Weekly Economic Commentary

November 24, 2008

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ECONOMIC CALENDAR

Monday, Nov 24
Existing Home Sales
October

Tuesday, Nov 25
GDP Price Index
Q3

GDP
Q3

Consumer Confidence
November

Wednesday, Nov 26
PCE
October

Personal Income
October

Initial Claims
wk 11/22

Durable Goods
October

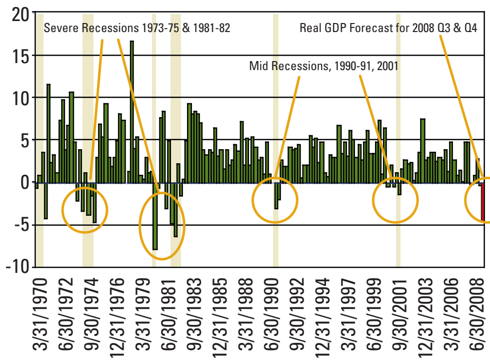
Chicago PMA
November

U of Mich Consumer Sentiment
November

New Home Sales
October

Thursday, Nov 27
Holiday

1 Real GDP in Q4 2008 Now Expected to Contract by at Least 4.0%



Source: Bureau of Economic Analysis

Executive Summary:

Revising Near Term Real GDP Forecast Due to Deteriorating Labor Market and Financial Market Conditions

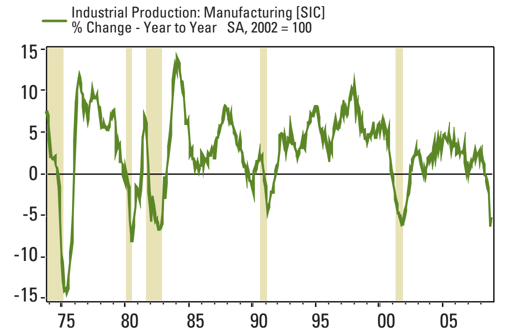
Earlier this month, we wrote that our best guess was that the U.S. economy probably contracted by between 3.0 and 4.0% (on an annualized basis) in the current (fourth) quarter of 2008 as measured by real gross domestic product (GDP). However, given the rapid deterioration in credit markets, overseas economies, and global equity markets, in combination with the much weaker tone of the U.S. economic data releases just this past week, we are lowering our forecast for Q4 GDP to a drop at the rate of 4.0% or more. In addition, we now think that real GDP could contract by a similar amount in Q1 2009. The Q4 2008 GDP data won't be released until January 30, 2009. [chart 1]

Until then, financial markets will continue to try to gauge the depth and breadth of this recession, and are now comparing this downturn to the severe recessions of 1973-75 and 1981-82, and in some cases, to the Great Depression of the 1930s. Right now, our view is that while we are not in a repeat of the Great Depression, this recession could end up being as severe as the 1974-75 downturn, which was second only to the 1981-82 recession in terms of duration and severity.

As noted above, the U.S. economic data released last week for October was abysmal, as we and most observers had expected. A quick history of how we got here may be helpful:

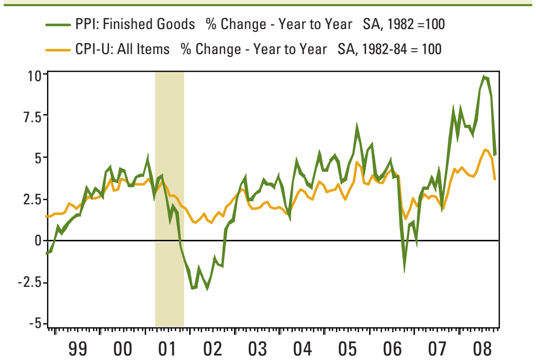
- The acute phase of the global credit crunch began in mid September, triggered by the collapse of Lehman Brothers.
- The resulting almost immediate freeze-up in bank lending persisted until the middle of October and brought the U.S. and global economies to a virtual standstill in October.
- The announcement in early October of direct equity injections by the U.S. government into major U.S. banking institutions (and similar moves by foreign governments) unfroze the interbank lending market over the course of the month of October, but the healing process was slow, and limited to just interbank lending.
- Although the global interbank lending freeze began to thaw in October, throughout that period and over the first three weeks of November banks have remained unwilling (or in some cases unable) to lend to business and consumers.

2 Industrial Production Declines Clearly Point to a Recession in the U.S



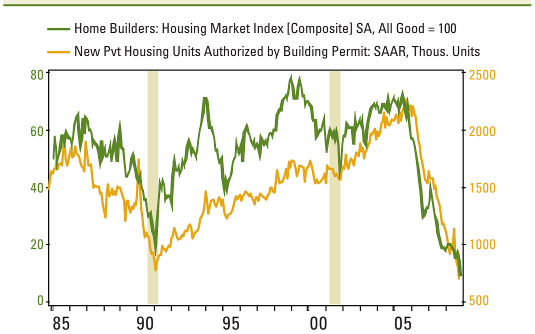
Source: Federal Reserve Board / Haver Analytics 11/21/08

3 Headline Inflation at Both the Producer and Consumer Level is Decelerating as Energy Prices Plummet



Source: Bureau of Labor Statistics / Haver Analytics 11/21/08

4 No Bottom Yet for Homebuilder Sentiment or Building Permits



Source: NAHB, CENSUS / Haver Analytics 11/21/08

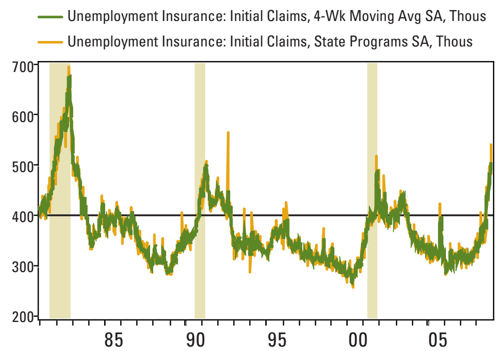
- Economic activity in the United States and abroad remained moribund through November, which has prompted us to revisit and revise down our forecast of economic activity in the current (fourth quarter).
- Looking ahead, the longer the credit crunch goes on, the more damage is done to the economy, and the longer the recession will last.

Against that backdrop, we can put last week's data into proper context. Heading into the week, the market was bracing for horrible data for October, but was hoping for some signs over improvement in the data between October and November. The market got the horrible data it expected, but there were few, if any, signs in the November data that the economy has stabilized. If anything, the data released for November suggests that the economy may be even worse in November than it was in October.

A quick recap of last week's data reveals that:

- The much larger than expected 1.3% bounce in industrial production in October was largely the result of a rebound in refinery and oil rig activity in the wake of Hurricane Ike, which hit the Texas coast in September. Aside from a surprising 0.6% gain in manufacturing output in October, there was little in the report to cheer about. As noted in the nearby chart, industrial production in the manufacturing sector was down 5.3% in October 2008 versus October 2007, a clear sign that the U.S. economy is in recession. [chart 2]
- The two inflation measures released last week —the October readings on producer prices (PPI) and consumer prices (CPI)—reinforced the market's fears that the U.S. economy is headed for a period of deflation. Both reports were dominated by the plunge in energy prices. Recall that just this past summer, as oil prices surged to near $150 per barrel, most market participants were concerned with runaway inflation and its impact on the economy, monetary policy and financial market valuations. The October PPI fell by a record 2.8%, led by plunging prices for gasoline (-12.8%), home heating oil (-9.6%), and natural gas (-5.9%). Excluding food and energy, the PPI rose 0.4%, but the gains therein—auto and truck prices— are likely to reverse in November and set the core PPI down the path of moderation over the next year. It was a similar story with the October CPI, with huge monthly declines in consumer energy prices (-8.6%) contributing to the record 1.0% drop in the CPI in the month. Core CPI was better behaved than core PPI in October, and we expect that moderation in core prices to persist well into 2009 as the economy slows. [chart 3]
- The housing data released last week —the November National Association of Homebuilders Index (NAHB) and the October housing starts reports— offered no sign that the housing market had bottomed. The NAHB report, which measures sentiment of homebuilders, slid from a record low 14 in October to a new record low of 9 in November. Thus, contrary to the market's hope, there was no improvement homebuilder sentiment, and in fact, sentiment deteriorated sharply between October and November. The forward looking component of the October housing starts report—building permits—also painted a grim picture for housing activity over the near term. While housing starts were expected to plunge in October, and they did, there was some hope that permits

5 The November 15 Jobless Claims Data Suggest that the Labor Market Deteriorated Significantly Between October and November



Source: Department of Labor / Haver Analytics 11/21/08

would stabilize, after falling by more than 65% since September 2005. That stabilization did not materialize, however, as permits fell 12%, the fourth consecutive monthly decline, leaving permits at their lowest level on record. [chart 4]

- Perhaps the most disturbing piece of news for the markets last week was the November 15 reading on weekly jobless claims, which is as close to a "real time" indicator of economic activity as the market gets. The weekly jobless claims data suggest that the deterioration in the labor market intensified between October and November, and this news severely disappointed financial market participants, who were looking to see some signs of stabilization in the labor market in November after a 240,000 drop in nonfarm payroll employment in October. Jobless claims unexpectedly rose by 26,000 to 542,000, the highest weekly reading since July 1992, when the U.S. economy was emerging from the shallow 1990-91 recession in the "jobless recovery". Because there is substantial variation in jobless claims from week to week due to holiday shifts and other calendar quirks, many market participants look at the four-week average on claims. On this measure, claims rose by nearly 16,000, to the highest level since mid 1993, when the U.S. economy was emerging from the deep and prolonged 1981-82 recession. [chart 5]

Looking ahead, this holiday-shortened week is a busy one for economic data, as the government number mills try to cram five days worth of data into two and a half business days. This week's data can be parsed into three distinct categories:

Housing:

- New and existing home sales for October
- The Case Shiller Home Price Index for the third quarter and September 2008

Manufacturing:

- The November Chicago Area Purchasing Managers Index
- The October durable goods orders report

The Consumer:

- Consumer spending and personal income for October
- The November reading on consumer sentiment
- The November 22 reading on initial jobless claims

In addition, the market will digest the first revision to the Q3 GDP report. Recall that in late October, the first look at real GDP in Q3 2008 found that the economy contracted by 0.3% in the quarter. The data released for Q3 2008 since then suggests that real GDP is likely to be revised down to -0.5%.

Finally, this Friday, November 28, marks the unofficial start of the 2008 holiday shopping season as stores open early for Black Friday. Most market observers expect this holiday shopping season to be one of the worst in a generation, so market participants will keep a close eye on the reports from the nation's malls and retailers over the long Thanksgiving holiday weekend for signs that the U.S. consumer isn't quite ready to give up yet.