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The Recovery You Thought Would Never Get Here

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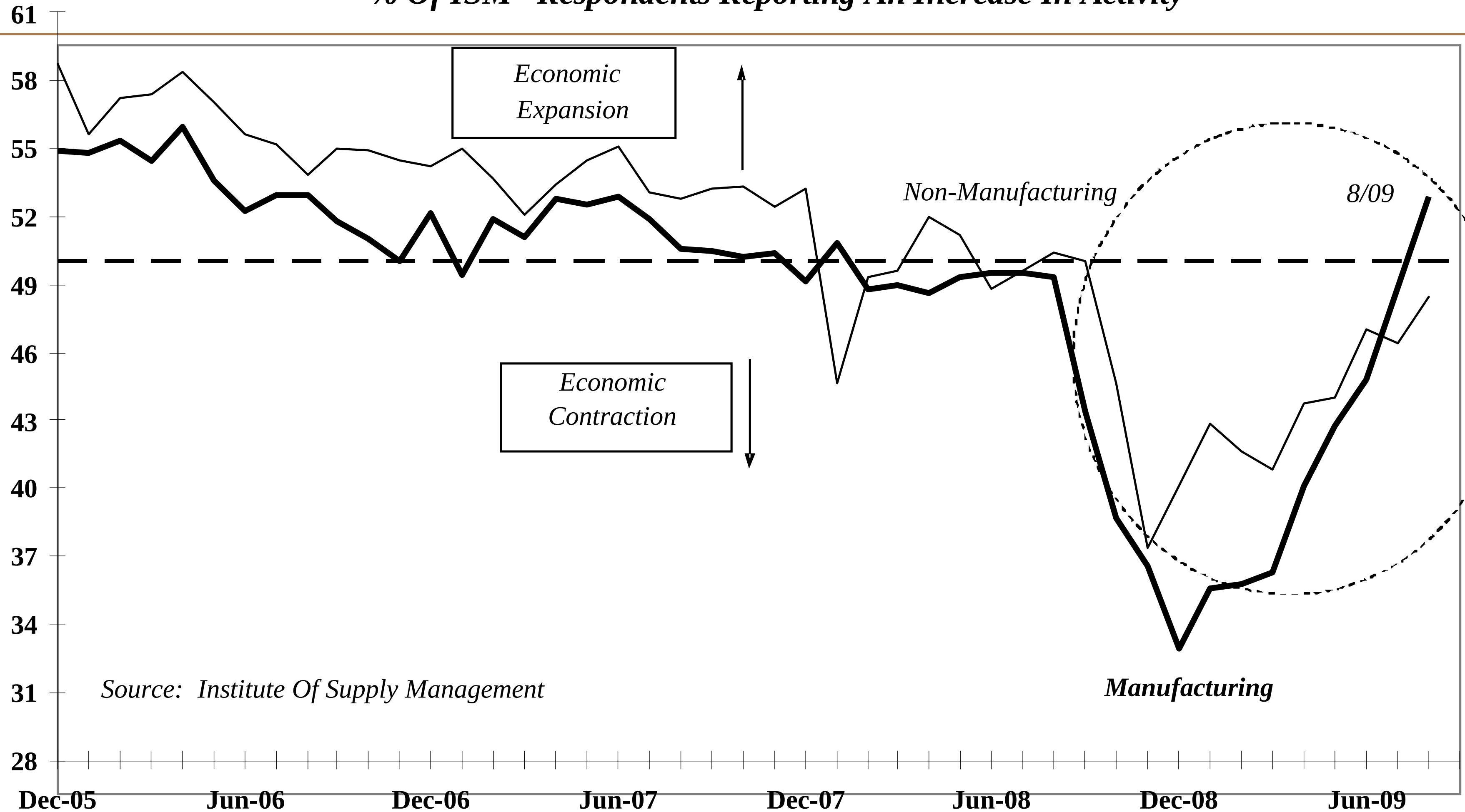
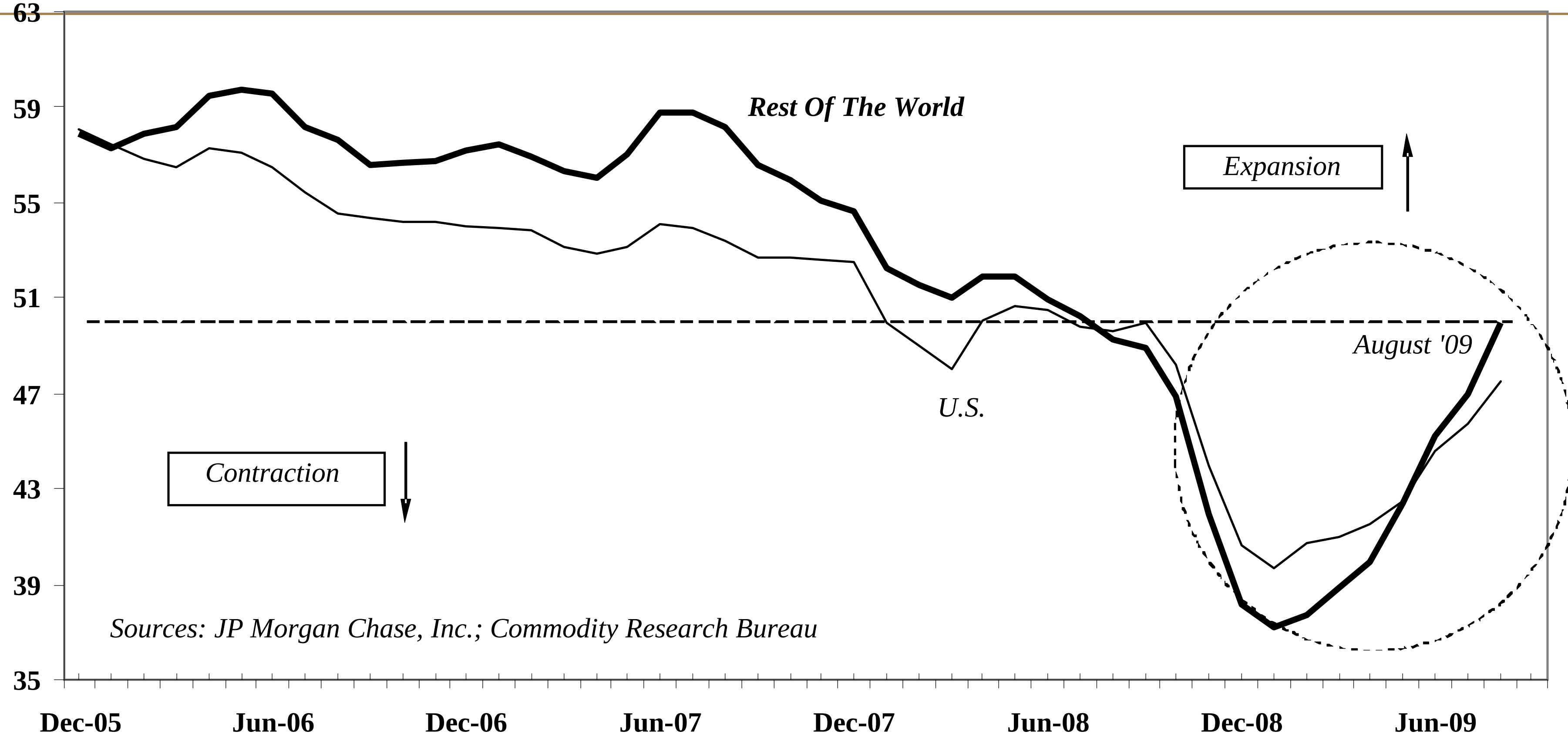
A MANUFACTURING-LED RECOVERY?

% Of ISM Respondents Reporting An Increase In Activity*



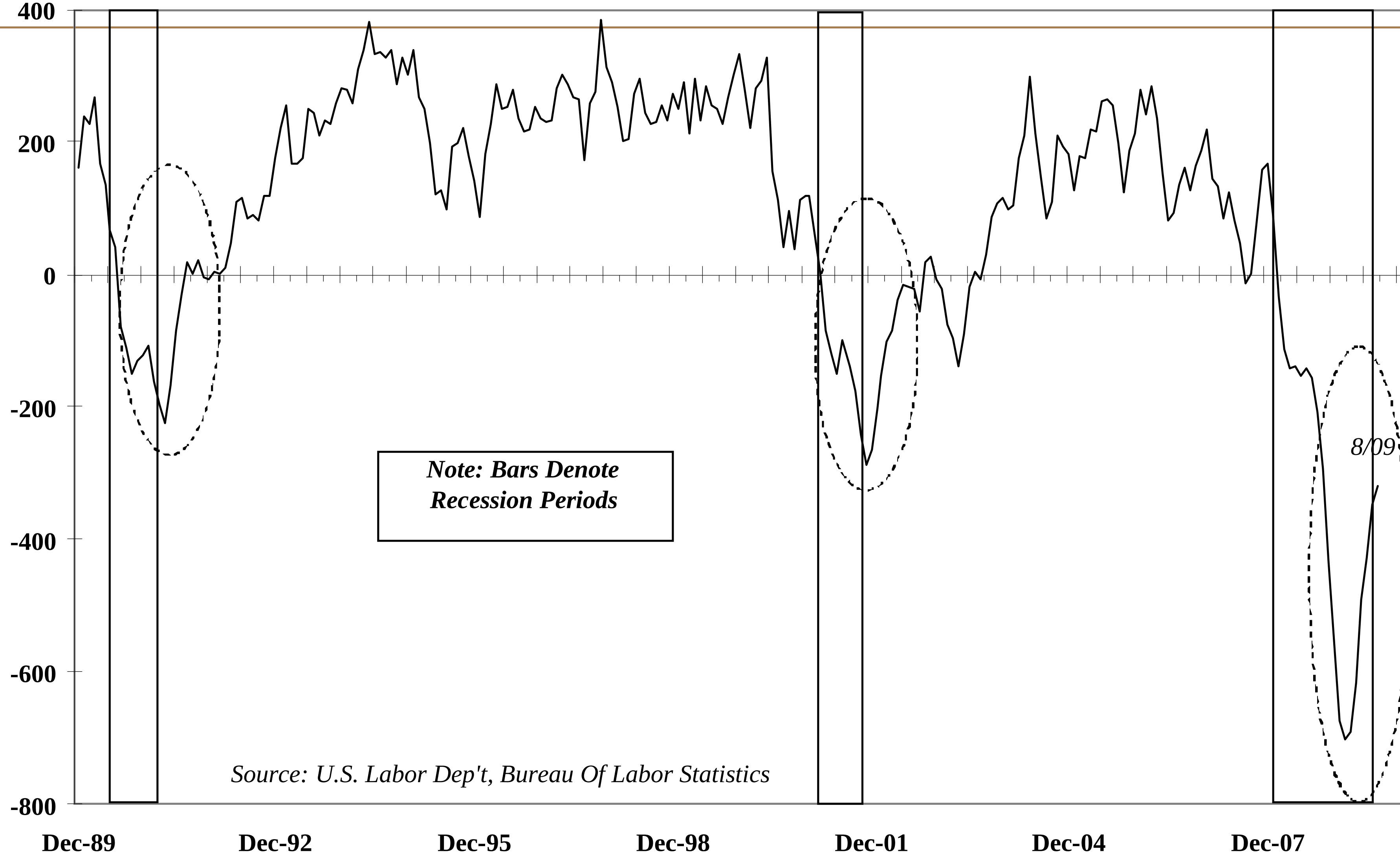
Cyclically sensitive manufacturing is on the leading edge of the turn toward economic recovery, much as it has been during past economic cycles. An eighth straight rise in the purchasing managers' composite index of manufacturing in August pushed it above the "fifty" threshold, separating growth from contraction, for the first time since January 2008. The activity index for the dominant non-manufacturing sector remains below that benchmark, fostering lingering doubts about the end of the recession. Manufacturing is drawing fairly broad-based support from exports, tech-led gains in business equipment sales and, most recently, from increased auto sales' direct and indirect boost to factory orders and output.

ARE OVERSEAS ECONOMIES THE ENGINE OF THIS GLOBAL RECOVERY?
% Of Respondents Reporting Increased Manufacturing & Non-Manufacturing Activity



The global economy appears to be transitioning from its "free-fall" of the past eight months, benefiting from broad-based economic stimulus, inventories now in better alignment with weaker sales and from a credit "thaw" supporting both world trade and domestic activity. Activity abroad apparently has arrived at the threshold of growth sooner than the U.S., reflecting the relatively strong performance of China and other key developing economies. In contrast to the U.S., in fact, purchasing manager's composite index of manufacturing and non-manufacturing, illustrated above, already has moved above to "fifty" threshold separating growth from contraction. While the debate has shifted from the depth and duration of this recession to the strength of the next recovery, "head winds" likely will keep it unusually modest for one following a deep recession. Immediate hurdles are rising fuel costs and interest rates. Longer-term, the recovery could be slowed by the need among households to rebuild wealth, through increased savings, and by the lingering effects of the credit "squeeze."

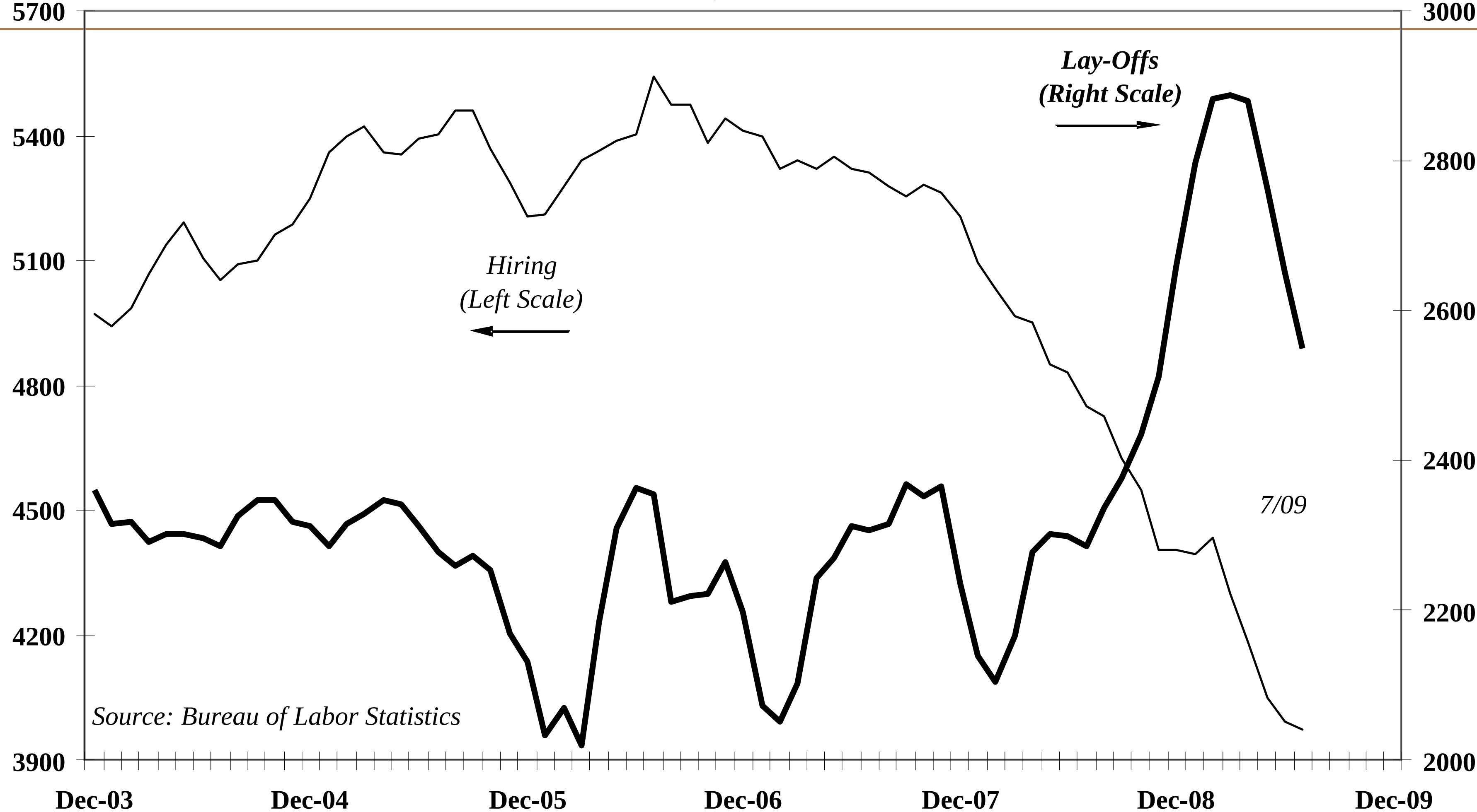
MODERATING JOB DECLINES---A PREREQUISITE FOR RECOVERY
Thousands of Workers, 3-Mo. Moving Avgs.



Though declining payroll employment has been viewed as a hurdle to an economic recovery, past growth cycles generally have started when the declines have moderated, not ended. Steep job losses in this cycle may test that relationship, though noticeably moderating declines since April may be lessening the threat from a slumping labor market.

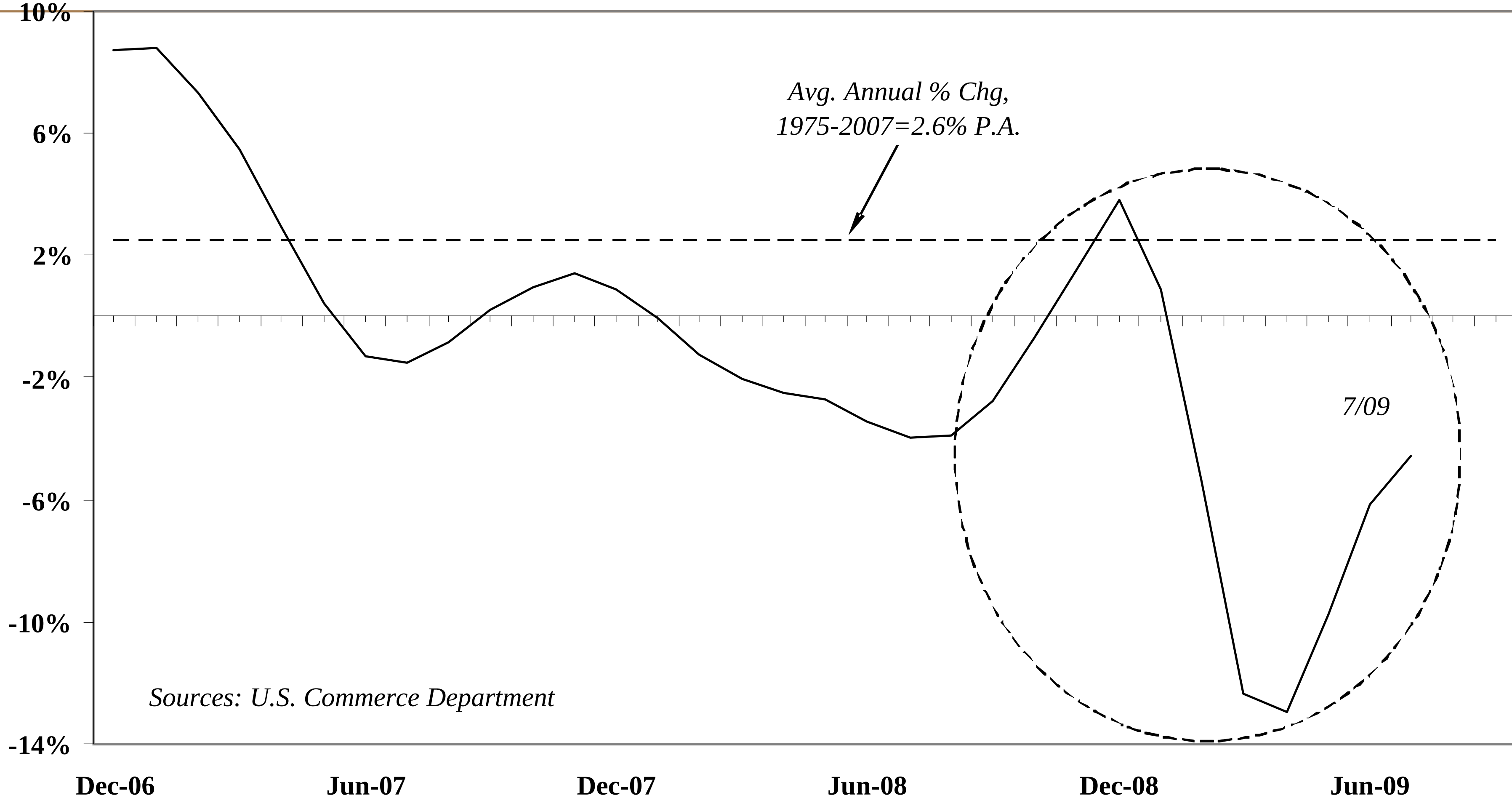
MODERATING LAY-OFFS OUT-WEIGH REDUCED HIRING

Thousands of Workers; Seasonally Adjusted Three-Month Moving Averages



Moderating employment declines in recent months have been due to reduced lay-offs exceeding ongoing declines in new hiring. The pattern is typical of a recession-recovery transition, when businesses are unusually cautious about adding to costs. The reluctance among businesses to hire--particularly after the deep recession of the past year and amid intense pressure on "pricing power"--also explains the unusually high duration of unemployment through the summer. Median time without a job was 15.4 weeks in August, down from its June peak but still well above its 12.3-week high just after the deep recession in 1981-82. Increased hiring probably won't occur until the average workweek, factory overtime and other leading indicators of employment improve from current depressed levels.

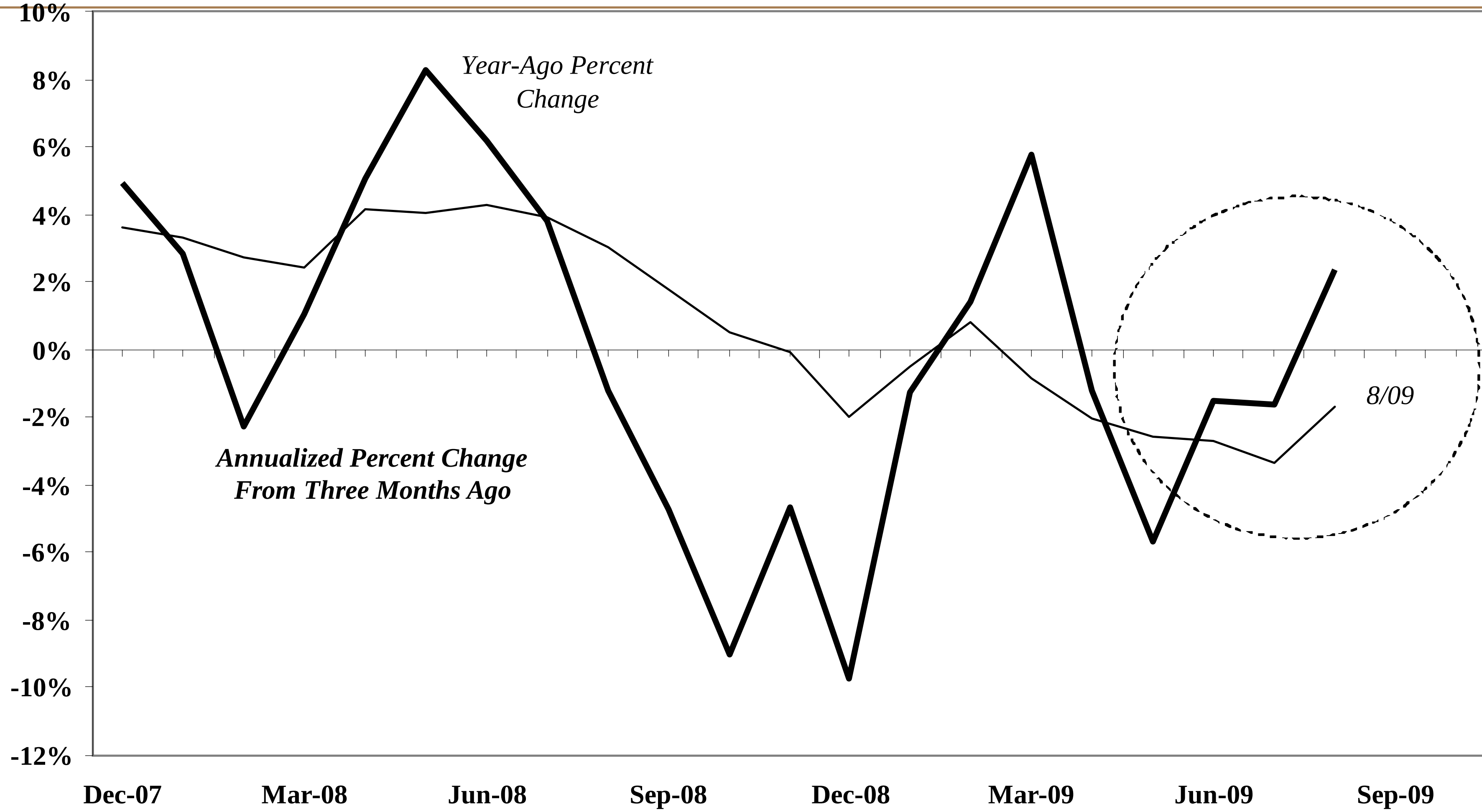
DECLINING "PURCHASING POWER" WEIGHS ON CONSUMER SPENDING
Annualized, Inflation-Adjusted % Chg. From 3 Months Ago; 3-Month Moving Average Data*



** Inflation as measured by the PCE deflator.*

Recent declines in consumer spending have raised fears of a "hollow," unsustainable recovery, because of the lack of support from the economy's main source of demand. Much of the weakness has been due to a steep drop in household "purchasing power," associated with sharply lower employment, sluggish wage gains and rising fuel costs earlier this year. However, spending and income declines appear to be decelerating and should begin rising again, soon, amid lower fuel costs and prospects for moderating declines in employment.

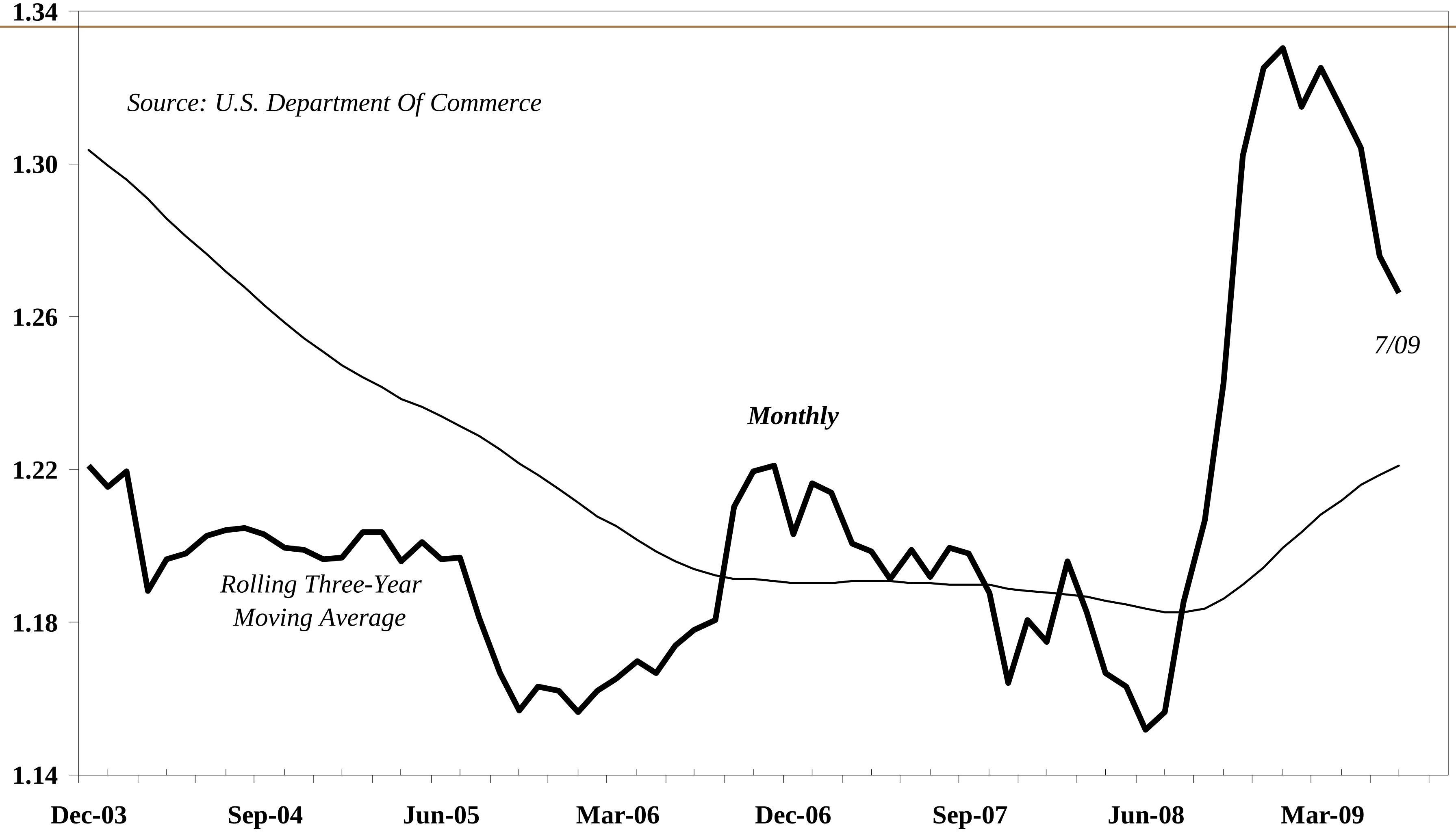
UNDERLYING RETAIL SALES REGAINING MOMENTUM
Percent Change In Retail Sales, Excluding Autos, Gasoline And Building Supplies



Masked by the auto-led jump in August retail sales was a respectable gain in the underlying sales category (i.e., excluding autos, gasoline stations and building-supply stores). The increase produced the first three-month rise in that category since March, significant because such sales was expected to be sapped by the diversion of spending to cars during the government's "cash-for clunkers" program. Broad-based gains in consumer spending are critical to a sustainable economic recovery, beyond the temporary "bounce" in third-quarter growth. The encouraging turnaround should get added support in coming months, as lower gasoline prices and moderating job losses take ease the pressure on household "purchasing power."

Source: U.S. Department Of Commerce

JUST HOW "LEAN" ARE INVENTORIES ?
Ratio Of Non-Auto Inventories To Sales; Months' Equivalent



Massive "liquidation" of business inventories through the second quarter undoubtedly has contributed to the revival of manufacturing, but much of the improvement may have centered on the auto industry. Sizable declines outside the auto industry have lowered inventories relative to sales, but relatively sluggish sales have prevented the sector's inventory-sales ratio from falling below its rolling, three-year average. That may change if, as expected, consumer non-auto spending builds on its August gains. For now, however, further inventory cuts may take some of the steam out of, what is likely to be, a respectable "bounce" from a deep recession.

THE FEDERAL GOVERNMENT'S HELPING HAND CONTAINS THE DAMAGE TO STATE& LOCAL FINANCES

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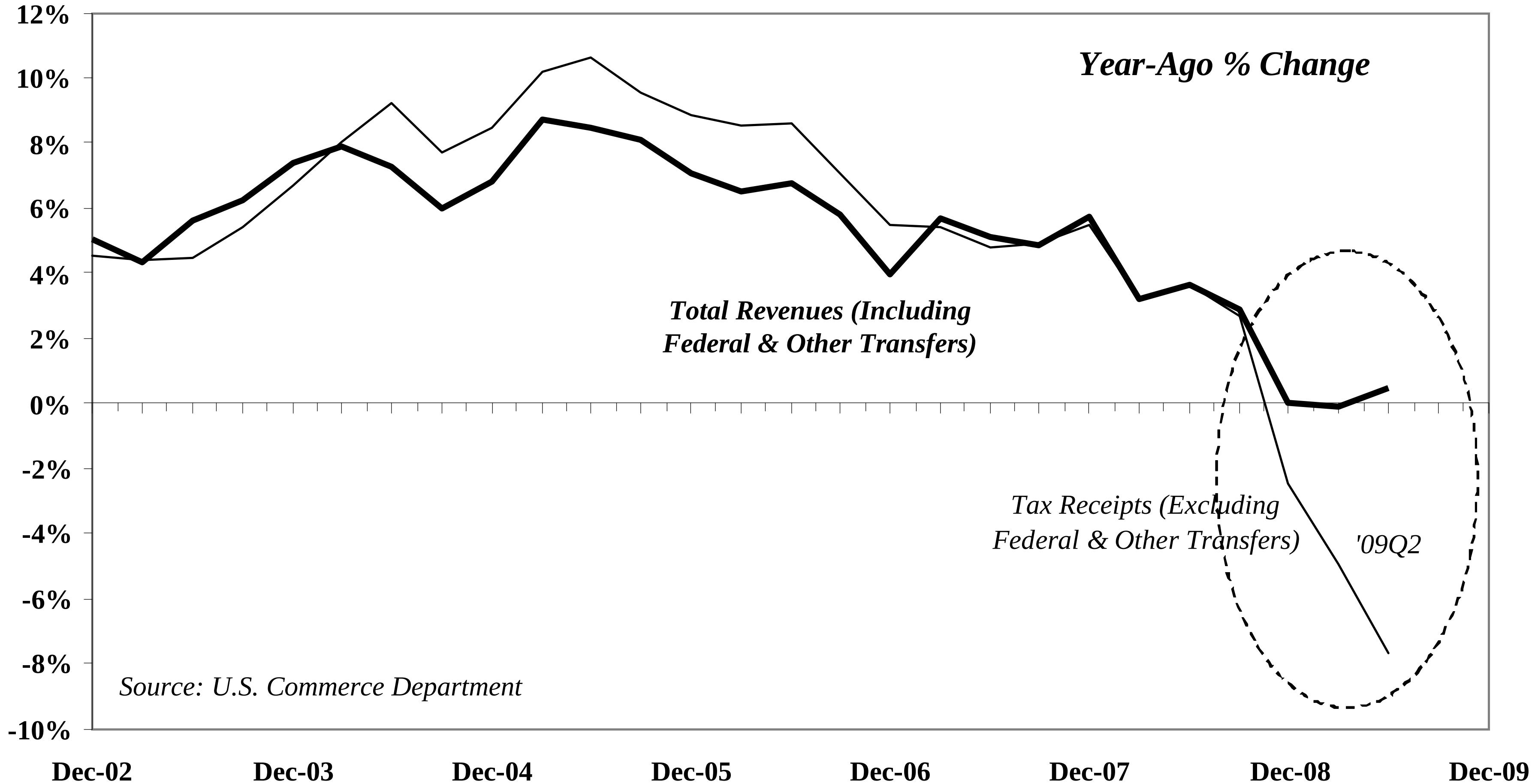
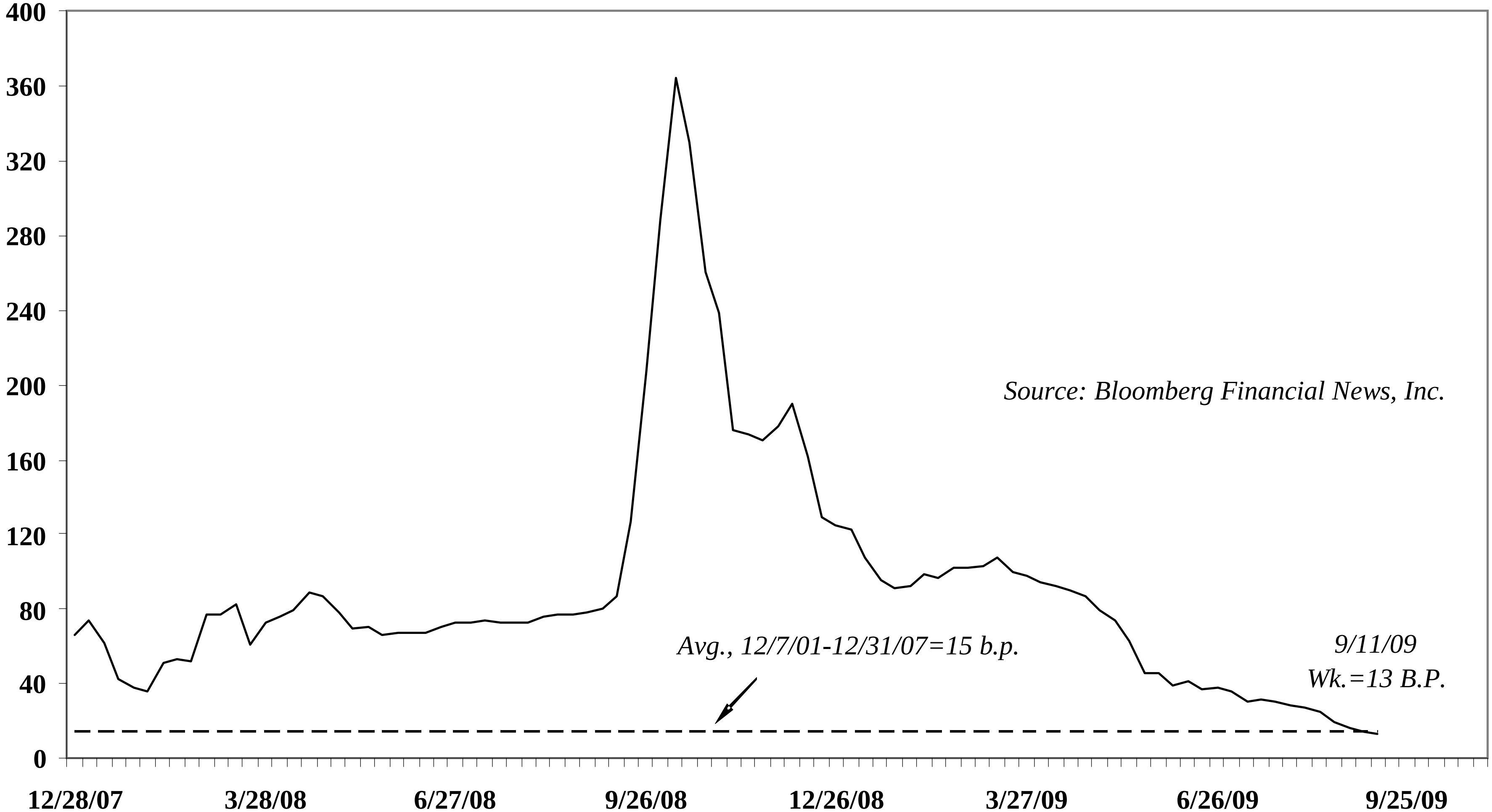


Federal aid has prevented an even more dramatic deterioration of state and local finances. Washington's disbursement's, part of the economic stimulus package, have countered accelerated declines in state and local tax receipts, contributing to a modest rise in total revenues during the second quarter. That, plus spending cuts, kept the sector's borrowing as a percent of total spending below its first-quarter peak of nearly 7.5% and well short of its double-digit peak when the economy struggled to emerge from the last recession in 2003. With state and local finances likely to lag the economic recovery, much as they usually do, efforts to close budget shortfalls partially will offset stimulus from the Federal government.

THE INTEREST "SPREAD" BETWEEN BANKING FUNDING COSTS AND FED FUNDS MOVES BELOW ITS PRE-CRISIS AVERAGE

Basis-Point Spread Between 3-Mo Euros & 3-Mo Overnight, Fed Funds Linked Swaps



A year after the Lehman-related blow-up in the financial market, the gap between the three-month LIBOR rate and a three-month overnight swap rate tied to the cost of Fed funds--a measure of inter-bank funding pressures--was just a fraction of its mid-September 2008 "spike" and <u>below</u> its pre-crisis average. This key interest-rate spread has been squeezed both by the increased availability of funds, associated with the credit "thaw," and weak demand for funds by banks amid balance sheet consolidation and declining loan balances.

TRANSITIONING BACK TO A LENDING "SQUEEZE" FROM A NEAR-"FREEZE"

Net % Of Large Commercial Banks Reporting Tighter Credit Standards

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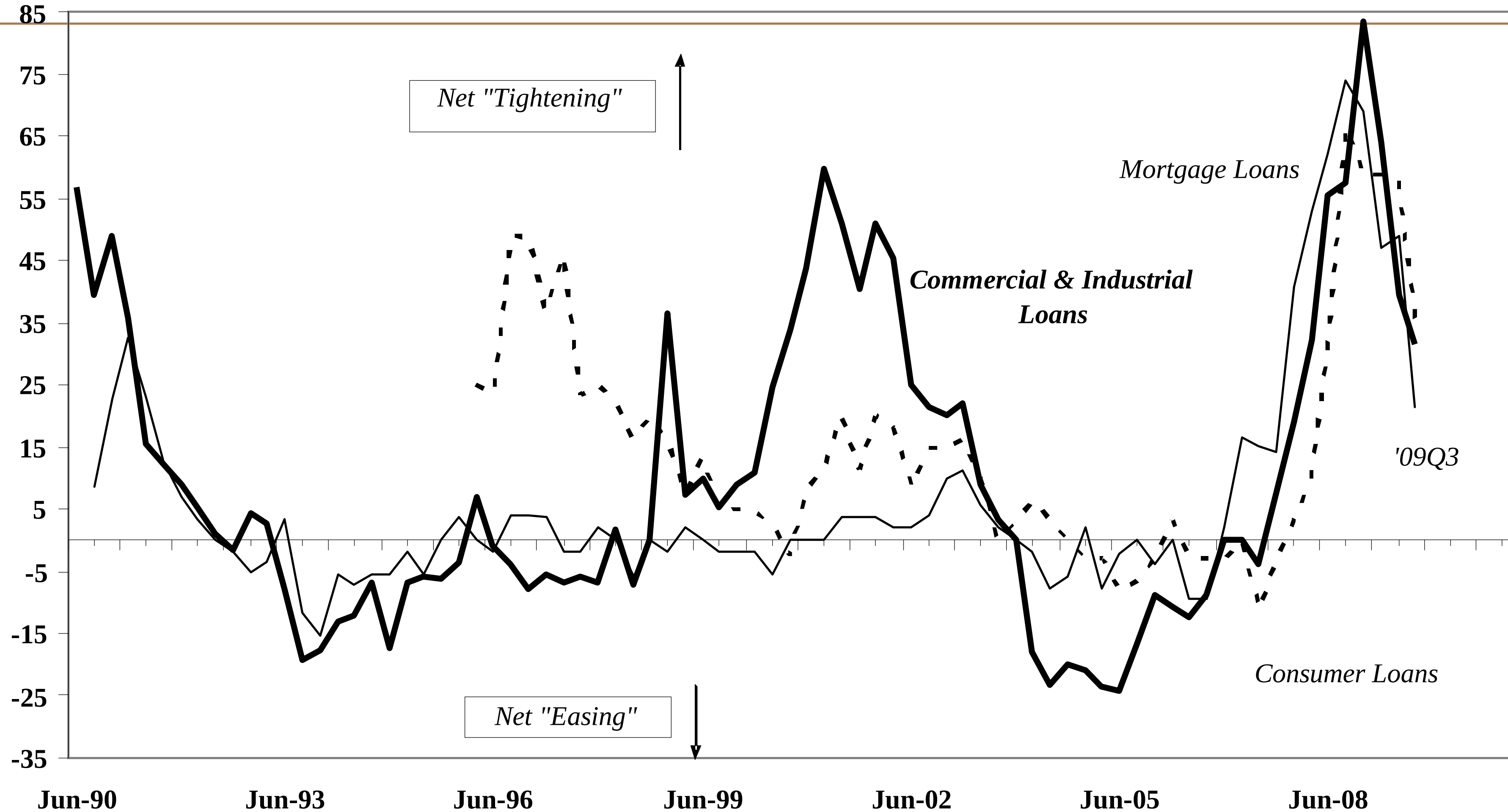

Banks continued to be less aggressive in tightening credit standards for a variety of loans during the spring, according to the Federal Reserve's latest Senior Loan Officer Survey, though pressure on bank capital and worries over the outlook for credit quality kept conditions very "tight." The improvement has been most noticeable for business commercial and industrial (or C&I) loans. Credit standards have changed more slowly for mortgages and, particularly, for consumer and commercial real-estate loans, amid looming credit-quality problems in those sectors of the market. Mortgage-loan demand has rebounded smartly with housing "affordability," while remaining weak for consumer and, particularly, business and commercial real-estate loans.

Source: Federal Reserve Board

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FEDERAL RESERVE SUPPORT ROTATES FROM BANKS TO THE MARKET FOR SECURITIZED ASSETS

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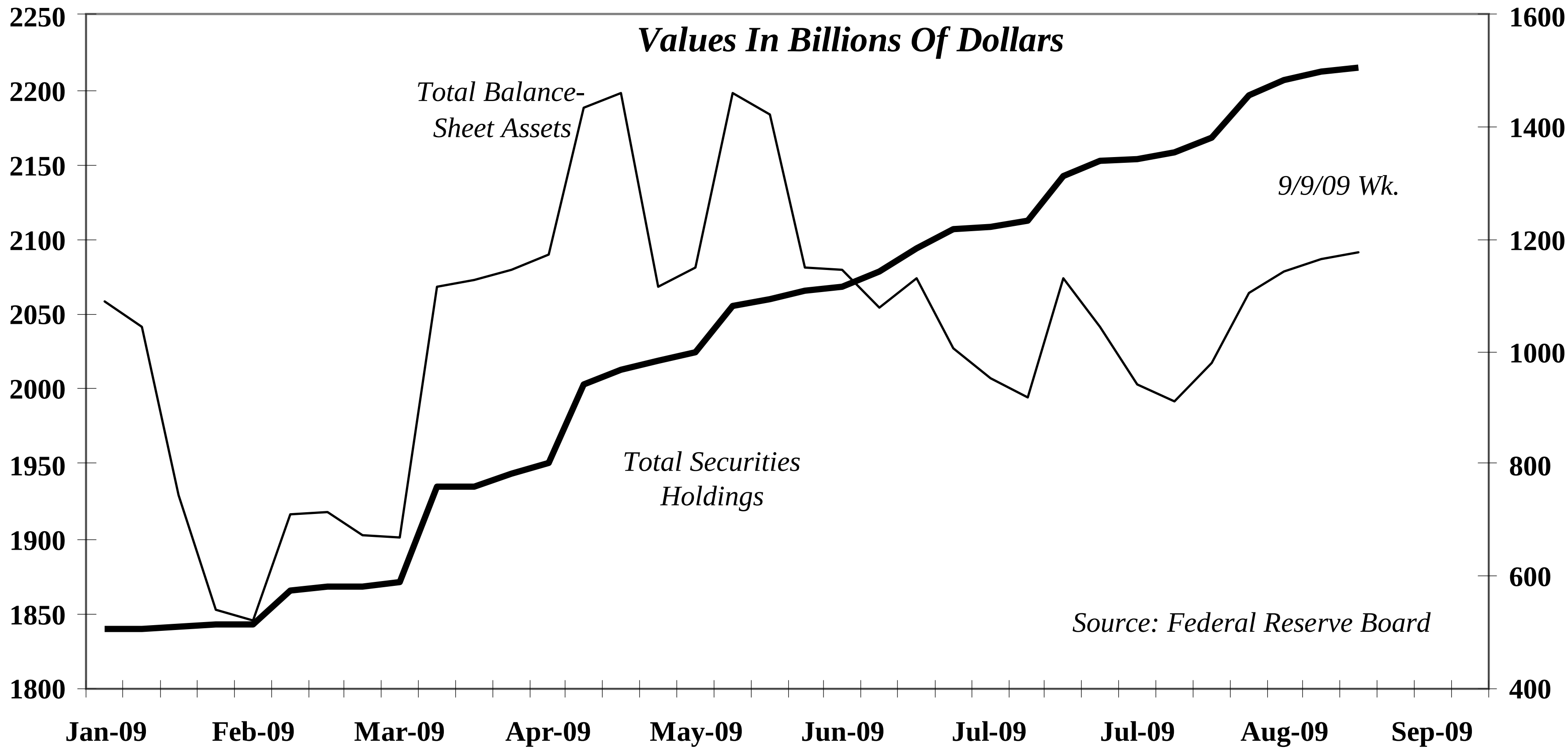
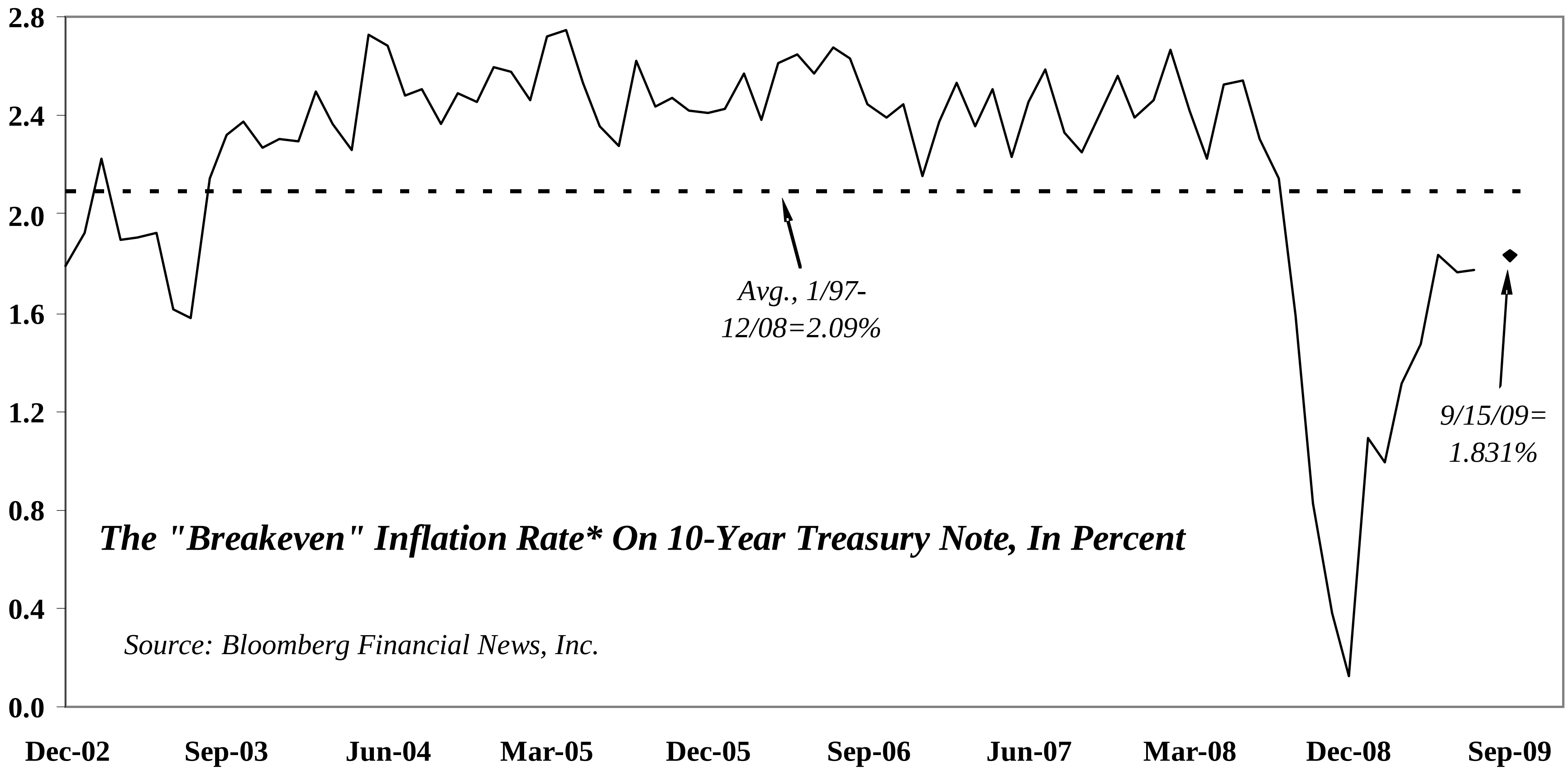


The Federal Reserve's balance sheet--a measure of its liquidity injections to the financial market--has stabilized just below last spring's peak, after doubling in the wake of the "shock" to the financial market a year ago. The biggest change in the past five or six months has been a shift in financial assistance from commercial banks to the market for securitized assets ("ground zero" in the financial market's initial blow-up). The Fed's direct purchases of securities have continued to rise, while many of the new loan and guarantee facilities for banks and money funds have been wound down or allowed to expire. The share of Treasury debt in the Fed's securities portfolio only recently has stabilized at just over 50% from 100% just prior to September's financial shock. The shift of support from the banking sector to securitized assets likely will continue, for now, as the Fed adds to its direct purchases of mortgage-backed securities and seeks to "re-liquefy" the market for securitized assets through TALF-related funding.

INVESTOR INFLATION EXPECTATIONS "THAWING" WITH THE CREDIT MARKET, BUT STILL SUBDUED BY HISTORIC STANDARDS…

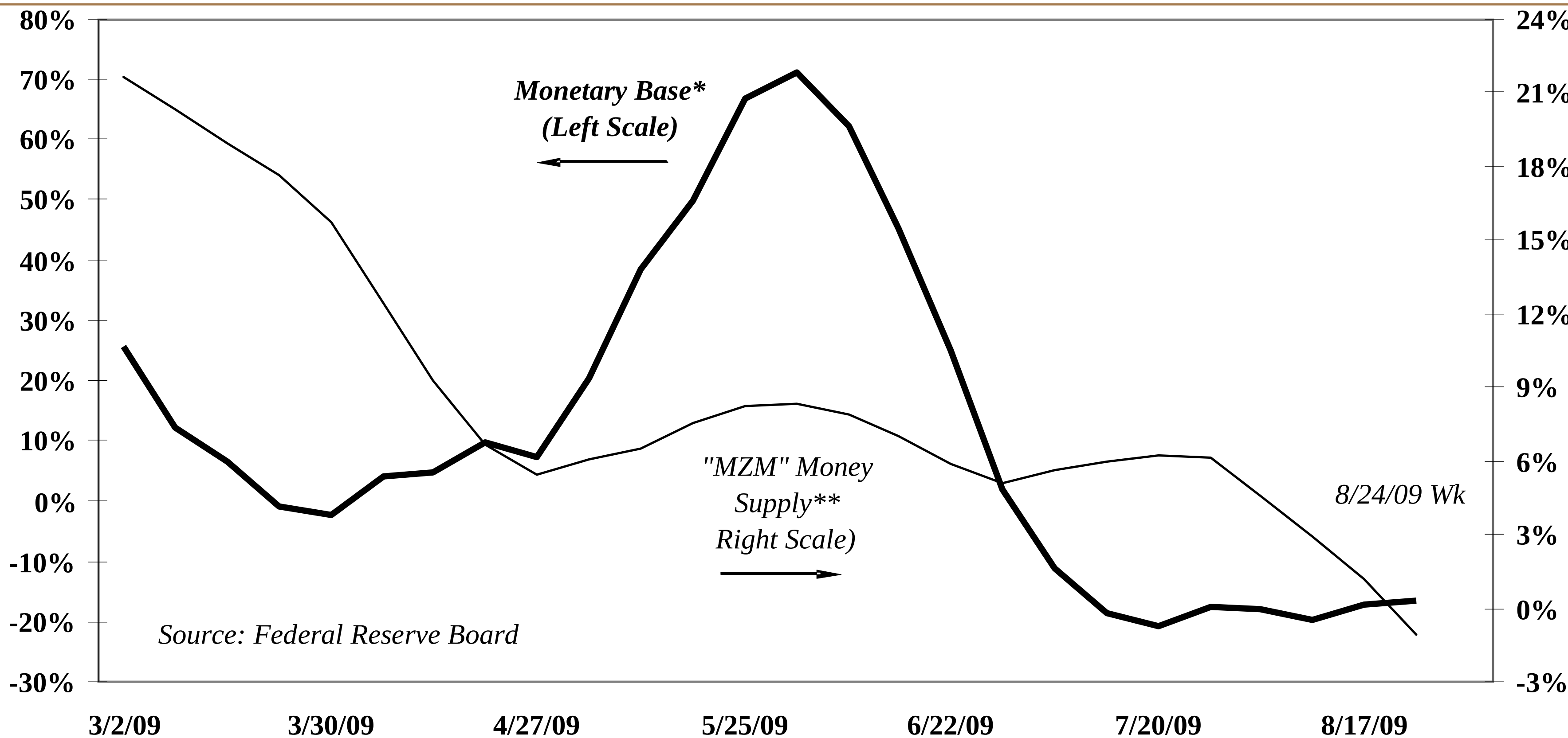


** The difference between yields on a conventional and an inflation-protected 10-year Treasury note, i.e., the inflation rate needed to keep the all-in yield on the inflation-protected security equal to that on a comparable conventional Treasury note.*

Investors' inflation expectations, based on the so-called "breakeven rate" in the market for Treasury inflation-protected securities (or "TIPS"), have risen with improved investor "visibility" on the economic outlook. However, these relatively subdued, long-term expectations still remain materially below their average rate of just over 2% since the inception of 10-year TIPS in 1997. While inflation worries likely will be restrained by the economy's sizable excess capacity and by intense global competition, any increase in expectations could signal reduced investor tolerance for massive deficit financing and debt "monetization" by the Federal Reserve.*

"QUANTITATIVE EASING" IN THE BANKING SYSTEM SHIFTS INTO REVERSE

Annualized 13-Week Growth, Based On 4-Week Moving Averages



** Currency plus bank reserves, the raw material for money creation. ** MZM is money M2, less small time deposits, plus institutional money market funds.*

The effects of the credit "thaw" and the recession-induced decline in credit growth, allowing the Federal Reserve to wind down its direct lending through newly created "windows," is apparent from the abrupt reversal of explosive growth in the "monetary base," the raw material for money creation. Triple-digit growth as recently as early February turned negative in late June, culminating in a double-digit decline by early August. Some of this reduced "quantitative easing" has been offset by the Fed's stepped-up securities-related lending. However, this unwinding, accompanied by a slowdown in the transactions-based, "MZM" money supply,** may be part of the recession and financial-sector de-leveraging and consolidation. However, the early effort by the Fed to restrain the growth of "liquidity" in the financial market also may shore up confidence in the Fed as the economic recovery proceeds.*

…ALONG WITH THE YIELD PREMIUM TO EXPECTED INFLATION

The Stated Yield On A 10-Year Treasury Inflation-Protected Note, In Percent

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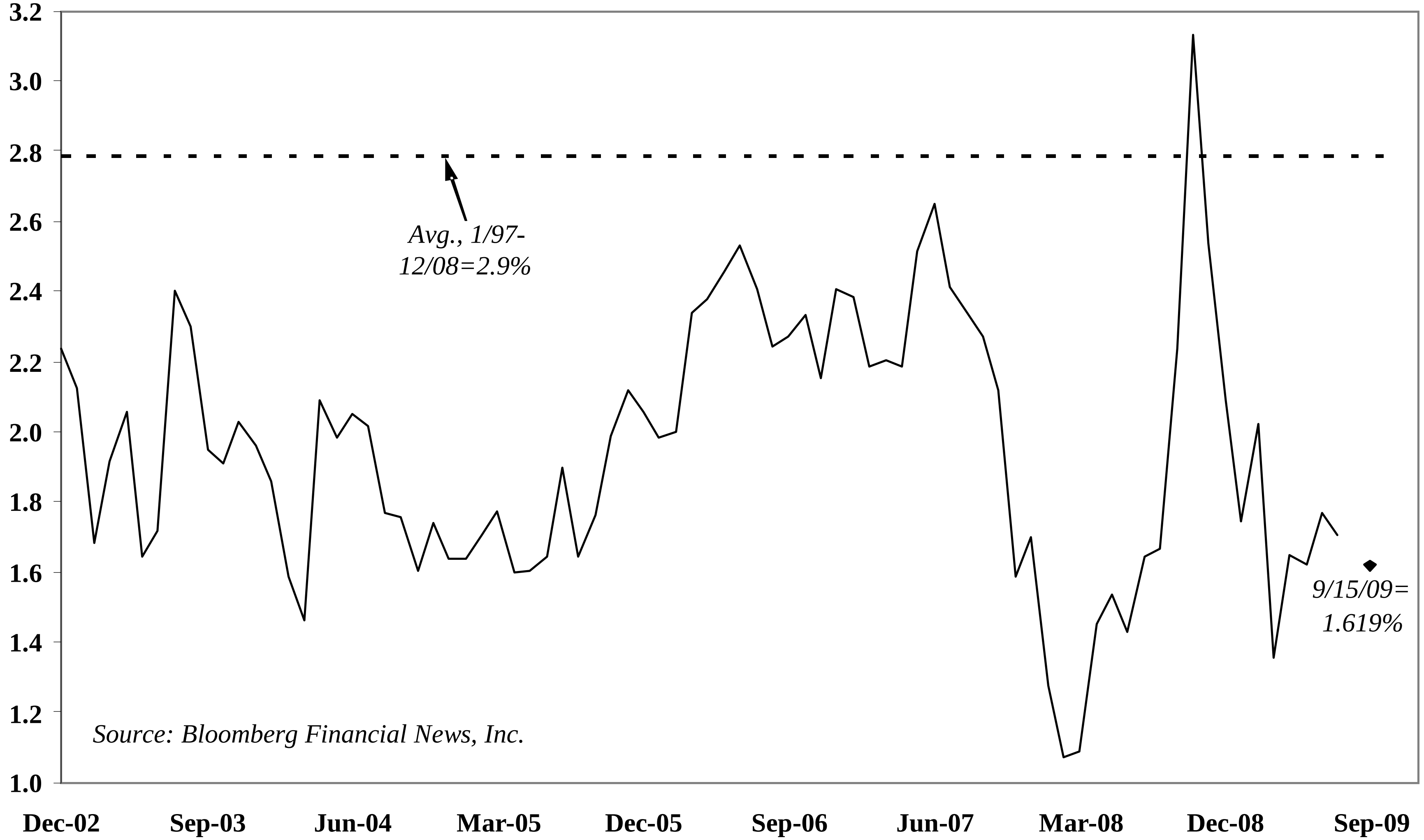

Historically low interest rates have helped keep the yield premium to inflation on a long-term Treasury note, as measured by the stated yield on a 10-year Treasury inflation-protected security (or "TIPS"), unusually "lean." Contributing to this narrow spread: "flight" capital, a weak economy, and confidence that sizable excess capacity in the economy will limit any future rise of inflation. This premium, like inflation expectations, is vulnerable to an improving economy, however.


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