



## Quarterly Economic Report – 1st Quarter 2010

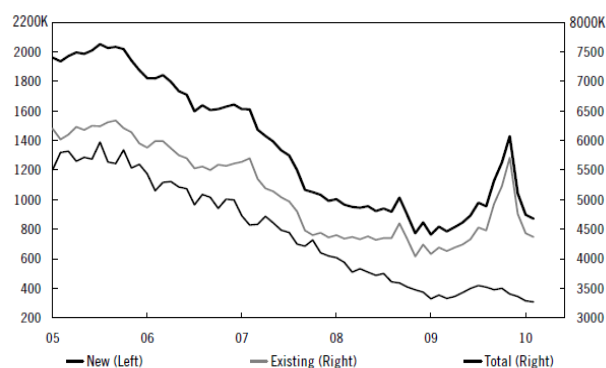
### *Growth Builds a Foundation- A Cyclical Environment in Transition*

The words have changed slightly but the tune remains the same. “Second verse same as the first...” as the old song taunts. The key factors which have, and will continue to, determine the strength or drag on the economy and markets prevail: jobs, housing, lending and debt. Added are the new stanzas of global sovereign credit worries and unknown health care and financial regulations. But, as we climb out of these scary depths, we see that the abyss was greater but the nature of it was not. This has been a cyclical move, much like those in the past, and now time is bringing about the transition that only it can. Extraordinary measures had to be used to stabilize a critical situation. The pivotal factors going forward will converge on withdrawing support in a timely and reasonable manner.

The verse on jobs has changed in tempo. The pace of jobs growth has been glacial, and after losing millions of jobs, the speed will not improve quickly. But hiring is beginning to outpace layoffs. With 27 states sustaining increased job losses and record highs in FL, NV, GA, and NC, certain areas will lag well into 2011. However, the 11% growth of corporate profits in the non-financial corporate sector, during the first quarter, provides prime support for hiring. It can be anticipated that the unemployment rate, as more people enter the workforce, will remain above 9% in 2010, which in turn provides a major component in the decision to keep short term rates low. The high headline rate and continuing unemployment claims also maintain a downward pressure on confidence, which has to grow to get people to hire, spend and invest.

The housing verse in this tune is changing less than that on jobs. After a jump last year with first time home owner credits, the mammoth inventory of existing homes and apartments is weighting the economy and home builders down again. Although permits are up slightly, new and existing home sales are down and foreclosures continue to climb. Total sales were up ever so slightly in the 1Q (under 1%) but after two preceding months of down 15% and 7%, optimism is difficult to muster. Inventories must be reduced and that takes time.

1. New, Existing and Total Single-Family Home Sales, 2005-Feb 10



Currently reluctant lenders, or weather, or lack of confidence in continuing jobs, are all slowing the process. A new federal program to reduce principal on delinquent mortgages for the unemployed will probably do more to heat up the political front than heat up housing sales.

The private housing arena is only one aspect of the real estate problem. Commercial properties may present a second dilemma for the economy as well as financial institutions. Regional and state banks hold the mortgage paper on the preponderance of commercial real estate. One has only to look at all the vacant strip centers along each road to estimate the magnitude of a spreading problem. If we have an expansion

of failed commercial properties, the community banks will bear the brunt. Bank failures may climb measurably in 2010, which will restrict lending further. The banks already have a conundrum on the lending front. They are being told by seemingly everyone to lend, but their regulators are more interested in balance sheet stability. And, with major looming losses in commercial real estate, even banks with plenty of liquidity have to focus more on the regulators. A growing absence of banks willing to accept new funds is a telling sidelight to this emerging problem.

The third verse in our economic composition involves the massive debt being created by the federal government. This is a dilemma because the debt plays a role in recovery, but can also lead to another longer downturn. The increase in debt has come from two major sources: the loss of revenue during the recession and large spending programs such as the bank rescue and fiscal stimulus. But, we can not spend our way to recovery. Ultimately sustainable recovery is dependent upon the private sector. The deficit gives us time for the private sector to recover and that move (with healthy earnings) is underway. Like a parent with a new two-wheeling child, you *have* to pull the support and let the child ride and grow. The federal debt now stands at \$12.7 trillion. \$4.5 trillion (35%) the US owes to itself and as we know this does not have to be paid off like normal folks. In fact, the debt is being issued at low rates, which keeps current interest costs at \$202 billion: a fully viable level. But marketable debt represents 56% of GDP currently and this must be reduced. As the recession clears, the goal would be to reduce the debt to around 3-4% of GDP but the ability and political will to do so is not really evident. Critical factors like the 2010 net flows out of social security, much earlier than expected, is concerning on a longer trend basis for this action. The impact from dominant new programs like health care can not even be judged until the regulations are written.

Currently the inflation verse is not part of our tune. There are few signs of inflation. However if the bond market sees job increases and anticipates higher prices along with higher issuances of debt paper, it is far-sighted enough to begin an inexorable rise in rates. Bond auctions in March struggled mightily, increasing debt costs. Doubts ranged from future large sales of debt to pay for our stimulus programs to the credit worthiness of the US. As the economy gains legs, the natural move out of the recession will raise rates and debt supply will exacerbate the problem causing rates to rise faster. Already the longer rates have created a considerably steeper curve.

A new verse was added to our economic melody over the past six months also with a global sovereign debt crescendo. Concerns have bubbled up from Dubai to Japan keeping markets on alert. A last minute save of Greece by the EU and IMF has raised concerns about other less than stable nations such as Portugal, Italy and Spain (the "PIGS"). The euro which had challenged the dollar for years, has abdicated and the dollar has strengthened, making our debt more attractive. This global unrest and re-direction to US debt may counter (in supply) part of the upward rate move. Timing and international events will continue to play out.

The Federal Reserve, and Mr. Bernanke in particular, is acutely aware that in the last two rate cycles rate changes (fed funds and discount rates), did not adequately communicate the Fed's intentions and did not create sufficient timely tightening. Certainly the message of the Fed is critical. Bernanke has stated that "as the expansion matures, the Fed will need to begin to tighten monetary conditions in order to prevent the development of inflationary pressures". But with slow progress in jobs and housing, rates must be kept low "for an extended period". As a result, the Fed has launched an effort to sell off much of the mortgage backed securities they bought to support the financial institutions and rebuild their own balance sheet. Long term, this will help the economy and the confidence levels globally pick up the beat.

The success of the Federal Reserve in withdrawing its support may make the difference between our tune being a sonata or a dirge. Clearly however the rates in the short end will continue low, probably through 2010 as time heals and the music plays on.