

THE ECONOMY

The U.S. economy advanced at an upwardly revised 3.3% pace in the second quarter, a sizeable increase to the initial estimate of 1.9%. This followed growth of 0.9% during the first three months of the year. This stronger-than-expected posting occurred during a period when recession and depression chatter was at a peak – but it’s hard to have either with economic growth expanding at such an elevated pace. There has been a bullish tone to the recent economic data. New and existing home sales jumped in July, confidence measures have crept higher, the lofty level of jobless claims has experienced a gradual descent, and new orders and shipments of durable goods have climbed well above the most optimistic of forecasts. This leads us to believe that the economy is not headed toward recession, and may in fact be gathering momentum and building on the solid 2Q posting.

Still, the stellar 3.3% second-quarter pace is not likely to be repeated. We don’t believe that it is an accurate depiction of the economy’s current condition. It is more likely that the economy was operating at a 2.0% pace during the middle of the year, which would roughly be the average of the first and second quarters. We look for the economy to expand by a slower 1.25% in the second half, largely due to the evaporation of government-issued stimulus checks. But by the time 2009 rolls around, gains should be well in to the 2.0%-3.0% levels. We believe the risk to this forecast is to the upside, especially if the momentum from the strong second quarter carries into the second half

There are several signs that the housing situation may be taking a turn for the better. New and existing home sales have increased, the pace of home price deceleration is no longer plunging uncontrollably, and several industry insiders believe the worst is behind us. We expect the housing recession to linger throughout the third quarter of 2009, but it should not weigh on

overall economic growth with the same intensity as it has in recent years.

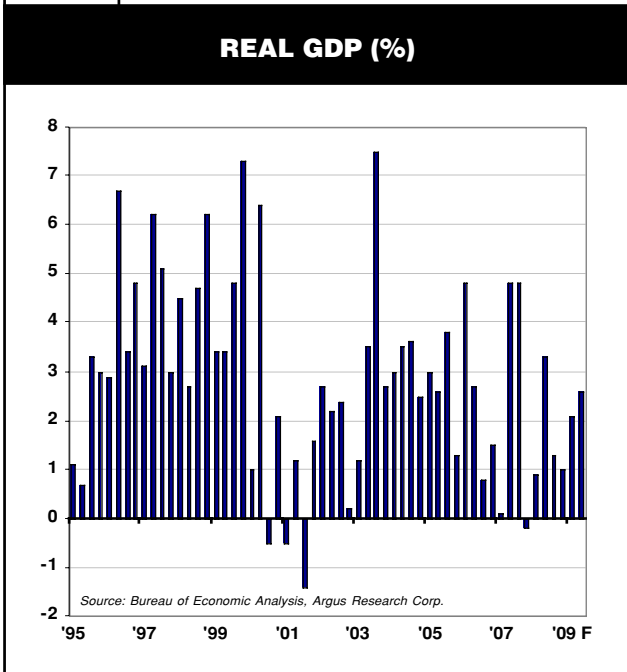
It’s comforting to know that the U.S. economy is so flexible and resilient. Consumer spending increased by 1.7% in the second quarter, the sixty-sixth consecutive quarter of positive consumer spending. This may be weaker than desired, but it’s not a dismal performance. We believe that most pundits are getting the forecast wrong because they are underestimating this resiliency. Confusing the goings-on in the financial markets (Wall Street) with activity in the real economy (Main Street) often leads to problems of this type.

It was trade, specifically exports of agricultural products, that protected the economy from the deep and prolonged housing downturn and helped prevent a definitive recession. AG trade may not be the sexiest of all components of aggregate demand — but without these gains, the economy would be mired in a frightfully ugly recession.

Monetary policy is as stimulative as it has been in several decades. The real Fed Funds rate is -2.33%, which is achieved when the actual rate of 2.0% is reduced by the inflation rate of 4.33% (as measured by the personal consumption expenditure deflator). The core personal consumption expenditure deflator is at 2.4% over the last 12 months, which exceeds the Fed’s comfort zone of 1.0%-2.0%. Nevertheless, given the uncertainties in the two most interest-rate sensitive industries (housing and autos) and the instability in the credit markets, a near-term rate hike isn’t in the cards.

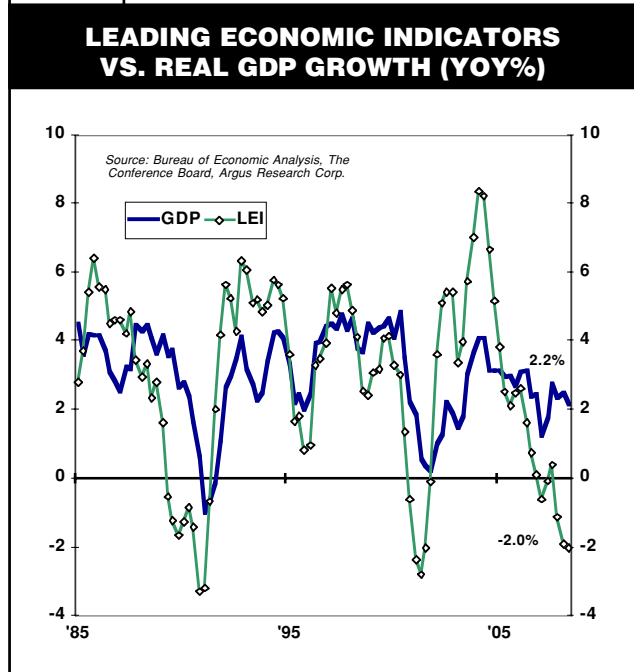
Richard Yamarone,
Director of Economic Research

TABLE 1



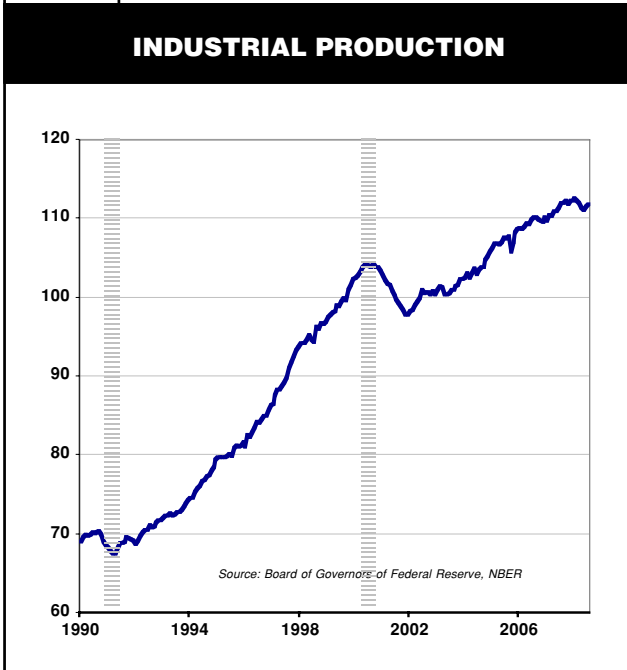
It's hard to say the "r word" amid better than 3.0% economic activity.

TABLE 2



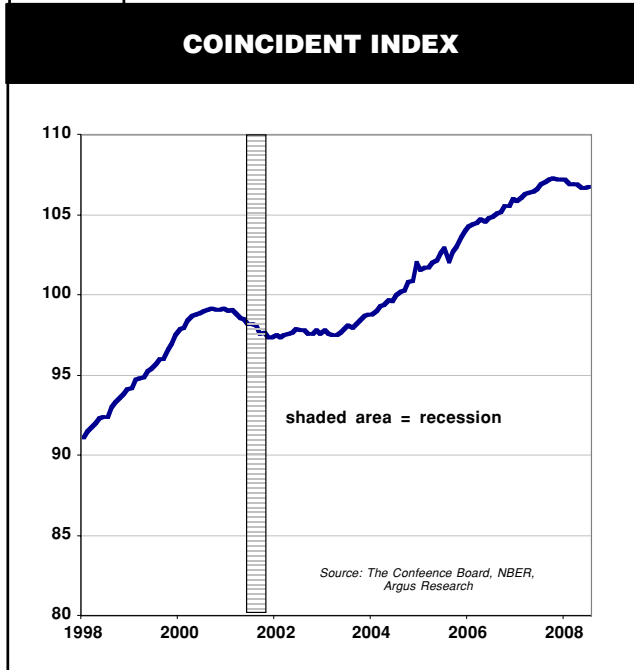
Despite the strong 2Q gain, several indicators point to continued softness.

TABLE 3



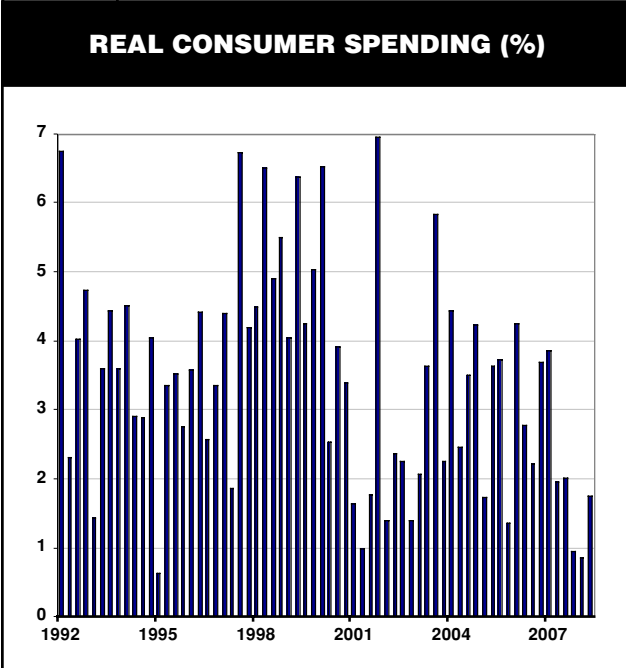
This recession indicator isn't exactly flashing red.

TABLE 4



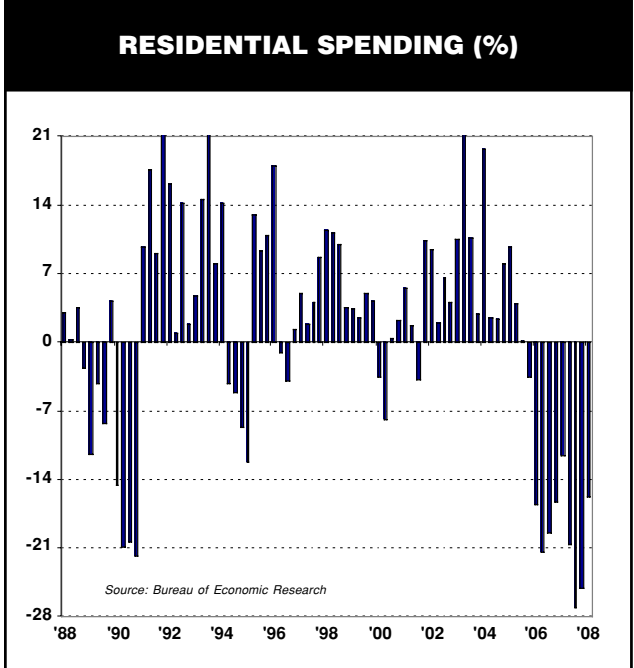
Economic conditions have definitely softened, but not definitively contracted.

TABLE 5



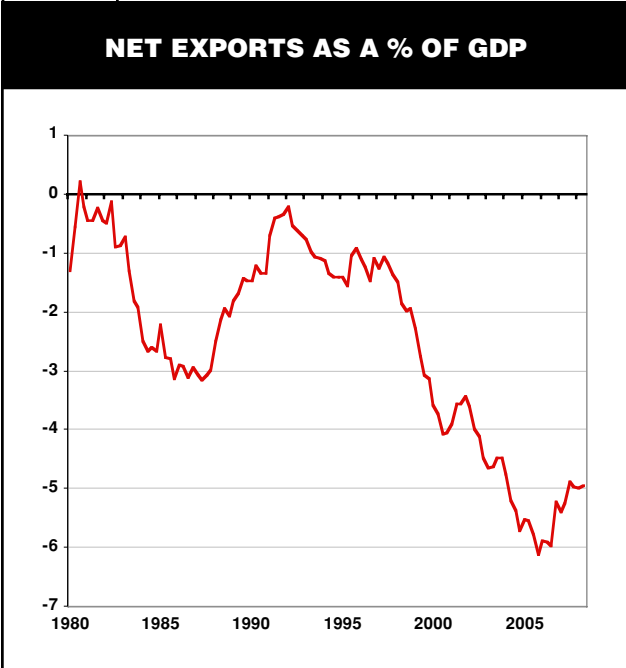
There have been sixty-six consecutive quarters of positive consumer spending.

TABLE 6



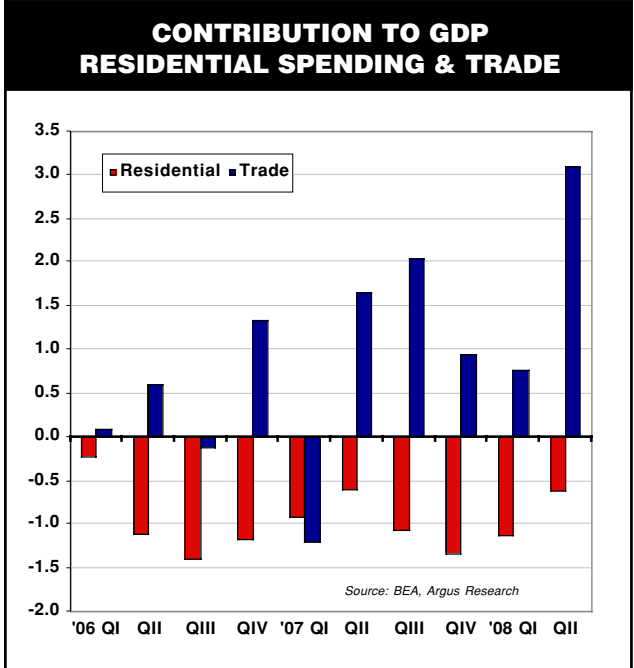
The housing recession continues, but the worst is probably behind us.

TABLE 7



We expect net exports to be less of a drag in coming years.

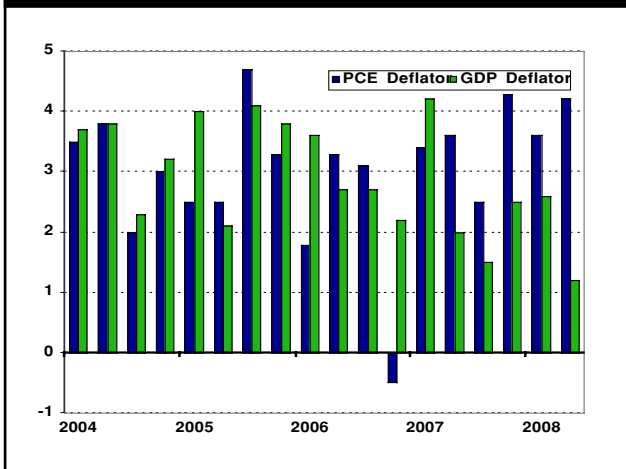
TABLE 8



The boom in exports is helping cushion the blow of the housing recession.

TABLE 9

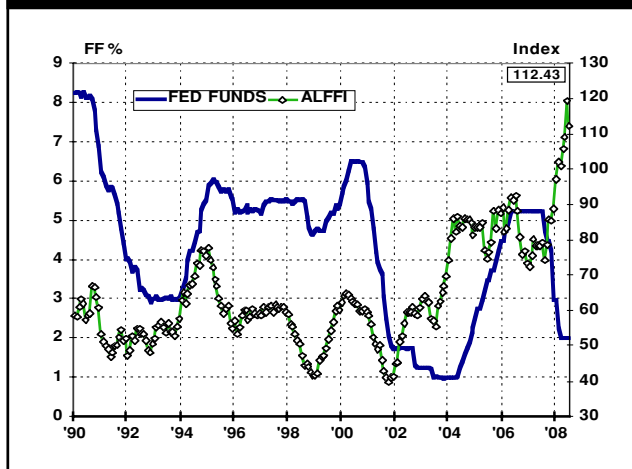
GDP DEFLATORS (%)



Inflation continues to be the top economic concern for Americans.

TABLE 10

ARGUS LEADING FED FUNDS INDEX



We look for the Fed to raise rates to thwart the elevated inflation environment.

GDP FORECAST TABLE

	2006 A				2007 A				2008 E				2009 E			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real Gross Domestic Product	4.8	2.7	0.8	1.5	0.0	4.8	4.8	-0.2	0.9	3.3	1.3	1.0	2.1	2.6	2.0	2.9
Annual:				2.4				2.4				1.6				2.4
Personal Consumption	4.3	2.8	2.2	3.7	3.9	2.0	2.0	1.0	0.9	1.7	1.8	0.7	1.8	1.2	1.3	1.8
Durables	18.9	1.8	3.5	4.2	9.2	5.0	2.3	0.4	-4.3	-2.5	-0.4	0.5	1.6	1.0	1.2	2.3
Non-Durables	4.4	3.1	2.3	3.1	3.5	1.9	1.2	0.3	-0.4	4.2	1.0	0.6	1.2	0.8	3.9	1.7
Services	1.6	2.8	2.0	3.9	3.1	1.4	2.4	1.4	2.4	1.3	1.2	0.7	2.1	1.4	1.2	1.7
Gross Domestic Investment	6.2	-0.4	-5.3	-15.0	-9.6	6.2	3.5	-11.9	-5.8	-11.9	1.7	1.2	2.5	8.1	3.3	6.3
Fixed Investment	8.3	-2.5	-4.8	-7.6	-3.4	3.0	-0.9	-6.2	-5.6	-2.5	-4.3	1.2	2.5	4.4	2.1	3.9
Non-Residential	15.9	6.4	5.4	-1.0	3.4	10.3	8.7	3.4	2.4	2.2	-1.8	3.5	5.9	5.7	3.6	4.5
Structures	15.5	19.7	14.3	2.5	11.2	18.3	20.6	8.6	8.7	13.6	3.9	6.4	8.6	6.6	7.1	8.5
Equip. & Software	16.3	1.8	2.0	-2.4	0.0	6.9	3.6	1.0	-0.5	-3.2	1.8	2.6	5.1	5.4	2.5	3.3
Residential	-3.6	-16.6	-21.5	-19.5	-16.2	-11.6	-20.6	-27.0	-25.0	-15.8	-10.0	-7.9	-11.0	-1.5	-4.3	0.6
Change in Pvt. Inventories	45.9	56.9	53.3	13.1	-15.0	-2.8	16.0	-8.1	-10.2	-49.4	-25.0	-25.0	-25.0	-10.0	-5.0	5.0
Net Exports																
Exports	16.7	5.4	3.5	15.6	0.6	8.8	23.0	4.4	5.1	13.2	6.8	5.7	5.6	6.1	6.0	5.9
Goods	18.1	6.6	3.6	10.4	2.1	6.8	21.8	5.1	4.6	16.6	8.0	6.1	4.4	4.6	4.6	5.5
Services	13.5	2.7	3.2	28.6	-2.7	13.3	26.0	2.7	6.4	5.9	4.0	4.7	8.6	9.7	9.4	6.9
Imports	10.3	0.1	3.1	2.0	7.7	-3.7	3.0	-2.3	-0.8	-7.5	5.3	2.5	2.3	2.0	1.7	1.6
Goods	9.0	0.5	3.8	-0.8	8.4	-4.0	2.4	-2.6	-1.9	-7.6	5.9	2.2	1.5	1.5	1.3	1.3
Services	17.8	-2.0	-0.3	18.4	4.2	-2.0	6.3	-0.8	5.5	-7.6	1.1	4.2	6.5	4.6	4.1	3.0
Gov't Purch. of Goods & Svcs.	3.9	1.3	1.7	1.6	0.9	3.9	3.8	0.8	1.9	3.9	-0.5	0.3	0.3	0.6	0.6	0.9
Federal	10.0	-1.6	1.9	1.8	-3.7	6.7	7.2	-0.5	5.8	6.8	-1.0	1.0	0.6	1.0	1.1	2.1
National Defense	8.8	1.9	-0.9	7.1	-5.9	8.4	10.1	-0.9	7.2	7.4	0.2	0.7	0.5	0.9	0.9	2.4
Non-Defense	12.4	-8.1	7.6	-8.1	1.3	3.1	1.1	0.5	2.7	5.5	-2.5	1.6	0.8	1.3	1.4	1.4
State & Local	0.5	3.0	1.6	1.5	3.6	2.4	1.9	1.6	-0.3	2.2	-0.3	-0.2	0.2	0.3	0.3	0.2
Final Sales of Domestic Prod.	5.1	2.3	0.9	2.9	1.1	4.3	4.0	0.8	0.9	4.8	0.4	1.0	2.1	2.1	1.9	2.6
Final Sales to Dom. Purch.	4.8	1.6	1.0	1.5	2.2	2.5	1.9	-0.1	0.1	1.5	0.6	0.7	1.6	1.5	1.3	2.0
Addendum:																
Nominal GDP	8.6	5.5	3.6	3.7	4.3	6.9	6.4	2.3	3.5	4.6	5.6	4.9	5.7	5.7	5.6	6.0
Personal Con Exp Deflator	1.8	3.3	3.1	-0.5	3.4	3.6	2.5	4.3	3.6	4.2	4.0	3.6	3.3	2.9	3.2	2.9
GDP Price Deflator (implicit)	3.6	2.7	2.7	2.2	4.2	2.0	1.5	2.5	2.6	1.3	4.3	3.8	3.6	3.1	3.5	3.0

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