



ECONOMIC AND MARKET COMMENTARY

THIRD QUARTER 2010

Economic Commentary

Overview: *The global recovery continues to be a combination of two stories - above trend economic growth in emerging markets; but, fragile and tentative economic growth in most advanced economies.*

In recent months, the largest emerging economies have maintained robust strength leading to policy tightening to prevent overheating or the creation of asset bubbles. Conversely, most advanced economies have recorded subdued economic growth, which suggests that the impact of the post-recession inventory surge and government stimulus have started to wane. We expect economic gains over the next two years to be secured with smaller and more focused initiatives.

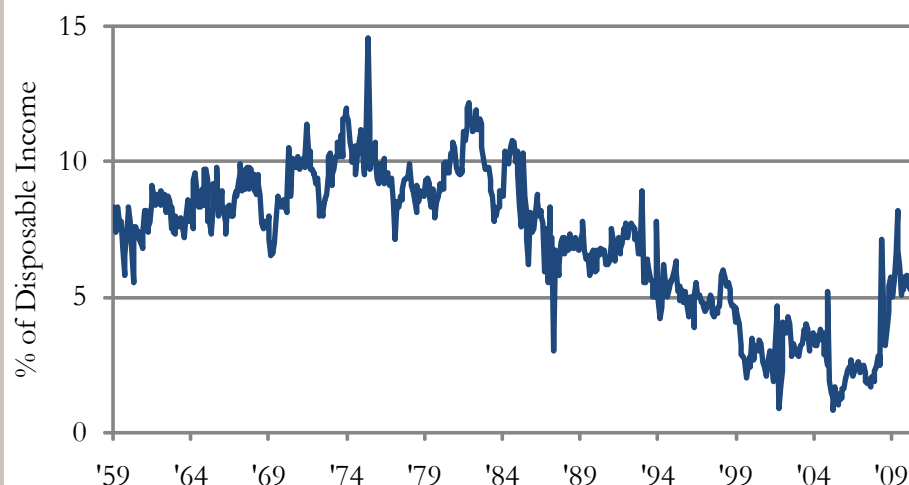
The U.S.: Economic growth in the U.S. slowed to 1.7% in the second quarter. We expect GDP to grow between 1.5% and 2.0% over the remainder of 2010 and 2011. As credit conditions improve and job growth gains momentum, real GDP growth should exceed 2.5% in 2012. *This represents historically sub-trendline economic growth.*



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Income and Savings: Personal income growth rose 0.5% in August, the highest monthly jump since the recession began. However, excluding transfer payments, income growth remained flat for the second month in a row. In other words, true income gains do not seem to have momentum. Personal spending was up by 0.4% while the saving rate climbed to 5.8% from 5.7% (see chart below) in July as consumers continue to repair their household balance sheets. Household deleveraging – evidenced by the 5.8% savings rate – will continue to hamper economic growth through 2011. We expect real personal consumption expenditures to grow around 2.0% annualized for the next several quarters, less than the average long run growth rate of 3.4%.

Personal Savings Rate





Consumer Confidence: The Conference Board's Consumer Confidence Index dropped to 48.5 in September from 53.2 in August reflecting consumer dismay with the lack of significant improvement in business and labor market conditions.

Retail Sales: U.S. retail sales in August increased for the second month in a row, rising 0.4%. Excluding auto sales, retail activity climbed 0.7%. Strong August retail sales on top of July's expansion are a good precedent for third quarter consumer spending. This suggests that the U.S. economy will remain on its recovery path.

Looking ahead, slow but continued improvements in the U.S. job market and slightly stronger household balance sheets should deliver a moderate improvement in private consumption, which is a good reason for cautious optimism. Stability of the consumer will also sooth the equity markets somewhat, and provide a modest support for higher equity prices.

Housing: The Case-Shiller Home Price Index gained 0.65% in July, recovering about 14% of its value since the trough in April 2009. Much of this improvement was due to the recently expired homebuyer tax credit. The Case-Shiller Index reflects activity over the past three months; the impact of the post-tax credit housing environment has still yet to show up in the price data releases. High foreclosure rates and depressed sales following the expiration of the tax credit suggest that inventories of unsold homes will remain high and price increases due to stimulus will gradually disappear during the remaining months in 2010.

Existing home sales, on the other hand, increased to 4.13 million from a record low of 3.84 million in July – a 7.6% increase. Moving forward, the tax credit distortion will gradually disappear, and existing home sales will very gradually improve due to favorable house prices, record low interest rates and continued economic growth.

U.S. housing starts rose by 10.5% to 598,000 in August. While the increase is welcome and suggests the payback from the homebuyers' tax credit could be over, starts remain at very depressed levels. We expect to see housing starts fluctuate near their current level through the rest of 2010, as elevated inventory levels impede more substantive growth. To summarize, headwinds in residential real estate remain including high unemployment and low consumer confidence which are a drag to demand for real estate across the country.

Inflation: The Consumer Price Index rose 0.3% in August, matching the July increase. Core inflation, which excludes food and energy, showed no change at all. The price increases in the last two months followed three straight months of price declines. Those declines raised concerns that our economy might be facing the threat of deflation. However, with overall prices rising again and the economy showing some signs of improvement those concerns have decreased. Over the last year, the CPI is up 1.1% and the Core CPI is up 0.9%.

Labor Market: In a recession characterized by private-sector deleveraging and balance sheet repair, income and job growth are fundamental to sustaining the economic recovery. Nonetheless, the U.S. labor market is beset by structural problems. Nonfarm payrolls fell by 95,000 in September while the unemployment rate remained at 9.6%. Private sector companies added 64,000 jobs, which wasn't enough to offset cutbacks in temporary census workers as well as state and local government employee cutbacks. The unemployment rate, which is calculated using a survey of households, is wrapping up its own distortions. Earlier this past summer, the unemployment rate dropped slightly, due in large part to people dropping out of the labor force as Congress let an extension of unemployment benefits lapse. Once that extension was put back in place, many of those people reapplied for benefits and are now counted as part of the work force. Much of that was accounted for in August, but it's still



reflected in September figures. In essence, unemployment is probably higher than this 9.6% figures suggests and we may see the rate rise this Fall unless the private sector can accelerate job creation.

The average time workers are unemployed remains very high suggesting continued credit and financial strain on many households. However, the gains in aggregate weekly hours worked supports the view that we should expect moderate economic growth ahead.

Of all economic data, we believe employment remains the most critical, since the jobs picture will determine whether this recovery is really sustainable. Persistently high unemployment represents a significant hurdle for consumer confidence and therefore consumer purchases. At present, corporate earnings and balance sheets are supportive of increasing payrolls. We have already seen productivity and sales improvements, and we think job growth could be just around the corner.

Federal Reserve: The disappointing pace of job growth over the last several months has been pivotal to the shift in tone of the Fed towards doing more to support the economic recovery. Given the Fed's explicit reference to their dual mandate of price stability and full employment, we expect a second round of quantitative easing (QE) to begin in early November. While the major impact of QE may be domestic – supporting demand by lowering borrowing costs and pushing up inflation expectations – printing more money also puts downward pressure on the U.S. dollar, and therefore has important ramifications for exporters as well as the trading partners of the U.S. and dollar denominated securities.

So far, Japan has paid the most attention to the net-export channel of U.S. monetary policy and has intervened in the foreign exchange market in order to reduce pressure on the Yen from the increasing likelihood of QE by the Federal Reserve. The Bank of Japan has recently announced a new 5 trillion Yen bond-buying program and lowered its overnight interest rate target from 0.1% to effectively zero (in fact a range of between 0.0-0.1%).

As more and more countries try to influence their exchange rates, *market participants are rightly beginning to worry about the implications of competitive currency devaluation.* At the center of this debate is China. While China has promised to follow a more flexible exchange rate, it has allowed the Yuan to appreciate against the U.S. dollar by only about 2% since the G-20 meetings in mid-June. China's resistance to allow its currency to revalue is aimed at maintaining employment growth within its leading export industries.

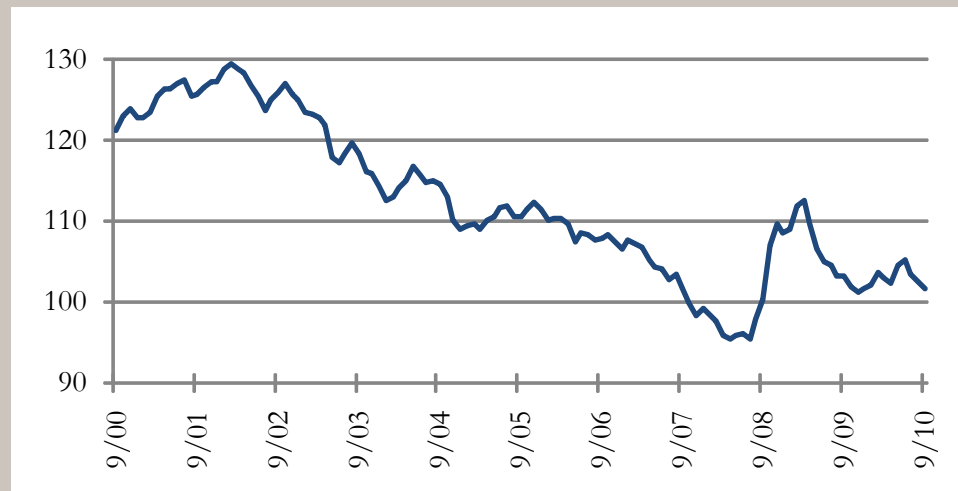
However, the strict nature in which the exchange rate is managed in China is perceived by its trading partners as favoring China's industries at the expense of its global competitors. The inflexibility of the Chinese currency puts upward pressure on a host of other currencies, further increasing the risk of a global currency war. The currency that has borne a considerable amount of the weight of a falling U.S. dollar has been the Euro. Given the challenges already facing Europe in terms of fiscal consolidation, this is a less-than-welcome development for that region. Within the U.S., the political pressure has also been stepped up with both the legislative branch and the Obama administration upping the pressure on the Chinese to allow their currency to appreciate further. Should the current situation deteriorate into a broad-based "beggar thy neighbor" currency war, the main loser could be the global economic recovery.

Global Currency Tension: Over the last few weeks, global currency tensions have been on the rise. Foreign exchange and regulatory interventions by Japan, Brazil and South Korea were followed by an escalation of official



rhetoric in the U.S. and Western Europe surrounding China's currency policy. However, the key mover in the currency market has been the signal that the Federal Reserve Bank may initiate a second round of quantitative easing in early November. The U.S. dollar has weakened (see chart below) against both major and emerging currencies with the dollar's trade-weighted index falling by more than 5%. The U.S. equity market rose and 10-year Treasury Bond yield fell.

**U.S. Dollar
Trade-Weighted
Index**



Current global currency tensions are driven in part by divergences in the strengths of global economic recoveries. In the advanced economies, disinflationary pressure and weak recoveries have forced monetary authorities to continue their accommodative policies. For example, the prospects for more an even more accommodative U.S. policy has led to the recent dollar weakness and strengths in the euro and the yen. On the other hand, the emerging markets are on a stronger economic growth path and face inflationary pressure. So the strength of foreign currencies manifests not only weakness in U.S. dollar but also strong domestic fundamentals and monetary policy trends.

In the short run, the stance of the Fed monetary policy will drive the currency markets. Given the strong possibility of further easing by the Fed, we see continued short term U.S. dollar weakness. The extent of the U.S. dollar vulnerability, however, will depend on the aggressiveness of the Fed's policy as well as monetary authority actions in other countries.

Europe: The euro zone economy grew 1.9% y/y in the second quarter, driven by a rebuilding in inventories, positive contributions from both private and public consumption, and a surge in German GDP. However, the lift to economic activity from the inventory build-up in recent quarters has run its course. As a result, consumption and fixed investment will need to carry a greater burden in driving the recovery, despite the headwinds imposed by still high unemployment and low capacity utilization rates. Unfortunately, a surge in consumption and investment does not appear to be happening. The best that can be expected is that these two components make a moderately positive contribution as the recovery progresses. Meanwhile, exports are also unlikely to fuel robust European growth as the euro has climbed in value in recent months.

Putting all of these together for 2010, we expect the euro area to grow by 1.5%, largely to reflect the stronger-than-expected growth in the second quarter. However, as discussed, the recent spurt of economic strength in the



euro zone has not changed the outlook in any meaningful way for 2011. Many of these countries still face a great deal of fiscal belt tightening that will reduce economic growth in 2011 and 2012. The lackluster performance of continental Europe will also likely result in a further weakening of the euro in 2011. .

China & Emerging Markets: China has spearheaded the solid run of emerging market economies since last year, and its economy remains buoyant, although it is showing some signs of slowing. Chinese real GDP grew by 11.1% during the first half of 2010, and it is set to end the year with a growth rate exceeding 10%. The restrictions imposed by Chinese authorities in April to cool down real estate activity have yielded a moderate deceleration in housing prices. However, increases in credit growth and inflation show that an abrupt economic slowdown is unlikely. Indeed, the policy-induced slowing seems necessary to temper asset price growth and the threat of inflation. We expect economic growth in 2011 to exceed 9%. Economic growth in other emerging markets, including India and Brazil, has also been high pushing central banks into a tightening mode.

Economic Outlook: The main threat to global growth continues to be the sovereign debt situation of some European nations and its possible implications for financial market stability. We have stated repeatedly that the efforts at fiscal *consolidation will last several years* and in the meantime high debt-to-GDP ratios will pose a risk to the financial stability of these countries. As such, any negative development involving a euro zone sovereign could impact financial markets. On the upside, a marked improvement in U.S. business and consumer sentiment and/or a sharp increase in U.S. credit flows could propel business investments and household consumption and improve labor market conditions, yielding much stronger output gains than we currently forecast. And, there is the possibility that Europe might surprise us with respect to its resiliency.

The bottom line is that these are very uncertain economic times. There are numerous risks and it is extremely important to watch them closely. Painful balance-sheet adjustments in both public and private domains will limit economic growth in advanced economies for a number of years, and make them more vulnerable to future shocks. This is particularly the case for a number of European nations, which will struggle to grow under the burden of oversized sovereign debts. Our outlook thus calls for the advanced economies to grow very timidly for several years and the emerging markets to continue to grow at a fast but declining rate.

Capital Market Consultants

CMC provides open architecture investment program and economic research consulting services to the financial services industry. For more information on how CMC can help your firm contact Barry K. Mendelson, CIMA 414-727-7995 or barry@cmarkc.com.

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What's New at CMC in 3Q?

Dr. Abdur Chowdhury, CMC's Chief Economist and Chair and Professor of Economics in the College of Business Administration at Marquette University, has been appointed to the Chicago Federal Reserve Bank's Academic Advisory Council. Dr. Chowdhury will join more than a dozen other professors within the Chicago Fed's district to provide monetary policy advice to the Chicago Fed...CMC was published in Horseshmouth.com during the 3Q...We will be relocating our headquarters offices to larger quarters in our current office building in the 4Q.



CAPITAL MARKET PERFORMANCE

Index Performance as of September 30, 2010	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth	10.92	12.98	4.80	12.81	2.08
3000	9.44	11.53	4.78	10.96	0.92
3000 Value	7.99	10.10	4.79	9.15	-0.39
1000 Growth	10.65	13.00	4.36	12.65	2.06
1000	9.19	11.55	4.41	10.75	0.86
1000 Value	7.76	10.13	4.49	8.90	-0.48
MidCap Growth	12.09	14.65	10.85	18.27	2.86
MidCap	10.58	13.31	10.97	17.54	2.60
MidCap Value	9.26	12.13	11.15	16.93	1.97
2000 Growth	14.15	12.83	10.23	14.79	2.35
2000	12.46	11.29	9.12	13.35	1.60
2000 Value	10.74	9.72	7.92	11.84	0.73
S&P 500					
Consumer Discretionary	11.10	15.17	13.34	23.63	2.10
Consumer Staples	5.86	10.63	7.54	12.94	6.51
Energy	9.20	12.95	-0.84	4.70	2.60
Financials	6.08	4.33	0.50	-2.84	-11.19
Health Care	9.03	8.86	-0.71	8.31	1.40
Industrials	11.40	14.31	13.34	19.44	1.88
Information Technology	12.14	11.78	-0.04	10.66	3.21
Materials	7.75	17.84	2.66	10.22	6.02
Telecommunication Services	8.15	20.96	10.83	19.07	5.11
Utilities	2.93	12.35	4.32	11.90	2.51
Other U.S. Equity					
Dow Jones Industrial Avg.	7.85	11.13	5.57	14.12	3.13
Wilshire 5000 (Full Cap)	9.43	11.68	5.57	11.86	1.42
International Equity					
MSCI EAFE	9.82	16.53	1.46	3.71	2.45
MSCI Emerging Markets	11.13	18.16	11.02	20.54	13.08
MSCI AC World	9.60	14.46	4.03	8.95	2.93
MSCI AC World ex: US	9.97	16.66	4.06	8.00	4.72
Fixed Income					
Barclays Aggregate Bond	0.11	2.48	7.94	8.16	6.20
Barclays 1-3 Month T-Bill	0.01	0.04	0.09	0.11	2.48
Barclays Government	0.05	2.52	8.05	6.97	6.10
Barclays Credit	0.65	4.64	10.53	11.67	6.48
Barclays High Yield Corporate	3.01	6.71	11.53	18.44	8.37
Barclays Muni Bond	-0.16	3.40	6.83	5.81	5.13
Barclays TIPS	0.60	2.49	7.00	8.89	5.49
Barclays Global Agg. Ex: US	3.96	10.85	6.37	4.72	6.96
Barclays Emerging Markets	1.76	8.14	14.24	16.97	9.15
Alternatives					
HFRI Equity Hedge	4.50	6.52	5.80	9.56	4.46
HFRI Equity Market Neutral	1.55	1.86	4.17	3.80	2.63
NAREIT Equity REIT	4.47	12.83	19.08	30.27	1.88
Dow Jones UBS Commodity	7.26	11.61	0.90	10.01	-2.35