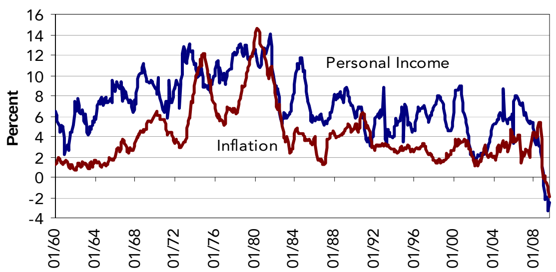
September 2009

Economic Review

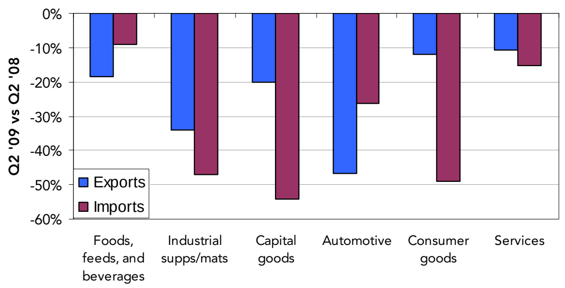
Stocks continued their upward trajectory in September, marking a seventh straight month of gains. Flooding in Georgia caused disruptions in economic activity, although the rains significantly eased the water shortage caused by consecutive years of drought. Farmers in California's central valley region remained cutoff from irrigation water as the federal government imposed water usage limitations aimed at saving endangered fish. The loss of agricultural production is expected to translate into higher fruit and vegetable prices nationwide as fields lay fallow. President Obama, at the request of U.S. steelworkers, imposed a 35% tariff on imported Chinese tires. In response, China imposed duties on American auto parts and poultry. The U.S. currently has little domestic production of the sizes and types of tires that are produced by Chinese companies. Germany reelected Angela Merkel after backing her pro-growth, low-tax platform. German growth is a necessity for a continued European recovery.

Inflation and Income Growth



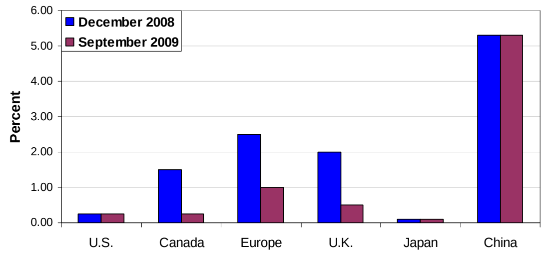
Sources: Bureau of Economic Analysis and Department of Labor

Export and Import Changes



Source: Bureau of Economic Analysis

Central Bank Interest Rates



Source: Bloomberg

Market Returns

As of September 30, 2009

	September	3 Months	YTD
S&P 500	3.7%	15.6%	19.3%
Russell 1000 Value	3.9%	18.2%	14.9%
Russell 1000 Growth	4.3%	14.0%	27.1%
Russell 2000	5.8%	19.3%	22.4%
MSCI EAFE	3.8%	19.5%	29.0%
Barclays Agg	1.1%	3.7%	5.7%
3-Month T-Bills	0.0%	0.1%	0.2%

The inflation outlook is uncertain as upward wage pressures remain absent. Year-over-year prices were down 1.4%, while prices in 2009 rose at a 2.7% rate. Investors betting on high inflation pushed gold over the $1000/oz level, while other metals have followed even steeper trajectories. Should a strong recovery begin to materialize in the near-term, the economy would face headwinds from rising materials costs.

The Federal Reserve reiterated its stance to keep interest rates near 0% as long as unemployment remains a concern. So far, the low rate policy has not ignited the growth that is typically expected in a recovery, but has begun to undermine the dollar relative to the Euro and Yen. The Yen also strengthened due to favorable tax policy for repatriated profits. Over the previous few years, the weak dollar contributed to the commodities bubble and the rise in prices throughout the economy. Investors cautioned the Treasury and Federal Reserve against a repeat of the dollar's slide, as the loss of purchasing power to inflation outweighs the growth garnered through increased exports.

The Fed extended its timeline for mortgage purchases through Q1 2010, while keeping the total outlay unchanged. The change facilitates a smooth exit from supporting low mortgage rates. The FHA has backed nearly 25% of new mortgages this year, and has experienced a higher default rate on its loans than the broad market (17% vs 13% for all loans). Its capital reserves currently cover 2% of its outstanding loans, which is lower than Bear Stearns and Lehman Brothers had at their collapse.

The FDIC explored options to recapitalize its insurance fund as reserves fell to $10.4 billion, or 0.22% of insured assets, which is below the 1.15% Congressional mandate. With bank failures expected to continue, especially in light of probable commercial real estate loan defaults, the FDIC may have to raise money, in addition to the $45 billion it will raise through early collection of fees, to remain solvent. Options available include assessing an additional fee on banks, borrowing from the member banks, or tapping the agency's line of credit at the Treasury.

September auto sales were over 43% lower than sales in August, marking a steep decline after the Cash for Clunkers terminus. Auto sales news was not all bad after removing the Cash for Clunkers sales from the analysis. Previous months in 2009 saw sales decline nearly one-third from 2008 levels, while September sales were about 25% lower than 2008. The decline from August to September was in line with the long-term average decline for the period, indicating a potential stabilization in the domestic auto market. Automakers increased production in August to cover depleted inventories. Expansion in the auto sector remains tied to employment levels, which are expected to continue declining through year-end.