Quarterly Economic Report – 3rd Quarter 2009
Proceeding with Great Caution…..but on Crutches

The recession may be technically over, as announced by Chairman Bernanke in September, but the third quarter certainly did not bring us into recovery mode and the fourth may or may not. Growth remains illusive and most probably will for several quarters. Every force for growth has at least one counter-force creating stutter-steps for the stock markets and continuing uncertainty for bonds thereby keeping rates low. The balance and relative strength between these forces will determine whether we see the "less worse" situation continuing or a dreaded double dip. The green shoots that starting appearing in spring are, unfortunately, still just shoots. No buds yet.

Cyclical drags are lessening and financial conditions are improving (very slowly) but payrolls and earnings are not giving the needed bottom line boost. Exports are growing but remain significantly below imports. Manufacturing has started to improve with lower inventory levels but is not likely to force significant hiring anytime soon. And, although industrial capacity is down one-third, business is using its cash for technology not capital needs. (In fact, many economists agree that capital spending may not be a growth catalyst until 2011.)

The private sector did create enough real income to sustain the economy this quarter on a GDP basis but not without fiscal *crutches.* One of best known and most popular *growth crutch* was 'cash for clunkers' which provided a temporary boost in auto sales to the 14 million unit range (from 9.5million) but will likely have little lasting effect. In fact, the program may have a more lasting effect by reducing next year's sales and increasing household debt levels because of new auto loans.

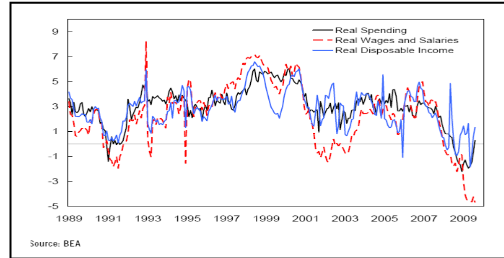
The $8,000 tax credit for first time home owners was another crutch which may have helped temporarily increase the barely breathing housing sector. Housing is still so weak that if this program is not extended before its end-date (10/31/09) it might signal another return to major weakness. Sales of existing homes have dropped markedly and new home sales are barely positive. A troubling indicator of the sector remains the "time to sale after completion" which remains at 12.9 months. A secondary effect of this sector morbidity is the impact it has on labor mobility. Workers will not be able to move as easily to take a new job as sectors begin to improve.

A third crutch tangentially supporting growth has been the Fed's continuing purchase of mortgage backed securities planed through 1Q'10. It became incumbent upon the Fed to be a buyer of MBS with the financial melt-down and the chronic mortgage delinquencies which changed market views of MBS risk. A positive impact of this program was to force the Fed to continue the purchases although it has signaled a preference for shorter term securities - thereby reducing the riskier securities in the marketplace. This Fed action, which will include purchases up to $1.25T, has made the current low rates temporarily acceptable to the markets which will keep rates low across the curve (thereby helping mortgage buyers). When this program does start to slow in 2010, its effect will be felt in rising longer rates as the market insists on return for risk. After such a downturn, it will take years before the market will consume mortgage risk as a commodity again.

Naturally one of the strongest crutches has been the zero fed funds rate which keeps short rates low for banks and consumers. The FOMC retained its policy by confirming in September that "economic conditions are likely to warrant exceptionally low levels of Fed Funds rate for an extended period." The bond market is confirming the weakness by slowing sinking rates. Bonds are indicating that the recovery has a long way to go.

Let's Be Real (Real Spending and Real Income):

The identities of the major factors which dictate the fate of growth have not changed in the past quarter: employment, housing, manufacturing and the consumer. They are the same factors weighing on the bond market. It took a long time to get to this position and will take as long, if not longer, to recover.



Unemployment hit 9.8% in September. Jobs have fallen for 24 consecutive months. This has to affect the shape of the recovery. Claims, though slowly decreasing since March 2009, remain at record levels. Claims are down but is it because many benefits have expired? If claims were extended we might see a jump of over 500,000 in claims. For the first time the time it takes fired employees to find new jobs is longer than the duration of their standard unemployment benefits. The average duration of unemployment is now 26.2 weeks versus the 26 week normal benefit period. Congress has extended benefits twice: once in July 2008 and then as part of the February stimulus bill. Currently unemployed are eligible for 46 weeks of benefits and 59 weeks in states where unemployment rates top 6%.

In addition, many economists believe the revisions which will have to be made in the 1Q may take unemployment levels up 800,000 to 1 million. If the data has been this far off for months, we are probably looking a seriously weaker employment picture than currently touted. The major layoffs have stopped but small business is not even accurately captured by the data. They are not hiring. Auto workers improvements may have been temporary and tied to the clunker deal. The Christmas season will tell the tale of the 4Q – but it is by no means a pleasant outlook to envision.

Holiday cheer is unlikely because job losses translate directly into consumer confidence and willingness to consume. Personal wealth has grown $2T the last 2 quarters but we are still 19% off the peak in personal wealth and without that peak and with continuing job losses the consumer will not return. Surveys showing consumer sentiment have risen dramatically to 73.5 from 65.7 within the quarter but the details show that consumers are more optimistic about the national economy than their own situation. That keeps the consumer hunkered down – hopefully not through Christmas but… have you noticed Christmas decoration are already out – and on sale!

Business activity: Manufacturing fell 15% from 12/07 to 6/09 erasing 6 years of gains, but, factory output is beginning to increase slowly (1.4% in July and .6% in August). The ever volatile durables indicator obscured a glacially slow upward trend because Boeing's new orders fell from 44 to 37 – but then again no orders were cancelled. This picture ignores small business however which still has extreme difficulty accessing credit. Healthcare mandates will further hurt small business employment and growth with the trade-off of insurance costs versus long-term hiring.

Fundamentally if there is not a cause for optimism there certainly is cause for cautious optimism. The trend is up but the trend line will be long and will probably require even more crutches before this economy can walk on its own. The economic scars from years of abuse will most likely delay and defy the recovery. The chronic rate of mortgage delinquencies, the fear of unknown healthcare costs, the federal deficits which could weigh the US down for 10 years and the newly learned caution on the part of consumers are just starting to scab over and everyone knows that is not a pretty process. Until more progress is made rates will stay low especially in the short term. But the optimist knows – rates can not get much lower!!