



# Economic and Market Update

June 19, 2009

## Recent Positives

**Giant steps** – May's leading indicators beat expectations, rising 1.2%. Combined with April's surprise 1.1% increase, it marked the best two-month showing since 2001. Overseas, Germany's Zew index of economic sentiment for June easily beat forecasts, hitting its highest level in three years. As we've said, we like baby steps – others call them green shoots – because they suggest the economy's bottoming. Giant steps are better. But at this stage of the market advance, more evidence will be required to show recovery is on the way.

**Companies are very lean now** – Last year's unprecedented cost-cutting pushed free cash flow margins at corporations to a near-record 7.5% in this year's first quarter, Empirical Research says. This could provide ammo for an upside surprise to second-half profits.

**Housing may be turning** – Housing starts and building permits rose a respective 17.2% and 4% in May, beating forecasts, with apartment construction surging the most since '92, single-family starts rising a 3rd straight month and single-family permits climbing to 19% above their January trough. These strong figures provide evidence housing is bottoming, that is all. Ned Davis notes housing starts and permits are still at 31% of their 10-year averages. And the National Association of Home Builders says it's taking a record 10.9 months to sell homes.

**International baby steps** – Indonesian industrial output hit a record high in April, a sign of improving economic health in emerging markets ... U.K. jobless claims slowed unexpectedly, rising in May by the smallest amount since last July.

**Total jobless claims dip** – Weekly jobless claims ticked up as expected but continuing claims surprised, falling 148,000, the first drop since January. This would be good if it's true, because Empirical Research cites statistics showing it's harder than ever to find jobs.

**Manufacturing back to pre-cliff (Lehman bankruptcy) days ...** – Despite negative surprises on industrial production and in New York (see opposite column), there was some good factory news. The Empire index's employment expectations rose to its highest since September, and the future capital spending component turned positive. Moreover, the Philly Fed's June regional index, while still negative, also surprised, jumping to its highest since September.

## What Else?

**For those worried about the market giving up gains** – If the recession is about to end and growth returns in this year's 2nd half as Federated and others predict, then history shows it's very rare for the market to experience a high single-digit/low double-digit correction.

**Devil's in the details** – As experts pore over proposed financial oversight reforms, they are finding unforeseen consequences. One issue: corporations such as Target that offer loans and credit cards to customers would now have to be treated as banks, making it likely they'll stop the practice, cutting off a source of consumer credit.

**Stimulus watch** – One reason economists are becoming more bullish about this year's 2nd half – stimulus spending is just kicking in. Only 7% of the \$787 billion has spent so far, but the pace is picking up.

**Offense trumps defense** – A key reason the MSCI Emerging Markets Index has nearly doubled the S&P 500's run from March lows? Consumer staples, health care and utilities – all defensive stocks -- account for 11% of the emerging markets index, vs. 30% for S&P.

**'Forget Coke. I'll have a gold bar'** – The London Telegraph reports shoppers in Germany can now buy gold at vending machines.

## Recent Negatives

**Price reports nix inflation worries but reflect cautious consumer** – The consumer foods component of the Producer Price Index fell at 2.1% annual rate in May, the biggest drop in nearly seven years, and the Consumer Price Index posted its biggest annual decline in 59 years. While the reports cooled inflation worries for now, they reflected a consumer who continues to refuse to spend. The \$64,000 question: when will he be comfortable enough to spend again?

**Refinancing cools off quick** – The past month's percentage-point spike in mortgage rates spilled over into the refinancing arena, with refi activity plunging 70% from its April peak. This is bad and the Fed knows it. Refinancing not only helps households pare debt, it also frees up money to spend. A rising mortgage rate can easily stop a budding economic recovery in its tracks.

**Beware protectionism** – China adopted a strict new "Buy China" requirement for its stimulus spending, which at \$586 billion is second only to the United States in size and the largest package as measured against the size of its economy. This raises the prospect of similar protectionist measures by other countries, one of our fears.

**Nicks and cuts** – Total net government savings stood at its lowest point in the post-war era in the 1st quarter, and it's not getting better – 47 states are facing deficits, making higher taxes and spending cuts the subject of state houses across the country. In California, lawmakers want to raise taxes on cigarettes \$1.50 a pack, eliminate the high school exit exam and reduce spending on state prisons. Sales tax increases of a percentage point or more have been proposed in Arizona and Massachusetts. And in Pennsylvania, Gov. Ed Rendell is pushing for a 16% increase in the personal income tax. Nevada, which has no personal income tax, raised hotel room taxes 3%. It seems a little bit more of what happens in Vegas will stay in Vegas.

**... But manufacturing struggles to get to a higher gear** – Hopes manufacturing activity will pick up much as companies restock keep getting dashed. May's report on industrial production disappointed, falling a worse-than-expected 1.1%, the 9th decline in 10 months. The drop-off was broad-based, and the 13.4% year-over-year decline was the most since '46. The New York Fed's regional Empire index also fell unexpectedly in June.

## Implications/Outlook

**HELP is on the way?** – As talks pick up over Obama's push for health care reform, members of the Senate Health, Education, Labor and Pensions (HELP) Committee and the Senate Finance Committee are heating up the debate over how to pay for it. It's always about the money. The Congressional Budget Office released an analysis of a bill seeking to address the White House's goal of extending coverage to all 49 million uninsured, and said the estimated cost of \$1 trillion over 10 years actually will be closer to \$1.6 trillion. Even then, the reform bill would only drop the number of uninsured to 37 million by 2016. Finance Committee Chairman Max Baucus delayed any action until committee members found ways to carve \$600 billion out of the legislation. Obama says it must be revenue neutral, meaning some combination of spending cuts and tax increases. Among options Baucus is considering: taxing employer-provided health benefits with premiums of more than \$17,000 a year. Hmm. Strategas Research notes history shows expansion of government health-care programs always exceeds their costs. It also notes most polls show voters support health-care reform – until they're asked to pay. This Wednesday, Obama is scheduled to hold a town hall meeting on national TV to promote government-run health care. I don't know about you, but I'll be watching. I want to find out how much I may have to pay. HELP!!!

*Past performance is no guarantee of future results.*

*Views are as of June 19, 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.*

*Mutual funds are subject to risks and may fluctuate in value.*

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

*The MSCI Emerging Markets Index was created by Morgan Stanley Capital International (MSCI) to measure equity market performance in global emerging markets.*

*The Conference Board's Composite Index of Leading Economic Indicators is published monthly and is used to predict the direction of the economy's movements in the months to come.*

*The ZEW Indicator of Economic Sentiment, conducted monthly by Germany's Centre for European Economic Research, polls financial experts to gauge whether they are optimistic or pessimistic about economic activity over the subsequent six months.*

*The Empire State Manufacturing Index is conducted monthly by the Federal Reserve Bank of New York to gauge the level of activity and expectations for the future among manufacturers in the state.*

*The Philadelphia Manufacturing Index is conducted monthly by the Federal Reserve Bank of Philadelphia to gauge the level of activity and expectations for the future among manufacturers in Greater Philadelphia region.*

*The Consumer Price Index is a measure of inflation at the retail level.*

*The Producer Price Index is a measure of inflation at the wholesale level.*

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