Weekly Economic Commentary

March 02, 2009

Sticking With Our Base Case on the Economy

Policy Uncertainty Hindering Recovery, Hurting Markets

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ECONOMIC CALENDAR

Monday, Mar 2
Personal Consumption
January

Personal Income
January

Construction Spending
January

ISM Manufacturing
February

Tuesday, Mar 3
Domestic Car/Light Vehicle Sales
February

Wednesday, Mar 4
ISM Non Manufacturing
January

Thursday, Mar 5
Initial Claims
wk 02/28

Productivity
fQ4

Chain Store Sales
February

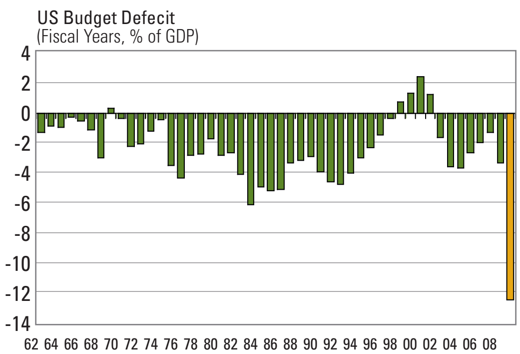
Factory Orders
January

Mar 6
Unemployment Rate
February

Nonfarm Payrolls
February

Consumer Credit
January

1 Budget Deficit Is Expected to Be 12.3% of GDP this Year



Source: Congressional Budget Office; Office of Management and Budget

It was another difficult week for the U.S. economy and financial markets last week, with another dose of bad news on the economy helping to push the broad U. S. equity market indices to their lowest levels in more than 12 years. In addition to the dour news on the economy, markets were buffeted by:

- The release of President Obama's first budget
- Key testimony from Federal Reserve Chairman Ben Bernanke
- More detail on the Administration's bank rescue program
- Yet another attempt by the U.S. government at shoring up Citibank
- The Federal Deposit Insurance Corporation's (FDIC) list of problem banks as of December 31, 2008
- A rash of dividend cuts from high profile major U.S corporations—including General Electric

On balance, the flood of news on the economy, policy and on corporate America was disconcerting, at best.

For now, we are sticking to our base case for the U.S. economy as outlined in the 2009 Outlook. However, we are growing more concerned with each passing week that the lack of clarity—and in some cases, lack of traction—on key policy initiatives aimed at ameliorating the crisis is weighing on both the economy and financial markets. Despite our concern, there is enough evidence to support our base case, and indeed, it does appear that the pace of decline in the economy has subsided a bit in the first two months of the first quarter relative to the sharp 6.2% drop in real gross domestic product recorded in Q4 2008.

On the plus side, aided by the $787 billion fiscal stimulus package and the Obama Administration's overwhelmingly large $3.9 trillion budget request for fiscal year 2009 (which includes a $1.75 trillion budget deficit, more than 12% of gross domestic product) [chart 1] **fiscal policy** should push the economy in the right direction over time. With overnight lending rates near zero, and real money supply growth surging to well over 10% year over year, [chart 2] the Federal Reserve's **monetary policy** is providing a solid backdrop for future growth. In addition, policymakers have provided some more details on elements of the Administration's four part **Financial Stability Plan,** including the bank rescue plan (Capital Assistance Program) and the housing rescue plan (Homeowner Affordability and Stability Plan). The details have been somewhat helpful in providing some clarity to market participants on what we view as two key (and intertwined) issues facing the economy—banking and housing. However, we (and the market) would like

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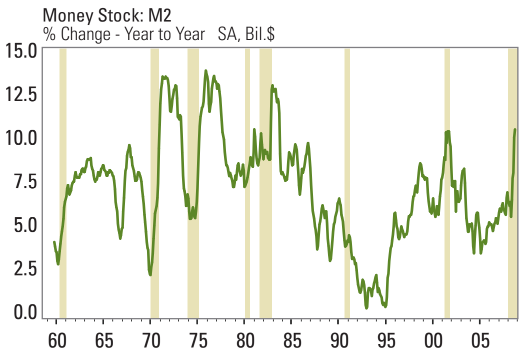
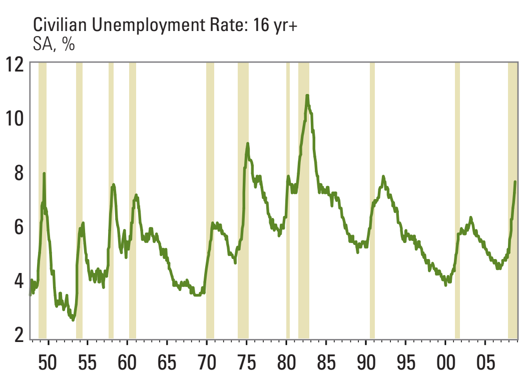
2 Money Supply Growth and Fed's Monetary Policy Will Eventually Lift the Economy



Source: Federal Reserve Board, Haver Analytics

However, to date, the scattershot approach to both the details and implementation of the aforementioned programs has hurt, not helped, confidence in the Administration's ability to combat the crisis.

3 The Unemployment Rate Typically Peaks Well After the Bottom in Both the Stock Market and the Economy



Source: Bureau of Labor Statistics, Haver Analytics

to see more details on both of these plans, and indeed the Administration is slated to release more details on the Homeowner Affordability and Stability Plan this week (March 4).

Still, policy voids remain to be filled. The market lacks details on the remaining two parts of the Financial Stability Plan (FSP), the Private- Public Investment Fund (PPIF) —aimed at lifting bad assets off of the balance sheets of the nation's banking system—and the expansion of the Term Asset Backed Securities Loan Facility (TALF), a join Fed-Treasury program designed to reignite the securitization market, which is as crucial to the nation's financial health as the traditional bank lending sector. Details on the PPIF are likely to be released this week, while the TALF was supposed to be up and running by the end of February. Needless to say, the TALF was not up and running by the end of February, and we aren't sure when the market will get more details on this integral part of the Financial Stability Plan. In time, the Financial Stability Plan, first outlined by Treasury Secretary Geithner on February 10th—and widely panned by financial market participants for its lack of detail, should help to put both financial markets and the economy back on the right path. However, to date, the scattershot approach to both the details and implementation of the aforementioned programs has hurt, not helped, confidence in the Administration's ability to combat the crisis. We remain hopeful that that the details of all the policies will be released soon, and that the programs themselves begin working to restore confidence in the financial system and the economy. Until then, we think the economy and markets will suffer, and remain volatile.

Economists and market participants are still looking for signs that the economy stopped getting worse in the first quarter, and as noted above, we have seen some signs that the pace of decline in the economy in Q1 2009 won't be as severe as the 6.2% drop in Q4 2008. Weekly retail sales have stabilized a bit, as have vehicle sales, while measures of manufacturing activity (like the Chicago Area Purchasing Manager's Index) have stabilized after a near-record plunge between Q3 2008 and Q4 2008, although they remain at deep recession levels. In addition, anecdotal information on business activity suggests that consumer spending had, remarkably, held up thus far in Q1 2009, while businesses continue to struggle to realign production and employment with sharply lower demand.

Leading up to the always important monthly jobs report (for February) on Friday, March 6, financial markets face a full slate of economic data this week. The market is looking for a 650,000 drop in jobs in February, far worse than the 598,000 decline in jobs posted in January and reported in early February. The unemployment rate is expected to rise to 7.9% in February from 7.6% in January. In short, if the consensus is correct, it was another dismal month for the labor market in February. While a stabilization of the labor market is not a precondition for stability in the economy—indeed historically, both the economy and the equity markets bottom out well before the labor market bottoms, some sign that the pace of deterioration in the labor market would be welcome news. [chart 3]

The other data due out this week for February include:

- The Institute for Supply Management's reports on manufacturing and non-manufacturing activity
- Vehicle sales
- Chain store sales
- Jobless claims for the week ending February 28
- Chain store sales for the week ending February 28

The data for January include:

- Personal income and spending
- Construction spending
- Pending home sales
- Consumer credit outstanding

In addition , the Fed will release its "Beige Book", a qualitative look at the economy in the period ending February 22, ahead of its March 18 Federal Open Market Committee (FOMC) meeting

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