



Economic and Market Update

September 4, 2009

Recent Positives

Forget green shoots. We're looking at pre-recessions levels – August's ISM manufacturing gauge expanded for the first time in 19 months to its highest since June '07. Notably, 70% of manufacturers reported increases in new orders and production (*clearly, this isn't just autos*), and the gap between orders and inventories was its widest since '75. All this points to a *sustained upturn*.

August jobs report has more upside than downside – The great news is the 216,000 lost payroll jobs was a positive surprise vs. 276,000 forecasted. ISI suggests if this slowdown in losses continues, payroll employment will actually increase by year's end. The headline news will probably point to a worse-than-expected 9.7% unemployment rate, but it's quite common for the rate to rise as discouraged workers sniff recovery and come back into the labor force. We fully expect a 10% unemployment rate before it's all over, which will probably be a political problem as we head into mid-term elections.

More signs housing is starting to mend – Pending home sales, a reliable indicator of future activity, rose a 6th straight month in August to 26-month high. (*This is great news for upcoming existing home sales*). Moreover, homebuilding giant Toll Brothers says 2nd-quarter contracts rose 3% from '08, the 1st increase in 14 quarters.

Global synchronized recovery – Britain and Russia had expansionary PMI services readings, and the euro-zone's and the U.S.'s were on the verge. Moreover, Japan, Germany, France, Norway, Australia and several emerging-market countries posted positive 2nd quarter GDP.

And it is quite possible global recovery could be stronger than expected – The 52-week average of oil prices is still declining. This, according to ISI, has the highest correlation with GDP as a leading indicator, suggesting A NEAR RECORD AMOUNT OF STIMULUS FROM OIL for GDP in 2010.

What Else?

It's not just emerging markets signaling recovery – 23 of 42 global markets Ned Davis Research tracks have broken to new bull-market highs, with developed European markets accounting for 15 of the 23.

Profitable trend – Profit margins widened the 1st 6 quarters in 7 of the last 8 recoveries. With margins as high as they've ever been in a recession, if history repeats *and* sales pick up, it could be way cool.

July's construction spending decline less than meets the eye – It was largely due to a big drop in public projects, which are about to take off now that stimulus bill's infrastructure portion is kicking in. Residential construction actually rose the most in 10 months.

At least they're getting a raise – President Obama cut 2010 pay increases for federal employees to 2% from 2.4%, saving \$20 billion.

Lost in translation – Japan's new first lady, whose husband (nicknamed "Alien") becomes the first non-Liberal Democrat prime minister in 50 years, said in a recent book: "While my body was asleep, I think my soul rode on a triangular-shaped UFO and went to Venus. It was a very beautiful place and it was really green." OK ...

Recent Negatives

Hard to argue we shouldn't have a correction – The Institutional Strategist's bullish daily sentiment figure for stocks reached 89% bulls, a point greater than when stocks hit all-time high in October '07. And Miller Tabak says the ratio of insider sales to buys is at its highest since spring of '07. Beyond the fact that everyone knows that September historically is the worst seasonal month, at this time in the first year of a presidential cycle, you often see a pullback. Furthermore, the last three times the ISM manufacturing had a reading over 50, it experienced a double dip – falling below 50 – before going to new highs, with stocks losing 7% on average in the interim.

Banks are not out of the woods yet – The number of troubled banks hit a 15-year high in the 2nd quarter, with banks setting aside record reserves for possible future loan losses – even as loan losses already are their highest since records started, the FDIC said. With 100 banks having failed so far, the FDIC is running out of money and may levy additional fees on banks, *further depleting their capital*.

Not a lot of oomph for consumers – A key factor raising concerns about the strength of the recovery is the wherewithal of the consumer to do his part. July's wages and salaries fell 5% from a year ago, probably the biggest setback since the Great Depression, while household liabilities relative to assets are running \$3.7 trillion above the historical trend-line. We haven't *begun* to deleverage.

Housing may be recovering, but it will take a long time to return to normal – Mortgage delinquency rates hit a record high in the second quarter, while the cure rate – the percentage of delinquent mortgage holders who were able to return to good standing – has fallen into the single digits, down from a 45% cure rate earlier this decade. It doesn't help that a third of homeowners have lost all equity in their home.

Implications/Outlook

Is a pullback inevitable? – We've been hearing and reading about a market "correction/consolidation" as much as we read and heard "green shoots" a few months ago. Even the bulls expect it. Tuesday's sell-off in the face of fabulous manufacturing news shows the market wants it. The S&P 500 hit 1037 in intraday trading early this month – close to the 1050 a lot of bulls are expecting by year's end. 1050 is a big resistance level. Dudack Research notes since '31, there have only been 211 days when the S&P closed 20% or more above its moving average – right about 1050. Moreover, every run since March's lows has been followed by a 7% pullback, which would argue for around 950 off the August high. Only then does this pullback become interesting. A 7% to 8% correction would be normal, even healthy, and health care could be the catalyst. President Obama finally plans to lay out his plan when Congress comes back next week. It appears he will take the public option off the table, angering liberals. But with plunging approval ratings, he needs to get something done, even if it's health-care *lite*. The markets will probably like seeing the costs of reform continue to fall – some guess toward \$500 billion. So until they start hearing about taxes going up and central bankers tightening, after S&P 1050, there's no real resistance until 1200.

Past performance is no guarantee of future results.

Views are as of September 4, 2009, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking index based on five indicators – new orders, employment, production, supplier deliveries and inventory – derived from a monthly survey of U.S. businesses.

The Institute of Supply Management nonmanufacturing index is a composite, forward-looking index based on five indicators – new orders, employment, supplier deliveries and business activity – derived from a monthly survey of U.S. businesses.

The Russian Services Purchasing Managers Index (PMI) is a gauge of the level of service sector activity in the Russia. Readings above 50 signal expansion while readings below 50 signal contraction.

The United Kingdom Services Purchasing Managers Index (PMI) is a gauge of the level of service sector activity in the U.K. Readings above 50 signal expansion while readings below 50 signal contraction.

The euro-zone Services Purchasing Managers Index (PMI) is a gauge of the level of service sector activity in the euro zone. Readings above 50 signal expansion while readings below 50 signal contraction.

The Institutional Strategist's bullish daily sentiment index is based on surveys of traders. Readings of 70% or more of traders indicating they feel bullish historically correlates with market tops.

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