Weekly Economic Commentary

June 8, 2009

Is the Labor Market Turning the Corner?

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ECONOMIC CALENDAR

Tuesday, June 9
Wholesale Inventories
April

Wednesday, June 10
Trade Balance
April

Treasury Statement
May

Thursday, June 11
Retail Sales
May

Initial Claims
wk 06/06

Business Inventories
April

Friday, June 12
Import Price Index
May

U of Mich Consumer Sentiment
June

Last week's economic data, including the better than expected May employment report, confirmed that that the U.S. economy was still on track for our base case as outlined in our 2009 Outlook publication. At the margin, the better than expected May nonfarm payroll report suggests that growth in the economy as measured by real gross domestic product (GDP) could resume by as soon as the third quarter of 2009. However, for now we are sticking with our base case which calls for a flat reading on real GDP in Q3 and a resumption of growth in Q4 2009. We will continue to monitor the incoming data closely.

The data due out this week is not likely to pack the same wallop as last week's economic releases. Still, with financial markets (and especially the U.S. Treasury market) becoming increasingly worried about a resumption of growth, an uptick in inflation and possible actions by the Federal Reserve to "take away the punchbowl", any one of the economic releases due out this week could be cause for concern. At the same time, any signs that the "green shoots" of March and April began to wilt in May and June, will not be embraced by equity markets, which have already begun to raise the bar for the economy in the second half of 2009.

On balance, last week's data included better than expected readings on:

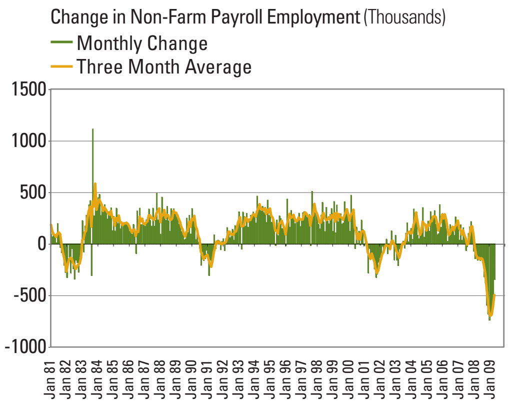
- Nonfarm payroll employment in May
- Manufacturing sentiment in May
- Vehicle sales in May
- Construction spending in April
- Consumer spending in April

And worse than expected news on:

- The unemployment rate in May
- Factory orders in April
- Service Sector sentiment in May
- Chain store sales in May

The data was generally supportive of the global recovery/global reflation/higher commodity prices theme that has been embraced by equity, fixed income and commodity markets for several months now and is reflected in the positioning of our portfolio recommendations.

1 The Pace of Job Losses Has Ebbed in Q2; Labor Market Stabilizing

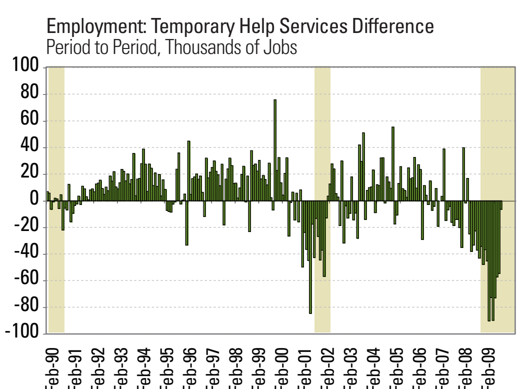


Source: Bureau of Labor Statistics /Haver Analytics

2 At 9.4% in May, the Highest Unemployment Rate in 26 Years, and Headed Higher

Source: Bureau of Labor Statistics /Haver Analytics

3 Temporary Help Supply Employment, a Leading Indicator of Labor Market Trends, is Beginning to Turn the Corner



Source: Bureau of Labor Statistics /Haver Analytics

The big news last week was that the release of the May employment report which was both better than expected and disappointing, and left some market participants skeptical of the results. As noted above, our view is that the May jobs report keeps the U.S. economy on track for our base case, which has the economy emerging from recession in the second half of 2009. The May employment report showed that the U.S. economy shed 345,000 jobs in May, far better than the consensus expectation of a 520,000 drop, better than the "whisper number" of a 450,000 drop, and even better than the most optimistic economists forecast of -450,000. The 345,000 drop in jobs in May was the slowest pace of job losses since last September. The details of the report were solid, with upward revisions to the prior two months totaling 82,000, and virtually free of one time distortions. The leading indicators of the report all moved in the right direction in May:

- Employment at temporary employment agencies (See chart)
- The diffusion index measuring the number of industries adding workers versus the number of industries shedding workers
- Overtime hours worked
- Employment in cyclical industries like retail, lodging and transportation

The one disappointment in the report was the larger than expected rise in the unemployment rate in May to 9.4% from 8.9% in April, versus expectations of a 9.2% reading. At 9.4%, the unemployment rate is the highest since 1983, and is likely headed higher, although it probably won't reach the 10.8% peak hit in the severe 1981-82 recession.

As for the skepticism as to the validity of the report, we point out that the unemployment rate and the nonfarm payroll jobs count are derived from two separate surveys. The unemployment rate is calculated via the "household survey", which queries thousands of U.S. households about their employment status. The nonfarm payroll job count data is derived from the "establishment survey" which surveys several hundred thousand businesses each month. Over time, the two surveys will tend to move together, but over shorter periods the two may diverge. Either way, the trend in the labor force data over the last several months clearly suggests that the labor market is stabilizing.

The Week Ahead

The section below provides a preview of this week's key economic releases by posing questions that the markets, the media, and yes, economists are likely to be asking as the data is released.

April Trade Balance (Due out on Wednesday, June 10)

- Imports have been falling faster than exports recently, helping to narrow the trade deficit which has helped to cushion the decline in real GDP
- With the economy improving, import growth is likely to rebound, especially given the uptick in oil prices recently, while export growth could lag, leading to higher trade deficits, and a bigger drag on GDP growth, over the remainder of 2009
- Export growth remains weak, as our major export partners (Japan, Western Europe, Mexico, Canada) struggle

- Typically, both exports and imports decline during recessions

Fed's Beige Book (Wednesday, June 10)

- The "Beige Book" is a qualitative assessment of the economy prepared for the June 24 Federal Open Market Committee (FOMC) meeting
- Markets will be looking for any anecdotal signs of improvement in labor market, retail sales, and housing and any impact on regional economies from the auto meltdown
- While the report won't address it directly, the market is becoming more and more preoccupied with what, if any, changes the FOMC will make to the pace and amount of quantitative easing at the June 24 FOMC meeting

May Treasury Statement (Wednesday, June 10)

Our view is that very few policymakers in Washington are talking about the budget deficit right now, but the Treasury and currency markets are obviously worried.

- Based on data from the Daily Treasury Statements, the U.S. government rang up an $802 billion deficit in the first 7 months (October 2008 through May 2009) of FY 2009, and is headed for a $1.7 trillion deficit in all of fiscal year 2009
- U.S. federal government revenues have fallen by about 18 percent thus far in FY 2009 compared with the same period in FY 2008, due to the recession's impact on corporate profits and income taxes
- In contrast, government outlays have grown by more than 18 percent, due to TARP related expenditures, and higher payments related to "automatic stabilizers" like employment benefits, as well as by the $787 billion fiscal stimulus plan which is only now beginning to ramp up
- Our view is that very few policymakers in Washington are talking about the budget deficit right now, but the Treasury and currency markets are obviously worried, and it won't be long before equity markets figure it out

Jobless Claims for the week ending June 6 (Thursday, June 11)

In the past, a drop of 40,000 from peak in the 4 week average on claims has signaled the end of recession (give or take a month or two).

- What will the impact be from the scheduled GM shutdowns and any lingering impact from the Chrysler bankruptcy?
- What impact (if any) will there be from the culling of the nation's auto dealer network?
- Can the U.S. economy build on the improvement in the labor market we have seen over the past few months?
- The four-week average on claims stands at 631,000 down about 30,000 from the peak of 659,000 in early April 2009
- In the past, a drop of 40,000 from peak in the 4 week average on claims has signaled the end of recession (give or take a month or two)

May Retail Sales (Thursday, 6/11)

- Weekly chain store sales were solid for most of May, but chain store

The market will be looking for signs of improvement in discretionary spending (non staples retailers, food away from home, furniture, etc).

sales weakened in May 2009 versus May 2008 due to distribution of stimulus checks in May '08

- Vehicle sales were strong in May, despite, and in some cases because of the turmoil in the auto markets
- Both gasoline prices and mortgage rates were up in May versus April, but so were consumer confidence and equity market prices.
- The market will be looking for signs of improvement in discretionary spending (non staples retailers, food away from home, furniture, etc) and should focus on retail sales excluding auto dealers and gasoline service stations for a good gauge of the underlying pace of consumer spending in May

April Business Inventories (Thursday, June 11)

The April business inventories data is the first "hard" data we have on business inventories in Q2, aside from the purchasing managers reports, which have indicated that pace of destocking has indeed slowed between Q1 and Q2.

- The monthly report on business inventories is most often greeted with a big yawn from financial markets, but the data are important around turning points in the economy
- The U.S. economy saw a big inventory drawdown in Q4 and again in Q1 as companies cut production (and jobs) to counter falling demand; this was a big drag on GDP
- Now, underlying demand has picked back up, and production has to catch up
- That means inventories are probably being restocked (or destocked at a slower pace) in Q2 than they were in Q1
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Early June Consumer Sentiment (Friday, June 12)

Will an improving (although still weak) labor market, a stabilizing housing market and rising equity markets be enough to offset rising gasoline prices and rising mortgage rates?

- Will an improving (although still weak) labor market, a stabilizing housing market and rising equity markets be enough to offset rising gasoline prices and rising mortgage rates?
- We have seen three consecutive months of improvement in Consumer Sentiment (March, April and May) after hitting the third lowest reading ever (56.3) in Feb '09
- The last time we saw three straight gains was in July, August and September of 2008, after oil prices peaked, but just prior to Lehman collapse
- Can we string together four straight gains, for the first time since late 2001 (post 9/11)?

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

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Alternative investment mutual fund strategies are subject to increased risk due to the use of derivatives and/or futures.

RES 1496 0609
Tracking #547840 (Exp. 06/10)