Weekly Economic Commentary

March 15, 2010

Dour U.S. Consumer Keeps on Spending

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ECONOMIC CALENDAR

Monday, Mar 15
NY Fed Empire State Mfg
Mar

Capacity Utilization
Feb

Industrial Production
Feb

NAHB Housing Survey
Mar

Tuesday, Mar 16
Import Price Index
Feb

FOMC Decision
Feb

Housing Starts
Feb

Wednesday, Mar 17
PPI
Feb

Thursday, Mar 18
Current Account
Q4

CPI
Feb

Initial Claims
wk 03/13

Philly Fed Index
Mar

Leading Indicators
Feb

Highlights

The vast majority of last week's U.S. economic reports support our view that the U.S. economy remains on track for a sustainable recovery in 2010.

The latest batch of Chinese economic data is likely to prompt more policy tightening in China in the coming weeks.

The week ahead is likely to be dominated by the outcome of, and discussion about, the Federal Reserve's Federal Open Market Committee (FOMC) meeting.

What We Make of the Key Reports Last Week:

The vast majority of last week's U.S. economic reports support our view that the U.S economy remains on track for a sustainable recovery in 2010. The key report of the week was the better-than-expected February retail sales data, but data on jobless claims, merchandise trade, mortgage applications, consumers' balance sheets, and business inventories also helped to make the case that the U.S. economy is continuing along the path toward a sustainable recovery.

It was not all good news last week, however, as the vulnerability of the economy was evident in several reports, including:

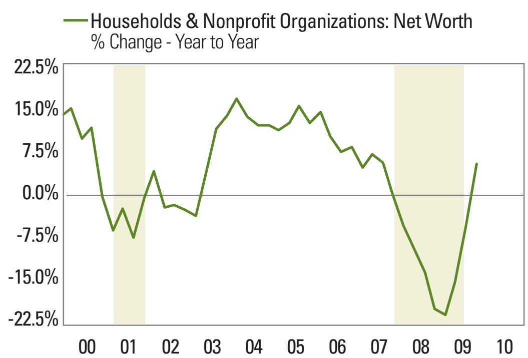
- Another weak reading on small business sentiment in February,
- A dip in consumer sentiment in early March, and
- The whopping $221 billion budget deficit racked up by the federal government in February.

In addition to the economic news last week, the market was bracing for this week's FOMC meeting. News reports suggest that President Obama will select Janet Yellen to replace Don Kohn as Vice Chairman of the Federal Reserve Board of Governors. Yellen, who is currently the President of the San Francisco Fed, is not a voting member of the FOMC, but would be a permanent voting member as Vice Chair of the Board. This is crucial, because Yellen is a well-known monetary policy "dove", who would lean to the "full employment" side of the Fed's dual mandate of full employment and low and stable prices.

Yellen was President Clinton's top economist (as Chairwoman of the Council of Economic Advisors) and was a Fed Governor in the mid-1990s. Traditionally, the Vice Chair of the Federal Reserve Board serves as the Administration's voice on the FOMC and, in this instance, being a "dove" Yellen would likely support the idea that rates should remain low for an extended period to help bolster the labor market and the overall economy.

Consumer spending continued to confound the experts in February, as retail sales posted a surprising gain versus expectations of a small month-over-month drop in sales. The gain in retail sales in February—despite the severe winter storms that hit the northeast corridor of the U.S. during the month—suggests that real consumer spending will again be a plus for overall GDP growth in Q1 2010. Early in the economic recovery, spending was mainly confined to items that consumers needed to buy. In February, and over the past two or three months, however, spending has broadened out to include discretionary items like electronics, sporting goods, and furniture.

1 Rebound in Household Net Worth Helps to Explain Resilient Consumer Spending



Source: Federal Reserve Board, Haver 03/15/10
Shaded areas represent recessions.

One of the key drivers of the better-than-expected consumer spending data has been the recovery in consumer net worth over the past year. Consumer net worth—defined as household assets (cars, houses, financial assets including stocks) less household liabilities (mortgage debt, credit card debt, consumer loan debt)—posted another quarter-over-quarter gain in Q4 2009, and has now posted three consecutive quarterly gains. The increase in consumer net worth is a result of higher asset prices (equity prices up more than 70% from their lows and home prices up 5–7%), combined with a drop in liabilities. While some of the drop in liabilities is certainly involuntary (consumers walking away from mortgages, consumer loans, and credit card debt), some of the big drop ($1.5 trillion) in household liabilities since early 2008 reflects a healthy, voluntary paring down of debt by consumers.

Among the bad news, last week was the February 2010 federal budget deficit. The $221 billion deficit recorded in February 2010 suggests that the budget is still feeling the effects of the recession. In fact, the $221 billion budget deficit in February 2010 was larger than any annual budget deficit recorded in the United States in any year up until 1991!

Fiscal year to date (October 2009 through February 2010), the budget deficit is running at $651.6 billion compared with the $589.8 billion deficit in the first five months of fiscal 2009. Thus, remarkably, the deficit has deteriorated by $61.8 billion from last year's record deficit.

The good news is that federal government receipts posted a 23% gain in February 2010 versus February 2009, marking the first time since April 2009 that has occurred. The bad news is that in the first five months of the fiscal year, federal government receipts are still down 7% versus the comparable period a year ago.

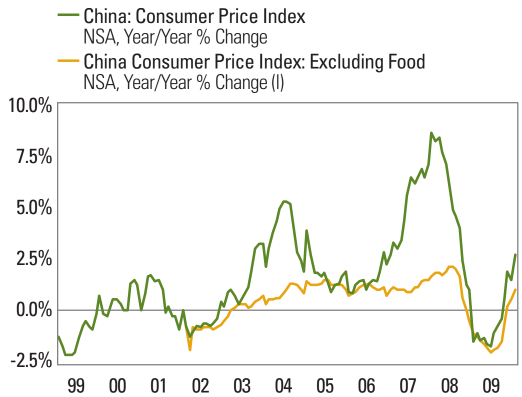
Worse still, is the fact that the spending on "three headed monster" (Social Security, Medicare and Medicaid) rose 8% in the first five months of fiscal year 2010 versus the same period in fiscal year 2009. Nominal Gross Domestic Product (GDP) has risen by less than 1% over the past year, which means that spending on the "three headed monster" continues to outstrip economic growth, which is unsustainable, even in the short run.

Some very difficult decisions need to be made in the next several years regarding these programs (such as possibly raising taxes, cutting benefits, or some combination of the two), but the risk is that Congress will wait until there is a crisis to address the issue.

China's Economic Data for February Points to More Policy Tightening Ahead

The latest batch of Chinese economic data for February is likely to prompt more policy tightening in China in the coming weeks, as the Chinese authorities try to head off a surge in unwanted inflation. The February trade data showed that Chinese exports surged a stunning 46% year-over-year in February 2010, while imports posted an equally stunning 45% year-over-year gain. While the timing of the Chinese Lunar New Year in 2009 versus 2010 may have impacted the year-over-year figures, the surge in Chinese exports shows just how bad global trade got in early 2009 and how far it has come since.

2 Accelerating Inflation in China Likely to Prompt More Tightening From Chinese Authorities



Source: China National Bureau of Statistics, Haver 03/15/10

China also reported the closely watched loan growth numbers for February last week. Bank lending grew by just 700 billion Yuan in February, well below the 1.39 trillion in January and, most importantly, 35% below the 1.07 trillion in new loans created during the loan binge in February 2009. At the same time, M2 money supply growth slowed in February, to 25.5% year-over-year from 26% in January, which indicates stabilization.

The key economic report released in China last week was probably the Consumer Price Index report. The report for February showed that inflation in China accelerated to 2.7% year-over-year growth in February versus expectations of a 2.5% year-over-year gain. China's CPI rose by 1.5% year-over-year in January 2010. Although the February data may have been distorted by the timing of the Chinese Lunar New Year in 2010 versus 2009, Chinese authorities will not be able to ignore accelerating inflation, stronger-than-expected loan growth, retail sales, and money supply growth for much longer. Having already embarked on a regime of monetary policy tightening in late 2009, more tightening is likely in China sooner rather than later to clamp down on the unwanted rise in inflation.

Markets remain hopeful that Chinese authorities can bring the huge Chinese economy in for a "soft landing" (a mild deceleration in economic growth to a more sustainable pace) in 2010, but will be quick to punish any investments related to China if the soft landing is too "hard", or too "soft". Please keep in mind that this is a key crosswind, or risk to our economic outlook, that we detailed in our *2010 Market Outlook: From Tailwinds to Headwinds*.

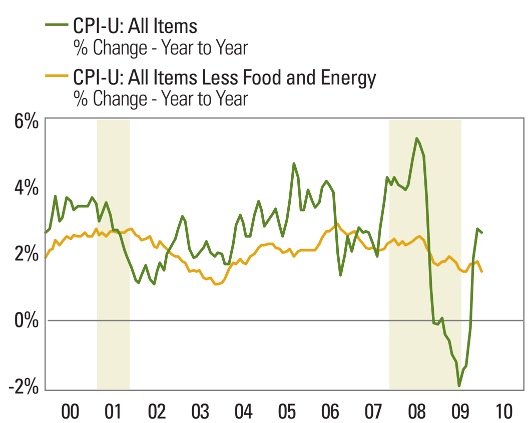
Our View on the Key Reports and Events of the Coming Week:

The week ahead is likely to be dominated by the outcome of, and discussion about, the Federal Reserve's Federal Open Market Committee (FOMC) meeting. However, key reports on inflation, housing, and the manufacturing sector will also fight for the market's attention.

FOMC:

- The market expects that the FOMC will retain the key "extended period" language in the FOMC statement, but leave interest rates unchanged.
- The FOMC is likely to comment on the end of its quantitative easing (purchases of Mortgage-Backed Securities) program in the statement—the program ends on March 31, 2010—and will likely acknowledge that the economy has improved since the last FOMC meeting in January, but not by enough to warrant immediate policy tightening.
- In addition, the FOMC is likely to continue to make a distinction between ending its various emergency liquidity programs, draining its balance sheet, and raising its policy rate—either the Fed Funds rate or the interest rate on excess reserves.

3 Overall Inflation Likely to Accelerate Over the Next Few Months, But Core Inflation Likely to Decelerate



Source: Bureau of Labor Statistics, Haver 03/15/10
Shaded areas represent recessions.

Inflation:

- The market has been sensitive in recent weeks about signs of inflation emerging the United States.
- The February Consumer Price (CPI) and Producer Price (PPI) indices are likely to continue to show accelerating overall (headline) inflation, but decelerating core (excluding food and energy) inflation in February.
- The divergence in headline and core inflation is the result of the big swings in energy prices since mid-2008. Energy prices plunged between mid-2008 and the first few months of 2009, as the global economy slowed sharply. This led to headline deflation (falling prices) for both CPI and PPI.
- As 2009 unfolded, the economy recovered, driving energy prices higher, although nowhere near as high as the mid-2008 peak.
- For the next few months (through late spring and early summer), headline inflation will likely continue to accelerate, as oil prices (close to 80 dollars), are still well ahead of oil prices in the first several months of 2009. Oil prices averaged around $50 dollars per barrel in the first five months of 2009.
- Long-term Inflation expectations remain low, and well contained, and have not moved at all since the Fed began its quantitative easing program in March 2009.

M2: A category within the money supply that includes M1 in addition to all time-related deposits, savings deposits, and non-institutional money-market funds. M2 is a broader classification of money than M1. Economists use M2 when looking to quantify the amount of money in circulation and trying to explain different economic monetary conditions.

Consumer Price index (CPI) is a measure estimating the average price of consumer goods and services purchased by households.

Producer Price index (PPI) tracks inflation by measuring price changes.