



Sound of the Economy

NORRIS, PERNÉ & FRENCH LLP

Investment Counsel
Established 1933



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Economy Overview

In May's Sound of the Economy issue our message was that the economic and financial situation was unlike any in recent times. The convergence of a housing market collapse, a near shutdown of credit, and a financial crisis created what Fed chairman Ben Bernanke called the perfect storm. These negative forces, the scale of which has not been seen since the 1930s, plunged the country into a recession in December, 2007. It is the longest since World War II. Other recessions have been more painful by some measures, but this recession delivered so many simultaneous severe blows to the economy that it feels worse than others.

Most cycles play out in a more or less consistent fashion. The average expansion or recession, bull market or bear market, lasts so many months and rises or falls by so much. But most of the time does not mean every time.

This past year we experienced a downturn that was atypical in a number of ways. While it has some of the trappings of a normal economic cycle -- particularly with respect to the need to slash inventories, a downturn in housing and, only recently, consumer spending -- it was not caused by high interest rates or inflation. Most recessions end when the Fed thinks it's done enough to fight inflation. But this downturn was set off by a housing and credit collapse, making Fed rate cuts less effective in spurring growth.

We see signs that the economy is stabilizing and may have hit bottom in the spring, 2009. There is, however, no evidence of a strong recovery on the horizon. The advance estimate of second quarter 2009 gross domestic product (GDP) showed a decline of 1.0 percent. This better than expected showing (consensus was -1.5 percent) provided the strongest signal yet that the longest recession since World War II is finally winding down.

The improvement from a recession/depression to just a recession is due largely to government spending. The federal

government increased spending at a pace of 10.9 percent, the most since the third quarter of 2008. State and local governments increased spending at a pace of 2.4 percent, the most since the second quarter of 2007. In addition to government spending, less drastic spending cuts by businesses and an improved trade picture were key forces behind better performance. Although exports fell, imports fell more, narrowing the trade gap and adding 1.38 percentage points to second quarter GDP.

Rising unemployment and lower investment and home values have weighted down consumer spending. Real personal consumption expenditures decreased 1.2 percent in the second quarter, as compared to an increase of 0.6 percent in the first quarter. For an economy driven by consumer spending, this is not good news. With consumers spending less on everything from cars to clothes, the savings rate rose sharply to 5.2 percent in the second quarter, the highest since 1998.

The second-quarter decline in GDP came after an economic freefall, declining at an annual rate of 6.4 percent in the first quarter. That was the sharpest decline in nearly three decades. The economy has contracted for four straight quarters for the first time since record keeping began in 1947. The Commerce Department reported that the recession inflicted even more damage on the economy last year than the government previously reported. It estimates the economy grew just 0.4 percent in 2008, much weaker than the 1.1 percent that the government earlier reported.

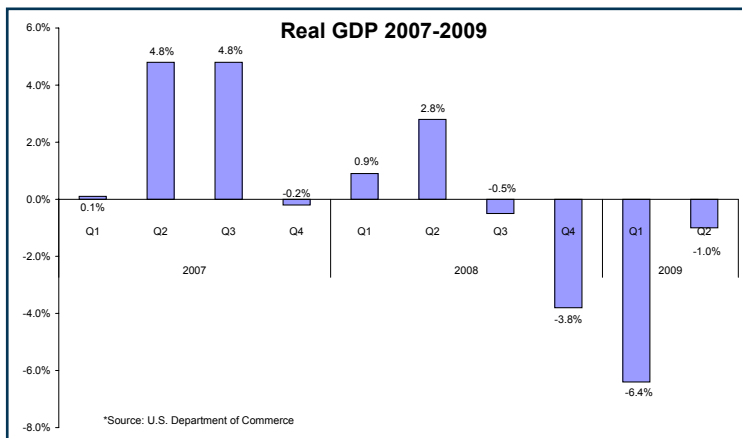
These revisions indicated that the first 12 months of the recession saw the economy shrink more than twice as much as previously estimated, reflecting even bigger declines in consumer spending and housing. This does not negate the current evidence of a near term pick-up in activity, but it leaves uncertainties about prospects out 12-18 months.



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Forecast Unchanged

Unlike Michigan's weather, the NPF economic forecast remains unchanged since February: The recession may officially end later this year, but the recovery will be sluggish.

Reviewing previous forecasts and commentaries is generally a humbling experience. Our view that we were in unfamiliar territory certainly was borne out. At the beginning of the year, we looked for more of the same bad economic news experienced in the second half of 2008. We expected the economic data to get meaningfully worse in the short-term. We saw the recession continuing through the first half of 2009, but we expected the economy to gradually improve in the third and fourth quarter and continue into 2010. Our forecasts seem to be on target.

We leave our 2009 forecast unchanged:

2009 Forecast

Real GDP	-1.5%
Headline CPI	-0.5%
Ten-year treasury range	3.2% to 4.5%
Year-end	3.8 %
S&P 500 return	7.0% to 10.0%

The real question for investors is how the economy is likely to perform once we get into the second half and beyond. On that score there is caution. As we wrote in the last issue, we did not see any coiled springs likely to make this a particularly robust recovery. We expected the US economy to crawl out of recession this summer. Three months later those are still our views.

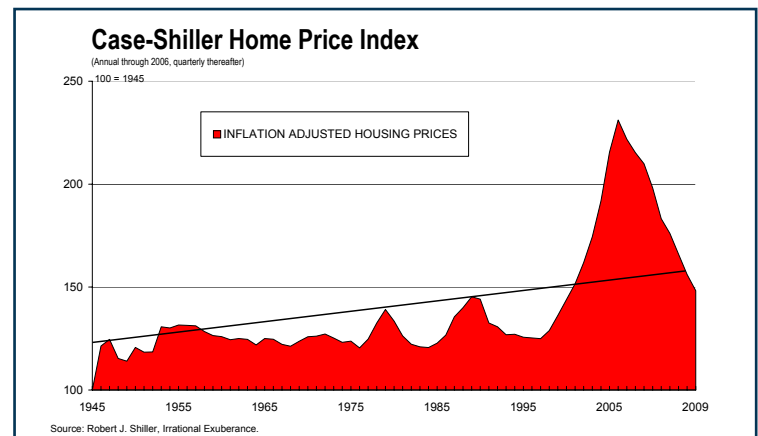
Outlook

Looking ahead there is considerable evidence that an economic turn is at hand. Tentative signs that the economy is bottoming emerged in June and July, particularly within the manufacturing and housing areas.

The last two monthly releases of the Institute for Supply Management's manufacturing index provide promising signals. The index rose to 48.9 in July from 44.8 in June, exceeding the 46.5 consensus estimate. The index was at 42.8 in May. A leading economic indicator, this index indicates activity in the manufacturing sector began to improve in the last two months. Though still contracting (readings below 50 indicate contraction) the reading was the highest since August 2008.

Housing data has begun to look less bleak. Home prices continue to fall, but at a slower rate. It's not the bottom, but the beginning of the bottoming process. New home sales rose 11 percent month over month to 384,000 and more importantly there is evidence of stability in home prices. The S&P/Case-Shiller Home Price Index of twenty metro areas

rose 0.5 percent in May. This was the first monthly gain of home prices in nearly three years. Home prices are down 17.1 percent from one year ago and roughly 30 percent lower than their peak in May 2006.

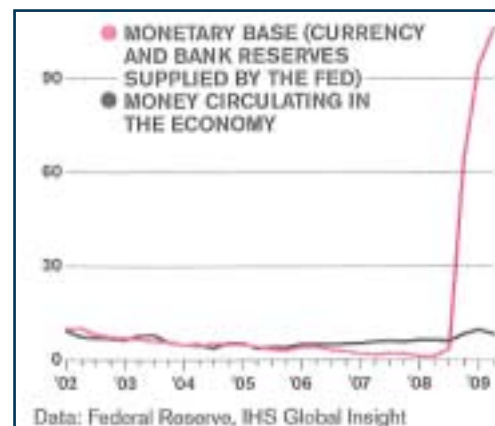


A large degree of economic slack should warrant further deceleration in core CPI readings. Declining capacity use, high unemployment, a weak housing market and low velocity of money all argue that inflation will remain low throughout this part of the cycle. While headlines scream about inflation because of the government's massive stimulus actions, the reality is most of the money injected into the "system" was used by banks to shore up their balance sheets. That money is not in circulation and is not affecting the "velocity" of money. The velocity of money is the rate at which money in circulation is used for purchasing goods and services. Until banks begin to inject those funds into the economy through lending inflation will be benign.

When discussing long-run inflation trends, members of the Federal Open Market Committee (FOMC) have emphasized "core" inflation which excludes food and energy prices. It is not that the Fed believes that food and energy prices do not affect economic decisions; they know very well that it is headline inflation that matters for household welfare. Rather, as chairman Bernanke noted in his July 18 monetary policy report to Congress, the emphasis on core measures is motivated by a desire to track and predict persistent inflation: "Food and energy prices tend to be quite volatile, so that, looking forward, core inflation (which excludes food and energy prices) may be a better gauge than overall (headline) inflation of underlying inflation trends."

In our 2009 forecast we are maintaining a forecast of -0.5 percent for headline inflation. Our core inflation forecast is +1.5 to +1.7 percent. Excluding the deflationary outlook for food and energy prices from our core CPI forecast results in a higher number than headline CPI.

We believe third quarter growth could improve as companies replenish inventory levels. The stimulus package of tax cuts and increased government



spending provided some support to second quarter economic activity. It will have more impact through the second half of this year and a greater impact in 2010.

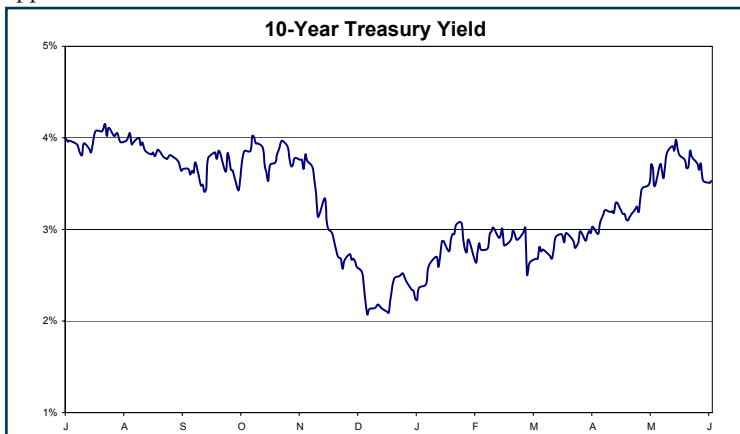
Even if the recession ends later this year, the job market will remain weak. Companies expect to

cut payrolls through the rest of the year. Unemployment, at a 26-year high of 9.5 percent, will keep rising. The Fed in their latest forecast said it will top 10% at the end of this year. Businesses will be unlikely to begin hiring until there is confidence that the recovery has staying power. We continue to see deterioration in the state of Michigan. The Detroit metropolitan area held onto the highest unemployment rate among major U.S. cities, with its rate surging 2 percentage points to above 17% in June.

Fears of a “Great Depression” have receded and the focus has shifted to the shape and longevity of the recovery. This year is turning out to be one in which the global economy and financial markets are much better behaved than they were in the second half of last year. It has been a trying period, but we are inclined to think the worst is past.

Interest Rates

Early this summer US Treasury yields rose modestly across most segments of the yield curve. On June 11th, the 10-year US Treasury yield reached the year’s highest level at 4 percent before declining to 3.6 percent at the end of July. Since December yields are up sharply reflecting both record supply and investor’s diminished appetite for these high quality assets. Signs of global stabilization boosted investors’ appetite for riskier assets.



The peak in interest rates coincides with evolving expectations of Fed policy. The implied probability of an increase in the Fed Funds target rate to either 0.50% or 0.75%, as measured by the December 2009 Federal Funds future contract, also peaked in early June. Since then, the Fed has made it clear it will continue very accommodative monetary policy. In testimony on July 21st, Fed Chairman Bernanke reiterated that “The FOMC anticipates that economic conditions are likely to warrant maintaining the federal funds rate at exceptionally low levels for an extended period.”

We believe the Fed Funds rate will remain at the current 0.0-0.25% rate through year-end. In May we provided a range of 3.2% to 4.5% and a year-end target of 3.8% for the 10-year US Treasury and we continue to feel this is an appropriate level for the balance of 2009. Despite the increase in yields during 2009, we look for the bond market to stabilize based on the benign inflation outlook, continued low short-term rates and attractive valuations. Many investors are focusing on what are perceived as low nominal yields. However, relative to inflation, the 10-year is currently at what has been a historically attractive level. Real or inflation adjusted yields are at their highest levels since late 1994 and well above the long-term average of 2.8%.

During the second quarter, U.S. investment grade corporate bonds posted stock-like total returns of 9.5 percent as measured by the Citigroup Index. At the other end of the spectrum, The U.S. Treasury

sector declined 3 percent for the quarter as the benchmark 10-year Treasury yield rose from 2.67 percent to 3.54 percent (bond prices move inversely to yields). The Barclay’s Intermediate Government/Credit Bond Index gained 1.67 percent during the second quarter.

The demand for municipal bonds remains robust, despite growing budget problems for many states and municipalities. In contrast to the taxable fixed income market, lower quality municipals have underperformed high quality securities. The Barclay’s 5-Year Municipal Bond Index gained 0.75 percent during the second quarter.

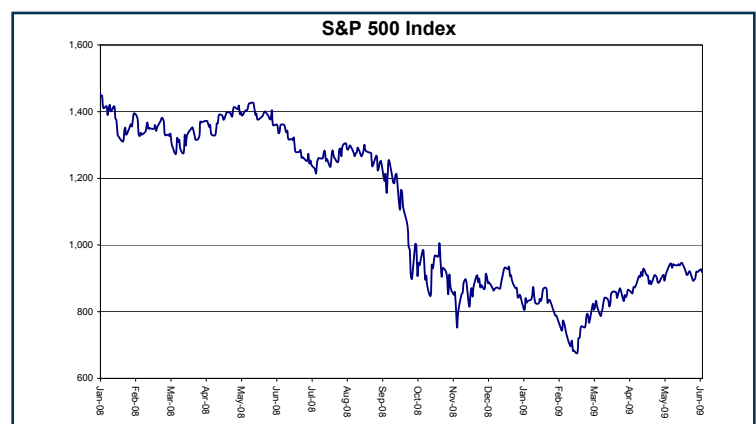
For taxable bonds we continue to emphasize shorter maturity corporate bonds that offer attractive spreads against Treasuries and Agency bonds. We remain focused on the importance of credit quality and attempt to identify the best value in both taxable and tax-exempt bond markets for our clients.

Equities

During the second quarter the S&P 500 stock index gained 15.9 percent. After declining in March on depressing employment and credit market news, stock market indices and Treasury yields surged as the government and Federal Reserve announced more monetary and fiscal stimulus moves. The resulting investor optimism and renewed risk appetite pushed stock indices and Treasury yields to year-to-date highs by early June. The equity market stalled late in June, as rising oil prices and expanding unemployment, credit defaults and mortgage foreclosures raised doubts about the immediacy and magnitude of the economic rebound. While government bailouts have improved liquidity and confidence on Wall Street, the mood on Main Street is more reserved as businesses and consumers continue to wrestle with large debt burdens and uncertain income streams. The S&P 500 return of only 0.2 percent during June reflected a growing realization that significant obstacles lie ahead for the U.S. economy on its road to recovery.

Following flat returns in June, stocks resumed their move upward in July, driven by better than expected second quarter earnings reports and improving economic data. The July gain in the S&P 500 stock index of 7.4 percent marks the index’s best July since 1997.

The stock market’s rebound from the March low has contributed to improved sentiment and expectations of recovery, with cyclicals and technology stocks showing the best gains and defensive issues lagging. The combination of aggressive monetary action from the Fed and massive fiscal stimulus is having the desired effect. However, the pick-up seems to be reflected in stock market valuation at this writing with the S&P 500 at 1002.63.



Conclusion

Peter Bernstein, the nation's leading financial philosopher of risk, passed away on June 5th at the age of 90. During his industrious career he wrote several books on finance, including our favorite, [Against the Gods: The Remarkable Story of Risk](#). In this book Bernstein wrote that the word risk derives from an old Italian word, *risicare*, which means "to dare". "To dare reminds us that the essence of risk is about making decisions or choices with unknown outcomes," Bernstein said. "At its heart, risk management means considering the consequences of each choice we face." "So you manage risks by comparing them to potential returns," he added. "Remember, just because more things can happen than will happen doesn't mean bad things will happen. The outcome may be better than you expect".

In response to being asked to comment on how the business landscape would be transformed by the financial crisis and recession, Bernstein wrote the essay "The Moral Hazard Economy". The Harvard Business Review wrote, "Bernstein stated that government interventions were necessary to prevent a meltdown of the financial system, but they might, by implicitly rewarding risk-taking, sow seeds for more crises to come." "How disastrous the consequences will be" Bernstein wrote, "depends on whether our appetite for risk has been increased by the bailouts or reduced by the meltdown." Even with the recent increase in risk appetite seen in the market, we believe the meltdown has caused a massive increase of risk aversion from pre-crisis levels.

Now that financial markets have stabilized and an inventory based recovery is expected for the balance of 2009, there is developing optimism that the growth of decades past will return. Conversely, we expect a period of slower growth, narrower profit margins and smaller asset returns than in decades past based upon deleveraging and reregulating of the US economy. American consumers have seen their net worth decline by at least \$15 trillion since early 2007. Last year's consumer complacency (call it wishful thinking) was characteristic of

the early stage of a downturn following a period of extreme optimism. During this period the consumer was resilient and maintained levels of consumer spending. But as the number of shocks to the economy grew reactions intensified and the mood changed to the dawning realization of the economy's dire straits. Consumer complacency that prevailed during much of last year has given way to concern. The consumer feels less rich. The result is lower spending and increased savings that will result in below average economic growth. The American consumer has abruptly switched from living beyond their means to saving more and paying down the debts incurred during the bubble years. Greed will return, but not in the foreseeable future.

Optimists would have us believe that easing by the Fed, massive fiscal stimulus, and the early signs of economic improvement are signals to buy. After all, timely Fed intervention revived the economy post 9/11 and prevented the collapse of Long Term Capital Management from bringing down the financial system in 1998. In these instances, the U.S. economy rolled on and stocks resumed their ascent. Having disparaged the "it's different this time" mindset that supported extreme speculation during the recent financial bubble, we believe today's situation really is unlike anything we've faced in recent times and that we should be leery of facile comparisons. These differences pose significant challenges for policy makers and investors, not only in the economic slowdown and market weakness we currently are experiencing, but in our expectations of conditions we are likely to encounter later on.

The light at the end of the tunnel is daylight, not an oncoming train. We remain confident in the power of capitalism and the US economy and believe we will emerge from this period of economic contraction. The second half of this year and next year should be a time of recovery for the economy and stocks, but it is hardly the beginning of a period of above-average growth and prosperity. *We look to the fundamental strengths of the companies in which we invest to pull us through.*

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