



## Economic and Fixed Income Market - Weekly Update

November 9, 2009

- > The manufacturing ISM purchasing managers' survey jumped to 55.7 from 52.6 in September, marking the third consecutive monthly reading above 50, pointing to growth in the manufacturing sector. The key components of the report were very encouraging with employment surging 6.9 points to 53 --the first growth in employment since July 2008. Production also surged 7.6 points to 63.3. New orders dipped a touch to 58.5 from 60.8, but remained solidly above the 50 growth mark.
- > The nonmanufacturing ISM index eased slightly to 50.6 from 50.9 in September, but the October report was the second consecutive monthly reading above 50. Within the survey, the employment component was disappointing, falling to 41.1 from 44.3 in September, however, new orders did rise to 55.6 from 54.2 and business activity was basically unchanged at 55.2 from 55.1.
- > The FOMC maintained the federal funds rate at zero to 0.25% and commented "that economic conditions... are likely to warrant exceptionally low levels of the federal funds rate for an extended period." That language had been included in the previous five statements. The Federal Reserve did upgrade its assessment of current economic conditions, however, by stating that housing activity has increased and household spending appears to be expanding.
- > The central bank began the dialogue of describing the criteria that would require a shift away from its current very accommodative monetary policy stance. Specifically, the FOMC directly linked low interest rates to "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations."
- > Our view remains that the high level of slack in the economy will restrain the buildup of inflationary pressures in the economy over the next couple years. Additionally, the Federal Reserve wants clear evidence that a self-sustaining recovery in the economy has taken hold before tightening monetary policy. We continue to expect the Federal Reserve to hold short-term interest rates steady until mid-2010 at a minimum.
- > The Labor Department delivered two assessments of the job market for October, one was poor and the other was a disaster. Nonfarm payroll employment fell by -190,000, slightly better than the -226,000 monthly average during 3Q 2009. However, the household survey, which captures self-employed and small business employment, reported a job loss of -589,000, pushing the unemployment rate to 10.2% from 9.8% in September. The unemployment rate reached double digits for only the second time since WWII, the other period lasting 10 months from September 1982 to July 1983, with the peak reading of 10.8% occurring in November 1982.
- > While the headline of 10.2% unemployment is about as grim a commentary on the severity of the recession as any the household sector has had to digest, the data on the labor market did contain several reasons to hold hope for better times ahead. Besides the pace of layoffs continuing to taper off, including payroll losses for August and September revised to show 91,000 fewer job losses than originally reported, temporary workers increased by 34,000 in October. This marked the third straight month of gains in temporary employment, which typically is a harbinger of businesses preparing to add full-time employment. Additionally, the unusually high 8.2% rate of productivity gains over the past two quarters is unsustainable, pointing to the need for companies to start increasing payrolls with the economy having emerged from the recession last quarter.

## Economic Forecasts - Percent Change

	2009				2010				Annual Changes		
	1QA	2QA	3QA	4QE	1QE	2QE	3QE	4QE	2008A	2009E	2010E
Real GDP	-6.4	-0.7	3.5	3.5	2.5	2.5	2.5	2.5	0.4	-2.4	2.5
Unemployment Rate	8.1	9.3	9.6	10.3	10.6	10.4	10.4	10.3	5.8	9.3	10.4
Housing Starts (mil)	0.53	0.54	0.59	0.60	0.60	0.65	0.65	0.70	0.90	0.57	0.65
GDP Price Index	1.9	0.0	0.8	1.5	1.5	1.5	1.5	1.5	2.1	1.3	1.5
CPI	-2.0	1.3	3.6	1.5	1.5	1.5	1.5	1.5	3.8	1.0	1.5
Core CPI	1.5	2.4	1.5	1.5	1.5	1.5	1.5	1.5	2.3	1.8	1.5

## Interest Rates - Percent (End of Period Yields)

	2009				2010				End of Year		
	1QE	2QA	3QA	4QE	1QE	2QE	3QE	4QE	2008A	2009E	2010E
Federal Funds Rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	0.25	0.25	1.00
3-Month T-Bills	0.2	0.2	0.1	0.3	0.3	0.5	0.7	1.0	0.1	0.3	1.0
2-Year T-Notes	0.8	1.1	0.9	1.2	1.2	1.5	1.7	1.8	0.8	1.2	1.8
10-Year T-Notes	2.7	3.5	3.3	3.8	3.8	4.0	4.2	4.5	2.2	3.8	4.5

## Bond Market Commentary

> The bond market appears to be taking the Fed at face value regarding commentary in the post-FOMC release that it intends to leave rates unchanged 'for an extended period.' The yield on the 2-year Treasury note began to decline on the news and closed Friday afternoon at 0.84%, which is some 16 basis points lower than the 1.00% closing yield observed only two weeks ago. Admittedly, the magnitude of the yield decline is not that impressive. What is impressive to us is that short-term yields remain at the lower end of a year-long trading range at a time when many economists and strategists, including us, are incorporating 2010 rate increases due to the nascent economic recovery.

> In the table above you see that we expect the Fed to begin pushing rates higher as early as the end of the 2nd quarter of next year. The Fed's carefully crafted language mentioned 'extended' rather than 'prolonged,' which likely means 'sometime into 2010.' This being the case, we continue to recommend reducing exposure to the Treasury sector and using the proceeds to add selectively to the Agency and Corporate sectors.

	11/06/09	(Percent)
	Treasury Yields	Agency Yields
2 year	0.84	1.08
3 year	1.36	1.52
5 year	2.30	2.62
7 year	3.01	3.32
10 year	3.50	3.86
30 year	4.40	4.86

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