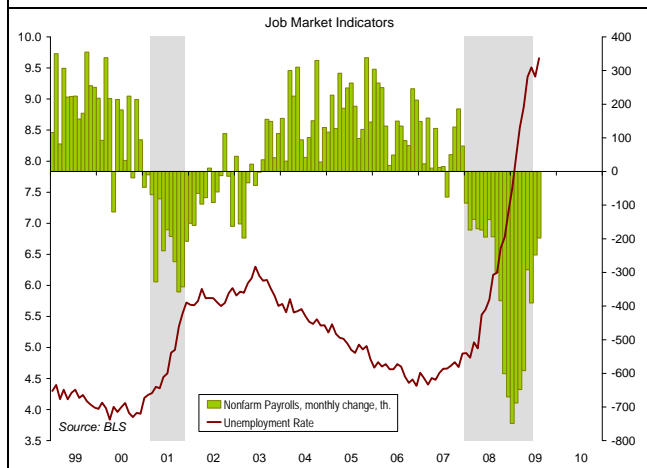
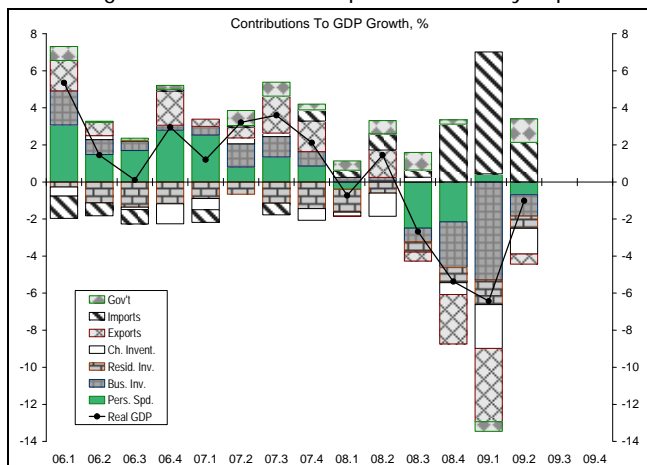


Monthly Economic Outlook

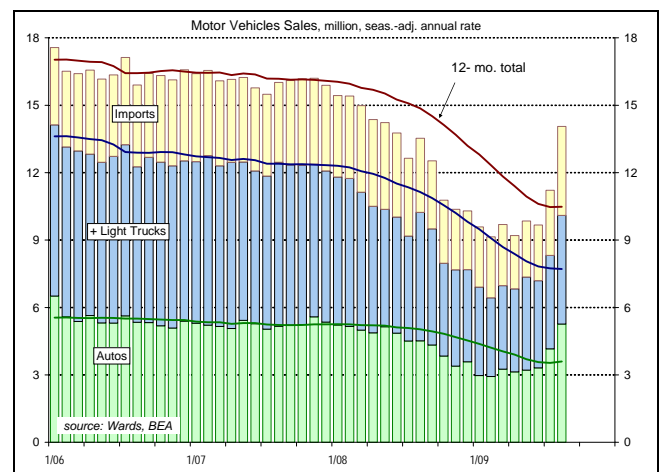
Fiscal Stimulus Having An Impact

- Recent data have suggested an increased likelihood that the recession has ended. However, the initial recovery is expected to be gradual with continued labor market weakness.
- Federal reserve policy and fiscal stimulus should provide support to the recovery into early 2010.
- There is some scope for a double dip in 2011, as the fiscal stimulus fades and the Fed begins to raise short-term rates.

Real GDP fell at a 1.0% annual rate in the second quarter, according to the government's second estimate (the same as the advance estimate). Job losses have slowed, but remain relatively high by historical standards (job growth is expected to lag in the overall recovery). Industrial production rose in July and August, an encouraging sign. New orders, while choppy on a monthly basis, are trending higher. Home sales and residential construction data for recent months have reflected a stabilization and some improvement. Trade figures suggest that the global economy may have bottomed out in the spring. The "Cash for Clunkers" program boosted auto sales in August, with a moderate pullback in early September.



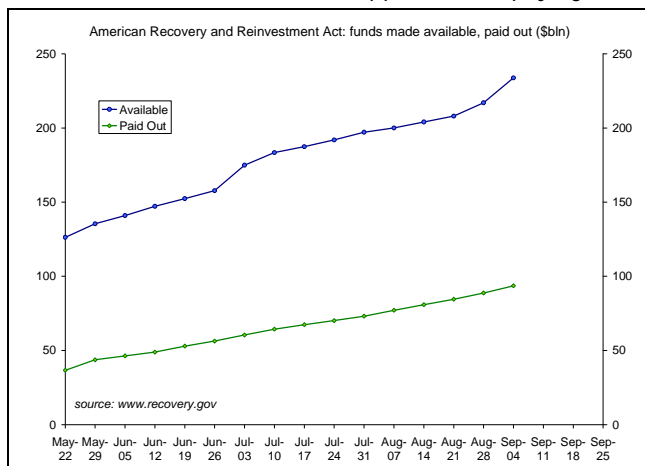
Nonfarm payrolls fell by "only" 216,000 in August, the smallest monthly decline in a year. On a net basis, the economy has shed more than 7 million private-sector jobs since the recession began. Further job losses are expected in the near term. However, the fiscal stimulus and hiring for the 2010 census should lead to job gains early next year. It will take a number of years for employment to fully recover. Estimates of potential GDP growth vary (1% growth in the working-age population and 1.5% productivity growth would yield a 2.5% rate of growth in potential GDP). Note that actual GDP growth would have to be substantially more than that for the unemployment rate to come down.



The government's "Cash for Clunkers" program ignited vehicle sales in late July and through August. There are some concerns that the program merely pulled forward sales that would have occurred in later months. That may be true to some extent (indeed, it's widely expected that sales will be lower in the fourth quarter). However, as with any recession, consumers had postponed big-ticket purchases over the last several months. "Cash for Clunkers" unleashed a lot of that pent-up demand. More importantly, as with 0% financing after the 9/11 terrorist attack, the program served to get people through the showroom doors, generating a lot of sales that would not have occurred otherwise. Automakers have announced production increases in recent weeks.

The ISM Manufacturing Index rose above the breakeven level in August. Details suggest that conditions remain mixed across sectors, but there is a general trend of improvement. New orders have been trending moderately higher, and unfilled orders stopped falling in August (a good sign). Industrial production advanced 0.8% in August, following a 1.0% gain in July. By most accounts, there still appears to be some room for a further correction in inventories, but that should play itself out within the next couple of quarters.

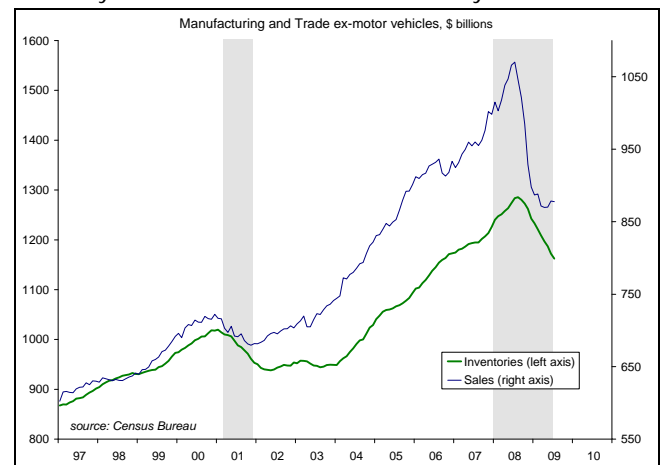
The fiscal stimulus is still gathering steam. The White House's Council of Economic Advisors estimates that the American Recovery and Reinvestment Act added roughly 2.3 percentage points to real GDP growth in 2Q09 (an estimate comparable to those made by private-sector economists). The CEA expects a larger contribution in the current quarter. The CEA estimates that nonfarm payrolls would have been one million lower without the fiscal stimulus. At the end of August, \$151.4 billion of the \$787 billion package has gone out to consumers and businesses, mostly in tax cuts, aid to the unemployed, and state fiscal relief. Other countries have also undertaken fiscal stimulus, which appears to be paying off.



The federal government's aid to states has not done much to propel the overall economy forward. Rather, state fiscal relief reduces the economic impact of state budget strains. States typically run pro-cyclical policies in recessions. Tax revenues fall as their economies weaken. To move back toward balance, states have to raise taxes or cut spending – both of which make the economic downturn worse. This relief is a band-aid, of course, but helps reduce strains for a while. A broader economic recovery will be necessary to restore state budget balance over the longer term.

Many investors are worried about the prospects for a double dip recession. There is some chance that we could see a return of some degree to the panic that developed a year ago. However, the odds seem low. The spread between 3-month LIBOR and overnight index swaps has fallen to about 12 basis points, about where it was in early 2007 (it peaked at about 365 bps on October 10 of last year). The bigger risk of a double dip comes later, in the form of policy. The fiscal stimulus will be ramping down into 2011, and a second and smaller fiscal stimulus may be needed to ease that transition. The Federal Reserve will have to raise short-term interest rates at some point. Fed Chairman Bernanke and Christina Romer, Chair of the President's Council of Economic Advisors, are both experts on the Great Depression, and both are aware of the danger of taking away the punchbowl too soon.

The threat of deflation has receded, which means that the Fed can exit its asset purchase programs. However, inflation is not an immediate threat. Note that large deficits are not inflationary. The national debt tripled under Reagan/Bush I and nearly doubled under Bush II, but bond yields fell.



GDP growth is expected to have picked up in 3Q09, due to the "Cash for Clunkers" program. A slower rate of inventory reduction should add considerably to GDP growth in the next few quarters, but it's difficult to peg the precise timing.

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	2008	2009	2010
GDP (↓ contributions)	-2.7	-5.4	-6.4	-1.0	3.1	3.1	3.8	3.8	3.7	3.4	0.4	-2.5	3.2
consumer durables	-1.0	-1.6	0.3	-0.4	2.0	-0.3	0.2	0.2	0.3	0.3	-0.4	-0.2	0.3
nondurables & services	-1.5	-0.5	0.2	-0.3	0.4	0.7	1.4	1.5	1.7	1.7	0.2	-0.2	1.1
bus. fixed investment	-0.7	-2.5	-5.3	-1.2	-0.6	-0.4	-0.1	0.2	0.3	0.4	0.2	-2.2	-0.1
residential investment	-0.6	-0.8	-1.3	-0.7	0.1	0.1	0.1	0.2	0.3	0.3	-1.0	-0.7	0.1
government	1.0	0.2	-0.5	1.3	0.8	1.4	0.8	0.8	0.6	0.5	0.6	0.5	0.9
Domestic Final Sales	-2.7	-4.9	-6.4	-1.2	2.7	1.5	2.5	3.0	3.2	3.3	-0.3	-2.8	2.3
exports	-0.5	-2.7	-4.0	-0.5	0.2	0.3	0.4	0.4	0.5	0.5	0.6	-1.5	0.3
imports	0.4	3.1	6.6	2.1	-0.6	-0.5	-0.4	-0.5	-0.6	-0.7	0.5	2.6	-0.3
Final Sales	-2.9	-4.7	-4.1	0.4	2.3	1.3	2.6	2.9	3.1	3.1	0.8	-1.7	3.2
ch. in bus. inventories	0.3	-0.6	-2.4	-1.4	0.8	1.8	1.2	0.9	0.6	0.3	-0.4	-0.8	0.9
Unemployment, %	6.0	6.9	8.1	9.2	9.6	9.8	10.0	9.9	9.8	9.8	5.8	9.2	9.9
NF Payrolls, monthly, th.	-208	-553	-691	-471	-229	-105	65	125	40	100	-257	-374	83
Cons. Price Index (3 mo)	3.1	-12.4	2.2	3.3	2.3	1.6	1.8	1.9	2.0	2.1	0.2	2.4	2.1
excl. food & energy	2.3	0.2	2.2	2.4	1.1	1.4	1.6	1.7	1.8	2.0	1.7	2.0	1.9
PCE Price Index (q/q)	4.7	-5.0	-1.5	1.3	2.7	1.9	1.8	1.8	1.9	2.0	3.3	0.2	1.9
excl. food & energy	2.4	0.8	1.1	2.0	1.5	1.6	1.6	1.7	1.8	1.9	2.4	1.6	1.7
Fed Funds Rate, %	1.96	0.53	0.19	0.18	0.18	0.20	0.22	0.27	0.67	1.16	1.94	0.19	0.58
3-month T-Bill, (bond-eq)	1.5	0.3	0.2	0.2	0.2	0.3	0.4	0.4	0.9	1.3	1.4	0.2	0.7
2-year Treasury Note	2.4	1.2	0.9	1.0	1.0	1.2	1.6	2.0	2.5	2.6	2.0	1.0	2.2
10-year Treasury Note	3.9	3.2	2.7	3.3	3.5	3.7	3.9	4.1	4.2	4.2	3.7	3.3	4.1