Weekly Economic Commentary

July 6, 2009

June Jobs Report Fails New Paradigm Test

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ECONOMIC CALENDAR

Monday, July 6
ISM NMI
June

Wednesday, July 8
Consumer Credit
May

Thursday, July 9
Initial Claims
wk 07/04

Wholesale Inventories
May

ICSC Monthly Chain Store Sales (YoY)
June

Friday, July 10
Trade Balance
May

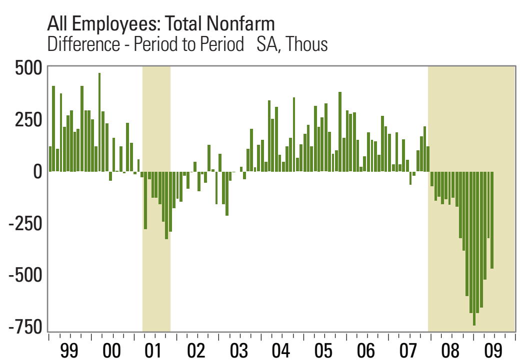
Import Price Index
June

U of Mich Consumer Sentiment
July

The June employment report turned out to be a major disappointment for market participants looking for continued, straight-line improvement in the labor market. After seeing steady improvement in the labor market since early 2009, markets had come to expect that the steady improvement would continue until the economy was adding jobs by the end of 2009. The June jobs report called into question that "steady progress", as the economy shed more jobs in June (-467,000) than it did in May (-322,000), and shed more jobs than the market expected—the market was looking for a 367,000 drop in payrolls in June. The only "bright spot" in the June labor market report was the unemployment rate, which rose only 0.1% to 9.5%, versus expectations of a 0.2% rise to 9.6%. While still unwelcome, the 0.1% gain in the unemployment rate in June versus May was the smallest month over month rise since the unemployment rate held steady between August and September 2008. Between October 2008 and May 2009, the unemployment rate moved up by an average of 0.4% per month.

In our view, the employment report for June does suggest that the improvement in the labor market from awful in Q4 2008 and Q1 2009 to "less awful" in Q2 2009 stalled in June, but it is far too soon to make the assumption that the economic recovery is not on track. **Economic data rarely moves in a straight line between point A and point B, and this is particularly true around turning points in the economy.** Looking back over the past 35 years, the labor market never exhibited anything close to "steady improvement" as recessions ended and recoveries took hold. In fact, job creation around economic turning points has almost always been choppy, with the more typical pattern being a slower pace of job losses, giving way to small job gains and then slipping back into job losses again, before robust job growth firmly takes hold.

1 The Steady Improvement in the Labor Market From Awful to Less Awful Stalled in June



Source: Bureau of Labor Statistics/Haver 07/02/09

However, from the market's point of view, we can certainly see how the June jobs report represented a clear violation of the "new paradigm" for economic data that has been in place for the past month or so. In recent weeks, markets have only been reacting positively to economic data if it beats raised expectations, shows actual improvement in the economy, or hints that the economy is on track to post positive growth in Q3 2009. Against that backdrop, the June jobs report clearly failed the "new paradigm" test.

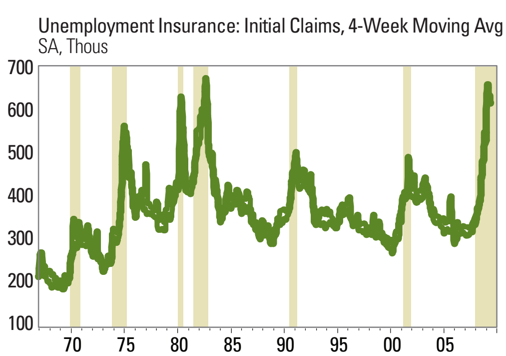
- The report failed to beat raised expectations,
- Failed to show that the economy was getting better, and
- Called into question whether or not the economy was on track to emerge from the recession in the second half of 2009.

2 Unemployment Rate Rose only 0.1% in June, the Smallest Increase Since September 2008

Source: Bureau of Labor Statistics/Haver 07/02/09

We take comfort in the fact that many of the other labor market indicators have continued to show improvement in recent weeks and months, which lead us to the conclusion that the labor market remains on track to post month—over—month job gains in the fourth quarter of 2009.

3 Jobless Claims Continue to Move in the Right Direction and Signal That Recession is almost Over



Source: Department of Labor/Haver 07/02/09

We take comfort in the fact that many of the other labor market indicators have continued to show improvement in recent weeks and months, which lead us to the conclusion that the labor market remains on track to post month—over—month job gains in the fourth quarter of 2009. Those indicators include:

- The average job loss in May and June was just 395,000 per month; job losses averaged nearly 650,000 per month in the six months ending in April 2009.
- The steady drop in jobless claims since the end of March, from 658,000 per week to 615,000 per week.
- The drop in the number of people receiving unemployment benefits since the beginning of June.
- The improvement in the employment readings on the regional and national ISM reports over the past six months.
- The drop in layoff announcements in June 2009 versus June 2008, the first such drop in 16 months.
- The improvement in the employment diffusion indexes— the number of industries adding workers relative to the number of industries shedding workers— in the past three months.
- The improvement in temporary help supply payrolls in recent months. Temporary help jobs fell by an average of only 8,000 in May and June after declining by an average of 72,000 per month over the prior six months.
- The 0.1 hour increase in the average workweek between May and June.
- The 0.2 hour increase in overtime hours worked since March.

Another weak jobs report in July or deterioration in any of the weekly or monthly indicators listed above would call into question our view. As always, we will continue to monitor the incoming data closely.

After a very busy two weeks, the economic and policy calendar takes a breather this week. As this report was being published, the Institute of Supply Management released its report on the service sector in June. This report failed the "new paradigm" as discussed above. Although the report came in better than expected in June, rose between May and June, and all the major components of the report—employment, new orders and business activity—improved between May and June, the overall index did not climb above 50, indicating that the service sector was still contracting in June.

Later in the week, the focus will be on the weekly jobless claims report, the chain store sales data for June and on the May merchandise trade report. The claims data will be closely watched by market participants looking for further evidence that the labor market continued to improve as July began.

June chain store sales will provide some insight into the government's retail sales report for June, which isn't due out until July 14. With consumer spending accounting for two thirds of gross domestic product (GDP), the June chain store sales data will help forecasters firm up their Q2 GDP forecasts. Currently, the consensus is looking for a 2.0% annualized drop in real GDP in Q2 2009 versus Q1 2009. Colder and wetter than usual weather in June, as well as rising gasoline prices over the first half of the month are likely to hold down sales in June. The May merchandise trade report will also help market participants refine their Q2 2009 GDP forecasts.

The trade sector was a big plus for GDP growth in 2007, 2008 and early 2009, more than offsetting the weakness in housing. However, with the U.S. economy recovering and the economies of our major export partners (Europe, Japan and Canada) sill struggling, exports will likely fall faster than imports over the remainder of 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.

June chain store sales (Thursday, July 9)

- Will give the market a better sense where spending in Q2 will be.
- Real consumer spending (which accounts for two thirds of GDP) rose 1.4% in Q1 2009 versus Q4 2008.
- The data released thus far for Q2 2009 suggests that consumer spending will be flat in Q2 2009 versus Q1
- Weekly retail sales were up in three of four weeks in June, but anecdotal evidence suggests that much of the spending remains concentrated in non-discretionary items.
- Cold and wet weather in much of the nation in June likely had an impact on sales
- On the plus side, the recent rebound in consumer sentiment, further signs of a bottoming in housing, the improving "wealth effect" due to rising financial markets and signs of stability in housing prices, and the high saving rate should act to boost consumer spending over the second half of 2009.

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May Trade Balance (Friday, July 10)

- Imports have been falling faster than exports recently, helping to narrow the trade deficit which has helped to cushion the decline in real GDP.
- **With the economy improving, import growth is likely to rebound, especially given the uptick in oil prices recently, while export growth could lag, leading to higher trade deficits, and a bigger drag on GDP growth, over the remainder of 2009**
- Export growth remains weak, as our major export partners (Japan, Western Europe, Mexico, Canada) struggle
- Typically, both exports and imports decline during recessions. This time around, imports starting falling first, but exports have fallen sharply since the collapse of Lehman Brothers in the fall of 2008.

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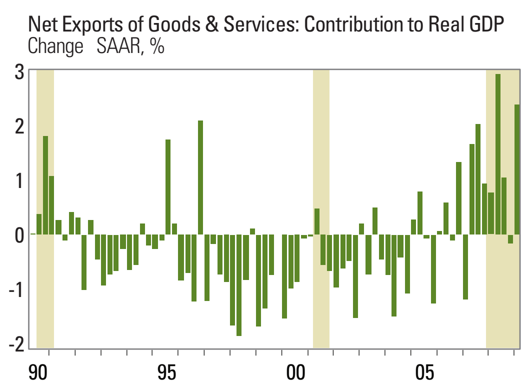

Source: Bureau of Economic Analysis/Haver 07/06/09

The last time we saw five consecutive monthly gains in consumer sentiment was in early 2007.

Early July Consumer Sentiment from the University of Michigan (Friday, July 10)

- Both gasoline prices and mortgage rates have ticked down in early July after a shift upward between May and June.
- On the other hand, equity prices have posted declines in early July. We have now seen four consecutive months of improvement in Consumer Sentiment (March, April, May, and June after hitting the third lowest reading ever (56.3) in Feb '09.
- The last time we saw five consecutive monthly gains in consumer sentiment was in early 2007.