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Economic Outlook
Forest and Wood Products Industries

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Executive Summary

Much like last month, reports continue to surface that support claims of a recovering (or at least stabilizing) U.S. economy. E.g., the first revision of 2Q's change in real GDP was left unchanged at -1.0 percent (after -6.4 percent in 1Q), and August's official rate of job loss was the slowest in a year. However, few positive contributions to 2Q GDP came from the private sector. The slowdown in jobs lost appear to have resulted largely from statistical modeling and seasonal adjustments, as claims for initial unemployment benefits suggest firms may have "cut loose" approximately two million employees in August. Housing starts and sales extended gains again in July, but foreclosures will be a drag on the recovery. The weaker dollar is a "mixed blessing." While providing some support for U.S. exports, especially paper, oil imports have become more expensive. ■

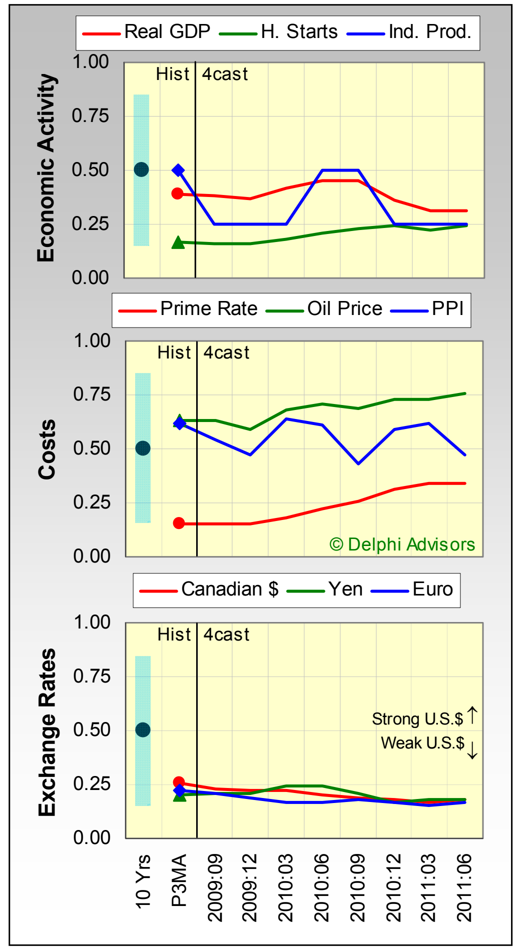

Figure 1. **Indexed forecasts of macroeconomic variables relative to their historical 10-year min, max and average (lower and upper ends of the blue bars, and black dots, respectively), and prior three-month averages ("P3MA"); see Table 1, p. 2., for full variable labels. Source: Delphi Advisors**

Economic Outlook

The Bureau of Economic Analysis (BEA) left its second estimate of change in gross domestic product (GDP) between the first and second quarters of this year essentially unchanged at -1 percent.[1] As we pointed out last month, however, the press release accompanying the BEA's 2Q2009 preliminary estimate of GDP is hardly the stuff of a roaring recovery:

> "The decrease in real GDP in the second quarter primarily reflected *negative contributions* from private inventory investment, nonresidential fixed investment, personal consumption expenditures (PCE), residential fixed investment, and exports that were partly offset by *positive contributions* from federal government spending and state and local government spending…" (emphasis added).

Details from the press release include:
- Motor vehicle output added to real GDP; but,
- Real personal consumption expenditures decreased;
- Real nonresidential fixed investment decreased;
- Nonresidential structures decreased;
- Equipment and software decreased;
- Real residential fixed investment decreased;
- Real exports of goods and services decreased;
- The change in real private inventories subtracted from real GDP;
- Private businesses decreased inventories;

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***Table 1*. Key economic 4cast statistics**

		Real GDP	Housing Starts	Industrial Production	Prime Rate	Oil Price	CDN$ / US$	Euro / US$	Yen / US$	PPI, Inter-med Materials
Actual	2009:06	-1.02	0.587	2.62	3.25	69.68	1.126	0.714	96.6	2.31
	2009:07	0.48	0.581	-1.10	3.25	64.09	1.123	0.710	94.4	-0.12
Estimated	2009:08	1.21	0.565	2.55	3.25	71.06	1.087	0.701	94.9	-0.09
Projected	2009:09	1.00	0.498	-1.15	3.25	72.69	1.078	0.694	96.3	0.60
	2009:10	-0.47	0.561	-0.21	3.25	68.21	1.070	0.698	96.0	0.81
	2009:11	-0.01	0.455	-1.35	3.25	61.91	1.060	0.689	95.0	-0.22
	2009:12	-0.85	0.495	0.57	3.25	58.73	1.057	0.669	95.5	0.14
	2010:01	0.29	0.451	-0.33	3.25	63.59	1.051	0.668	95.8	-0.04
	2010:02	0.52	0.613	1.04	3.25	65.23	1.051	0.667	97.0	-0.21
	2010:03	-0.35	0.599	-0.92	3.25	70.15	1.060	0.652	97.4	0.37
	2010:04	1.14	0.660	-0.88	3.65	78.49	1.066	0.652	99.1	0.57
	2010:05	1.13	0.741	0.31	3.65	81.21	1.070	0.654	100.0	1.34
	2010:06	0.79	0.762	4.20	3.65	81.93	1.051	0.649	99.7	0.47
	2010:07	1.13	0.878	-3.35	4.15	80.54	1.036	0.643	98.9	0.90
	2010:08	1.34	0.944	1.67	4.15	78.36	1.020	0.645	99.0	0.57
	2010:09	1.16	0.960	-0.22	4.15	75.67	1.019	0.656	97.8	-0.31
	2010:10	0.73	1.111	-0.22	4.70	77.26	1.025	0.666	96.5	-0.19
	2010:11	1.17	1.077	-1.76	4.70	79.39	1.025	0.660	95.0	-0.43
	2010:12	0.62	1.125	-0.40	4.70	82.00	1.015	0.644	92.9	1.09
	2011:01	-0.46	1.146	-0.78	4.75	83.00	1.000	0.647	91.1	-0.17
	2011:02	-0.40	1.095	0.68	5.00	86.13	0.989	0.645	90.0	0.80
	2011:03	-0.51	1.042	0.86	5.00	83.41	0.991	0.629	91.0	0.65
	2011:04	-0.85	0.979	-1.98	5.00	83.23	0.987	0.630	93.0	0.80
	2011:05	-0.81	0.961	0.24	5.00	84.42	0.983	0.633	94.0	0.61
	2011:06	-0.63	1.148	2.19	5.00	86.99	0.995	0.640	93.7	-0.19
	2011:07	-0.82	1.098	-2.77	5.00	89.39	1.008	0.648	92.6	-0.27
	2011:08	-0.78	1.133	1.88	5.00	88.38	1.016	0.658	92.0	0.43

Notes: All actual data from St Louis Federal Reserve Board's FRED database unless otherwise indicated:
Real GDP is annualized percentage change (chained 2000 US dollars)
Housing Starts are millions of units (seasonally adjusted, annualized rate) as reported by U.S. Census Bureau
Industrial Production is monthly percentage change in index (index not seasonally adjusted) as reported by the Federal Reserve's G-17 report
Prime lending rate is monthly average of daily figures
Oil price is West Texas Intermediate crude, monthly average of daily $/barrel
Canadian dollar, euro and yen exchange rates are monthly averages of daily figures
Monthly percentage change in Producer Price Index, intermediate materials, as reported by Bureau of Labor Statistics
Projections developed by Delphi Advisors

- Real federal government consumption expenditures and gross investment increased;
- National defense increased;
- Nondefense increased;
- Real state and local government consumption expenditures and gross investment increased.

In case it's not obvious, virtually all of the "negative" contributions originated in the private sector, while almost all of the "positive" contributions came from the public sector. In other words, the private sector is contracting but the public sector is expanding – again, hardly the makings of a robust economy. GDP records the dollar amount of goods and services produced in the economy during a given period, but makes no judgment as the relative merits of the underlying source of spending. The BEA equates government spending with private spending and ignores the wealth and potential growth destroyed by taxation. What is especially troubling to us is that most of the government spending is being done with borrowed money that will ultimately need to be repaid with interest – again, funded through taxation.

One of the most evocative descriptions of the economy we've seen during the past month came from Kevin Harrington, managing director at hedge fund Clarium Investment Management. "This is more likely a ski-jump recession, with short-term stimulus creating a bump that will ultimately lead to a more precipitous decline later. "Some critical initiatives have been cut short," added Paul Tudor Jones, Clarium's manager. "As a result, toxic assets remain on balance sheets and credit growth is likely to be subdued for a long period."[2]

Figure 1 (p. 1) is a new feature that we hope will enable readers to better relate to the numeric details of our macroeconomic forecasts (shown in Table 1) within the context of both the recent and more distant history. The forecasts are grouped into three categories:

- Economic activity (including annualized monthly percentage change in real GDP, annualized monthly housing starts, and monthly percentage change in the seasonally unadjusted index of industrial production);
- Business costs (prime interest rate, oil price and producer price index of intermediate goods); and

- Currency exchange rates (loonie, yen and euro per U.S. dollar).

The past 10-year history of each series has been indexed such that the historical average equals 0.50 on the corresponding graph, while the historical extremes fall between 0.15 (historical minimum) and 0.85 (historical maximum). Each series starts with the average of the prior three months, then transitions to the forecast. Indexing history as we have allows the forecasts to deviate outside the historical range while remaining within the graph. As one can see, the rate of change in both real GDP and industrial production during the forecast will be "below par" relative to the past 10 years. Housing starts will start out at historical lows and gradually strengthen only slightly. The prime interest rate will also gradually rise after starting out at historical lows. Despite some weakening during the first six months of the forecast, the price of crude oil will remain in the upper half of the 10-year historical range. The rate of change in the producer price index of intermediate materials will undulate back to the middle of the historical range. Finally, the U.S. dollar will be "stuck" near the bottom of the historical range during the entire forecast.

Manufacturing and service industry output: Industrial production increased 0.5 percent in July (Figure 2), marking the first monthly increase (other than the hurricane-related rebound in October 2008) since December 2007.[3] Manufacturing output advanced 1.0 percent in July, thanks primarily to a jump in motor vehicle assemblies from an annual rate of 4.1 million units in June to 5.9 million units in July. According to *MarketWatch*, the boost in vehicle production during July had little to do with the government's "cash-for-clunkers" program; rather, it was a planned increase following earlier severe production cutbacks as General Motors and Chrysler went through bankruptcy. Production levels are still below the pre-"clunkers" sales pace.[4] Excluding motor vehicles and parts, manufacturing production edged up 0.2 percent. Total industrial production was 13.1 percent below its level of a year earlier.

Wood Products output ticked up by 0.7 percent in July, the second consecutive month of increases; activity in that sector remains 23 percent below year-earlier levels. Paper manufacturing activity rose for a third month, although July's 0.6 percent advance was muted when compared to the two prior months; activity in the Paper sector is nearly 12 percent lower than the levels of July 2008.

In July, the total-industry capacity utilization rate edged up for the first time since October 2008 (from a record-low 68.1 percent in June), to 68.5 percent, but remains nearly 13 percent below the year-earlier level (Figure 3). Capacity utilization in the Wood Products and Paper industries extended gains, by 1.1 and 0.7 percent, respectively. Compared to July 2008, Wood Products capacity utilization is off by approximately 21 percent, while Paper is off about 10 percent.

The value of all shipments was essentially flat (declining 0.05 percent) in July. Shipments from Wood manufacturers jumped by 1.4 percent, while Paper ship-

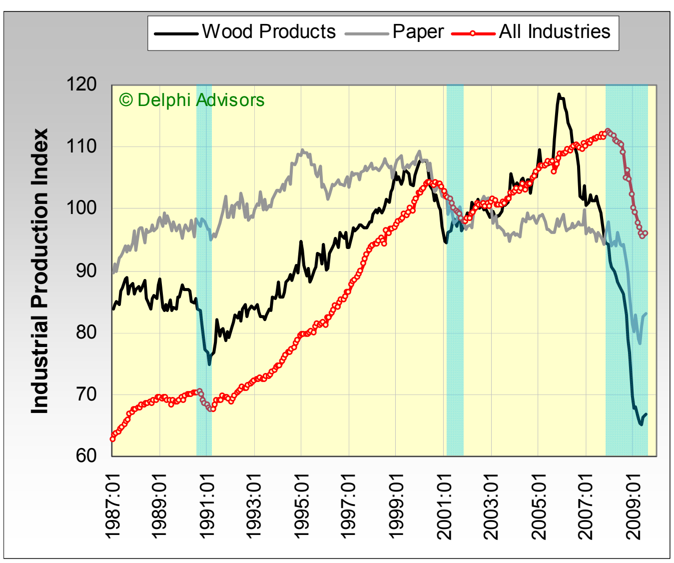

***Figure 2*. Seasonally adjusted industrial production (2002 average index = 100) by wood product and paper manufacturers, and all industries; recessions shown in blue. Sources: Federal Reserve Board and National Bureau of Economic Research**

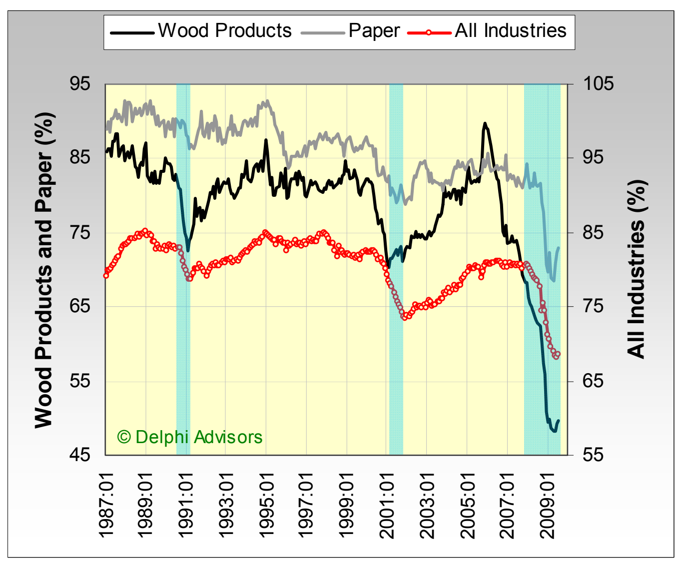

***Figure 3*. Seasonally adjusted capacity utilization among wood product and paper manufacturers, and all industries; recessions shown in blue. Note that the "All Industries" series is shifted to reduce clutter. Sources: Federal Reserve Board and National Bureau of Economic Research**

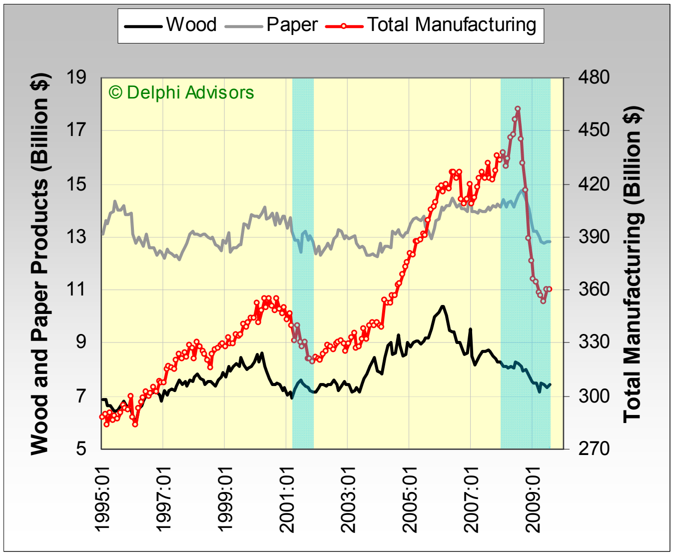

***Figure 4*. Seasonally adjusted value of shipments, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research**

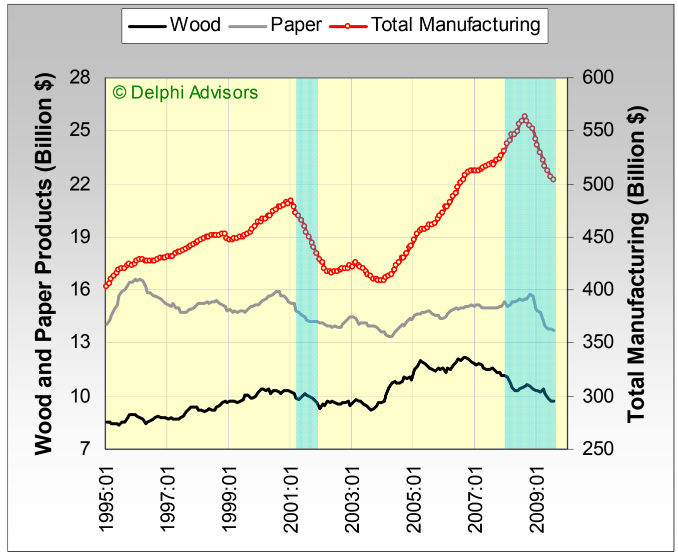

***Figure 5*. Seasonally adjusted value of inventories, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research**

ments were flat for a fourth consecutive month (Figure 4).

Despite the uptick in output and flat shipments, inventories at the Total Manufacturing level *declined* (by \$3.7 billion, or 0.7 percent) in July (Figure 5). Paper manufacturing told the same story; inventories fell by \$94 million (-0.7 percent) in spite of higher output and flat shipments. In both cases, seasonal adjustments are the likely culprits for the counterintuitive inventory changes. Wood Products was the "oddball" in that both output and shipments increased – shrinking Wood inventories by \$50 million (-0.6 percent).

The Institute for Supply Management's (ISM) index of manufacturing activity for August provides a foretaste of what may appear in the Federal Reserve and Census Bureau reports to be published in September, related to manufacturing. According to Norbert Ore, chair of ISM's Manufacturing Business Survey Committee, U.S. manufacturing expanded in August for the first time in 18 months (Figure 6).[5] "The year-and-a-half decline in manufacturing output has come to an end, as 11 of 18 manufacturing industries are reporting growth when comparing August to July," Ore said. "While this is certainly a positive occurrence, we have to keep in mind that it is the beginning of a new cycle and that all industries are not yet participating in the growth. The August index of 52.9 percent is the highest since June 2007. The 4 percentage point increase was driven by significant strength in the New Orders Index, which is up 9.6 points to 64.9 percent, the highest since December 2004. The growth appears sustainable in the short term, as inventories have been reduced for 40 consecutive months and supply chains will have to restock to meet this new demand." That restocking process could take some time because, as a Paper Product respondent remarked, "In addition to improved business come the complications of a supply chain drained of inventory."

Ore's observation that not all industries are participating in the rally seem to pertain to Wood Products; the only bright spots for that industry are in new orders and inventory levels (Table 2, p. 5). Ore's uncertainty about the long-term sustainability of the rally are reflected in comments by an unnamed manufacturer. "Regarding the uptick in the manufacturing index: from where I'm sitting I don't see it as an increase in demand for our prod-

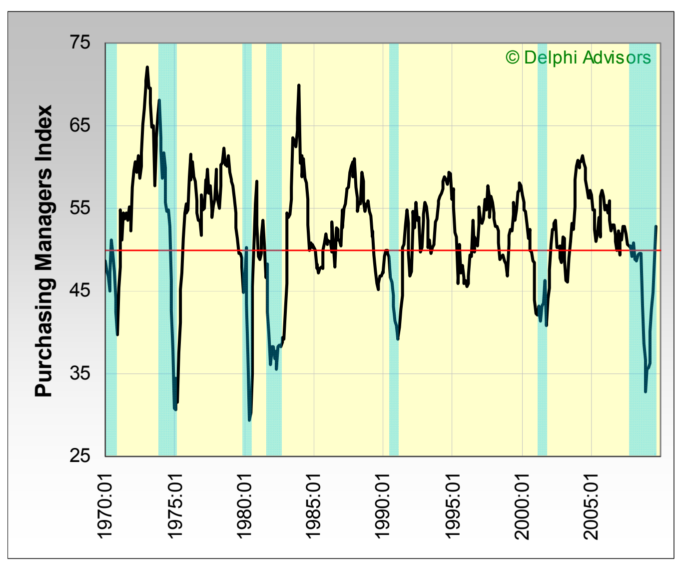

***Figure 6*. Purchasing managers' index for manufacturers; an index of 50 is the threshold between expansion and contraction. Recessions shown in blue. Sources: Institute for Supply Management and National Bureau of Economic Research**

***Table 2*. Performance overview for Wood and Paper Products during August 2009. Source: Institute for Supply Management**

Category	Wood Products	Paper Products
Overall activity	▼	▲
New orders	▲	▲
Production	▼	▲
Employment	▼	▲
Pace of supplier deliveries	—	▼
Inventories	▼	▼
Customers' inventories	▼	—
Input prices	—	▲
Backlog of orders	▼	▲
New export orders	—	▲
Imports	—	—

▲ = increase, higher or faster
— = no change, or no mention
▼ = decrease, lower or slower

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ucts, but rather a rebuilding of inventories from an oversold position. We've seen a bounce off the bottom in May that has been carried through this month but it appears to be leveling off."[6] That anonymous correspondent's remarks notwithstanding, the picture looks quite bright for Paper Products, as virtually all categories of the most recent survey point to additional anticipated activity.

Contraction in service industry activity has nearly stopped.[5] "The Non-Manufacturing Index registered 48.4 percent in August, 2 percentage points higher than the 46.4 percent registered in July, indicating contraction in the non-manufacturing sector for the eleventh consecutive month but at a slower rate," said Anthony Nieves, chair of ISM's Non-Manufacturing Business Survey Committee. "Respondents' comments are mixed about business conditions and the overall economy; however, there is an increase in comments indicating…signs of improvement going forward." Real Estate, Rental & Leasing was one of six industries reporting growth in August. Construction; Agriculture, Forestry, Fishing & Hunting; and Wholesale and Retail Trade were among the dozen industries that contracted.

International trade: Imports of goods and services into the United States rose for the first time in nearly a year in June, driven by higher oil prices (Figure 7). Excluding oil, however, imports fell to the lowest level in five and a half years. The U.S. trade deficit rose to $27 billion in June from a 10-year low of $26 billion in May. Most of the increase in imports and exports in June was driven by higher prices, not higher volumes. In inflation-adjusted terms, the trade deficit fell to the lowest level in 10 years.[7, 8]

Exports of U.S. wood pulp, paper and paperboard rose modestly in June (Table 3, p. 6), surpassing the year-

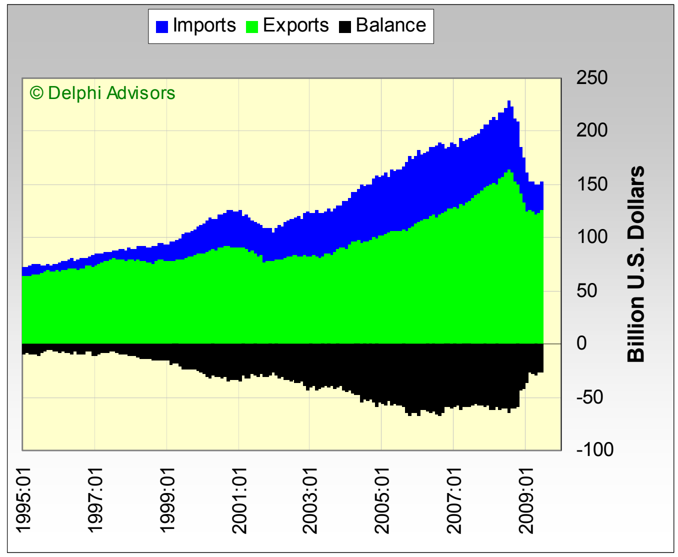

***Figure 7*. Total nominal value of goods and services imported into, and exported from, the United States. Data are seasonally adjusted and reported on a balance-of-payments basis. Source: U.S. Census Bureau, Foreign Trade Division**

previous level for the first time since October 2008. Imports continued their downward trend, resulting in a small year-over-year increase in net exports. Comparing year-to-date numbers, however, 2009 net exports are lagging behind 2008 levels. Lumber exports returned to the trend that has been in place since December 2008,rising to nearly 80 million board feet in June (Table 4, p. 6). But imports have also been trending higher since January, and June's imports of 781 million board feet were about on trend.

Employment: According to the Bureau of Labor Statistics' (BLS) establishment survey, non-farm payrolls in the United States fell by a seasonally adjusted 216,000 – to 131.2 million jobs – in August (Figure 8, p. 7).[9] The private sector lost 198,000 jobs, while the public sector shrank by 18,000 jobs. Although August represented the twentieth consecutive month of job losses, it was also the slowest pace of contraction in employment in a year. On a year-over-year percentage change basis, private sector employment is down 5.0 percent; public sector employment is off by 0.3 percent.

The BLS' household survey is somewhat more pessimistic. According to it, the number of unemployed persons increased by 466,000 (to 14.9 million), and the unemployment rate rose by 0.3 percentage point to 9.7 percent in August. Since the recession began in December 2007, the number of unemployed persons has risen by 7.4 million, and the unemployment rate has grown by 4.8 percentage points. Adding the 758,000 "discouraged" workers (i.e., persons not currently looking for work because they believe no jobs are available

***Table 3*. Most recent six-month trends in U.S. wood pulp, paper and paperboard trade. Source: USDA Foreign Agricultural Service**

	Thousand Metric Tons							Prior Six-Month	
Current Year	**2008:12**	**2009:01**	**2009:02**	**2009:03**	**2009:04**	**2009:05**	**2009:06**	**Totals**	**Change (%)**
Exports	2,275	2,395	2,302	2,583	2,464	2,814	2,859	15,417	
Imports	408	376	356	363	347	361	347	2,151	
Net Exports	1,867	2,019	1,946	2,220	2,117	2,452	2,512	13,266	
Month-to-month change (%)		8.2	-3.7	14.1	-4.7	15.9	2.4		
Prior Year	**2007:12**	**2008:01**	**2008:02**	**2008:03**	**2008:04**	**2008:05**	**2008:06**		
Exports	3,502	3,279	2,915	2,684	2,629	2,934	2,834	17,277	
Imports	519	588	525	571	551	529	504	3,269	
Net Exports	2,982	2,692	2,390	2,113	2,078	2,405	2,329	14,008	
Year-over-Year Change, by Month									
Exports	-1,227	-884	-613	-102	-165	-121	25	-1,860	-10.8
Imports	-112	-212	-169	-209	-204	-168	-157	-1,118	-34.2
Net Exports	-1,115	-672	-445	107	39	47	182	-742	-5.3
Change (%)	-37.4	-25.0	-18.6	5.1	1.9	2.0	7.8	-5.3	
Change between Current Year-to-Date vs. Prior Year-to-Date, by Month									
Exports	1,563	-884	-1,497	-1,599	-1,764	-1,885	-1,860		
Imports	-778	-212	-380	-589	-793	-961	-1,118		
Net Exports	2,341	-672	-1,117	-1,010	-971	-924	-742		
Change (%)	9.6	-25.0	-22.0	-14.0	-10.5	-7.9	-5.3		

for them) to the number of unemployed would bump the unemployment rate to at least 16 percent.[10]

Long-time readers are aware of our frequent criticism of the BLS' employment report because of seasonal and other statistical adjustments that have often yielded seemingly counterintuitive results. During several months in 2009, for example, seasonal adjustments changed apparent growth in employment to contraction; in other instances those seasonal adjustments greatly reduced the negative changes exhibited by the unadjusted numbers (Figure 9, p.7). August's adjusted and unadjusted numbers are at least of the same order of magnitude, although the seasonally adjusted result might have been more negative were it not for the birth/death adjustment (which attempts to account for business start-ups/closures that occurred too recently to be tallied in the employment survey[11]).

Another reason for our criticism of the employment report is that its numbers often bear no resemblance to the initial claims for unemployment insurance (UI). For

***Table 4*. Most recent six-month trends in U.S. softwood lumber trade. Source: USDA Foreign Agricultural Service**

	Million Board Feet							Prior Six-Month	
Current Year	**2008:12**	**2009:01**	**2009:02**	**2009:03**	**2009:04**	**2009:05**	**2009:06**	**Totals**	**Change (%)**
Exports	66	70	68	79	76	74	80	447	
Imports	743	646	714	792	717	752	781	4,402	
Net Exports	-676	-577	-646	-713	-641	-677	-702	-3,955	
Month-to-month change (%)		-14.8	12.0	10.4	-10.0	5.6	3.6		
Prior Year	**2007:12**	**2008:01**	**2008:02**	**2008:03**	**2008:04**	**2008:05**	**2008:06**		
Exports	74	78	86	86	91	87	89	518	
Imports	1,144	1,002	1,051	1,202	1,314	1,188	1,113	6,870	
Net Exports	-1,070	-924	-965	-1,116	-1,222	-1,101	-1,024	-6,352	
Year-over-Year Change, by Month									
Exports	-7	-9	-18	-7	-15	-13	-9	-71	-13.8
Imports	-401	-356	-338	-410	-596	-437	-332	-2,468	-35.9
Net Exports	393	347	319	403	581	424	323	2,396	-37.7
Change (%)	-36.8	-37.6	-33.1	-36.1	-47.5	-38.5	-31.5	-37.7	
Change between Current Year-to-Date vs. Prior Year-to-Date, by Month									
Exports	31	-9	-27	-34	-49	-62	-71		
Imports	-5,704	-356	-693	-1,103	-1,699	-2,136	-2,468		
Net Exports	5,735	347	666	1,069	1,650	2,074	2,396		
Change (%)	-33.0	-37.6	-35.3	-35.6	-39.0	-38.9	-37.7		

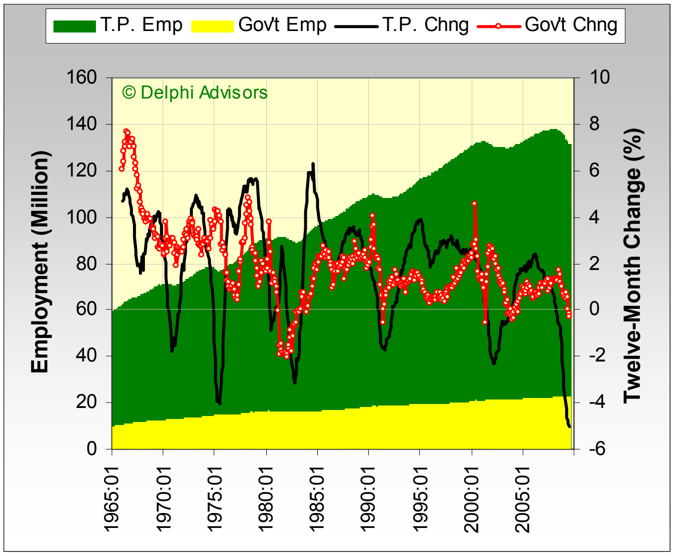

***Figure 8*. Components – total private ("T.P.") plus government ("Gov't") – of total non-farm employment versus percentage change from prior 12 months in those components; data are seasonally adjusted. Source: Bureau of Labor Statistics**

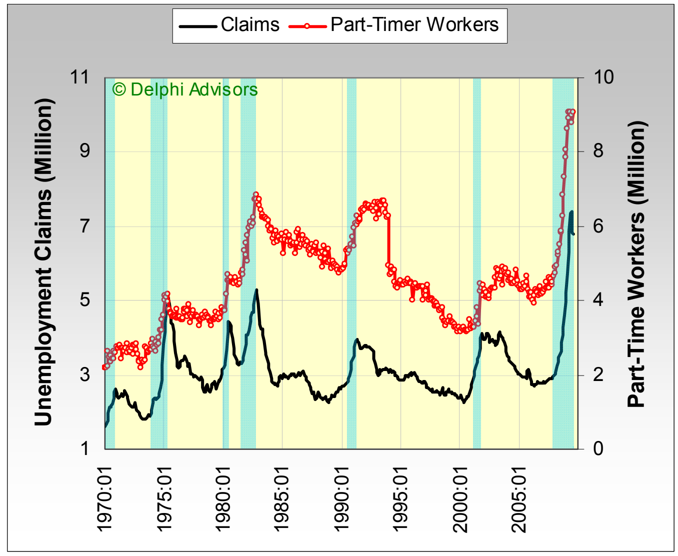

***Figure 10*. Total (initial plus continuing) unemployment insurance claims (monthly averages of weekly values) versus the number of part-time workers (economic reasons, all industries). Note that the two series are offset to reduce clutter. Data are seasonally adjusted; recessions shown in blue. Sources: Bureau of Labor Statistics and National Bureau of Economic Research**

example, the seasonally unadjusted number of initial UI claims for just the week ended 29 August was over 452,000, while the *seasonally adjusted four-week moving average* was over 571,000.[12] In other words, between 1.8 and 2.3 million people were thrown out of work and filed initial UI claims during the month of August – far higher than either the 216,000 lost jobs reported by the August establishment survey or the increase of 466,000 unemployed persons tallied in the household survey. As we have stated in the past, it will be the roughly two million people – not the "fictitious" 216,000 or 466,000 – whose contributions to consumer spending, economic growth and taxes will be diminished.

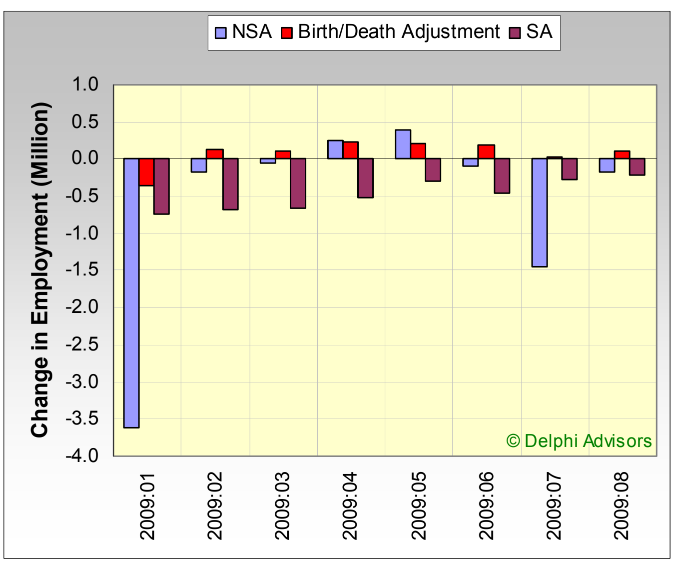

***Figure 9*. Monthly changes in employment during 2009: not seasonally adjusted ("NSA"), birth/death-model adjustments, and seasonally adjusted ("SA"). Source: Bureau of Labor Statistics**

Total (i.e., initial plus continuing) UI claims declined during the first half of August, albeit at a slower rate of change than in July (Figure 10). But, as we pointed out last month, the BLS doesn't track for UI purposes anyone who has been unemployed longer than 26 weeks. Since 65 percent of UI filers have now run out of their standard 26 weeks of benefits (and that percentage will continue climbing for some time to come),[13] the UI statistics may appear to improve primarily because filers are "falling off the BLS's radar." The August increase in the number (278,000) of part-time workers provides another indication that renewed hiring by businesses is likely *not* the explanation for falling UI claims. While recent activity in the industrial sector has been encouraging and will likely cause a small increase in the nation's economic activity in 3Q2009, we expect the rise in unemployment to stall the recovery during 4Q2009 before achieving a more sustained expansion in 2010.

Consumer spending: Personal income increased $3.8 billion, or less than 0.1 percent, and disposable personal income (DPI) decreased $4.6 billion, also less than 0.1 percent, in July (Figure 11, p. 8).[14] Personal consumption expenditures (PCE) increased $25.0 billion, or 0.2 percent "as Americans jammed auto showrooms to take advantage of the 'cash for clunkers' program while

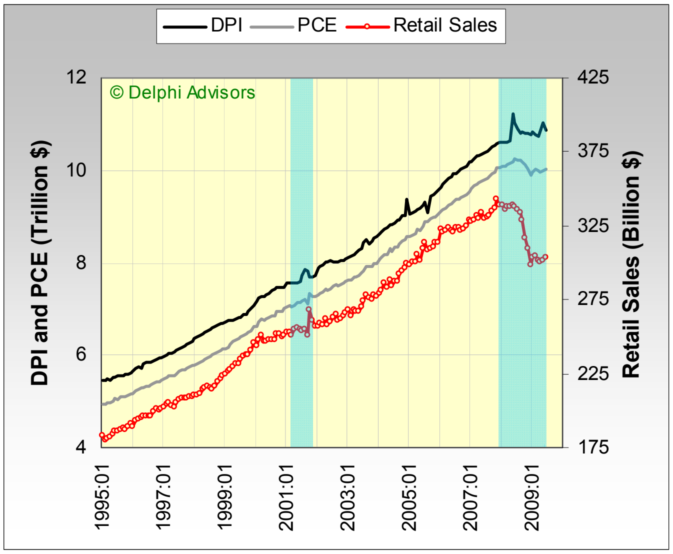

***Figure 11*. Disposable personal income and personal consumption expenditures (nominal dollars, SAAR) versus seasonally adjusted total retail (excl. food service) sales; recessions shown in blue. Sources: Bureau of Economic Analysis, Census Bureau and National Bureau of Economic Research**

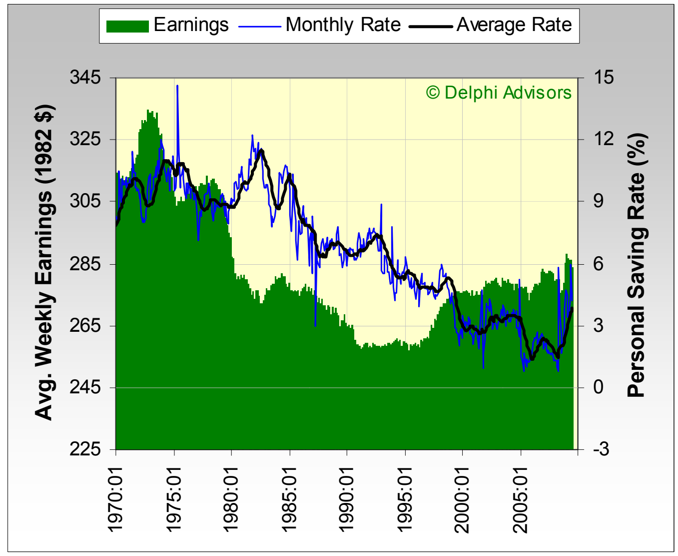

***Figure 12*. Average weekly earnings (1982 dollars) of all private sector workers versus monthly and rolling 12-month average personal saving rates. Sources: Bureau of Labor Statistics and Bureau of Economic Analysis**

avoiding other purchases."[15] Real disposable income decreased 0.1 percent in July, compared with a decrease of 1.6 percent in June. Real PCE increased 0.2 percent, compared with an increase of 0.1 percent.

Non-food retail sales (a narrower view of consumption activity than PCE) declined by $354 million (or 0.1 percent) in July, thanks largely to falling gasoline prices. Excluding gasoline, retail sales increased 0.1 percent; excluding motor vehicles and parts, sales fell 0.6 percent. The July retreat is "misleading," according to Barton Biggs, hedge fund manager at Traxis Partners. He claims that July's retail sales were skewed because a number of states moved their sales tax holidays for back-to-school sales to August, from July last year. "That caused people to delay [purchases], and pushed sales into August," Biggs said. However, "in the last three weeks in particular retail sales have already started to respond and [look to be] quite strong in August."[16]

Average weekly earnings, which had been trending lower since December, also increased in July – by $1.23 in constant-dollar terms (Figure 12). With nominal disposable incomes remaining essentially flat and personal consumption expenditures rising, July's personal saving rate dropped to 4.2 percent.

U.S. consumers reduced their credit burden for a sixth straight month in July. Total seasonally adjusted consumer debt fell by a record $21.55 billion (a 10.4 percent annual rate), to $2.47 trillion (Figure 13). Consumers have retrenched since the financial crisis hit last September; the amount of outstanding consumer credit has fallen every month since then except January. Credit-card debt fell $6.11 billion (8.5 percent), to $905.58 billion – a record eleventh straight monthly drop. Non-revolving credit (e.g., auto loans, personal loans and student loans) fell a record $15.44 billion (11.7 percent), to $1.57 trillion. Consumer spending has accounted for roughly 70 percent of GDP, so a slowdown in the use of credit implies a weak economy.

On an encouraging note, the rate of U.S. credit card defaults showed signs of stabilizing in July, an indication

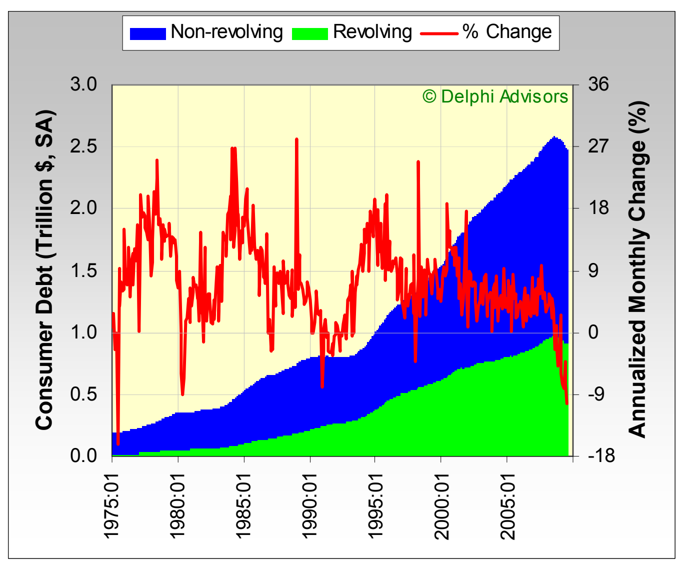

***Figure 13*. Total (revolving plus non-revolving) consumer debt outstanding versus annualized percentage change from prior month in total consumer debt outstanding. Source: Federal Reserve Board**

that American consumers may be in better financial shape than feared despite job losses and the housing slump. Bank of America, JPMorgan Chase, Citigroup, and Discover Financial Services all reported drops in bad-loan levels. "It just seems to bear out what we heard in the second-quarter calls, that things seem to be getting marginally better – and I would stress marginally – on the consumer side," said Nancy Bush, founder of NAB Research. Tempering that good news, though, Bush warned that "there's a seasonality concern. [I.e., consumers may be using tax refunds to pay down debt, meaning that bad-loan levels could rise again once all refunds have been dispensed.] There's also a more legitimate concern that we're finishing up the first wave that was related to subprime and now we're going to get into the second wave related to good [old-fashioned] recession losses."[17]

Interest and currency exchange rates. The U.S. dollar depreciated in August against most of the currencies we track (Figure 14). The dollar retreated by 1.2 percent against the euro and 3.3 percent against Canada's "loonie," but gained 0.6 percent relative to the yen. On a trade-weighted index basis, the dollar gave up 1.3 percent against a basket of 26 currencies, and is 8.1 percent below its March peak.[18] The following subsections explore some of the reasons behind last month's currency movements.

Canada: The news from our neighbor to the north has been mixed, but with more positive than negative aspects, during August. Although GDP contracted at an annualized rate of 0.6 percent during 2Q2009,[19] a number of sectors are experiencing growth. For example, the value of building permits rose by 1 percent (to C$5.2 billion) in June, thanks to support from both the residential and non-residential activity. To maintain perspective, however, the value of permits is 26.2 percent lower than the year-earlier level.[20]

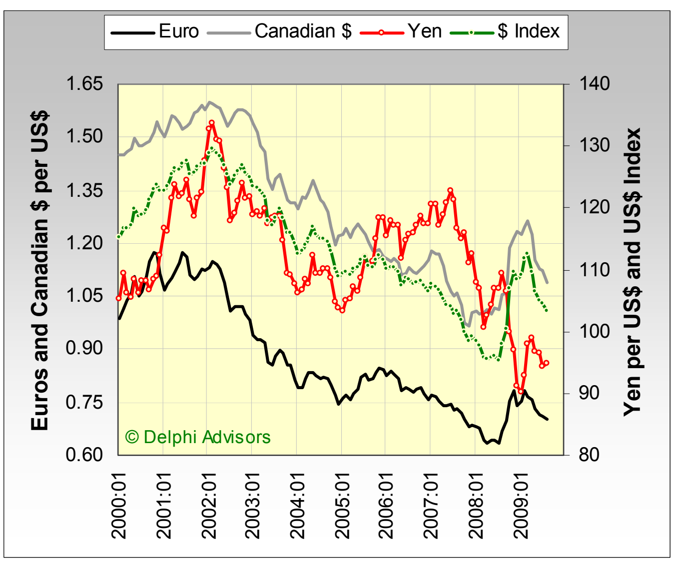

***Figure 14*. Exchange rates between the U.S. dollar and selected foreign currencies, and the trade-weighted, U.S.-dollar exchange rate index; smaller values mean a weaker dollar. Source: Federal Reserve Board**

Manufacturing posted a gain of 1.9 percent (C$39.7 billion) in June that partially reversed May's 4.9 percent decline. Strong sales in the aerospace industry and a rise in the price of petroleum and coal products largely explain the increase. Excluding both industries, Canada's manufacturing sales would have *decreased* 0.5 percent.[21]

Canada's monthly trade deficit was substantially smaller in June (C$55 million) than May's figure of C$1.1 billion.[19] On the domestic front, wholesale trade advanced in terms of both value and volume for the first time in nine months, mainly due to increases in the automotive products and food, beverages and tobacco products sectors.[22] Retail sales rose for a fifth month out of six in June.[23] Despite the downturn in their country, Canadian developers have added about 6.8 million square feet of retail space in 1H2009, more than in all of 2008. "A record amount of new retail space continues to be delivered and constructed even though the retail sector is showing some signs of stress," said Ricky Hernden, an analyst with CB Richard Ellis. Canada's retail boom contrasts with the United States, where bankrupt retailers vacated two million square feet this year.[24]

Monthly lumber production increased 3.0 percent (to 3.7 million cubic meters) in June. Again, for perspective, that volume is 22.7 percent below the June 2008 level. Sawmills shipped 4.2 million cubic meters of lumber in June, up 12.7 percent from May.[25]

Europe: Although the 16-country Euro Area (EA16) remains in recession, several member states – most importantly Germany, France and Greece – have begun to expand.[26] However, at 9.5 percent in July, the unemployment rate is essentially on par with the United States, and provides one indication of the headwinds the EA16 economy will face when attempting to gain strength. Rising unemployment damped retail sales for a fifteenth month in August,[27] and contributed to the slowest pace of growth in loans to households and companies since records began in 1991.[28]

Asia: Japan's economy grew 0.9 percent (3.7 percent annualized) in real terms in the April-to-June quarter from the previous quarter, boosted by exports and private spending.[28] That was the first quarter of growth in over a year. But the nascent recovery was dealt a blow when exports fell in July by 36.5 percent from a year earlier – steeper than June's 35.7 percent drop.[30] "The

U.S. hasn't quite recovered, and China's economy looks somewhat shaky too," said Junko Nishioka, chief economist at RBS Securities Japan Ltd. Exports appear to have also been eroded by the yen's advance against the dollar, as a stronger yen cuts into exporters' profits when they are repatriated back into local currency.[31]

Although Japan's GDP has been flirting with expansion, the employment picture remains grim. The national jobless rate hit 5.7 percent last month, overtaking the previous postwar record of 5.5 percent set back in April 2003. Other numbers painted a similarly bleak picture; for example, the ratio of job offers to job seekers also hit the worst on record. Wholesale prices fell 8.5 percent in July,[32] and the core consumer price index dropped 2.2 percent.[33] Despite the gloomy figures, analysts think there are signs that suffering in the labor market may have finally bottomed, and that Japan may be on the mend. The ranks of the unemployed grew at a slower rate, while the number of those seeking work grew by a seasonally adjusted 150,000 on month. "It is a well documented phenomenon that in the initial phase of an economic recovery, people who had previously suspended their job search come back to the job market, resulting in an increase in the labor force population and consequently a higher unemployment rate," remarked Credit Suisse analysts headed by Hiromichi Shirakawa in Tokyo. Another encouraging sign includes the Nomura/JMMA Manufacturing purchasing managers index (PMI), which hit a seasonally adjusted 53.6 in August (up from July's 50.4) – the highest level since November 2006. A value above 50 indicates manufacturing is expanding.[34]

China's manufacturing PMI posted its sixth consecutive month above 50 in August, rising to 54 from 53.3 in July.[6] Some industries (e.g., steel and cement) have become sufficiently "overheated" that the government is contemplating curbs on overcapacity; policy makers seek to rein in investment growth fueled by a record credit expansion earlier this year. The restrictions are "good over the long term for these industries, which have real serious surpluses," said David Fang, a director with the China Coal Transport and Distribution Association in Beijing. Steel mills, for example, have capacity to produce 660 million metric tons each year, but there's demand for only 470 million tons. The government "tolerated" overcapacity in the first half of the year as they "urgently needed an economic recovery amid the global recession," he said. "China is trying to move its focus from investment to stimulating domestic consumption," said Jeffrey Tan, head of research at HNA Futures Ltd. in Shanghai. "The clear recovery in the United States and Europe has made it a good time now for China to make structural changes."[35]

China continues to expand the influence of its currency (the yuan/renminbi) in the international arena. According to a recent article in the *South China Morning Post*, "Vice-Premier Wang Qishan has been put in charge of a task force to make the renminbi (yuan) a currency for international trade. The recession has encouraged Chinese officials to speed up the currency program. As the downturn erodes U.S. influence, China is losing faith in the dollar and sees the time coming for the renminbi to become a major world currency….The renminbi is not convertible for purely financial purposes, ruling it out as a reserve currency for now, but China has started to carve out a bigger international role for it, beginning with the currency swap agreements China has put in place."[36] Speaking of currency swaps, Thailand is the latest country to study a possible currency swap agreement with China that would make it easier for exporters to settle some of their trade in yuan and baht, although the process has not yet progressed to the formal-discussion stage. Like many other countries, Thailand has been diversifying from U.S. dollar assets in its reserves during the past few years, according to Bank of Thailand Deputy Governor Atchana Waiquamdee.[37]

U.S. Treasury security purchases rose in June (Figure 15) even though China reduced its net holdings 3.1 percent (to $776.4 billion). Although China, the biggest holder of U.S. Treasuries, sold *short-term* U.S. bills in June, it reversed recent behavior by subsequently rotating into longer-dated maturities.[38]

<u>United States</u>: With the U.S. dollar now yielding "almost zero return"[39] and perceptions the global economic crunch is easing, the dollar is weakening as investors renew their appetite for riskier assets (e.g., commodities). Also, the central banks of "commodity cur-

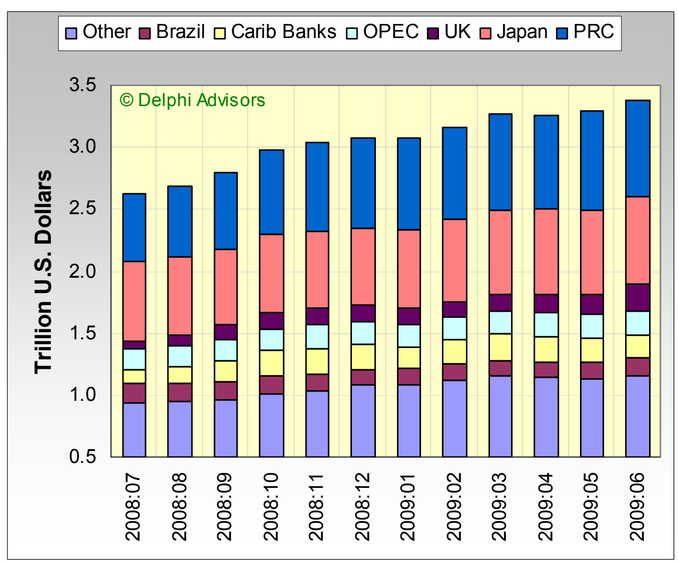

***Figure 15*. Foreign holders of U.S. Treasury securities. Source: U.S. Treasury Department**

rency" countries have already raised – or soon will – their respective interest rates; expectations surrounding possible expanding interest rate differentials are also making the greenback less attractive. "We don't like currencies in countries that we think will have low rates for a good long time, such as the United States, Switzerland and Japan," said Steven Englander, head of foreign exchange for the United States at Barclays Capital.[40]

The build up of the U.S. federal deficit (Figure 16), debt and "the boiling up of the [Federal Reserve's] balance sheet" is cause for anxiety, Nobel Prize-winning economist Joseph Stiglitz said.[39] "The massive amounts of U.S. dollar liquidity produced in response to the crisis" have helped reduce demand for the currency, agreed Curtis Mewbourne, a Pimco portfolio manager. "While we have not yet reached the point where a new global reserve currency will arise, we are clearly seeing a loss of status for the U.S. dollar as a store of value even in the absence of a single viable alternative," Mewbourne added.[41]

New York Federal Reserve Bank President, William Dudley, appears unperturbed that the Fed's balance sheet is endangering the dollar's reserve-currency status. Nor does he think this will contribute to future inflation problems. The Fed's lending programs have led to a large expansion in the reserves that banks keep at the central bank, but those reserves can be drained from the system before leading to an increase in lending and worsening inflation, Dudley said. "My view is we have tools to manage our balance sheet so we're not going to have…a bad inflation outcome." With the Fed's ability to pay interest on excess reserves, the banks just take the excess reserves to the Fed, [and] get paid interest. They don't lend them out. So you don't get that cycle of the excess reserves leading to a credit boom and an overheated economy." Dudley said the Fed is "far along" in its planning for an exit from the extraordinary policy actions of the past year. Along with paying interest on excess reserves, the central bank may also do reverse repurchase agreements, lending securities into the market in exchange for cash, and create special interest-bearing accounts at the Fed for banks to deposit their excess reserves. The Fed is making money on its lending, he said. "The excess reserves are funding the purchase of Treasuries, and agency debt and agency mortgage-backed securities," Dudley said. "Now, we're essentially borrowing the money at 0.25 percent, and investing in assets that are yielding 3, 2.5, 4, 4.5 percent." That does create a rate mismatch, he said, "because the liabilities, the interest on excess reserves are overnight, and the assets we're buying are longer-term, so we do have a bit of an interest rate mismatch, in the sense that if short-term interest rates went up dramatically, then the earnings would not be as favorable."[42]

Therein lies the "rub," at least in our opinion. While the excess reserves that banks have deposited with the Fed may be successfully drained before spawning inflation (and we contend that's an unlikely assumption), the U.S. government has allowed other trillions of dollars to "go viral" in the broader economy through its various stimulus programs. Most of those stimulus funds originated in the form of debt issuance. And there appears to be more of the same to come – perhaps as much as $5.4 trillion – worldwide during this fiscal year (Figure 17). All of that debt creation means competition for capital is likely to

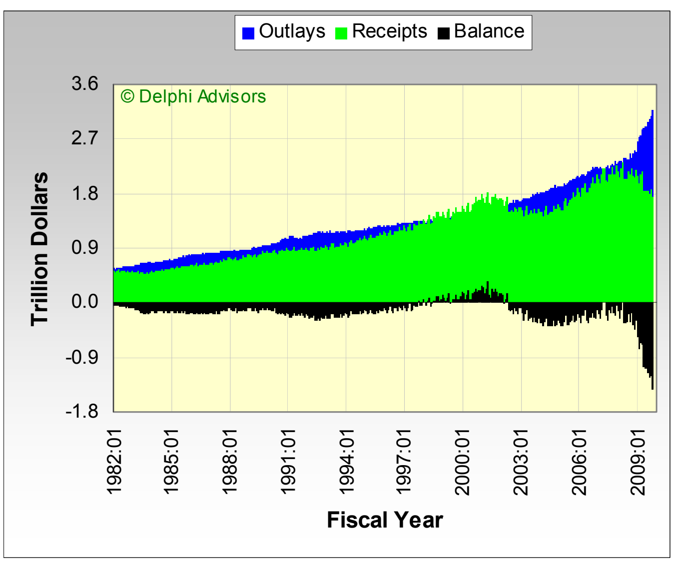

***Figure 16*. Rolling 10-month sum of federal receipts and outlays, and resulting balances. Note that month one of a fiscal year corresponds to October of the prior calendar year. Source: U.S. Treasury Department**

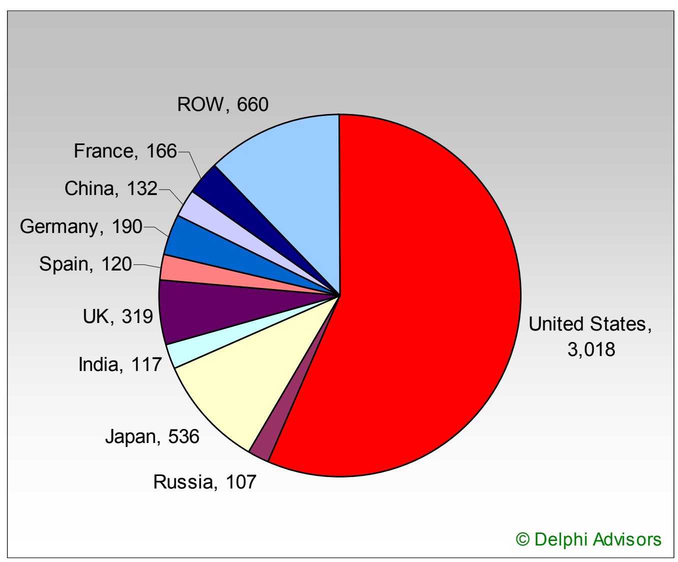

***Figure 17*. Projected government debt issuance during fiscal year 2009 (billion U.S. dollars). Source: Hayman Capital via Eternal Value Review[44]**

intensify – not only among governments but also between the public and private sectors. Market forces will eventually push interest rates higher despite the Fed's increasingly futile attempts to support the U.S. economy by keeping interest rates in check.[43] If demand at U.S. Treasury auctions falls off, bond prices will fall – which will increase the interest rate on the bond. The Treasury can improve demand for its bonds by offering higher yields but that defeats the purpose of keeping interest rates low to support the economy.

For one of the clearest expositions of how monetary injections by the banking system affect not only the general price level but the structure of the economy itself, please read the article by Steve Saville linked below.*

A rising stock market appears to be giving the public the impression that all is well in the financial sector. We think, however, that the behavior of the various stock indexes is more a symptom of cash chasing returns than a healthy economy.[45-47] In fact, one could argue that the rising equity markets are an early manifestation of inflation in the U.S. economy, precipitated by the Fed's policy of quantitative easing.[48] Considerable problems remain in the financial sector; for example, Elizabeth Warren, head of the Congressional Oversight Committee, says most of the toxic assets former Treasury Secretary Henry Paulson convinced Congress to give him $700 billion to buy are still on the banks' books. "The first $350 billion went directly into the banks for stock and warrants," Warren told MSNBC. "This was the 'don't ask, don't tell' money. We didn't ask how they were going to spend it and they didn't tell us." Recent tweaks in mark-to-market accounting rules that allow banks to carry toxic assets on their book at higher than market values have made banks want to hold onto those assets. Selling them at actual values means banks would have to recognize their losses – and many would be put out of business. Warren also warned (citing Deutsche Bank) that default rates on the commercial mortgages coming due between 2010 and 2012 may be as high as 60 percent. "The bottom line: defaults are exploding," says Deutsche Bank analyst Richard Parkus. "It's terrible. It's going to be worse than in the early 1990s."[49]

Of even greater magnitude than just defaulting commercial mortgages is the problem of nonperforming loans (a term for commercial and consumer debt that has stopped collecting interest or will no longer be paid in full). More than 150 publicly traded U.S. lenders own nonperforming loans that equal 5 percent or more of their holdings,[49, 50] a level that regulators say can wipe out a bank's equity and threaten its survival. The number of banks exceeding the threshold more than doubled in the year through June, according to data compiled by *Bloomberg*, as real estate and credit-card defaults surged. Almost 300 reported 3 percent or more of their loans were nonperforming.[52] "At a 3 percent level, I'd be concerned that there's some underlying issue, and if they're at 5 percent, chances are regulators have them classified as being in unsafe and unsound condition," said Walter Mix, former commissioner of the California Department of Financial Institutions. "At the 5 percent range, you're probably hurting," said William Black, an associate professor of economics and law at the University of Missouri-Kansas City. "Once it gets around 10 percent, you're likely toast."

Missed payments by consumers, builders and small businesses pushed 89 lenders into failure this year, as of 4 September.[53] More collapses may lie ahead as the recession causes increased defaults and swells the confidential U.S. list of "troubled" banks, which stood at 416 at the end of June.[54] The Federal Deposit Insurance Corporation (FDIC) is expected to levy an additional special assessment on banks (on top of the five cents per $100 of assets imposed back in May) to boost its dwindling insurance fund by $5.6 billion.[55] The rescue fund has fallen to 0.22 percent of insured deposits; Congress requires it to remain above 1.15 percent. Many speculate the real reason the Fed doesn't want its books audited is not that it fears hampering competition but, rather, "it is scared to death" doing so would trigger runs on those troubled banks. "If the Fed is required to publish the names of financial institutions to which it has extended credit and this publication induces financial institutions to refrain from borrowing from the Fed, one can only speculate if this would be the tinder for another liquidity conflagration in the coming months," observed Paul Kasriel, of Northern Trust.[56]

The banking system isn't the only source of credit experiencing problems; so, too, is the commercial paper (CP) market. The CP market is essentially a private debt market used by corporations as a cheaper means of funding typical recurring operations than drawing on a line of bank credit. As Figure 18 (p. 13) shows, the CP market fell off a cliff in the wake of the first credit crunch in August 2007; although subsequently contracting at a slower pace, the downward pace has accelerated in recent months – calling into question claims by many economists that the credit crunch has passed.[57] The value of commercial paper outstanding in August was 35 percent below the year-previous level, and 47 percent less than the July 2007 peak. Anecdotal accounts indicate this behavior is more a case of parties either unwilling or unable to lend, not companies being unwilling to borrow.[58]

* http://www.caseyresearch.com/displayCdd.php?id=214

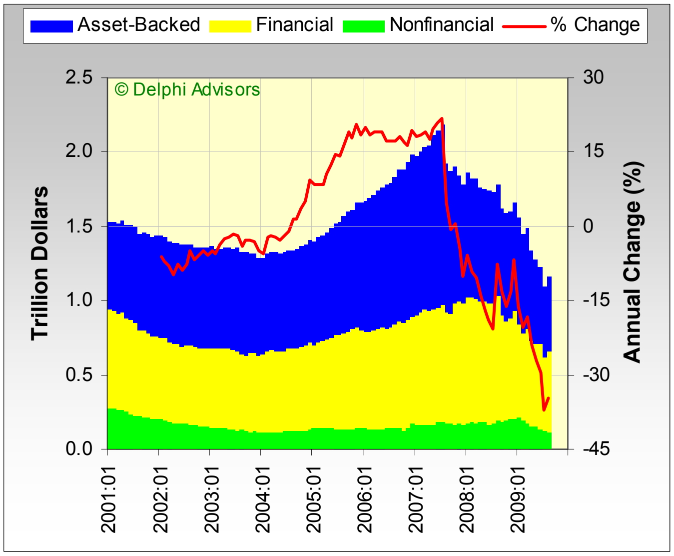

***Figure 18*. Components of total monthly value of commercial paper outstanding versus annual percentage change in total value outstanding. Source: Federal Reserve Board**

Construction. Construction spending during July 2009 was estimated at a seasonally adjusted annual rate (SAAR) of $958 billion, 0.2 percent below the revised June estimate of $960 billion (Figure 19). The July figure is 10.5 percent below the year-earlier estimate of $1.1 trillion. During the first seven months of this year, construction spending amounted to $544 billion (not annualized), 11.4 percent below the $614 billion for the same period in 2008.[59]

Spending on private construction rose by 0.1 percent (to $630 billion SAAR) in July. Residential construction increased by 2.3 percent (to $246 billion), while non-

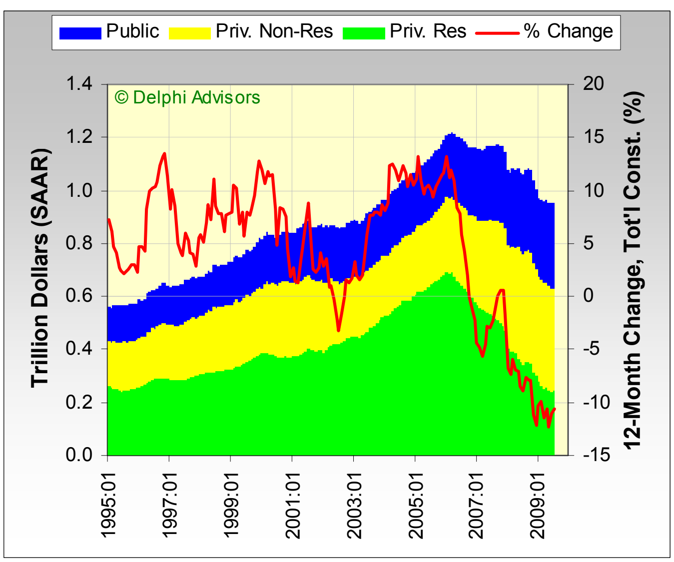

***Figure 19*. Total value of construction (public, private non-residential and private residential) put in place versus percentage change from prior 12 months in value of total construction. Source: Census Bureau**

***Table 5*. Overview of most-recently available housing market conditions, and comparisons to prior month, prior year, and each category's respective peak. Source: Census Bureau and National Association of Realtors**

	2009:07	2009:06	2008:07	Peak
Activity (SAAR, Thous.)				
New Homes		-------- *Change (%)* --------		
Permits				
1-unit	463	6.9	-19.5	-74.2
All units	564	-1.1	-39.0	-75.1
Starts				
1-unit	490	1.7	-22.5	-73.1
All units	581	-1.0	-37.7	-74.4
Completions				
1-unit	491	-4.1	-40.6	-74.3
All units	802	-0.9	-26.4	-64.3
Sales (1-unit)	433	9.6	-13.4	-68.8
Existing Homes				
Sales (All units)	5,240	7.2	5.0	-27.7
Inventory		-------------- *Thousands* ---------------		
New (1-unit)	271	280	419	572
Existing (All units)	4,091	3,811	4,575	4,575
		----------------- *Months* -----------------		
New (1-unit)	7.5	8.5	10.1	12.4
Existing (All units)	9.4	9.4	11.0	11.3
Median Price (Thous. $)		------- *Change (%)* --------		
New (1-unit)	210.1	-0.1	-11.5	-20.0
Existing (All units)	178.4	-2.0	-15.1	-22.5

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residential retreated by 1.2 percent (to $385 billion). Public construction spending also decreased by 0.7 percent (to $328 billion SAAR).

American builders broke ground on more single-family homes in July for a fifth straight month, an indication the housing industry may be stabilizing. Work began on single-family dwellings at a 490,000 annual pace, up 1.7 percent from June. Total housing starts unexpectedly fell, however, depressed by a 13 percent decrease in multifamily units (Table 5 and Figure 20, p.14).

Single-family completions dropped 4.9 percent (to 491,000 SAAR), while comparable new-home sales increased 9.6 percent (to a 433,000 annual pace) in July (Table 5 and Figure 21, p. 14). Although completions were ostensibly greater than sales, the number of houses on the market dropped to 271,000, a 7.5-month supply at the current sales pace. This seeming logical inconsistency is explained by realizing completions and sales are tallied using different methodologies: Completions (like starts) are tallied irrespective of the circumstances under which the homes are built whereas sales are tallied only for houses constructed on a speculative basis by builders. If one reduces single-family completions in Table 5 by 300,000 to exclude owner-built and contract homes, sales exceeded "speculative" completions.

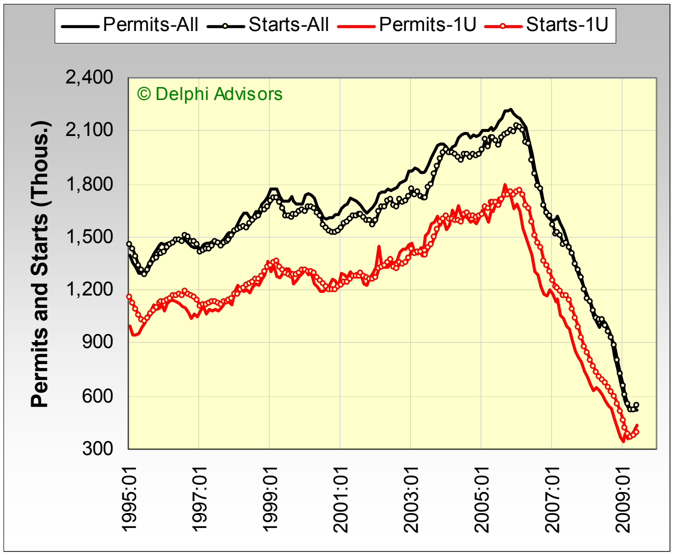


***Figure 20*. Moving averages of new, single- and multi-unit housing starts versus permits; data are seasonally adjusted and annualized. Source: Census Bureau**

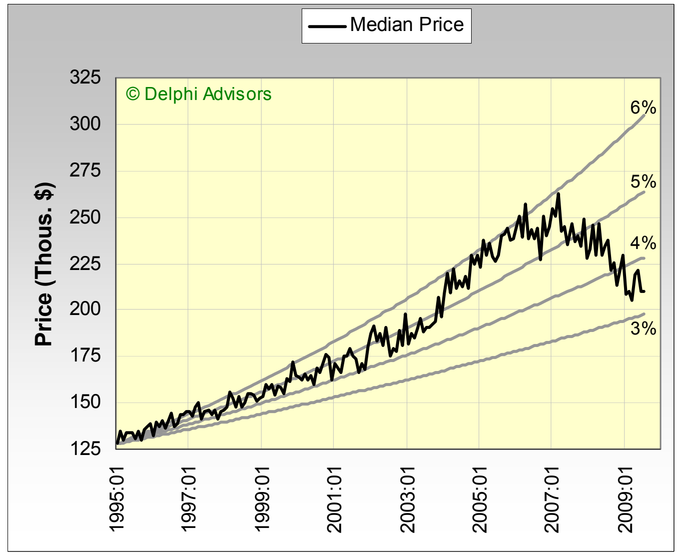


***Figure 22*. Median price of new, single-unit homes versus various compound annual growth rates. Source: Census Bureau**

The median new-home price dropped 0.1 percent between June and July, to $210,100 (Table 5, p. 13 and Figure 22). The latest figure is 20 percent below the March 2007 peak of $262,600. The annual appreciation rate of new-home prices (relative to January 1995) has retreated to a 3.4 percent rate, well below the most recent peak rate of 6.2 percent set in April 2006.

Existing home sales climbed 7.2 percent (to 5.24 million SAAR), the most since August 2007. The gain was the biggest since records began in 1999. The median price of all existing housing types fell by 2 percent between June and July, to $178,400 (the median price was

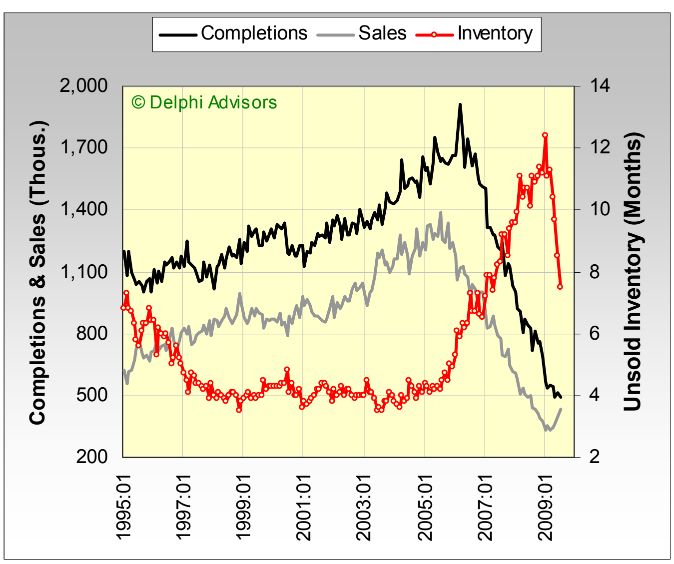


***Figure 21*. New, single-unit housing completions and sales versus unsold inventory expressed as the number of months required to clear the market; data are seasonally adjusted and annualized. Source: Census Bureau**

$178,300 for single-family homes and $178,800 for condos); even so, affordability was little changed (Figure 23, p. 15). The unsold inventory of existing homes rose to almost 4.1 million in July (from 3.8 million in June), but the months of inventory remained unchanged at 9.4 months due to the July increase in the pace of home sales (Table 5).[60] "The housing market has decisively turned for the better," said Lawrence Yun, chief economist at the National Association of Realtors (NAR). "A combination of first-time buyers taking advantage of the housing stimulus tax credit and greatly improved affordability conditions are contributing to higher sales." First-time buyers purchased 30 percent of homes in July, and distressed homes accounted for 31 percent of transactions. "In addition to first-time buyers, we're also seeing increased activity by repeat buyers," said NAR President Charles McMillan. "While many entry-level buyers are focused on the discounted prices of distressed homes, they're also freeing some existing owners to sell and make a move."

Prices of single-family homes in 20 major cities rose a seasonally unadjusted 1.4 percent in June, the second increase in a row after falling every month for three years, according to the S&P/Case-Shiller home-price index; the 10-city index rose 0.4 percent (Figure 23).[61] "For the second month in a row, we're seeing some positive signs," said David Blitzer, chair of the Index Committee at Standard & Poor's. "The U.S. National Composite rose in the second quarter compared to the first quarter of 2009. This is the first time we have seen a positive quarter-over-quarter [change] in three years. Both the 10- and 20-city composites posted monthly increases, as did most of the cities. As seen in both sea-

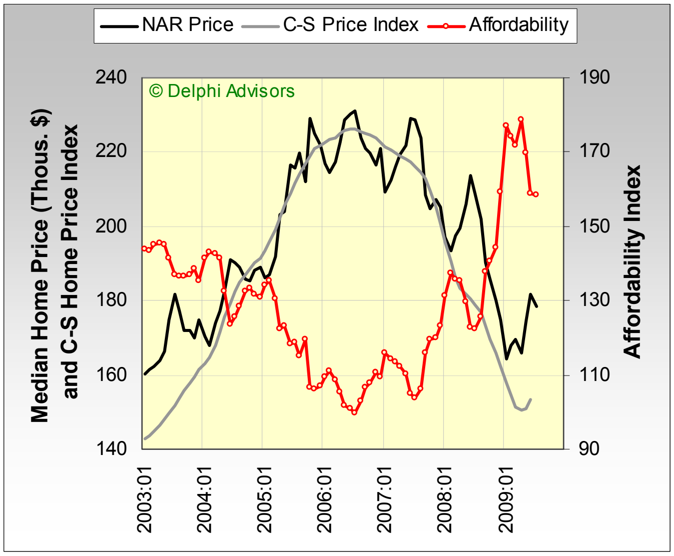


***Figure 23*. NAR median existing home price and Case-Shiller 10-city home price index versus NAR housing affordability index. Sources: National Association of Realtors and Standard & Poor's**

sonally adjusted and unadjusted data, as well as the charts, there are hints of an upward turn from a bottom. However, some of the hardest hit cities, especially in the Sun Belt, show continued weakness."

In a related note, Freddie Mac announced that its Conventional Mortgage Home Price Index (CMHPI) Purchase-Only Series registered a 1.7 percent quarterly gain (7.0 percent annualized) during 2Q2009 for the United States, following a downwardly revised 1.5 percent drop (–5.9 percent annualized) in the first quarter. Year-to-date through 2Q2009, U.S. home sales prices fell 6.7 percent in the CMHPI Purchase-Only Series – less than the 8.5 percent annual decline recorded between 1Q2008 and 1Q2009. "The pickup in home price growth rates is consistent with other housing market indicators that show home sales and single-family construction up in the second quarter," said Frank Nothaft, Freddie Mac vice president and chief economist. "The lowest mortgage rates in a half-century have pushed housing affordability to the highest level in at least 40 years, helping to encourage buying. The spring is generally the strongest buying season each year, and we normally see home price growth respond similarly – this year was no exception. Moreover, the price gains were broad-based and for the first time in two years average home sales values rose at least a little bit in every region."[62]

Despite these promising signs of a long-awaited turn in the housing market, some troubling issues indicate we are not yet entirely out of the woods. Mortgages either in foreclosure or with at least one payment past due hit 13.2 percent in 2Q2009, the highest percentage ever recorded by the Mortgage Bankers Association (MBA). The delinquency rate for mortgages on one- to four-unit properties rose to a seasonally adjusted 9.2 percent of all mortgage loans outstanding in the second quarter, up from 9.1 percent in the previous quarter. Mortgages somewhere in the foreclosure process reached 4.3 percent of all mortgages, up from 3.8 percent in the first quarter, the MBA said. "While the rate of new foreclosures *started* was essentially unchanged from last quarter's record high," said Jay Brinkman, MBA's chief economist, "there was a major drop in foreclosures on subprime [adjustable-rate mortgage (ARM)] loans. The drop, however, was offset by increases in the foreclosure rates on the other types of loans, with prime fixed-rate loans having the biggest increase. As a sign that mortgage performance is once again being driven by unemployment, prime fixed-rate loans now account for one in three foreclosure starts. A year ago they accounted for one in five. While 41 states had increases in the foreclosure start rate for prime fixed-rate loans, 43 states had decreases in that rate for subprime ARM loans."[63, 64]

U.S. loan demand fell 2Q2009 for every major category except prime residential mortgages as banks tightened credit standards and borrowers remained cautious. In its quarterly survey of senior loan officers,[65] conducted between 14 and 28 July, the Federal Reserve said the percentage of banks that tightened loan standards for business and households was slightly lower than in the first quarter. But the majority of institutions maintained previously tightened standards, while virtually none eased standards when compared to the previous three months. The Fed has pumped hundreds of billions of dollars in liquidity and lending support into financial markets in the past year, in addition to more than $200 billion in direct capital injections from the U.S. Treasury; but that extra liquidity has done little to spur demand for loans. Prime mortgages were the only major category to show an improvement in loan demand, but the rate of increase also slowed from April, when interest rates were lower.[66]

Energy. The monthly average price of West Texas Intermediate crude oil rose by $6.97 (11 percent) in August, to $71.06 per barrel (Figure 24). Although at least some of the price rise can be attributed to a weakened U.S. dollar, we suspect the lagged impact of the June uptick in demand (Figure 25) – which helped bring oil stocks closer to the upper end of the five year average range (Figure 26) – and renewed speculation in commodities also played a part.

There have been a number of developments in the energy realm during the past month. The following bullet points were taken from the 7 September *Peak Oil Review*,[67] with support from other sources where indicated:

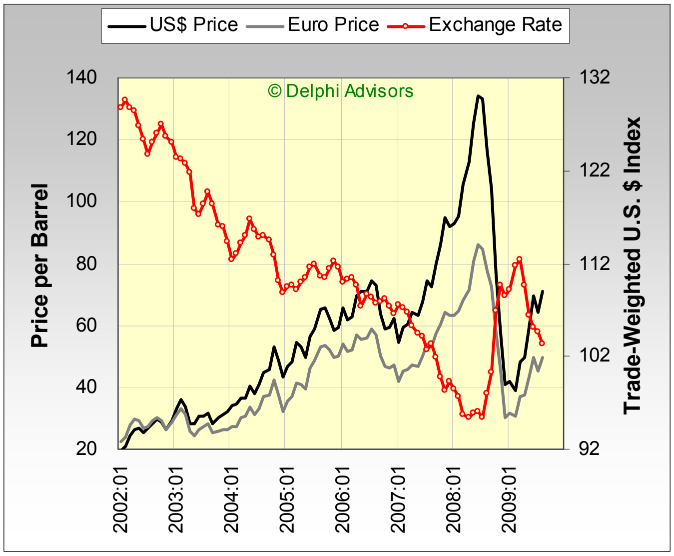


***Figure 24*. Monthly average West Texas Intermediate crude oil price expressed in U.S. dollars and euros, verses monthly traded-weighted U.S.-dollar exchange rate index. Sources: Dow Jones & Co. and Federal Reserve Board.**

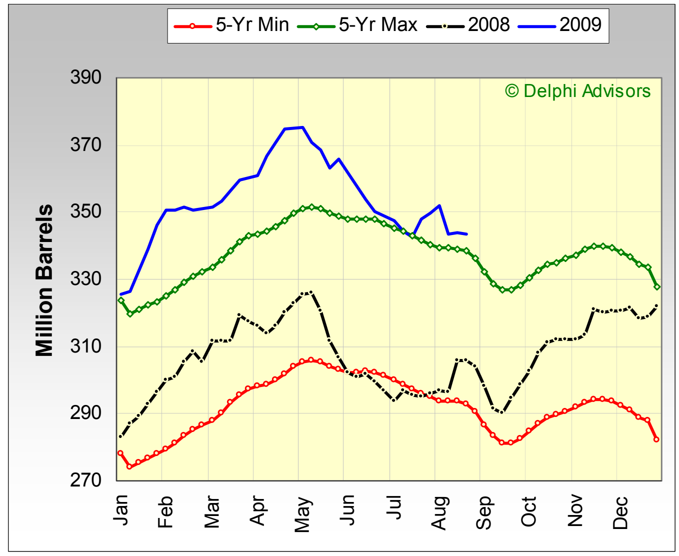


***Figure 26*. Current- and prior-year weekly U.S. crude oil stocks versus average minima and maxima of previous five years (Strategic Petroleum Reserve excluded). Source: U.S. Energy Information Administration**

- Oil prices have been trying to balance a sharp sell-off in the Chinese stock market, reports of weak U.S. demand for oil and increasing U.S. unemployment, a falling greenback, and possible restrictions on commodity speculation. Market analysts are starting to talk about oil prices dropping further in the near future since the economic recovery is not shaping up to be as strong as anticipated, demand for oil continues weak, and distillate stockpiles continue to build.

- OPEC production cutbacks have slipped to 68 percent of cuts agreed on last winter. So long as oil prices remain in the vicinity of $70 a barrel, OPEC members have little incentive to comply.

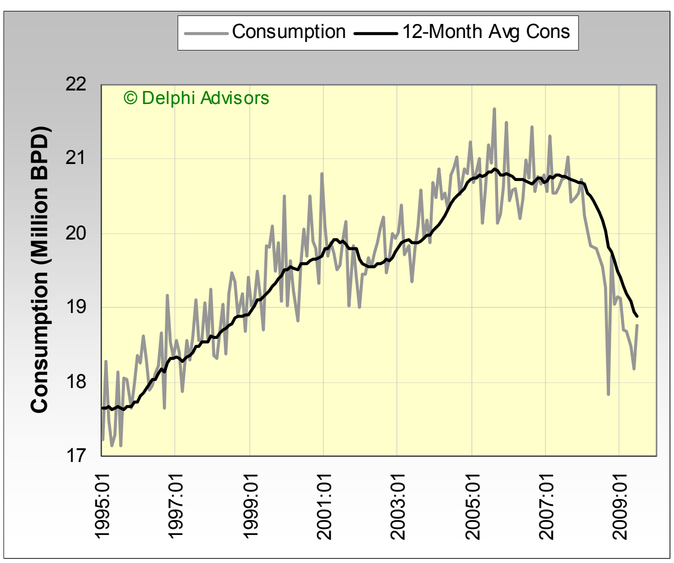


***Figure 25*. U.S. consumption (monthly and 12-month moving average) of total crude oil and petroleum products, in million barrels per day (BPD). Source: U.S. Energy Information Administration**

- A number of European refiners are shutting down their plants for extended repairs in an effort to help ease the glut of oil products. British oil production in the North Sea may drop as smaller producers are unable to get financing for projects. The Norwegians say their production will drop to 1.6 million b/d by 2013 after averaging as much as 3.1 million b/d in 2000. In the last two weeks, three of the top world producers – Russia, Mexico, and Norway – have warned that their production will decline faster than expected in the next few years.

- BP announced on 2 September that it had made a "giant" oil field discovery called Tiber, 35,000 feet beneath the surface of the Gulf of Mexico.[68] BP did not announce the size of the find, but said it was comparable to other discoveries in the area, leading to press speculation that the Tiber find was on the order of one to three billion barrels. Initially the announcement that oil could be found so far below the surface was greeted with much enthusiasm, and some stories suggested that a new era of finding oil was at hand and that exploration in the Gulf would revive. Reality set in a day later, however, as reporters learned that it was likely to take 10 years of difficult and expensive drilling before any oil could be produced. Even then, less than a third of the oil – and possibly as little as 5 to 15 percent – can be recovered.

- Beijing has discovered that it has a near monopoly on rare earths, such as dysprosium, that are needed for building advanced electromagnets used in green technologies. Last week China clamped export quotas on the 17 rare earths. The draft policy would completely ban the export of dysprosium, terbium, thulium, lutetium and yttrium. The export ban plus a 42 percent export duty would force manufacturers to produce many advanced products in China. At week's end there were indications that Beijing was modifying its stance in face of a worldwide outcry.

John Stossel, co-anchor of ABC's news show "20/20," has been highly dubious of the government's "cash for clunkers" program. Among his criticisms is the argument that proponents look at only the first-order (i.e., immediate and most visible) effects:[69]

> "The government paid car owners to trade in their old cars, which will be destroyed. But the government is running a deficit. So it doesn't have $3 billion to hand out. It must borrow the money, which reduces the amount of money for other investments. Moreover, the government must raise taxes in the future to pay back the principal and interest – or the Federal Reserve will monetize the debt through inflation. Either way, we pay.
>
> "That isn't all. Those car buyers were either going to trade in their used cars soon or they weren't. If they were, Cash for Clunkers simply moved up the schedule. The stimulation of the auto industry occurred earlier. Big deal. But if buyers planned to keep their cars longer, the program imposed costs that are less visible.
>
> "Without the government incentive to buy cars, consumers would have bought other things – computers, washing machines, televisions. The manufacturers and sellers of those products didn't get to make those sales. Why should the auto industry get privileges at the expense of others?
>
> "Then there are the mechanics who would have serviced those used cars. They've lost business. Some will be laid off. Nor should we forget low-income people who depend on the used-car market for their transportation. The cheap cars they would have bought were destroyed."

Using research from economist Christopher Knittel, Stossel pointed out the "cash for clunkers" program will cost more than $365 per ton of carbon saved. The Waxman-Markey cap-and-trade carbon-emission control legislation, by comparison, estimates the cost of reducing a ton of carbon to be $28 across U.S. industries.

On a different note, the perceived need to cope with climate change is fueling a desire to make climate forecasts as common as weather forecasts. Jane Lubchenco, head of the National Oceanic and Atmosphere Administration (NOAA), said the world needs better ways to share information about climate change. "We're seeing now a convergence between what users are beginning to ask for and the ability of the scientific community to provide something on a scale and in a fashion that is relevant to what the users need." Predicting climate – i.e., forecasting general weather patterns over a period of months or years – will help countries adapt to climate change that will happen because of greenhouse gases already in the atmosphere regardless of any future agreements to limit carbon emissions. "You get a weather forecast and people count on it because they take action on it," said Thomas Karl, director of NOAA's National Climate Data Center. "We want to do the same thing for climate services." While weather forecasts predict temperature characteristics for a certain day, climate forecasts will tend to say things like 'August will have an 80 percent likelihood of a very severe heat wave.'[70]

The United States is prepared to provide up to $10 billion in loans to finance the development of hydrocarbon reserves off Brazil's coast. General James Jones, President Obama's national security adviser, said the U.S. Export-Import Bank already has signed a letter of intent with Brazilian state oil company Petrobras. Brazil can repay the loan facility with oil as opposed to cash.[71]

PetroChina International Investment Co. Ltd. has struck a deal to buy a 60 percent interest in Athabasca Oil Sands Corp.'s (AOSC) northern Alberta MacKay River and Dover projects for C$1.9 billion and other financing arrangements. The purchase of those two projects doesn't give PetroChina control over the entire privately held AOSC, but rather roughly three billion of the 10 billion barrels of recoverable bitumen – a tar-like mix of crude and sand that is processed into useable products such as gasoline and jet fuel – the Calgary-based company owns. "China's strategy is to take bite-sized portions initially to get an understanding of [Canada's] business practices… [and] to give the government a sense China will be a good corporate citizen," said Mike Percy, dean of University of Alberta School of Business. "By taking over a private company, it gives you the platform to demonstrate you respect existing rules and regulations."[72]

One news item that hasn't caught the press attention it may deserve is a report[73] (some dismiss it as mere rumor[74]) that Chinese state-owned companies will be allowed to default on commodity derivative contracts. In other words, if those enterprises bet wrong on commodity prices, for example, they could walk away from those contracts without having to pay the price of their errors. It appears state-owned enterprises in China feel they were misled when trying to protect themselves against skyrocketing oil prices (just before prices crashed at the end of 2008) and now want to terminate the associated derivatives contracts. Investment banks are understandably upset about this development, as it has the potential to topple the entire derivatives market (which some estimate exceeds $700 trillion worldwide[75]). A very in-depth analysis of this unfolding story is available at *The Fundamental View*.[76]

Macroeconomic forecast summary

Manufacturing: New factory orders can provide a forecast of potential future manufacturing activity. As Figure 27 shows, factory orders rose by 1.3 percent in July – the fourth consecutive month of increases. Orders for durable goods increased 5.1 percent, but nondurable goods orders fell 1.9 percent – the sharpest decline since last December.[77] Much of the support for durable goods derived from orders for aircraft. Excluding aircraft, nondefense capital goods (a.k.a., "core") orders fell 0.3 percent in July.

Despite its implementation[78] drawbacks, the Obama administration's $3 billion "cash for clunkers" initiative boosted auto sales by almost 700,000 units, according to the Transportation Department. If true, it means car manufacturers could soon see orders to restock depleted inventories, giving related industries a jolt in the process. "We have modest growth in demand in an environment of depleted inventories, and that will coax new output," said David Resler, chief economist at Nomura Securities International Inc. Improving conditions for manufacturers "will hopefully generate smaller declines in jobs in this sector." The White House Council of Economic Advisers estimates the initiative will boost U.S. 3Q2009 GDP by 0.3 to 0.4 percentage point and create 42,000 jobs by the end of 2009.[79, 80]

Interest and currency exchange rates: Canada's index of leading economic indicators advanced 0.4 percent in July – the first increase in 11 months – led by gains in stock prices and housing and a rise in durable goods sales (Figure 28).[81] The country's Financial Conditions Index is also well into positive territory.[82]

Those numbers and the results of the Bank of Canada's (BOC) summer survey of businesses signal the Canadian economy could begin expanding within the next few months. The BOC's survey found that:[83]

- Businesses foresee an improvement in the economic outlook. In particular, the balances of opinion on both future sales and employment have turned positive. Nevertheless, firms expect their activity to recover only gradually, and they continue to be cautious regarding investment.

- Pressures on production capacity remain quite low. Overall, firms still expect input and output prices to grow at a slower pace over the next 12 months. Expectations for inflation over the next two years have increased and have moved back within the Bank's target range as fewer respondents expect inflation to be below 1 percent.

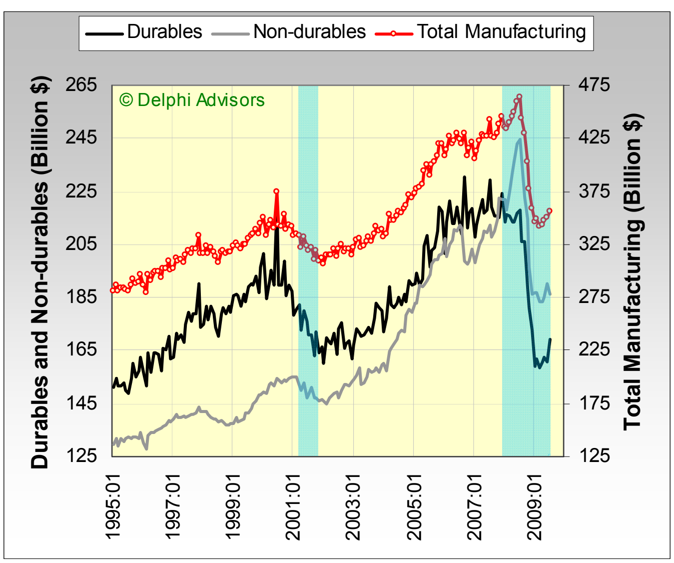


***Figure 27*. Seasonally adjusted value of new orders, by sector; recessions shown in blue. Sources: Census Bureau and National Bureau of Economic Research**

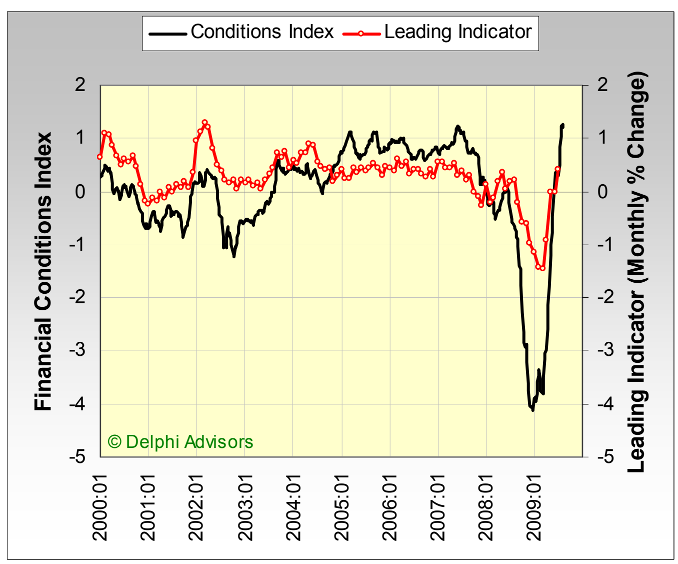


***Figure 28*. Canada's financial conditions index versus monthly percentage change in the composite leading indicator. Sources: Bank of Canada and Statistics Canada (Table 377-0003)**

- Although the balance of opinion still indicates tightening credit conditions, fewer firms reported tightening than in recent surveys.

We anticipate that generally rising oil prices (see our oil price forecast in Table 1 on p. 2), in response to increasing global demand, will strengthen the Canadian dollar. PetroChina's C$1.9 billion investment in two Alberta oil sand projects (described on p. 17) will likely require a substantial purchase of loonies to consumate the deal; that currency conversion will also provide a modicum of support to the Canadian dollar. The loonie could receive some medium-term support if, as Societe Generale expects, the BOC raises interest rates in 2H2010; that may seem like a long time to wait, but most analysts think the United States, Europe and Japan would prefer to keep rates unchanged until 2011 or later.[40] Should Canada be among the first countries to raise interest rates, the loonie will gain against the greenback.

The loonie's value could prove to be Canada's "Achilles' heel," especially for forest products manufacturers. Prospects for Canadian OSB mills look particularly grim in the short term. The severe oversupply of OSB caused prices to remain at or below cash costs for much of the last 12 months. The strong Canadian dollar and higher transportation costs to market are two of the main reasons higher-cost Canadian OSB mills account for some 70 percent of the OSB curtailments and closures to date.[84] Even so, not enough capacity has yet been closed to allow for a better supply/demand balance, and thus we expect much of the additional capacity that will be shuttered will be located in Canada.

The ZEW indicator of German investor confidence increased by 16.6 points in August; at 56.1 point, the highest reading in three years, the value is well above the indicator's historical average of 26.5 points. Positive 2Q2009 GDP growth and a repeated rise of incoming orders (albeit from a very low base[85]) and increasing exports have brightened the economic perspectives for Germany in the next months. "There is, however, no reason for euphoria," cautioned Wolfgang Franz, ZEW's president. "The German economy develops parallel to the world economy and should, hence, recover only gradually."[86] A parallel indicator that measures German business confidence also posted an increase for the fifth consecutive month in August.[87]

The Conference Board's leading economic indices (LEI) rose in July for the 16-nation Euro Area and its three largest individual economies. "Considering the strong performance of the LEIs for the Euro Area, Germany and France, the recent small gains in GDP in the latter two countries may extend to the Euro Area as a whole by the third quarter," said Jean-Claude Manini, the Board's senior economist for Europe. "Nonetheless, as current economic conditions are still weakening, it is too early to say that the Euro Area will experience a sustainable recovery anytime soon."[88]

Manini's cautionary note was echoed Axel Weber, Bundesbank president, who said that while he is "not yet convinced" the recovery can be sustained, third-quarter growth may be "better than [expected]."[89] Yves Mersch, a European Central Bank (ECB) Governing Council member, also feels the economic recovery in the euro zone is not sustainable because it depends on public funds and is not yet supported by private investment and new job creation. "There are two explanations proving why the current recovery cannot be sustainable," Mersch said, pointing to the depletion of inventories caused by very low capacity utilization and to fiscal and monetary stimulus that has been necessary to keep the economy going. "The danger of a renewed downturn is not yet over," he said, because of the possibilities of protectionism and financial nationalism.[90]

High and rising unemployment will likely be one of the main reasons for a slow recovery in the Euro Area economy. The European Commission projects unemployment will reach 11.5 percent in 2010 and that will weigh on household spending, said Conin Ellis, an economist at Daiwa Securities SMBC Europe Ltd. "The question remains what will act as a spur to growth once the fiscal stimulus measures abate."[27]

Axel Merk, chief investment officer at Merk Investments and manager of the Merk Hard Currency Fund, thinks the euro is likely to strengthen against the greenback despite shaky prospects for an EA16 recovery. That's partly because he anticipates the Fed will keep rates lower and money looser than its European counterpart in a bid to drive growth – even risking that low rates will stoke inflation. "The Fed wants to have inflation, wants to have the price level to go higher, whereas the ECB is highly concerned about inflation," Merk commented. "When you devalue the currency and push for inflation, you may get higher growth. The Europeans may not get growth, but the currency will be fairly strong because they will be tight."[40]

Although analysts' views on Japan's future are mixed, everyone seems to agree that exports are the key indicator. "We're unlikely to see a recovery in [Japanese] exports in the short term." said Junko Nishioka, chief economist at RBS Securities Japan Ltd.[91] "Exports may be losing momentum," agreed Nomura Securities economist Minoru Nogimori. "We will have to focus on new export orders increasingly as one of the most important indicators regarding the outlook for Japan's economy."[34] Of course, not everyone is convinced that a dire future is inevitable. Robust growth in China will support demand, according to Kyohei Morita, chief economist at Barclays Capital in Tokyo. China overtook the United States as Japan's largest overseas destination this year[92] and is also Japan's largest source of imports.[93]

China's economic growth may exceed 10 percent in 1Q2010, thanks to a "moderately loose" monetary policy," said Ba Shusong, deputy director of the Development Research Center, an affiliate of the nation's State Council. That policy will stay in place in the short term to ensure a "stable recovery." The research center believes the Chinese economy has already passed its worst period and can achieve 8 percent growth this year. Ba expects the government's next policy focus to encourage a shift in demand from the public to the private sector.[94]

Beijing was dismayed by the Fed's recourse to "credit easing," according to Cheng Siwei, head of China's green energy drive. "We hope there will be a change in monetary policy as soon as [the United States has] positive growth again," he said. "If they keep printing money to buy bonds it will lead to inflation, and after a year or two the dollar will fall hard. Most of our foreign reserves are in U.S. bonds and this is very difficult to change, so we will diversify incremental reserves into euros, yen, and other currencies." Mr. Cheng said the Fed's loose monetary policy was stoking an unstable asset boom in China. "If we raise interest rates, we will be flooded with hot money. We have to wait for [the Fed]. If they raise, we raise. Credit in China is too loose. We have a bubble in the housing market and in stocks so we have to be very careful, because this could fall down."[95] China is seeking some protection for its portfolio by agreeing to purchase $50 billion of bonds to be issued by the International Monetary Fund (IMF), the first such notes in the IMF's history. The global organization said the purchase agreement "offers China a safe investment instrument," and is part of a broader plan to help the IMF weather the economic downturn.[96]

According to a prominent currency trader, borrowing costs are now lower in U.S. dollars than in Japanese yen; he expects the greenback to become the new carry trade currency – which would put additional downward pressure on the dollar.[97] Mohamed El-Erian, the CEO of bond giant PIMCO, believes the greenback's value is ripe for a fall. "The question is not whether the dollar will weaken over time, but how it will weaken," said El-Erian. "The real risk is that you will get a disorderly decline." According to El-Erian, the euro will rise to $1.60 by the end of 2010 and the loonie will achieve near parity with the U.S. dollar.[98]

Billionaire Warren Buffett wrote in a *New York Times* commentary[99] that the dollar is under threat from the "monetary medicine" that has been pumped into the financial system. "Enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects," Buffett wrote. "For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself." The "greenback emissions" will swell the deficit to 13 percent of GDP this fiscal year, while net debt will increase to 56 percent of GDP, he added.

In the press release following its 12 August meeting, the Federal Open Market Committee (FOMC) promised to keep interest rates exceptionally low "for an extended period of time," even as it drew encouragement from the stronger economic outlook. "Economic activity is leveling out," the FOMC said. "Conditions in financial markets have improved further in recent weeks. Household spending has continued to show signs of stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing but are making progress in bringing inventory stocks into better alignment with sales." The Committee also said it would slow its purchases of long-term Treasurys and let the program die a natural death by the end of October, a decision that could send long-term yields higher. The Fed said slowing the pace of purchases would "promote a smooth transition in markets."[100, 101]

A *Bloomberg* article[102] pointed out that, following the last two recessions, the Fed waited for at least a year after the unemployment rate peaked, before raising rates. If the unemployment rate peaks in 2010 as many economists expect – and the Fed remains true to form, the implication is that it will resist raising interest rates until 2011. That decision may be taken out of their hands this time around, however, because of competition for limited capital relative to massive deficit spending around the globe and increasing demand for capital from the private sector as global economies recover. In the United States, another looming financing demand on the horizon is the need to refinance debt used in private equity merger and acquisition activity earlier in the decade. The Wall Street Journal, citing Standard and Poors, reports that $1.4 trillion of below investment-grade debt is coming due between now and 2014.[103] Available capital will have to be rationed between competing demands and that will be done through the market by driving interest rates higher whether or not the Federal Reserve elects to increase rates.

According to a survey of business economists the Federal Reserve will be unable to prevent the trillions of dollars in government stimulus pumped into the U.S. economy from stoking inflation over the next decade. The price gauge tracked by the central bank will rise 3 percent a year on average from 2014 through 2018, according to the median estimate in a poll taken by the National Association of Business Economics (NABE). The rate exceeds the 2 percent pace that the respondents said was the Fed's unofficial target. "An excessively stimulative fiscal policy and a complicated exit from its quantitative easing policies over the medium term will result in the Fed tolerating a higher level of inflation than it desires," the NABE report concluded. The main reasons cited for concern over the inflation outlook included "lagged effects of policies now in effect," "monetization of the debt" and an "ineffective exit strategy" by the central bank, the report said. Half of those surveyed thought the government's fiscal measures were excessive, up from 33 percent in the group's March survey. Almost eight out of every 10 economists surveyed said a second stimulus bill wasn't needed. Three-quarters said they would like to see the government cut spending over the next two years, while only 28 percent projected the reductions would actually take place.[104]

Between 150 and 200 more U.S. banks will fail in the current banking crisis, and the industry's payments to keep the Federal Deposit Insurance Corp (FDIC) afloat could eat up 25 percent of pretax income in 2010, according to Richard Bove, of Rochdale Securities. Others predict failures could reach 1,000 over the next two years.[105] Bove said this will likely force the FDIC to turn increasingly to non-U.S. banks and private equity funds to shore up the banking system. As support for his contention, Bove pointed to the closure of Texas-based Guaranty Financial Group, whose assets were sold to Banco Bilbao Vizcaya Argentaria – a Spanish bank.[106]

The dollar's role in international trade should be reduced by establishing a new currency to protect emerging markets from the "confidence game" of financial speculation, the United Nations' Conference on Trade and Development (UNCTAD) said in a recent report.[107] U.N. countries should agree on the creation of a global reserve bank to issue the currency and to monitor the national exchange rates of its members. "There's a much better chance of achieving a stable pattern of exchange rates in a multilaterally agreed framework for exchange-rate management," said Heiner Flassbeck, co-author of the report and a UNCTAD director. While it would be desirable to strengthen the IMF's Special Drawing Rights (SDR), a unit of account based on a basket of currencies, it wouldn't be enough to aid emerging markets most in need of liquidity, Flassbeck said. Emerging-market countries are underrepresented at the IMF, hindering the effectiveness of enhanced SDR allocations. Instead, an organization should be created to manage real exchange rates between countries measured by purchasing power and adjusted to inflation differentials and development levels, the UNCTAD report recommended.[108]

<u>International trade</u>: Nils Andersen, CEO of the world's largest shipping container line A.P. Moeller-Maersk A/S, says world trade is improving and some container rate increases are "sticking." The shipping line has been announcing rate increases on various routes since the beginning of the year. "The rate increases we've given out are sticking," Andersen said. "Rates bottomed out later and deeper than we expected, with the lowest levels in May to June. Since then they've increased gradually. They are not enough to make the industry profitable, but these are steps in the right direction."[109]

Baltic Dry Index (BDI) watchers might beg to differ with Andersen, however. Adherents claim that the BDI, which measures freight rates for bulk goods and commodities, is a reasonably accurate leading indicator of future trade activity (and hence global economic vitality). The index has been falling almost continuously for most of the last three months.[110]

<u>Construction</u>: Although the housing market may have stopped falling deeper into a hole, the climb back out is likely to be a slow process fraught with reversals. As an example, building permits – a sign of future construction – fell 1.8 percent in July to a 560,000 annual pace from 570,000 (Figure 20, p. 14). Permits for single-family houses climbed 5.8 percent, while those for multifamily units dropped 26 percent.

The recovery in home prices has Robert Shiller, Yale professor and co-creator of the Case-Shiller housing index, suggesting that the U.S. housing market could be on the road to recovery. "I think it might represent a change in trend," Shiller told CNBC. "The only doubts about it are that the market is rather abnormal now with all these foreclosure sales. But the outlook has certainly changed with this data." People shouldn't get overly optimistic, though, as the exchange-traded instrument Shiller created to track home prices, MacroShares Major Metro Housing Up, puts home prices up just 6 percent five years from now. "That is not a huge recovery," Shiller noted. In addition, the overhang of foreclosures does not bode well, despite the short-term uptick on home sales. "There's a lot of problems out there. And I think there's a real possibility we're going to see some bad news, and it's going to be a reversal again," he warned.[111] The National Association of Realtors thinks there is a high likelihood existing home prices will retrench again in the future. "We are bouncing back," Lawrence Yun, NAR's chief economist, said. Even so, "we still need to wait until year-end before we see price stabilization." As previously mentioned, at the current sales pace, 9.4 months would be required to deplete the current inventory of existing homes. A seven months' supply is usually consistent with stabilization in prices, Yun said.[112]

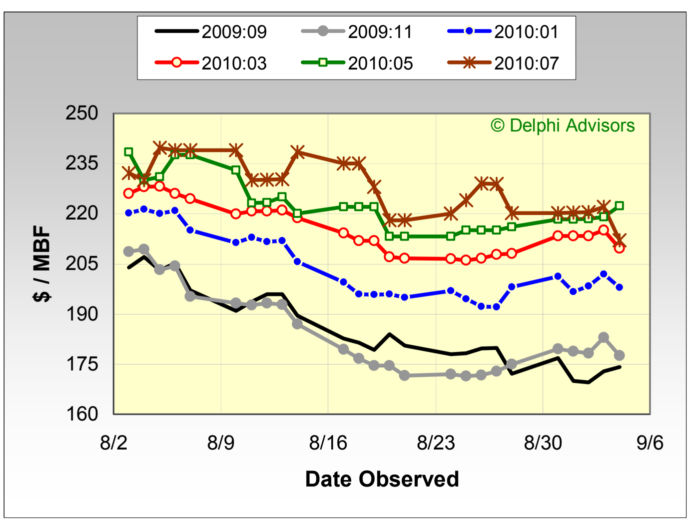
On the subject of foreclosures, about $3.4 trillion worth of houses are at risk of default because the owners owe more than the property is worth, Santa Ana, California-based First American CoreLogic said in early August. Meanwhile, foreclosure-driven declines in prices are lifting sales. Homeowners cut asking prices by $27.8 billion in the year through 1 August, according to Trulia Inc., a San Francisco-based real estate data provider.[113]

"As for the [Mortgage Bankers Association's (MBA) foreclosure] outlook, it is unlikely we will see meaningful reductions in the foreclosure and delinquency rates until the employment situation improves," said Jay Brinkman, MBA's chief economist. "In addition, in some areas where a number of borrowers have mortgages that are larger than the current value of their homes, any life events such a divorce or loss of a job are likely to translate into foreclosures until prices in those areas recover, not just flatten…. Finally, while the various loan modification programs continue to have an impact on holding foreclosure rates below where they otherwise would be, the issue is that many of the foreclosures involve homes that are vacant, borrowers who no longer have jobs, or loans where there was fraud involved. Therefore, in measuring the effectiveness of industry or government loan modification programs it is necessary to compare the results not with the total foreclosure and delinquency numbers reported here but with the smaller subset of borrowers who can and want to qualify," Brinkmann said.[63]

Boosted by low prices and a home-buyer tax credit, contract activity for pending sales of existing homes rose in July for the sixth straight month, the longest streak on record. NAR's pending home sales index rose 3.2 percent in July – thanks to improvement in the South and West. The index is 12 percent above July 2008. NAR expects sales of existing homes to rise in response sometime between September and October. "Housing affordability has been at record highs this year with the added stimulus of a first-time buyer tax credit," said Lawrence Yun. "Other buyers are taking advantage of low home values before prices turn higher. Nationally, the typical mortgage payment now takes less than 25 percent of a middle-income family's monthly income to buy a median priced home, with payment percentages so far in 2009 being the lowest on record dating back to 1970. As long as home buyers stay within their budget, mortgage payments will be very manageable." NAR estimates that about 1.8 to 2.0 million first-time buyers will take advantage of the $8,000 tax credit this year, with approximately 350,000 additional sales that would not have taken place without the credit. Buyers have little time to act because they must complete the transaction by 30 November to qualify for the credit (unless the tax credit program is extended); it is taking approximately two months to complete home sales in the current market.[114]

Although the housing market appears to be finding its bottom, lumber futures traders do not appear to be feeling especially upbeat about upcoming demand. Futures prices for all delivery dates have trended downward during the past five weeks (Figure 29). Sentiment for all dates except September 2009 and May 2010 took a hit on 4 September mostly due to formula trading.[115]

The MBA intends to ask Congress to transform mortgage lenders Fannie Mae and Freddie Mac into several smaller, privately held companies that would issue



Contract	High	Low	Median
	---------- $ / MBF ----------		
2009:09	207.00	169.60	181.40
2009:11	209.40	171.40	179.40
2010:01	221.30	192.10	199.50
2010:03	228.20	206.00	213.40
2010:05	238.50	213.20	222.00
2010:07	239.70	212.00	229.00

	Open	Close	Trend
	---- $ / MBF ----		
2009:09	204.00	174.10	NEG
2009:11	208.70	177.50	NEG
2010:01	220.20	198.00	NEG
2010:03	226.00	209.60	NEG
2010:05	238.50	222.30	NEG
2010:07	232.20	212.00	NEG

***Figure 29*. Statistics of prior five-week lumber futures prices, by contract delivery month. Source: Chicago Mercantile Exchange**

mortgage-backed securities with a government guarantee. The new companies would guarantee the securities against defaults on underlying mortgages and pay fees into a federal insurance fund that would make good on interest and principal payments to bondholders if the companies were unable to do so. "The government has an important, limited role to play to ensure a stable flow of funds for mortgages." said Michael Berman, chair of the Council on Ensuring Mortgage Liquidity. The MBA plan calls for government agencies, rather than the new companies, to assume the "mission" of promoting affordable housing that Congress has long assigned to Fannie and Freddie.[116]

The Fed extended its Term Asset-Backed Securities Loan Facility (TALF), the trillion-dollar program created in November and set to expire at the end of the year. The Fed said it would bump the program's termination back to 31 June 2010 for commercial mortgage-backed securities, and to 31 March 2010 for other asset-backed paper. In theory, the program's extension should encourage banks to securitize new mortgage and consumer loans.[117]

And on a slightly different note, China's sovereign wealth fund is preparing to buy up to $2 billion in U.S. mortgages.[118] As one analyst quipped, "Having not felt quite enough pain from their Morgan Stanley and Blackstone investments, China Investment Corp. is rumored to be vying for a seat at the Public-Private Investment Plan – the yet-to-be-launched scheme the U.S. Treasury cooked up to get mortgage backed sectors off of U.S. bank balance sheets." The fund has been described as "eager to participate in real estate securities" because it believes the U.S. property market will start to recover later this year in a gradual fashion.

Energy: The U.S. State Department, citing Energy Information Administration forecasts, estimates the "balance between domestic supply and demand" will require imports of "unconventional" (i.e., tar sands) oil from Canada to grow from current levels of roughly 1.5 million barrels a day to some 4.3 million barrels by 2030. After weighing the benefits of increased supply from a friendly source against the perceived environmental impacts, the federal government approved construction of a new pipeline (dubbed the Alberta Clipper Project) that will run more than 300 miles from the Canadian border just west of Minnesota, across the north of that state, to the western tip of Lake Superior near Duluth. Although the project runs along an existing pipeline corridor, environmental groups are suing to block the project because it may expand the width of that corridor as much as 100 feet.[119]

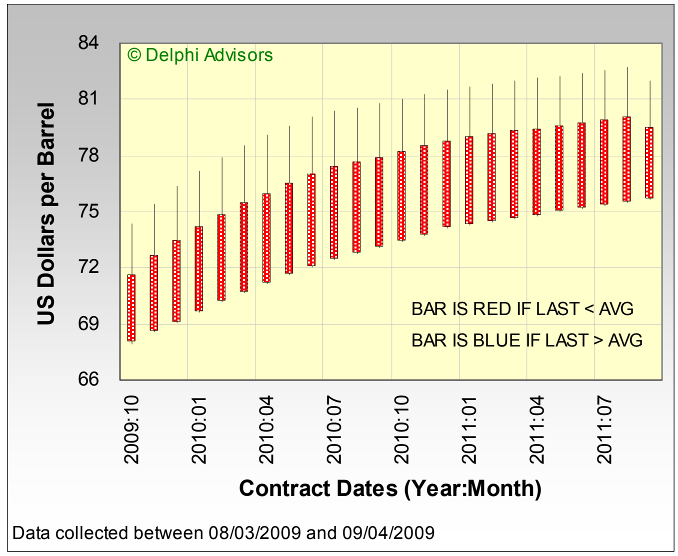


***Figure 30*. Futures prices for light crude oil by delivery month. The vertical black lines represent the range of closing prices during the data-collection period; the colored bars show the relationship between the last observed and average closing prices. Source: New York Mercantile Exchange**

Although oil futures prices remain in contango – i.e., the price of each subsequent delivery date is higher than the price of the prior date – futures traders have become more pessimistic about oil's prospects (Figure 30). Prices fell an average of $7.44 per barrel during the past month.

Employment and consumer spending: The view ahead in terms of employment and consumer spending is mixed, with more downside than upside risk. "Reluctant Shoppers Hold Back Recovery" read a 19 August headline in *The Wall Street Journal*,[120] as though the economy could be put aright just by convincing "hunkered-down" consumers to pull out their credit cards and start spending. "Common sense tells us," countered bond fund manager Bill Gross, "that consumer spending growth comes from highly employed, well-compensated labor, and we are far from even approaching that elemental condition. The fact is that near-double-digit unemployment has resulted from numerous business models that are now broken: autos, home construction, commercial real estate development, finance and retail sales. Construction of a new Humpty Dumpty capitalistic 'oeuf' will be a Herculean task."

Gross is preparing for "lower profit growth, permanently higher unemployment, capped consumer spending growth rates and an increasing involvement of the government sector, which substantially changes the character of the American capitalistic model. High-risk bonds, commercial real estate and even lower-quality municipal bonds may suffer more than cyclical defaults if not government supported. Stock [price/earnings ratios] will rest at lower historical norms, and higher stock prices will ultimately depend on tangible earnings growth in the form of increased dividends, not green shoots hope."[121]

Roger Wiegand of *Trader Tracks Newsletter* suggests the "cash for clunkers" program will have lingering effects on consumer spending by diminishing discretionary cash. "Cash for Clunkers was a real clunker. One out of four auto buyers using this program is having buyer's remorse as they just signed-up for so many new payments they cannot afford."[122]

Obviously, the outlook is not entirely gloomy. One positive anecdote comes from outplacement firm Challenger Gray & Christmas. The firm announced that layoffs planned by major U.S. corporations dropped 21 percent during August from July's pace. The August total of 76,456 job-cut announcements was the second lowest of 2009, and 14 percent lower than those of August 2008. Year-to-date 2009, however, the firm's unscientific count of announced job cuts has now cracked the one million mark – 60 percent more than through August 2008. The job-cut figures aren't seasonally adjusted, and count only a fraction of the actual number of layoffs that take place each month, mostly in small- and medium-sized firms.[123]

Online advertised job vacancies rose by 169,000 (to 3,464,800) in August, according to The Conference Board's Help-Wanted OnLine Data Series. Since April 2009, online job demand is up by 300,000, with many of the largest states now showing stable trends following about two years of losses. "The August increase is good news showing what we hope will be a continued improvement in job demand this fall," said Gad Levanon, senior economist at The Conference Board. August job demand data are in line with The Conference Board's recently released Consumer Confidence Index which also rose in August, largely reflecting consumers' feelings that jobs were becoming easier to find. "While all of this is good news, the gap between the number of unemployed and the number of advertised vacancies still remains at about 11 million, with over four [persons] unemployed for every online advertised job vacancy," said Levanon.[124]

Although credit card default rates have recently declined, regulatory changes mandated by Congress[125] may reverse that trend and send them higher in the future. Lenders are raising rates across the board, according to Schwark Satyavolu, president and co-founder of BillShrink.com, which compares terms offered to consumers for credit cards, mobile phones and gasoline.

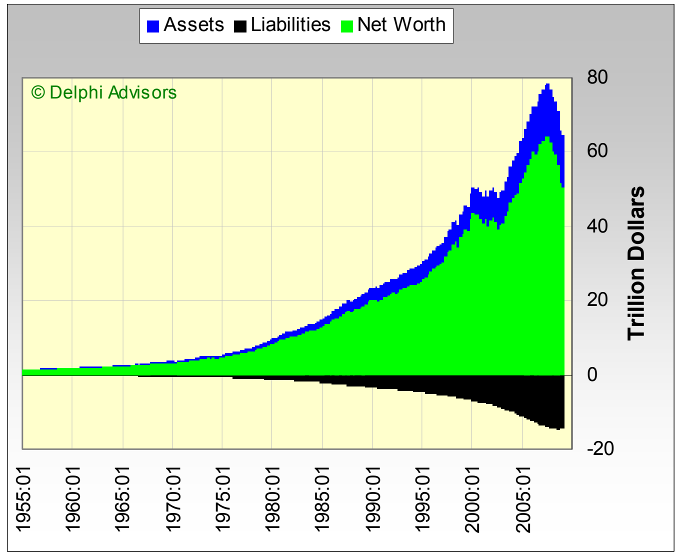


***Figure 31*. Assets, liabilities and resulting net worth of U.S. households and non-profit organizations. Nominal amounts outstanding at end of period, not seasonally adjusted. Source: Federal Reserve Board**

The company says the average lowest card rate is about 11.25 percent, up from 8.85 percent in January. The average for less credit-worthy customers rose to 15.75 percent in July, up from 13.75 percent in January.[126] Raising rates and fees will push marginally solvent consumers "closer to the edge." Indeed, households have a lot of tough "slogging" ahead of them in terms of rebuilding tattered balance sheets (Figure 31), particularly in the current environment of high unemployment.

GDP: As one might expect given the condition of the economy, there are as many (or more) opinions regarding the future as there are economists. Some, like Nouriel Roubini[127] and Martin Feldstein,[128] believe the risk of a double-dip recession is rising. "There are also now two reasons why there is a rising risk of a double-dip W-shaped recession," Roubini wrote recently. "For a start, there are risks associated with exit strategies from the massive monetary and fiscal easing: policy-makers are damned if they do and damned if they don't. If they take large fiscal deficits seriously and raise taxes, cut spending and mop up excess liquidity soon, they would undermine recovery and tip the economy back into stag-deflation (recession and deflation). But if they maintain large budget deficits, bond market vigilantes will punish policymakers. Then, inflationary expectations will increase, long-term government bond yields would rise and borrowing rates will go up sharply, leading to stagflation. Another reason to fear a double-dip recession is that oil, energy and food prices are now rising faster than economic fundamentals warrant, and could be driven higher by excessive liquidity chasing assets and by speculative demand. Last year, oil at $145 a barrel was a tipping point for the global economy, as it created negative terms of trade and a disposable income shock for oil importing economies. The global economy could not withstand another contractionary shock if similar speculation drives oil rapidly towards $100 a barrel."

Others, of course, think such an outcome is "out of the question." The Economic Cycle Research Institute (ECRI), a New York-based independent forecasting group, said its Weekly Leading Index (WLI) soared to its highest yearly growth rate reading since the week of 28 May 1971. "With WLI growth continuing to surge through late summer, a double dip back into recession in the fourth quarter is simply out of the question," said Lakshman Achuthan, ECRI's managing director, reinstating the group's recent warning to ignore negative analyst projections.[129]

"My forecast for a slow recovery implies a protracted period of high unemployment," said Dennis Lockhart, head of the Atlanta Federal Reserve Bank. Lockhart added that it would be difficult to stimulate jobs through additional public spending. "Further fiscal stimulus has been mentioned, but the full effects of the first stimulus package are not yet clear, and the concern over adding to the federal deficit and the resulting national debt is warranted," he said. Prior to the recession, Lockhart said, construction and manufacturing together accounted for slightly more than 15 percent of employment. But during the recession, those sectors represented more than 40 percent of all U.S. job losses. "In my view, it is unlikely that we will see a return of jobs lost in certain sectors, such as manufacturing," he said. "In a similar vein, the recession has been so deep in construction that a reallocation of workers is likely to happen – even if not permanent."[10]

Our current view is that GDP will expand weakly in 3Q2009, but contract again in 4Q before mounting a more sustained recovery through 2010. Growth will begin to slow in late 2010 in preparation for the subsequent, shallower recession of 2011. ■

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