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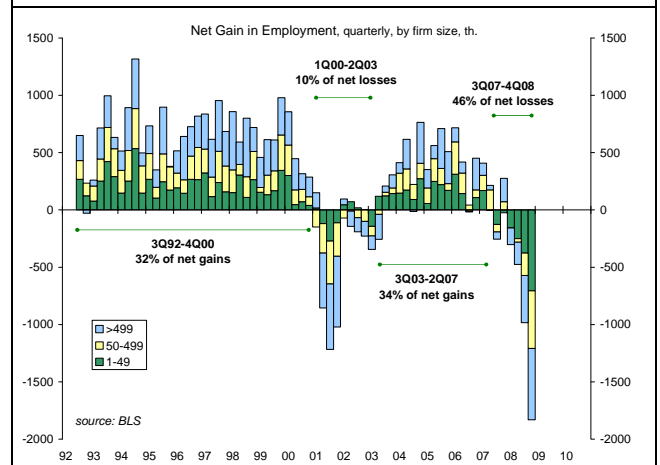
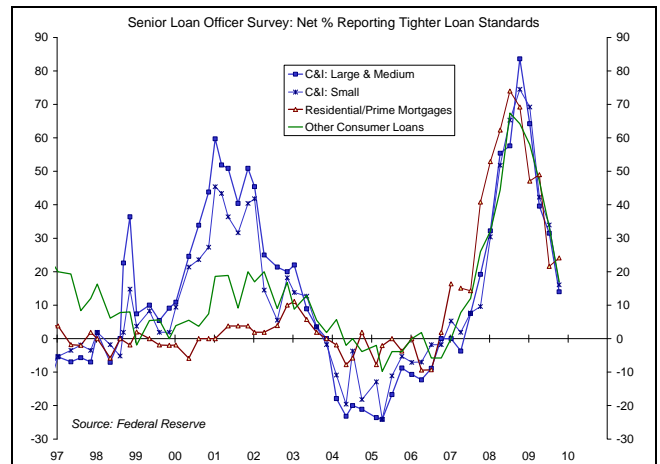
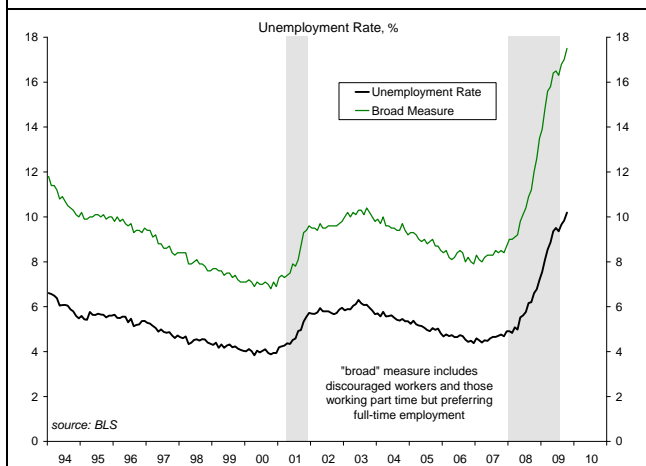
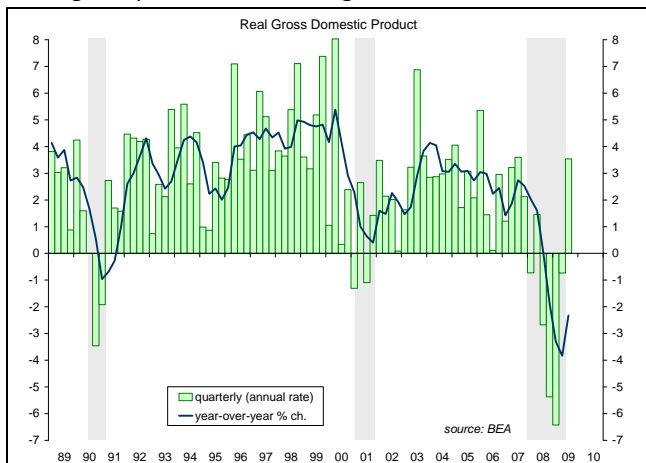
November 11, 2009

The Recovery: “V”, “U”, “L”, Or “W”?

- Recent data have continued to suggest that the economy is improving. The pace of job losses has moderated.
- Tight credit should keep the recovery on a relatively moderate track into the early part of next year. The labor market will remain soft in the near term, but fiscal stimulus and hiring for the census will provide support into early 2010.
- The Fed has signaled that short-term interest rates will stay low until the unemployment rate falls, core inflation picks up, or inflation expectations start to rise.

Real GDP rose at a 3.5% annual rate in the government’s advance estimate for 3Q09. Consumer spending on motor vehicles added a full percentage point to overall growth, but with the “Cash for Clunkers” program behind us, a slower pace of vehicle sales will be a drag on GDP growth in 4Q09. Ex-vehicles, inflation-adjusted consumer spending would have risen at a 2.0% annual rate in 3Q09. Business fixed investment posted a smaller decline in the third quarter, and residential homebuilding made its first positive contribution since the fourth quarter of 2005. Imports and exports began to recover, following sharp corrections during the recession.

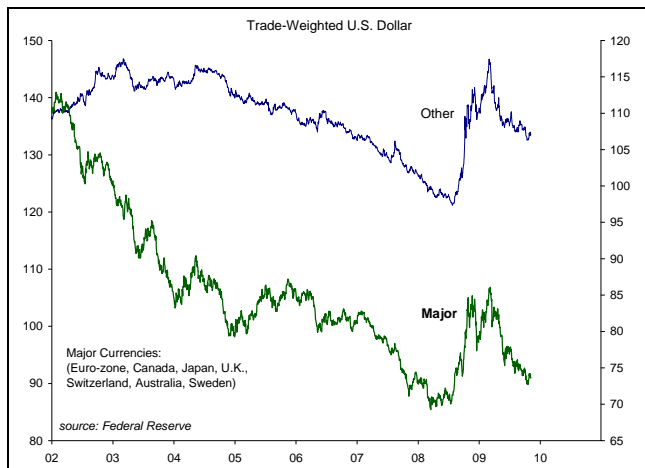
The unemployment rate jumped to 10.2% in October, from 9.8% in September, with the bulk of the surge in teenagers and young adults. That could reflect seasonal adjustment problems (the number of unemployed teenagers and young adults actually went down), but more likely, there are fewer jobs available than usual due to strains in state and local government budgets. Nonfarm payrolls fell by 190,000 in the initial estimate for October, a -188,000 monthly pace since July (vs. -691,000 in 1Q09). Job losses have moderated and have become less widespread. Employment at temp-help services rose for the third consecutive month in October, a good sign.



The Fed’s most recent survey of senior loan officers showed that banks generally continued to tighten terms and standards on all types of loans over the three months ending in October, but a much smaller percentage did so. Tight credit for small businesses (those with fewer than 50 employees) has been particularly worrisome, as small firms accounted for about a third of net job gains in the last two economic expansions. We may see further policy efforts to aid small businesses, and bank lending should loosen up as the economy recovers (in turn, helping to reinforce the recovery).

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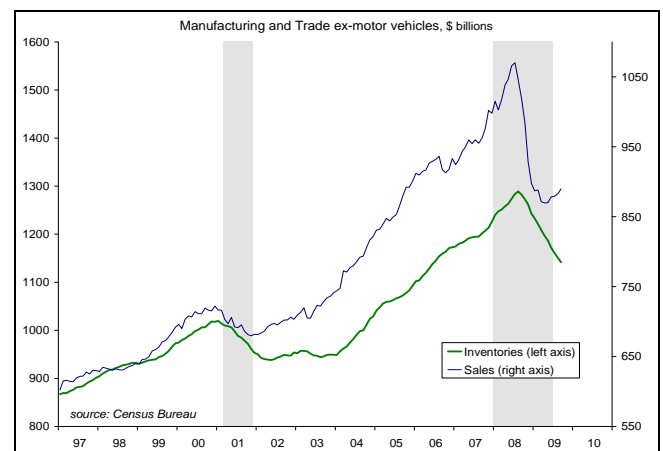
Commercial real estate activity tends to lag in the economic cycle, turning over late in the recession and declining well into the early part of the recovery. Overall, the magnitude of the problem will be a lot smaller than the residential real estate troubles. However, many of the small to medium-sized banks that escaped residential mortgage problems will have a harder time dealing with a commercial real estate downturn. Many have already taken precautions against future losses, but more banks will fail in the months ahead. Yet, the government is very efficient in closing failed banks. It's a relatively seamless transition for most depositors.



The U.S. dollar had been in a moderate downtrend over the last several years. A year ago, global financial turmoil led to a flight to safety in the dollar. With the global economy showing clear signs of recovery, that flight to safety has unwound. Policy efforts were expected to lead to a faster economic rebound in the U.S., but results have been mixed to date. Concerns about the strength and longevity of the U.S. recovery, fears of future inflation, and low interest rates put downward pressure on the dollar in the near term. The Fed will eventually begin to raise short-term interest rates, which would support the dollar, but that may be some time away.

After its November 3-4 meeting, the Federal Open Market Committee left the target range for Fed funds unchanged at 0% to 0.25%. The FOMC also made explicit conditions that would warrant exceptionally low rates for an extended period: should the unemployment rate head lower, or core inflation trend higher, or inflation expectations start to take off, then the FOMC would be more inclined to tighten policy. A Fed rate hike seems unlikely until the second half of next year.

In recoveries from severe recessions, growth tends to rise sharply due to pent-up demand for homes, autos, and other durable goods. However, with continued financial headwinds, there's much less scope for a rapid rebound. Hence, the odds of a sharp V-shaped recovery are low. However, the recovery is also unlikely to be L-shaped. The economy is growing and fiscal stimulus will continue to provide support into early 2010. The double-dip scenario (a W-shaped recovery) would depend on a policy mistake – either the Fed raises short-term interest rates too soon or more fiscal stimulus is needed but unavailable.



Inventories fell at a slower pace in 3Q09 and are poised to add significantly to GDP growth as they stop falling in the quarters ahead, but it probably won't be a smooth transition. While GDP growth is likely to be uneven, it should be moderately strong on average, but not enough to push unemployment down by much over the next several quarters.

	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	2008	2009	2010	2011
GDP (↓ contributions)	-5.4	-6.4	-0.7	3.5	3.3	3.3	3.3	3.2	3.1	0.4	-2.4	3.1	3.4
consumer durables	-1.6	0.3	-0.4	1.5	-0.3	0.2	0.2	0.3	0.3	-0.4	-0.3	0.3	0.3
nondurables & services	-0.5	0.2	-0.2	0.9	1.4	1.3	1.4	1.5	1.6	0.2	-0.1	1.3	1.6
bus. fixed investment	-2.5	-5.3	-1.0	-0.2	-0.1	0.1	0.3	0.4	0.5	0.2	-2.1	0.1	0.5
residential investment	-0.8	-1.3	-0.7	0.5	0.2	0.3	0.3	0.4	0.4	-1.0	-0.6	0.3	0.4
government	0.2	-0.5	1.3	0.5	0.6	0.4	0.3	0.1	-0.1	0.6	0.4	0.4	0.1
Domestic Final Sales	-4.9	-6.4	-0.9	3.0	1.7	2.3	2.6	2.8	2.8	-0.3	-2.7	2.2	3.0
exports	-2.7	-4.0	-0.5	1.5	1.3	1.0	0.8	0.7	0.5	0.6	-1.3	0.9	0.6
imports	3.1	6.6	2.1	-2.0	-1.6	-1.2	-1.0	-0.8	-0.7	0.5	2.3	-1.1	-0.7
Final Sales	-4.7	-4.1	0.7	2.6	1.4	2.0	2.4	2.6	2.7	0.8	-1.6	3.0	3.1
ch. in bus. inventories	-0.6	-2.4	-1.4	0.9	1.8	1.3	0.9	0.6	0.4	-0.4	-0.8	1.0	0.5
Unemployment, %	6.9	8.1	9.2	9.6	10.3	10.4	10.3	10.2	10.2	5.8	9.3	10.3	10.0
NF Payrolls, monthly, th.	-553	-691	-436	-226	-135	50	125	40	100	-257	-370	79	141
Cons. Price Index (3 mo)	-12.4	2.2	3.3	2.5	2.1	1.8	1.9	2.0	2.1	0.2	2.5	2.0	2.1
excl. food & energy	0.2	2.2	2.4	1.3	1.3	1.4	1.5	1.6	1.7	1.7	1.8	1.6	1.7
PCE Price Index (q/q)	-5.0	-1.5	1.4	2.8	2.1	1.8	1.8	1.9	2.0	3.3	0.2	2.0	2.0
excl. food & energy	0.8	1.1	2.0	1.4	1.4	1.5	1.6	1.6	1.7	2.4	1.5	1.5	1.7
Fed Funds Rate, %	0.53	0.19	0.18	0.15	0.14	0.22	0.27	0.42	0.96	1.94	0.16	0.47	2.09
3-month T-Bill, (bond-eq.)	0.3	0.2	0.2	0.2	0.1	0.3	0.4	0.9	1.3	1.4	0.2	0.7	2.2
2-year Treasury Note	1.2	0.9	1.0	1.0	0.9	1.2	1.7	2.2	2.5	2.0	1.0	1.9	2.7
10-year Treasury Note	3.2	2.7	3.3	3.5	3.5	3.6	3.7	3.8	3.9	3.7	3.3	3.7	4.1