Weekly Economic Commentary

November 2, 2009

Assessing the Sustainability of the Recovery

John Canally, CFA
Economist
LPL Financial

ECONOMIC CALENDAR

Monday, Nov 2
Construction Spending *Sept*
ISM Mfg *Oct*

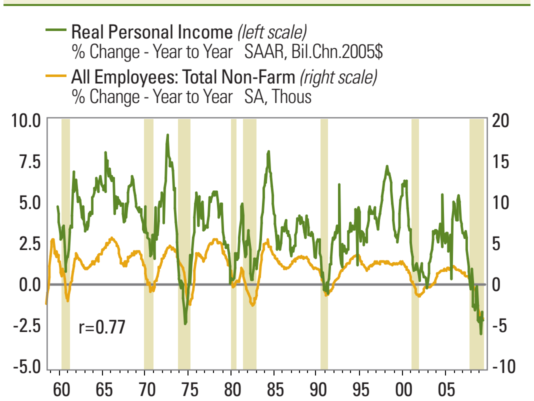
Tuesday, Nov 3
Factory Orders *Sept*
Domestic Car/Light Vehicle Sales *Oct*

Wednesday, Nov 4
Service Sector ISM *Oct*
FOMC Decision
Challenger Job Cuts *Oct*

Thursday, Nov 5
Productivity *Q3*
Initial Claims *wk 10/31*
ICSC Monthly Chain Store Sales (YoY) *Oct*

Friday, Nov 6
Unemployment Rate *Oct*
Nonfarm Payrolls *Oct*
Wholesale Inventories *Sept*
Consumer Credit *Sept*

1 Income Growth Tends To Trough before Job Growth



Source: Bloomberg; LPL Financial Research

Taken together, last week's economic reports raised concerns about the sustainability of the recovery. While our view remains that the economic recovery that began in Q3 2009 is sustainable and will persist into 2010 and beyond, the market began to doubt that view after a mixed week of economic data.

The sustainability of the recovery, and more importantly, the health of the labor market will be at the forefront of debate this week amid a very busy (and meaningful) weak of economic data. The week begins with the release of the October ISM report on Monday and culminates with the release of the nonfarm payroll jobs report for October on Friday. In between, markets will digest key reports on housing sales, vehicle sales, chain store sales, and construction spending. Throw in the FOMC meeting, and the market will be just as overwhelmed by the economic calendar this week, as it was by the busy earnings calendar over the past two weeks.

Among last week's busy slate of economic reports, the good news included the:

- Better than expected readings on gross domestic product growth in Q3 2009,
- Chicago Area Purchasing Managers index,
- Durable goods orders report for October,
- Benign reading on the Q3 employment cost index, and
- Drop in weekly jobless claims.

However, that good news was largely overwhelmed by continued erosion in consumer confidence in October, the pullbacks in several regional manufacturing surveys (though they continue to suggest that the expansion in manufacturing continued into October), and the drop in real income in September, the third month-over-month drop in the past four months. The weakness herein reflects the inability of the private sector to create jobs (and income) after the U.S. government's efforts to boost incomes faded in mid 2009.

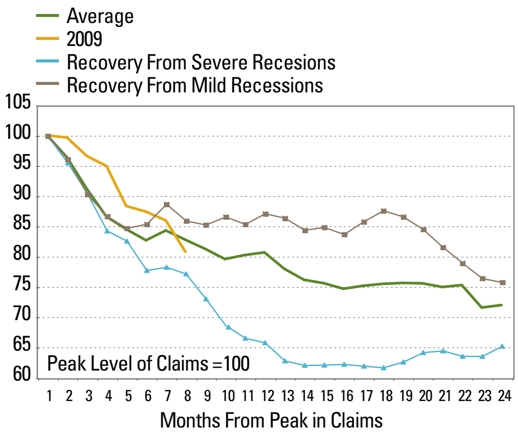
Not surprisingly, there is a strong correlation between employment and income, as you can see [Chart 1]. The good news is employment growth doesn't necessarily lead income growth. In fact, employment tends to trough a few months before income growth in most cycles. That happened in this cycle as well, as real income bottomed in June 2009 (-3.0%yoy), while employment troughed at -4.3%yoy in August 2009.

The Week Ahead

The section below provides some observations on this week's key economic releases. Alongside the preview are questions that markets, the media and, yes, economists are likely to be asking as the data is released.

October Employment Data (released throughout the week)

2 Jobless claims are no longer tracking toward the jobless recoveries of 1991 and 2001, but, instead, have moved closer to the pattern seen in the robust job recoveries from the severe recession in the mid 1970s and early 1980s

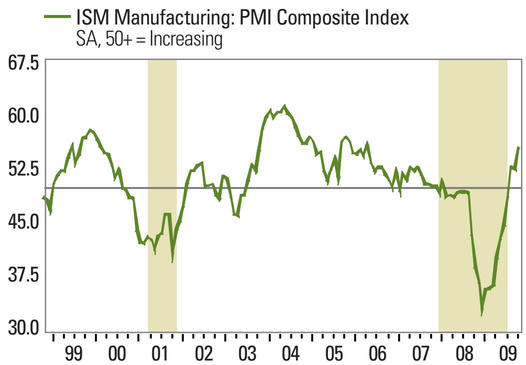


Source: Haver, LPL Financial Research

- The employment components of the national ISM report, due out on Monday, November 2, will provide an early window into Friday's nonfarm payroll report. The employment components of several of the regional Federal Reserve Banks (New York, Kansas City and Richmond) for October already indicate that hiring in the manufacturing sector has resumed.
- However, the employment readings within the Chicago and Milwaukee Area Purchasing Managers index (released late last week) remained below 50, indicating that job losses in the manufacturing sector in those regions of the country persisted into October, albeit at a slower pace than earlier in 2009.
- Through the worst of the recession in late 2008 and early 2009 the ADP employment report (Wednesday, November 3), provided a fairly reliable "early read" on the overall national employment report, as it accurately predicted the direction and magnitude of the job losses. In recent months, however, the ADP report has had a spotty track record, overestimating the number of jobs lost relative to the national report in each of the past five months.
- The Challenger job cut (Wednesday, November 4) data has been a good leading indicator of the labor market in 2009, peaking in January of 2009, roughly two to three months before jobless claims peaked in late March. Layoff announcements fell between August and September, and were down sharply (30%) from a year ago (September 2008). The market would be comforted by another drop in layoff announcements in October.
- As October turns into November, the weekly jobless claims data (Thursday, November 5) have now been free of the auto related distortions for several months. Jobless claims fell 1,000 to 530,000 in the week ending October 24, leaving the four week average on claims at 526,250, down 6,000 from the prior week, and down more than 130,000 from their peak in March 2009. Jobless claims are no longer tracking toward the jobless recoveries of 1991 and 2001, but, instead, have moved closer to the pattern seen in the robust job recoveries from the severe recession in the mid 1970s and early 1980s. We don't think the market has recognized this yet.
- The market expects the October jobs report (Friday, November 6) to show a slower pace of job losses in October versus September. The consensus is looking for a 175,000 drop in payrolls in October versus the 263,000 drop in September. If the consensus is correct, the pace of job loss in October would be the slowest since August 2008.

- We expect the pace of job losses to slow over the next several months but we don't expect the economy to begin to create new jobs on a sustained basis until early 2010.
- The consensus is looking for the unemployment rate to tick up to 9.9% in October from 9.8% in September.

3 In August, the ISM finally pushed above the 50 mark (52.9), and remained above 50 at 52.6 in September, indicating that the manufacturing sector has been expanding since the beginning of August



Source: Institute for Supply Management, Haver

October ISM (Monday, November 2)

- The October ISM report was released as the Weekly Economic Commentary was being published.
- The ISM index of manufacturing has been above the key 41.2 level since May 2009, indicating that while the manufacturing sector was still contracting, the overall economy was expanding.
- In August, the ISM finally pushed above the 50 mark (52.9), and remained above 50 at 52.6 in September, indicating that the manufacturing sector has been expanding since the beginning of August. The August 52.9 reading marked the first time the index had been above 50 since January 2008, and was the highest reading since June 2007.
- The consensus is looking for the October ISM to come in at 53.0.
- With the "Is the recession over?" question now largely moot, thanks in part to the 3.5% gain in Q3 GDP, the question the market is asking now is "how strong will the recovery be?" An ISM reading above 60 in October would be an important data point in confirming that the initial stages of the recovery may be stronger than expected. On the other hand, if the ISM slips back below 50, it may raise further doubts about the sustainability of the recovery.
- Along with the employment sub index within the ISM report, the new orders index will be of interest to the market looking for forward looking information. The new orders series moved above 50 in July to 55.3, and pushed up to 64.9 in August, marking the first time the new orders series was above 50 on a consistent basis since mid to late 2007. New orders fell back to 60.8 in September.
- Although the new orders series has risen faster in this recovery than in any other recovery since 1970, a drop in the new orders index below 60 could be a signal that the manufacturing recovery will stall in the coming months.

September Construction Spending (Monday, November 2)

- The September construction report was released as the Weekly Economic Commentary was being published.
- After 14 quarters (dating back to Q1 2006), housing construction finally was a net plus for real GDP growth in Q3 2009.
- Although the housing market has stabilized, the ongoing pain in private non-residential construction (malls, shopping centers, office parks, industrial facilities), which are being impacted by the lack of financing available to developers is likely to persist for some time to come. Probably until the end of 2010.

Only about $86 billion of the expected $250 to $300 billion of the infrastructure funds have been spent through mid September, so the full impact on the construction data has yet to be felt.

- Public construction spending is being positively impacted by the infrastructure component of the $787 billion fiscal stimulus package. The non partisan Congressional Budget Office notes that more fiscal stimulus funds will impact the economy in 2010 than in 2009.
- Only about $86 billion of the expected $250 to $300 billion of the infrastructure funds have been spent through mid September, so the full impact on the construction data has yet to be felt.

October Vehicle sales (Tuesday, November 3)

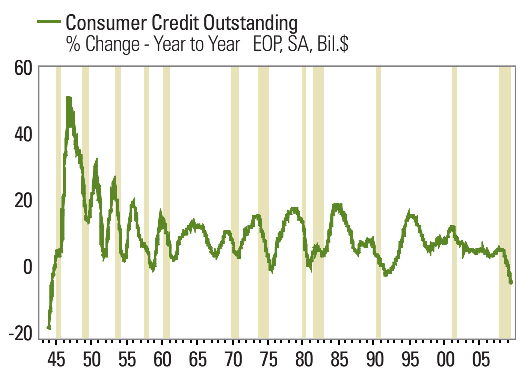
- September's vehicle sales report can be summed up in six words: The hangover from cash for clunkers.
- Vehicle sales fell to 9.2 million annualized pace in September versus the 14.1 selling pace in August. Sales were 11.3 million in July (cash for clunkers was in place for the last week of July), and were 9.7 million in June.
- Sales in October are expected to tick up to a 9.8 million pace, just above the pre-clunkers sales pace. As a reminder, vehicle sales were running at a 15 to 16 million pace prior to the onset of the recession in late 2007.
- In any case, auto production probably needs to increase noticeably over the final months of 2009 to help replenish inventories depleted by cash for clunkers, which will continue to boost GDP.

In any case, auto production probably needs to increase noticeably over the final months of 2009 to help replenish inventories depleted by cash for clunkers, which will continue to boost GDP.

September Consumer Credit (Friday, November 6)

- Consumer credit outstanding has plunged this year as consumers continue to repair their balance sheets. Consumer credit fell by $12 billion in August, $19 billion in July, and is down 4.4% from a year ago, the largest drop on record (post WWII) for this series.
- The good news is that it is not unusual at all to see consumer credit growth slow (decelerate) or decline outright as the economy moves through and out of a recession [Chart 4].
- Another silver lining in the dramatic drop in consumer credit ($119 since the peak in mid 2008) is that consumers have already begun to repair their balance sheets.
- The bad news is that the ratio of disposable consumer credit outstanding to disposable income remains elevated by historical standards, and may have to come down further, which will dampen consumer spending in the coming quarters.
- Real disposable income and consumer net worth (value of stocks, bonds, housing, consumer durables) both of which are up sharply over the past nine months, are better predictors of future consumer spending than consumer credit.

4 The good news is that it is not unusual at all to see consumer credit growth slow (decelerate) or decline outright as the economy moves through and out of a recession.



Source: Federal Reserve Board, Haver

An improving economy and the "wealth effect" (rising equity prices and rising home prices), are supports for spending, but the still weak labor market and ongoing debt repayment by consumers act as headwinds to robust spending.

October Chain Store Sales (Thursday, November 5)

- In the aftermath of cash for clunkers, expectations for consumer spending in Q4 2009 are low. The consensus expects real consumer spending to rise by only 1.0% in Q4 versus Q3, after rising by more than 3% in Q3.
- On balance, consumers are still spending on things they need, not things they want, but over the last few months, that has begun to change. We would like to see that change accelerate over the remainder of 2009 to convince us that the recovery is sustainable. The return of jobs is key.
- An improving economy and the "wealth effect" (rising equity prices and rising home prices), are supports for spending, but the still weak labor market and ongoing debt repayment by consumers act as headwinds to robust spending.
- Weekly retail sales were up in each of the first four weeks of October, suggesting that consumers continued to spend even after the end of cash for clunkers.

LPL Financial