Outlook for the Economy- Second Quarter 2009

The U.S. economy continued to contract in the second quarter with a 1% decline in real GDP following the revised declines of 6.43%, 5.37%, and 2.68% in the prior three quarters. If the downturn ends with the second quarter of 2009, the peak to trough decline in the economy would reach 3.9%. The downturn, which is the worst since the Great Depression, dates back to late 2007. After18 months of contraction, the economy appears to be stabilizing for the second half of 2009. The fiscal stimulus is likely to kick in with maximum impact just as the economy finds its bottom and begins a recovery. Even with the stimulus the recovery should be slow and uneven. Labor market improvement will lag the performance of the rest of the economy. Approximately 3.4 million jobs disappeared since the start of 2009 and 6.5 million jobs have been lost since the onset of the downturn. The plunge in wages and reductions in total compensation to workers over the last few quarters will hold back spending, aggravate credit conditions, and keep home foreclosures going.

Aggressive monetary policy and historic lows in short term interest rates are likely to continue throughout 2009. The depth of the economic downturn has offset the Fed's easy money position, keeping inflation pressures low. The core personal consumption expenditure (PCE) inflation rate increased 1.7% on a year-ago basis in the first quarter. The PCE year-over-year change should remain below 2% with the core rate of about 1.25% through 2009. Long run fears of high inflation due to mounting government debt and the Fed's easy money policies are on hold for now.

Many sectors of the economy are improving but any real expansion will require a full recovery in housing. Housing markets are linked to many other sectors of the economy that will not rebound until housing inventories shrink and new construction picks up. High rates of mortgage delinquencies and defaults suggest lingering problems in housing. Real GDP should see a small increase in the second half of 2009 as conditions stabilize and monetary and fiscal policy boost demand. Still, the expansion will be weak. There is little pent-up demand for autos and housing, which traditionally lead expansions.

Demand will slowly accelerate in 2010, with weak growth until the end of the next year. However, large downside risks remain. Efforts to address growing foreclosure could prove inadequate, leading to larger declines in house prices and to a further downturn in consumer spending. Also, financial markets remain vulnerable, and additional disruptions could further reduce the flow of credit, short-circuiting any recovery.

A Very Fragile Recovery

Good news comes from manufacturing where customers have successfully cut inventories, and final demand is slowly improving. New orders for manufactured goods rose 0.4% in June, following May's 1.1% gain. Revised durable goods orders show a 2.2% decline, compared with the 2.5% previously reported. Nondurable goods orders increased 2.7%, their largest rise since 2008. The inventory to sales ratio declined to 1.42 months, compared with June's 1.45 months.

Manufacturing conditions should continue to improve as the bulk of inventory drawdown is over. Support for improvement in manufacturing conditions also come from freer credit, increases in business sentiment, and a rebound in auto production. Demand is also gradually improving. New orders for manufactured goods have increased for three consecutive months, which is a positive for factory activity. The improvement in manufacturing is also seen in the ISM manufacturing index, which has increased over the past several months and is closing in on its neutral threshold of 50. June factory data provided further confirmation that manufacturing is about to turn from steep declines through the first half of the year to respectable growth. Surveys of manufacturing point to a slow recovery. With government policy helping to stabilize consumption and slow the decline in capital spending, manufacturers need to raise output simply to slow the pace of destocking. While manufacturing will improve, business investment likely will not turn positive until early next year.

Conditions for consumers and workers are not as promising. Wage income is tracking nearly 5% below its year-ago level and dividend income is now tracking nearly 25% below its year-ago level. Stimulus efforts and low inflation in general are providing some support to real disposable income, but real spending has declined in every month but one since February. That trend should be broken in July and possibly August because of strong growth in auto sales related to the cash for clunkers program, but that break will likely prove to be a one-time lift.

The labor market contraction is moderating. Initial claims reached as high as 674,000 in March. Initial claims have been lower since then, but recovery is a long way off. The slow pace of hiring continues as employers remain cautious about adding costs until business prospects are more certain. Once hiring begins to recover, it will be a gradual process before the excess labor supply can be absorbed.

Households face a lengthy list of economic obstacles. The housing market downturn left many homeowners with severely diminished home equity, limiting that as a source of additional cash flow. Wealth has been reduced for many consumers as financial markets struggle. Rising joblessness, along with faded prospects for wage growth, will induce consumers to save rather than spend. The few small positives for households include low energy prices, reduced taxes, and increased government transfer payments. Still, slowing wage growth and increased costs associated with benefits—such as higher healthcare and retirement savings outlays—will be a large concern for consumers in the coming quarters.

Consumer confidence dipped in June and July following large gains in April and May. Gains in confidence recorded in the spring have come to an end. The weak views of the labor market, combined with expectations of little growth in income are weighing on buying plans. The share of consumers planning to purchase a home fell to match its cyclical low in July. Plans to buy other items also fell but remain marginally above cyclical lows. Consumers are focused on saving money and will be slow to ramp up spending.

The Fed – How Long Will the Engines Run Full Forward?

The Fed will face an important timing question when and if the economy begins to recover. The ongoing massive expansion of the money supply coupled with the Fed's accommodation of fiscal deficit spending will be inflationary if the direction of policy is not turned. The minutes from the FOMC's June 23-24 meeting revealed a more positive attitude toward the economy. FOMC members discussed indicators of a moderation in the pace of the economy's contraction. However, the Fed wanted to see more improvement in financial markets. The Fed remains cautious due to concerns over financial market and credit conditions plus concern that consumer spending could falter in the second half of the year.

The June 23-24 minutes also showed that the Fed may be reluctant to expand its purchases of long-term Treasury securities because of its uncertain impact on inflation expectations and the broader economy. When the Fed buys Treasury securities in the open market there is net increase in the money supply from government deficit financing. Given the dramatic increase in the money supply over the last year, the Fed will likely not increase its commitment to purchase $300 billion in Treasury securities unless the economy takes a turn for the worse. Given the Fed's current pace of weekly Treasury purchases, it will burn through the $300 billion by the end of September or early October. Federal Reserve Chairman Ben Bernanke is cognizant of the mistake made by the central bank in the late 1930s, when it prematurely shifted away from an accommodative monetary stance and extended the Great Depression. Unless inflation expectations become dislodged, there is little reason to expect the central bank to begin tightening soon. Monetary policy should remain expansionary, and the Fed is not likely to increase its target rate until the second half of next year.

Summary of Recent Economic Data

GDP- The economic decline continues

- According to advanced estimate by the Bureau of Economic Analysis, real gross domestic product fell 1% at an annualized rate in the second quarter of 2009. Downward revisions of GDP growth in prior quarters revealed a much more severe downturn. Real GDP growth declined in four consecutive quarters and in five of the last six quarters. Exhibit 1 shows real growth for GDP and its components since the first quarter of 2008

Exhibit 1. Real Growth in GDP and GDP Components*

	IIQ 2009	IQ 2009	IVQ 2008	III Q 2008	II Q 2008	IQ 2008
Real GDP	-1.02	-6.43	-5.37	-2.68	1.46	-0.72
Consumption	-1.24	0.61	-3.09	-3.52	0.06	-0.60
Investment	-13.48	-38.98	-20.25	-8.33	-2.74	-6.25
Exports	-6.95	-29.95	-19.47	-3.59	12.09	-0.15
Government	5.64	-2.62	1.17	4.82	3.62	2.62
Implicit Price Deflator	0.23	1.92	0.00	4.15	2.00	1.75

Measures are annualized percentage change from quarter to quarter
Source: Bureau of Economic Analysis

- For second quarter performance compared to first quarter performance, there was a smaller decline in investment, a smaller drop in inventories, less of a decline in exports, and strong government spending. Consumer spending continued to decline in the second quarter.

- Net exports added 1.4 percentage points to growth in the second quarter, compared with a 2.4-point contribution in the first quarter.

- Real government spending rose 5.6% annualized in the second quarter, compared with a 2.6% drop In the first quarter. The federal government increased almost 11% as the stimulus package started to kick in. Government added 1.1 percentage points to growth in the quarter, after subtracting 0.5 of a percentage point in the first quarter.

Manufacturing- improving, but a long way to go

- Orders for manufactured goods increased 0.4% in June, representing the third consecutive monthly increase. Nondurables led the way with a 2.7% increase in June. An18% increase in the price of crude oil in June supported nondurable orders and shipments. The dollar value of petroleum and coal shipments increased 13.2% in June, the largest increase since 2007.

- Revised durable goods orders showed a 2.2% decline in June, compared with the 2.5% decline previously reported. Capital goods orders fell 7% in June, offsetting the bulk of May's 8.8% gain. Capital goods orders excluding defense fell 2.3% in June.

- Orders of nondefense capital goods excluding aircraft increased 2.6% in June following May's revised 4.3% gain (previously 4.7%). Shipments of core capital goods rose 0.7%, their first increase since December 2008.

- Unfilled orders fell 0.9% in June, compared with May's -0.3%. Unfilled orders have steadily declined since October 2008.

- Inventories fell for the 10th consecutive month in June and are back down to their nominal value of 2006. Despite manufacturers' efforts to reduce inventories, the inventory-to-shipments ratio remains high at 1.42 months compared with May's 1.45 months. The decline in inventories over the first six months of this year is the steepest in the past 60 years. Retailers and wholesalers are becoming more comfortable with their inventory levels, which is a positive for production. Manufacturers will have to increase production just to slow the pace of inventory liquidation. Exhibit 2 shows the monthly percentage changes in manufacturing for 2009.

Exhibit 2. Manufacturing Shipments, Orders and Inventories*

	June 2009	**May 2009**	**April 2008**	**March 2009**	**February 2009**	**January 2009**
Factory Shipments	1.4	-0.8	-0.5	-1.8	-0.5	-2.6
New Orders	0.4	1.1	0.5	-1.9	0.7	-3.5
Unfilled Orders	-0.9	-0.3	-1.1	-1.7	-2.0	-1.5
Inventories	-0.8	-0.8	-1.2	-1.2	-1.3	-1.1

**Percentage Change from One Month Ago*

- Orders for manufactured durable goods fell a larger than expected 2.5% in June following two consecutive months of increase.

- The ISM nonmanufacturing index edged down to 46.4 in July from 47 in June. The survey portrays a nonmanufacturing sector that is stabilizing but not yet growing.

Personal Income – falling income and wages cripple the consumer

- Personal income fell 1.3% in June, and the saving rate fell to 4.6% without the lift from stimulus payments to Social Security recipients. Income rose 1.3% in May (previously reported as 1.4%).

- Wage income fell for the eighth consecutive month in June as labor markets weakened. Spending rose 0.4%, following a 0.1% gain in May (previously 0.3%). Real spending fell 0.1%. Wage and salary income fell for the eighth consecutive month and for the ninth in the last 10 as job losses weighed on wage income. Further, declines in wage income in January and February were revised upward significantly (-1.8% instead of -0.3% in January, -1% instead of -0.4% in February). Bonuses, stock option income, and wage increases at the start of the year were much smaller than previously reported.

- Transfer income dipped in June because of the absence of stimulus checks to recipients of government retirement benefits. Dividend income also continued to fall with a decline of at least 3% every month this year. In June, dividend income was nearly 25% below its year-ago level.

- Interest income was the only component of personal income to rise significantly in June. Spending rose 0.4%, but most of the gain came from price-related increases in nondurable goods spending. Real spending fell 0.1%. Real spending has been flat since February.

Exhibit 3. Personal Income, Wages & Salaries and the Saving Rate

	June 2009	May 2009	April 2009	March 2009	February 2009	January 2009
Personal Income*	-1.3	1.3	0.2	-0.5	-0.8	-1.1
Wages and Salaries*	-0.4	-0.1	-0.3	-0.7	-1.0	-1.8
Saving Rate - %	4.6	6.2	4.7	3.7	3.6	4.6

Source: Bureau of Labor Statistics

Inflation– low inflation as recession trumps money supply growth

- The core PCE deflator rose 0.2% in June, after rising 0.1% in May. The top-line deflator rose 0.5% in June. The data incorporate the BEA's benchmark revisions. The PCE deflator grew 1.6% at an annualized rate in the second quarter.

- Headline producer prices rose unexpectedly in June. Prices for finished foods, energy and core goods all grew at their fastest rates since the onset of recession. Over the second quarter as a whole, core prices for finished goods rose at a 2.1% annual rate.

- The finished energy goods index rose by 6.6% in June on the heels of a second month of large gasoline price increases. During the second quarter as a whole, prices for finished energy goods rose at a 4.5% annualized rate. Prices for finished consumer foods bounced back sharply in June, largely due to a swing in vegetable prices. Excluding food and energy products, core inflation among finished goods was the fastest (0.5%).

- Prices for intermediate (8.9%) and crude (10.9%) energy products continued to recover from losses incurred at the end of 2008. Prices for natural gas and petroleum products are rising sharply.

- Core prices for both intermediate and crude goods have turned the corner. Prices for core intermediate goods rose for the first time in nine months. During the second quarter as a whole, core prices for intermediate goods fell at only half the rate (-3.0%) they did during the first quarter, while core prices for crude goods rose sharply (40%).

- The top-line CPI for June came in at 214.5, which represents a 0.7% increase from the May level of 212.9 but down by 1.2% from June 2008. The core CPI for June came in at 219.3, up by 0.2% from its May level of 218.9 and up by 1.7% from its June 2008 level.

Exhibit 4. Inflation Rates *– Percentage Change from One Month Ago

	June 2009	**May 2009**	**April 2009**	**March 2009**	**February 2009**	**January 2009**
PCE Deflator	0.5	0.1	0.1	-0.1	0.3	0.2
Core PCE Deflator	0.2	0.1	0.3	0.1	0.2	0.1
CPI	*0.7*	*0.1*	*0.0*	*-0.1*	*0.4*	*0.3*
Core CPI	*0.2*	*0.1*	*0.3*	*0.2*	*0.2*	*0.2*
PPI-Finished Goods	1.8	0.2	0.3	-1.1	-0.1	0.9
PPI-Core Finished Goods	0.5	-0.1	0.1	0.1	0.1	0.2

Source: Bureau of Labor Statistics

Unemployment – weak labor market will continue

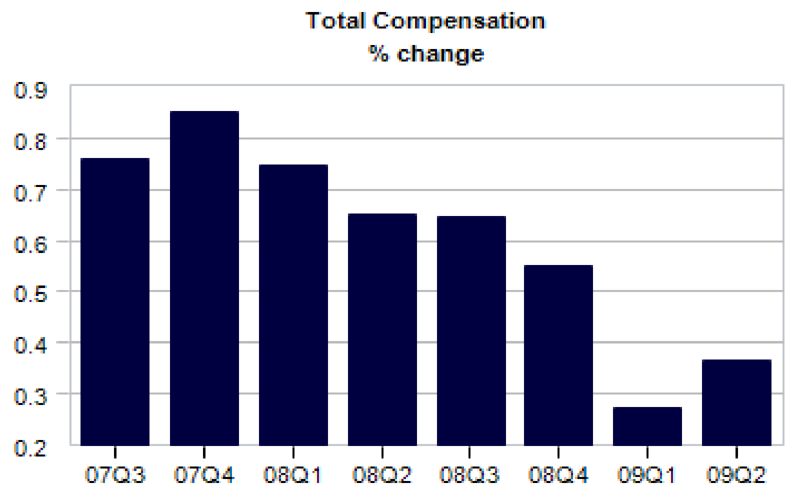
- The unemployment rate eased down from 9.5% to 9.4% in July. Nevertheless, unemployment is the highest since the early 1980s and should peak slightly above 10% in early 2010.

- Initial claims for unemployment insurance benefits for the week ending August 1 fell to 550,000 from a revised 588,000. This brings the four-week moving average to 555,250.

- Compensation costs for civilian workers rose 0.4% in the first quarter. On a year-ago basis, total compensation growth slowed to 1.8% in the second quarter, down from 2.1% in the first quarter. This is the slowest year-ago expansion since the beginning of the series in 1982.

- In the second quarter, wages and salaries costs rose 1.8% from a year ago, also a series low and down from a 2.2% gain in the first quarter of 2009. Benefits advanced 0.3%, down from 0.4% in the each of the prior two quarters. Compared with one year ago, benefits were up 1.8%, extending the slowing trend that began in early 2008. The change in total compensation since the third quarter of 2007 is illustrated in Exhibit 5 below.

Exhibit 5. Change in Total Compensation From IIIQ 2007 through IIQ 2009



Source: Bureau of Labor Statistics

Sales – improving in some segments, but levels are low

- Retail sales posted their second consecutive modest gain in June. Gasoline prices accounted for a large part of the increase, and core sales posted their fourth consecutive decline.

- Sales in total were 9% below their year-ago level. That was the smallest decline since February. The 4% decline in core sales was the largest year-over-year decline on record for that series.

- Numerous segments had double-digit year-ago sales declines. Year-ago growth was small and limited to drug stores and restaurants.

- Total vehicle sales improved to 11.2 million units (SAAR) in July, as about 250,000 car buyers took advantage of the clunkers incentive. The 16% month-to-month increase in the annualized sales rate was the largest gain since the introduction of 0% financing in October 2001.

- Despite the dramatic improvement in July, the level of sales is still well below the industry's decade-long average sales rate of 16 million units.

Housing/Construction– improvement, but the hole is deep

- As expected, sales of new homes increased in June; however, the gain was surprisingly strong. Starts gained by 11% from May to reach 384,000 annualized units. This pace is the strongest in six months, and the gain is the strongest monthly increase since December 2000. Further, the current pace remains weak, but the stabilization in sales is much needed.

- In the second quarter, new home sales increased by an annualized 2.2%, the first increase since the third quarter of 2005. The inventory of new homes available for sale dropped sharply in June, continuing a positive trend driven by the sharp curtailment of new residential construction. The inventory level has been falling nonstop for more than one year, for a 36% y/y decline in June. Months of available inventory fell from a high of 12.4 months in January to 8.8 months in June.

- The median new-home price is down by 12% y/y, as homebuilders cut prices in order to compete with foreclosures. Despite June's decline, the second quarter seasonally adjusted median price is up by an annualized 15%, the first gain in three quarters. Year over year, the median new-home price is down by 9.5% in the second quarter.

- Total construction spending for June came in at a seasonally adjusted annual rate of $965.7 billion, a 0.3% increase from the revised May total of $963.2 billion, though still down by 10.2% from its level in June 2008.

- Private construction spending for June came in at $643.9 billion, a decline of 0.1% from the revised May total of $644.8 billion. Private construction spending is still down by 16.3% from June 2008, no surprise given that investor confidence in the economy is still falling despite a better outlook in housing markets.
- Private residential construction spending in June came in at $246.1 billion, an increase of 0.5% from the revised May level of $244.7 billion. Despite the monthly increase, residential construction spending has stayed roughly level since March and is down by 30% from its June 2008 level.
- Private nonresidential construction spending for June came in at $397.9 billion, a decline of 0.5% from the revised May total of $400 billion and down by 4.8% from its June 2008 level.
- Of the largest categories of private nonresidential construction, spending on power and utility structures fell by 2.4% for the month but is up by 15% compared with one year ago. Spending on manufacturing structures increased by 0.9% from May to June and is up by 45.7% from one year ago. Spending on commercial structures fell by 0.6% from May to June and is down by 30.1% from one year ago. Spending on office structures increased by 1% from May to June but is still down by 21.1% from one year ago.
- Public construction spending for June came in at $321.7 billion, up by 1% from the revised May total of $318.5 billion and up by 5.1% from its level in June 2008.

Sentiment -low and consistent with a recession

- The Conference Board's consumer confidence index fell 2.8 points in June to 46.6. The index has fallen 8.2 points in the last two months after surging nearly 30 points the previous three months. The expectations component of the index led the decline, dropping 3.6 points in July and 9.5 points in the last two months. Expectations had risen over 44 points the prior three months.

- Assessments of current business conditions were mixed. The share of consumers who viewed conditions as good increased, as did the share who viewed them as bad. However, the share who viewed conditions as normal decreased. Expectations for stock market gains slipped as did expectations for inflation. Buying plans fell across all categories.

- Confidence is likely to improve slowly over the rest of the year and into next year, as jobs continue to be lost well into 2010 and other consumer fundamentals will remain weak.

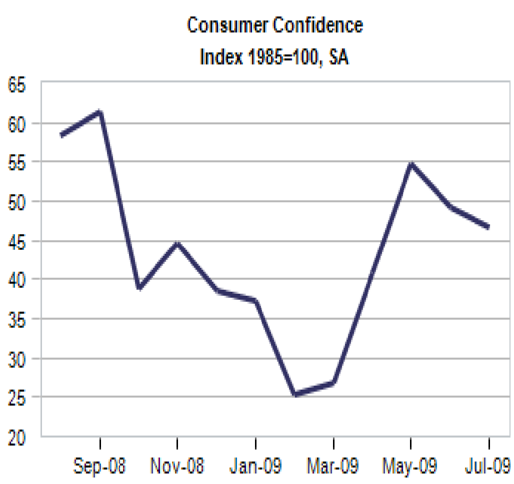
- The University of Michigan consumer sentiment index fell in July to its lowest level since April. The index came in at 66, down 4.8 points from June but above the preliminary 64.6. The decline in July was led by a sharp drop in expectations, although assessments of current conditions also fell. The bulk of the upward revision came from the expectations component. Inflation expectations were down in the short term.

- Confidence reversed most of the gains of the last two months in July, according to final data from the University of Michigan. The index dropped to its lowest level since April. The decline was led by a 6-point drop in the expectations component of the index, although that was revised up from an initially reported 8.3-point drop. The current conditions component fell 2.7 points, nearly unchanged from the preliminary reading.

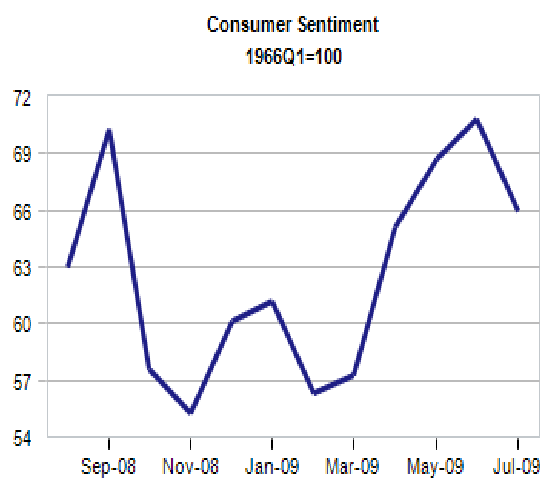
- Inflation expectations dropped from the preliminary report. One-year expectations fell to 2.9%, from 3% in the preliminary report and June's 3.1%. This reading remains firmly above the first quarter average of 2%. The five-year outlook fell to 3%, down from the preliminary 3.1% but unchanged from 3% in June. This is up more modestly from early in the year.

- Conference Board and University of Michigan sentiment measures appear in Exhibit 6.

Exhibit 6. Comparisons of Conference Board and University of Michigan Confidence Indexes



Conference Board Consumer Confidence



University of Michigan Sentiment Index

Household Credit- the stretch to make ends meet

- According to data from CreditForecast.com, aggregate credit conditions deteriorated in the second quarter. The good news is the decline in aggregate 30- and 60-day delinquencies. The level of default is beginning to purge the system of bad accounts.

- Mortgage delinquency and default rates rose in the second quarter. Performance was similar for non-mortgage segments. They generally remained better for non-mortgage segments than for mortgages, although the gap is narrowing. Nonetheless, aggregate conditions continued to deteriorate while short term delinquencies generally improved.

- Auto credit conditions are very weak and deteriorating. The total dollar delinquency rate has moved about 0.8 percentage points above its 2001 recession high, although the increase in the second quarter was the smallest in over two years. The default rate has nearly doubled from its previous high. Both are inflated by declining balances. Credit conditions are particularly weak in the auto finance segment.

- Bankcard dollar delinquencies jumped about a percentage point in the first half of the year and rose convincingly above their 2001-2003 highs. Account based delinquencies rose, but remained below their early decade highs.

- Household loan balances were below their year-ago level in the second quarter. Total household debt fell at a 1.8% rate compared to a year earlier. Balances declined on a quarterly basis for the third consecutive quarter. Growth was led by student loan and HELOC lending with second mortgage, auto, bankcard and first mortgage balances below their year-ago levels.

- A drop in mortgage interest rates this spring boosted refinancing and HELOC lending in the second quarter. Rates have since reversed their declines bringing refinance applications back down. Hence this support to balance growth has been eliminated, at least for now.

- Auto balances fell 8.7% on a year-ago basis in the second quarter as balances declines accelerated in response to the problems at GM and Chrysler. Auto finance lending dropped 20% at an annual rate from the first quarter.

- Bankcard balances fell for the second time after three years of growth in the second quarter taking balances below their year-ago level by the largest amount on record. The decline in balances was partially a choice by consumers, but partially due to actions by lenders to limit their risk.

- Consumer finance balances fell sharply in the second quarter although the decline was insufficient to move balances below their year-ago levels. The number of accounts also dropped sharply, furthering a decline that started at the end of last year. Tighter lending standards remain a drag on the number of new accounts.

- Student loan balances are up 11.9% from a year ago.

- First-mortgage loan defaults—the first step in the lengthy foreclosure process—are surging. At the end of June, 3.9 million loans were in default on an annualized basis. For all of 2008, 2.7 million first-mortgage defaults occurred, up from nearly 1.5 million in 2007, and under 1 million in 2006.