

Wednesday, September 10, 2008

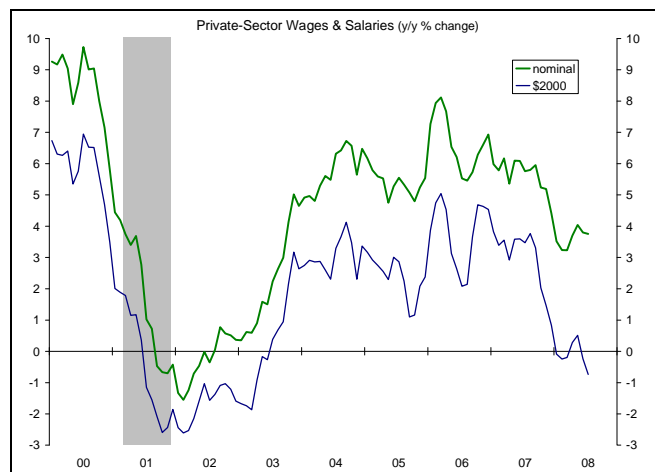
Economic Research – Scott J. Brown, Ph.D.

Near-Term Weakness, Recovery Next Year

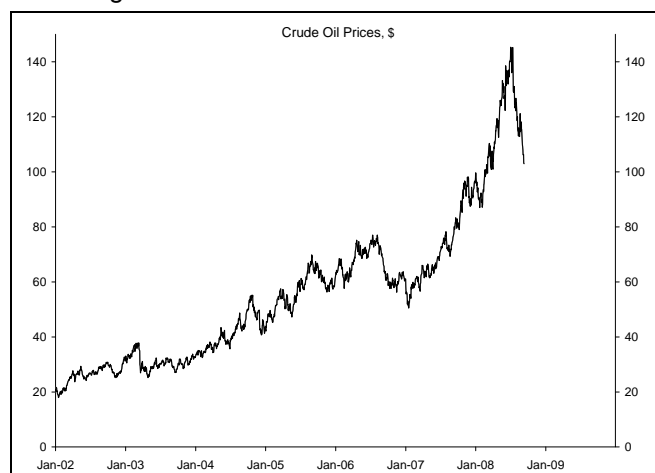
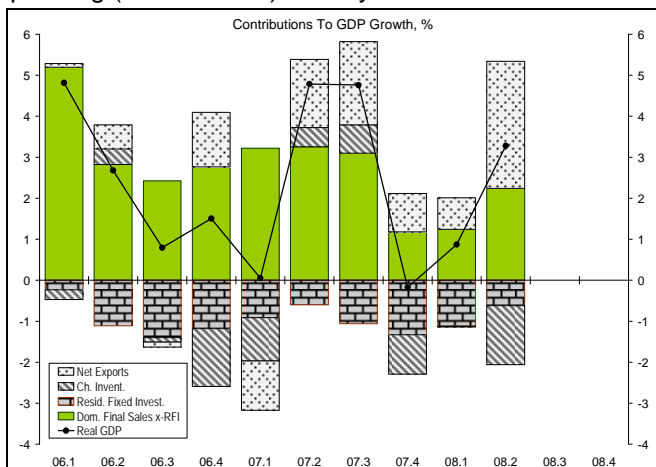
- Economic data remain mixed, consistent with lackluster growth and a weakening labor market. The housing correction, tight credit, and high energy prices will continue to restrain growth in the near term.
- Lower energy prices should help lift consumer purchasing power into early 2009.
- Fed officials' opinions are mixed, with some fearful of inflation and some worried about more pronounced financial problems. Short-term rates should remain on hold.

Real GDP rose at a 3.3% annual rate in 2Q08 according to the government's revised estimate, boosted by a surge in net exports (higher exports and lower imports). Domestic Final Sales (GDP less inventories and foreign trade) rose at a 1.5% pace, with consumer spending at 1.7% (helped by tax rebates) and business fixed investment at 2.2% (structures up 13.7%, equipments and software down 3.2%). The further decline in residential homebuilding subtracted 0.62 percentage point from overall growth. With tax rebates behind us and the job market deteriorating, consumer spending (70% of GDP) is likely to remain weak.

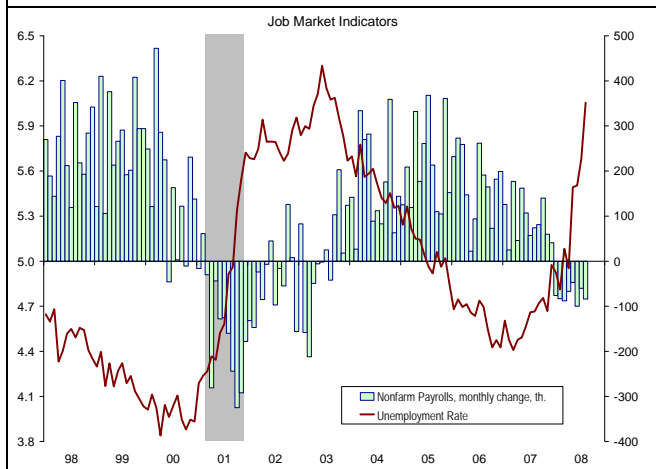
Nonfarm payrolls fell by 84,000 in August, down in each month this year (averaging -75,000 per month). Job losses remained widespread, somewhat lower in construction, but higher in manufacturing (especially motor vehicles). The unemployment rate jumped to 6.1%, vs. 5.7% in July and 4.7% a year ago. A small part of that increase may have been due to an extension of unemployment insurance benefits (which boosts labor force re-entrants). However, the broader range of labor market indicators is consistent with a greater rate of job destruction. Job losses will likely continue through the end of the year and into early 2009.



High oil prices have led to declines in inflation-adjusted wages, the key fuel for consumer spending growth. Job losses and tighter consumer credit will remain significant restraints in the near term.



Crude oil prices have fallen sharply since mid-July, and while still very high by historical standards, further declines are likely. Headline inflation is coming down. Energy prices have a lagged impact on consumer spending, so we may see further sluggishness in the near term, but improved conditions toward the end of the year.

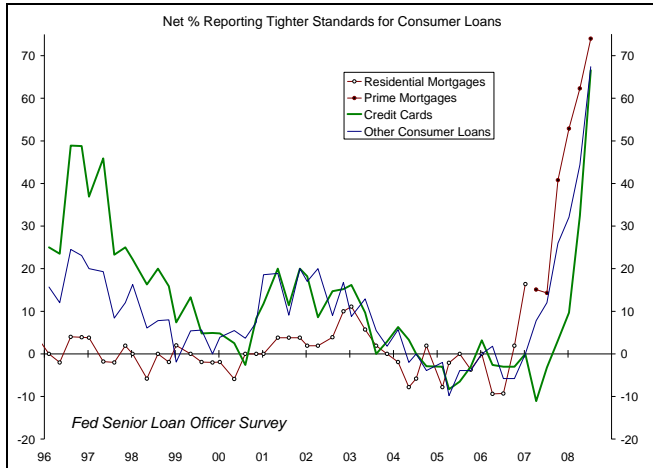


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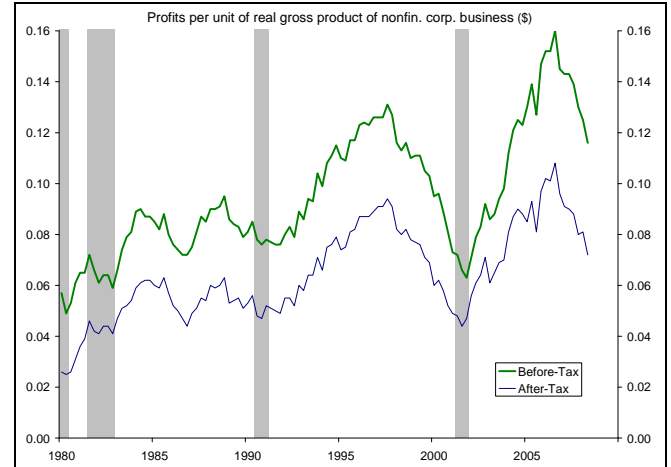
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The government placed Fannie Mae and Freddie Mac into conservatorship on September 7. These companies should continue to operate as usual, but with new CEOs and a stronger backing for holders of mortgage backed securities and agency debt. The decision relieves some uncertainty, but raises more questions (such as what will eventually happen to these companies). Theoretically, mortgage rates should come down and Treasury yields should rise. However, there are still significant problems in the financial sector and the demand for liquidity (Treasuries) remains high.



The liquidity crisis has turned into a credit crunch. The Fed's latest survey of senior loan officers showed that banks continued to tighten terms and standards for a wide range of consumer and business loans over the three months ending July. It's difficult for the economy to expand without loan growth (think of Japan's lost decade). This tightening of credit has come despite the Fed's rate cuts over the last year. A steeper yield curve should encourage banks to take risk. However, the recapitalization and general deleveraging of the banking system, along with continued weakness in housing, imply that bank credit will remain tight for some time.

While excess leverage was clearly a problem in the financial sector, nonfinancial corporations were generally not highly leveraged heading into the current slowdown. Cash flows were strong. However, a slowing in overall demand and higher costs have squeezed corporate profit margins. One response is for firms to cut costs – and the largest expense is typically labor. Hence, jobs losses are likely to continue through the end of the year.



The global economic outlook has worsened. Europe and Japan appear to be in recession. Emerging economies have held up relatively well, but should slow. The dollar is looking relatively more attractive.

The overall outlook is still characterized by an unusually high level of uncertainty. The housing sector appears to be in the early stages of a bottoming process, but given the large number of homes for sales, it will be a long time before we see a full recovery. The consumer sector will be battered by opposing forces – lower energy prices will help, but the job market is likely to remain weak. Since business fixed investment did not appear to be excessive heading into the slowdown, the downside may be more limited than usual. However, financial conditions are still far from normal.

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	2007	2008	2009
GDP (↓ contributions)	4.8	-0.2	0.9	3.3	0.2	1.4	1.6	2.1	2.4	2.5	2.0	1.8	1.7
consumer durables	0.2	0.0	-0.3	-0.2	-0.5	0.1	0.1	0.2	0.2	0.2	0.4	-0.1	0.0
nondurables & services	1.3	0.6	0.9	1.4	0.2	0.7	1.0	1.2	1.4	1.5	1.6	0.9	1.0
bus. fixed investment	0.9	0.4	0.3	0.3	-0.2	-0.1	0.0	0.1	0.2	0.3	0.5	0.3	0.0
residential investment	-1.1	-1.3	-1.1	-0.6	-0.5	-0.3	-0.1	-0.1	0.1	0.1	-1.0	-0.9	-0.2
government	0.8	0.2	0.4	0.8	0.3	0.4	0.2	0.2	0.2	0.2	0.4	0.5	0.3
Domestic Final Sales	1.9	-0.1	0.1	1.5	-0.6	0.8	1.1	1.7	2.1	2.3	1.9	0.7	1.2
exports	2.5	0.5	0.6	1.7	0.2	0.0	0.2	0.2	0.3	0.4	0.9	1.0	0.3
imports	-0.5	0.4	0.1	1.5	0.2	0.1	-0.1	-0.2	-0.4	-0.4	-0.4	0.4	0.0
Final Sales	4.0	0.8	0.9	4.8	-0.2	0.9	1.2	1.6	2.1	2.3	2.4	2.1	1.4
ch. in bus. inventories	0.7	-1.0	0.0	-1.4	0.4	0.4	0.4	0.5	0.3	0.1	-0.4	-0.3	0.3
Unemployment, %	4.7	4.8	4.9	5.3	6.0	6.3	6.5	6.6	6.6	6.6	4.6	5.6	6.6
NF Payrolls, monthly, th.	71	80	-82	-71	-75	-50	20	35	70	95	91	-70	45
Consumer Price Index	2.5	6.2	3.1	7.9	1.6	-1.6	1.8	2.1	2.2	2.3	4.1	2.7	2.1
excl. food & energy	2.5	2.6	2.0	2.5	2.7	2.1	2.1	2.1	2.1	2.1	2.4	2.3	2.1
PCE Price Index (q/q)	2.5	4.3	3.6	4.2	4.9	-1.4	1.1	2.0	2.0	2.1	2.6	3.5	1.6
excl. food & energy	2.1	2.5	2.3	2.1	2.7	1.9	1.9	1.9	1.9	1.9	2.2	2.3	2.0
Fed Funds Rate, %	5.09	4.49	3.18	2.09	2.00	2.00	2.00	2.00	2.36	2.92	5.02	2.32	2.32
3-month T-Bill, (bnd-eq.)	4.4	3.5	2.1	1.7	1.7	1.7	1.8	1.9	2.5	3.1	4.5	1.8	2.3
2-year Treasury Note	4.4	3.5	2.0	2.4	2.4	2.4	2.6	3.2	3.8	4.2	4.4	2.3	3.5
10-year Treasury Note	4.7	4.3	3.7	3.9	3.9	4.0	4.4	4.7	4.9	5.0	4.6	3.8	4.8