



INVESTMENT SERVICES

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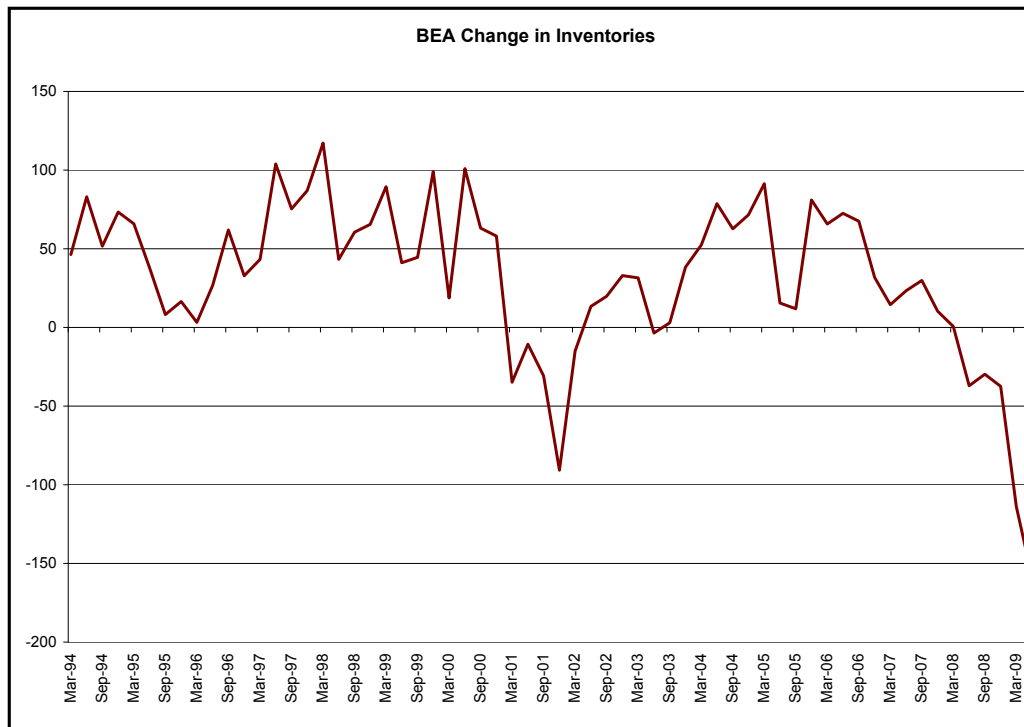
Yes Virginia, the recession is over. But no, there is no Santa Claus.

Given last month's employment report many would not believe the recession to be over. The US economy lost 263,000 jobs and its unemployment rate rose from 9.7% to 9.8%, hitting the highest level since June 1983. However, the fact that the economy's labor markets continue to struggle is not surprising given that the recovery is in its very early stages. The labor markets are among the most lagging of indicators during a recovery as businesses will wait until it is certain that final demand is strong enough and sustainable enough to warrant increasing their staffing levels. Note for example, that during the past four recessions the economy did not start adding jobs consistently (in this case this is defined as not incurring monthly job losses until the next recession) an average of ten months after the end of the recession.

The important distinction to recall is that dating the end of a recession only requires that a recovery has begun, not that an economy is in an expansion (i.e. creating jobs). Therefore, it is sufficient to simply identify an inflection point in the economic data. This reversal of a trend is apparent even in the severely lagging employment reports as last month's job losses were substantially better than the peak in the cycle last January when the country lost 741,000 jobs.

The key inflection points monitored by the National Bureau of Economic Research (or NBER-the official arbiter of the economy's business cycle) are industrial production, manufacturing and trade sales, personal income and the aforementioned nonfarm employment. Regrettably, the NBER is notoriously slow in determining when a recession has ended. For example, the last recession ended in November 2001 but the NBER did not announce its ending until July 2003. Therefore, although we propose that the recession ended in the July – August time frame, it will be sometime before this is made official by way of an NBER announcement.

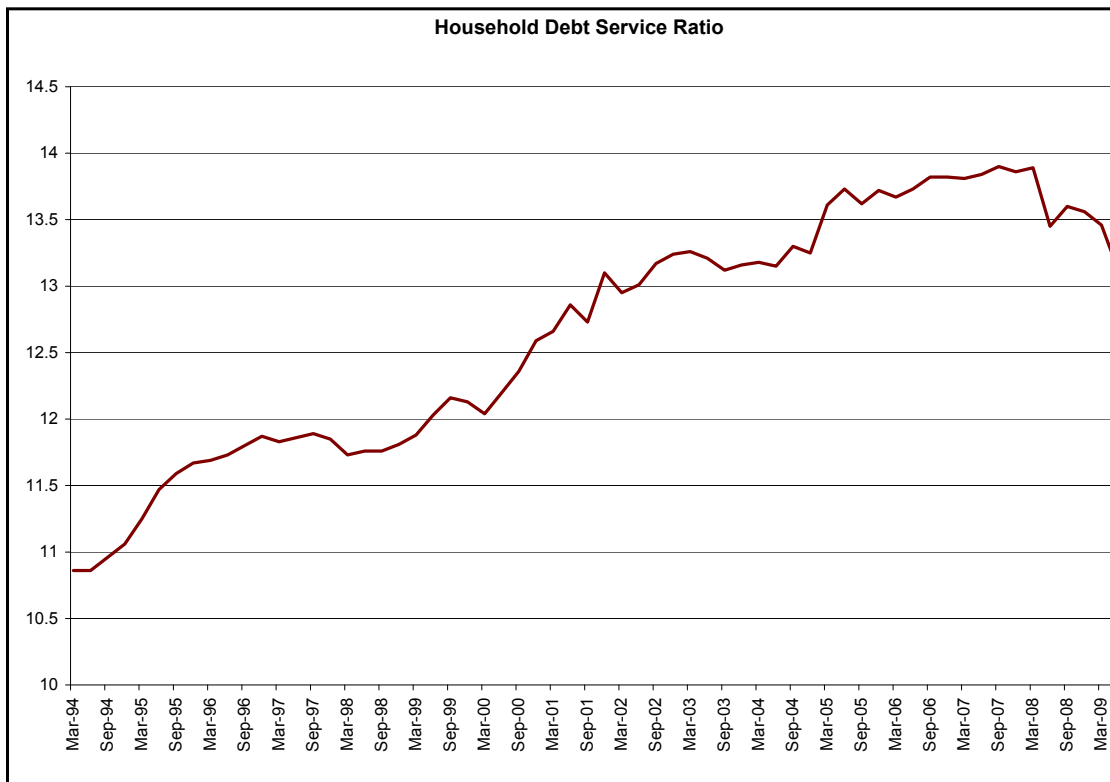
Driving a large portion of the improvement in economic activity over the course of the last several months has been the reaction to the inventory depletion that occurred during the last several quarters. In fact, inventories fell the most ever in the second quarter of 2009, with the second largest decline occurring in the prior quarter. A decline in inventories will reduce the nation's



GDP output during that particular quarter because the goods that were sold were produced during the preceding quarters. However, as we are currently witnessing, an inventory reduction aids future quarters as more is produced in order to replenish these depleted inventories. In fact, it is interesting to note that even if inventories were not increased during the third quarter but simply remained constant; it will add approximately 1.5 % to the third quarter real GDP, all else constant. This increase would have resulted in positive GDP growth for the second quarter.

Given the decline in final demand, it is reasonable to assume that the size of the inventory decline has been appropriate and may fall further, resulting in a future drag on GDP. However, it is interesting to note that the inventory-to-sales ratio has declined steadily from 1.46 times in January of this year to 1.36 times in July, implying that inventories have declined more than final demand. It is also noteworthy that the July level is less than the 1.40 times recorded in November, 2001, the end of the last recession.

Although we believe that the recession has ended, over the near term the recovery itself will likely be restrained by the lack of capacity associated with the traditional growth engine of the US economy, the consumer sector. During the last several recoveries the consumer sector led the economy out of the recessions, in large part due to increased borrowing which in turn increased final demand. However, the opposite appears to be occurring now as this sector continues to engage in its de-leveraging process. In fact, during the last two months, consumer credit fell by the largest combined two-month amount ever, a whopping \$31 billion, or 7.5% on an annualized basis. Last month represented the tenth out of the last eleven months that consumer debt has declined. As shown below, the ratio of consumer debt payments to disposable income still stands at a high 13.11%. Whether intentional because of consumers' new found frugality or unintentional due to restrictive credit conditions, this reduction in borrowing will continue to serve to reduce demand. These declines, of course, also reflect debt which has been charged off by lenders. Increased regulatory capital requirements on financial institutions as well as an impaired asset-backed securities market will further restrain the expansion in consumer balance sheets.



Nonetheless, as the economy's growth picks up steam in mid-2010, the Fed will be seeking to remove the extremely accommodative monetary policy that it has implemented during the last two years. Despite a tepid recovery, the Fed will increase rates due to its extremely accommodative stance presently. The extent of the current accommodation is evident when one considers that the Fed's preferred inflation measure, the core personal consumption deflator, stands at 1.30% while the top end of the Fed funds target range is 0.25%. Therefore, the Fed could increase the targeted Fed funds range by 100 basis points and still have negative rates on an inflation adjusted basis. Look for the Fed to initiate its tightening cycle in the third quarter of 2010.