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U.S. Economy Continuing on a Recovery Trajectory



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Economic data released over the past week show that the U.S. economy is continuing to revive, with most reports typical of the early stages of a cyclical recovery. In particular, while the unemployment rate increased to 10.2% in October, job losses continued to moderate and job losses for August and September turned out to be considerably smaller than previously estimated. Non-farm productivity grew at an extraordinary 9.5% rate in the third quarter; such productivity gains are encouraging for profits but also tend to lead increases in employment. Both the non-farm payrolls report and the productivity data are consistent with our forecast that employment should begin to grow again in the first quarter of 2010.

At this early stage of recovery, the turn in the inventory and industrial production cycle is an important driver of growth in the United States and around the world. This helps explain the difference in the two purchasing management indices released by the Institute for Supply Management (ISM). The ISM manufacturing index increased more than forecast in October, with the production index rising to 63.3, but the non-manufacturing index fell slightly compared with consensus forecasts for a modest increase.

The Federal Open Market Committee (FOMC) announced on Wednesday that it intended to leave monetary policy essentially unchanged. The committee saw some further improvement in economic conditions, but still anticipated weak economic growth and low inflation. We believe that the FOMC's assessment of economic conditions is somewhat conservative, and continue to expect that it will begin to raise the Fed Funds target starting in the second quarter of 2010 and raise rates very gradually thereafter.

Non-farm payrolls (10/09) fall more than forecast; unemployment above 10%

The Bureau of Labor Statistics reported on Friday that non-farm payrolls fell more than expected in October, but that employment declines in August and September were materially smaller than previously estimated. The unemployment rate, computed from the separate household survey, rose more than forecast and broader measures of unemployment continued to increase. Hours worked were flat in the private sector as a whole and increased slightly in manufacturing. Although the report showed a greater than expected decline in payrolls, it is consistent with our forecast that declines in employment moderate through year end and that employment begins growing early in 2010. Taken as a whole, the report is positive news for employment conditions.

- Total non-farm payrolls fell by 190,000 in October, following declines of 219,000 in September and 154,000 in August. The Bureau initially had reported September's decline at 263,000 and revised August's from 201,000. The mean forecast for October had been a decline of 175,000 and individual forecasts ranged from -250,000 to -105,000. Average private sector hours worked was unchanged at 33.0 and manufacturing hours rose to 40.0 from 39.9, although the aggregate weekly hours index fell 0.2 to 98.3.
- Government employment was unchanged in October, so that the entire 190,000 decline in jobs came in the private sector, a bit smaller than the 203,000 decline in private sector jobs reported earlier this week on the ADP survey. Manufacturing job losses increased in October to 61,000 from an average of 47,000 in the previous three months, with most of the decline in durable goods manufacturing. (Continued)

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declines in manufacturing employment despite a recovery in production reflect large gains in manufacturing productivity: while October data are not yet available, manufacturing productivity rose at a 13.6% annual rate in the third quarter and a 6.8% rate in the second.) Construction jobs fell by 62,000 in October, in line with the July-September average.

- Service sector employment as a whole fell by 61,000, with the decline entirely in the private sector. Retailing jobs fell by nearly 40,000, leisure and hospitality jobs fell by 37,000, and transportation and warehousing jobs fell by 18,000. Health care and education employment continued to increase, while financial services jobs fell modestly. Temporary help jobs increased by 34,000; this is an important leading indicator of future employment.
- The unemployment rate rose to 10.2% as the separate household survey showed a loss of 589,000 jobs and a 31,000 decline in the labor force. The mean forecast had been for the unemployment rate to rise to 9.9%, with individual forecasts ranging from 9.8% to 10.1%. Broader measures of under- and unemployment continued to rise. The broadest measure — the officially unemployed plus discouraged workers plus those working part-time for economic reasons — rose to 17.5% of the labor force from 17.0% in September and 12% in October 2008.
- Earlier in the week, the ADP survey, which covers private sector jobs alone, showed that private sector employment fell by 203,000 in October, and that private sector job losses in August and September were smaller than first estimated. September's job decline was revised to 227,000 from 254,000 while August's was revised to 267,000 from an originally reported -298,000. The ADP results thus paralleled those from the Bureau of Labor Statistics.
- On a shorter-term basis, the U.S. Department of Labor reported that initial unemployment insurance claims fell 20,000 to 512,000 in the week ending October 31, below the consensus forecast of 522,000. Continuing claims fell to 5.75 million in the week ending October 24, in line with consensus expectations. We expect weekly initial claims to fall below the 400,000 weekly level normally associated with the turn to recovery by year-end.

Source: U.S. Department of Labor, Bureau of Labor Statistics, ADP

Non-farm productivity (3Q09, preliminary) rises more than expected

The U.S. Bureau of Labor Statistics reported that non-farm productivity had risen sharply, and more than forecast, in the third quarter. The increase in productivity outpaced the increase in hourly compensation resulting in lower unit labor costs.

- Non-farm business productivity grew at a 9.5% annual rate in the September quarter, faster than the 6.5% mean forecast. Individual forecasts ranged from 3.8% to 8.5%. This was the largest gain in productivity since the third quarter of 2003, when it rose 9.7%. The gain in productivity resulted from a 4% increase in non-farm output and a 5% decline in hours worked. Unit labor costs fell at a 5.2% rate compared to an expected 4.2% decline. From the third quarter of 2008 to the third quarter of 2009, non-farm output fell 3.5% and hours worked fell 7.5%, resulting in a productivity increase of 4.3%. Unit labor costs declined 3.6% over the last four quarters.
- Manufacturing productivity rose 13.6% in the third quarter. Manufacturing output increased 7.7% but hours worked fell 5.2%. This was the largest increase in quarterly productivity since 1987. Productivity changes were larger in durable goods industries than in nondurable goods industries. Unit labor costs fell 7.1% in manufacturing.
- Revisions to earlier data show that productivity growth was higher (6.9% vs. 6.6%) than previously believed in the second quarter of 2009. Unit labor costs were revised down to -6.1% from -5.9%. Roughly speaking, this suggests that the potential growth rate of U.S. GDP should be over 3.0%, higher than the 2.0–3.0% rate assumed by the consensus.

- Research from the Federal Reserve Bank of New York suggests that non-farm productivity is a leading indicator of employment, with a lead of about four quarters. Since productivity growth turned up dramatically in the second quarter of this year, this relationship suggests that employment should begin to grow in the first quarter of 2010, consistent with our forecast.

Source: U.S. Department of Labor, Bureau of Labor Statistics

These data suggest potential for margin improvement in U.S. companies as demand revives in the U.S. and globally and thus support an optimistic view of earnings prospects. Furthermore, the decline in unit labor costs highlights the absence of any short-term upward pressure on core inflation.

ISM manufacturing index (10/09) increases more than forecast, while the non-manufacturing index falls slightly

The Institute for Supply Management (ISM) manufacturing index increased more than forecast in October, following a slight decline the previous month. Components of the index, particularly the production index, were generally strong but the new orders index declined modestly. The employment index moved over 50, and the rate of inventory liquidation appeared to slow. The report points to a strong expansion in manufacturing production, which we expect to continue into next year. At the same time, however, the non-manufacturing index, which largely reflects service sector activity, fell, although remaining above the 50 growth threshold.

- The headline manufacturing PMI rose to 55.7 in October from 52.6 in September and 52.9 in August. Consensus expectations had been for 53.2, with individual forecasts running from 52.0 to 55.0. Thirteen of the 18 industries surveyed reported expanding activity in October, with only primary metals, non-metallic minerals and wood products reporting contraction. According to historic relationships, October's 55.7 level is consistent with 4.5% annualized GDP growth, considerably above the consensus forecast for fourth quarter growth of 2.4%. The manufacturing PMI averaged 44.6 from January through October, which is consistent with a 1.1% annual GDP growth rate; the consensus forecast for full-year 2009 GDP is -2.5%.
- The one major index component that did not increase in October was new orders, which fell to 58.5 from 60.8. In October 34% of firms reported stronger new orders, down from 42% in September, while 24% reported weaker new orders. Nine industries reported new order growth in October: furniture, apparel and leather products, computers and electronic equipment, electrical equipment, machinery, appliances, fabricated metals, chemicals and food/beverages/tobacco. Industries with declining new orders were mostly raw material producers: primary metals, non-metallic minerals, plastics and rubber and wood products.
- The production index, by contrast, rose to 63.3 from September's 55.7, as 37% of firms reported higher production levels and only 15% reported lower production. Eleven of the 18 industries reported growth in production, while only non-metallic minerals and primary metals reported declines. The order backlog index was unchanged at 53.5 with slightly larger numbers of firms reporting both higher and lower backlogs than in September. Manufacturing inventories continued to contract in October, although at a lower rate than in previous months. The inventory index rose to 46.9 from 42.5 as 26% of firms reported further inventory reductions (vs. 31% in September) and 19% reported raising inventories.
- The employment index rose above 50 in October (to 53.1 from 46.2) after 14 months below this threshold. The share of firms increasing employment was still only 20% (up from 15% in September), but it exceeded the share of firms cutting jobs (16%, down from 23% the previous month). Eight industry groups reported higher employment while four reported declines. While the increase in this index is encouraging, it does not signal that manufacturing employment actually increased in October, or will any time in the near future, since manufacturers are paying extremely close attention to productivity and costs. However, it should signal a reduced rate of decline.
- The price index rose to 65.0 from 63.5 as 37% of firms reported paying higher prices for their inputs, up slightly from 36% in September. Only the non-metallic minerals industry reported paying lower prices. Commodities reported up in price were metals – aluminum, copper products, steel and stainless steel – as

well as chemicals (caustic soda and polypropylene), plastics and plastic products, and natural gas. Only corrugated containers were down in price, and no goods were reported to be in short supply.

- The headline index for non-manufacturing sectors, by contrast, fell to 50.6 from 50.9 in September vs. a mean forecast of 51.6. The business activity/production index for the non-manufacturing economy rose to 55.2 from 55.1. Broadly speaking, the industries that reported growth were more cyclically sensitive than those reporting lower levels of activity.
- The non-manufacturing new orders index rose to 55.6 from 54.2, as 25% of respondents reported stronger new orders (again, unchanged from September) but 17% reported weaker new orders (down from 21%) and nine industry groups reported stronger new orders. The order backlog index rose to 53.5 from 51.5 as 19% of respondents reported greater backlogs (also unchanged from Sept.) but 12% reported lower backlogs (down from 16%).
- The index for employment outside manufacturing fell back to 41.1 in October from 44.3 in September, its 21st contraction in 22 months, as only 5% of non-manufacturing organizations reported higher employment (down from 13%) and an unchanged 27% reported job cuts.

Source: Institute for Supply Management

We have highlighted over the past several months that the sharp decline in inventories and industrial production that occurred globally late last year and in early 2009 was likely to be followed by an equally sharp upward move in production. This is clearly underway now, with the manufacturing ISM index above 50 for the third consecutive month and the production index above 60. Nevertheless, firms are still reducing inventories. We believe that the upward move in industrial production can continue for several more months both in this country and around the world, and serve as a powerful catalyst to recovery in the world-economy as a whole.

October's non-manufacturing survey points to a continued moderate rate of expansion in the non-manufacturing sectors of the economy, with the total PMI still slightly above 50 and the activity index at 55. Activity in many service industries included in this report, e.g., government, health care and education, varies less with the business cycle than does activity in most manufacturing industries. Many other service industries derive most of their sales from consumer spending. As a result, at this early stage of recovery when GDP growth is being driven by the inventory and industrial production cycles, the non-manufacturing ISM index should continue to show a somewhat lower level of activity than the manufacturing index.

FOMC leaves policy largely unchanged; assessment of economic conditions is cautiously optimistic

At the end of a two-day meeting, the Federal Open Market Committee (FOMC) announced that it once again intends to keep its policy stance largely unchanged. The committee acknowledges some further improvement in economic conditions, but still anticipates weak economic growth and low inflation. The improvement in cyclical conditions is not yet enough for the committee to abandon its pre-commitment to keep the Fed Funds rate "exceptionally low" for an "extended period." The only change to policy in the statement was a modest reduction in targets for agency debt purchases.

- The analysis of current economic conditions in today's statement changed little from that following the previous meeting on September 23. In our view, it represents a cautious and conservative assessment of conditions. Economic activity has "continued to pick up," with the level of housing activity rising and some growth in consumer spending. The statement once again emphasized pressures facing households: job losses, weak income growth, lower housing wealth and tight credit. The assessment of business investment, hiring and inventory liquidation was unchanged from September's report, noting that businesses "are still cutting back on fixed investment and staffing." The FOMC continues to expect that economic conditions will "remain weak for a time," but that a combination of policy and intrinsic market forces should eventually bring about stronger growth. As in September, the FOMC made no mention of recoveries outside the U.S. providing support for export demand. As distinct from the economy, "financial markets" were "roughly unchanged" since September in the FOMC's view.
- The statement's wording on inflation was unchanged from September. In the FOMC's view, the output gap ("substantial resource slack") remains large enough to dampen cost pressures; with the broadest

measure of unemployment and under-employment at 17% in September and likely to rise further, it is difficult to quarrel with that view. Long-term inflation expectations remain stable in the FOMC's view; we will get an update on this in a few days when the Survey of Professional Forecasters, a measure of expectations closely watched by the FOMC, is updated.

- The committee's characterization of the current policy stance is largely unchanged from September. The committee will keep the Fed Funds target in its zero to 25 basis point range. The committee has kept the wording that "economic conditions...are likely to warrant exceptionally low levels of the Fed Funds rate for an extended period," but was a bit more explicit in saying what those are – and thus what would have to change in order to warrant a tightening. The conditions are, in its view, high unemployment ("low rates of resource utilization"), subdued inflation trends and stable inflation expectations. Describing these conditions more clearly is some help to markets in trying to assess what the FOMC will look for as it decides when to tighten.
- The asset purchase program has been cut slightly, with the target for agency debt cut to \$175 billion from \$200 billion. This reflects the "limited availability" of agency debt rather than any view that a smaller purchase program is warranted for macroeconomic reasons. The MBS and agency debt program is still expected to be completed by March 31, 2010.

Source: Federal Reserve Board

This decision was largely in line with expectations, although any additional bit of clarity on the reversal of monetary stimulus is doubtless welcome to the markets. We continue to expect that the FOMC will begin to raise the Fed Funds target starting in the second quarter of 2010, but will raise rates very gradually next year.

Pending home sales (9/09) rise sharply vs. expectations for no change

Pending home sales, reported by the National Association of Realtors (NAR), increased unexpectedly in September. The increase probably reflects a surge of contracts signed in anticipation of the expiration of the homebuyer tax credit. Although some extension of the credit into 2010 now appears likely, September's strength probably will be followed by a decline in pending sales for a few months. The timing effects of the credit and its extension, however, do not alter our view that pending home sales should remain on an upward trend and that existing home sales should continue to rise.

- The pending home sales index rose 6.1% in September following a 6.4% rise in August (which was not revised). The mean forecast had been for no change in the index, and individual forecasts ranged from -2.5% to +5.5%.
- Contract signings varied by region in September, with the pending sales index up 10% in the West, 8% in the Midwest and 5% in the South, but down 2% in the Northeast. Year-over-year, the index was up 21.2%, with regional increases ranging from 17% in the Northeast to 24% in the West.
- The NAR housing affordability index increased to 162.7 in September from 159.5 in August. The index remains below its spring 2009 peak of 179 because home prices and mortgage rates have risen while median income has actually declined. Nevertheless, the September figure indicates that a household earning the national median income could afford a house priced 63% above the median single-family home. Affordability varies by region, with the index at 198 in the Midwest, 169 in the South, and about 131 in the Northeast and West. Median prices vary from \$147,000 in the Midwest to \$238,000 in the Northeast.

Source: National Association of Realtors