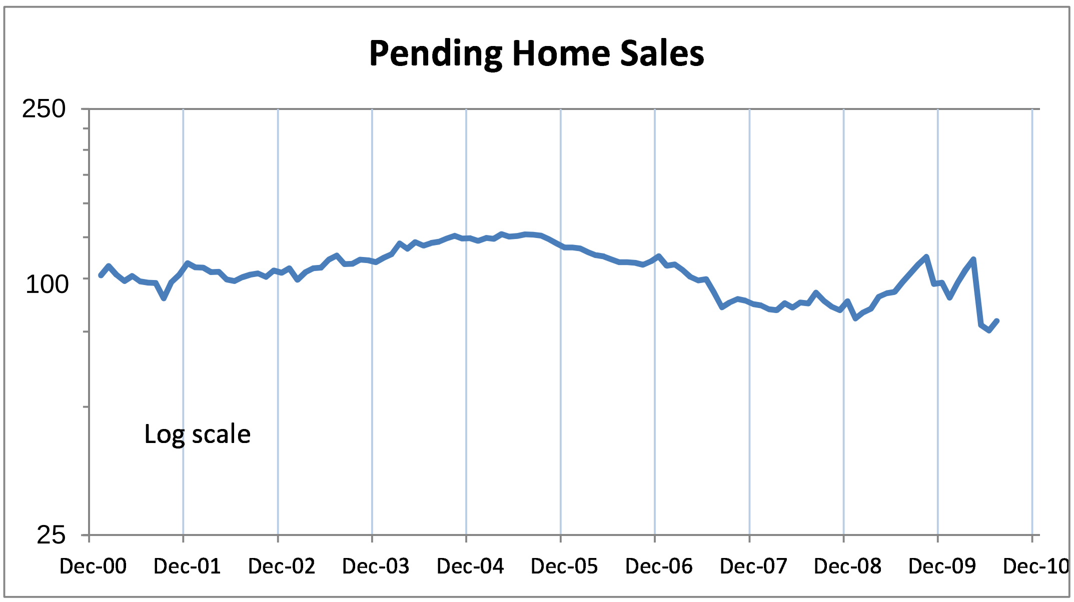
A second straight day of stock market advance ahead of August jobs report…

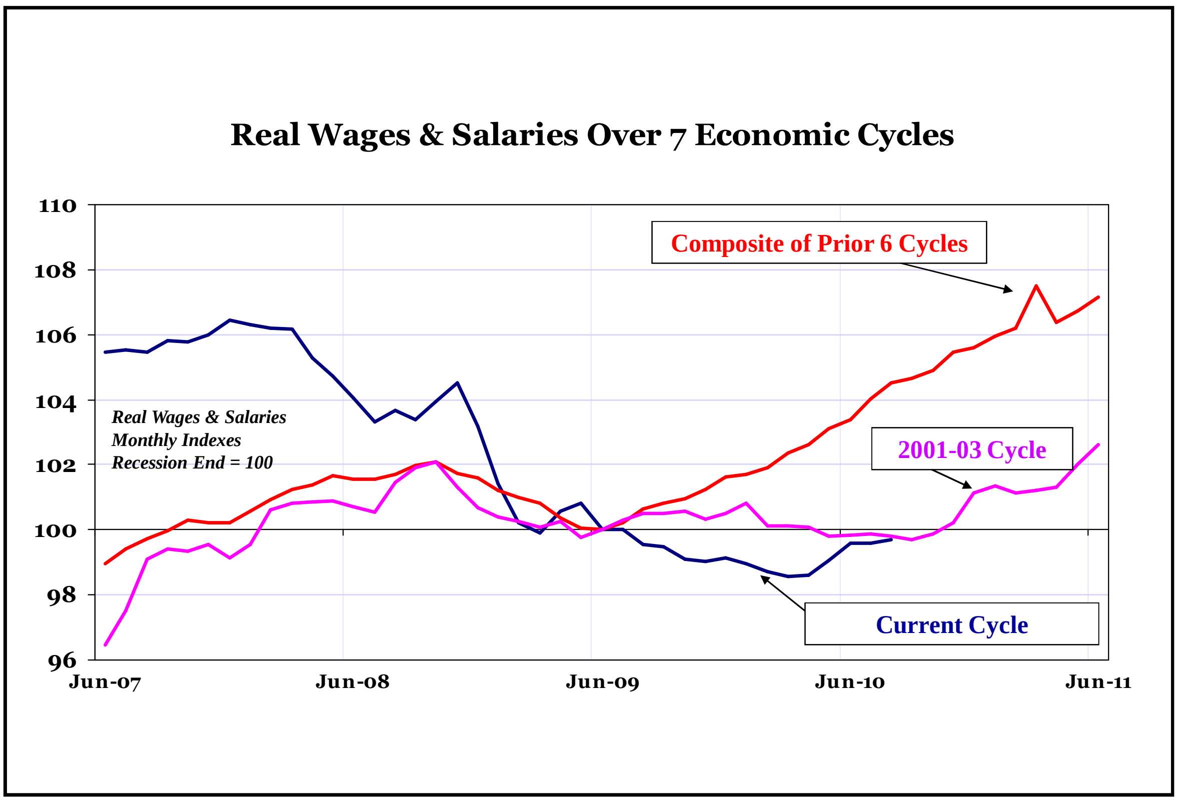
September 2, 2010…On the eve of what these days is the most watched data release of the month – Friday's nonfarm payroll report from the Labor Department – investors managed to put together a second good day for stock prices. Trading lacked the conviction of Wednesday's broad rally, but by day's end the S&P 500 was at its high for the session, up 0.9% on top of Wednesday's nearly 3% rise. Today lacked Wednesday's data catalyst for rising stock prices – the surprisingly good ISM purchasing managers survey for August – but there was a minor positive in the reported 5% rise in pending home sales for July. As the chart below suggests, though, there is a lot of ground to make up before home sales even come close to the artificially higher levels produced by the home buyer tax credits. We have not been counting on a big boost from housing in our economic model, but just the absence of the last four years of decline will represent a step in the right direction. If tomorrow's employment report manages to come in on the high side of expectations, something at least hinted at by the stock market action of the past two days, it will have to be followed by many months of improvement before housing truly begins to recover.



INVESTMENT OUTLOOK…U.S. GDP has increased 3.0% over the past four quarters, a number that is on the anemic side by comparison with historical recoveries from deep recessions. Easy money stands to keep the recovery going into 2011, but fiscal policy is in the process of shifting to restrictive by virtue of the stimulus starting to run out. The leading economic indicators still point to growth ahead. Still, consumer confidence is tenuous due to weak labor markets. Improvement in employment conditions, in our view, will be key to the strength of the recovery in 2011; current indications on the labor front are not exactly inspiring. We are heartened by business investment and corporate earnings, two of the stronger aspects of the economic recovery. The Q2 sell-off in stocks

represents the first genuine market correction in over a year, and while July brought some welcome respite (a positive leading indicator in its own right), the same cannot be said so far for August.

August 30, 2010…Figures for July show a stall in real-dollar incomes last month as inflation outstripped nominal gains in disposable personal income. Private sector wages and salaries had a respectable increase for the month but wages in the government sector shrank in real terms as census layoffs picked up. As the chart below indicates, real wage and salary compensation is still below the level of last June – which is when many economists (but not the NBER) believe the recession ended – and well below where it typically is a year after recession's end. Note also that the current cycle is similar in this respect to the post-2001 recovery, which was anemic into its second year. What is disappointing about the current cycle is that, unlike the previous one, the recovery is coming off a deep recession and a bigger rebound ought to be occurring. While stock prices were slightly negative following the consumer spending report, they weakened further during the day, as concerns that Friday's employment report won't meet already modest expectations. The S&P 500 ended Monday down 1.5%, while the Barclays U.S. bond market aggregate rose 0.4%; bonds have produced a 7.6% return to date in 2010 as compared with a 4.7% decline in the S&P 500.



August 27, 2010…With one more month's worth of data – mainly the weak trade report for June – the Commerce Department lowered its estimate of second-quarter U.S. economic

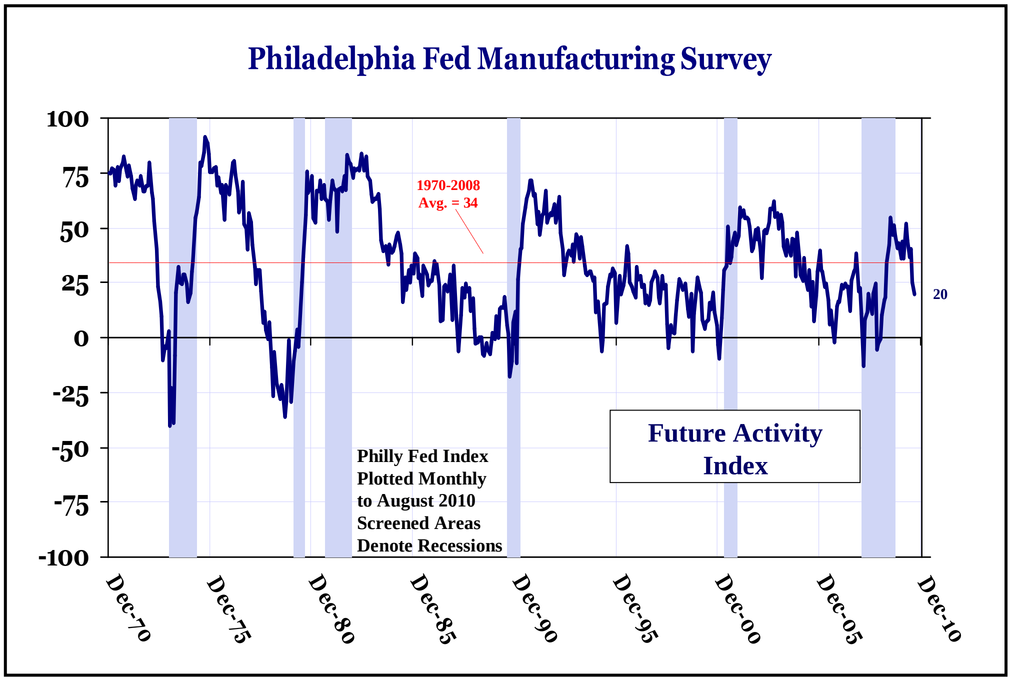
growth from the original 2.4% to 1.6%. While nothing to brag about, the revision was a bit less severe than Wall Street had been anticipating (which was 1.4% according to Bloomberg). In addition, some of the details of the report were more promising than the headline numbers: in real dollar terms, GDP was revised down $25 billion (annual rate), but final sales of domestic product were reduced by only $11 billion, as there was a smaller buildup of inventories than earlier estimated, and final sales to domestic purchasers were actually revised higher by $8 billion. As the table below shows, the big bulge in imports last quarter detracted from GDP significantly. Consumer spending, business investment and even residential construction all made bigger contributions to Q2 GDP than they did in Q1, although the latter will surely be a detractor in the current quarter, as evidenced by the fall-off in housing activity after the end of the home buyer tax credit this spring.

		Contributions to Percent Change in Real GDP					Details of Consumer Contribution			Details of Investment Contribution			
	GDP	Consumer						Non-			Equip. &		Chg. in
	% Chg	Spending	Investment	Exports	Imports	Govt	Durables	Durables	Services	Structures	Software	Residential	Inventories
12/31/07	*2.9%*	1.0%	-1.5%	1.3%	1.9%	0.2%	0.2%	0.1%	0.7%	0.3%	0.4%	-1.4%	-0.8%
3/31/08	*-0.7%*	-0.5%	-1.5%	0.7%	0.2%	0.4%	-0.9%	-0.5%	0.9%	0.0%	0.3%	-1.2%	-0.5%
6/30/08	*0.6%*	0.1%	-1.2%	1.6%	-0.6%	0.7%	-0.2%	0.3%	0.0%	0.3%	-0.5%	-0.5%	-0.5%
9/30/08	*-4.0%*	-2.5%	-2.0%	-0.7%	0.0%	1.0%	-1.0%	-0.9%	-0.6%	-0.1%	-0.9%	-0.8%	-0.1%
12/31/08	*-6.8%*	-2.3%	-6.3%	-3.0%	4.5%	0.3%	-1.8%	-0.8%	0.3%	-0.4%	-2.5%	-1.2%	-2.3%
3/31/09	*-4.9%*	-0.3%	-6.8%	-3.6%	6.5%	-0.6%	0.4%	0.1%	-0.8%	-2.0%	-2.5%	-1.2%	-1.1%
6/30/09	*-0.7%*	-1.1%	-2.3%	-0.1%	1.6%	1.2%	-0.2%	-0.1%	-0.8%	-0.8%	0.0%	-0.5%	-1.0%
9/30/09	*1.6%*	1.4%	1.2%	1.3%	-2.7%	0.3%	1.4%	0.3%	-0.2%	-0.4%	0.3%	0.3%	1.1%
12/31/09	*5.0%*	0.7%	2.7%	2.6%	-0.7%	-0.3%	-0.1%	0.5%	0.3%	-1.0%	0.9%	0.0%	2.8%
3/31/10	*3.7%*	1.3%	3.0%	1.3%	-1.6%	-0.3%	0.6%	0.7%	0.0%	-0.5%	1.2%	-0.3%	2.6%
6/30/10	*1.6%*	1.4%	2.8%	1.1%	-4.5%	0.9%	0.5%	0.3%	0.6%	0.0%	1.5%	0.6%	0.6%
Averages													
2000-10	*1.8%*	1.5%	-0.1%	0.4%	-0.4%	0.4%	0.3%	0.3%	0.9%	-0.1%	0.2%	-0.2%	0.0%
1990-99	*3.3%*	2.3%	1.0%	0.7%	-1.0%	0.3%	0.5%	0.4%	1.3%	0.0%	0.7%	0.1%	0.1%
Post-1950	*3.2%*	2.2%	0.5%	0.4%	-0.5%	0.6%	0.4%	0.5%	1.2%	0.1%	0.4%	0.1%	0.0%

- **Ben Bernanke spoke some reassuring words about the Fed's intention to keep the economic recovery going at the Fed's annual Jackson Hole conference and the stock market appeared to like what he had to say.** At 1:00 NYT, the S&P 500 was up nearly 1% and the DJIA was comfortably back above 10000. There was significant profit taking in Treasury bonds today, as the GDP numbers beat expectations slightly; the 10-year T-note was down about a point and one-third, its yield rising back to the 2.63%, where it was up some 20 basis points from this week's low.

August 20, 2010…The past several days have brought data suggesting that the economic recovery is struggling to maintain its forward momentum, and stock prices and bond yields fell accordingly. For the week, the S&P 500 declined 0.7%, the DJIA lost 0.9%, and Nasdaq managed a 0.3% rise. Treasury bonds continued their improbable drive to lower lows, with the 30-year T-bond yield falling 20 bps to 3.66%, while the two-year T-note ticked up to 49 bps from Thursday's low of 48 bps. The twos/tens yield curve flattened another two basis points on the week, although it remains steep at 2.12% on Friday's close.

- **Like the prior two cycles, the current cycle is somewhat anemic and of the jobless variety, but the odds are still against the dreaded double dip recession, in our view.** The leading economic indicators ticked up 0.1% in July, with the main booster the past several months being the steep yield curve. An upsloping yield curve is regarded as a positive leading indicator – normally with good reason. Banks can borrow short and lend longer with ample spread and a generally favorable effect on credit. Currently, however, banks are borrowing from the Fed at 25 basis points and buying Treasury securities – which is probably not what the economy needs at this point, although demand for credit is hardly robust in any case. There may be reason then to doubt the efficacy of the positive yield curve as forecaster in the current cycle. Ex the positive yield curve, the other nine leading economic indicators are down three out of the last four months (as compared with just one including the yield curve). The Philly Fed survey's big tumble in the latest period – combined with the increase in jobless claims to 500k last week – were not well received by investors Thursday.



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Still, we judge the economy's chances of avoiding a double-dip back into recession as more likely than not. Economic recoveries do not unfold in a straight line, and the prior two (1991-93 and 2002-04) were particularly anemic. If the recession ended 11 months ago as we believe, the current cycle looks better by comparison in terms of industrial production at a similar point in those recoveries. Clearly, we are in a soft patch, and policy mistakes or extraordinary shocks could upset our forecasts. As the chart above shows, the Philly Fed's index of future manufacturing activity is still in positive territory.

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