Weekly Economic Commentary

July 13, 2009

Firming Up Q2, and Second Half '09 GDP Forecasts

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After a very slow week of economic news last week, there is an enormous amount of data due out this week, which will help to firm up forecasters' estimates of gross domestic product (GDP) growth in Q2 2009 and over the second half of 2009. The Q2 GDP report is due out at the end of July.

Last week's key economic data—jobless claims, May merchandise trade, May wholesale inventories and June service sector sentiment—suggested that real GDP in Q2 2009 was on pace to contract at about a 1.0% annualized clip in Q2, after dropping by 5.5% in Q1 2009 versus Q4 2008. Our published forecast is for real GDP to decline between 2.0 and 3.0% in Q2 2009, with real GDP growth turning positive in Q3 and Q4 2009, and we will stick by that forecast for now. The consensus is looking for a 1.8% drop in real GDP in Q2, a 1.0% gain in Q3 and a 1.9% gain in Q4.

This week's data will help market participants to further solidify their GDP forecasts for Q2 2009 and beyond. The key reports in that regard will be the June retail sales report and the May report on business inventories. Consumer spending is two thirds of GDP, and retail sales is a pretty good proxy for spending, although it does not capture spending on services, which makes up about 60% of consumer spending. To date, the market has only the April data on business inventories in hand as a gauge of the pace of inventory destocking in Q2 versus Q1. The paring of inventories was a big drag on GDP in Q2, accounting for 2.2 percentage points of the 5.5% drop in GDP. The inventory data for April, along with the qualitative reports on inventory levels in the economy from the various Federal Reserve and ISM surveys suggest that inventories were drawn down at a much slower pace in Q2 than in Q1, and will therefore exert less downward pressure on GDP

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.

U.S. federal government revenues have fallen by about 18% thus far in FY 2009 compared with the same period in FY 2008, due to the recession's impact on corporate profits and income taxes.

June Treasury Statement (Monday, July 13)

- Based on data from the Daily Treasury Statements, the U.S. government rang up a 1.1 trillion deficit in the first eight months (October 2008 through June 2009) of FY 2009, and is headed for a $1.7 trillion deficit in all of fiscal year 2009
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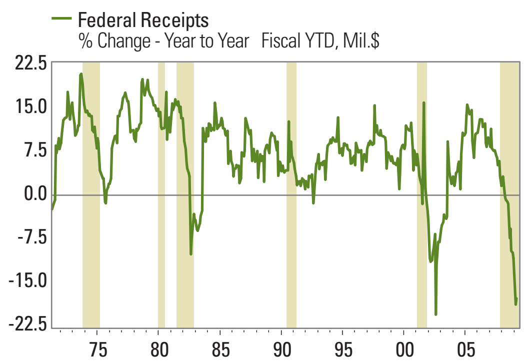
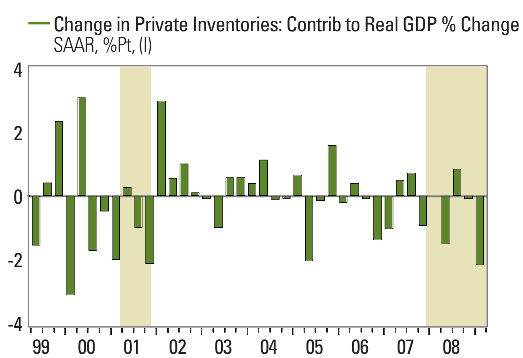


Source: U.S. Treasury, Haver 07/13/09

The market will be looking for signs of improvement in discretionary spending (non staples retailers, food away from home, furniture, etc).

2 Inventories will be less of a drag on Q2 GDP than they were on GDP in Q1.



Source: Bureau of Economic Analysis, Haver 07/13/09

- In contrast, government outlays have grown by nearly 21%, due to TARP related expenditures, and higher payments related to "automatic stabilizers" like employment benefits, as well as by the $787 billion fiscal stimulus plan which is only now beginning to ramp up
- Over the last month or so, policymakers and pundits in Washington have begun to take notice of the deficit, and the issue is likely to stay on the front burner over the summer as Congress debates healthcare reform and climate change

June Retail Sales (Tuesday, July 14)

- Despite cooler and wetter than normal weather, weekly chain store sales were solid for most of June, but chain store sales weakened in June '09 versus June '08 due to distribution of stimulus checks in May and June '08
- Vehicle sales held steady between May and June despite the turmoil in the auto markets
- Both gasoline prices and mortgage rates rose sharply between May and June, while the recent rise in both equity markets and consumer confidence stalled out in June
- The market will be looking for signs of improvement in discretionary spending (non staples retailers, food away from home, furniture, etc) and should focus on retail sales excluding auto dealers and gasoline service stations for a good gauge of the underlying pace of consumer spending in June

June Producer Price Index (Tuesday, July 14)

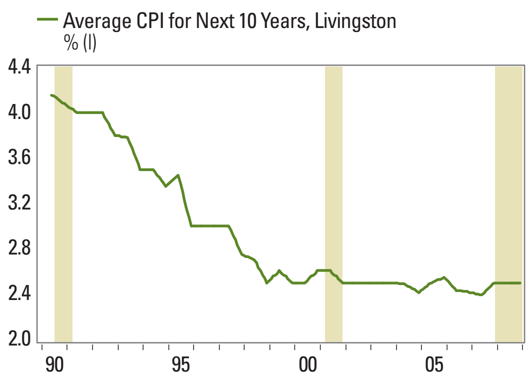
- Consensus forecast is for headline deflation on producer prices for finished goods in June, but inflation on "core" PPI
- We are likely to see inflation first at the producer level, (especially at the intermediate and crude levels) before we see it at the consumer level; we are already seeing commodity price inflation return
- There was a big move in crude oil and gasoline prices between May and June, which will impact the June headline PPI reading
- Tobacco and new and used vehicle prices are always wildcards for the PPI.
- CPI and PPI tend to move together over long periods, but month to month, they are not highly correlated

May Business Inventories (Tuesday, July 14)

- The monthly report on business inventories is most often greeted with a big yawn from financial markets, but the data are important around turning points in the economy
- The U.S. economy saw a big inventory drawdown in Q4 and again in Q1 as companies cut production (and jobs) to counter falling demand. This was a big drag on GDP

- Now, underlying demand has picked back up, and production has to catch up
- That means inventories are probably being restocked, or destocked at a slower pace, in Q2 than they were in Q1
- The May business inventories will help forecasters firm up their Q2 GDP forecasts. To date, the only "hard" data we have on business inventories in Q2 is from April. However, the inventory data in the various purchasing managers reports through June do suggest that the pace of inventory destocking has slowed between Q1 and Q2 2009, meaning that inventories will be less of a drag on Q2 GDP than they were on GDP in Q1

3 Overall, long term inflation expectations remained well anchored—even in the face of the Fed's massive quantitative easing program



Source: Federal Reserve Bank of Philadelphia, Haver 07/13/09

July Empire Manufacturing (Wednesday, July 15)

- Provides the markets with the first look at the health of the manufacturing sector in July and Q3 2009.
- While the Empire State Manufacturing Index dipped between May and June all the other major regional manufacturing indices (Philadelphia, Chicago PMI, Richmond, and Milwaukee) improved last month.
- What impact is a weaker dollar having on manufacturing, which is heavily dependant on exports?
- Has there been any spillover from the auto shutdowns into other areas of manufacturing in July?
- **Can the index push above zero for the first time since late 2007/ early 2008, which would indicate that manufacturing in the New York region was expanding?**

June CPI (Wednesday, July 15)

- On a year-over-year basis, the market expects headline deflation, but inflation on core CPI in June
- Both headline and core CPI inflation are likely to continue to fall well after the end of the recession
- The June data is likely to be impacted by rising energy and food costs. In addition, gasoline prices rose 27% in June versus May (but have fallen back in early July)
- Overall, long term inflation expectations remained well anchored—even in the face of the Fed's massive quantitative easing program—, which will allow the Fed to keep rates lower for longer
- In its most recent statement, the Federal Open Market Committee (FOMC) downplayed the risk of deflation in 2009, but we still think deflation, not inflation is a bigger risk in the second half 2009 and early 2010
- The Treasury market is less concerned about inflation than it was a month ago, but a "bad" CPI report could move the markets, especially the Treasury market. Equity markets are worried about a "W" shaped recovery that would be precipitated by a surge in inflation, and draconian round of policy tightening by the Fed in response to the inflation.

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What is the impact of auto plant shutdowns on the data? Chrysler produced no cars in June, and GM began shuttering plants in mid May to reduce inventory.

Can the index post a month to month improvement (from deeply negative territory in February 2009) for the fifth consecutive month? If so, it would mark the longest streak of month over month improvements in this index since 2003, when the economy was rapidly recovering from the mild 2001 recession.

June Industrial Production/Capacity Utilization (Wednesday, July 15)

- What is the impact of auto plant shutdowns on the data? Chrysler produced no cars in June, and GM began shuttering plants in mid May to reduce inventory. We expect auto production to post a big increase in Q3 2009 versus Q2 2009, which will flow through into the industrial production and other manufacturing data in July.
- The market will want to look behind the headline to see if there was any stabilization in non auto manufacturing in June versus May, as was hinted at by the June ISM report and most of the regional manufacturing indices in June.
- The end of inventory destocking (see business inventories) suggests that industrial production will begin to pick up in the second half of 2009.
- If the consensus is correct, on a year-over-year basis, industrial production will be down 13.6% in June versus -13.4% in May. The annual loss in IP would be the largest in more than 60 years, since July 1946's -16% decline.
- How will the much cooler and wetter than usual weather in June impact utility production and utilization?
- Capacity utilization is likely to fall to a new all time low in June. Slack capacity will help to keep a lid on any uptick in inflation late this year and into 2010.

July Philadelphia Fed (Thursday, July 16)

- One of the first readings on the manufacturing economy in July and Q3.
- Can the index post a month to month improvement (from deeply negative territory in February 2009) for the fifth consecutive month? If so, it would mark the longest streak of month over month improvements in this index since 2003, when the economy was rapidly recovering from the mild 2001 recession
- The index has been below zero, indicating that manufacturing activity in the Philadelphia area is contracting, in every month but one since the recession began in 2007.
- Other items of interest to the financial markets will be the prices paid index—are inflationary pressures building—and the inventory index—did the inventory destocking subside as Q3 2009 began.

July NAHB Housing Market Index (Thursday, July 16)

- The market is looking for another small improvement to 16 in July vs. 15 June, after the unexpected 1 point drop between May and June.
- A reading below 50 suggests that homebuilders think conditions are poor/above 50 conditions are good. The index has not been above 50 since April 2006.
- At 15 in June, the NAHB index is up from a low of 8/9 in late 2008/early 2009, but still well below peak of 72 hit in 2005

Will the stabilization in home prices—albeit at the lowest level in five years—help to push buyers into the market?

- Mortgage rates have moved down about 0.50% to around 5.20%, from their early June highs. Will the recent drop in mortgage rates drive buyers who are on the fence?
- Will the stabilization in home prices—albeit at the lowest level in five years—help to push buyers into the market?
- Lowball appraisals have become an issue in the housing market lately, with lenders requiring bigger down payments from buyers or price cuts from sellers to make deals happen

June Housing Starts (Friday, July 17)

Single-family starts are more economically sensitive and they have now posted four consecutive non-negative months over month readings since February, the longest streak since mid 2005!

- Looking for more signs that the housing market has stabilized, albeit at a very low level.
- Housing has been a drag on GDP growth for 13 consecutive quarters through Q1 2009 and will likely be a drag again in Q2 2009, but much less of a drag than in the past. We expect housing to begin to contribute to GDP growth by Q4 2009.
- Single-family starts are more economically sensitive and they have now posted four consecutive non-negative months over month readings since February, the longest streak since mid 2005!
- Multi-family starts are very credit market sensitive, and it's still tough sledding right now for builders and developers who are dependant on financing. Despite this, multi family start bounced 61.7% between April and May. This is a notoriously volatile series, so multi family starts are likely to drop in June versus May
- Weather is sometimes a factor for housing starts, but usually not in the summer months. However, June was much wetter than usual in most of the country, and that could negatively impact start activity
- Permits are not weather sensitive and are a good leading indicator of future housing activity

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.