately, unemployment will not show much if any improvement other than temporary hiring for the holiday season. Any employment data improvement is more likely to show up in the average work week, which is currently at only 33 hours a week. Layoffs are slowing but net new job creation is lagging improvements in other areas of the economy. Interest rates will likely remain low throughout 2009 and into 2010 with a gradual increase in the second quarter of next year.

Inflation is not a concern at the present even though money supply growth has been massive. The core PCE deflator, which excludes food and energy prices, was up 1.4% at an annual rate in the third quarter. Consumer demand remains too weak to drive price increases. Capacity utilization is currently only 70.5%, far below the threshold of 81% that normally defines the point where bottlenecks lead to inflation. While spiraling inflation is not likely to drive interest rates higher, the glut of government securities in the market will push real interest rates higher sometime into next year. The Fed will soon begin to wean the Treasury from artificial market conditions created when the Fed buys Treasury securities. Without help from the Fed, market clearing yields of government securities will be driven up (prices down). Overall market rates will follow the direction of higher Treasury yields.

Will the Shape of the Recovery be a V, U, or W?

In a traditional V-shaped recovery, employment initially lags behind other measures of economic improvement. The lag is short as the rebound gains speed soon after hitting bottom. Even so, the current combination of GDP growth in excess of 3% and an unemployment rate over 10% is unusual. Drags on this recovery are numerous and deeply rooted in housing, debt accumulation, wealth erosion, and instability of the business environment. Consumer sentiment remains mired at low levels even though public pronouncements of the recession's end may have provided some bounce in expectations. An upward path in expectations will not be smooth as evidenced by the decline in confidence in early October followed by improvement in the second half of the month. This inconsistent upward trend in confidence is likely to continue. Consumer fundamentals are still very weak and will improve at a very gradual rate. Third quarter spending was largely fueled by temporary government programs that have not permanently improved the overall condition of consumers. Job losses continue, even though they are well below their pace early in the year. The problem for consumers is that hiring remains comatose, raising the question of whether a jobless recovery can be sustained. Business is reluctant to add permanent labor with such high levels of uncertainty about worker benefit costs, taxes, and future sales.

Income growth must improve if the consumer is to play a larger role in the recovery. Income growth continues to be dominated by the government, with transfer income by far the largest positive dollar contributor to income in most recent months. Asset income remains a major drag. From a longer-run perspective, the main support to spending continues to be the government. Transfer receipts and rental income are the only components of personal income above their year-ago levels if we exclude government support programs for vehicle sales, housing and appliance sales. Wage income is more than 5% below its year-ago level. Dividend income is tracking over 25% below its year-ago level while transfer income is up nearly 15%. These relationships are not sustainable for a real recovery.

The stock market is trending upward, suggesting improved market expectations. However, market movements are tenuous and fragile. Wages are well below their year-ago levels even though they have stabilized. Average house prices have stopped declining in recent months, but massive foreclosures will dampen any upward pressure. Gasoline prices are rising, something not common this time of year and a clear negative for household finances. Concerns about the outcome of major policy debates over healthcare, the environment, consumer credit card policies, and tax policy all tend to undermine confidence. The bottom line is that even though economists proclaim that the recession is over, consumer fundamentals and conditions for sustained GDP growth remain on a thin edge that could easily topple backward. A normal recovery must be driven by more dramatic improvements in the labor and housing market joined by growing confidence in future sales and earnings.

When will the Fed Wean the Economy from a Reliance on Money Creation?

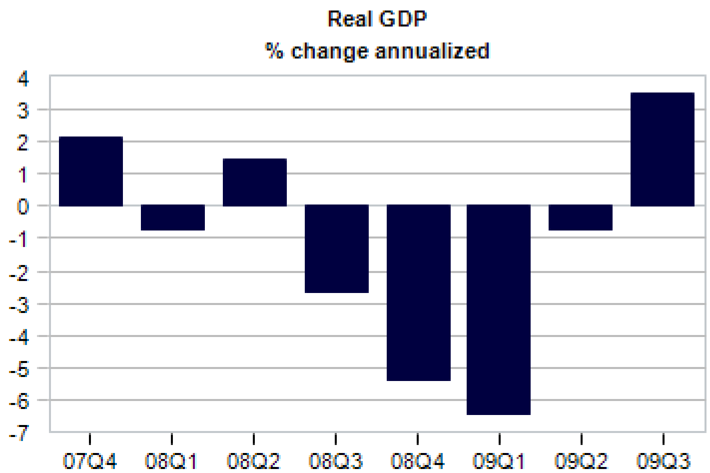
Part of the Economic Recovery Act provided the Fed with an allotment of $1.25 trillion for Mortgage Backed Securities (MBS) purchases in order to help support the housing market. The program allowed the Fed to be a big buyer in the MBS market helping keep MBS prices high and home loan rates low. Fed purchases peaked back in May and the program is now winding down. The remaining MBS purchases will be rationed through the end of March 2010 with no additional purchases beyond the allotted amount. Housing loan rates will be on the rise in the second quarter of 2010 without the buying support from the Fed.

In a similar manner, the Fed is winding down purchases of U.S. Treasuries. As the government deficit mushrooms the market must eventually begin to absorb the supply of Treasuries without as much help from the Fed. Treasury prices will fall and yields will increase. The upward pressure on Treasury yields will be felt across all markets with generally higher interest rates that will work against a recovery. The Fed is currently searching for an exit strategy from unsustainable monetary expansion without slowing the recovery. A likely alternative is for the Fed to develop a new policy allowing them to pay interest rates on bank deposits. If banks are using reserves too fast and expanding the money supply the Fed can raise the interest rate on reserves to slow down the process. In this way the Fed can slow the use of excess reserves from prior Fed purchases of Treasuries. Without such a new approach interest rates will climb as the Fed begins to moderate the excessive growth of the money supply.

Summary of Recent Economic Data

GDP and Production – can GDP continue to growth after the stimulus?

- The U.S. economy expanded at a 3.5% annualized rate in the third quarter, according to the advance estimate by the BEA. This was the first quarter of growth since the second quarter of 2008. Subsequent revisions will probably bring the growth rate closer to 3.0%. The chart below illustrates real GDP growth in the last eight quarters.



Source: Bureau of Economic Analysis

- Third quarter expansion came from increased consumer spending, including a big jump in auto sales, a smaller rate of decline in inventories, stronger exports, stronger investment in housing, and a smaller drop in business investment. Drags on growth came from the third quarter were stronger imports, a contraction in state and local government spending, and a smaller increase in federal spending. Changes in GDP and its components over the last four quarters are provided in the table below.

Annualized Percentage Change of GDP and GDP Components from the Prior Quarter

	Q3'09	Q2'09	Q1'09	Q4'08
Consumption	3.35	- 0.87	0.61	- 3.09
Investment	2.27	- 12.54	- 38.98	- 20.25
Government	2.32	6.72	- 2.62	1.17
Exports	14.73	- 4.12	- 29.95	- 19.47
Imports	16.35	- 14.75	- 36.37	- 16.73
Real GDP	3.53	- 0.74	- 6.43	- 5.37
Implicit GDP Deflator	0.76	- 0.02	1.92	0.00

- New orders for manufactured durable goods increased by 1% in September compared to a downward revision of -2.6% for August. New orders for the third quarter increased at a 12.3% annual rate, compared to 4% growth in the second quarter. The third quarter report suggests that manufacturing is recovering and supports a more positive outlook for fourth quarter business investment.

- Industrial production increased 0.7% in September, the third consecutive monthly gain. This marks the first period of sustained increase since 2007. Much of the strength reflected motor vehicle production, which has been ramping up since June.

- Capacity utilization rose from 69.9% to 70.5%, the highest since January but still far below the pre-recession level of almost 79%.

- The Manufacturers Alliance/MAPI composite index grew from 24% in June to 38% in September. This is the strongest survey result since the third quarter of 2008 and the second consecutive quarter of improvement. It suggests that manufacturing conditions are beginning to recover. The inventory index dropped from 15% to 7%. This is an encouraging sign, since low inventories will promote production when sales improve.

- The recovery in manufacturing continued in October according to the increase in the Institute for Supply Management's manufacturing index (52.6 to 55.7). The index reached its highest level since April 2006. The October ISM suggests the fourth quarter got off to a better than anticipated start.

- Total business inventories fell 1.5% in August, in line with expectations for a faster rate of inventory drawdown. The aggregate I/S ratio declined to 1.33 compared to a high of 1.46 in January. Low inventory levels suggest improved manufacturing in the fourth quarter if consumer demand continues to build.

Labor and Employment – can we have a recovery without more job growth?

- The unemployment rate increased to 10.2% in October from 9.8% in September and from 9.7% in August. The labor force also contracted sharply, by 571,000 as discouraged workers dropped out of the market. The labor force participation rate fell by 0.3 percentage points to 65.2%, and the employment-to-population ratio fell even more, to 58.8%, from 59.2%.

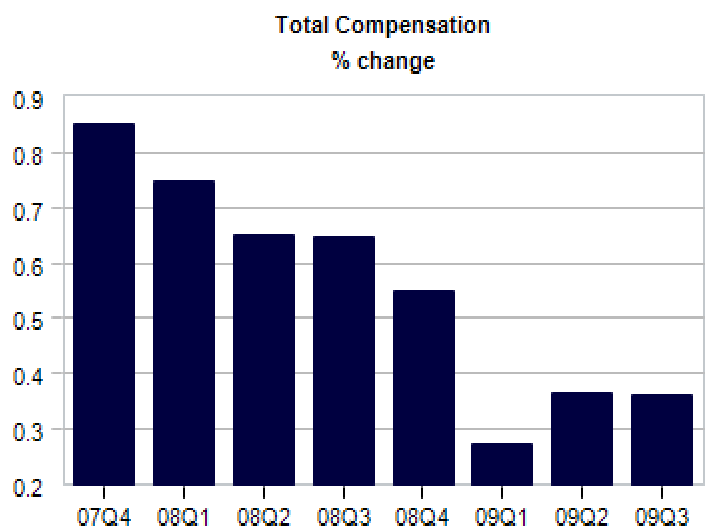
- Job losses increased to 263,000 in September from 201,000 in August. Some of the increase can be attributed to job cuts in state and local government. Job losses in the private sector increased from 182,000 in August to 210,000.

- A weak labor market is also revealed by the decline of the average workweek to 33 hours. The combination of a shorter workweek and reduced employment pulled down the aggregate hours index by 0.5%.

- Average hourly earnings increased 0.1% in September following the 0.4% increase in August. Wage increases reflect the scheduled increases in the minimum wage. Average hourly earnings are 2.5% higher than a year ago. However, low inflation is allowing for real gains, unlike a year ago.

- Initial claims for unemployment insurance benefits increased to 531,000 in the week ending October 17 from a revised 520,000 (previously 514,000). This brings the four-week moving average to 532,250. Weekly jobless claims have been on a declining trend since March of this year..

- On a year-ago basis, total compensation slowed to 1.6% in the third quarter of 2009 from in the second quarter. Third quarter year-ago compensation growth set a new historical low in total compensation growth for the second consecutive quarter since the beginning of the series in 1982. The chart below illustrates the quarter to quarter percentage change in total compensation.



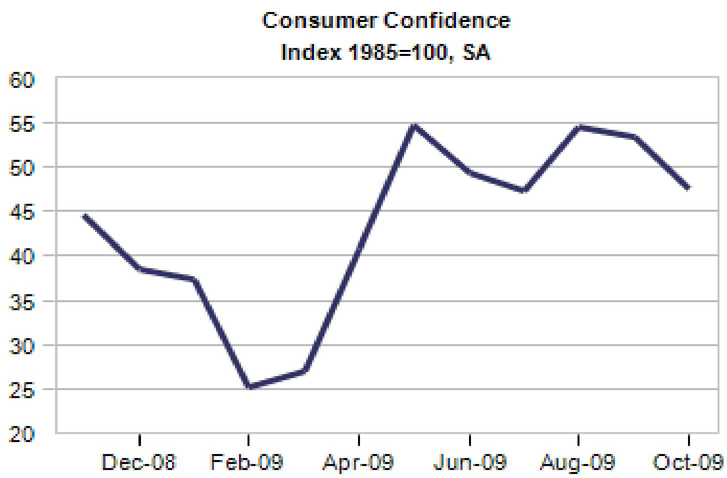
Source: Bureau of Labor Statistics

Confidence and Sentiment – we may not have fully turned a corner.

- The Conference Board index of consumer confidence fell more than expected in October, reflecting a pessimistic view of the economy. The index fell to 47.7 from an upwardly revised 53.4 (previously 53.1). Buying plans weakened across all durable goods.

- Consumers expect stock prices to decline and nearly half of consumers expect interest rates to rise.

- The expectations component of the index led the decline, falling to 65.7 from 73.7 (previously 73.3). The present situation component also fell to 20.7 from 23 (previously 22.7). Movement of the Confidence Board's index since December of 2008 appears below.

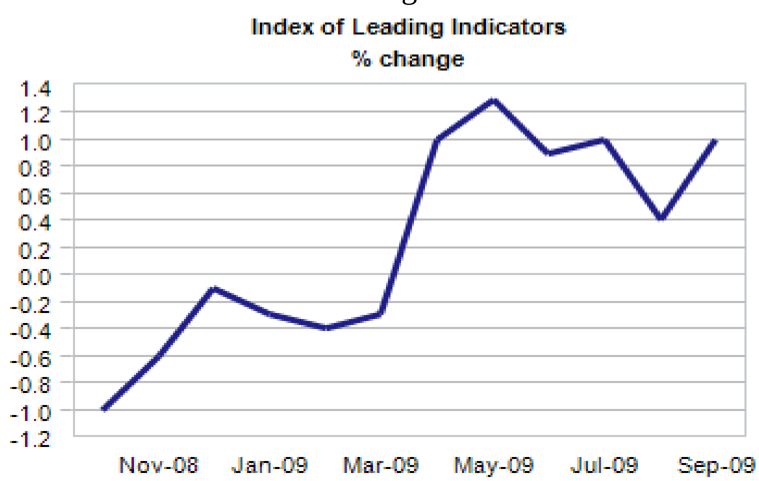


Source: Conference Board

- September's 1% increase in the index of leading indicators was the sixth consecutive monthly gain. The coincident index was unchanged, but August's figure was revised to 0.1% (previously 0%). The rise in the leading index suggests that a recovery is underway.

- The leading index in September was 2.8% higher on a year-ago basis.

- The general increase in the index of leading indicators is illustrated in the chart below.

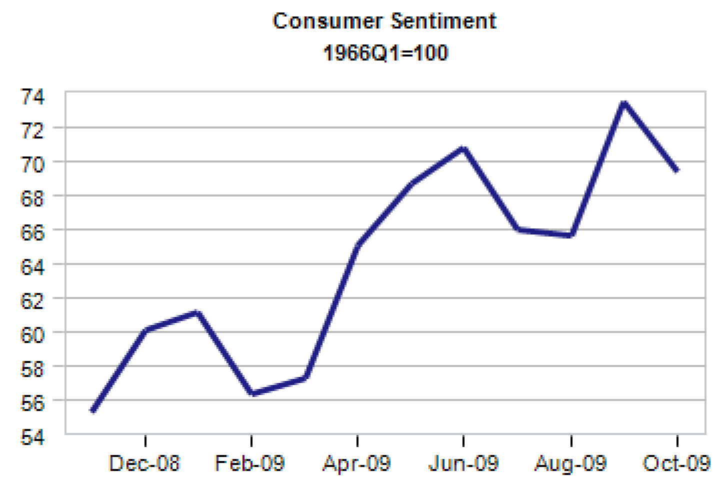


Source: The Conference Board

- The University of Michigan consumer sentiment index gave back part of its September gain in October. Short-term inflation expectations rose sharply from September.

- One-year inflation expectations jumped to 2.9%, from 2.2% in September. The five-year outlook inched up to 2.9% from 2.8% in September and August.

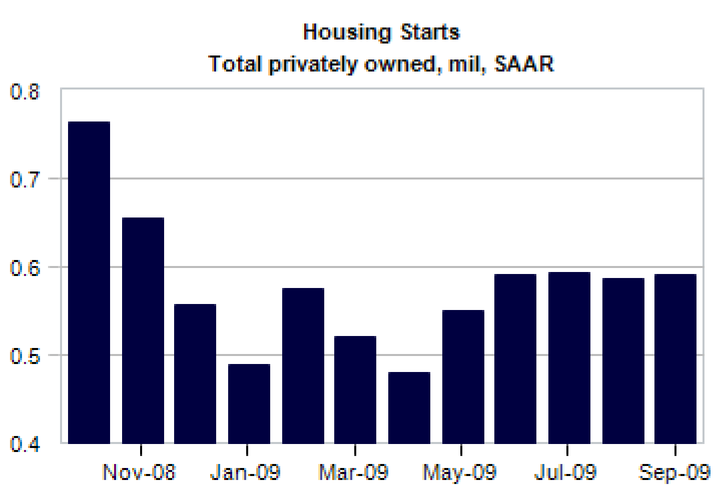
- The chart below illustrates the upward trend in the Michigan index over the year.



Source: University of Michigan

Housing… the housing market appears to be on a <u>very</u> slow path to recovery.

- Housing starts increased from 587,000 to 590,000 annualized units from August to September but this 0.5% gain falls below consensus expectations. The September gain is due to strength in single-family starts, which has been trending upward for most of the year. Even so, the pace remains very weak compared with one year ago.



Source: Census Bureau

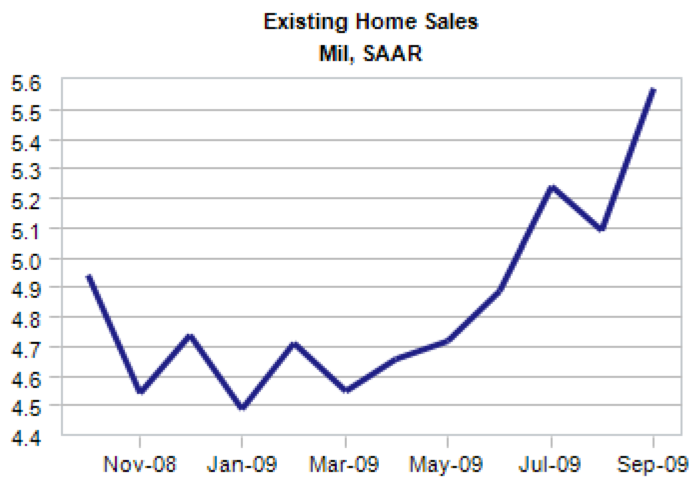
- Total housing permits fell by 1.2% from August and were down by 29% on a year over year basis. Housing completions for September came in at 693,000, a 10% decrease from August. Unlike starts and permits, completions have not bottomed and continued to trend downward.

- The seasonally adjusted S&P/Case-Shiller 20-city home price index increased 1% for the three months ending in August from the prior three months ending in July. The 10-city index also increased by 1% over the month. .

- The 20-city composite index suffered its smallest decline in 19 months falling by 11.4% on a year ago basis. The 10-city index decreased by 10.7% from a year ago in August, compared with a 12.7% decline in July.

- The NAHB housing market index fell slightly in October but the index is still up by 28.6% compared with its October 2008 level.

- Sales of existing homes increased by 9.4% in September with sales of 5.57 million annualized units (the strongest pace since August 2007). Sales increased by more than 9% on a y/y basis while inventories improved significantly, sliding to 7.8 months (the lowest since mid-2007).



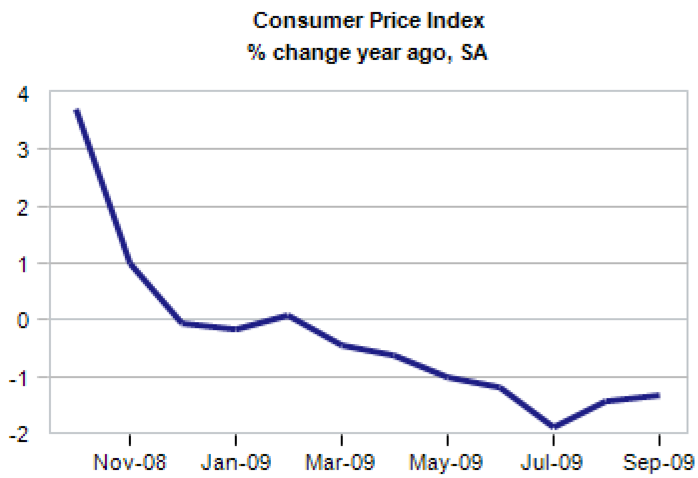
Source: National Association of Realtors

Inflation …deflation may be come to an end as signs of inflation slowly emerge.

- The personal consumption expenditure price index (PCE) increased by a 2.8% annualized rate in the third quarter after a 1.4% increase in the second quarter. The core PCE deflator, which excludes food and energy prices, was up 1.4% in the third quarter. The PCE core deflator increased 2% in the previous quarter. The core PCE deflator is the Federal Reserve's preferred inflation measure.

- Producer prices for finished goods gave ground in September (-0.6%), largely because of falling prices for energy products. Excluding food and energy products, core prices for finished goods fell slightly (-0.1%). While prices for finished goods are falling, core inflation among intermediate and crude products remained very rapid for the second month in a row.

- The top-line CPI for urban consumers increased by 0.2% from August to September thanks to lower increases in gasoline prices and a continuing fall in food prices. The core CPI also increased by 0.2% for the month and is up by 1.5% from September 2008. Inflation is staying relatively level for the moment after a sustained period of deflation, as shown in the chart below.



Source: Bureau of Labor Statistics

Retail Sales – not out of the woods.

- Retail sales fell but less than expected in September. The decline was due to a sharp drop in auto sales as the cash for clunkers program ended. Total sales fell 1.5% but rose 0.5% excluding autos and 0.4% excluding gas stations. The data imply consumer spending is improving.

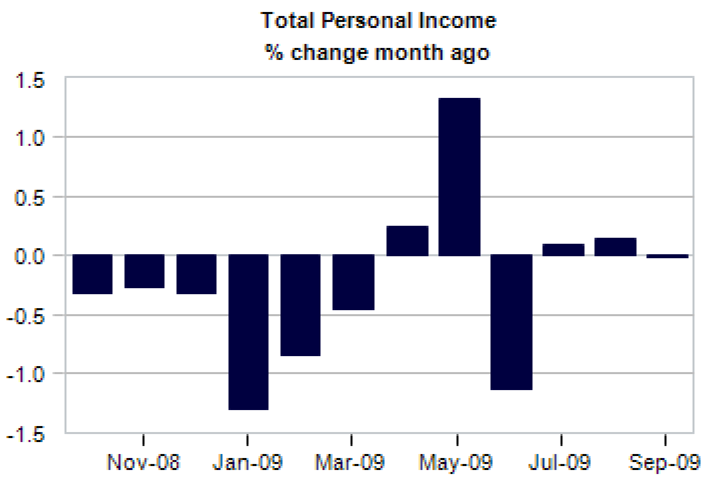
- Chain store sales posted their fifth consecutive modest gain in the latest week. Recent gains have averaged only 0.25% per week and have not returned the index to its level of six weeks ago.

Personal Income – improvement but not much fuel for spending.

- Personal income increased .1% in August but remained unchanged in September. Spending declined 0.5% following a 1.4% gain in August, as vehicle sales plunged in the aftermath of the cash for clunkers program.

- The saving rate rose to 3.3% in September as consumers returned to saving after buying cars to get clunker monies in August. Real spending dropped 0.6%.

- Monthly personal income changes are illustrated in the chart below.



Source: Bureau of Economic Analysis

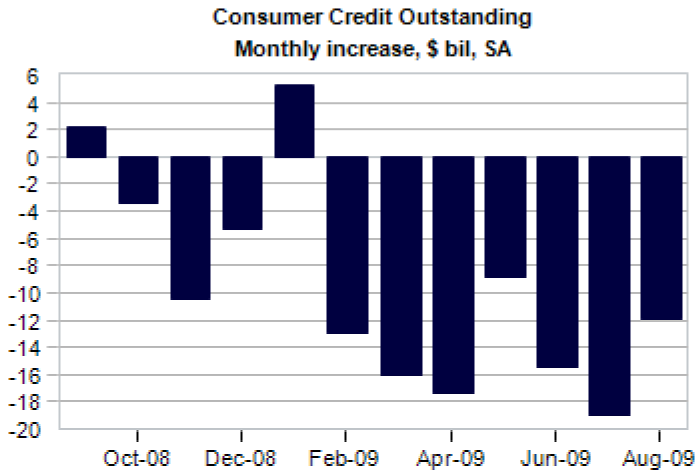
Consumer Credit – paying down debt is a new priority.

- Consumer credit balances declined rapidly in August as consumers continued to reduce debt. Total credit balances fell at an annualized rate of 5.8%.

- Revolving credit dropped by $9.9 billion in August, which is a 12.3% annualized rate of decline.

- Non-revolving credit balances declined moderately in August. The $2.1 billion decline represents an annualized change of -1.6%. Greater vehicle sales related to the cash for clunkers incentive helped non-revolving credit balances hold up better than they did in previous months.

- The chart below illustrates the declining pattern for consumer credit over the past year.



Source: Federal Reserve

International Trade – narrower deficits with slower trade overall.

- The U.S. trade deficit narrowed to $30.7 billion in August, from July's $32 billion deficit. Exports were up by $200 million from the month before, but imports were down $900 million.

- The trade deficit with the U.S.'s largest trading partner (Canada) narrowed by 27.9% to $1.5 billion in August and the trade deficit with China also narrowed but by less than 1% to 20.2 billion. The trade deficit with Mexico, the U.S.'s second largest export destination and third largest import destination, widened by 34.6% to $4 billion. The trade deficit with Japan widened by 11.6% to $4.3 billion.

- The dollar depreciated against the currencies of most of its major trading partners. The dollar fell 4% against the British pound, 3% against the Canadian dollar, and 2.5% against the Japanese yen.