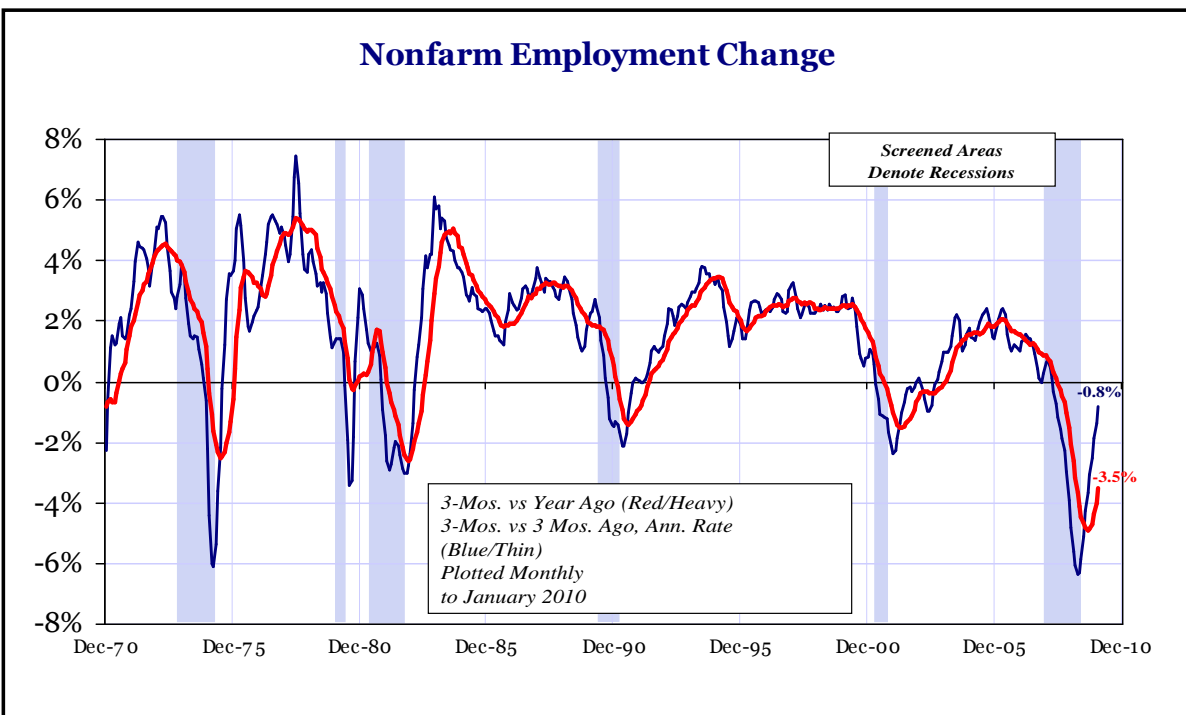


Stock price correction reaches 9% at 2:00 Friday, then shares rebound...

February 5, 2010...The S&P 500 fell roughly 1.75% by mid-afternoon Friday, extending the correction of the past three weeks to 9%, but then gained it all back in the final hour of trading. Prices were slightly higher at the open, as the January employment report released an hour before trading began was generally seen to have more positive aspects than negative ones. But the concerns that have produced the recent selling – mainly the financial woes of Greece (and its Eurozone partners) and diminishing expectations for the economic recovery – continue to induce risk-averting selling in commodities and share prices. For a second day in a row, the Dow managed to win the fight to stay above 10000, and all three major stock market averages still boast gains of between 53% (Dow) and 69% (NASDAQ) from their March 2009 lows. Despite Friday's gyrations in stock prices, U.S. Treasury bonds held on to most of their price gains on the day, and most commodities ended with fairly steep losses (crude oil and aluminum were each off 2% and nickel down 3%), although gold and copper had small rebounds.



- **Among the positives in Friday's report on the employment situation in January were:**
 - >>> A drop in the unemployment rate to 9.7% from 10.0% in December as a result of a 540k increase in employment in the household survey. The broader so-called U-6 underemployment rate also fell, from 17.3% in December to 16.5% in January.
 - >>> Aggregate hours worked rose 1.4% last month, the first increase in 23 months and the best showing since July 2007.
 - >>> Temporary help services, a leading indicator of changes in permanent employment, had a 52k increase in jobs in January, bringing the four-month job additions to nearly 250k.

>>> Diffusion indexes over one-, three- and six-month spans increased last month, indicating some broadening of strength in employment – although all three readings remain below the 50% breakeven.

- **On the negative side of the employment report for January:**

>>> The establishment survey still showed 20k jobs lost in January, and benchmark revisions put total jobs lost in the recession at 8.4 million, roughly one million more than previously believed. (Claims about the number of jobs created or saved by the stimulus program look increasingly spurious.)

>>> The duration of unemployment continues to be historically long, as 6.3 million remain on unemployment rolls for 27 weeks or longer.

>>> While manufacturing saw a nominal increase in jobs last month, service industries have yet to show any sign of consistent improvement, construction had its biggest job losses in six months (75k), and job cuts at the state and local government level offset new hires at the federal level (including 9k temporary census takers).

>>> The unemployment rate for 16-to-24-year olds stayed at 18.9% in January, down only slightly from October's 19.2% peak.

- **Ten-year Treasury bond yields fell 3.57%, lowest since Christmas week.** Based on its “flash” estimate, the Barclays U.S. bond market aggregate total return index closed at an all-time high, 1.8% above its December 2009 close and 8.9% above the year-ago level.

INVESTMENT OUTLOOK...Real GDP grew at a 5.7% annual rate in the fourth quarter, which together with Q3's 2.2% growth rate has put the U.S. economy in forward gear after one of the worst recessions in decades. The powerful monetary and fiscal policy actions taken over the past 18 months should keep the recovery going through 2010. To be sure, consumers continue to drag their feet due to the weak labor market, small businesses are still feeling the pinch of the credit crunch, and commercial real estate looks to be a drag on economic growth for some time yet. On a year-over-year basis, GDP is slightly to the plus side (+0.1%), a vast improvement on the nearly 4% rate of decline seen through the middle of 2009. It could take a couple more quarters before U.S. real GDP returns to a trend growth rate around 2.5%. Still, the economy is digging its way out of recession, which makes us think that any correction in the stock market rally here will not rise to bear market proportions.

February 4, 2010...Stock market averages fell 2% in the first hour of trading today and roughly another 1% or so over the rest of the day, to finish Thursday with their biggest losses in 10 months. After two strong days to open the week, the S&P 500's 3.1% loss on Thursday on top of Wednesday's 0.5% retreat brings the market's cumulative decline to 7.6% since the January 19 high. Where Wednesday's stock market weakness reflected disappointment with what was only modest improvement in the ISM purchasing managers' index for service industries during January,

the proximate cause of Thursday's weak market open appeared to be higher-than-expected weekly jobless claims, another indication of the fitful economic recovery. Growing concern regarding Greece's ballooning deficits and their potential implications for Europe added to market anxiety, pushing market volatility to 26% (VIX), nearly 50% above January's low reading of 17.5%. Investors sought the safety of Treasuries – the 10-year was up about three-quarters of a point – selling crude oil (down 5%) and gold (down 4%). The dollar reached a nine-month high vs the euro.

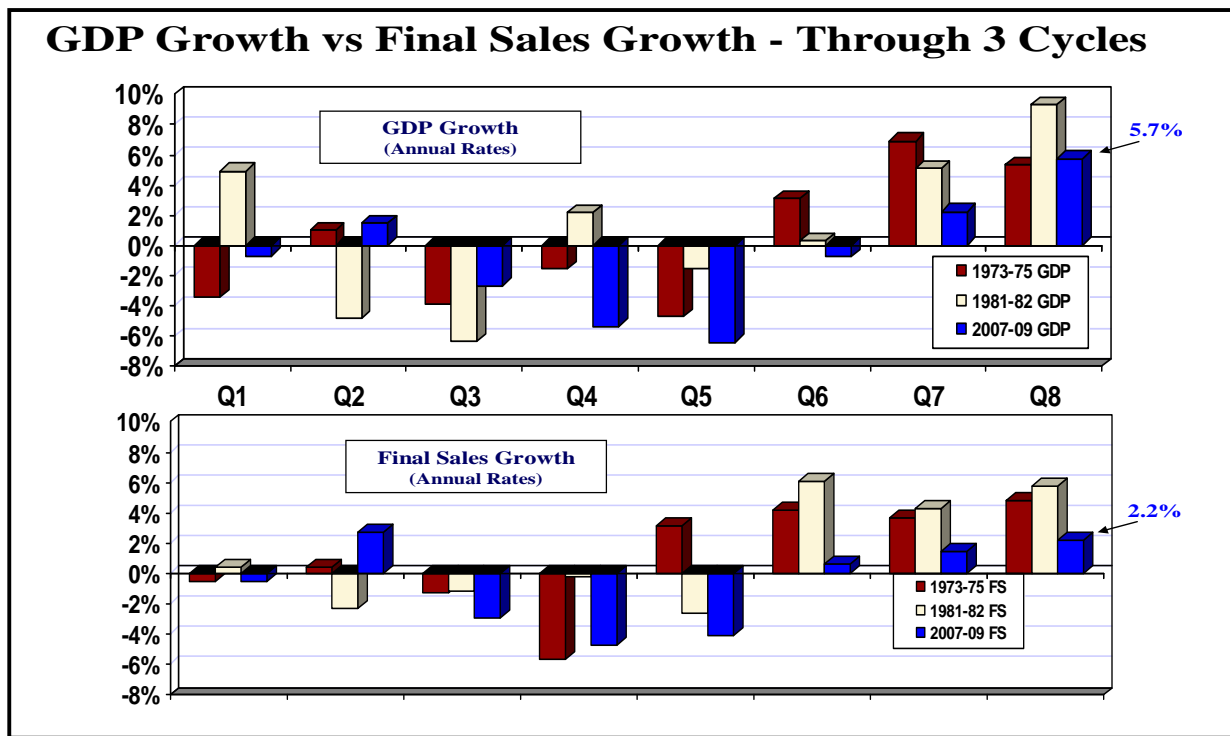
- **The nearly 8% decline in the S&P 500 from last month's high so far qualifies as a correction or even a mini-correction, although it is the biggest since the market rally began last March.** Following the past year's 70% low-to-high increase in the S&P 500, such a decline is probably overdue. Friday's employment report, which traders appear to be betting will be a disappointment, has the potential to turn this correction around abruptly, should it come in on the positive side. Still, the economic recovery looks to us as if it will remain on a somewhat anemic trajectory, suggesting that investors may have to wait a while for economic fundamentals to support higher stock prices. Nevertheless, we believe that the economy's healthy productivity growth trend should generally contribute to better-than-expected earnings, helping to modulate the market's downside.

February 3, 2010...Stock prices rose more than 1% yesterday, the second day in a row of healthy gains, taking the S&P 500 back above the 1100 level. At Tuesday's close, the S&P 500 index is roughly 4% below its 15-month high hit two weeks ago. February has certainly started out better for stocks (up 2.7% on the S&P 500) than January ended (down 6.6% from the January high). The latest upleg got its start on Monday with the solid improvement in the ISM manufacturing purchasing managers' survey for January, which came in at 58.4% as compared to a consensus expectation of 55.5% – diffusion readings above 50% indicating expansion. A better-than-expected reading in manufacturing was also seen one month ago (55.9% vs 54.3%), but there was no follow-through in the ISM for service industries; indeed, the December reading for non-manufacturing was barely over the 50% level at 50.1% vs 50.5% expected. This morning at 10:00 we'll see how the January ISM non-manufacturing survey compares with expectations centering at the 51% level, according to Bloomberg. One would have more confidence in the staying power of the economic recovery if the inventory adjustment that has boosted the manufacturing purchasing managers' index would be accompanied by a corresponding firming in the service sector – unlike the disappointment of the past few months.

- **(10:00 EST.) – Late note: the ISM services survey numbers are in for January, and once again they come up a little short of expectations.** There was improvement in the composite service sector index, which rose from 50.1% to 50.5%, but it came up short of the 51% Bloomberg consensus and only mildly to the plus side of the 50% expansion/contraction breakeven. There were some positive aspects, mainly the uptick in the new orders component (54.7%, up from 52%) and the slight improvement in the employment component (44.6% vs 43.6%). Of course, the latter number, being still shy of 50%, remains the weak link in the national employment picture, a suggestion that Friday's nonfarm payroll report might not get into positive job-creating territory as many people, not least those in the Obama Administration, are hoping.

January 29, 2010...Stock prices rose more than 1% in the first hour of trading following Commerce's report that U.S. GDP grew at a 5.7% annual rate in the fourth quarter of 2009, but stocks gave up all their gains and the S&P 500 ended Friday down 1%. The headline

number – GDP up 5.7% - surpassed Wall Street forecasts by about one percentage point, which pretty clearly puts the end of the recession sometime around the start of last summer. The two subsequent quarters of GDP growth – 2.2% in Q3 and 5.7% in Q4 – are a bit on the slow side as compared with the recoveries following the two other major recessions of the past four decades, as seen in the top panel of the chart below. While there were positive aspects to today’s report, for example the 13% rate of increase in business spending on equipment and software, the composition of growth was problematic in that 3.4 percentage points of growth (or about 60%) resulted from a reduced rate of inventory liquidation. In another words, final sales, which is GDP less the change in inventories, rose at a more pedestrian 2.2% annual rate in the fourth quarter. Of course, that’s almost always the way recessions end; indeed, it’s the need to rebuild inventories that stimulates business ordering and hiring, initiating the next upturn in the business cycle. As panel two in the chart indicates, the 1.5% (Q3) and 2.2% (Q4) growth rates for final sales over the past two quarters are relatively shallow compared with the recoveries following the 1973-75 and 1981-82 recessions.



- As the old saw has it, “Don’t look a gift horse in the mouth.” All along, we’ve been expecting the economic rebound to be constrained by the weak labor market and the financial bind facing many consumers. So while we take Q4’s 5.7% GDP growth figure with a grain of salt, we have to acknowledge that Q4’s final sales growth of 2.2% was a little better than our 1.8% forecast. What we need to see in coming months to confirm the economic recovery will be growth in wage and salary income, which was up only 2.2% in the fourth quarter of 2009 (and down 0.4% after inflation). For that to happen, watch for the Holy Grail of increasing employment, which with any luck we’ll see next Friday, when Labor reports on employment conditions in January.