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Economic and Market Update

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What's ahead?

What about next year? – Not too many are arguing whether we're in recovery; it's now about how strong a recovery. As new data comes in, Wall Street keeps revising up estimates for this year's 2nd half and into 2010. But the numbers are still well below what's typical for a recovery out of a steep recession. Research shows 1st-year growth out of recessions in the '70s and '80s, when we had 3% to 4% declines (as in this recession), averaged 8% – well below the current 2½% consensus. There are reasons to believe the consensus is wrong. For one, the inventory rebuild that is expected to be a big bump to GDP keeps getting pushed back, with August inventories falling a record 12th month. For another, more stimulus is in the works, even if it won't actually be called stimulus. Extensions and expansions of tax breaks for new home purchases are being discussed, as are tax incentives for companies to hire. On top of this, spending from the actual stimulus package passed last February will surge in next year's first and second quarters. Lastly, corporate earnings continue to surprise, with 3rd-quarter earnings to date running nearly 18% above estimates. We broke through the 10,000 threshold on the Dow this week, and it's quite possible we won't move a whole lot from there through the end of the year, since the market seems to be pricing in better-than-expected growth for this year's 2nd half. But if growth also surprises into the New Year as we expect, then we could have a good thing going on for some time.

What else?

What do they know that we don't know? – Immigrants constitute only 12% of the U.S. population, but according to Mirae Asset Global Investments, have started more than half of Silicon Valley's startups, account for 25% of patents and half of Ph.D.'s in science and technology – and are heading home to countries with more welcoming entrepreneurial policies.

If commercial real estate is the next shoe to drop, it'll be more like a sandal than a steel-toed boot – I get a lot of questions as I travel about commercial real estate. Bankers have been worrying it'll be the next shoe to drop. But American Banker notes in most cases, "the shoe is falling at a pace slow enough to suggest a controlled landing instead of a thud.''

What's next for health care – Now that the Senate Finance Committee signed off, watch for a Senate floor vote, followed by a behind-closed-doors conference bill in December that merges House and Senate versions. Empirical Research puts the odds of some type of a public option in the conference bill at 50-50.

Will affluent play Scrooge? – The American Affluence Research Center said wealthy Americans plan to spend 5% less on gifts this holiday season. The good news: The top 10% are big equity investors. It is the top 10% that surveys say account for most discretionary spending. This is the group we must decide about when pondering the consumer spending outlook.

Recent Positives

Holidays may be next upside surprise – There's an 88% correlation between holiday sales and equity performance, which suggests this season's sales could rise more than 5%. Moreover, sales sequentially plunged 5% last September through December, meaning even sideways sales will represent a 5% year-over-year gain. Sales for September surprised, with ex-autos rising instead of falling. We are watching consumers and jobs, and think a stronger-than-expected consumer is not currently factored into the markets.

Regional readings keep manufacturing on expansion path – The New York Fed's regional manufacturing index easily topped estimates, and the Philadelphia Fed's companion index, while slightly below consensus, beat forecasts for new orders and capital spending. This indicates U.S. manufacturing activity expanded a 3rd straight month in October.

Why rates aren't going up anytime soon, part 1 – Consumer prices fell year-over-year for the 7th straight month, with the core commodity index (excluding energy) dipping below services for the 1st time since '83, and year-over-year food costs falling for the first time since'67 … no inflation yet.

Why rates aren't going up anytime soon, part 2 – Minutes from the Federal Reserve's latest policy meeting showed even as it raised its economic outlook, it was concerned growth could be weaker than expected … all systems go.

Recent Negatives

Small businesses largely absent from recovery – The NFIB Small Business Optimism Index hit a 4-month high but is still up only 1% since November. By comparison, the ISM's composite manufacturing and services index jumped 37% the same period. Small businesses say weak sales are their biggest problem and that job openings are at 27-year low. It's unusual for small businesses to be so weak in recovery vs. large businesses. This could be a problem if it doesn't improve.

States completely absent from recovery – Just 3 months after passing a budget, California tax collections are $1 billion below forecasts. Meanwhile, Illinois has $3 billion of unpaid bills, a record so far for a new year. The National Association of State Budget Officers called states' deteriorating revenues "close to unprecedented.'' Get ready to pay more taxes.

I (don't) quit! – Jobless claims dipped more than expected in the past week, but there are no signs of net job growth. The government's monthly tally shows job openings at a record low, with six applicants vying for every opening. The quit rate – the percentage of employed workers who voluntarily leave – is a record low 1.3%. And long-term unemployed now represent a record 3½% of the labor force.

Past performance is no guarantee of future results.

Views are as of October 16, 2009, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in the United States.

The Institute of Supply Management (ISM) composite manufacturing and services index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

The Empire State Manufacturing Index is conducted monthly by the Federal Reserve Bank of New York to gauge the level of activity and expectations for the future among manufacturers in the state.

The Philadelphia Manufacturing Index is conducted monthly by the Federal Reserve Bank of Philadelphia to gauge the level of activity and expectations for the future among manufacturers in Greater Philadelphia region.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation, and their plans.

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