Weekly Economic Commentary

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Highlights

After a blistering two-week stretch of mostly sub-par economic data, this week is a very quiet one for economic data and policy events in the United States.

The June employment report capped off another disappointing weak of economic data, reviving talk of a "double dip" recession.

How likely is a "double dip" recession?

Summer Double Dip?

This week (July 5-12) is shaping up to be one of the quietest weeks of the year on the United States economic calendar. On the policy front, the Federal Reserve (Fed) is in vacation mode this week as well. However, major central banks overseas—the European Central Bank (ECB), the Reserve Bank of Australia (RBA), and the Bank of England (BOE)—will meet to set policy this week. There are no major reports due out this week on the Chinese economy, but the data calendar in Europe is relatively heavy. With the United States Congress in recess this week, the ongoing saga of the financial regulatory reform bill in the United States will linger into mid-July.

As is the case with the economic data calendar in the United States this week, it is likely to be a quiet week for the Fed as well, with no key policy announcements on tap, and only a few Fed officials slated to speak. Looking ahead, the Fed will release the minutes of the June 22-23 Federal Open Market Committee (FOMC) meeting, along with its latest economic forecast on July 14. Fed Chairman Ben Bernanke will deliver his semiannual monetary policy testimony to Congress in mid to late July. The next FOMC meeting is August 10. We don't expect the Fed to change policy until 2011.

With the Fed quiet this week, the market's attention will be on overseas central banks. The ECB, the Reserve Bank of Australia, and the Bank of England will meet to set policy this week. None of these banks are expected to raise rates this week, although the RBA has been tightening since September 2009. Although many global central banks have pushed back plans to remove monetary stimulus in light of the uncertain fiscal situation in Europe, the central bank of Malaysia is expected to engineer its third rate hike of the year this week. The central bank of South Korea, however, is expected to keep rates unchanged at its policy meeting this week.

There is no significant economic data due out in China this week, but next week (the week of July 12-16) the market will absorb all the major Chinese economic data releases for June. In sharp contrast to the United States and China, there is plenty of data due out this week for May and June in Europe. Market participants continue to try to gauge the health of the economy in Europe just prior to the onset of what are likely to be significant government spending cuts and meaningful tax increases.

Economic Calendar

Monday, July 5
Holiday

Tuesday, July 6
ISM Service Sector
June

Thursday, July 8
Initial Claims
wk 07/03

Chain Store Sales
July

Consumer Credit
May

Friday, July 9
Wholesale Inventories
May

How Likely Is A "Double Dip"?

There has been increased talk recently about the possibility of a "double dip" recession occurring in the United States. A "double dip" recession would mean that the United States economy—which has most likely been in an economic recovery since the summer of 2009—would slide back

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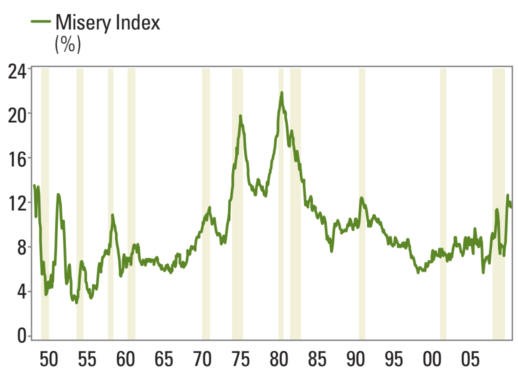
into another recession at some point in the near future. In our view, while the odds of a double dip have increased in the past few months, we don't think a "double dip" is likely to occur given the current economic and policy backdrop. However, a sudden surge in commodity prices, a sharp increase in global central bank policy rates, a collapse in overseas economic growth, rapid reigning in of fiscal stimulus in the United States, and/or a dramatic flattening of the yield curve would cause us to change our view.

For background, over the past 80 years, the economy has endured two "double dip" recessions, in 1937-38 and again in 1981-82. In this section, we will look at each of the prior "double dips", and then compare those periods with the current period. The 1937-38 recession was quite severe, and is often lumped in with the "Great Depression" of the 1930s. The National Bureau of Economic Research (NBER), the apolitical, nonpartisan, academic think tank that assigns dates to recessions and expansions, tells us that the Great Depression ended in early 1933 and a recovery that lasted four years, until mid-1937, ensued. At that point, the Federal Reserve began to tighten policy, the United States government raised taxes and cut government spending in order to balance the budget, and the economy hit a wall, plunging into a severe downturn that lasted for 15 months.

1 While Elevated Relative to Recent History, the "Misery Index" Now Stands at About Half of its Early 1981 Level



Source: Bureau of Labor Statistics/Haver Analytics 07/06/10
Shaded areas represent recessions.

The Misery Index is the inflation rate plus the unemployment rate.

Jumping ahead 40 years, there was a sharp, Federal Reserve induced recession in the first half of 1980. The causes of the first leg of the early 1980s "double dip" recession are fairly clear:

- The Fed raised rates sharply in late 1979/early 1980 to combat 13% inflation.
- The President went on television in early 1980 and urged people to not use their credit cards.
- Oil prices were surging, in part due to the Iranian hostage crisis, which began in November 1979.

As a result, consumer spending, business investment, and housing activity collapsed. The Fed eased in early 1980 to end the recession, but inflation, even inflation excluding food and energy, was still high and market interest rates started going up again. In addition, the wage price spiral was still intact, oil and other commodity prices continued to move higher, and the economic recovery in late 1980-early 1981 was shaky at best. The United States economy entered another severe recession in July 1981, which lasted until November 1982.

We recently completed an analysis that looked at the behavior of dozens of economic indicators today and in late 1980 and early 1981. Unfortunately, there is not enough data readily available for the 1936-37 period to make a similar comparison. Of the dozens of metrics we looked at (comparing late 1980/early 1981 to today) we found that only a handful are "worse today" (i.e. pointing to "double dip") than they were in mid 1981, when the second leg of the double dip began.

Those indicators that are worse today than in mid 1981 include:

- Credit spreads today are wider than they were in mid 1981, just prior to the onset of the second half of the "double dip".
- Private sector employment gains since the end of the prior recession.

The recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981.

- Consumer sentiment and consumer expectations (although the evidence is mixed here).
- Real Money Supply Growth (evidence is mixed here as well).

Looking at the data, it is clear the 1980-81 period should have been called one big recession. The already fragile economy coming out of the sharp 1980 recession just buckled under the weight of high inflation, a tightening Fed, the lagged effect of soaring oil prices, and very weak trading partners, a soaring dollar, and extremely high nominal interest rates that dissuaded investment.

We have none of these things now: In fact, the recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981:

- Oil prices had risen by 40% and 30% over the prior three and four years in mid 1981.
- Both headline and core (excluding food and energy) inflation was over 10%, so the Fed was raising rates.
- Business capital spending was tepid at best in late 1980 and early 1981, weighed down by exorbitant financing costs.
- The US dollar surged, (crimping exports) while our major foreign trading partners saw modest growth at best.
- Equity prices, as measured by the S&P 500, were only up modestly in mid 1981 versus the end of the recession in 1980.
- The absolute level of the 10-year Treasury note, mortgage rates, and the 3-month t-bill were absurdly high, crushing investments and consumption.
- The so-called "Misery Index" (the inflation rate plus the unemployment rate) was in the 20s. It is closer to 10 today.
- In addition, the ISM (and its key leading components) in the 1980-81 period barely got over 50, let alone above 60 as they have been now.
- The slope of the yield curve—the difference between the 10-year treasury note and the fed funds rate—was negative, often a harbinger of recession.

Looking at the data today, it's hard to make a case for "double dip", but the data does point to a slowing pace of growth in the second half of 2010 relative to the first half:

- Today, the ISM and its key components have been above 50 for most or all of the past 12 months, and many have spent significant time above 60.
- The Fed today is on hold (not raising rates as they were in late 1980 and early 1981) and even today, we are still feeling the effect of the Fed's recently quantitative easing program and prior rate cuts.
- Over the past 3-4 years, the price of oil and gasoline have seen little change, while in late 1980 and early 1981 they were soaring, crimping the consumer.
- Today the 10-year/fed funds rate yield curve is hugely positive; in 1980-81, it was negative and inverted most of the time, signaling a recession.

- Our exports are booming today, and although our trading partners are slowing, economic growth in our trading partners today (even post Europe debt crisis) is more than triple what it was in 1981.
- The dollar is flat vs. a year ago, while in mid 1981, the dollar was up 15%yoy vs. mid 1980 hurting exports.
- Today, business capital spending (led by low absolute interest rates, and low corporate financing costs, plenty of cash on corporate balance sheets, soaring profits and cash flows and a 25%yoy gain in equity prices is a much more robust back drop for corporate spending than was the case in late 1980/early 1981.
- On housing, inventory of unsold homes is way lower today than it was in 1980-81, housing affordability is triple what is was in 1981, and mortgage rates are at all time lows now. In late 1980/early 1981, mortgage rates were at all time highs.
- As previously noted, one of the few metrics that is "worse" now than in late 1980/early 1981 is private sector job creation. However, when you adjust for outsourcing (there is a ton of outsourcing now and there was none in 1981), productivity (negative to +1.0% in 1980-81, soaring 5 to 6% now), and job growth today is on a par with early 1981.

In addition, fiscal policy in the United States, while tightening a bit relative to where it was in 2009, is still loose by historical standards, and a balanced budget is years away.

What We Make of Last Week's Key Reports and Events

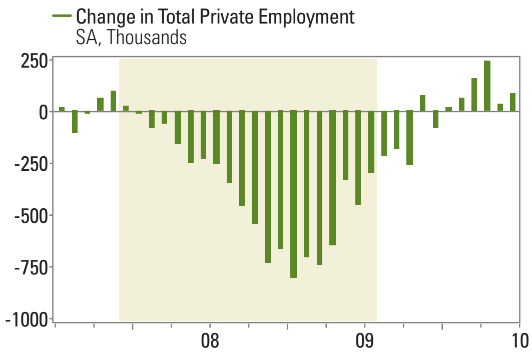
Last week (June 28-July 2) marked the third consecutive week, dating back to mid June that the economic data in the United States, on balance, came in below expectations. The biggest offender last week was the weaker than expected employment report for June. The economic data overseas was no better, as data in China and Europe continued to show slowing economic growth. The Fed was quiet last week, and of the handful of central banks that met last week, only Norway opted to raise rates.

For now, that's all we think it is, a "soft spot", but we will continue to monitor the incoming data for evidence that the "soft spot" is broadening or deepening.

For most of the past 12 months (through about early June 2010), the economic data in the United States came in better than expected (and generally better than the prior period), as the economy climbed out of the worst recession since the 1930s. As we have written about in our *Weekly Economic* and *Weekly Market Commentary* over the last few weeks, it is not unusual to hit a "soft spot" in the data about a year after the onset of an economic recovery. For now, that's all we think it is, a "soft spot", but we will continue to monitor the incoming data for evidence that the "soft spot" is broadening or deepening.

The June employment report (released on Friday, July 2) did little to dispel the notion that the United States economy was in a "soft spot." While not uniformly weak (i.e. an outright decline in private sector jobs in June), the June jobs report had a little something for everyone, the economic bulls, the economic bears, and the "double dippers". In general, the market's focus was on the private sector jobs, as the hiring and firing of up to 1 million temporary workers to help conduct the 2010 Census continues to distort the overall payroll count.

2 The Private Sector Has Added Jobs in 7 of the Past 8 Months



Source: Bureau of Labor Statistics/Haver Analytics 07/06/10
Shaded areas represent recessions.

As previously noted, the June employment report had something for everyone. For the economic bulls, the report revealed that the economy added 83,000 private sector jobs in June, after adding 33,000 in May. The private sector has now added jobs in seven of the last eight months, totaling nearly 600,000 jobs. Bulls will also note that the unemployment rate unexpectedly fell to 9.5% in June from 9.7% in May. The rate was expected to rise to 9.8%. The rate, which is calculated by dividing the number of people who are unemployed by the number of people in the labor force, peaked in the Fall of 2009 at 10.1%.

For the economic bears and the "double dippers", the private sector job count came in below expectations for the second consecutive month in June, as the 83,000 gain in private sector employment fell short of the consensus estimate, which called for the economy to add roughly 100,000 private sector jobs in June. The economic bears and "double dippers" will also point out that the pace of private sector hiring has downshifted in the past two months (an average of 58,000 jobs created per month in May and June versus an average of a monthly gain of 200,000 jobs per month in March and April) and note that the economy lost 8.4 million private sector jobs during and after the Great Recession, and has only added 600,000 jobs back.

We also looked through the June employment report for any impact from the Gulf of Mexico oil spill and/or from state and local budget cuts on the national employment picture. While there has certainly been plenty of evidence that the oil spill in the Gulf of Mexico has had a discernable impact on the local economies in Louisiana, Alabama, and Mississippi, it was difficult to find any impact on the national economy from the oil spill in the June employment report:

- Employment in oil and gas extraction industry, which accounts for 166,000 mostly high paying jobs throughout the nation, was unchanged between May and June, although one could argue that this figure should be moving steadily higher with the recent upswing in oil and gas prices.
- Employment in accommodation and food service rose by 6,000 after a 4,000 gain in May. It was thought that perhaps restaurants and hotels in the Gulf region (tourism related employment accounts for between 15 and 20% of employment in the region) would have to lay off employees due to tourists changing travel plans away from the Gulf. While this may have happened, hotels and restaurants in other regions may have had to hire extra workers to handle the increased volume. It's also possible that some of the hotels and restaurants in the Gulf region could be benefitting from the spending related to the cleanup effort.
- Because commercial fishermen are considered agricultural workers, any job losses by this group of workers would not be captured in the monthly nonfarm job count.

On the state and local government front, there was some evidence that well publicized state and local budget cuts were beginning to have an impact on employment in June. In our view, the best-case scenario is that state and local government employment holds steady over the next six months. The base case is that the same pace of job loss that has occurred in the first half of 2010 persists into the second half. In June, employment at the state government level fell by 2,000 and is down by 20,000 since the beginning of the year. Local government employment fell by 8,000 in June, and has dropped by 76,000 this year. Most of those losses are outside of education, but with the school year beginning in some states in July (with most in August and September); we would expect to see more job losses in the local education sector soon.

ISM Manufacturing Index: An index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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