



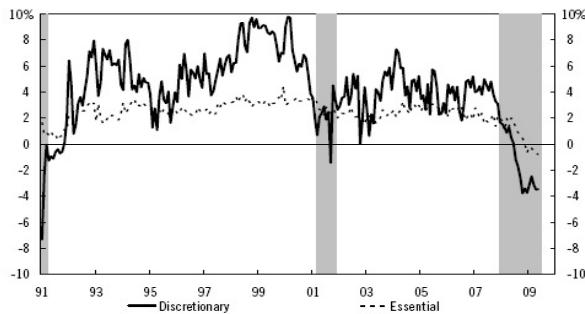
Quarterly Economic Report – 2nd Quarter 2009

What a Tangled Web We Weave

Fears of depression and total economic collapse from the first quarter have calmed but the outlook for the next six months remains relatively constant. In most areas there has been little change since the first quarter when financial conditions bottomed. Conditions have improved on several fronts such as housing and bank stability but consumer confidence has worsened amid high and growing unemployment and continuing uncertainty. Much of the improvement has been directed at the banks and not the consumer or home owner so the consumer is not going to be the one leading out of this recession. The problem was so deep that we can throw money at it but the prime ingredient for recovery unfortunately is time. A 23% loss in personal wealth in the last five quarters for individuals and the absence of short-term borrowing for companies is weighing heavily on the economy. Though the worst is probably over we start from a new low in what is shaping up to be a normal recessionary cycle. The rally in stocks may have not been so much a sign of growth as a release from the gripping fear of last year.

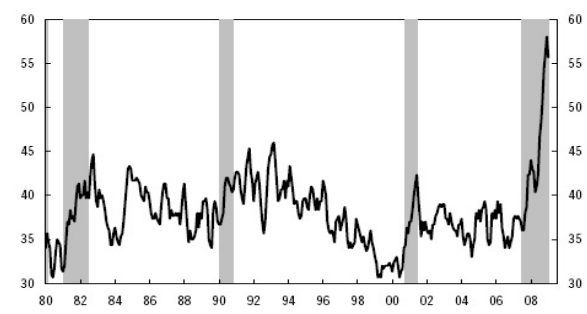
In February, massive stimulus programs were initiated but little of the \$400B has been released and housing refinance programs have been less than successful. Despite \$790B appropriated, to date only \$50B is out and the \$250 checks sent to seniors does little to jump-start spending or inspire confidence. The reduction in withholding tax has been offset by rising energy costs. The big factor in what may end up being a job-less recovery (like 2001) is stubbornly raising unemployment. Over 6.5 million people have lost jobs and are falling off the unemployment benefit rolls. Even prime (non-toxic) mortgage loans are failing now as consumers out of work default on loans of all types. The job market continues to deteriorate albeit more slowly with an unemployment rate of 9.5% and rising. We are losing jobs at about 500K each month (which, with re-hires may be closer to 350,000/month). The largest unemployment figures are in energy and now non-residential construction is outstripping residential construction lows. All professional groups lost jobs this quarter except the central bank (Fed) and trust and fund managers. The only consistent gains are in health and education. Obviously as unemployment actuality and fears dampen even the mighty American consumer spirit the loss of the wealth effect and real wealth will continue to drag.

Consumer Spending: Real Discretionary and Essential Spending (Year-to-Year Percent Change), 1991-May 09



Note: Shaded regions denote recessions.
Source: Bureau of Economic Analysis

Percentage of Consumers Expecting Income to Fall or Stay the Same in the Next Year, 1980-Jun 09



Note: Shaded regions denote recessions.
Source: University of Michigan

The Federal Reserve is on hold indefinitely until they see employment gains. Janet Yellen, President of the San Francisco Fed, stated flatly on 6/30/09 that the Fed keeping overnight rates at zero for *several years* is “not outside the realm of possibilities”. The one positive side of unemployment for the Fed is that no inflation will come from wages for some time. It is clear though that inflation from the massive infusions of cash by the federal government must be inflationary at some point. Budget deficits have to rise.

Short-term inflation remains tame. CPI has decreased 1.2% in 12 months reflecting the unwinding of energy prices primarily. All indications are of benign inflation in June and energy – after a normal seasonal

boost for summer driving – is not a factor. The weakness in the economy however stops producers from raising prices which keeps inflation in check. As inventories of materials – and stores - decrease the natural push to higher prices will return. Currently the only major factor in current inflation increases is tobacco taxes which are surging nationwide. Inflation will stay low temporarily because of the global slowdown but as countries – like India and Japan – come back on line and debt stays high inflation will be hard to control without much higher interest rates.

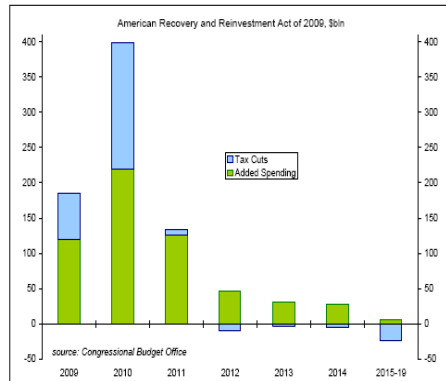
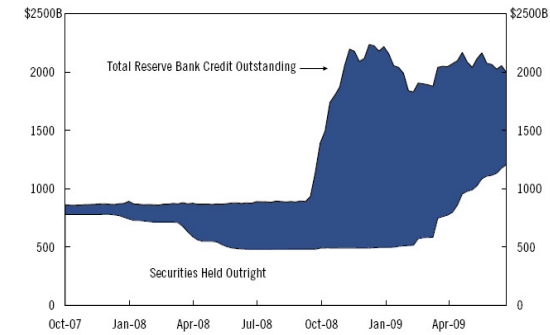


Figure 1. The Federal Reserve's Balance Sheet (Dollars in Billions), Oct 07-24 Jun 09



This government debt will soon be 80% of the US's GDP, the country's income statement. Italy, Germany and France rank higher (which is hardly a positive) and continuing conditions severely limit our trade balance and currency. This massive debt burden has begun to worry the holders of our bonds. While it seems very unlikely that a direct move will actually be made against the status of the USD (US dollar), as the reserve currency for the world's trade it is under attack, which presents a monumental challenge. China has lead (with India and Japan) in arguing that a blend of currencies would work better than an individual currency for a base in trade and they propose an international central bank lead by the IMF. But, as the current crisis moderates, hopefully cooler heads will determine that such a move could be more unstable overall and create a new speculative trading target. The Federal debt level however is the driving force in the argument and has to be reined in to reduce the chance of a major world order shift.

The Federal debt is only one concern in this environment. If we were looking for the next bubble perhaps we have been seeing it emerge as the *governmental bubble* at all levels. California is, as always, leading the way. A failure of CA in closing their \$26.3B budget gap will have major implications for the municipal market. A longer recession will only exacerbate the problem. The question will be – after GM, Chrysler and the banks – will the Feds find CA too big to fail? One number is the answer to that question: 55. The number of the state's Electoral College votes. Such a move will only worsen the overall situation and focus aid away from other states.

Recovery may be in sight but it will take time. It will take time to see if the stimulus – or new stimuli – takes hold. It will take time for the banks to start lending on healthier balance sheets. The required global recover which drives much manufacturing will take time and is not controllable internally. The steps taken are encouraging but the recovery will not be vigorous nor will it come in 2009. The economy is on life support with huge injections of federal stimulus but the effects of that stimulus will have to be closely watched.

As financial markets come back the massive issuance of federal debt may raise some mid-term rates. But short-term rates should remain low as the Fed battles unemployment and slow growth. The tangled web seems to get more tangled everyday.