Weekly Economic Commentary

November 9, 2009

Running the Table

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ECONOMIC CALENDAR

Monday, Nov 9
Fed Senior Loan Officer Survey
Nov

Thursday, Nov 12
Initial Claims
wk 11/07

Treasury Statement
Oct

Friday, Nov 13
Trade Balance
Sept

Import Price Index
Oct

U of Mich Consumer Sentiment
Nov

With many market participants fretting about the sustainability of the economic recovery, we thought that last week's slate of economic data would have to "run the table" in order for the equity market to break the slump it had been in since mid- October. For the most part, the data released last week did "run the table", with the vast majority of reports coming in at or above expectations. The market also benefited from another "friendly" FOMC statement, in which Federal Reserve (Fed) policy makers upgraded their assessment of the economy, but again promised to keep rates low "for an extended period." Equity markets responded positively to the preponderance of good news, as the S&P 500 posted a healthy 3.2% gain in the week, the first weekly gain since mid October.

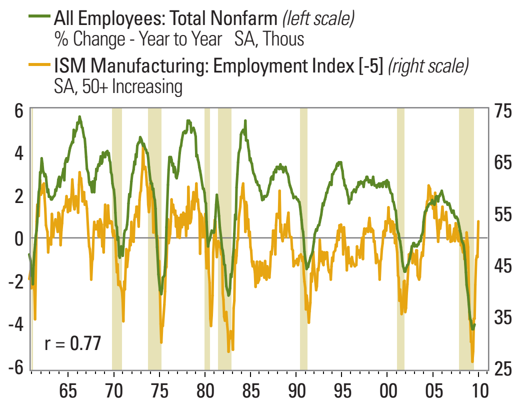
There were some exceptions to the good economic news of course, including the disappointingly weak employment reading within the service sector ISM report for October, as well as the unexpectedly large increase (to 10.2%) in the unemployment rate in October.

This week, markets won't have much in the way of economic data to digest, which will draw more attention to the weekly readings on retail sales (Tuesday), mortgage applications (Wednesday) and jobless claims (Thursday). As this report was being prepared, the Fed released its Senior Loan Office survey for November, a key gauge of banks' willingness to lend (and of business and consumers' willingness to borrow). Late in the week, the September merchandise trade data and the early reading on the University of Michigan's consumer sentiment report for early November will take center stage.

Reports that exceeded market expectations last week included the:

- Institute for Supply Management's (ISM) index of manufacturing for October, along with several of the key subcomponents of the report.
- September construction spending report, which revealed that spending on housing construction, continues to stabilize, while spending on commercial real estate remains challenged.
- Pending home sale for September, which rose 6.1% versus October, suggesting that the recovery in the housing market will continue into 2010.
- October vehicle sales, which came in much better than expected without any boost from "cash for clunkers".
- Job cut announcements in October, which were down 50% from October 2008, and suggest that the labor market will continue to heal in the coming months.

1 The Employment Component of the ISM Report on Manufacturing is a Reliable Leading Indicator of Overall Employment



Source: Bureau of Labor Statistics, Institute for Supply Management, Haver

2 At 10.2%, the Unemployment Rate in October was the Highest Since 1982

Source: Bureau of Labor Statistics, Haver

- Chain store sales for October, which exceeded expectations for a second consecutive month, despite numerous consumer headwinds.
- Initial jobless claims data for the week ended October 31.

Of the reports mentioned above, the most reassuring to markets was probably the employment component of the October ISM report. This indicator—which tends to lead overall employment by four to six months—surged to 53.1 in October from 46.2 in September (and a low of 26.1 in February 2009). It was the first reading above 50 (a reading above 50 indicates that employment in manufacturing is expanding) since July 2008. The employment component of the ISM report hasn't spent any significant time over 50 since 2007. A sustained reading above 50 on the ISM employment index suggests that the overall economy is close to creating jobs. Job creation is a precondition for a sustained economic recovery that the market is looking for.

The bad news last week was found in the ISM's report on the service sector, which stayed above 50 in October, but failed to match expectations. Notably, it was the weak reading on the employment portion of this index that dragged the index down between September and October. Outside of employment, the components of the report —inventories, productions, new orders, etc—were all quite strong, but the failure of the employment component to climb above 50 this far into the recovery is a concern.

The other major disappointment, at least on the surface, was the much anticipated October jobs report. In our view, however, the report was better than the headline 10.2% unemployment rate and 190,000 drop in jobs in October suggested. Why?

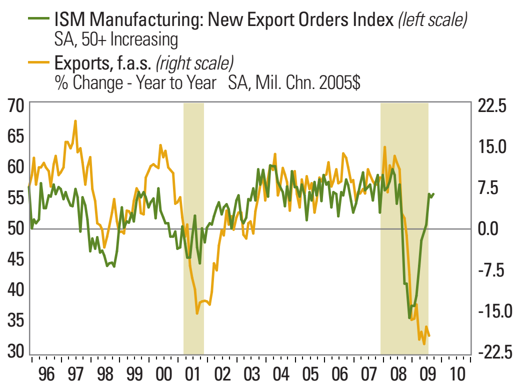
While the 190k drop in jobs in October was worse than the consensus (-175,000), the prior two months (August and September) were revised up by a total of 91,000, taking the sting out of the miss (relative to consensus) on the October reading. In addition, many of the leading indicators of employment within the October jobs report (temporary help jobs, hours worked, overtime hours, and the employment diffusion indices) suggest that headline job growth is only a few months away.

Still, it was the bad news that the unemployment rate rose to 10.2% in October—the highest reading in almost 27 years—that dominated the headlines. The 10.2% reading on the unemployment rate in October was up from 9.8% in September, and above the consensus estimate of 9.9%. At 10.2%, the unemployment rate is within striking distance of the post WWII high of 10.8% set in 1982. Although it is a lagging indicator of both economic activity, and the labor market itself, the 10.2% unemployment rate will put more political pressure on Congress and the Administration to "do something". In our view, there is no political will to do anything right now, especially with the 2010 mid term elections looming.

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.

3 Judging by the New Export Orders Data, there is pretty Solid Evidence that Exports have begun to Turn Up



Source: Institute for Supply Management, Census, Haver

September Trade Balance (Friday, November 13)

- Net exports were a drag on Real Gross Domestic Product (GDP) growth in Q3 2009, shaving 0.5% off of growth. It was the first time in nearly four years (2005) that trade was a drag on GDP growth.
- With global economies recovering quickly, we expect the trade sector to once again be a positive contributor to GDP growth in Q4 2009 and in 2010.
- The September trade data will help to firm up expectations for the fist revision to the Q3 GDP data. The revised Q3 GDP report is due out in late November.
- The government's initial estimate of Q3 assumed that the trade gap widened substantially between August and September, thus any narrowing of the trade gap between August and September would portend an upward revision to GDP from the originally reported 3.5% gain.
- Judging by the new export orders data embedded within the various national and regional ISM and Federal Reserve manufacturing surveys for August, September and October, there is pretty solid evidence that exports have begun to turn up. With the economy improving, import growth is likely to rebound, especially given the uptick in oil prices recently.
- Exports have helped to lead the U.S. economy out of recession during the last two recoveries, in 1991 and in 2001.