



## WEEKLY ECONOMIC COMMENTARY – WEEK OF JULY 5, 2010

FINANCIAL INDICATORS				
INTEREST RATES	July 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.16%	0.13%	0.12%	0.16%
6-month Treasury bill	0.21	0.19	0.21	0.29
3-month LIBOR	0.53	0.53	0.54	0.58
2-year Treasury note	0.62	0.65	0.73	0.98
5-year Treasury note	1.81	1.89	1.98	2.42
10-year Treasury note	2.97	3.10	3.20	3.49
30-year Treasury bond	3.94	4.06	4.13	4.32
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.67	1.76	1.65	2.10
10-Year	3.05	3.18	3.02	3.50
30-Year	4.43	4.45	4.41	4.85
30-year fixed mortgage rate	4.58	4.69	4.79	5.32
15-year fixed mortgage rate	4.04	4.13	4.20	4.77
1-year adjustable rate	3.80	3.77	3.95	4.94
STOCK MARKET				
Dow Jones Industrials	9686.48	10143.81	9931.97	8280.74
S&P 500	1022.58	1076.36	1064.88	896.42
NASDAQ	2091.79	2223.48	2219.17	1796.52
Commodities				
Gold (\$ per troy ounce)	1211.90	1255.40	1221.20	929.50
Oil (\$ per barrel) - Crude Futures (Nymex)	72.27	79.04	70.98	66.38
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Personal Income (May) - % change	0.4	0.5	0.4	0.4
Personal Consumption (May) - % change	0.2	0.0	0.6	0.3
ISM Manufacturing Index (June) - Index	56.2	59.7	60.4	58.5
Consumer Confidence (June) - Index	52.9	62.7	57.7	54.8
Nonfarm Payrolls (June) - change in 000s	-125.0	433.0	313.0	147.0
Unemployment Rate (June) - Percent	9.5	9.7	9.9	9.7

**Prime Rate: 3.25%****1-Month LIBOR: 0.35%**

The latest jobs report had something for everybody but satisfied no one on either side of the philosophical spectrum. For sure, it did little to squash the ongoing debate – raging here and abroad – as to whether more stimulus is needed to nourish the fledgling recovery or whether fiscal austerity would be a more appropriate

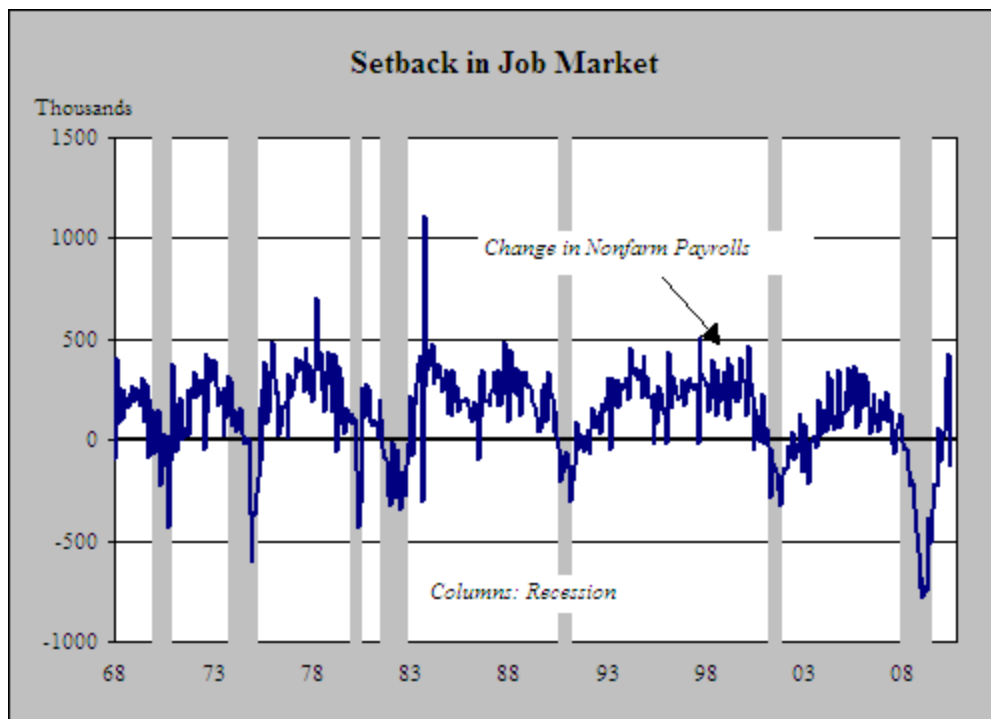
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cure for the confidence-shattering bloated deficits that are creating turmoil in the currency and financial markets around the world. The debate has strong advocates on both sides, although the austerity argument has gained more traction in Europe, where stringent deficit-reduction measures are being imposed. Not surprisingly, critics of this strategy claim that policy makers are repeating the same mistakes made in the U.S. during the 1930s and in Japan during the 1990s, when tax increases and budget cutbacks were adopted prematurely, thus aborting the recoveries.

In the U.S., President Obama is pushing for more stimulus while Congress is reluctant to pass any measure that would add to the deficit ahead of highly contentious midterm elections. Unlike in Europe, however, the political sentiment on Capitol Hill is not committed to an “austerity now” mantra, which would involve immediate budget cutbacks. That’s probably a good thing, as the economy would have a difficult time overcoming a fiscal drag that would be reinforcing other powerful headwinds holding back growth. The biggest headwind, of course, is the reluctance of companies to ramp up hiring to the extent they had coming out of past recessions. That’s particularly disconcerting now considering there are quite a few who feel that the nation is still mired in a recession.

That perception is understandable. Despite a year of growth, there are still fewer workers holding jobs now than when the recession ended last June. To be sure, non-farm payrolls have increased in five of the past six months, so technically speaking, the current upturn does not qualify as a “jobless recovery”. But in the context of the massive layoffs that occurred during the recession, progress on the hiring front is hardly impressive. Keep in mind that 8.4 million jobs were extinguished in the two years ending last December, and the gains this year only recaptured about 900,000 of those losses. Hence, there are still 7.5 million fewer jobs now than existed when the recession began in December 2007. That’s a deep hole to climb out of - one that understandably leaves many Americans believing the nation has not escaped the grip of the Great Recession.



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Indeed, the tepid recovery of jobs parallels the sub-par performance of the overall economy. Since exiting the recession around the middle of 2009, the economy has posted an annual growth rate of 3.5%, well below the 5.8% pace registered over the first three quarters of the last nine recoveries. The discrepancy is even starker if the current upturn is compared to those that followed past harsh recessions. For example, over the first nine months following the deep 1981-82 recession, real GDP surged by a torrid 7.5% pace. Needless to say, the weaker the recovery, the more vulnerable it is to a setback from a shock or other headwind. Some believe the festering European debt crisis, which is spurring the fiscal austerity measures, may yet qualify for such an event, producing a double-dip recession overseas and financial turmoil that could spread to the U.S.

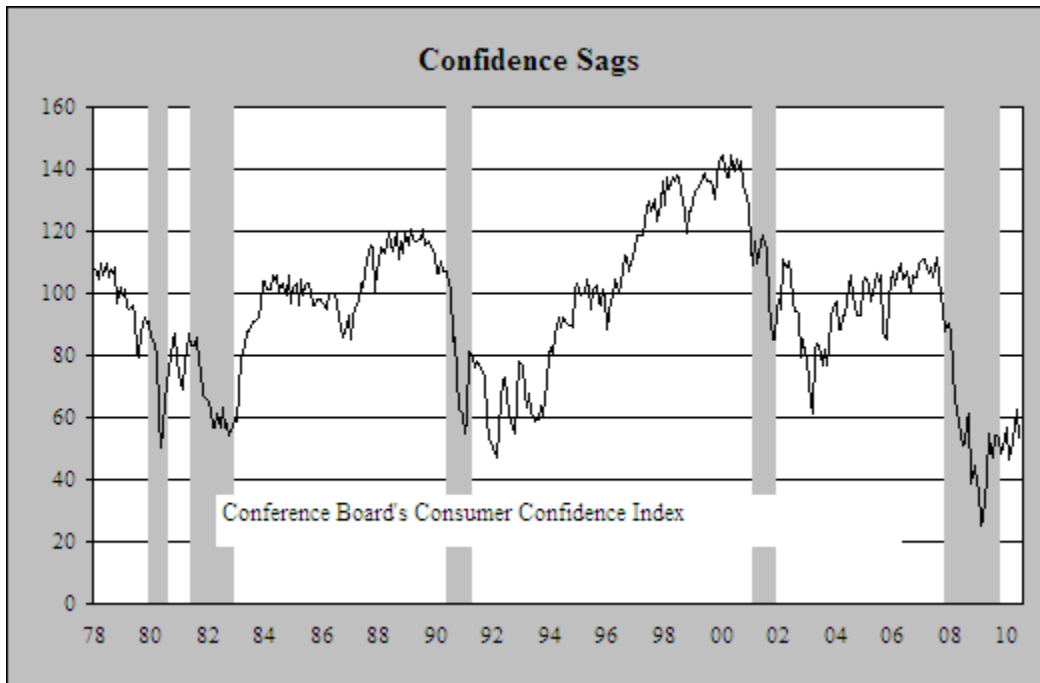
We are far from convinced that such is the case. Indeed, the U.S. may actually be benefiting to some extent from Europe's woes, as capital is fleeing the Euro into Dollar-denominated assets, lowering interest rates below where they otherwise would be. Last week, the 10-year Treasury bond yield – which influences borrowing costs for homebuyers and a range of other borrowers – slid below 3 percent for the first time since April 2009, when the economy was indeed still in the grips of a recession. In predictable fashion, the 30-year fixed mortgage rate plunged, falling to a record low of 4.58% in the latest week. To be sure, low mortgage rates will not overcome the powerful headwinds depressing the housing market, but they are generating a surge in refinancing activity among homeowners, which should put extra cash into their bank accounts.

That said, the housing slump as well as the subpar performance of the overall economy both share an underlying malady, namely the anemic recovery in jobs. The employment report released on Friday revealed little change in that condition. As we noted at the outset, the report presented a highly mixed picture but on the whole has to be considered a disappointment. Overall, non-farm payrolls fell by 125,000 in June, following a 433,000 surge in May. But, as is well known, the wide swings reflect the temporary hiring and firing of government census workers, which somewhat masks the underlying trend in employment. The May surge, for example included 411,000 Census hiring and the June decline was more than accounted for by the termination of 225,000 of those workers. More will be let go in July and August, although the influence will wane during those two months.

The more accurate picture of what's happening in the labor market can be gleaned from the private sector. In June, private companies increased payrolls by 83,000 following a 33,000 increase in May. Despite the sequential improvement, hiring activity in the private sector has to be considered a disappointment. The 53,000 average increase over the past two months is actually a dramatic slowdown from the 200,000 average over the previous two months. In other words, just when it looked like the job market was turning considerably stronger in the spring – poised to drive the recovery into a higher gear – it ran into a wall and downshifted abruptly. More than anything, that's the primary reason consumer sentiment has tanked and prompted one economist after another to downgrade their growth forecasts for the balance of the year.

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It is difficult to understand precisely why companies have taken a step back in the hiring process. But if there is one consistent thread underpinning corporate behavior, it is that uncertainty breeds caution. Clearly, there are a host of uncertainties that have cropped up in recent months, not many expect, an important export market for U.S. goods will weaken as well. Keep in mind that strong exports have been a major source of manufacturing strength this year, one of the few bright spots of the recovery in the U.S. If that fades, so too will a major pillar propping up the recovery.

By the same token, if it turns out the EU policy makers are on the right track the least of which is the sovereign debt crisis, which is still unfolding. A related uncertainty is the ambiguous outcome of the policy response. If the wave of fiscal austerity measures stifles growth in Europe, as, or at least their actions do not derail the recovery in Europe, the export market may hold up. That, in turn, could encourage corporate chieftains to resume the burst of job creation that looked to be underway during the spring. But other uncertainties also cloud the outlook and are no doubt sustaining a cautious mindset in corporate boardrooms. These include policy choices that have yet to be made in the U.S. including budgetary decisions about taxes in the coming year, how financial regulation and healthcare will affect credit availability and costs, and what will be the prevailing political attitude towards business leading up to the elections. If businesses become more of the whipping boy for political candidates, they are not likely to view the environment as conducive to growth.

At this juncture, it does appear that the economy is heading for some rough sledding going forward, which supports the notion that growth will slacken over the next quarter or two. However, we do not view the overhanging clouds as dark enough to short-circuit the recovery. While the odds of a double-dip recession have probably risen in recent months, they still remain less than 50-50 in our view. If there is one consistent message to come out of the history of business cycles, it is that once recoveries get underway, they almost never stop. On the rare occasion when a recovery is prematurely aborted, it is usually due to a policy mistake or an unexpected shock from an external source, such as a war or an oil crisis. Since the U.S. is not going down the same draconian fiscal path as Europe, and the Fed remains committed to an easy policy for an "extended period", we do not expect a policy mistake to upend the recovery here. The most visible external shock looming on the horizon is from the ongoing housing bust that may be intensified by the

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potential wave of foreclosures. But this is not exactly a new, unexpected, crisis that would suddenly send the economy into a tailspin.

Having said that, we are disappointed with the latest jobs report, not only because of the weak increase in private sector jobs (83,000), but also because the Household Survey (from which the 9.5% unemployment rate is derived – and which seems to do a better job at picking up new jobs in the early stages of a recovery), showed a loss of 322,000 jobs. When we look at the trend in both surveys (establishment & household - using December 2009 as the low), the two surveys show a total of between 600,000 (establishment) and slightly over 1 million (household) jobs have been created in the private sector this year. The truth probably lies somewhere in between. At this level, job growth is running at an annualized pace of about 1.5%. That's not very impressive, as in good times, job growth rises 2% - 3% per year.

What was also discouraging was the failure of companies to increase the workweek, which had been lengthening in recent months. Additionally, average hourly earnings slipped during the latest month, which together with the decline in the workweek means that labor income also stagnated in June. That's not good news for consumer spending, which is already showing signs of fatigue. Real personal consumption edged up by a scant 0.3% in May after a flat showing in April, leaving the average for the second quarter on pace for a 2.3% annualized gain. That would be weaker than the 3 percent increase posted in the first quarter, which was a decent but not great reading. More to the point, the setback in labor income in June points to little momentum heading into the third quarter. Since consumer spending accounts for about 70 percent of total activity, that loss of momentum supports the view that the recovery is set to downshift over the second half of the year.

Hopefully, the stagnation in labor income last month was an aberration rather than the start of a trend. It is unclear why worker hours were cut in the midst of a solid upward trend. Even with the setback, hours worked for the third quarter as a whole increased by a robust annual rate of 3.3%. We suspect that the upward trend in this important barometer of labor input will resume in coming months, providing workers with a much-needed boost in compensation. One reason to hope this will be the case is that businesses are still retaining a huge army of 8.6 million workers who are working part time for economic reasons, i.e. either because their hours were cut or they can't find full-time position. As the economy continues to grow, companies will extend the hours of this enormous pool of part-timers – which is about double the size at the start of the recession – or convert many to full-time jobs. The downside of this, of course, is that companies will tap into this reservoir of part-time workers before creating new jobs. That will hold back the hiring process, which remains the strongest headwind holding back the recovery.

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