

INVESTMENT UPDATE

There's an old Wall Street adage, "The Fed's job is to take away the punchbowl just when the party gets started." The "punchbowl" is economic stimulus, which in the Fed's case means low short-term interest rates; the "party" is of course, economic growth. Translated into plain English, it means that the Fed will begin to raise interest rates once the economy gets moving, and will keep raising rates in order to prevent the economy from overheating and producing inflation.

Over the past few quarters, it's seemed like the US economy has needed a respirator more than a punchbowl, as the idea of a festive economic environment has been a distant dream, overshadowed by a collapsing housing market, job losses in the millions, and a banking system on the brink of collapse. Forget the punch, bring on the hemlock!

And yet, there are unmistakable signs that the US economy is on the mend. Third quarter GDP, spurred on by the "cash for clunkers" program and general inventory liquidation, rose at an annual rate of 3.5%, and fourth quarter GDP is expected to come in only slightly below that figure; this marks the end of our longest and deepest post-WWII recession. Home prices appear to be bottoming (although this could take another few months), and the recent inventory liquidation is spurring activity in the manufacturing sector.

So the question is, when will the Fed look to make a change in their highly stimulative monetary policy? The Fed themselves gave us a hint in their press release follow-

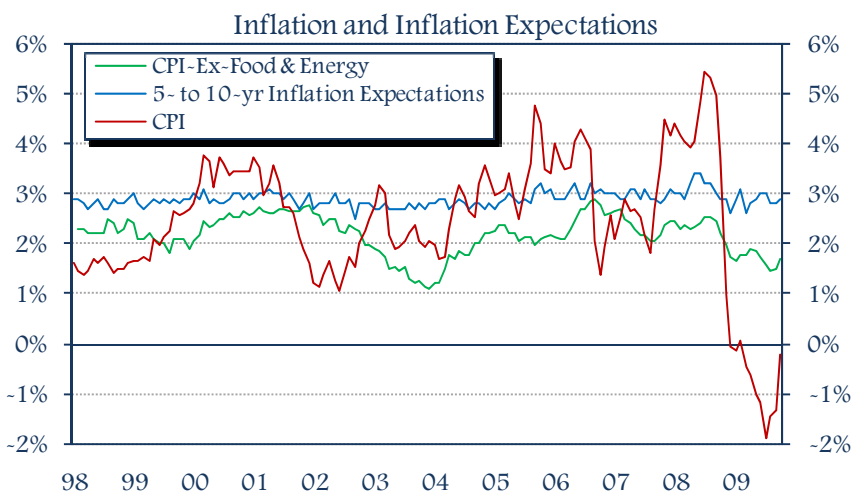
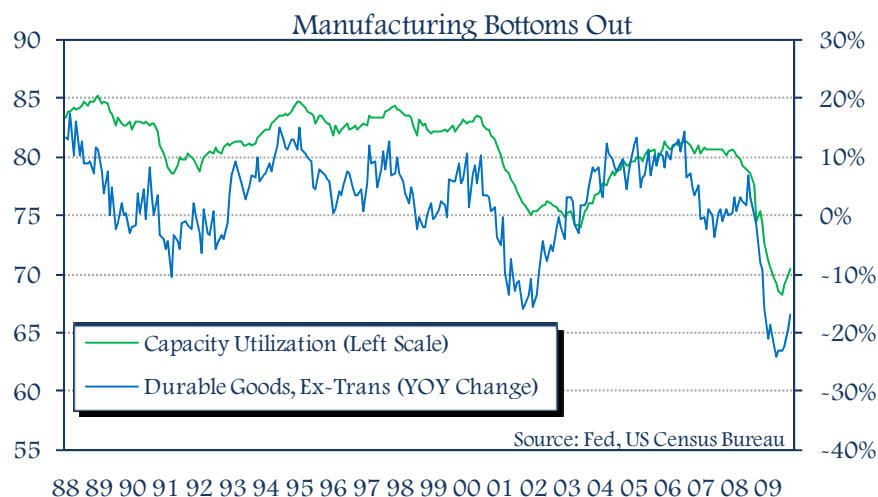
ing this month's FOMC meeting, reiterating their commitment to maintaining an "exceptionally low" Fed funds rate for an "extended period," which they've been saying for the past year. But this month, they added a disclaimer, noting that they would keep short rates near zero as long as there were "low rates of resource utilization, subdued

inflation trends, and stable inflation expectations."

When we examine these factors, we see little sign that there is an imminent change in Fed policy. The top chart shows what's going on with resource utilization in the manufacturing sector, as measured by the Census Bureau's survey of new orders for durable goods (excluding the volatile transportation component), and by the Fed's own capacity utilization figure, which measures the percentage of maximum output at which US factories are running. Clearly, this recession has hit the manufacturing sector hard, as durable goods orders fell by 25% peak-to-

trough, and are still running at a rate 17% lower than where they were a year ago. Even worse is the capacity utilization rate, which has recently bounced off its lowest level ever recorded (68.3 in June of this year). This is what the economists are talking about when they refer to "slack resource utilization." Excess manufacturing capacity is not just a US phenomenon; globally, there is massive slack in the main inputs of production, and therefore little "cost push" inflationary pressure.

The Fed also mentioned that current and prospective inflation trends would need to show signs of upward pressure



before they consider raising rates. As the bottom chart on page one shows, the current level of core inflation (CPI excluding food and energy) has been trending lower, while the “headline” CPI measure has been driven below zero due to the recent plunge in energy prices. With energy prices now on the rise (year-over-year comparisons will soon become quite unfavorable, considering how low energy prices fell in late 2008), we expect the CPI will rise back above zero in the next few months and settle in the 1% to 2% range. Meanwhile, core CPI is likely to remain stable to slightly lower, trending towards the 1% level. As far as prospective inflation, the University of Michigan’s inflation expectation surveys show virtually no change over recent months, with both the one-year and the five-to-ten-year outlooks hovering right at 3%. Incidentally, over the past few years, inflation expectations have consistently overshoot the actual realized rate of inflation.

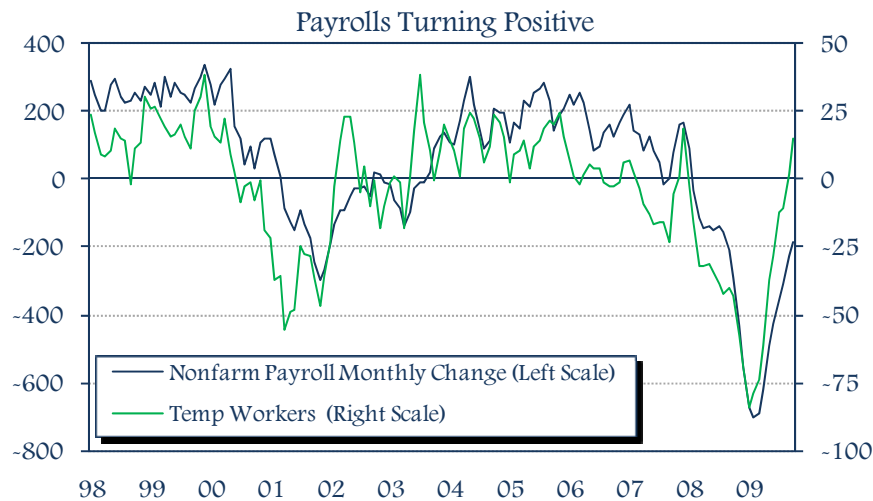
While Fed policy on short rates may be pretty much fixed for the next few quarters, there is more to the Fed than simply their management of short-term rates, and much more in the way of stimulus programs than just those under the Fed’s control. Short rates can remain low while other programs are scaled back or eliminated. In fact, we have already seen the end to certain programs that the Fed implemented last year, including the term securities lending facility and the primary dealer credit facility. In addition, the Fed is winding down the commercial paper lending and funding facilities. The Fed is nearly done with their program of direct purchases of US Treasuries and is scheduled to end their buying of GSE mortgage securities in the first quarter. While most of these programs have ended in an orderly fashion, completing the MBS buying program may prove to be highly disruptive. By March 31, 2010, the Fed will have bought \$1.2 trillion in Agency-backed mortgage bonds; unless organic demand materializes, the winding down of this program could push up fixed mortgage rates by 50 to 100 basis points.

And we should be clear that despite the substantial slack in productive capacity in the manufacturing sector both here and overseas, the main input of production in the service-heavy US economy is labor. The labor market is worth examining a little closer, as there are telltale signs indicating that a big bounce may be in store in the US employment picture.

US payrolls and unemployment statistics are the classic trailing economic indicator, as companies are typically

slow to hire full-time employees, with their expensive benefit packages, until there is clear evidence that their business prospects have picked up. Furthermore, in this economy, employers slashed payrolls at a rate which easily outpaced earlier recessions, evidently due to extreme pessimism in their outlook for the US economy and their businesses’ prospects. But there is growing evidence that employers might have overshoot, and may soon find themselves scrambling for labor. Productivity, while always high in the early stages of a recovery, grew nearly 7% in the second quarter and clocked a whopping 9.5% annual rate of increase in the third quarter, both well above the post-WWII recovery average. Clearly, companies are running lean.

The chart on this page is an update of an exhibit we’ve used before, showing the relationship between the monthly change in US payrolls of full-time workers compared to those of temporary workers (both series show the three-month moving averages). Typically, the payroll figure for temporary workers leads that of full-time employees by approximately six months, both on the way down and on the way back up. In the past two months, net hiring of temporary workers turned positive, indicating that the overall employment picture will soon follow suit.



In addition, it appears that the normal six month delay in the turning points between these two series has compressed, with the broad payroll number bottoming out at essentially the same time as the temporary workers’ number. The fact that the temporary workers’ series is acting

more like a coincident—and not a leading—indicator suggests that job losses for full-time workers came early this time, and leads us to believe that the recovery in full-time employment will likewise come sooner, and possibly be stronger, in this cycle.

In fact, that could be the big surprise of 2010—namely, that the US economy rebounds more vigorously than consensus estimates. As with inflation, economic forecasters have consistently underestimated the strength of the US economy in the “up” phase of the past few recessions, and that could well prove to be the case this time around as well. Given the late 2008-early 2009 near-shutdown of the US economy, year-over-year comparisons will be positive, but a strong rebound in the US economy in 2010? Even if it’s not our base case scenario, we have to consider the possibility and be ready to respond accordingly.

